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Establishing Incentive Structures and Planning  
Agencies That Support Market-Oriented Transformations

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Abstract

This note addresses various types of incentives that must be established before a market economy can function effectively. It also argues that the enormous challenge of restructuring large industrial enterprises or reabsorbing their workers, while appropriately based on market signals, cannot be accomplished by the market alone. Some type of planning will eventually be required. Ideally, such planning should receive high priority from the outset with clear recognition that durable macroeconomic stabilization will be very difficult to achieve in a democratic political system until the large state enterprises have been successfully transformed or their workers reabsorbed.

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1/ The analysis and opinions are those of the authors and do not necessarily reflect the views of the International Monetary Fund or other members of its staff. We gratefully acknowledge, without implicating, Donald Mathieson, Peter Wickham, and Leif Hansen for comments on a previous draft.

<u>Contents</u>	<u>Page</u>
I. Introduction	1
II. Incentives to Manage Scarce Resources Appropriately	1
III. Conditions for Credit Allocation Mechanisms to Function Effectively	2
IV. Incentives to Accept Financial Payments for Goods and Services	5
V. Incentives for Residents to Hold Domestic Financial Assets	6
VI. Incentives for Nonresidents to Provide Capital Inflows	9
VII. Restructuring Large Enterprises and the Case for a Planning Agency	10
References	13

## I. Introduction

One purpose of this note is to address the types of incentives that must be established before a market economy can function effectively. These incentives, which are often taken for granted in industrialized market economies, are created by the structure of employment contracts, banking regulations, bankruptcy laws, and many other pieces of "the woodwork" that typically receive little attention in discussions of macroeconomic policy design. Unless similar incentives are firmly embedded in the new institutional infrastructure of the previously centrally-planned economies that are now undertaking market-oriented transformations, it is hard to imagine how the transformation efforts can lead anywhere but to severe economic hardship (both high unemployment and high inflation) and political instability.

A second purpose of the note is to argue that the enormous challenge of restructuring large industrial enterprises or reabsorbing their workers, while appropriately based on market signals, cannot be accomplished by the market alone. The authorities will eventually be forced to undertake some type of planning in this area. Ideally, such planning should receive high priority from the outset, with clear recognition that durable macroeconomic stabilization will be very difficult to achieve in a democratic political system until the large state enterprises have been successfully transformed or their workers successfully reabsorbed into other parts of the economy.

The discussion below is organized as follows. Section II addresses incentives to manage scarce resources appropriately. Section III discusses the conditions that are necessary for credit allocation mechanisms to function effectively. Section IV analyzes the requirements for a well functioning financial payments system for settling transactions among the former CMEA countries and the Soviet republics. Sections V and VI discuss the incentives for residents to hold domestic financial assets and for nonresidents to provide capital inflows. Section VII discusses the challenge of restructuring large industrial enterprises, including its fiscal implications, and the case for a planning agency.

## II. Incentives to Manage Scarce Resources Appropriately

The most distinguishing feature of a market economy is its reliance on a system of uncontrolled prices to coordinate the behavior of many separate economic units. Relative prices are left free to adjust as necessary to equilibrate supplies and demands, and the information they convey provides an efficient guide for production and investment decisions. 1/

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1/ Efficient allocation requires that the relative prices faced by decentralized decision makers accurately reflect the relative shadow prices to society. In the presence of externalities or "noneconomic objectives," there may be a case for appropriate controls on some relative prices.

The benefits of a market price system will not be realized, however, if economic units do not have adequate incentives to rely on relative prices in making their allocational decisions. Unless decision makers perceive that reliance on relative prices can be expected to increase their individual standards of living, the price adjustment mechanism will not function appropriately, and scarce resources will not be allocated efficiently.

One of the key areas in which appropriate incentives must be established is in the management of state enterprises during the period before privatization takes place. Historically, these enterprises have operated with "soft budget constraints," 1/ under which financial losses have been routinely covered or disguised by subsidies, tax concessions, or credits from the state. To break the mentality of soft budget constraints, and to establish financial discipline based on market prices, "employment contracts" must be established that link the remuneration of managers and workers elastically to the financial performance of the enterprises. 2/ Managers and workers must be made to perceive that they face significant losses if they ignore the information provided by relative prices. 3/ At the same time, if popular support for the transformation process is to be maintained, the macroeconomic reform program must make it feasible for managers and workers, acting in response to market signals, to avoid sharp declines in living standards in the short run and to raise their living standards gradually over time. Successful behavioral modification requires that bad performers incur losses, but also that most participants in the economy have incentives to support an ongoing transformation process.

