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Macroeconomic Adjustment and Reform in Planned Economies

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Abstract

This paper examines the relationship between macroeconomic stabilization and market-oriented reform in planned economies. It emphasizes that market-oriented reform should enhance the likelihood that adjustment to exogenous disturbances will involve genuine adjustment in the sense of actually eliminating or at least reducing both internal and external imbalances. Market-oriented reform should also increase the ability of the authorities to carry out stabilization policies relying on indirect rather than direct instruments. The paper argues that the sustainability of such reform may critically depend on the pursuit of policies that contain inflationary pressures, but that the environment for adoption of such policies will depend in turn on the appropriate sequencing of reform measures.

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Contents

Summary

This paper examines the relationship between macroeconomic stabilization and market-oriented reform in planned economies. After discussing the distinguishing features of macroeconomic stabilization in traditional centrally planned economies, the study explores the changing nature of the stabilization process in such economies undergoing market-oriented reform.

Market-oriented reform should in principle enhance the likelihood that macroeconomic adjustment to exogenous disturbances will involve genuine "adjustment" in the sense of actually eliminating or at least reducing the imbalances--whether external, internal, or both--brought on by these disturbances in the first place. It should also increase the ability of the authorities to carry out a policy of macroeconomic stabilization relying on indirect rather than direct instruments. The paper notes, however, that most past reform experiments were unsuccessful in achieving the degree of financial discipline and price flexibility, or in developing generalized instruments of fiscal and monetary control, that would enable the authorities fully to achieve the above objectives.

The paper argues that the sustainability and ultimate success of market-oriented reform will depend, inter alia, on the ability of the authorities to fashion a set of macroeconomic policies and instruments adequate to containing the growth of inflationary pressures and, ultimately, the rate of open inflation. It also suggests, however, that the ability to establish a noninflationary environment for reform will likely depend in turn on decisions made regarding the sequencing of reform initiatives. More specifically, the pace of retail price revisions and price liberalization, together with wage decontrol, should not be permitted significantly to outrun attitudinal changes and modifications in institutional arrangements that would radically improve financial discipline. Included in such changes would be the acceptance of the principle and implementation of positive real rates of interest. The macroeconomic challenge facing the authorities, and therefore the threat to the sustainability of reform, is likely to be greater, the larger the excess demand prevailing at the time that a market-oriented reform program is launched.

I. Introduction

It has long been evident that macroeconomic adjustment in centrally planned economies (CPEs) differs in some important respects from the adjustment process in market economies. 1/ As CPEs undertake market-oriented reforms, however, many of the distinguishing features of macro adjustment in those economies become less pronounced. At the same time, the very market orientation of these reforms presents the authorities with the challenge of fashioning new instruments for macroeconomic stabilization. Their success in meeting this challenge can in turn impinge on the sustainability and ultimate success of the reform program.

This paper is concerned with relationships between macroeconomic adjustment and reform in planned economies. The distinguishing features of macroeconomic stabilization in CPEs are briefly discussed, by way of background, in Section II. The changing nature of the stabilization process in CPEs undergoing market-oriented reform (or "modified" planned economies (MPEs)) 2/ is examined in somewhat greater detail in Section III. The fourth section, drawing in part on the general experiences of three MPEs--China, Hungary, and Poland--briefly discusses the macroeconomic environment for reform. It suggests that the adoption of appropriate macroeconomic policies is a necessary condition for successful market-oriented reform, and that these policies in turn may be influenced by the sequencing of reform initiatives. Some concluding remarks are presented in Section V.

II. Adjustment in the Centrally Planned Economy

The main systemic and policy features of the traditional CPE are too well known to bear repetition. Some of those features which directly influence the process of macro-adjustment in the CPE, however, may usefully be recalled. One of these is the absence of a so-called hard budget constraint for enterprises (Kornai (1979)) due to the vast scope for bargaining between enterprises and the authorities over all aspects of enterprise performance, including their financial position, as well as to the reluctance of the authorities to allow state enterprises to go out of business. The institutional apparatus that promotes this bargaining consists of an administrative hierarchy composed of several tiers, including powerful branch ministries, a highly discretionary system of fiscal management, and a monolithic banking system that chiefly plays a passive, accommodative role in meeting the credit demands of government and enterprises.

