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Statement by the Staff Representative on
Eastern Europe - Key Issues
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The pace of change this year in Central and Eastern Europe--including the Soviet Union--has been unprecedented. Far-reaching programs of reform and stabilization have been adopted in Bulgaria, Czechoslovakia and Romania. Hungary and Poland, which had already embarked on the systemic transformation from centrally-planned to market-based economies, broadened their reform efforts. And Albania, whose application for Fund membership is now well-advanced, began the process of integration into the world economy.

The international community has strongly welcomed these dramatic changes and, by and large, has moved swiftly to support them. The Fund itself has deepened its involvement in the region considerably in 1991. Fund arrangements are in place in all five of the European Fund members that used to participate in the Council for Mutual Economic Assistance (CMEA); disbursements to these countries are expected to amount to some US$4 billion in 1991. Fund staff have also helped in the efforts of the Group of 24 countries (G-24) to raise exceptional balance of payments assistance for a number of Central and Eastern European countries implementing Fund-supported programs. The Fund's work has been coordinated with that of the other international organizations, notably the World Bank. Substantial additional official financing has also been provided under the aegis of the Paris Club.

However, much more remains to be done, both by the countries themselves and by the international community. Recent events demonstrate that, far from slowing down, the transformation in the political and economic character of the region is gathering speed. The Soviet Union has indicated its intention to accelerate economic reform and integration with the world trade and payments system. As indicated to the Board last week, formal understandings on the terms and conditions of special association with the IMF are to be concluded shortly. IMF cooperation under such a regime would help economic reform while the membership application is being processed. The new Baltic states have declared their commitment to a restructuring of their economic and financial systems and also applied for Fund membership. Clearly, the challenges for the rest of the world in fostering these momentous changes will be undiminished in the period ahead. Indeed they are likely to increase, with even greater support from the international community required to ensure a successful transformation, not only in those countries that began the process a year or two ago but also in those that are just setting out. This buff pulls together for Directors' consideration the key issues facing the region, and the lessons that may be drawn from our--albeit limited--experience so far.

First, it is clear that the process of creating new, market-oriented economies, based on successful private sector enterprise, is a lengthy and, in many ways, a difficult one. Governments in the ex-CMEA five have moved swiftly to dismantle the widespread controls--on prices, trade, and production--that distorted resource allocation under central planning. But in order to meet the popular aspirations for higher living standards that has been the driving force behind reform, they must now tackle the much harder task of rebuilding the productive base of their economies in line with the appropriate new incentives and world market prices, and on the basis of private enterprise. This is likely to involve temporary but large declines in production, during the period of structural adjustment.

Experience in 1991 has been mixed. On the one hand, governments have moved to liberalize and open their economies with remarkable speed, without this having as strong an impact on external payments as initially feared. Financial developments have been favorable and the inflation performance after the initial reaction to price liberalization, has been broadly satisfactory. There are clear indications of a quick response from the small scale, informal private sector. However, it is also clear that the adjustment costs associated with economic transformation may be considerably larger--and sustained for longer--than first expected. Economic activity has declined sharply across the region this year, following widespread declines in 1990. The cumulative drop in output since 1989 ranges from about 10 percent in the Czech and Slovak Federal Republic and Hungary to about 20 percent in Poland and Romania and as much as 40 percent in Bulgaria. The recent weakness in output reflects to a varying, but in all cases significant, extent the precipitous decline in trade between Eastern Europe and the Soviet Union, as a breakdown of administrative arrangements and a shortage of foreign exchange sharply curtailed imports into the U.S.S.R. This is discussed in Annex 1 to the WEO documents now before the Board. But declining activity predominantly reflects the greater inefficiency of the newly opened economies of Eastern Europe than had been generally suspected, and the inevitable lags between policy changes and their effects.

Second, the primary responsibility for carrying through the enormous task of transforming these economies rests at home. Governments must not relax their commitment to stabilization and structural change; only then will the supply responses develop on which improved living standards depend, including the required financing from the private sector. Rapid progress in building a new and favorable institutional framework, and in particular resolution of ownership uncertainties that may deter private investors, will be critical in limiting the output declines. The firm steps and strong actions on economic reforms already taken by a number of governments and endorsed by those just beginning the process, are very encouraging. But even in the countries that embarked earlier on reform, much remains to be done to reduce the role of the state in productive activities and shift to a market economy where the private sector is pre-eminent.