### III. Conditions for Credit Allocation Mechanisms to Function Effectively

Another key area in which appropriate incentive structures are crucial is in the operation of credit allocation mechanisms. A well known economic theorist has concluded that capital markets are like bumble bees. Engineers can prove that bumble bees do not meet the minimum requirements for flight. Finance experts can show that financial markets do not provide the minimum level of information and trust required for savers to set their wealth adrift in a capital market.

Bumble bees do fly and capital markets in a few industrial countries do work most of the time. But trying to transplant a modern capital market into a transforming economy in Eastern Europe (or developing countries more generally) may be exceedingly difficult. Equally important, trying to

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1/ Kornai (1979).

2/ Financial performance, of course, must be carefully measured, with appropriate valuation of inventories and other forms of capital.

3/ Managers must also be prevented from exploiting their positions in undesirable ways, perhaps by placing them under the scrutiny of boards of directors or planning agencies. See Sachs (1991).

control the growth of money and credit with tools that work in a few industrial countries can lead to very poor macroeconomic performance.

The weakest link in a reform program is likely to hide in the balance sheets of the banking system. The basic problem is that the incentive structure that keeps credit markets working most of the time in industrial countries is generally missing in an economy in transition. The missing element is so basic it seems trivial. It is that at every point of a chain of financial intermediation there must be strong economic incentives for participants to satisfy their contractual obligations, even when doing so incurs losses. In the absence of effective nonfinancial punishment mechanisms, performance is only assured if each participant has a positive net worth that a counterparty can appropriate as a penalty for nonperformance. Moreover, counterparties must be able to monitor both the assets of participants and other claims on those assets.

Participants in credit markets often invest in reputation in order to maintain the trust of others. But a shorthand summary of recent experience in industrial countries is that any hole in a system of accountability attracts individuals for whom reputation is less important than a fast dollar. Thus, accountability requires in practice that each participant maintain a positive net worth in order to take a position in the capital markets.

This fundamental criterion for participation in a capital market is not met by a large number of nonfinancial enterprises and banks in an economy in transition. 1/ Almost by definition, the large change in relative prices that are the centerpiece of a move toward a market economy will make many existing firms insolvent. Moreover, banks and other firms will inherit a stock of claims on the insolvent firms that are worthless.

It is hard to imagine conditions that create a worse incentive structure for a private capital market. The managers or owners of the insolvent firms have every incentive to cover operating losses by borrowing from the banks. The banks should say no to these requests, but banks that are already insolvent have nothing to lose by carrying the firm with new credit. Moreover, the new loans allow the banks to carry existing credits to insolvent firms at full value. The regulatory authority is faced with the uncomfortable choice of either turning a blind eye or acting as lender of last resort and guaranteeing the value of the banking system's liabilities, at considerable cost to the government.

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1/ Interenterprise credits are extensive in these economies, perhaps more so than credits extended from banks to nonfinancial enterprises. Moreover, many of the private commercial banks that are emerging draw their capital and deposits primarily from nonfinancial firms rather than households and should thus be regarded as new mechanisms for interenterprise credit extensions--and equally as unsupervised potential sources of financial crises.

As painful as financial restructuring is likely to be, it will ultimately be necessary. One important cost of delaying actions to clean up the balance sheets of banks and nonbank state enterprises is that market-oriented monetary control mechanisms will not curb the inflationary growth of money and credit in a situation with insolvent firms. Again the point is a simple one that typically receives little attention in discussions of macroeconomic policy design. Any type of market-oriented credit rationing system depends on the system's intolerance for insolvent players. Suppose, for example, that the government attempts to restrict the growth of credit by maintaining positive and, by historical standards, high real interest rates on bank credit. A natural reaction of solvent firms is to withdraw from credit markets. Insolvent firms will be less intimidated. In fact, at very high real rates only insolvent firms will show up at the bank for additional credit. In this extreme case the banking system is implicitly insured by the government. Raising interest rates further may actually increase the rate of monetary expansion. The only way to stop this process is for the government to administratively exclude the insolvent firms and banks from the credit markets. 1/