1/ See Holzman (1968), Wiles (1968), Allen (1982), and Wolf (1985a).

2/ For an early stylized model of the MPE, see Wolf (1978); also Wolf (1985a).

Another key feature of the CPE is the inflexibility of most domestic prices, which are subject to tight central control, and the general lack of short-term supply response by socialized enterprises to market imbalances, particularly for consumer goods. The implication is that households may frequently be unable to carry out the expenditures they desire, i.e., the demand for output of the socialized sector at the given price level may exceed the supply. As a result, households may find themselves with excess liquidity. Observe, however, that the existence of excess household liquidity need not be dependent on the existence of aggregate excess demand for consumer goods--a controversial notion (Portes (1984))--but rather may exist simply as the result of micro level imbalances (Wolf (1985a)). If parallel markets and other avenues for eliminating excess liquidity exist, the problem is transformed into one of latent excess demand for aggregate output--or for specific outputs, in the event that there are only microlevel imbalances--of the socialized sector (Nuti (1985)).

A third important characteristic is the strict separation of domestic and foreign currency prices through the so-called price equalization mechanism, combined with a high degree of central planning and control over foreign trade. The authorities in the CPE are unlikely to attempt to use the official (valuta) exchange rate as an instrument for macroeconomic stabilization. This is because the state-owned foreign trade organizations (FTOs) lack autonomy and may not in any event be interested mainly in maximizing their profits (hence trade flows are unlikely to respond to changes in valuta prices); also, domestic prices are insulated from valuta price changes. Consequently, the official exchange rate in the CPE has largely only an accounting, rather than an economic function (Wolf (1988a)).

The implications of these systemic and policy features for macroeconomic adjustment can be illustrated with some examples. Consider, for instance, an adverse domestic supply shock that reduces the availability of an important intermediate product used in the production of both investment and consumer goods. A likely although certainly not inevitable reaction to this shock may be that the authorities may accommodate enterprise fulfillment of the (typically) higher priority investment plan by permitting firms to reduce their net exports and/or production and sale of consumer goods below planned levels. With money wages, prices, employment and budgetary transfers to households remaining unchanged, this would require above-plan government subsidies or bank credits to enterprises, in order to make up for the loss in net revenue to the enterprise sector from sales to consumers and/or net exports. In this case, the soft budget constraint would be directly associated with an increase in net credit extended by the banking system to enterprises and/or government. 1/

1/ See Wolf (1985a) for a more detailed analysis.

A second type of disturbance might emanate from abroad, say in the form of a deterioration in the terms of trade. In this case, assume that the CPE faces a binding trade balance constraint. The authorities would have to mandate a cutback in domestic expenditure which might be implemented by directives to producing enterprises and FTOs to divert tradables to foreign markets. With rigid domestic prices, insulated by the system of price equalization from the movement in foreign currency prices, together with unchanged nominal incomes and transfers, the diversion of resources into net exports would generate or exacerbate excess demand on domestic markets. This would be reflected, on the books of the banking system, in a net increase in credit to government to finance the fall in net price equalization taxes collected in foreign trade. 1/ Such a disturbance is therefore likely to have an inflationary effect--although not necessarily expressed in higher open inflation--in the CPE, whereas in the market economy the effect may be either deflationary or inflationary depending on the macroeconomic policy stance of the authorities.

As a third example, consider an attempt by the authorities to improve the trade balance by indirect means, namely by the setting of a lower ceiling on domestic credit creation. In this case, enterprises would presumably seek to maintain their desired level of liquidity by increasing their net exports (as intended by the authorities) or, if there were initial excess demand for consumer goods at the prevailing official price level, by increasing their supply of consumer goods to the domestic market at the expense of investment goods, at unchanged official prices. In this latter event, however, the authorities might be tempted to fall back on direct trade controls in order to achieve their policy objective.

These examples illustrate two key aspects of macro-adjustment in CPEs: (1) indirect instruments, such as credit ceilings, cannot always be relied on to achieve a specific internal or external objective; 2/ and (2) even if a specific objective is attained by means of direct or indirect instruments, it may still not involve genuine adjustment in the sense of moving the economy toward equilibrium in all markets, external and internal, and within the latter in both investment and consumption. 3/

1/ See Wolf (1988a) and the references therein for a more detailed analysis.

