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Speech by Michel Camdessus
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on "The Transition to a Market Economy
and the Role of the Joint Vienna Institute"
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at the Joint Vienna Institute
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It is a great pleasure to be at the Joint Vienna Institute on this, its inauguration day. And I welcome this opportunity to participate in the IMF Institute's inaugural seminar here, and to meet and speak with such a distinguished group. The composition of the participants in this seminar--from eastern Europe, the states of the former Soviet Union, and Asia--brings to mind how the membership of the Fund has expanded in recent years. It also illustrates how geographically extensive is the move toward market economic systems. In recent years many nations have changed their minds about the way they wish to organize their economies and their relations with the rest of the world. The schism that divided the world for half a century is no longer there, and we are entering a time of truly global interdependence which offers great potential benefit for all.

The subject of this seminar is "Transition and Adjustment", and your program for the next couple of days shows that you will be discussing many important issues relating to stabilization and reform, and examining the experience gained in many countries. This afternoon I would like to share with you some thoughts on the appropriate policy strategy for the transition process, and on some of the requirements for the successful execution of that strategy.

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Let us first consider in general terms the problems faced by formerly centrally planned economies and the appropriate <u>policy strategy for an effective transition</u>. First, recall the starting point, which you know much better than I. After decades of central planning, there were problems of distorted price and trading systems, uncompetitive markets, macroeconomic imbalances, and undeveloped and essentially unsound financial systems. And there were also the consequences of these problems, including the massive misallocation of resources, obsolete capital stocks, and, in some cases, extensive environmental damage. In addition, in some cases, the old structure had begun to disintegrate even before the transformation process got underway. Thus in eastern Europe and the former U.S.S.R., economic planning and control structures broke down as the political system unravelled; the CMEA system collapsed at the beginning of 1991; and the ruble area has been under extreme stress during 1992. Thus--and here I repeat what I have said frequently before--many of the "transition economies" were in a state of "shock" before any transformation or "therapy" began.

These features of the starting point and the inheritance from the old system tell us a lot about the policy actions required during the transition period. In fact, the policy strategy that is needed has <u>three essential components</u>: and it can be summed up in three key words--liberalize; stabilize; and reform. The need for each component is clear from the initial conditions that I have described; but they are all interdependent.

First, substantial liberalization of prices and of external economic relations is needed at the outset to give undistorted price signals to producers and consumers, so that the reorientation and reconstruction of the economy can begin. From the perspective of the IMF, I would naturally place special emphasis on the importance of opening the economy. The establishment of an open, multilateral system of trade and payments with the rest of the world, with a substantial degree of currency convertibility, 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. Recall also the havoc that can be wrought by <u>gradual</u> price corrections, through the incentive to hoard that they can create.

Second, it is also 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--the blurring of changes in relative prices, which can mislead producers and consumers; the increased uncertainty; and the 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.

The third essential component of the strategy is systemic reform. Here I include a whole range of structural changes needed for the new system to perform effectively, such as:

- 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. 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 components--liberalization, stabilization, and reform--that we can think of policy strategy for an effective transition. It is clear to me that a policy strategy must include all these components if it is to bring about a successful 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 public expenditure, and so on. But as far as the broad strategy is concerned, all three components are essential; they are interdependent; and the fastest possible progress is required with each. But we must also recognize that the risks and pitfalls are formidable. The road of economic transformation cannot be fully mapped out in advance, and it is important to respond effectively as the transformation unfolds.

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The policy strategy that I have outlined is clearly a very tall order. Let us now consider the <u>requirements for its successful execution</u>. At the domestic political level, the consistent execution of the strategy, in the face of the inevitable setbacks and demands for quick results, requires courage, perseverance, and skill on the part of the leadership. But it also requires the support of a very broad national consensus. The IMF's experience in many member countries shows that governments are more likely to succeed with their economic strategies if they marshall a popular consensus, and that this is more likely if there is a pluralistic system of political representation; if public participation is encouraged in the decision-making process; and if there is widespread confidence that policies are applied uniformly and equitably. Thus successful execution of the strategy requires "good governance", by which I mean accountable and responsive governments.

The development of good governance in this sense must necessarily be mainly a domestic endeavor, although the international community can provide encouragement and help. But when it comes to other requirements of the successful execution of the transition strategy, international cooperation and assistance are not only possible but indispensable. And this is where the IMF, the World Bank, the EBRD, and the other institutions sponsoring the Joint Vienna Institute have their role to play.

Speaking for the IMF, I would say that I see our contribution taking three forms. The first is what seems to attract most public attention, namely the provision of our financial resources. And I am happy to report that this is something we have been doing on a large scale. Thus in the past two to three years stand-by or extended arrangements have been negotiated with all countries in central and eastern Europe. And in Asia, the Fund has been providing financial support for the transition process in Laos and in Mongolia. More recently, a first credit tranche arrangement for Russia was approved in August, and stand-by arrangements were approved last month for Estonia and Latvia. I hope that similar assistance in support of stabilization and reform programs will soon come into place with other states of the former Soviet Union--Lithuania, for example; Belarus; and also Kazakhstan and Kyrgyzstan, which I visited last week, and where I saw ample demonstration of the determination of the authorities to implement speedily strong reform programs. I hope we shall soon be in a position to recommend these programs to the international community for its support.

