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On the Sequencing of Reforms in Eastern Europe

Prepared by Hans Genberg *

Authorized for Distribution by Bijan B. Aghevli

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Abstract

This paper discusses issues related to the sequencing of the reforms that are necessary to transform the economies in Eastern Europe into market economies. It is first argued that the transition path of these economies will be smoother and less costly if a clear statement of the ultimate goals of the reforms is made at the outset. Interdependence between different aspects of the reforms implies that an appropriate strategy is to move on a broad front from the very beginning of the transformation process dealing simultaneously with macroeconomic stabilization, price reforms and convertibility, and privatization of state enterprises. It is also argued that a rapid reform process is preferable to a gradual one.

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* Mr. Genberg is Professor of Economics at the Graduate Institute of International Studies in Geneva, Switzerland. This paper was written while he was a visiting scholar in the Research Department of the International Monetary Fund. He has benefitted from discussions with Bijan Aghevli and comments from participants in a Research Department seminar where a first draft of this paper was presented.

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Summary

Transforming Eastern European economies into market economies requires unprecedented reforms. After identifying the main features of these reforms, this paper analyses their sequencing, that is, whether an optimal ordering of their introduction can be discerned.

A clear statement about the intended end results of the reforms is indispensable for their success and to smooth the transition path. Not only do the final objectives of the reforms condition the nature of the required policies, but also private sector responses are more likely to reinforce government action if the ultimate objectives of the reforms are clearly understood.

The various aspects of the reforms are interdependent. Issues of macroeconomic stabilization, for instance, are not easily distinguished from structural reforms, nor is it always correct to propose, as is common in the context of developing countries, that the former should precede the latter. Similarly, price reform is ultimately linked to currency convertibility, and problems associated with privatization, decentralization, and enterprise management are interrelated.

This interdependence implies that a reform strategy should be as broadly based as possible. At a minimum, the first phase of a reform package should contain measures to achieve macroeconomic stabilization by removing open-ended subsidies to enterprises, price reform by introducing external convertibility to make the economy more competitive, and rapid but prudent privatization of state enterprises.

The paper also gives a number of reasons for preferring a rapid to a more gradual reform process. Finally, it recommends that in the early phase of the reforms a social safety net should be established to defuse opposition to the reforms.

I. Introduction

Economic reforms are currently being considered in Eastern Europe on a scale that is unprecedented. Socialist systems are being dismantled and market oriented structures are intended to take their place. The reforms needed to carry out this transformation are so numerous that they cannot administratively be introduced at once. Even if this were feasible, it has been suggested that the process of change must be spaced in time in order to limit disruptions during the transition period.

A challenge for economists in this context is to devise a sequence of reforms that will lead to the ultimate objective of a market economy in the most efficient manner. The purpose of this paper is to identify and analyze the principal issues relating to the design of such a sequence. The strategy is first to develop a set of criteria that can be used to compare alternative reform scenarios, then to identify those areas in which reforms are most urgently needed, and finally to analyze a number of competing views on the appropriate ordering of the required reforms. With this in mind, the next two sections take up some relatively general issues regarding reforms and their sequencing. Section II discusses the link between the ultimate aims of the reforms and the transition path. It is argued that a clear view about the aims can make the transition path smoother and the ultimate success of the whole process more likely. Section III identifies a number of criteria for evaluating alternative sequencing strategies, and looks briefly at what the evidence from economic liberalizations in developing countries appears to be telling us about sequencing. Issues more specific to the situation in Eastern Europe are taken up in Section IV. The major areas which urgently require reforms are identified, and sequencing issues are discussed taking each problem area separately. Section V takes a more global view by presenting and evaluating three relatively complete proposals from the literature. Based on the analysis in the paper, a case is finally made for a reform strategy that is broad-based and speedy. Concluding remarks are offered in Section VI.

It should be emphasized that the intention of the paper is to discuss the advantages and disadvantages of alternative reform strategies in relatively general terms and not to present a blueprint for reforms in any particular country. To do so would require paying more attention to the objectives and the initial conditions of that country than is possible here. This being said, the analysis in the paper is intended to establish a number of general principles that should be applicable to more detailed country-specific programs.

II. Where to Go and How to Get There

In discussions of reforms in Eastern Europe it is often asserted that "We know where we want to go, but not the best way to get there". This is meant to convey the idea that there is agreement on the desired end result of the process of economic reform, but not on the most appropriate

transition path. While it is true that the correct sequencing of reforms is not easy to determine, it also seems that the degree of consensus on the end result is exaggerated.

The reform process is supposed to lead to a "market-based economy", but the exact meaning of this term is not often clearly enunciated. It is for example possible to conceive of an economy where the means of production are state owned but where production and consumption decisions are decentralized and where prices of goods and factors are market determined. This is probably not what most people have in mind when they speak of a market-based economy. On the other hand, they do not have in mind a complete laissez-faire system either. In between it is possible to imagine a number of systems which can be called market based but which exhibit relatively large differences with respect to the involvement of the state in such areas as social security, health care, education, transportation, banking, research and development, international trade, etc. Western industrialized countries differ significantly from each other in many of these areas, so to the extent that the socialist economies of Eastern Europe are striving to adopt an economic system of that type, they are still left with a substantial degree of freedom in many areas. 1/

A clear understanding about what the end result of the economic reforms ought to be is important for the transition path for at least two reasons. The most obvious is that certain reforms will be conditioned by the nature of the final objective. Two examples suffice to make the point. Suppose it were decided that the telephone communication system in the country should be privately based. In this case it would seem important to make it possible for firms to invest in this industry early in the reform process rather than trying to upgrade the existing nationalized system before privatizing it. Similarly, if a particular distribution of income were among the final goals of the reforms, then this should be taken into account from the very beginning since it could influence the type of measures taken for instance in the tax area.

A second reason why it is important to be clear about the ultimate objectives of the reforms is that private sector responses are more likely to reinforce the reform process when there is less uncertainty about its final aims. 2/ If, for instance, it is quite clear that private ownership of land and capital will be encouraged and protected, then individuals are

1/ There are significant differences between the reforming countries regarding the ultimate goals of the reform process. Czechoslovakia, Hungary, Poland, and Yugoslavia seem to be the most committed to a Western-style market economy, whereas the objectives of Bulgaria, Rumania, and the Soviet Union are less transparent.

2/ One caveat to this statement should be mentioned. To the extent that some aspects of a reform are detrimental to certain groups, they might more easily organize political opposition to these measures if they are known with substantial lead time than if they are introduced as a surprise.

more likely to start up firms than if the final role of private enterprise in the economy is left vague.

In very general terms the objectives of the reforms of the socialist countries is to remove existing inefficiencies in their economies. It has become widely recognized that these inefficiencies stem in large part from the system of central planning. Previous reforms thus centered on measures aiming to decentralize economic decisions and making firms more autonomous. Elements of a market system were introduced in some countries (notably in Hungary and Yugoslavia), but private ownership of factors of production was never seriously contemplated. 1/ Attempts to establish a rational structure of prices and to make enterprise managers respond to price signals were predicated on the hope that the greater efficiency could be achieved if only prices were right. The underlying theoretical rationale was the neo-classical model with competitive goods and factor markets. In the event, the reforms that were undertaken did not prove successful. Some of the reasons that have been evoked for this failure are the absence of clear rewards (sanctions) for competence (incompetence) with regards to economic decisions, the administrative failure to establish a rational price system, the inefficient allocation of investment, and the trade system based on artificial specialization within the CMEA and severe barriers towards the rest of the world.

It can be argued that for an economic system to induce technical progress, growth, and efficiency, it is necessary not only that decisions are taken on the basis of competitive market prices. An additional critical ingredient is the owner-entrepreneur. 2/ If this is correct, then the failure of previous reforms in Eastern Europe can be explained by the fact that they excluded this essential element. It also follows that an important ingredient of the current restructuring process must be the creation of a substantial private enterprise sector in the socialist economies.

Although the previous discussion suggests a certain degree of freedom regarding some aspects of reforms, it has also identified a number of areas where changes are imperative. A list of the most obvious would include a greater room for private ownership of land and capital than is currently possible, decentralization of decision making concerning resource allocation, decentralized responsibility for the consequences of such decisions, greater reliance on market forces in the determination of prices, and greater integration of the economies with the rest of the world.