2/ It should be noted that indirect instruments may be similarly unpredictable in their effects due to changes in the income velocity of money, a phenomenon which of course is not restricted to planned economies, but occurs in market economies as well.

3/ A fully elaborated although not entirely transparent model of internal-external balance in the CPE appears in Portes (1979). Also see Brada (1982).

III. Adjustment Under Market-Oriented Reform

Market-oriented reforms in planned economies generally have aimed at giving socialized enterprises increased responsibility, incentives and authority to act through the market to increase efficiency, improve product quality, and stimulate innovation. Increased responsibility is intended to be imposed in the form of financial discipline, or a hard budget constraint. Improved incentives are to include a greater emphasis on profits as an evaluative criterion and as a source of funds for investment and managerial and employee remuneration; a wage structure more closely correlated with differences in labor productivity; and the establishment of a stable financial and regulatory environment for enterprises. Enhanced authority actually to exercise command over resources through the market is intended to result from the devolution of authority to enterprises regarding price-setting, wages, employment, investment, production decisions, and foreign trade. So as to ensure that the profit incentive will lead enterprises to operate in ways that are also efficient from society's point of view, profits are meant to reflect a price structure that in turn progressively mirrors the underlying pattern of relative scarcities, including in foreign trade. In practice many of these objectives, including financial discipline, a stable incentive system, and enterprise autonomy, have only been partly achieved in economies undergoing market-oriented reform. Nevertheless, the emergent MPE does differ in some significant respects from the traditional CPE, and these differences show up in the area of macroeconomic adjustment as well.

Perhaps most significantly, the scope for the authorities' use of direct controls is reduced in the MPE, while the plain for bargaining with enterprises shifts perceptibly from negotiating over plan targets and input allocations to bargaining over taxes, subsidies, preferential interest rates, and price controls. The banking system is meant to become somewhat less accommodative in the MPE, however, and more emphasis is placed on the interest rate and the regulation of credit expansion as a tool of demand management. The budget, as well, is intended to play a more active role as an instrument of macroeconomic stabilization policy. Regulation of the wage fund or the average wage of an enterprise is now carried out only indirectly, but quite imperfectly in some cases, through the mechanism of progressive taxes on "excessive" wage increases. Many prices are freed, but many still remain subject to various degrees of regulation or are administratively set. Various attempts are made to increase the competition faced by state enterprises, partly through a relaxation of restrictions on private activities and also imports, although actions in the latter area may be restricted by existing price distortions and, in some cases, sizable general excess demand pressures.

The exchange rate system is usually fundamentally reformed in the MPE, with the establishment of a single commercial exchange rate (for each currency area) which is related more closely than the earlier valuta rate to the average domestic cost of earning one unit of foreign exchange through exporting. This new exchange rate is used to calculate so-called transaction prices for traded goods which are ultimately meant to be the prices which exporters and importers, respectively, receive and pay. This would mean abandonment of price equalization, too, but as a practical matter it persists in the interim. As a further step, the domestic prices of tradable goods (beyond those actually entering into foreign trade) are meant to be equated with the transaction prices for comparable traded goods. This, however, is typically only a longer run objective, as complete reconciliation of the structures of border and domestic prices must await the overall reform of the latter. Although reform of the exchange rate system in MPEs has usually been accompanied by a sizable de facto depreciation of the exchange rate, it typically remains overvalued. 1/

As noted, complete or even a moderate degree of price liberalization has usually not accompanied the early phases of market-oriented reform. Typically, in the early stages the authorities seek administratively to restructure prices for an important subset of economically strategic goods, such as energy and basic raw materials. Even with successive administered price reforms, however, both the overall price level and relative prices are likely to remain distorted for an extended period.