In relation to the scale of the problems to be faced, however, our financial contribution is often not large. Indeed, the formerly centrally planned economies, like all other economies engaged in adjustment, will need to rely for their financial resources, soon after the initial stage of the transition, when official foreign financing will be predominant, mainly their own domestic saving and the private investment they can attract from abroad. This again highlights the importance of sound domestic economic policies--fiscal discipline, and policies that foster private sector confidence. But this is where the Fund can make its second contribution, namely policy advice. What distinguishes IMF financial assistance is that it is conditional on agreement on, and then application of, certain macroeconomic policies that we help to design. And we also provide policy advice as part of our surveillance activities, especially in Article IV Consultations. Our policy advice is based not on any ideological position, but on the knowledge and experience that the IMF has accumulated over almost five decades. Even in eastern Europe our experience now goes back about twenty years--years during which our involvement in the region has been growing and deepening. I would not of course claim any infallibility for the IMF: on the contrary, we are all in uncharted waters and participating in a learning experience. But I would say that the policy advice that comes from the IMF--whether in the negotiation of a program or in the course of normal consultations--is based on a wealth of experience gained from being intimately associated, year after year, with the efforts, successes, and failures of a large and growing number of countries--now 172--over almost five decades. This is a rich experience indeed, from which we have surely gained some modesty but also some wisdom--virtues which are both useful when we face the unique situation of any country in transition, at a unique moment of its history.

So financial assistance alone is not enough. But I would go further: even financial assistance accompanied by good advice is not enough. This is because good advice needs to be acted on. The effective transfer of knowledge and experience requires more intensive human interaction, in the form of <u>technical assistance</u>--not only to provide advice, but to train personnel, to establish the institutions and laws, and to encourage the habits of mind that are needed for a market economy. In fact, I consider this to be the key channel through which the international agencies and western governments can contribute to successful economic transition.

As I indicated when I referred earlier to the systemic reform component of the transition strategy, the transformation of an economic system requires a reconstruction of the institutional and regulatory framework of government. It is not only a question of dismantling the over-centralized apparatus of a command economy. It means creating whole new institutions--a central bank with a sufficient degree of independence to operate a consistent counter-inflationary policy and which can supervise the banking system; a regulatory framework and administrative apparatus that, among other things, ensures a competitive market environment; social safety nets that include unemployment insurance and job retraining schemes; a legal and accounting system that facilitates and promotes the proper functioning of economic policy institutions and productive enterprises in the private and public sectors; and so on. The list is virtually endless.

In the design, establishment, and operation of these new institutions you, in the economies in transition, have a great resource of your own to draw on--your own human capital. And it is primarily your task, not ours. But it is a tremendously difficult task, and the governments of the established market economies, together with the international organizations such as the sponsors of the Joint Vienna Institute, do have a stock of knowledge and experience from which the new market economies should benefit. To characterize the particular contribution of the IMF, I would say that our technical assistance is focused primarily on ways to improve macroeconomic management and budgetary procedures, in particular by

- helping to improve the functioning of the central bank and the financial system, including banking supervision;

- helping to reform the tax system and tax administration, and to improve expenditure controls;

- helping to improve the country's economic statistics.

For example, in the states of the former Soviet Union a major effort has been proceeding since late 1991 in a range of areas including fiscal and monetary policy management, financial sector reform, commercial law and regulatory reform, enterprise restructuring, privatization, statistics, and various aspects of sectoral and infrastructural development planning. Efforts are being made to ensure that technical assistance is carefully sequenced and coordinated among the different international agencies and donor governments according to their respective areas of expertise. We also attempt to ensure consistency in policy advice, and to avoid duplicating efforts and overburdening the national authorities.

From our experience, the two most effective forms of technical assistance are the assignment for periods of at least several months of expert advisors to government agencies in the countries concerned, and the training of economic policy officials. As you know, the IMF Institute runs training courses in Washington and in the field, and also now here at the Joint Vienna Institute where the courses are designed especially for people like you, officials in transition economies. The fact that the Joint Vienna Institute is sponsored by six international institutions, and that a number of countries are expecting to contribute to it financially, shows that we are not alone in assigning great importance to the training and retraining of policy advisors and implementers. The Joint Vienna Institute also shows how we can enhance the sum of our modest individual contributions to the momentous change of your economies, by cooperating effectively among ourselves.

Thus the Joint Vienna Institute will be a very important arm of the technical assistance that we provide, and I expect that it will demonstrate that the training of high-level officials is one of the most important forms of external assistance to the economies in transition.

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It is most appropriate that the Fund is inaugurating its activities here with this seminar of high-level officials on "Transition and Adjustment". The work in which you are engaged in your countries is of the very highest importance. I trust that you will gain much from the speakers and from the discussions among yourselves. But please do not forget that we expect also to learn a lot from your own views and experiences, and that we look forward to sharing with those who will follow you here your own input to our common experience. I extend my warmest wishes for success both in your deliberations here, and in your work at home.