In order to achieve significant changes in each of these areas, a number of fundamental reforms have to be made in the way the socialist

1/ See Economic Commission for Europe (1990), (esp Chapter 5) for an excellent description of the evolution of the reform process.

2/ For forceful arguments emphasizing the importance of ownership, see Hinds (1990) and Kornai (1990).

economies are currently operating. Discussions about sequencing of reforms center on the order with which these reforms are undertaken. Why should this matter? It is possible to identify at least three reasons. First of all, it must be recognized that administratively it is impossible to carry out all changes immediately. Therefore, some distortions will remain in certain markets for some time. The general theory of second best then tells us that removing distortions elsewhere may lead to a reduction in welfare. The order in which markets are liberalized may influence the size of this welfare loss.

Even if reforms could be carried out very rapidly from an administrative point of view, it is not clear that this should be done if speeds of adjustment to the reforms in different markets are not the same. It has for instance been argued [Frenkel (1983)] that asset markets should be liberalized after goods markets in order not to create distortions during the slow adjustment process of the latter.

Finally it is possible that some reform sequences are more credible than others in the sense that they are more likely to be carried out in full rather than aborted in mid-stream. Such sequences are clearly to be preferred.

III. Criteria for Evaluating Alternative Sequencing Strategies

Economic reform programs can be thought of and evaluated as investment projects. Typically the costs of the programs are likely to be front-loaded, whereas the uncertain benefits will be realized only in the more or less distant future. Viewed in this way, comparisons of alternative strategies should take into account not only of static efficiency gains and of dynamic effects arising from adjustment costs but also of the implications of uncertainty for the performance of the program. In this section these issues are taken up under four headings; the sequential removal of distortions, income distribution and equity considerations, adjustment costs, the credibility/irreversibility/robustness of reforms. In each case examples will be given that illustrate how the sequencing of a reform program may influence its overall desirability.

1. Distortions and second-best analysis

The central idea of the theory of second-best is that the removal of only one of a number of existing distortion in an economy may not lead to a welfare improvement even though such a policy would in a sense constitute a move in the "right" direction. The reason is that the welfare cost of the remaining distortions may increase. It is easy to think of examples where this argument is likely to be important in the context of socialist economies. Suppose, for example, that central allocation of resources is abandoned in favor of decentralized decision making based on some enterprise profit criterion. Suppose also, however, that prices continue to be

centrally administered. In this case it is quite possible that the outcome is a less efficient allocation of resources from society's point of view. In other words, central allocation of resources, wasteful as it might be, may actually be superior to decentralization given the other existing distortion in the economy. The obvious lesson for sequencing is that price reform should be enacted before decentralization of decision making (enterprise reform).

A second example relates to the consequences of allowing some room for privately owned firms without having clearly defined property rights over socialized enterprises or binding performance criteria for the enterprise managers. Under such circumstances it is again possible that giving enterprises autonomy over resource allocation decisions (as opposed to centrally planned allocation) will be undesirable because it can lead to the observed phenomenon of spontaneous privatization. A manager of a socialized enterprise, perhaps in accord with the workers, sets up a private firm with the purpose of competing with the enterprise he is currently managing. He sells or leases the machines and inventories of this enterprise to his own firm for a very low price. The socialized firm will either go under or have to receive state subsidies to continue operations. In the former case the manager has simply taken over, for a very low price, the business that he previously managed for the state. In the second case, he is in the position first to invest the proceeds of the subsidy in the state enterprise and then proceed to transfer the investment goods to his own firm again. In both cases, decentralized decision making has not improved resource allocation. The reason is that property rights over the machines and inventories of state enterprises should have been defined clearly before allowing private ownership of firms and decentralized enterprise control.

Examples of this type can be multiplied. For instance, price liberalization without removing monopoly power of certain firms may be harmful, similarly for financial deregulation in the absence of bank supervision, or financial deregulation in the presence of distortions in goods markets. In all cases, the removal of some distortion or restriction opens up the possibility of private gains at the expense of the rest of society.

The general lesson to be learned from these examples is that it cannot automatically be assumed that every liberalization move will be beneficial for the economy. A proper sequence of reforms may help eliminate privately profitable but socially damaging side effects. The authorities should also be on the outlook for unintended effects after the reform has been adopted and stand ready to take action to correct errors before they get out of hand. 1/

1/ An example of such action is the response of the Polish authorities to so-called spontaneous privatizations mentioned above. After some of these had been exposed, much stricter control over the privatization process was introduced.

2. Adjustment costs

Suppose that it is socially costly to reallocate factors of production between different sectors of the economy. In and of itself this suggests that the sequence of reforms should be such as to avoid shifting resources back and forth between sectors. Consequently, price reform should right away be based on world prices rather than on some notion of domestic market clearing prices since the latter would not ensure that factors would move monotonically in the right direction. For the same reason, price reform should precede decentralization of decision making (and privatization). Furthermore, to the extent that liberalized credit markets facilitate movements of real resources, price reform should precede financial reform.

More generally, however, the sources of the costs of resource allocation should be determined and, if possible, removed. In socialist countries a very important source of this type is the fact that state enterprises traditionally provide a number of social services that in market economies are provided directly by the state or privately. This is the case for housing, social security, education and health to mention some of the most important. If leaving an employer implies a loss of entitlement to some or all of these services, the private cost of changing employer can indeed be substantial resulting in very little actual labor mobility. High on the agenda for reforms should therefore be a restructuring of the provision of such services so that they are independent of the location of employment.

3. Income distribution and equity considerations

One of the underlying goals of socialism is an equitable (if not equal) personal distribution of income. In an unfettered market economy there is no guarantee that this will come about. During the transition path some sectors of the economy will be scaled down or eliminated entirely. This implies that certain industry- or firm-specific human capital will become obsolete and that a number of jobs will disappear. The owners of the obsolete human capital and the holders of disappearing jobs will be hard hit in the reform process.

Under complete laissez-faire principles one might argue that the hardship is tough luck and that the individual has to bear the consequences of past economic decisions. This overlooks the point that the allocation of resources in a centrally planned socialist country is not a matter of personal decisions. The fact that a person happens to work in an activity which under the new rules is unprofitable was the result of decisions taken by the central planners in the past. Thus, just as it has been suggested that the capital stock in such an economy belongs to all citizens, a case can be made that the losses in human capital should also be socialized in

the reform process. This is one justification for the establishment of a social safety net. ^{1/}

Having argued that some form of social safety net may be justifiable does not imply that income distribution considerations should receive a large weight in the evaluation of alternative reform strategies. The possibility of becoming wealthy is presumably one of the driving forces behind a market-based capitalist economy. Removing this incentive by a substantial emphasis on income equality would be likely to reduce the aggregate gain from the reform effort.

How does the sequencing of reforms matter for the income distribution issues discussed here? The main point is that some form of social safety net should be part of reform strategies, and that it should be present from the start. Secondly, there may be a trade off between income distribution objectives and aggregate growth objectives in reforms, not only at the end of the process but equally importantly during the transition.

4. Credible, irreversible, and robust reforms

Uncertainty about the future may have important implications for the evaluation of alternative reform strategies. There are several reasons for this. First of all, decisions of economic agents are influenced by their expectations about the rules of the game that will prevail in the future. Reform strategies that are believed to be sustainable (credible strategies) are likely to elicit private sector responses that reinforce the reforms and conversely for strategies that are believed to be reversed. For instance, a price reform which is meant to improve the allocation of a country's resources will not elicit the required movement of factors of production if decision makers are uncertain about the permanence of the price reform. Similarly, a reduction in import controls may lead to a surge of imports and an external disequilibrium if there is a strong possibility that the controls will be reintroduced in the near future. Calvo (1989) analyzes a number of additional examples of incredible reforms and establishes the general proposition that imperfect credibility implies the existence of an intertemporal distortion. Second-best analysis then tells us that liberalization is not certain to be welfare improving. There are two possible reactions to this problem. One would be to structure the content of the reforms or their sequencing in such a way as to minimize the by-product distortions. The second possibility is to search for ways to increase the credibility of the reform package. This is related to the notion of irreversibility of a reform.