As long as domestic prices are largely administered or closely regulated, the question arises as to what extent the potential price effects of exchange rate changes designed to improve the balance of trade should be "passed through" to the domestic price level. There are basically two possibilities. One is not to allow enterprises to reflect in their domestic sales the higher transaction prices of goods actually entering into foreign trade, presumably so as to avoid the inflationary consequences of a devaluation. In this case the devaluation could be expected in principle to have a de facto expenditure shifting effect, as the higher transaction prices received by exporters induce them to shift production away from the home market toward exports and, to the extent they are not able to pass the higher cost of imports on to domestic customers, to reduce their demand for imports as well. However, because the domestic price level would in this case remain unchanged despite the diversion of production into net exports, excess demand pressures would be increased, and the authorities might actually feel compelled to exert formal or informal pressures on exporters to avoid diverting supplies from the domestic market (Kornai (1982)). Because of this, much or even all of the trade balance improvement expected from the devaluation might effectively be blocked.

1/ For some of the reasons, see Wolf (in press). Detailed discussions of the evolution of exchange rate systems in planned economies appear in van Brabant (1985) and Wolf (1985b).

The other extreme possibility is full passthrough of the exchange rate change into domestic prices. Again there is scope for expenditure shifting and in this case the authorities may be more likely to allow it to take place because it will not increase domestic excess demand pressures. The prices of traded goods sold domestically and possibly those of other tradables will tend to be raised in this case pari passu with the transaction prices of products actually traded. While the price incentive for exporters to switch supplies of these goods from domestic markets will therefore be less than in the case of no passthrough, and also the relative price change between traded goods and other goods (including nontradables) that induces the shifting of production away from the latter will be smaller, the passthrough of the exchange rate change into the domestic prices of traded goods (tradables) will also raise the domestic price level. Assuming nonaccommodative financial policies by the authorities, this will have a demand-reducing effect. Whether it will also be expenditure reducing (and therefore, in this case, also expenditure shifting), which is essential to actually improving the trade balance, will depend on the size of the price level change relative to the initial level of excess demand in the economy (Wolf (1988b)).

Broadly speaking, the basic choice for the authorities in formulating their policy on passthrough when following an active exchange rate policy in the MPE is between aggravating excess demand pressures (with no passthrough), and inducing a higher level of domestic prices which in itself, assuming nonaccommodative financial policies, will actually reduce excess demand in the economy (complete passthrough). If there is no passthrough and the authorities do not impose new controls on exports, an improvement of the trade balance will necessarily involve increased domestic excess demand. Allowing passthrough, by contrast, will improve both the external and internal balances.

The issue of the effectiveness of exchange rate policy in improving the trade balance in MPEs remains controversial. Several arguments have been put forward to suggest that devaluation in the MPE is likely to have mainly, or only, an inflationary effect, but not all these arguments stand up to scrutiny (Wolf (1988a)). Probably the most persuasive arguments for the relative ineffectiveness of devaluation in the MPE, vis-à-vis the market economy, would be those which stress that: (1) enterprises in the MPE still may not generally be subjected to financial discipline; (2) firms benefiting from devaluation might expect effective confiscation of "excessive" profits; (3) exporting enterprises may be subject to informal pressures to supply domestic markets at lower than world market prices; and (4) firms may be subject to significant constraints on labor and capital mobility in the short and medium run. All of these factors could dampen the effective supply elasticities of enterprises in modified planned economies during the transition. It should be emphasized, however, that prevailing price elasticities of export supply, as well as the responsiveness of domestic expenditure to devaluation (and credit policy), are in reality not exogenous parameters beyond the influence of the authorities. Indeed, the price elasticity of export supply can be raised in the short run by policies that enforce hard budget constraints and avoid conveying nonprice signals to enterprises. Moreover, in the medium term, measures aimed at increasing the mobility of capital and labor would also tend to increase the responsiveness of firms to changing price signals.

