DOCUMENT OF INTERNATIONAL MONETARY FUND AND NOT FOR PUBLIC USE

0450

SM/91/55

CONTAINS CONFIDENTIAL INFORMATION

March 6, 1991

To: Members of the Executive Board

From: The Secretary

Subject: Central and Eastern Europe - Interim Assessment of 1990 Programs

The attached paper on an interim assessment of the 1990 Fund programs in Central and Eastern Europe is tentatively scheduled for discussion in a seminar on Wednesday, March 13, 1991. Conclusions for discussion appear on pages 16 and 17. A set of country notes on developments in 1990 in Hungary, Poland, Yugoslavia, and east Germany will be circulated shortly.

Mr. Deppler (ext. 4610) is available to answer technical or factual questions relating to this paper prior to the seminar discussion.

Att: (1)

Other Distribution:
Department Heads

CONTAINS CONFIDENTIAL INFORMATION

INTERNATIONAL MONETARY FUND

Central and Eastern Europe--Interim Assessment of 1990 Programs

Prepared by the European Department

(In collaboration with the Exchange and Trade Relations, Fiscal Affairs, and Research Departments)

Approved by Massimo Russo

March 5, 1991

The past eighteen months have witnessed a sea change in the orientation of the economies of Central and Eastern Europe. Every government in the region has made clear its determination to transform its economy from one guided by the tenets of central planning towards one guided by those of the market. Indeed, while similar breaks with the past have occurred elsewhere in the world, nowhere else has the break been both so radical and so widespread--involving not only each of the economies in the region, but also the pre-existing nexus of trading relationships of the region.

The Fund declared early on its willingness to help. The reasons are straight forward. First, these countries have actively sought membership in and integration with the multilateral trade and payments system. Second, the reform process has and will induce large initial disequilibria, which the Fund is well-placed--indeed, mandated--to help these countries address. Third, in line with their wish to shift toward market economies, the authorities in these countries have committed to the kinds of financial, exchange rate, trade and structural policies that have always elicited strong support from the Fund. As a result, the Fund's involvement in the region has increased markedly. In 1990, programs were put in place with respect to three countries (Hungary, Poland, and Yugoslavia), and membership, Article IV and/or UFR missions were carried out with three other countries (Bulgaria, Czechoslovakia, and Romania). The Fund also convened the joint study of the U.S.S.R. economy. In 1991, all the Members of the region either already have or are seeking arrangements with the Fund.

Against this background of deepening involvement, the purpose of this paper is to carry out an interim stock-taking of the Fund's experience in Central and Eastern Europe for informal discussion by the Executive Board. It focuses on the experience with the three programs that were in effect during 1990, with an eye to any lessons they might have for future programs. 1/ An accompanying paper includes three notes describing, and drawing preliminary assessments of, the Hungarian, Polish, and Yugoslav programs.

1/ A brief sketch of the 1991 programs is contained in The Role of the Fund in Assisting Eastern European Countries (SM/91/46, February 28, 1991).

That paper also includes a note on the experience in east Germany, where the transformation has been the most complete. Drawing on these notes, other Fund documents, and the experience of the staff working on Central and Eastern Europe, the present paper highlights a few key points and issues. It reviews developments in 1990 and then discusses the role of stabilization policies--exchange rate, monetary, fiscal, and income policies--and structural factors.

Two provisos should be noted. First, the paper is deliberately brief and thus selective. In particular, the focus is on the implications of the 1990 experience for stabilization policies rather than for the process of structural reform. Second, as a policy-oriented exercise in interim stock-taking, the paper embodies views that are necessarily tentative and provisional pending the availability of detailed and comprehensive studies as well as more experience and hindsight.

1. Developments in Hungary, Poland, and Yugoslavia

It is tempting to think of Central and Eastern Europe as an entity dealing with one dominant problem. While it is true that all countries in the region were seized roughly contemporaneously by the same zeal for political and economic change, this tide nevertheless caught countries at different stages in their transition to a market economy and in different macroeconomic situations. This is well illustrated by the three countries that had programs in 1990. Thus, whereas all three programs reflected a markedly increased commitment to improve economic efficiency through structural reform, notably through the liberalization of domestic prices and foreign trade, the magnitude of the reform effort undertaken in 1990 varied considerably. It was relatively small in Yugoslavia, which had been opening its economy toward the rest of the world for many years and had capped this with significant reforms in 1989; it was moderate in Hungary, where it consisted of giving added impetus to the gradualist approach to reform instituted a number of years previously; and it was quite major in the case of Poland, where previous reform efforts away from the central planning mould had not taken hold and where relative prices were much more seriously out of line with those in the world economy.

Equally pronounced differences were present as regards financial balances. Inflation had remained reasonably under control in Hungary, but was rapidly headed toward hyper-inflation in Poland and Yugoslavia. Pronounced differences obtained as regards countries' external situations as well. In Yugoslavia, the external position was reasonably strong at the outset both in terms of reserves and the current account. Rather weak positions prevailed on both counts in Hungary and Poland, however, and the need to adjust was considerable: in Hungary in reflection of the authorities' commitment, despite a high level of indebtedness, to avoiding rescheduling and thereby maintaining open access to international capital markets; and in Poland in order to contain the substantial deterioration in the current account expected as a result of rapid liberalization externally.