In an environment where reforms create short-term costs to individuals and society as a whole, there will be temptations to reverse or at least

^{1/} A case for such a safety net can also be made on the grounds that it makes the reform politically more palatable and therefore increases in credibility. See further below.

deviate from the initially charted course. This is the problem of time-inconsistency discussed in the monetary policy literature, and it arises because current policy makers can not easily precommit future governments to the chosen path of reforms. 1/ Even if a particular policy is in the long-run interest of the country, short-sightedness may induce a future policy maker to deviate from the initial reform program. By sequencing reforms in such a way as to make it costly to reverse decisions already taken, the credibility of the program may be enhanced.

Finally, the fact that the results of reforms will materialize mainly in the future means that the economic conditions prevailing then may have an important bearing on the performance of the strategy. A plan that performs well under a number of plausible states of the world seems preferable to one that is designed for only one specific scenario. This has been referred to as the requirement of robustness of reform sequences. 2/

5. Lessons from the literature

Efforts by a number of developing countries to liberalize their economies has given rise to a large literature attempting to evaluate their experiences. 3/ What lessons can be drawn from these attempts, and do they carry over to the East European context?

The first point emphasized by observers of liberalization attempts in developing countries is that macroeconomic stability is a prerequisite for liberalization. Excess demand pressures need to be brought down to moderate levels by the appropriate policies. 4/ Often the sources of inflationary pressures are to be found in government budget deficits. Stabilization policies should then be achieved by restrictive fiscal measures.

The suggestion that stabilization should be carried out before attempts to liberalize is based on two judgments; that high inflation reduces the information content in prices and therefore makes resource allocation decisions difficult, and that the external consequences of excessive domestic demand (current account deficits and/or rapid real exchange rate changes) will reduce the credibility of the liberalization measures.

1/ The vast literature on the time-consistency problem in the macroeconomic context started with Kydland and Prescott (1977). Examples of subsequent developments are Barro (1983), Barro and Gordon (1983), and Rogoff (1987).

2/ See Portes (1990), p. 12.

3/ Corbo and de Melo (1987) reviews that literature. The following discussion is heavily influenced by their analysis.

4/ What moderate means in practice is of course not easily determined, but Corbo and de Melo mention an inflation rate of less than 25 percent per annum.

The second main conclusion from the reforms in developing countries is that liberalization in goods markets should precede liberalization in financial markets. 1/ One reason for this is that asset prices would be distorted if they were determined in an economy with distorted prices of goods. Another reason relates to relaxing capital controls before or simultaneously with trade liberalization. The suggestion here is that such a sequence would bring about large capital flows with undesired consequences for the real exchange rate.

It is important that these lessons be retained when reform programs are developed for the Eastern European countries. But some additional critical factors need to be kept in mind. In particular, it may be difficult to distinguish between stabilization policies and structural reform measures in these economies. Furthermore, the fact that the socialist economies by definition have an extremely small private sector means that issues related to privatization and the management of public sector enterprises must be addressed. 2/ Both of these factors will be emphasized in the next section.

IV. Reforms in the Socialist Economies of Eastern Europe

1. If it is broken, fix it!

Any discussion of economic reforms must be based on a clear understanding of the problems that the reform is supposed to rectify. In the context of the Eastern European economies it is perhaps easier to enumerate sectors that function well rather than those in need of overhaul, so pervasive are the distortions. Nonetheless, the following discussion will regroup the difficulties most often mentioned in the recent literature under four headings: excess demand and shortage, price distortions, low productivity, and inadequate institutional infrastructure.

a. Excess demand and shortage

Excess demand appears to be a chronic problem facing socialist economies. It manifests itself in terms of generalized shortages of goods and rationing by queues on the one hand and by the expansion of a secondary

1/ Two additional points need to be made here. First, since the purpose of the reforms is to improve the allocation of domestic resources, it is of course necessary first to remove any existing obstacles to such movements. Second, financial liberalization should not be undertaken in the absence of a reliable supervisory system covering banks and other financial intermediaries. On the second point, see the evidence presented in Villanueva and Mirakhor (1990).

2/ This is not to suggest that these issues are completely absent in some developing countries that have attempted reforms. The distinction is a matter of degree but, especially with respect to the size of the public versus the private sectors, this may be decisive.

economy on the other. The proximate reasons for the excess demand have been large and growing government budget deficits financed by money creation, but the more fundamental causes can be traced to features of the central plans themselves and, after the emergence of some decentralization, to the functioning of the state-owned enterprises in these economies. Under central planning, excess demand at the consumer level tended to emerge because actual wage payments often exceeded the planned wage bill, and the planned wage bill was set high enough to ensure that all planned production would be sold. 1/ Excesses of costs over the value of sales were covered by the subsidies from the state.

With the advent of decentralized decisions by the state enterprises, the problem of immoderate wage payments and consequent excess demand was in large part the result of two factors: the lack of clearly specified property rights to the capital of the enterprises on the one hand, and the readiness of the government to cover operating deficits by subsidies in order to avoid bankruptcy on the other. These factors created incentives for excessive wage settlements since in effect the enterprises did not face a binding ex ante budget constraint. 2/

The above discussion implies that excess demand in the socialist economies is as much a structural problem as a stabilization problem, a point that will be important in the discussion of reforms.

b. Price distortions

One of the most frequently cited flaws of the socialist economies is their highly distorted price structure. As a result of central control, both the general level of prices and relative prices are far from those that would prevail in a market economy. The general price level is below that required for macroeconomic equilibrium due to the planners' tendency to "control" open inflation by holding prices constant for long periods of time. Relative prices do not necessarily reflect relative scarcities as in a properly functioning market economy. To the extent that they correspond to any logic at all, they are set to achieve other goals than a rational allocation of resources, mainly income distribution for consumers and subsidies to preferred industrial sectors.

A consequence of the distorted price level is the emergence of generalized excess demand and shortages referred to in the previous section. A once-for-all correction and subsequent maintenance of macroeconomic balance would be required to achieve the goal of aggregate price stability without direct controls.

1/ In addition, planned production targets of consumer goods were rarely met. See Ofer (1990) pp. 25-26.

2/ Janos Kornai has described this situation as one where enterprises operate with "soft" budget constraints.

The effects on the economy of disequilibrium relative prices are more complicated. In a completely centrally-planned environment, the production decisions by firms are determined by the physical plan both on the input and output sides, effectively removing any influence of relative costs and prices. In addition, since enterprises' ex post profits or losses are eliminated by adjustable taxes and subsidies, the price and cost structure have little bearing on their viability. In this sense, the resource allocation effects of the distorted relative price structure per se is relatively minor under strict central planning.

The gradual increase in the autonomy of enterprises observed in most of the countries concerned requires a change in this analysis. With greater autonomy, more decisions concerning input use and production will be made according to the signals given by relative prices and costs. There is thus the possibility that the allocation of resources will actually deteriorate as a result of decentralization, contrary to the expressed rationale for this policy. 1/

On the consumption side, the subsidies implied by the controlled price structure has two implications that merit emphasis. First, those who benefit from the subsidies will be reluctant to give them up making a price reform all the more difficult. Secondly, to the extent that artificially low prices means rationing, it is likely that a secondary market for the rationed goods will develop where those with privileged access to rations can capture scarcity rents. The two-tiered market is apt to lead to rent seeking behavior which is potentially highly profitable privately, but which is socially unproductive.

c. Low productivity

The growth rate of real output has been on a downward trend in Eastern Europe since the 1970s. 2/ An often cited reason for this development is the low and declining productivity of capital. While investment rates have traditionally been high, reflecting the emphasis placed by the authorities on growth, the return to this "extensive" approach to growth has declined. The reasons for this decline are certainly to be sought in many places, but a good case can be made that the lack of a capital market is one of the more

1/ One should be careful not to push this conclusion too forcefully. First of all, the central directives may themselves be highly distorted so that replacing them with decentralized production plans may be an improvement even if the latter are taken on the basis of distorted prices. Secondly, government purchases remain important in the socialist countries limiting considerably the overall autonomy of enterprises. Finally, since enterprises are typically not allowed to fail, losses (and profits) do not sanction their behavior. Ex post bargaining over subsidies and taxes continue to be important which limits the necessity to take price and cost signals into account even in a decentralized setting.