Governments are only just beginning to take essential steps in a number of key areas, notably concerning the reform and privatization of public enterprises, implementation of hard budget constraints in the remaining state sector and measures to put the banking and financial system on a sound footing. At the same time, pressures to relax the stabilization effort, and in particular to ease the fiscal stance, must be resisted if inflation is to be kept under control and external confidence maintained. Slippage in this area will postpone creation of the conditions for sustained economic growth, making the transition to a market economy even more costly. As the recent Board paper on the economic transformation of Germany demonstrated, the German experience points to the importance of wage restraint, and the maintenance of external competitiveness, to mitigate output losses.

But, third, while it is gratifying that governments have so far reaffirmed their commitment to reform, notwithstanding the unexpectedly large declines in activity, it is also crucial that early external assistance be provided to alleviate the adjustment burden. Without this, the popular support needed to push ahead with reform is likely to wither, especially given already large declines in real wages, and rapidly growing unemployment. The two key elements to this external assistance--improved access to industrial country markets and financial support--must complement each other. Expanding external markets are needed to allow these countries in effect to pay for some of the huge reconstruction costs through their own exports. Financial assistance is needed to cover remaining trade deficits associated with the investment effort.

Fourth, progress in the area of trade access has been rather limited. It has been recognized from the outset that increased access to export markets was an essential condition for the successful transformation of the economies of central and Eastern Europe. Major steps have already been taken in many of these countries to liberalize their trade and payments. The effective dissolution of the trading arrangements of the CMEA this year hastened the process of reorientation. But while some of the Eastern European countries whose economic transformation is more advanced, notably Hungary, have succeeded in switching exports from the collapsing CMEA bloc to new markets, most have not. Much of their old export base, dependent on production of manufactured goods intended for the Soviet market and planned on the basis of distorted relative prices, is no longer economic. Other traditional exports to the Soviet Union, notably of agricultural goods, may even have been squeezed out in some cases by products from the West, financed by government-guaranteed export credits. At the same time, the rapid opening up to external market forces has led to substantial import penetration in some cases. These difficulties underline the importance of ensuring access for these countries to markets in which they can compete.

While certain barriers to exports of manufactures have been lowered in non-CMEA industrial countries, major impediments remain in a number of areas--particularly agriculture, steel, and textiles--in which it is believed that the countries of central and eastern Europe may have comparative advantages. Against this background, the heads of state or government participating in the London Economic Summit in July 1991 undertook "... to improve further" the access of the central and east European countries "to our markets for their products and services, including in areas such as steel, textiles, and agricultural produce."

The exigencies of the situation add urgency to the speedy implementation of this important declaration, but recent developments have not been encouraging. It would seem of utmost importance that the wish of these countries to integrate their economies with the rest of the world be accommodated as quickly as is feasible. In this connection, the European Commission, stressing the importance for all of the reforming economies of improved access to the EC market, has proposed that EC members grant trade concessions on a number of sensitive products--including textiles, coal, meat, fruit and vegetables--in order to speed agreement on EC association for Czechoslovakia, Hungary and Poland. It is of course important at the same time that liberalization not undercut the efforts to achieve a similar opening of markets to trading partners generally under the aegis of the Uruguay Round.

Finally, the need for exceptional financial assistance is likely to continue for some while, even with swifter progress on the trade side. In time, of course, these countries' exports, together with inflows of private capital, should be sufficient to cover their import needs; a successful transition must be expected to lead to a sustainable external position. But estimates suggest that the capital needs involved in bringing about this transition, and in particular in achieving the high growth rates needed to raise living standards towards those in neighboring Western countries, will be very substantial for some time, and no doubt in excess of the saving that can be mobilized domestically. It is extremely difficult to project financing requirements beyond the near future. Much will depend on the speed with which efficiency gains--which are potentially very large in all these cases--can be realized, as well as on the income level ultimately viewed as acceptable in each country. In one sense, the very size of the problem may help; the new investments needed in almost all sectors should incorporate the latest technology and thus allow for a rapid improvement in efficiency. But attracting this investment will be difficult.

It was in recognition of the special costs of reconstruction that the G-24 was established under the chairmanship of the EC Commission to provide concerted support for the countries of central and eastern Europe. This has successfully mobilized exceptional balance of payments financing for a number of countries with Fund-supported adjustment and reform programs. In 1991, disbursements to the four countries--Bulgaria, Czechoslovakia, Hungary and Romania--of as much as US$2.9 billion are still hoped for. However, the process has involved serious delays in both commitments and, even more importantly, disbursements. This has meant that some countries have embarked on liberalization with dangerously low levels of international reserves. There is thus a need to speed up both commitment and disbursement of G-24 resources, in part because of its implications for future Fund support.