The stabilization programs mirrored these differences in situations and in the authorities' policy priorities. The programs for Poland and Yugoslavia were of the big bang type--with respect to stabilization for Yugoslavia and both liberalization and stabilization in the case of Poland--and aimed to achieve drastic decelerations in inflation while preserving sustainable external positions under conditions of near complete convertibility for current account transactions. The core of the programs was the deliberate use of the exchange rate as anchor (on the heels of a large initial devaluation of the official exchange rate in the case of Poland), backed-up by access to substantial external reserves and tight limits on credit expansion, the fiscal deficit, and wage increases. In Hungary, the initial domestic imbalances were smaller and the program focused on strengthening the current external account and the previously instituted gradualist approach. It embodied a further tightening of financial policies and a moderate devaluation, in line with the authorities' existing approach of periodic adjustment of the exchange rate.

These programs met with a mixture of success and disappointment (Table 1). On one level, the programs were relatively successful in attaining their primary stabilization objectives. Poland and Yugoslavia achieved striking reductions in inflation, particularly during the early stages, and Hungary and Poland experienced major turn-arounds in their external accounts. Indeed, the three countries effected major and unexpectedly large improvements in both their external and fiscal positions over the period when the programs remained in compliance. On the other hand, all three countries experienced significantly more inflation over the year than originally anticipated; all experienced marked declines in real output, despite unexpectedly strong convertible currency exports; and the programs for Poland and Yugoslavia went off-track in the second half of the year. In Yugoslavia, this reflected mainly persistent slippages in incomes policy that forced a loosening of monetary policy; in Poland, a shift to less restrictive policies in the face of the unintentionally severe contraction experienced in the first half of the year. In both countries, the political situation evolved in a way that made program implementation more difficult. In Hungary, the program remained on track, owing in part to corrective fiscal policy measures taken at mid-year.

2. Issues in the Design and Implementation of Stabilization Policies

a. Exchange rate policy

While the three programs were obviously tailored to rather different situations, two uses of the exchange rate as an instrument of policy predominated: the exchange rate as an anchor to tackle inflation, and, as such, viewed as among the last of the policy instruments to be adjusted in the face of emerging imbalances; and the exchange rate as an instrument to protect the external position through periodic nominal depreciations. Thus, in Yugoslavia, where inflation was the paramount problem, the program emphasized the use of the exchange rate as an anchor; in Hungary, where the priority objective was strengthening the external position, exchange rate

Table 1. Central and Eastern Europe: Selected indicators for 1990 Fund programs

	GDP	Consumer prices	Consumer prices	Broad money	Net domestic assets 1/	Credit to general government	Budget balance	Convertible current account	Convertible current account	Nonruble export volume
	(Percent change)	(Monthly % ch.by mid-year)	(Percent change during the period)			(Percent contribution to money growth)	(Percent of GDP)		(In mill. U.S. dollars)	(Percent change)
HUNGARY										
1989 Actual	-0.9	...	19	13	13	16	-0.8	-4.9	-1438	4.8
1990 Program	-0.3	...	17-18	15	9	2	0.6	-1.7	-550	8.5
1990 Estimate	-5.0	...	37	24	10	1	0.6	0.4	128	10.0
Jan.-Jun. 1990 Program	...	...	14	4	4	2	...	...	-354	...
Jan.-Jun. 1990 Actual	...	...	21	6	2	1	...	...	-185	...
POLAND										
1989 Actual	0.2	18% 2/	640	239	199	20	-5.4	-2.8	-1843	9.3
1990 Program	-5.0	1%	94	87	52	—	-0.1	-7.1	-3033	—
1990 Estimate	-12.5	3-5%	249	118	71	-16	3.5	1.1	668	48.9
Jan.-Jun. 1990 Program	...	...	83	59	33	4	...	...	-2600	...
Jan.-Jun. 1990 Actual	...	...	*170*	*57*	*15*	*-33*	...	...	*1129*	...
YUGOSLAVIA										
1989 Actual	0.8	32% 2/	2653	2619	1984	— 3/	1.8	3.4	2010	10.0
1990 Program	-2.5	1%	33	19	7	— 3/	0.8	2.2	1300	5.0
1990 Estimate	-7.5	0%	77	40	27	— 3/	...	-1.5	-858	4.7
Jan.-Jun. 1990 Program	...	...	25	8	2	— 3/	...	...	285	...
Jan.-Jun. 1990 Actual	...	...	31	24	9	— 3/	...	...	804	...

COMMENTS: HUNGARY

The main aim of the program was to improve the convertible current account so as to preserve external solvency. In practice, the current account improvement exceeded initial expectations. However, output and inflation performance was substantially worse-than-programmed.

