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in Eastern Europe and the Former Soviet Union"
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I am grateful to the International Vienna Council for providing me with the opportunity to participate in this Conference on "Europe in Transition". It is always a pleasure to visit Vienna, which is now playing such an important role as a center for the dialogue between policy makers in the formerly centrally-planned economies and the established market economies. In fact, the inauguration today of the Joint Vienna Institute illustrates Vienna's growing contribution to this dialogue. This new institution will contribute, through the training of high-level officials, to the formulation and implementation of policies needed for the transition to market-oriented economic systems. The International Monetary Fund is happy to be one of the six international organizations sponsoring this unique enterprise, which will further increase Vienna's role as a center for the communication of knowledge, experience, and ideas.

This occasion provides a good opportunity for me to speak to you about the progress being made by the formerly centrally-planned economies of central and eastern Europe and the former Soviet Union in their transition toward market economic systems.

These countries are undergoing a unique process of political, economic, and social transformation, and their success in this transition is immeasurably important for all of us--governments, international institutions, and private agencies. In fact, not since the reconstruction effort after World War II have we seen such a need for international cooperation in a shared enterprise that promises so much for the common destiny of mankind.

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Before turning to the progress that has been made, let us consider in general terms the problems faced by formerly centrally-planned economies and the <u>policy strategy for an effective transition</u>. You will recall the starting point. Characteristic of these economies after decades of central planning were problems of distorted price and trading systems, uncompetitive markets, macroeconomic imbalances and instability, primitive and fundamentally unsound financial systems, and, perhaps more fundamentally, a widespread dependency culture, contrasting with the culture of individual freedom and responsibility in which any well-functioning market economy must be rooted. Also characteristic were the consequences of these problems, including the massive misallocation of resources, obsolete capital stocks, and extensive environmental damage. And in addition to all this, the old structure had begun to disintegrate long before the transformation process got underway. The so-called Brezhnev era of stagnation was not only a time of economic inertia, but one of deep crisis following which economic planning and control structures collapsed as the political system unravelled. Not surprisingly, the CMEA system collapsed at the beginning of 1991, and the ruble area has suffered considerable stress during 1992. The "transition economies" therefore began the process of transforming their economies in circumstances of crisis and vacuum rather than quiet reform. Indeed, when I hear people talk of "shock therapy", I sometimes wonder whether they appreciate the shocks that these countries suffered before any therapy began. In fact, the policy strategies supported by the Fund are, if anything, therapies for shocks rather than therapies through shocks.

The nature of the inheritance from the old system has meant that a policy strategy for the transition must have <u>three basic components</u>. As we shall see, the three components are interdependent; and the programs that we help to put together and finance necessarily contain all three.

The <u>first</u> requirement is to <u>free the economy</u> and allow economic agents to assume responsibility for their actions. Substantial liberalization of prices and of external economic relations at the outset is needed to give undistorted price signals to producers and consumers, so that the reorientation and reconstruction of the economy can begin. In particular, the establishment of an open, multilateral system of trade and payments with the rest of the world, with a substantial degree of currency convertibility, is essential; it will help to ensure that the domestic economy is subject to the discipline of international competition, that the exchange system provides undistorted signals to producers and consumers, and that domestic prices are aligned with world market prices.

The <u>second</u> requirement is to <u>stabilize</u> the economy: it is essential at the outset to ensure macroeconomic stabilization through appropriately tight monetary and fiscal policies. By macroeconomic stabilization I mean decisive progress toward domestic price stability, together with sustainable external and internal imbalances. Macroeconomic stabilization is particularly important at the beginning of the transition process, for several reasons. One is that the initial stage of the process tends to bring especially virulent inflationary pressures, as a result of price liberalization against a background of monetary overhang and large price distortions. Those pressures have to be contained, and inflation has to be reduced sharply after the initial unavoidable jump in prices. Another point is that the bad effects of inflation--such as the blurring of changes in relative prices (which can mislead producers and consumers), increased uncertainty, and arbitrary changes in the distribution of income and wealth --can be especially destructive during the transition process, when the direction of change needs to be clear, and political stability needs to be maintained. In addition to all this, it is essential to establish the credibility and soundness of the domestic currency at an early stage in the transition, in order to set the tone for the new system.