These perspectives underscore the importance of cleaning up the balance sheets of banks and nonbank state enterprises at an early stage in the transformation process, and of somehow insuring that all intermediaries and ultimate borrowers in domestic financial markets have something to lose. In some cases the latter objective can be achieved by endowing intermediaries and ultimate borrowers with equalization claims on the public sector in connection with a monetary reform process. 2/

The above considerations also point to the danger of rationing credit on the basis of market interest rates alone. To avoid a high incidence of default, an effective credit allocation mechanism requires careful ex ante evaluation of prospective borrowers, which in turn requires access to meaningful information about their balance sheets and cash flow prospects. Accordingly, while indirect control over market interest rates can be relied upon to drive away some credit applicants, 3/ market interest rates should only be pushed up to a level that still leaves a reasonably large excess demand for credit, thereby providing adequate scope for screening out high risk borrowers via creditworthiness evaluations.

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1/ The irony of this argument should be evident. Although we are among the greatest fans of the power of markets to help these countries join the rest of the world in the benefits of market-oriented institutions, we start out by emphasizing the nonmarket institutional structure upon which markets depend. See McKinnon (1991) for a financial reform proposal that addresses these issues.

2/ See Calvo and Coricelli (1991), who use the term "debt socialization" to refer to the process in which the government "capitalizes" various sectors of the economy.

3/ Direct controls, such as interest rate ceilings, are easily circumvented and should not be relied upon.

demand for credit, thereby providing adequate scope for screening out high risk borrowers via creditworthiness evaluations.

#### IV. Incentives to Accept Financial Payments for Goods and Services

The former centrally-planned economies of Eastern and Central Europe, including the newly independent Baltic republics, are launching their market-oriented transformation efforts with industrial structures that are highly specialized and heavily dependent on each other as sources of inputs and markets for output. The specific physical characteristics of intermediate products, as well as quality characteristics, limit the extent to which producers can shift in the short run to new sources of inputs, or find new markets for outputs. In this context, a significant part of the output losses of the former CMEA countries over the past year has been associated with a curtailment of purchases by the Soviet Union. Similarly, real activity levels in the individual Soviet republics depend very heavily in the short run on maintaining trade with other republics. Currently there are reports of widespread production cutbacks attributed to input shortages associated with the refusal of republics to export goods to other republics.

To a large extent the drying up of interrepublican and inter-CMEA trade appears to be associated with shortages of hard currency reserves and the lack of a workable financial payments mechanism that is not heavily dependent on hard currency. Barter transactions continue to take place when they can be arranged, but exports of goods in exchange for financial means of payment have reportedly been sharply curtailed.

This problem needs to be addressed with urgency if recent output losses in the Soviet republics and other former CMEA countries are to be reversed and a deeper output collapse averted. Enterprises throughout the Soviet republics and former CMEA countries need to have recourse to a payments instrument--either pieces of paper or accounting entries, guaranteed by a credible institution, and backed with hard currency--that they can use to purchase imports from others, and that they are willing to accept in payment for exports. A net settlements mechanism (perhaps, but not necessarily, involving a formal payments union) could greatly economize on the amount of hard currency that would actually be required for settlements, but only if enterprises are willing to accept the payment guarantees of whatever institution stands behind the system.

In market economies where there is general confidence in private financial institutions, international payments are often made with bankers' acceptances. The exporter is willing to accept payment from an importer when a reputable bank guarantees that it will deliver funds for the importer.

By contrast, there currently appears to be no private or government institution within the former Soviet Union or other former CMEA countries

whose payment guarantees are widely acceptable in other countries or Soviet republics. The problem appears to be partly an issue of coordination failure: the Soviet republics and former CMEA countries recognize that they must remain mutually dependent in the short run if they want to avert an output collapse, and all stand to benefit greatly from having a workable financial payments mechanism to support interrepublican and inter-CMEA trade. One possible solution to the problem would be for each of the "countries" involved to deposit hard currency (or gold) reserves with some reputable outside official institution (such as the BIS or the Fund), which could then perform the necessary clearinghouse functions. If appropriate, the initial reserves could come in part from official external assistance flows, and quantitative floors could be set on reserve holdings within the clearinghouse as part of the conditionality governing subsequent flows of credit from the Fund.