POLAND

The program aimed to reduce inflation drastically and quickly. The table shows that while a swift reduction was achieved, the monthly rate by mid-year was somewhat above target. The NDA performance criterion was violated in the second half of the year, and inflation remained higher-than-expected throughout the program period. The performance of the budget and the convertible current account exceeded expectations throughout the year—especially during the first half, when the NDA expansion remained within program ceilings. The output performance was substantially worse-than-expected.

YUGOSLAVIA

The key program target was to reduce the monthly rate of inflation to 1% by mid-year. As the table shows, this was achieved. However, a breakdown of the agreed incomes policy and a serious loosening of financial policies led to a flare-up of inflation during the second half of the year. Output performed significantly worse-than-programmed.

1/ Net domestic assets of the banking system at fixed exchange rates. For Hungary, the related performance criterion was defined as NDA of the banking system plus net nonconvertible foreign assets; for Yugoslavia, the related program limits applied to NDA of the central bank.
2/ Average monthly rate of increase in 1989.
3/ No bank credit was extended to the government sector per se in 1989 or 1990.

policy was used primarily to secure a real depreciation; and in Poland, where both inflation and the external position were in need of correction, the program combined an initial depreciation with use of the exchange rate as an anchor at its new level.

The innovation for Poland and Yugoslavia in these policies was the adoption of the exchange rate anchor approach. This represented a marked shift from the rapid sequence of devaluations that had prevailed until then. This change reflected first and foremost the alarmingly rapid deterioration in these countries' inflation performance and the prospect of a significant further price shock in Poland in conjunction with the liberalization of prices. Against this background, the Polish and Yugoslav authorities and the staff elaborated the programs around high-profile commitments to fixing the exchange rate vis-a-vis the dollar and the deutsche mark, respectively. The commitment to maintain a fixed exchange rate vis-a-vis the anchor currencies during the stabilization phase was expected, through its effect on expectations, to reinforce the authorities' credibility in implementing tight financial policies; to strengthen the Government's position in implementing an effective incomes policy; and, in the Polish case where prices and trade were substantially liberalized, to provide a ready and stable reference for setting domestic prices and to clarify quickly the new structure of relative prices. Both programs would appear to have been effective in attaining these objectives. They achieved spectacular reductions in inflation during the first few months of the program.

The more traditional use of the exchange rate to strengthen external positions through depreciations also appears to have been successful. While a number of other factors contributed, both Hungary and Poland achieved substantial improvements in their external positions.

These positive aspects of the use of the exchange rate in these three cases were accompanied by some less favorable ones. In Yugoslavia, the "pure" anchor case, the program veered increasingly offtrack during the year. The problems were rooted in persistent slippages in the implementation of incomes policy (reflecting in large part a more deep-seated breakdown in the political consensus). These slippages were initially met by a tightening of monetary policy. However, that tightening, together with continuing wage pressures and increases in regional taxes on enterprises, increasingly strained the latters' financial viability and export performance, and eventually forced a shift to a more accommodative monetary policy and, in the end, renewed devaluation. The lesson is that, while anchor approaches to the exchange rate can be effective in quickly stabilizing incipiently unstable situations, they also require correspondingly strong wage and monetary anchors to be maintained if the exchange rate is to be sustained into a period where inflationary expectations have adjusted fully.

Similarly, in Hungary, the improvement in the external position was accompanied by a significant acceleration in inflation. While this was partly due to extraneous factors such as the rise in oil prices, it is likely also to have reflected some accretion in inflationary expectations at least in part as a result of anticipated future depreciations in the exchange rate in the context of the authorities flexible use of exchange rate policy to strengthen the external position.

The Polish case, which combines the two approaches, can in some respects be viewed as having made the most of both of them. The improvement in inflation and in the external position has been large, and the anchor remains unexpectedly viable more than a year later, in part because of the depreciation of the dollar. On the other hand, the price output split was unexpectedly adverse--a feature that may be partly attributable to an excessive depreciation of the exchange rate before fixing the anchor, although other factors were at work, as addressed below. For the moment, it should be noted that while the situation currently being faced by several countries in the early stages of liberalization (notably Bulgaria and Romania) is reminiscent of that of Poland at end 1989, this does not mean that the Polish "model" is necessarily appropriate to them. In particular, Poland benefitted at the outset from a relatively strong reserve position which was critical to the design of the program.

b. Money and Credit

(i) Design issues

Perhaps the most important issue of relevance for monetary policy in centrally planned economies (CPEs) in rapid transition is whether the Polish program was too tight. This is perhaps not surprising given the hindsight of the program's strong performance in virtually every respect except output. That hindsight was of course not available either to the authorities or the staff at the time the program was designed, when there was enormous uncertainty about the effects of monetary measures, as is made clear in the note on the Polish program. Nonetheless, hindsight on the Polish case may serve as foresight on those to come.