With the official exchange rate set below market clearing levels and less than complete price reform, the authorities in some MPEs have sought to promote exports by supplementing exchange rate policy with a range of other export incentives including tax reliefs, export subsidies, preferential credit terms, and foreign exchange retention accounts for exporters. The latter also serve, of course, as an important source of foreign exchange for imports; together with foreign currency auctions, retention accounts have been playing an increasing role in some countries in the decentralized allocation of foreign exchange. 1/

Some observers have viewed various differentiated export incentives as more effective than devaluation in encouraging short- and medium-run expansion of exports in MPEs (Tyson et al. (1988)). If the authorities are unwilling to harden enterprise budget constraints or to eliminate excess demand in the economy, it is possible that such a differentiated approach might indeed be effective in the short run. There is little in such a pattern of intervention, however, that ensures the efficiency of the structure of exports. Furthermore, to the extent that the favored enterprises and sectors are also able to claim a share in new investment that matches their relative importance as exporters, the economy may only become more locked into a relatively inefficient pattern of exports. Even if these nonprice export incentives were not differentiated among products or enterprises, they would still be inferior to an exchange rate change, even without passthrough, in that they would act only to encourage exports but not to discourage relatively inefficient imports. Moreover, the problem of domestic excess demand will not be reduced by such an approach and indeed may even be exacerbated. 2/

In sum, market-oriented reform in principle involves increased price flexibility, fewer controls on inputs and foreign trade, greater financial discipline, and a generally greater concern with avoiding market imbalances--including in the consumer goods sector--in part through more active credit, interest rate, fiscal, and exchange rate policies.

Having outlined the institutional features of the MPE which bear most closely on the process of macroeconomic stabilization, this process can be examined by briefly drawing on the three examples of adjustment

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1/ For a more detailed discussion of supplementary export incentives and retention accounts, see Wolf (in press).

2/ The reasoning is similar to that presented earlier in the discussion of the case of no passthrough of the price effects of a devaluation.

tasks discussed in Section II in the context of the CPE. The first two examples were similar, in that they respectively involved an adverse domestic and external supply shock. Given the short-run rigidity of virtually all prices in the CPE, direct controls on inputs and foreign trade, widespread financial indiscipline, and the presumed priority given to investment, the basic impact of both types of supply shock was assumed to be some combination of trade balance deterioration and increased excess demand pressures domestically. In other words, "adjustment" to these shocks would in general not move the CPE closer to a position of general equilibrium.

To the extent that reform initiatives in MPEs are successfully implemented, relative price changes and movements in the price level will absorb part of these supply shocks, while enterprises, operating in a less accommodating financial environment, will at the same time have the responsibility, authority, and incentive to respond to these price changes in both their expenditure and production decisions. The adverse supply shocks will be reflected, to an extent not usually experienced in the CPE, in a redistribution of real incomes across enterprises and among individuals. Moreover, statistical real incomes, as reflected by the ratio of nominal incomes to the price level, should in the aggregate reflect more closely the negative impact of these shocks on the actual real income of the economy as a whole. Provided there is an effective trade balance constraint, the real expenditure of economic agents will likewise reflect the adverse nature of these supply shocks. In short, to the extent that credit policy is not relaxed and prices are flexible, the MPE should adjust toward a new equilibrium position with only limited inflation in the interim, as in the stylized market economy.

The third case considered in Section II involved the use of an indirect instrument, credit policy, to improve the trade balance. The main problem in the CPE was that in the presence of initial excess demand on domestic markets for consumer goods the authorities could not be certain that enterprises would not recoup their initial level of liquidity by merely diverting output from investment to the consumer market, rather than to net exports. Additional indirect instruments eschewed by the planners in the CPE are available to the authorities in the MPE, in particular the interest rate and the exchange rate. Whether they can attain their trade balance objectives in this case solely through credit contraction or interest rate policy aimed at enterprises will depend fundamentally on whether prices initially were high enough to rule out excess demand, or, if they were not, on the authorities' pursuit of a credit and interest rate policy vis-à-vis households that is sufficient to eliminate their excess demand for consumer goods.

Moreover, the success of their policies will also depend on whether firms are subject to financial discipline and immune from confiscation of profits thought to be "excessive." 1/

As noted earlier, currency devaluation can in principle lead to an improvement in the trade balance without being accompanied by domestic price movements (i.e., no passthrough allowed) but this will in turn create (or exacerbate) excess demand domestically and move the economy away from general equilibrium. Moreover, the excess demand so created will mean that the future effectiveness of a given interest rate and credit policy will be reduced. Devaluation accompanied by an increase in the domestic price level and a rise in the relative price of tradables, however, will both improve the trade balance and maintain domestic balance.