Preliminary estimates of the overall financing in 1992 for the five countries with Fund arrangements now in place suggest that this will be somewhat smaller than the US$20 billion in 1991. 1/ The private sector is expected to provide, partly through debt rescheduling, more than half of the US$17 billion or so financing presently envisaged. This is a bigger share than in 1991, and the remaining overall financing gap will be considerably smaller than in 1991, at US$2.3 billion. This, however, hides the fact that for three countries the gaps remain very large, in part because of the need to rebuild reserves levels. Moreover, for two of these--Bulgaria and Romania--there have been serious difficulties in mobilizing and disbursing G-24 financing in 1991.

In light of the above, Executive Directors may wish to express their views on the following issues:

--the prospects for actions in the near term to improve access to industrial country markets for those products in which these countries are most likely to have a comparative advantage.

--the usefulness of substituting tariffs for the quantitative restrictions which formerly governed imports. This could both mitigate the impact on these economies of the sudden dismantling of administrative import controls, and provide public sector revenues to limit the sharp declines now being experienced. It would imply adoption by these countries of different tariffs from the generally low ones now in place and, in some cases, agreed with the GATT.

--the implications for both the Fund and the G-24 process of the financing needs now foreseen for 1992. In this connection, it must be remembered that the level of Fund involvement in 1991 was exceptional; it reflected both disbursements under the oil facility and the unusually high access levels agreed for some countries, in view of the balance of payments and exchange rate implications of liberalization. With a more normal level of Fund access in 1992, the likely financing would seem to point clearly to a continuing significant role for the EC/G-24 process in Eastern Europe. This raises an important question. In addition, one should keep in mind the needs of the prospective Fund members--including Albania, the Baltic republics and the Soviet Union--which are likely to overshadow the magnitudes indicated in the attached tables, and which the international community will have to address in the period ahead.

1/ The estimates for 1992 shown in Table 4 attached are preliminary staff estimates which have not been discussed with country authorities. They assume continued medium-term adjustment and reform, consistent with the paths envisaged in the formulation of economic and financial programs for 1991, adjusted in light of developments since the beginning of the year. The policies underlying these projections have been specified only in broad terms. These policies and more refined projections for 1992 for each country will be given greater precision in the context of discussions with country authorities of programs for 1992.

In sum, steadfast commitment of the countries to strong stabilization policies and thorough-going reform and restructuring will be the key to their future success. But the response of the international community to the needs of the newly reforming economies will also be critical. Without a supportive international environment, involving both improved access to markets and timely financial assistance, the prospective trade deficits associated with the reconstruction of these economies would likely exceed financeable levels. This would necessitate a slower and more vulnerable pace of restructuring and output growth. But this in itself could risk a reversal of external liberalization measures, and a resort to disorderly adjustment expedients. It is clearly in the interests of the Fund membership as a whole that such an outcome be avoided.

Table 1. Eastern Europe: Revised Balance of Payments Outlook and Financing Needs, 1991

(In billions of U.S. dollars)

	Bulgaria		Czechoslovakia		Hungary		Poland		Romania	
	Initial	9/91	Initial	9/91	Initial	9/91	Initial	9/91	Initial	9/91
Current account	-2.0	-2.0	-2.5	-1.5	-1.2	-0.8	-2.7	-3.7	-1.7	-2.4
Other capital 1/	-1.0	-0.9	0.4	-0.6	-2.7	-2.5	-4.6	-5.9	-0.3	0.1
Reserve change (increase -)	-0.5	-0.3	-1.6	-1.1	-0.9	-0.9	-0.7	1.1	-0.7	-0.5
Elimination of arrears	-0.4	-0.4	--	--	--	--	--	2.2	--	--
Financing requirements	3.9	3.6	3.7	3.2	4.8	4.2	8.0	6.3	2.7	2.8
Financing	3.9	3.6	3.7	3.2	4.8	4.2	3.7	6.3	2.7	2.8
Private capital 2/	1.6	1.6	1.0	0.9	2.1	1.9	0.3	0.3	0.5	0.6
Of which:										
Direct investment	(0.1)	(0.1)	(0.4)	(0.6)	(0.6)	(0.7)	(0.3)	(0.1)	(0.1)	(0.1)
Debt relief	(1.5)	(1.5)	--	--	--	--	--	(--)	--	--
Official capital	2.3	2.0	2.7	2.3	2.7	2.3	3.4	6.0	2.2	2.2
World Bank and parallel financing 3/	0.3	0.2	0.3	0.2	0.5	0.5	0.6	0.4	0.3	0.3
EC (outside G-24)	--	-- 4/	...	...	0.4 5/	0.4	...	0.1	...	...
G-24 6/	0.8	0.6	1.0	0.8	0.6	0.4	...	--	1.1	1.1 7/
Debt relief	0.7	0.9	--	--	--	--	1.9	5.0	--	--
Use of Fund resources	0.5	0.4	1.4	1.3	1.2	1.0	0.9	0.5	0.8	0.8
Remaining financing gap	--	--	--	--	--	--	4.3	--	--	--

Sources: "The Role of the Fund in Assisting Eastern European Countries," SM/91/46 and update 3/8/91; and IMF staff estimates.