The first question is whether the program overestimated the significance of the so-called "monetary overhang", the accumulation by households of "undesired" domestic liquidity as a result of the unavailability of consumer goods at official prices. The presence of such an overhang justifies a commensurate initial contraction in real credit for otherwise the attempt to control the flow of new monetary resources over the balance of the program period would be frustrated by the availability of excess liquidity. There was agreement at the time of the negotiations that the overhang in Poland was less of a problem than earlier feared, but less agreement on when it was eliminated. Those of the "too tight" view think it was eliminated during the second half of 1989 while others view it as possibly explaining part of the unexpectedly large jump in prices in the first month of the program. Be this as it may, the overhang is generally acknowledged to be large in countries where the liberalization process is still in its initial stages, notably Bulgaria and Romania. It was not and is not an issue in Hungary and Yugoslavia.

A second issue arises from the uncertainty regarding the size of the price shock likely to be induced by price and trade liberalization and exchange rate depreciation. From a monetary management standpoint, this price shock serves to extinguish excess liquidity in the system and to effect the desired real contraction in credit. 1/ However, the size of the price jump in the Polish case proved to be unexpectedly large, despite the known role of the exchange rate. This has been variously ascribed to the emergence in the course of liberalization of previously repressed monopoly elements (which is consistent with the too tight hypothesis) and to the overhang (which is not).

A third aspect is the choice of the new level for the exchange rate, again a choice subject to considerable uncertainty in the Polish case. On the one hand, the initial devaluation needed to be large enough to achieve the improvement in the external position posited in the program while at the same time absorbing the direct and indirect effects of the monetary overhang and the shock to the price level induced by liberalization--the whole within the context of major changes in the structure of costs (e.g., as regards the role of taxes, subsidies, and transfers). On the other hand, it was also important to avoid an excessively large devaluation that would fuel inflation, unduly depress domestic demand, and undermine efforts to establish financial stability on a sustainable basis. In the end, a rate of 9,500 zloty to the dollar was chosen--a choice that, against the background of market rates that had reached as high as 12,000 zlotys to the dollar three months earlier, prompted concerns whether the authorities would not initially confront large scale capital outflows. In the event, the rate chosen appears if anything to have been on the high side as Poland's external position tended to be quite strong throughout 1990.

A fourth aspect is whether the credit ceilings in the Polish program allowed firms the credit necessary to finance the much higher priced inputs required by the production process. Not to have done so, as charged by some, is to have risked inducing a "credit-crunch" and the associated supply-side curtailment of output as enterprises sought to reduce their input costs to match the availability of credit. Concerns in this respect have crystallized not so much around the credit ceilings specified in the program--these were not reached during the period of rapidly falling

---

1/ As a general matter, it might be preferable to tackle this excess liquidity through means other than an increase in the price level that could trigger a lasting rise in inflationary expectations. However, non-inflationary alternatives have not proven very viable: monetary reform is politically difficult for newly democratic governments intent on establishing a break with authoritarian practices; and the sale of public assets is slow and cumbersome.

output--as around the high level of the independently targeted interest rates. Here again, the uncertainties intrinsic to the situations of CPEs in rapid transition come to the fore. While there is general agreement that interest rates should be positive in real terms, there is a great deal of uncertainty about what this means in practice. The programs tend to be elaborated against a background of accelerating inflation and an initial large price jump. Accordingly, a backward-looking view of expectations formation argues for extremely high nominal rates. However, the programs also tend to project a very rapid deceleration of inflation within weeks of the beginning of the program. Hence, the very high nominal rates consistent with a "backward-looking" view imply very large triple digit real rates from a "forward-looking" view of expectations formation, if one grants the authorities full marks for credibility. (Ex post, real interest rates were negative in January and February and became positive thereafter.) Given the abrupt break in inflation built-in to the program and its uncertain implications for expectations, it is not surprising to find that, with the benefit of hindsight, some of the more widely held concerns regarding the Polish case have focused on whether interest rates were set too high and whether that contributed to the drop in output by inducing firms to minimize their borrowing even if at the cost of foregoing necessary inputs.

Returning to the issue of exchange rate policy, one question is whether the decision to adopt an anchor approach contributed to any undue tightness in the program. It is difficult to say. It is clear that the level chosen for the exchange rate allowed for a margin of error. It is also true that interest rates were partly set with an eye to ensuring the credibility of the program as a whole, particularly since a fiscal deficit was anticipated in the first quarter. These are normal precautions and they do not seem to have been disproportionate in this case, after allowance for the scale of the uncertainties. One possible lesson to draw from the Polish case may be instead that, particularly in cases where the authorities have a preference for a big bang approach, one should take care not to err unduly on the side of extra adjustment in the face of extra uncertainty.

One should perhaps also be careful not to reach too quickly a judgement that the Polish program was too tight. While several indicators point in that direction, it remains that the inflation performance has been worse than expected. Moreover, given the emphasis placed in some analyses of the Polish program on the under performance of output, there would seem to be some need to explain why similar developments occurred elsewhere in Central and Eastern Europe (see Section 4). More fundamentally, the decline in output may have been caused primarily by the large structural transformation taking place in the measured economy (see Section 3). Indeed, a case could be made that monetary policy may have been too loose given the large decline in output caused by structural shifts. Finally, the test of the Polish program will not be how it performed in the first six or twelve months, but whether it succeeded in establishing a reasonably stable financial environment over the medium term.