Real-world MPEs have heretofore by no means managed to achieve degrees of financial discipline or of price flexibility, or to develop generalized instruments of monetary and fiscal control, comparable to those prevailing in most market economies. The reliability and effectiveness of indirect instruments of macro-stabilization therefore have remained limited, although certainly increased over the level achieved in traditional CPEs.

IV. The Macroeconomic Environment for Reform

Market-oriented reform in planned economies has tended to be accompanied by an acceleration of open inflation and in some cases by larger external imbalances. It does not necessarily follow, however, that market-oriented reform need create an underlying inflationary bias and threat to the balance of payments. Much of the acceleration in open inflation in these countries has been caused by administered price changes and further price liberalization, i.e., repressed inflation, in the form of shortages, has simply been reduced. It must also be noted that aggregate demand management, the external balance, and the price level are ultimately issues of macroeconomic policy. The effects of shortcomings in these policies should not be attributed to reforms of institutional arrangements which happen to have occurred at the same time but were not necessarily related to macro-policy failures.

1/ Recall, from Section II, that enterprises faced by credit restraint can maintain their initial level of liquidity by increasing their sales to consumers, if the latter initially have excess demand. The desired effects of credit contraction in the aggregate could also be offset if the tightened credit policy impinged disproportionately or even solely on the more profitable enterprises, including exporters (see Tardos (1988)).

It is worth asking, however, to what degree the process of market-oriented reform may bring with it a new set of pressures and institutional arrangements that effectively result in a loosening of macroeconomic policies. This is an important question because if reform is indeed accompanied by a serious worsening of underlying inflationary pressures and the external position, and these pressures exceed the population's tolerance for open inflation and the borrowing capacity of the economy, the authorities will be forced to react with a tightening rather than a relaxation of controls over prices and imports. Such controls may well lead to an increase in price distortions and will certainly lead to greater de facto restrictions on the autonomy of enterprises and their ability to exercise command over resources through the market, in the form of formal and informal rationing of scarce inputs. With the expansion of both price and quantity controls, the bureaucratic scope will also be broadened for bargaining over prices and the availability of physical and financial resources, and financial discipline and incentives will be weakened. With aggravated internal and possibly external imbalances, the reform process will likely degenerate into a series of stop-and-go measures (Szapary (1989)) and the momentum of the reform may be lost or even reversed.

Whether looser demand management need be associated with market-oriented reform may critically depend on the sequencing of the reform measures themselves. In MPEs, the administered upward revision of retail prices and their partial liberalization, together with decentralization of decision making with respect to the enterprise wage fund (or average wage), have tended to proceed more rapidly than (1) fundamental and more difficult institutional changes favorable to the strengthening of competition and financial discipline, and (2) changes in attitudes regarding the trade-off between economic efficiency, on the one hand, and income equality and job security on the other. Moreover, although market-oriented reform programs usually highlight the interest rate as an important emergent policy instrument, the actual interest rate structures established by the financial authorities in MPEs have heretofore been virtually entirely negative in real terms.

Sudden and significant retail price increases, in economies in which inflation was largely repressed in the past, may trigger demands for wage increases that, due to rising inflationary expectations, may well outpace the current rate of open inflation. Moreover, egalitarian attitudes that have developed over decades of central planning may mean that the productivity-related wage gains of some will effectively be translated into broadly similar wage increases for all, with the result that the growth in the overall real wage may significantly outpace that of labor productivity, and wage differentiation, an important desideratum on the supply side, will not be enhanced. If decisions on wage growth have effectively been turned over to the enterprises and there exists neither the political will nor the institutional safeguards (and new policy instruments 1/) to prevent de facto accommodation of

1/ On this issue, see Blejer and Szapary (1989) and Szapary (1989).

excessive wage increases through discretionary credit policy and fiscal reliefs 1/ (i.e., no effective ceiling on the growth of net credit to enterprises and the government), demands for excessive wage growth may be successful. To the extent that the growth in nominal wages outstrips the domestic supply and import capacities of the economy and the desire of households to add to their savings, excess demand pressures will accumulate that may suggest a further round of price increases. If these price and wage policies are accompanied by a structure of interest rates which is negative in real terms, households will be loathe to add to their desired savings and enterprises will have the incentive to over-invest in stocks and new investment projects, 2/ the aggregate effect of which will be to exacerbate the excess demand problem and pressures on the trade balance.