2/ See Economic Commission for Europe (1990).

important. The lack of a capital market is related to the minuscule size of the private sector in Eastern Europe, 1/ and to the absence of clearly defined property rights of the economies' capital stocks.

Hinds (1990) argues that the lack of ownership of a substantial portion of an economy's capital leads to inefficient investment projects since the benefits to sound decisions do not accrue to the managers of the projects to any significant degree. The absence of a capital market furthermore prevents the emergence of any objective measure of the value of a firm and therefore any readily available indication of where resources should be allocated.

The recommendations to privatize the socialist economies should be seen as a means to increase their productivity. The major gains should be expected from the increased efficiency of individual production units this is likely to bring, and especially from improved investment decisions. 2/

d. Inadequate institutional infrastructure

An advanced market economy is supported by an extensive infrastructure of legal, informational, administrative, and financial institutions. In a socialized centrally-planned economy most of these are not needed and therefore do not exist. For instance, corporate law and laws pertaining to property rights have no place in a completely centralized system. Likewise, financial markets that value risk and potential returns are replaced by planners. A corollary to the lack of institutions is the scarcity of personnel trained to operate in a market system based on private property and enterprise.

1/ In Poland, state-owned enterprises accounted for over 70 percent of total economic activity in 1989. In Hungary the comparable figure is over 90 percent. See Lee and Nellis (1990). Other socialist countries are likely to be even more dominated by state enterprises. Two caveats should be added to these statistics. The first is that the official manufacturing sector is likely to be even more concentrated in state sector than these numbers suggest since private sector activity is likely to be concentrated in agriculture (especially in Poland) and services. Secondly, the informal private economy is not covered by official statistics which implies an underestimate of the contribution of the private sector to overall economic activity although probably not to manufacturing.

2/ Hare (1990) asserts that the main benefits from economic reform are not likely to come from the static efficiency gains associated with the removal of price distortions. He refers to a study on Hungary by Zalai (1984) which in Hare's words concludes that "the static allocative effects of even large distortions are surprisingly small; hence reforms are only likely to be beneficial if they stimulate significant improvement in micro-level efficiency within most production units and/or if they result in superior investment decisions." Hare op. cit., page 586.

The state of the financial system in many East European countries is a good example of the need for institutional reform. Typically commercial banks are simply an extension of the Central Bank or the Finance Ministry. ^{1/} As such they are not set up to evaluate the commercial viability of loans they extend. They lack both the personnel experienced in carrying out such evaluations and the information necessary to do so, the latter due to the absence of standardized accounting practices for enterprises.

2. Major issues in the design of reforms

Each of the problems identified in the previous section can be solved only by more or less drastic reforms of the economic system. The end result of the reform process is fairly clear in each case, but the decisions concerning the transition path involve a number of thorny issues, economic as well as political. The main controversies will now be discussed taking one problem area at a time. In recognition of the fact that many of the reforms are interdependent, Section V attempts to take a more global view of the sequencing issues involved.

a. Stabilization vs. reform, a chicken-and-the-egg problem?

A standard recommendation from the literature on economic stabilization and reform in Latin America is that stabilization must precede measures to liberalize the economy. This conclusion is based on the idea that liberalization will magnify certain distortions in the economy if excess demand is allowed to persist or that unwanted side effects of the liberalizations call into question their sustainability.

The remedies to excess demand pressures obviously depend on their underlying causes. More often than not, however, these can be traced to excessive government deficits implying that radical spending cuts or tax increases are seen as necessary stabilization measures. Noticing large deficits in Eastern European countries has lead some observers to propose that elimination of government deficits should be a prerequisite for the launch of major reforms. Two considerations suggest that this advice may need to be qualified. First of all, there is always the risk that the perceived need to stabilize first will be taken as an excuse to postpone reforms indefinitely. ^{2/} To the extent that both stabilization and reforms involve some short-run costs to some parts of the population, the postponement of reforms may be used to marshal forces against their

^{1/} It bears re-emphasis that significant differences may exist between countries with respect to the structure of their financial system. The description here is intended to provide only a stylized account of some recurrent features of institutional weaknesses.

^{2/} A related issue is how small domestic imbalances need to be before "stability" is achieved. Clearly one would not want to define stability too stringently.

adoption. In terms of the discussion in Section III, this stabilization-reform sequence has a non-trivial probability of being reversed.

A second problem with the proposal to stabilize first is peculiar to the socialist countries. It has already been shown that their budget deficits are intimately linked to the functioning of their economies, especially to the widespread subsidization of industries necessary to keep them from having to shut down. The need for subsidies is in turn related to the "softness" of the budget constraints facing enterprises. In other words, stabilization, interpreted as removing the root causes of budget deficits, and certain economic reforms are one and the same. In Eastern Europe therefore, appropriate stabilization involves removing subsidies to enterprises and hardening their budget constraints. ^{1/} This involves a non-trivial change in regime under which the enterprises operate. In addition, if subsidies to enterprises are to be removed it is also necessary to rationalize the price structure unless resource allocation should deteriorate further. Rationalization of the price structure is in turn related to questions of external convertibility and tax reform. Clearly, stabilization in Eastern Europe cannot be divorced from significant reform, so it is not possible to design a satisfactory policy sequence in which stabilization comes first and substantial economic reforms later.

b. Price reform and currency convertibility

Price reform involves two distinct set of issues corresponding to the problems of the current price structure in the socialist economies; how to establish and maintain the correct price level on the one hand, and how to install and uphold an appropriate system of relative prices on the other.

Most observers agree that the system to strive for is one where domestic relative prices are linked to world market prices through an open non-distorted trade system. The price level would be tied down either by the adoption of a fixed exchange rate vis-a-vis a suitably chosen currency (or basket of currencies), or by monetary/fiscal policies pursuing a domestic inflation target independently of the rest of the world with a flexible exchange rate. Which of the two approaches to follow can be analyzed with reference to the literature on the choice between fixed and flexible exchange rates. The bulk of that literature has emphasized the short-run (business-cycle) stabilization properties of each system, and has concluded that the sources of shocks (especially whether they are real or monetary) determines which regime is best. More recently, the emphasis has shifted to issues of inflation control and policy credibility under alternative exchange-rate arrangements. Here conclusions are less clear-cut, but it has been suggested that a central bank which does not have

^{1/} A stabilization package that cuts back on government expenditures elsewhere without changing the subsidy system would probably be counterproductive.

a good record of inflation control may be able to "import" stability through a fixed exchange rate policy supported by the government at large. 1/

The recent reforms in Poland and Yugoslavia have taken the first route (convertibility at a fixed exchange rate), and have done so at the very outset of the reform process. In both cases it was also made quite clear that the fixed exchange rate part of the arrangement was introduced as a stabilization device intended to increase the credibility of the price reform.

The main alternative to the external convertibility method for price reform is to maintain fairly rigorous control on international trade for some time and to allow prices to be established at domestic market-clearing levels. 2/ The main argument in favor of this approach seems to be that a rapid adoption of world prices and convertibility may bring about substantial adjustment costs as certain industries become unprofitable and have to be liquidated. The counter-argument is that adjusting first to domestic market clearing prices and subsequently to world prices may involve greater total adjustment costs. Furthermore, opening the economy to foreign competition will decrease the power of domestic monopolies and put greater pressure on domestic producers to increase efficiency. Finally, uncertainty is likely to be reduced by adopting a relatively stable and known price structure. 3/

Of course, the effectiveness of an open trading system in providing a comprehensive relative price structure will depend on the openness of the economy. In this respect there are substantial differences between the East European countries. The greatest initial impact of external prices would probably occur in Poland, Czechoslovakia, Hungary, and Yugoslavia whereas prices in substantial segments of the Soviet economy would still be determined by local market forces.

1/ Genberg (1990) surveys the literature on both the stabilization and the credibility aspects of exchange rate policy.

2/ A third alternative can also be envisaged in which approximate equilibrium prices are first calculated and imposed by decree before domestic markets are liberalized. (See Leontief (1990).) The rationale for this proposal is that it would prevent potential instabilities as market mechanisms groped for the equilibrium. In view of the failure of central planning in general, it does not seem that this would prove to be an attractive method of price reform.