(ii) Issues of implementation

The monetary aspects of the programs also faced problems of implementation, particularly in Poland where the process of institution building was less advanced. Perhaps the main hurdle was the lack of financial markets able to give ongoing feedback about monetary conditions and through which to make flexible adjustments in policy. This lack of markets was of course known from the outset. Indeed, it was the main reason for relying on both credit ceilings and administratively set interest rates. Nonetheless, the importance of this weakness was not fully appreciated in advance: when substitute signals from the foreign exchange market early in the Polish program suggested that some easing of interest rates might be in order, the time required to effect the change was unexpectedly long because of rigidities in banks' operations. Experiences such as these have prompted the Fund, in collaboration with industrial country central banks, to mount major technical assistance efforts in the central banking area, among others. As a result, rigidities impairing the conduct of monetary policy are gradually being addressed throughout Central and Eastern Europe. Progress, however, remains slow.

In the same vein, Fund resident representatives have proven useful in helping national authorities become familiar with the use and role of monetary policy in decentralized market economies. This role is in sharp contrast to its traditional function within the central planning system: lubricating the production process by providing the liquidity needed to attain the output targets. The transposition in thought processes required to go from this passive approach to that required for monetary management in a market-oriented economy is considerable, and all the more challenging for the authorities of countries where the transition has been relatively rapid (Poland and, a fortiori, Czechoslovakia, Bulgaria and Romania).

The effectiveness of monetary policy in all three countries under consideration has also been impaired by a number of structural rigidities and deficiencies. Four may be mentioned: the weakness of banks' balance sheets; the lack of competition in financial markets; the segmentation of markets; and the archaic payments and accounting systems. The first is a legacy from the accommodating finance tradition of CPEs. It reflects in part the distribution to second-tier banks of the often worthless claims on enterprises of the former monobank, together with nominally equivalent liabilities. The second rigidity, the lack of competition, is a legacy from the monobanking structure characteristic of CPEs whereby the newly created second-tier banks largely comprise the branches of the former monobank and the specialized institutions of the former system, which also tended to be monopolies. The segmentation of markets in turn contributed to consolidating these monopoly positions by preventing surplus funds from one sector from being invested in another. In tandem, these rigidities are thought to explain two of the more unfortunate features, apparent in varying degrees in individual countries, of the monetary landscape in 1990: very large spreads between deposit and lending rates, as banks exercised their monopoly positions and sought to make-up for the deficiencies of their portfolios; and a skew in the allocation of scarce credit in favor of loss-making enterprises, as banks' sought to preserve the value of their portfolios. Both of these reactions and the antecedent rigidities would exacerbate the price-output split likely to be associated with any given monetary stance and inhibit the emergence of new suppliers. In the medium term, the solution is to increase competition in financial markets, e.g., by allowing entry to foreign banks, and to strengthen portfolios by fiscalising bad debts and recapitalizing the banks. In addition, large investments in computing facilities and technical assistance are needed to modernize the payments and accounting systems and to give banks the requisite flexibility. In the meantime, the experience so far suggests that temporary direct controls on interest rates, e.g., ceilings on spreads between borrowing and lending rates, may also be necessary.

c. Fiscal policy

All three of the 1990 programs aimed to reduce fiscal imbalances and to achieve some restructuring of the public finances. The most ambitious objectives were set for Poland where the fiscal deficit had been a major contributing factor behind the acceleration in inflation. The actual fiscal performances under the three programs were quite varied. The Hungarian experience was one of incipient shortfalls that were overcome once the authorities implemented corrective measures at mid-year. In Poland, the fiscal outturn was much better than targeted despite some loosening in the second half because of the unexpected buoyancy of revenues. In Yugoslavia, expenditure increased much more than in the program, owing in large part to excessive wage increases. But revenues also increased more than planned, so that there was little public borrowing but an increased tax burden on enterprises. How did the fiscal performance affect the attainment of the program objectives? In Poland and Hungary, the stance of fiscal policy was contractionary and contributed thereby to the strengthening in the balance of payments. However, the growth and inflation performances were worse than targeted. This again suggests that cost push factors may have been more prominent than anticipated, thus forcing the contractionary policies to fall more heavily on output growth.

Although the 1990 programs did not provide for large scale fiscal restructuring, either because major changes had been initiated earlier as in Hungary or Yugoslavia or were being planned for future implementation as in Poland, fiscal operations contributed to promoting reforms in other areas. This was especially the case in the curtailment of subsidies to give greater effect to price reforms. The reduction in subsidies to the state enterprises was an important element in subjecting them to greater financial discipline and, together with credit restraints, in hardening their budget constraints. Much remains to be done, however. The subsidies are still substantial and are supplemented by sizable quasi-fiscal subsidies provided through the credit system. While the magnitude of these non-budgetary subsidies is uncertain, the experience with Yugoslavia suggests that the quasi-fiscal elements can significantly dilute the impact of a given fiscal adjustment.