Keynes once quoted and endorsed Lenin's view that inflation ("debauching the currency") was the best way to destroy the capitalist system. This was quite a pertinent economic observation, and one that we should bear in mind if we want to preserve and foster the emerging market economies and democratic systems of government. The main task of monetary policy in the transition process is basically to ensure that the collapse of the communist system is not followed by the debauching of the currency and the collapse of democracy.

But in the transition economies, market systems need not only to be preserved and fostered: they need to be constructed. This means that a formidable effort is needed to reform the structure of the economy. Thus the <u>third</u> essential component of the strategy is <u>systemic reform</u>. Here I include a whole range of structural changes needed for the new system to perform effectively:

- changes required to support effective fiscal and monetary policies, such as new tax collection systems, and the establishment of strong central banking institutions sufficiently independent of political pressures to maintain a consistent and credible anti-inflationary stance;

- changes required to increase the responsiveness of enterprises to market forces, including demonopolization, privatization, the commercialization of state-owned enterprises, and legal reforms;

- improved social safety nets, which effectively target the needy at acceptable budgetary cost; and measures to improve the functioning of labor markets.

Many of these changes will necessarily take time, especially those reforms that require deep institutional changes. For me, this carries a number of implications. First, start reform as quickly as possible; and make the most of the initial momentum, lest fatigue sets in. (We could call this the "<u>carpe diem</u>" principle if these words were not associated in our minds with an epicurean way of life.) Second, make sure that a critical mass of the most important reforms is achieved as soon as possible; these are likely to include the reforms needed to support effective fiscal and monetary policies, and the removal of obstacles to the development of new economic activities. Third, go for simplicity rather than perfection in designing reform in the early stages, when this can speed the process.

So it is in terms of these three essential and interdependent components--liberalization, stabilization, and reform--that we can think of policy strategy for an effective transition. This of course leaves many strategic choices to be made according to national circumstances--the choice of exchange rate regime, the constitutional status of the central bank, the structure of taxes and government expenditure, and so on. In addition, the road to economic transformation cannot be fully mapped out in advance, and it is obviously important to respond effectively as the transformation unfolds. But as far as broad strategy is concerned, all three of the components to which I have referred are essential; they are interdependent; and the fastest possible progress is needed with each..

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Let me now turn to the question of how much progress has been made. We can think of progress in terms of each of the three components that I have described.

As far as freeing the economies is concerned, I am glad to say that in almost all of the countries of eastern Europe most of the work has been done. In these countries, prices have been almost completely liberalized; subsidies have been significantly reduced; a substantial degree of currency convertibility has been established; and the trade regime has been substantially liberalized. The speed of this liberalization has been unprecedented. In the former Soviet Union, prices have been largely liberalized in Russia and most of the other states during 1992. Current account convertibility is a policy objective of the Russian authorities that is recognized in Russia's current arrangement with the Fund, and most of the relevant restrictions have now been removed. Substantial convertibility has also been established in the Baltic states. This progress with liberalization is a clear indication of the unambiguous rejection of central planning, and of the recognition of the urgent need for the "invisible hand" of market forces to begin its work.

As regards the second component, macroeconomic stabilization, the challenge has been more demanding than was originally envisaged. In eastern Europe, significant progress has been made; but in the former Soviet Union stabilization is still an elusive objective of great urgency. Now let me expand a bit on this.

The challenge of macroeconomic stabilization has been greater than envisaged partly because in most cases the initial jump in prices was significantly larger than expected: we probably underestimated the imbalances and repressed inflation that lay hidden in the old system until it was dismantled. Stabilization has also been complicated by the large declines in output that have occurred. These may be explained partly by the collapse of the CMEA system and difficulties with trade and payments arrangements within the former Soviet Union. But they may also be seen as a largely unavoidable consequence of exposing to market forces an obsolescent and non-viable structure of production.