3/ Remember that the alternative is the set of relative prices that will eventually emerge as domestic markets clear. With relatively little experience with market mechanism, and with rapidly changing laws and regulations affecting domestic firms, it would seem difficult to predict where domestically determined prices would settle down and how they would evolve over time.

The legacy of trade relations within the CMEA creates its own problem for price reform. Even for the economies of the region that have large external sectors, the fact that specialization has been substantially influenced by CMEA agreements means that the adoption of world market prices as the norm will involve significant reallocation of resources. But this should not be taken to mean that an open trading system should not be adopted. On the contrary, without a comprehensive CMEA-wide agreement on a medium- to long-term price and trade reform, the uncertainty about trade relations within Eastern Europe is likely to be such that no investment and growth will be associated with CMEA trade. With the objective of creating an environment in which enterprises can make long-term investment decisions, there is little alternative than to move directly to a relative price structure based on world prices. ^{1/}

c. Privatization vs. decentralization

A thriving private sector based on private property is essential for the creation of economic growth. Incentives to introduce new products, search for new markets, initiate cost-reducing production techniques, etc. clearly depend on factors like the presence of competition between firms and individuals, on the existence of a price structure that transmits appropriate signals, and on an efficient banking system to mention only the most obvious. But these are merely enabling structures that will not be exploited unless individuals can reap the rewards from taking the appropriate decisions. Private ownership of firms and the possibility to benefit from increases in the value of the firms is necessary for these enabling factors to be fully utilized.

Some previous reforms in the socialist countries were based on the notion that decentralization of decision making while maintaining socialist ownership of factors of production could be designed so as to create the proper incentives for productivity and growth. Managers appointed by the state or by worker councils were supposed to maximize profit rather than other objectives thereby ensuring that appropriate decisions would be taken with respect to resource allocation and production methods. But the reforms left the property rights over the enterprises' capital stock either in the hands of the state or essentially undefined and they failed to a large extent for this reason. Nobody had a stake in the return to capital. Investment decisions were therefore poorly made and economic stagnation followed.

^{1/} Note that intra-CMEA trade is supposed to be based on world market prices as of 1991. Economic relations between republics within the Soviet Union appear to be moving in this direction as well. It has been reported that Russia and Lithuania has signed an economic cooperation treaty in which trade between the two republics will gradually be based on world-market prices.

To recognize the need for private property is one thing, but how to establish it in economies where the overwhelming part of the capital is public is quite another. Arguably the most important, as well as the most difficult, decision concerning reform sequencing concerns this topic.

There are two broad approaches to the privatization of an economy, one would be to encourage the private sector to grow while limiting investments severely in the state sector, and the other would in addition involve significant privatization of existing state enterprises. Each of these will be discussed in turn.

Arguments in favor of the gradual method of privatization have been presented in Murrell (1990b). ^{1/} Briefly stated, the basic approach is one which stresses the importance of organizations for the performance of economies. Enterprises are organizations that have evolved to accomplish certain goals. The most suitable organizational structure for a given environment evolves over time in competition with other structures. If the external environment changes radically, the "capital" embodied in existing structures will lose much of its value and the output of the organization will decline substantially.

Applying this argument to socialist economies, Murrell argues that a rapid change to a market-based economic system would wreak havoc among large numbers of state enterprises because they would not have any experience in operating in such an environment. It would take a long period of adjustment before new suitable organizational structures would evolve during which time there would be considerable economic losses. For this reason he proposes that the socialist countries should be split up into a private sector which would operate with a minimum number of constraints, and a state sector which would be strictly controlled in a centralized fashion. The private sector would be allowed and even encouraged to grow whereas the state sector would be phased out gradually by attrition.

Although this is not the place to evaluate this proposal in detail, it seems that it might face a severe credibility problem. How likely is it, for instance, that the private sector will be willing to expand and try to compete with the state sector when it is the stated goal to phase out the latter only gradually? In addition, how likely is it that the private sector will be allowed to compete on an equal footing with the state sector? If it is not, will the private sector be able to succeed? Based on the performance of state enterprises in the past, my judgement is that it would be very difficult to reduce the size of the state sector in this way. Many reasons, similar in nature to those that were used to argue in favor of the gradual approach to privatization in the first place, would probably be found why a given enterprise should be allowed to invest in new capacity and continue

^{1/} This paper is a by-products of Murrell (1990a). A brief summary of the arguments is contained in The World Bank (1990).

its operations. For this reason I have reservations about this approach to the growth of the private sector.

A more rapid strategy for privatization involves the transfer of existing state-owned enterprises into private hands at the same time as encouragement is given for the creation of new private enterprises. Many issues are involved in the analysis of privatization of existing enterprises. 1/ The following seem to be among the most important:

- Should enterprises be sold or given away?
- To the extent they are sold, how should prices be established?
- To what extent should foreign investors be allowed to buy domestic firms?
- Should the large state conglomerates be broken up before they are sold? How should the break-up be done?
- How should the management of the enterprises be chosen and monitored if ownership is distributed widely?

Space and time constraints make it impossible to deal adequately with these issues here. Only some fairly general remarks will be presented, concentrating on issues that seem most important in the initial design of a privatization strategy.

The choice between selling and giving away state-owned enterprises has been discussed mainly in terms of three underlying concerns; the income distribution consequences, the relation to stabilization efforts, and the creation of a widespread capitalist base in the countries. The income-distribution argument is based on the notion that state enterprises belong to society as a whole and should therefore be given away on a more or less equal basis to all members. Poor people would not be able to afford to buy shares in companies, and could thus not benefit from sales. While I would agree that all members of society should benefit from privatization, this implies giving enterprises away rather than selling them only if it is assumed that prices will necessarily be below the true value of the firms, or that the fiscal system can not be used to transfer the revenue of the sales in an equitable manner. At least the first of these conditions seems questionable.

Selling enterprises could support stabilization efforts in two respects, by eliminating any monetary overhang that might otherwise lead to inflation, and by enabling the government to retire outstanding debt, thereby reducing the interest component of government spending. In principle, both of these objective could be achieved by appropriate taxes, but administratively it may be easier to do it by means of sales of state enterprises.

1/ See Grosfeld (1990), Hinds (1990), Lee and Nellis (1990), Lipton and Sachs (1990), Vanous (1990) for recent analytical discussions about privatization in Eastern Europe.

The third argument which seems to favor outright transfers of state property relates to the creation of a widespread stake in a system of private property. The benefits of extensive ownership is said to be two-fold, it would make a larger percentage of the population concerned with the efficient functioning of the system, and it would make it more difficult to re-nationalize the enterprises should the authorities ever contemplate this. The credibility and irreversibility of the reform strategy would be enhanced on both accounts.

The upshot of this discussion seems to be that a combination of sale and transfer is desirable. The recent legislation in Poland covering privatization methods does indeed contain exactly this compromise. 1/

The degree to which foreign ownership should be allowed or encouraged is both important from an economic point of view and politically loaded. The economic argument is partly based on the foreign exchange receipts that would be generated by sales of domestic firms to foreign investors but, more importantly in my view, on the management expertise, access to new technology, and access foreign markets that could be associated with foreign ownership. The second and third of these could perhaps be acquired independently of foreign investments, but application of foreign management know-how probably requires foreign control of the enterprise. In view of the scarcity of local entrepreneurial experience this consideration argues in favor of quite liberal rules regarding foreign ownership of domestic firms. But it is exactly here that the political problem may be the greatest. During several decades, the idea of foreign ownership has been cast in very negative terms in Eastern Europe. 2/ To allow it on a massive scale may bring about a political backlash. Such a reaction is partly related to the fear that the price paid by foreign investors for domestic firms will systematically be too low, and that foreigners will make huge profits once the economies start growing rapidly. Whether or not such fears are well-founded, a potentially promising way out of the problem might be to design sales contracts and management incentives such that the host country will share in the gains from making the enterprise and the economy more

1/ This legislation was approved on July 13, 1990. According to Raphael (1990), the government will be "... awarding every adult Pole free 'privatization bonds' exchangeable for shares in the company of his or her choosing. Workers will be given preferential prices (at one-half market price) for up to 20 percent of their company's shares. To quell the fears of many Poles of foreign ownership, foreigners need official permission to purchase more than 10 percent of a company's shares. The transition process will be overseen by a newly created Ministry of Ownership Transformation."