One source of increases in expenditure in 1990 was the provision of income supports to the unemployed. These benefits were negligible at the beginning of the program since, in the old scheme of things, no one was avowedly unemployed. However, in response to the shift toward hard budget constraints and market-oriented labor markets, enterprises began adjusting their employment levels in the light of their financial situation. With the Fund's encouragement, the programs provided fiscal resources to cover the cost of unemployment benefits. In the event, the weakness of output occasioned significant rises in unemployment and a rapid increase in the recourse to unemployment benefits. The rise in these expenditures has been most pronounced in Poland where state budgetary outlays rose from negligible amounts at the beginning of 1990 to 1 percent of GDP for all of 1990 and, prospectively, to a budgeted 2-2 1/2 percent of GDP in 1991. These expenditures have been helpful in spreading the costs of reform across the population and in facilitating the political consensus needed to continue adjustment. While problems of implementation have surfaced, efforts are being made to improve the targeting of benefits and to establish comprehensive social safety nets.

The uncertainties regarding the performance of CPEs in transition make fiscal planning in these countries hazardous. These hazards are not reduced when key financial variables, notably interest rates, the exchange rate and tax bases, are also uncertain. While one can seek to protect program targets by having at hand a package of fiscal measures to deploy in the event of unanticipated deviations of these variables from their target path, this can be difficult to prepare and implement in the light of these countries' weak fiscal systems and the ongoing process of restructuring. Moreover, the deviations are not necessarily in the direction of increased deficits, as is clear from the Polish case. Given these uncertainties, it is important to carry-out relatively frequent reviews, inter alia, of the fiscal aspects with the view to forestalling slippage due to a lack of stabilization efforts by the authorities while partially accommodating unanticipated exogenous shocks.

d. Incomes Policy

All three of the 1990 programs involved the use of incomes policy: a wage freeze in the case of Yugoslavia and norms for the growth of wage incomes in Hungary and Poland which, if exceeded, gave rise to tax penalties. As elsewhere, a major purpose of such arrangements is to hasten the adjustment of domestic demand to levels more commensurate with domestic supply while minimizing the opportunity costs of adjustment, notably in terms of employment. This is accomplished by controlling costs from the ground up, so to speak, as well as from the top down via restrictive financial policies. This bottom-up aspect is necessary and potentially quite useful to the countries of Central and Eastern Europe, for two reasons: the "softness" of the budget constraints facing enterprises; and the tradition of cost-plus pricing which, in these economies, means not only that enterprises price to maintain their margin rather than their market, but also that they tend to accept, rather than seek to control, costs. In this environment, which reflects at root the ill-defined nature of property rights, it is important that policies have some means of hardening the budget constraints of enterprises from below if the pressures from that quarter are not to overwhelm the macro constraints.

This potential usefulness of incomes policy needs, however, to be set against its rather mixed record. In Yugoslavia, the wage freeze was breached early on by wage increases granted or condoned at the regional level, breaches that were a major factor in the eventual undoing of the program. In Hungary and Poland, the deterrence provided by the tax penalties had been mitigated in prior years by the granting of waivers. It is only in last year's program with Poland that the income policy provisions can be considered to have been in the main successful both in helping control inflation and in strengthening the competitiveness of the export sector.

Even in this case, however, there is some question whether certain aspects were optimal. The arrangement was that wages would adjust very incompletely, with a coefficient averaging to about .25, to the price changes projected for the first four months of the program. The basic objective was to bring real wages into line with what was considered viable from the standpoint of a sustainable external position, correcting along the way for the sharp rise in real wages that had occurred in the preceding period. In the event, the initial price shock was considerably larger than expected, which meant that the fall in real wages was also much larger than intended. This clearly was beneficial from the standpoint of short-run inflation control, the strength of the external position, and the credibility of the exchange rate. At the same time, however, it must have contributed to the weakness of demand, and hence output, during the first half of 1990. Moreover, because of provisions in the original wage agreement for compensation for differences between actual and projected price rises, the arrangement may also have contributed to the tendency for inflation to remain at a relatively high level (3-5 percent a month) in the second half of the year. All in all, therefore, it would seem advisable not to make necessary corrections in real wages straight-forwardly contingent (e.g., proportional) upon a nominal variable, inflation, whose precise course is under the circumstances highly uncertain. 1/

3. The Role of Structural Factors

The adverse output-price split experienced in 1990 is partly traceable to the uneven pace of reform. Some reforms are technically relatively easy to implement, e.g. the liberalization of prices and foreign trade. Others require totally new institutions, legal arrangements, work practices, economic structures, and attitudes. As is illustrated by the accompanying note on the reform process in East Germany, these are extremely difficult

---

1/ For instance, by making the cumulative fall in real wages subject to a maximum, as in the case of Czechoslovakia.

changes to make even in a case such as this one where the model of what is to be established already exists and massive assistance in institution building is at hand. Elsewhere in Central and Eastern Europe, the assistance is less and the new structures need to be elaborated and agreed upon from the ground up by newly democratic institutions grappling with unfamiliar issues.