For such a settlements mechanism to operate effectively, however, all parties would have to have strong incentives to meet their settlement obligations. If national or republican governments accept the responsibility of standing behind the settlement obligations of enterprises residing in their countries or republics, it is important that monitoring procedures be in place to control the import activities of large enterprises that remain subject to soft budget constraints. Indeed, because private entrepreneurs will be quick to recognize opportunities for state enterprises to evade controls by exploiting opportunities to import or conduct other restricted activities through private intermediaries, an economy-wide system of monitoring import documents may be strongly advisable to help maintain overall balance between imports and exports during the period until large state enterprises have been privatized. There must also be an enforceable mechanism for penalizing any national or republican governments that do not meet their settlement obligations.

#### V. Incentives for Residents to Hold Domestic Financial Assets

The viability of any macroeconomic reform effort depends critically on its success in attracting resources to finance productive investment. Accordingly, the authorities must attempt to create strong incentives for residents to increase their holdings of domestic financial assets and for nonresidents to provide capital inflows.

In an economy in which domestic residents have been effectively prevented from moving savings abroad, the removal or relaxation of restrictions on international transactions may lead to large-scale capital outflows, even in the presence of sound monetary and fiscal policies. Capital outflows in this context would simply represent a rational attempt to diversify sources of income by residents who initially are totally reliant on domestic labor and capital income. Diversification reduces the extent to which total income is exposed to any one particular type of risk. Thus, even if the expected returns on domestic assets were somewhat higher

than those on foreign assets, the portfolio diversification motive could provide strong incentives for residents to reduce their exposure to shocks affecting domestic incomes and increase their exposure to shocks affecting foreign incomes.

The domestic authorities basically have two ways they can attempt to prevent large-scale capital outflows. One approach is to enhance the attractiveness of domestic financial assets--both by acting to instill confidence in the financial institutions that provide domestic savings vehicles, and by implementing macroeconomic policies that are conducive to high yields on domestic investments. The second approach is to rely on direct controls.

The conditions under which controls on capital outflows can be justified are: (1) when the country does not have access to offsetting capital inflows; and (2) when net capital outflows generate negative externalities. Both conditions seem realistic for the countries pursuing market-oriented transformations. To the extent that the success of a transformation effort depends critically on the strength of domestic investment, individual decisions to move capital abroad generate negative externalities, and the residents of a country undertaking reforms may well be better off individually when they are collectively forced to keep capital at home than when each freely chooses to move capital abroad. Capital controls can thus be justified as the solution to a coordination problem in the presence of the negative externalities.

Whether capital controls are likely to be effective is quite another matter. A number of countries have experienced large scale capital flight in the presence of capital controls. In general, the strength of the incentive to move capital abroad in the presence of controls depends on the size of the prospective gains from doing so, on the ability to do so without being detected, and on the costs of being detected.

The prospective gains from moving capital out of a country obviously depend on the attractiveness of the country's macroeconomic prospects. Unless residents have confidence in the country's policy institutions and policy stances, and unless the country has adequate international liquidity and faces a favorable external environment, it may be difficult for residents to resist any opportunities they have to move capital abroad. To some extent, however, the temptation to evade controls can be countered by imposing severe penalties on any residents caught doing so.

The ability of residents to evade capital controls will generally depend on arrangements governing convertibility for current account transactions. Indeed, many countries that claim to have established current account convertibility have actually retained various exchange restrictions on current account transactions, implicitly recognizing the dangers of capital outflows through the current account. Countries that document exports and impose foreign exchange surrender requirements on exporters, and

that require those who bid for foreign exchange to provide documentation of import orders, may be able to monitor current account transactions fairly closely, thereby making it easier to detect attempts to move capital out of the country through false invoicing or leads and lags in current account payments. Needless to say, careful consideration should be given to devising a mechanism that minimizes the bureaucratic hassles and administrative costs of filing documents and obtaining foreign exchange, and that keeps the market for foreign exchange competitive. One approach that seems attractive is to make it illegal for residents to hold foreign exchange per se, but to establish an unrestricted competitive and unified market for foreign exchange certificates, and to allow importers to convert these certificates automatically (at a fixed 1:1 conversion rate) into foreign exchange when import documents are approved. At the same time, exporters and recipients of transfers or capital inflows could be allowed to surrender their foreign exchange receipts for foreign exchange certificates that they could either retain, deposit in interest bearing accounts or sell. 1/ 2/ Under such a system, the domestic currency price of foreign exchange certificates would essentially represent the exchange rate between domestic and foreign currencies, and the domestic authorities would have the option of orienting their monetary policy toward stabilizing this exchange rate if they so desired.