2/ This is not to suggest that citizens of western countries are free from hostility towards foreign investors, but only that the dislike may be somewhat greater in socialist countries.

efficient. 1/ Options pricing theory could perhaps be used to this end. Care must however be taken to avoid restricting the size of the potential gains to the foreign investor too much lest he will decide not to invest at all in the country.

From the point of view of the sequencing of enterprise reform and privatization, an issue that is often raised is whether or not to restructure enterprises and make them profitable before they are sold. Two separate problems are involved here. The first concerns the break-up of the conglomerates that are so pervasive in Eastern Europe. As emphasized in Vanous (1990), such break-ups should not be done for their own sake but should be decided on economic grounds, preserving, when appropriate, economies of scale associated with large units. Otherwise the value of the firms will be reduced by the break-up. 2/ With regard to restructuring before selling, a major reservation would seem to be that the firms were unprofitable in the first place because they were managed by bureaucrats rather than entrepreneurs. To appoint other bureaucrats to restructure the firms does not seem likely to succeed. In addition, the whole privatization program would be held up for too long if one had to wait for the restructuring to have an effect.

d. Financial reform 3/

The financial sector has an important role to play in the transition to a market economy. Ideally it would ensure that credit is channeled to those sectors of the economy that are most profitable, and it would provide households with alternatives to money, foreign exchange and consumer durables in which to invest. As suggested in Corbett (1990), a well-functioning financial (especially commercial banking) system may also play a constructive role in monitoring and controlling managers. In view of these advantages, it would appear that financial liberalization should come fairly early in the sequence of reforms. Experience shows that financial systems that are dominated by the government are not likely to perform the above functions well.

But the lessons from liberalizations in developing countries must be kept in mind when similar reforms are contemplated in Eastern Europe. Villanueva and Mirakhor (1990) argue that experiences of a number of countries where financial liberalization has been a success support the conclusion that a strong system of bank supervision (in addition to

1/ Giving the government a state in the operations of foreign-controlled firms limits the risk that these firms will be discriminated against in domestic legislation, government contracts and the like.

2/ Vanous gives the example of a nationwide distribution company being broken down into regional units with an evident loss of scale economies.

3/ See Dooley and Mathieson (1987) for a thorough discussion of financial reform in developing countries which is also applicable to Eastern European countries.

macroeconomic stability) should be established before restrictions on financial markets are lifted. ^{1/} In view of the lack of personnel and information systems needed for a supervisory agency to function well, there is perhaps no alternative to retaining substantial central control over the financial systems in Eastern Europe for some time.

e. "Big bang" vs. gradualism

This is an issue which has received a lot of attention without generating much agreement. Part of the reason could be that economic analysis may not as yet have much to offer in the form of adequate models. Arguments often tend to proceed by metaphor: The fact that "You cannot cross a precipice in two jumps" is used to justify rapid across-the-board reforms whereas "One would not recommend a patient recovering from a heart bypass to run a marathon, a slow return to exercise would be better" is meant to suggest that gradualism is to be preferred. Both propositions seem reasonable in their own context, but they cannot simultaneously be correct in the context of economic reform strategies.

In my opinion a rather rapid pace of reforms is to be preferred. I base this judgment on three arguments of increasing order of importance. The first is that previous reform processes in Czechoslovakia and Hungary did not have much success arguably because they proceeded in a deliberately slow and cautious manner thereby failing to provide a momentum for growth. Secondly, I would dismiss the argument that a slow reform process could be planned so as to eliminate (or even reduce substantially) the adjustment costs inherent in changes as fundamental as those being considered in Eastern Europe. The difficulties in designing reform packages are such that one should expect significant disruptions in the economy even if the reforms are undertaken relatively slowly. Using the size of adjustment costs as a criterion, the choice between a rapid and a gradual reform process then comes down to a choice between an extended period of disruptions under a gradual adjustment program, compared to a shorter period of possibly somewhat greater disturbances under a big bang approach. It is not clear that the balance would tip towards the gradual approach. In fact, one might well imagine that it is easier to sustain a reform process in which the benefits start to exceed the costs relatively early compared to one in which there are no net benefits for an extended period of time. In addition, in situations where newly elected political leaders enjoy a limited period of *unquestioned confidence*, an economic shock treatment will have a greater probability of being accepted than a prolonged adjustment program.

The third reason for favoring a rapid reform process is based on the judgement that increased investment is essential for the resurgence of economic growth and the success of the adjustment programs in Eastern Europe. Decisions to embark on an invest project obviously depend on its

^{1/} Dooley and Mathieson, *op. cit.*, also emphasize the importance of supervision and regulation of financial intermediaries.

expected future profitability which in turn depends intimately on the prevailing economic "rules of the game". If there is uncertainty about these rules, a rational investor might well decide to postpone capital expenditures. The return to waiting may in other word be quite high when there is some doubt about future government policies and regulations. A gradual reform process is likely to foster such doubts since it is very difficult for a government to commit itself credibly to reforms that are intended to be implemented only in the more or less distant future. By introducing reforms quickly on the other hand, the authorities may be able to remove doubts about the nature of the future economic environment and thereby avoid postponement of investment decisions. Rapid reforms will thus encourage early implementation of investment projects whereas a gradual approach would do the contrary.

V. Examples of Comprehensive Reform Sequences

The design of a sequence of comprehensive economic reforms must obviously deal with the fact that reforms in different sectors are interdependent. It must also incorporate the criteria for evaluating alternative transition paths identified in Section III. Furthermore, the design would have to take account of the fact that the initial state of the economy is likely to matter for the choice of a transition path. Examples of the interdependence between reforms were given in the previous section of the paper. It was, for instance, argued that decisions on price reform, external convertibility, and the choice of exchange-rate system may have to be taken together. Likewise, fiscal stabilization, reform of enterprise management, and price reforms are connected. The benefits that one might expect from any one of the individual reforms may be substantially lower or even absent if the whole package is not adopted.

Comparing the costs associated with different aspects of a reform involves difficult judgements. How large is, for instance, the welfare loss due to transitional unemployment associated with rapid privatization and price liberalization based on external convertibility compared to the loss resulting from slower economic growth if firms initially remain under state ownership but management is decentralized? What is the impact on the credibility of a reform and hence on private sector initiatives of a transition path which relegates issues of property rights and privatization to the indefinite future compared to one which tackles these issues early? Questions of this type could be multiplied. To resolve them is complicated not only because the performance of the economy under the alternative scenarios has to be determined, but also because subjective value judgements have to be made on tradeoffs such as that between unemployment today and unemployment in the future. Differences of opinion on either of these problems could easily imply substantially different reform sequences.

The importance of initial conditions should not be underestimated. Contrast, for instance, two economies with distorted price structures and a

heavily controlled financial system. One of them has a substantial private sector and a relatively small number of unprofitable state enterprises, whereas the other is overwhelmingly dominated by the state sector. 1/ How should reform sequences differ between these countries? One might imagine that second-best arguments relating to the order of liberalization of goods and financial markets would dominate in the context of the first country, and that issues of privatization of the state enterprises would be relegated to later stages of the reform process. In the second country, on the other hand, the low productivity of the large state sector may be viewed as the most pressing problem and traditional second-best arguments as less critical. As a consequence, privatization would be placed earlier in the sequence of reforms than liberalization of goods and financial markets.

Other initial conditions that are often mentioned as being important include the popularity of the government that is introducing the reforms and the availability of external financing to ease the transition period. Poland is frequently given as an example where the government has enough support of the population that it can introduce radical reforms without fear of being overthrown. The governments of Czechoslovakia and especially the Soviet Union are said to face entirely different situations. Unemployment related to reforms introduced by the central Soviet government could, for instance, easily be used as a pretext of certain republics to withdraw from the union. 2/

1. Three examples from the recent literature

Equipped with the caution dictated by the preceding discussion, we now turn to some concrete proposals for transition paths in Eastern Europe. Many who write on the topic of reforms in these countries only deal implicitly with sequencing issues by the choice of sector they focus on. There are relatively few who put forth recommendations that can be called comprehensive. Fischer and Gelb (1990), Hinds (1990), and Nuti (1990) are three such examples and their proposals are summarized in Figures 1, 2, and 3, respectively. 3/ The next part of this section will examine these propositions with the aim to identify the essence and the analytical justification of each, and to explain the reasons for similarities and differences between them.