The asynchronous and relatively sluggish pace of reform that is likely to result generates transitional inefficiencies. The general proposition is grounded in the theory of the second best which demonstrates that, under certain conditions, the removal of one of two rigidities can be welfare reducing. More concretely, price liberalization in Poland appears to have given vent to monopolistic forces that had previously been repressed by the mechanisms of central planning and were as yet not effectively checked by competition from alternative domestic or foreign sources of supply or by regulation. That is, public enterprises, which tend to be monopolies in Central and Eastern Europe, took advantage of the liberalization of prices to carry-out a one time increase in prices and reduction in output. The beneficial effects of trade liberalization can be similarly thwarted if steps are not taken to ensure that the distribution of imports is not monopolized because of, e.g., restrictive import licensing arrangements or the structure of the existing distribution system. Imbalances between the pace of liberalization and the formation of competitive market structures may well have contributed to the unfavorable price-output splits observed in 1990.

Delays in the clarification of property rights are also thought to have contributed to the costs of reform in 1990. These rights remain relatively ill-defined. This is particularly troublesome with respect to public or socially-owned enterprises, which often remain dominated by their workers' councils rather than by the "owners" or the managers charged to represent them. This may result in upward pressure on the wage bill--a source of inflationary impulse which, for a given financial environment, again tends to worsen the price-output split. The uncertainties attaching to property rights, and to privatization programs, also inhibit investment and the new, market generated supply responses that are a principal objective of the reform effort.

Inefficiencies do not, however, arise only from the difficulty of establishing new structures and institutions. They can also reflect a reluctance to carry-through with reforms. The problems raised by the soft budget constraint on public enterprises in Central and Eastern Europe has been known for some time. Indeed, with a view to hardening those constraints, governments have clarified the laws and procedures relating to bankruptcy. For the most part, however, these remain to be given effect. The closing of public enterprises has proven to be as politically difficult in Central and Eastern Europe as in the rest of the world. These and other structural shortcomings in these economies point to the likelihood that price-output splits may be relatively adverse for some time to come.

4. <u>A Regional Perspective on Output Developments</u>

The focus on the output losses associated with the 1990 programs in Central and Eastern Europe can make one lose sight of the fact that 1990 was a difficult year throughout the region. As shown in Table 2, every country experienced large declines in output. While declines had been widely expected, these had not generally been expected to be so large. As an antidote to ascribing too much significance to stabilization policies in this development, it is useful to review some of the wider systemic forces at play.

First, reform and the expectation of reform generate large changes in actual or expected relative prices, as well as heightened uncertainty. Either way, the result must be to induce a massive suspension of forward looking spending decisions be they for investment or for durable consumption. The exceptions would be items whose relative prices are expected to rise during the process of reform--e.g. previously subsidized staples or imports from the convertible currency area before the adjustment in the real exchange rate. Here, the process of reform is instead likely to induce an initial withholding of supply. Liberalization would also be expected to generate a marked downward adjustment in the demand for inventories as firms eliminated the over-stocking characteristic of CPEs.

Second, the change in relative prices induced by liberalization renders some of the output unmarketable. This phenomenon found its strongest expression in east Germany where industrial production was halved as the barriers to exchange with the West were eliminated. Elsewhere, the size of the output drop was smaller, presumably because in these cases it could be more easily controlled, e.g., through exchange rate based variations in real incomes and relative prices. Nevertheless, here also the change in relative prices must have rendered a significant part of the existing output uneconomic. Given that it is easier to cut the output of those products that are not in demand than to increase production of those that are, a further transitory cut in output is implied. It should also be noted that these declines in output do not have their usual economic connotations since no one wished to consume the outputs at a cost-covering price.

Third, economic and political developments in Central and Eastern Europe must have severely tested the performance of the central planning system. As the study on the Soviet Union has made clear, that system's reliance on detailed centralized meshing of inputs and outputs makes its performance susceptible to localized bottlenecks and disturbances. Given the extent of the upheavals in Central and Eastern Europe, a good part of the output declines of 1990 seem likely to be traceable to break-downs in the central planning system.

Fourth, a large, systematic, and more concrete source of disruption in 1990 was the contraction in CMEA trade (Table 2). This contraction appears to have been in part due to the decline in the USSR's exports to the region, be it because of disruptions to supply in the Soviet Union or to a decision

Table 2. Central and Eastern Europe: Changes in Output and CMEA Trade--1990
(annual changes, in percent, except where noted)

	Real GDP 1/	Industrial Output: 1990 over 1989 2/	Industrial Output: 1990-Q3 over 1989-Q3	CMEA Trade Volumes 3/: Exports	CMEA Trade Volumes 3/: Imports
Bulgaria	-11.3	-16	-13	-27	-18
Czechoslovakia	-3.5	-4	-5	-18	-4
East Germany	...	-28	-48	...	...
Hungary	-5.6	-10	-10	-27	-20
Poland	-12.5	-25	-20	15 4/	-32
Romania	-10.2	-15	-20	-37	-8
Yugoslavia	-7.5	-11	-10	-22	-21