The threat of capital flight underscores the importance of strong and credible transformation programs. It also suggests that, where external resources are meager and macroeconomic prospects are subject to a high degree of uncertainty, a cautious approach to convertibility is advisable. 3/ The main benefits of current account convertibility come from the effects of import competition on the efficiency of domestic production and the guidance that relative prices on world markets can provide for the allocation of resources. To a large extent, countries can secure these benefits by establishing a single exchange rate for permissible transactions, removing quantitative restrictions on imports, and adopting a

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1/ The experiences with foreign exchange certificates in Taiwan Province of China in the late 1950s and Korea in the mid 1960s may be instructive in this regard.

2/ Where trade with some partner countries is settled with foreign exchange while trade with others is financed initially with settlement credits (and ultimately with hard currency via a clearinghouse mechanism), there could be unrestricted competitive markets for both foreign exchange certificates and settlement credit certificates.

3/ See Greene and Isard (1991). The system of foreign exchange certificates just described would essentially establish current account convertibility, but without allowing residents to hold foreign exchange per se.

uniform import tariff. <sup>1/</sup> The complete removal of all exchange restrictions relating to current account transactions is not necessary, however, to promote a healthy degree of import competition and to align internal relative prices with those on world markets. Without some exchange control mechanism or reporting system for commercial transactions, it is likely to be easy for residents to move capital out of the country through false invoicing or leads and lags in current account payments.

#### VI. Incentives for Nonresidents to Provide Capital Inflows

Inflows of foreign investment capital can significantly help the transformation process. When foreign investors assume ownership positions in domestic enterprises, capital inflows can also lead to new and possibly better management, and to valuable information about production technologies and marketing opportunities abroad.

Attracting foreign investment capital will be difficult, however, particularly in the early stages of the transformation process when property rights have not yet been clearly defined and when the country's economic prospects may be very uncertain. Until a legal code is in place that clearly defines the investor's share of whatever income stream results from the investment, and until investors can be reasonably confident about macroeconomic prospects and the overall size of the income stream, capital inflows are likely to remain small. Uncertainty about property rights is bad for all investors, but it must be particularly problematic for nonresidents who would in the future provide an attractive target for domestic interest groups.

Even with a clearly defined legal code and reasonably predictable macroeconomic prospects, investors may perceive considerable uncertainty about the extent to which their earnings will be taxed. And nonresident investors are likely to feel more vulnerable to higher effective tax rates than resident investors, since nonresidents have less voice in the domestic political process.

Beyond clarifying property rights, one way to improve the climate for capital inflows is to act to reduce sources of prospective strains on future fiscal budgets, thereby reducing fears of higher effective tax rates on capital income. In this connection, debt relief can play an important role in reducing fiscal strains.

Another factor that may significantly affect the climate for direct investment inflows is the perceived attitude of the industrialized countries

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<sup>1/</sup> It may be more advisable to rely on a depreciated exchange rate, rather than a uniform tariff, to limit the general strength of import competition, since import tariffs create a bias against production for export.

toward opening their markets to imports from the transforming economies. A clear invitation for these countries to eventually join the European Community, and a commitment by the EC to keep trade barriers low in the interim, could significantly stimulate foreign direct investment flows into export-oriented activities.

#### VII. Restructuring Large Enterprises and the Case for a Planning Agency

Large shares of the populations in formerly centrally-planned economies are employed in large industrial enterprises. In addition to providing employment and "wages," many of these enterprises provide housing, health care, and other benefits. The mobility of the workforce is generally low, reflecting in part the lack of much available housing. Accordingly, closing a large industrial enterprise creates pressures for the government to provide income support.

Continuing to operate an industrial enterprise may also, in many cases, involve an ongoing net drain on the government budget in one way or another. Many enterprises may be generating less value added (at market prices) than the value of the wages and other benefits that they are paying their employees. A large number of enterprises may even be generating negative value added.