1/ Includes amortization (including Fund repurchases); short-term trade credit; and utilization of CMEA balances accumulated under the CMEA trading system.
2/ Includes officially supported export credits.
3/ Excludes parallel financing that is part of G-24 process.
4/ A small amount of PHARE and other assistance is incorporated in the capital account.
5/ Second tranche of loan approved February 1990. Does not include additional contribution to 1991 financing.
6/ Includes parallel financing of World Bank loans when part of G-24 process.
7/ Assumed disbursements from the EC; the G-24; the EIB and the EBRD.

Table 2. Eastern Europe: Economic Activity, Domestic Demand and Imports, 1991

(1989=100)

	Bulgaria	Czech and Slovak Republic	Hungary	Poland	Romania
GDP	59	87	91	79	83 1/
Domestic demand	...	...	89	79	...
Imports	41	62	77	103	70
Of which:					
CMEA	(28)	(35)	(40)	(35)	(20)
Non-CMEA	(71)	(106)	(119)	(168)	(143)

Sources: Data provided by national authorities and IMF staff estimates.

1/ A decline of 5.8 percent had already taken place in 1989, bringing the cumulative decline since 1988 to 21 percent.

Table 3. G-24 Commitment of Balance of Payments Assistance to Central and Eastern Europe, 1991

	Czech and Slovak Republic	Hungary	Bulgaria	Romania
	(In million of U.S. dollars)			
EC	500	250	400	500
Japan	200 1/	150 1/	100 1/	100 1/
Austria	50	20	20	25
Finland	15	10	10	...
Norway	16	15	13	15
Sweden	25	20	20	25
Switzerland	40	30	32	40
Turkey	1	1	...	...
Canada	25	12.5	9	22
United States	15	10	25	...
Iceland	--	...	...	...
Saudi Arabia	60	--	--	--
Kuwait	50	--	--	--
Total	997	518.5	629	727
Memorandum item:				
Initial request	1,000	500	800	1,000

1/ Cofinancing of IBRD Structural Adjustment Loan.

Table 4. Eastern Europe: Preliminary Balance of Payments Outlook and Financing Needs in 1992 1/

(In billions of U.S. dollars)

	Bulgaria	Czech and Slovak Republic	Hungary	Poland	Romania
Current account	-1.7	-1.5	-0.4	-0.9	-1.8
Other capital 2/	-0.7	-0.2	-2.7	-1.9	-0.2
Reserve change (increase -)	-0.3	-0.6	-0.6	-0.2	-0.3
Elimination of arrears	--	--	--	-2.9	--
Financing requirements	2.7	2.3	3.7	5.9	2.3
Financing	2.7	2.3	3.7	5.9	2.3
Private capital 3/	1.3	0.9	2.2	3.9	0.9
Of which:					
Direct investment	(0.1)	(0.6)	(0.8)	(0.2)	(0.2)
Debt relief	(1.1)	(--)	(--)	(3.3)	(--)
Official capital	0.5	0.8	1.4	2.3	0.6
Of which:					
World Bank	(0.1)	(0.3)	(0.4)	(1.1)	(0.3)
EIB/EBRD	(0.1)	(0.1)	(0.2)	(0.3)	(0.1)
EC (outside G-24)	(--)	(--)	(0.3) 4/	(--)	(--)
G-24 5/	(--)	(0.3)	(0.1)	(--)	(--)
Debt relief	(0.3)	(--)	(--)	(--)	(--)
Use of Fund resources 6/	(0.1)	(0.1)	(0.4)	(0.6)	(0.1)
Remaining financing gap	0.9	0.6	--	--	0.8

Source: IMF staff estimates.
1/ Components may not add to total due to rounding.
2/ Includes amortization (including Fund repurchases); short-term trade credit; and utilization of CMEA balances accumulated under the CMEA trading system.
3/ Includes officially supported export credits.
4/ Third tranche of loan approved February 1990.
5/ Assumed carryover of disbursements from 1991 commitments.
6/ Existing commitments only.