1/ The examples are chosen in an attempt to illustrate the differences between what might be most important in Latin America on the one hand and Eastern Europe on the other.

2/ One might speculate that a suitable sequence of reforms in the Soviet Union would start by giving the individual republics more political and economic autonomy. This would provide the local governments with a "honeymoon" period within which drastic reforms could be introduced with less risks of creating political opposition.

3/ Many other proposals can certainly be found. These three were singled out to illustrate some significant differences in recommendations that they represent.

Figure 1
Proposal by Fischer and Gelb (1990)

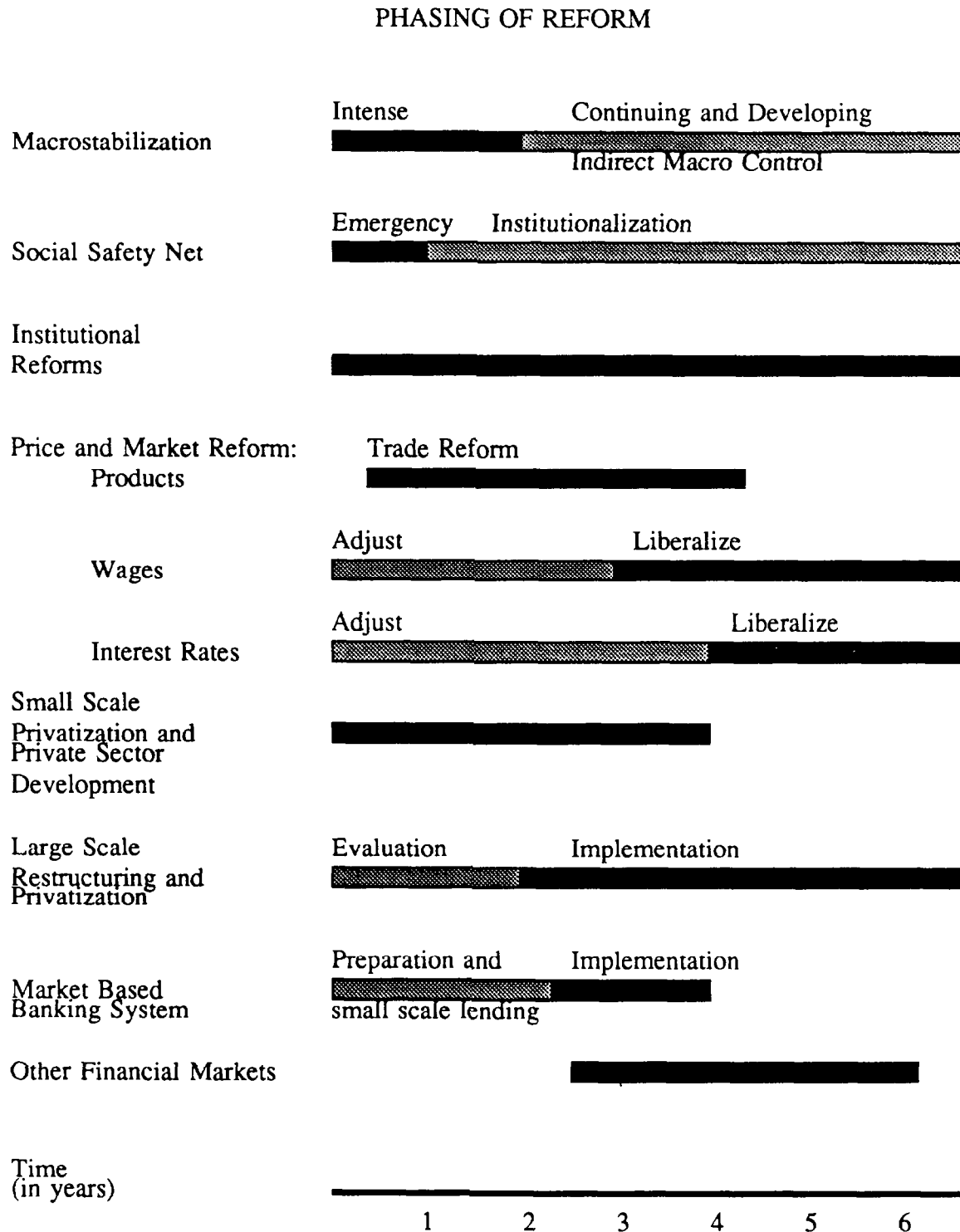


Figure 2
Proposal by Hinds (1990)

SEQUENCING OF REFORMS
AND STABILIZATION

	PHASE I Preparation	PHASE II Privatization	PHASE III Financial Discipline	PHASE IV Privatization of banks
ENTERPRISES	Holdings created. Downsizing	Giving away enterprises. Creating new management systems for socialized.	Bankruptcies Restructuring	
PRICES	CONTROLLED		LIBERALIZED	
INTEREST	CONTROLLED		CONTROLLED LIBERALIZED	
BANKS	STATE-OWNED		STATE-OWNED Writeoffs Recapitaliza- tion	PRIVATIZED
BUDGET	SURPLUS		DECLINING SURPLUS	BALANCED
MONETARY POLICY	RESTRECTIVE		NOMINAL ANCHORS	ACCORDING TO DEMAND

↑

BIG BANG

Figure 3
Proposal by Nuti (1990)

"From the arguments developed above a tentative possible sequencing pattern emerges. First monetary restraint and budgetary discipline must be placed in position, strengthened by a wages and prices policy preferably enshrined in a social pact, with some indexation guaranteeing living standards stability in exchange for their moderation. Second, market clearing balances must be obtained in existing markets, whether through supply effects (presumed modest if any), net imports (possibly with international assistance) of the issue of bonds (non-indexed) without a premature privatization of state assets. Third, competitive conditions must be ensured, not only in the output market but also in access to the existing capital stock, with compulsory surrender of assets by current users if others can employ those means more productively and bid more for their use. Fourth, the redistributive function of the state budget must be abolished; the residual nature of entrepreneurial income must be guaranteed; enterprise and product subsidies are to be replaced by income subsidies to alleviate adverse distribution effects. Fifth, the hierarchical link between enterprises and central administration must be cut, through leasings, state holdings and privatization. Sixth, exposure to international trade signals and pressures, up to this point present but mediated through central planning structures, can be gradually increased; it is essential that the exchange rate should be unified in order to avoid trade distortions which might result in very low (or even negative) value added of trade operations. Last, full-fledged convertibility may be attempted."

[Nuti(1990), p. 24.]

Fischer and Gelb emphasize that the starting point of the economy is important for the reform path and state that they have in mind a country "with initial conditions somewhere between those of Poland and Czechoslovakia". They emphasize macroeconomic stabilization as the most urgent task in the reform strategy. This is to be done by tightening of credit granted to enterprises. The creation of a social safety net is also envisaged from the very beginning since it is expected that the stabilization efforts will lead to transitory unemployment. Soon after the program is launched, Fischer and Gelb see the need for price reform based on world prices through an "essentially unrestricted access to foreign exchange for current account transactions". Enterprise reform is seen to be introduced on a substantial scale only after two years at the end of a period of preparation. 1/ Whether restructuring should precede privatization or vice versa depends on the size and shape of the enterprises. The authors recommend that large and weak enterprises should be restructured by the state before they are privatized whereas strong ones could be privatized more rapidly. Wages are to be controlled until a substantial number of firms are privately owned and managed because experience has shown that market-determined wages do not coexist well with socially owned and managed enterprises. Reform of financial markets, including decontrol of interest rates, should start with the banking system but is envisaged to occur only at the later stages of the strategy.

The sequence recommended by Fischer and Gelb is based on the lessons drawn from reforms in developing countries; stabilize first, then liberalize goods markets, and leave financial liberalization until the end. Privatization is seen as important at some stage, but a process that does not have to be started on a large scale early in the program.