In spite of these enormous problems, significant progress has been made in eastern Europe. This includes substantially lower inflation rates following the initial corrective price adjustments; initially satisfactory budget outcomes in most countries; the overachievement of targets for the current account of the balance of payments; and the rapid growth of private sector productive activity, much of it for export. Recent developments in Hungary, Czechoslovakia, and Poland, in particular, justify cautious optimism that the sharp contraction of output of the past few years has ended or is likely to end soon, and that 1993 may see positive GDP growth after about five years of decline.

But there is no room for complacency. At least in Bulgaria, Poland, and Romania, inflation remains much too high, and stabilization is far from assured. Initial success in achieving satisfactory fiscal balances has in many cases not been sustained, owing to weakening of the revenue base; and thus further fiscal discipline has been required. And apart from all this, the social problems associated with the transformation process have been immense. Further progress in stabilization depends to an important extent on systemic reform; and I shall turn to this in a moment. But for eastern Europe, I shall say again that the progress already made is encouraging.

The states of the former Soviet Union, of course, started their transition later than the eastern Europeans, and they inherited problems much larger in scale and scope. Their progress is therefore understandably less far advanced. The key element of Russia's current arrangement with the Fund is a package of financial policies designed to reduce inflation to a monthly rate in single digits by the end of this year. I regret that at present the objective of getting inflation down to low levels is far from secure: in fact, the risk of hyperinflation remains. If Russia is to maintain the momentum in its stabilization efforts, and bring inflation down to low levels, it is critical that the fiscal and monetary policy measures contained in this package be implemented fully and without delay.

Russia aside, there has been notable progress in initiating stabilization and reform in the Baltic states; and the development of policies is also progressing in Belarus, Kazakhstan, and Kyrgyzstan. Elsewhere in the former Soviet Union, the development of effective programs has, I regret, been hindered in some cases by a lack of political commitment, and in others by the disruptive effects of conflicts. Let me add some remarks about the Baltic states, and about Kazakhstan and Kyrgyzstan. I visited all three Baltic states this summer, and I must tell you I was most impressed by the courage and determination of these people to confront head-on their very difficult economic circumstances. The Fund's Executive Board has already approved stand-by arrangements with Estonia and Latvia, and I hope that a similar arrangement will soon be approved with Lithuania. The programs being embarked on in all three countries are strong by any standard. I have just visited Kazakhstan and Kyrgyzstan, where the particularly close integration into the former Soviet economy makes the situation especially difficult. Kyrgyzstan has also suffered tragic natural disasters this year. In both countries, the determination and realism of the political leadership are refreshing, and great progress has been made in the few months since independence, with the support of a substantial technical assistance effort. I believe we shall soon be able to announce that the time has arrived to support the strong programs now in preparation.

I must also refer to the problems that have arisen in the ruble area. Here a decisive clarification of policies is urgently needed. To stay within or to leave the ruble area is the sovereign choice of each state, and we stand ready to support each country whatever its choice. But for those staying, it is essential that effective and workable arrangements for the management and coordination of monetary policy be established. As long as the ruble remains the currency of more than one country, it will be difficult, if not impossible, to reduce inflation and stabilize the ruble without extensive monetary cooperation. I would also emphasize that states that exercise their legitimate right to withdraw from the area must do so in a way that minimizes the disruption of trade and payments arrangements. And they must also, of course, recognize that departure from the area does not remove, but rather reinforces, the need for fiscal and monetary discipline.

I come finally to the systemic reforms required to ensure a well-functioning market economy. By this I mean in particular an economy whose supply side is responsive to market signals, and in which fiscal and monetary policies are effective in stabilizing aggregate demand and the price level. Here, regrettably though understandably, progress has been more difficult, controversial, and protracted than in the areas of liberalization and stabilization policy. After all, what is involved is nothing less than a complete transformation of these societies. Here I give only a few examples.