The reality of large pockets of essentially immobile human resources with ongoing consumption needs and desires to increase their standards of living over time poses an enormous challenge. Allowing the market to simply drive these resources into unemployment is not likely to be socially acceptable; and political leaders who failed to see the dangers of relying entirely on the market could not survive for long in a democratic political system. Decisions must somehow be made about how best to re-employ the resources initially employed in large state enterprises, taking into account their initial skills and whatever plant, equipment, and other nonhuman resources are available. In most cases, the process of changing production activities will require investment outlays in new equipment and material inventories, which may well require an extension of credit.

Restructuring the employment of the human resources associated with large industrial enterprises is likely to take time. In the interim, the fiscal authorities will have to spend money, both to keep people subsisting and to provide investment finance. The way in which the government divides its spending between consumption subsidies and credit to support restructuring efforts may make no difference in terms of the overall fiscal strains on its current-period budget, but it can have a major influence in shaping the incentives that motivate workers and managers, with important feedback effects on fiscal spending needs over time.

To create an incentive structure that motivates workers and enterprise decision makers to pursue activities with high value added (per capita), and

thereby to reduce the drain on fiscal revenues over time, it seems likely that the government will have to make a significant amount of resources available to finance the initial investments and other start-up costs of those new activities that promise to generate high value added. Governments may thus want to try to keep industrial wages and income support payments relatively modest and allocate their initial resources as much as possible toward providing credit for enterprises with promising restructuring plans.

There seems to be no attractive alternative to government involvement in credit allocation. Private intermediaries are unlikely to be able to attract household deposits or other types of private domestic funds without government guarantees, and inflows of private foreign capital are unlikely to be forthcoming on a sufficiently large scale. Moreover, in the absence of government credit, restructuring will never occur, much of the population will remain heavily dependent on disguised or overt income support payments, and standards of living will never rise.

If the government does choose to become involved in providing credit for industrial restructuring, its effectiveness will depend critically on its ability to decide what restructuring plans deserve financial support. It cannot hope to be effective in this area without acquiring considerable expertise (or outside technical advice) on production technologies, marketing issues, and other aspects of managing industrial enterprises. While much of the planning for industrial restructuring should take place at the enterprise level, and should involve the managers and worker representatives associated with the enterprises, there is a clear need for an industrial "planning agency" within the government.

The idea of "planning agencies" brings back unpleasant memories of the ineffective role that such agencies have historically played in centrally-planned economies. We are not, however, advocating a suppression of market forces or a return to the past. Nor are we advocating that the focus of planning extend beyond the large state enterprise sector; in many respects the proper role of government is to "get out of the way" of private entrepreneurship. Rather, the case for a planning agency is based on the major externalities associated with the challenge of transforming or liquidating large state enterprises. Until the large state enterprise sector is successfully transformed or its labor force reabsorbed elsewhere, long-lasting macroeconomic stabilization will be very difficult to achieve in a democratic political system, and major costs will be incurred by other sectors of the economy.

A planning agency is important not only for choosing between creditworthy and noncreditworthy restructuring proposals, but also for exploiting economies of scale in obtaining information about production technologies and marketing opportunities, and in generally providing helpful education and advice to decision makers at the enterprise level. A planning agency could also play an important monitoring role in protecting against "asset stripping" or other undesirable actions by managers/workers in the

context of a legal framework for "corporatization" of the state enterprise sector during the period prior to privatization. Another useful function of a planning agency would be to make sure that the economy-wide industrial restructuring effort is proceeding in a balanced manner.

The bottom line is that market mechanisms alone cannot succeed in transforming economies in which large clusters of the population are essentially immobile and initially dependent on large industrial enterprises that could not survive in a laissez-faire environment. Until these enterprises can be successfully restructured or their workers absorbed elsewhere, governments cannot avoid providing overt or disguised consumption subsidies if they want to maintain political support, and durable macroeconomic stabilization will be difficult to achieve. In all likelihood, governments will also have to provide much of the credit required to restructure large industrial enterprises, and must therefore be able to distinguish between creditworthy and noncreditworthy proposals if restructuring is to be successful. Planning the transition of large industrial enterprises is unavoidable and should receive high priority from the start. Without guidance from planning agencies with access to considerable expertise on production technologies and marketing opportunities--whether in-house expertise or outside technical assistance--market-oriented transformation efforts are likely to flounder.

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