The reform strategy proposed by Hinds contains some important differences compared to that of Fischer and Gelb, the main one being the role of privatization. 2/ As already noted, Hinds views the creation of a sizable private sector as a sine qua non of a successful reform strategy. As a consequence, he places privatization of state-owned enterprises first in the sequence together with monetary and fiscal measures to stabilize the economy. 3/ Hinds does not recommend price liberalization until a large fraction of enterprises are in private hands. Price liberalization itself should, as in the Fischer-Gelb proposal, be linked to trade reform. Finally, financial reform and liberalization would again come towards the end of the process.

1/ The authors emphasize that the time scale is more indicative of the sequence of the reforms rather than their exact timing.

2/ Note that Hinds too has in mind a prototype economy in which there is excess demand but not to the point of causing hyperinflation.

3/ The fiscal stabilization would initially involve measures other than the removal of enterprise subsidies which would be eliminated only after privatization.

The reason for the different sequences recommended by Fischer-Gelb and Hinds can be found in different assessment as to the importance of private property and a sizable privately-owned enterprise sector for the transition path itself. ^{1/} Hinds argues that one of the main lessons from previous attempts at reform in Eastern Europe is that "... decentralized socialism does not seem to work." It is the underlying cause of macroeconomic instability as well as slow growth in these countries. For this reason he sees rapid privatization as a priority. Fischer and Gelb put more emphasis on resource misallocation and hence argue that price reform is the most urgent. They also view the privatization process as one where enterprises should be performing relatively well before they are privatized, whereas Hinds would leave the restructuring to the private sector.

The early part of the sequence of reforms favored by Nuti puts primary emphasis on stabilization. By this he means not only fiscal and monetary restraint, but also price reform. In this sense it is similar to the suggestions by Fischer and Gelb. But the price reform advocated by Nuti is less firmly anchored in an open trade regime which is envisaged only at a later stage. Instead, prices are to be determined at level that are expected to clear domestic markets with a controlled volume of imports and exports. An end to enterprise subsidies is not envisaged during the stabilization stage of the reforms. It comes after competition has been established on domestic goods and factor markets, and is followed by enterprise reform and privatization.

The underlying philosophy of Nuti's strategy is that competitive conditions on domestic markets must be established before substantial liberalization of external trade and before enterprise reforms and privatization. Otherwise these reforms would make stabilization efforts difficult and bring about unnecessarily large losses in output and employment. This view is in contrast with that of Fischer and Gelb who regard external liberalization as the best way to introduce competition in domestic markets. It is also in contrast with the view of Hinds who sees privatization as necessary for the creation of an incentive structure conducive to domestic economic adjustment.

2. A case for broad-based and rapid reforms

In view of the drastic changes in behavior that will be required from economic agents as an economy is transformed from a socialist to a market-based structure, it must be made clear from the very beginning of a reform process that a new economic regime is being introduced. This will make it more likely that the behavior of the private sector will reinforce the reform process which in turn increases its credibility. It is therefore important to structure reforms such that they give an early indication that major changes are being introduced. Emphasis should be put on measures that

^{1/} There is no disagreement concerning the role of the private sector in the fully reformed economy.

demonstrate clearly the direction of the reforms and that are difficult to reverse.

These criteria, and the fact that certain reform measures are interdependent, suggest that the authorities should take bold steps and move on a fairly broad front right from the early stages of the reform process. In other words, they should move rapidly on all elements that are placed in the beginning of the three proposals we have just examined: stabilization based on removal of open-ended state subsidies to enterprises, price reform based on external convertibility to induce greater competition in the economy, and rapid but prudent privatization of state enterprises. The justification for starting with these measures will be presented very briefly since many of the arguments have already been developed earlier.

Macroeconomic stabilization should be placed at the beginning of the reform sequence with the proviso that the policies introduced include the elimination of the principal causes of fiscal imbalances, namely the easy credits and subsidies given by the government to state enterprises. ^{1/} The rationale for this is twofold. The first is that the persistence of macroeconomic imbalances will make it less likely that subsequent reforms will be successful and hence reduce the credibility of the reforms. The second is that removal of easy credits and subsidies eliminates one of the major features of the old system and gives a clear signal that rules have changed.

Simultaneously with, or very shortly after stabilization policies have been started, two other measures that signal the transformation to a market economy should be introduced: a market based price system based on competition and private ownership of factors of production. The simplest way to introduce a price system which is rational and which simultaneously introduces competitive forces into the economy is to adopt an open trade regime. The alternative of trying to establish market clearing prices depending on domestic demand and supply combined with restricted foreign trade has several disadvantages. First, it would have to deal with the problem of domestic monopolies lest they exert their power in a liberalized system. Secondly, it would be more uncertain in the sense that domestic market clearing prices would undoubtedly be found only after considerable trial and error. Finally, price changes would be viewed more as a consequence of government action and hence be likely to lead to political lobbying.

The second important component of this early phase of the reforms would be the encouragement of private property and private sector enterprises by the removal of restrictions on the creation of new private firms, and by an early implementation of privatization of state enterprises.

^{1/} Another important component of the initial stabilization program is some form of wage restraint. See Kornai (1990) and Lipton and Sachs (1990).

Privatization is meant to accomplish two objectives. It would first of all give a clear indication that the government is serious about reducing its role in the enterprise sector. This could decrease the number of demands for subsidies, easy terms on credits, and other special favors. In this way privatization would support the stabilization aspects of the reform and increase the credibility of the entire program. Secondly it would create a vested interest among the private sector in maintaining the newly acquired property rights, making the reform more difficult to reverse. Finally, to the extent that it is easier to find competent and independent (from the political process) managers for privately owned firms, the early implementation of privatization would increase efficiency in the economy, certainly in the medium- to long run but possibly also in the shorter run.

Since the implementation of a privatization program will require some time, it is indispensable to keep close control on the remaining state-owned enterprises to ensure that they do not continue to operate as if the old system were still in effect.

Finally, the early phase of the reforms should include the establishment of a social safety net to defuse opposition to the reforms.

Later stages of the transformation of the economy must of course deal with the whole host of other areas that need restructuring such as the tax system, commercial banking and other financial markets, health and social security, etc. The appropriate sequencing of reforms in these areas will probably depend on the outcome of the initial phase, and it may indeed present itself naturally as events unfold. In any case, my suspicion is that the most important task of a reform sequence is to start the process off rapidly in the right direction with the appropriate initial steps.

VI. Concluding Remarks

The preceding discussion has been quite general. In order to be applicable to a specific situation, each element of the reform proposals would have to be refined. In some areas, such as the stabilization and the trade-liberation cum price-reform aspects, there are experiences from other countries that may be looked at for advice. But with respect to the privatization of the economy, the reformers in Eastern Europe will be breaking new ground, at least if they decide to opt for large-scale transfers (by free distribution or by sale) of state-owned enterprises to the private sector. Experiences from other countries that have privatized parts of their state sectors may not be applicable because of the sheer size of the undertaking being proposed in Eastern Europe. A careful identification and analysis of the alternatives available to the governments would seem to be an urgent task for research.

Another area where more analysis is needed concerns enterprise management. An important aspect of privatization, in some sense perhaps the crucial aspect, is how to select the management of the privatized firms and how to make sure that they act in the interest of the new owners. Unless this question is solved satisfactorily, there is no guarantee that the privatization efforts will bear the intended fruit of increased efficiency and growth.

Even a determined effort to privatize rapidly is not going to eliminate state enterprises overnight. The authorities will therefore have to find ways to operate these enterprises profitable, or at least with minimal losses. Part of the solution to this problem is surely to exercise strict control on the credit they receive either through the budget and through the state-run banking system. It should also be expected that a significant number of the enterprises will have to be liquidated. Great pressures will certainly be exerted on the government to resist such solutions if the resulting unemployment starts to grow significantly. Whether the ultimate goals of the reform program will be reached or not will be influenced by the ability of the government to withstand such pressures.

Finally it should be realized that an economic transformation of the scale contemplated in Eastern Europe and the Soviet Union will entail some transitory costs. It is illusory to believe that there exists a reform sequence that will not lead to temporary disruptions. Recognizing this makes it possible to focus the debate about alternative strategies on the tradeoffs implicit in choosing one proposal over another, because if the analysis in this paper is correct, it is indeed possible to identify schemes that are less disruptive and more conducive to growth than others.

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