Perhaps the most fundamental requirement of a market economy is the clear establishment of property rights, and the framework of laws that enable the exchange of those rights, enforce contracts, and set the rules for entry and exit into and out of productive activities. In eastern Europe, considerable progress has been made toward establishing such a legal framework; but progress to put in place the administrative and judicial machinery for enforcing laws and resolving disputes has been slower. In the former Soviet Union, meanwhile, there is less of a market-oriented legal tradition to draw on, and the establishment of property rights and reform of the legal system have only just begun. And of course, major problems of implementation and enforcement remain to be overcome.

Apart from the establishment and enforcement of a market-oriented legal framework, it is also essential to reform the incentive system within enterprises. This is one of the central motivations for privatization. But in addition, in enterprises that remain under state ownership, budget constraints must be hardened, and management improved. In eastern Europe there has been considerable progress in privatizing small enterprises, and in the formerly centrally-planned economies more generally there has been a proliferation of less formal private activity, the true magnitude of which is not easy to gauge. But progress in privatizing medium and large state enterprises has been limited. Some eastern European countries have recently adopted measures to speed up this process, but in most of the states of the former Soviet Union plans remain in a formative stage.

I am afraid that the lack of enterprise reform has not only damaged the functioning of market mechanisms and limited supply-side responses; it has also compromised the effectiveness of macroeconomic stabilization policies. Thus enterprises operating without hard budget constraints tend to be unresponsive to interest rate policy as well as other price signals; and in addition, they have been willing to accept growing claims on other enterprises, even though those enterprises themselves might not be viable in the new environment. This problem of inter-enterprise arrears has developed in most of the eastern European countries, and, to a much greater extent, in Russia and other countries of the former Soviet Union. It has potentially serious implications for government budgets and macroeconomic stability. It is a striking example of the close link between macroeconomic stabilization and structural reform. It leaves no doubt in my mind that enterprise reform is now a major challenge of the greatest importance; I shall return to this in a moment.

Apart from legal reform, enterprise reform, and privatization, there are, of course, many other structural reforms that are of crucial importance to the success of the transition process. There is no time to consider them here, but I cannot fail to mention the importance of establishing effective central banking institutions, efficient clearing systems, and commercially-oriented banking institutions. In all of these areas, the international community has an extremely important role to play in providing technical assistance. The Fund is continuing to make a strong contribution to technical assistance throughout the economies in transition, concentrating its attention in the areas where it has particular expertise, namely the design and implementation of macroeconomic policies, central banking, and economic and financial statistics. But of course the transition will require systemic reform across a much broader range of economic, social, and political activity than I can even mention. I would now place particular emphasis on all forms of cooperation that could speed up enterprise reform. This is a great challenge indeed, since it requires a much more decentralized approach than the one entailed in stabilization.

It is clear from this progress report that the two most immediate challenges confronting the economies in transition are macroeconomic stabilization and enterprise reform. The solutions to both challenges must go hand-in-hand; neither will be complete, or even viable, without the other. But this does not mean that the process of stabilization should be slowed down while the necessary enterprise reforms are put in place. What is needed, rather, is an acceleration of the systemic changes; and that need is urgent. No one should assume that progress is inevitable, and that the tempo of change is the only issue. No: the risks and pitfalls are formidable. Hyperinflation and a collapse of economic activity are a real threat in many of these countries if stabilization and enterprise reform are not addressed vigorously; and that would set progress back incalculably.

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In closing, let me say that a momentous process has started in all these countries. Their leaders are engaged in the immense task of creating new societies and institutions and establishing new relations both among themselves and with the rest of the world. We should have no illusions: this will not be a quick or easy process. It calls not only for courageous and persistent leadership, but also for the continuing support of the international community, both in providing external assistance and in opening markets. We should be unstinting in our provision of that support. I have no doubt that Austria will continue strengthening its already outstanding contribution to that effort.