1/ For Czechoslovakia: real NMP. For Yugoslavia: real GSP.
2/ For Hungary: based on data for January-November. For Yugoslavia: based on data for January-September.
3/ For Bulgaria and Romania: based on nominal data for trade in transferable rubles. For Czechoslovakia: based on data for trade with socialist countries. For Hungary: based on data for ruble-trade. For Yugoslavia: based on data for trade in nonconvertible currencies.
4/ The CMEA trade agreement for 1990 was not finalized until March of that year. The agreement's volume targets would have implied a significant reduction in Polish CMEA exports. However, in practice the export target was exceeded because the Polish authorities had issued export licenses during the first quarter of 1990 under the assumption that the agreement would allow exports to expand.

in that country to delay exports until after end-1990 when, in line with the announced reform of CMEA trade, these exports would earn considerably more convertible foreign exchange. Be this as it may, the reaction in some countries was to match shortfalls in imports from the Soviet Union with restrictions on exports to that country for fear that these might otherwise generate TR claims of doubtful value in 1991. This reluctance to accumulate non-marketable claims on each other's output must have had a fairly pervasive influence on the region's trade and output, even if it did have the silver lining of contributing to a marked shift in exports towards the convertible currency area.

Fifth, the manner in which the statistics are compiled suggests that they are likely to give undue weight to the traditional, socialized sectors that are contracting and little if any weight to the many activities that have arisen in their place. It is thus likely that the official statistics overstate the weakness of output.

Taken together, these factors--and the negative interactions among them--point to the likelihood of fairly massive reform-induced shifts in demand away from traditional domestic outputs. Indeed, it is these shifts together with the liberalization of trade and prices that generate the disequilibria that stabilization policies are meant to address. In this respect, the cross-country pattern of output declines in 1990 is noteworthy: in terms of GDP, double digit declines were experienced in Bulgaria, Poland, Romania and east Germany where reforms were of the big bang type or the disruptions unusually large; and declines in the 3½ to 7½ percent range were recorded in Czechoslovakia, Hungary and Yugoslavia, the countries where the approach to reform has been more gradual or with smaller initial domestic imbalances (Table 2). Needless to say, many other factors were at work: drought, an explosion in consumption after years of repression in Romania, etc. Nonetheless, it seems clear that reform, and the expectation of reform, exercised an independent but unavoidable negative impact on the output of the region in 1990.

5. Some Conclusions for Discussion

The programs were reasonably successful in their basic objective--to establish a relatively stable macroeconomic framework within which these countries might proceed effectively with the structural reforms necessary to transform their economies into functioning market economies. The programs were not, however, as successful as one might have hoped: structural factors loomed much larger than had been expected; there were significant slippages in the implementation of the programs; and, with reference to Poland in particular, the program was, in its very initial stages, more restrictive than intended.

The main--and preliminary--policy implications of the 1990 experience in Central and Eastern Europe would seem to be the following:

(1) One should not be too sanguine about the performance likely to be achieved under programs. The structural inadequacies of these economies in terms of missing or grossly inefficient markets, ill-defined property and legal rights, insufficient financial discipline on enterprises, and weak balance sheets, to name but a few, will take time to correct. The enthusiasm for structural reform in Central and Eastern Europe does not take away from the sheer magnitude of the task to be accomplished. In the meantime, the process of adjustment is likely to involve a weaker performance on inflation and output than in a fully fledged private enterprise economy. It is thus essential that programs continue to provide the social safety net necessary to help these countries through the transition.

(2) The more fundamental answer is to speed-up if at all possible the pace of reform notably in the direction of establishing more competitive and financially disciplined market structures. These are a sine qua non of an efficient market economy as well as of effective macro policies.

(3) In the meantime, stabilization programs can alleviate some of the adverse effects of structural deficiencies by being comprehensive. For instance, the use of multiple anchors and the reliance on both credit ceilings and an interest rate policy were helpful in making-up for deficiencies in markets in the Polish case. Administrative controls may however also be necessary in certain instances to keep non-competitive forces in check during the transition.

(4) The very large uncertainties associated with the price and trade liberalization process may lead both the staff and the authorities to err on the side of undue restraint in the design of the associated program. By the same token, this possible lesson from the Polish program should not lead one to err in the opposite direction at the expense of the objective of establishing financial stability. (Needless to say, the program with Czechoslovakia and those with Bulgaria and Romania about to be discussed by the Executive Board have sought to strike this balance.)

(5) The use of the exchange rate as an anchor proved very useful in the Polish and Yugoslav cases. It provided a clear nominal anchor in a situation of marked financial instability where monetary policy was difficult to set correctly and to implement. It should be noted, however, that certain aspects of these cases, notably the combination of marked financial instability and relatively comfortable reserve positions, limit their applicability. Moreover, the slippages observed in the Yugoslav program in particular make it clear that exchange rate anchors are not panacea--they are no stronger than the underlying wage, fiscal, and monetary anchors.