To summarize, macroeconomic policy is the key determinant of the degree of macroeconomic balance in any economy. In an MPE, however, the effective degree of macroeconomic restraint will as a practical matter be strongly influenced by the extent to which the authorities have decided, and the institutional adaptations have been made, to ensure financial discipline. The apparent proclivity of economies undergoing market-oriented reform toward the acceleration of underlying inflationary pressures (and, in turn, accelerating open inflation) may be largely the result of initial excess demand pressures 3/ combined with a sequencing of reforms that permits the rate of retail price and wage increases to outrun the pace at which the broader institutional environment, as well as general attitudes toward the necessity for economic restructuring, are changed. The above problem is seriously reinforced by the reluctance of the authorities to ensure that interest rates are

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1/ Observe that although the growth of wages is frequently subjected to indirect regulation through taxation of "excessive" wage increases, such taxation is typically subject to a number of exemptions, both of a "systemic" nature and of an ad hoc negotiated character. See International Monetary Fund (SM/89/203, 1989; SM/89/204, 1989; and SM/89/205, 1989).

2/ The growth of interenterprise credits may also complicate the task of credit policy in MPEs (Wolf (1985a)). Positive real rates of interest on enterprise deposits and credits extended by the banking system, however, may have a dampening effect on the growth of interenterprise credits because they would raise the opportunity cost to creditor enterprises of lending directly to other enterprises and would most likely raise the cost of such credit to borrowing firms.

It should also be pointed out, however, that positive real rates of interest may not effectively impose financial discipline if loan contracts are not scrupulously enforced (Szapary (1989)).

3/ Clearly, the macroeconomic challenge facing the authorities in MPEs will be greater, the larger the extent of excess demand prevailing at the time that a market-oriented reform program is launched.

positive in real terms, a reluctance that can be explained both by attitudinal barriers and by the unwillingness to force unprofitable firms to bear the full cost of positive real interest rates.

Critical institutional changes needed to facilitate policies of macroeconomic restraint would be those that dismantle the bureaucratic structure that facilitates bargaining over financial regulators, and that establish the basis for nondiscretionary fiscal policies and a truly independent banking system. 1/ The establishment of many new institutions, including the retraining of old and the training of new cadres, cannot occur overnight. Hence, the critical importance of initiating these institutional changes as early as possible in the reform program. Such an approach need not imply that market-oriented reform should proceed only gradually. Rather, it suggests that what is needed is a bolder vision of institutional change, and more ambitious measures designed to accelerate changes in the institutional environment favorable to tightening financial discipline, than have heretofore characterized the MPEs.

V. Concluding Remarks

Market-oriented reform in planned economies should in principle enhance the likelihood that macroeconomic adjustment to exogenous disturbances will involve genuine "adjustment" in the sense of actually eliminating or at least reducing the imbalances--whether external, internal or both--brought on by these disturbances in the first place. It should also increase the ability of the authorities to carry out a policy of macroeconomic stabilization relying on indirect rather than direct instruments. The main differences between traditional CPEs and MPEs in this respect were discussed in Sections II and III. As noted in Section III, however, real-world MPEs such as China, Hungary, and Poland have as yet been unable to achieve degrees of financial discipline and price flexibility or to develop generalized instruments of fiscal and monetary control which would enable them fully to achieve the above objectives.

The paper argues in Section IV that the sustainability and ultimate success of market-oriented reform probably will depend, inter alia, on the ability of the authorities in MPEs to fashion a set of macroeconomic policies and instruments adequate to containing the growth of inflationary pressures and, ultimately, the rate of open inflation. It also suggests, however, that the ability to establish such an appropriate

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1/ The imposition of financial discipline without eliminating or at least significantly reducing price distortions could, of course, involve increased efficiency losses. It is therefore important to begin to eliminate these price distortions as quickly as possible once financial discipline has been tightened. If price reform indeed follows relatively rapidly, additional efficiency losses should be insignificant.

environment for reform will likely depend in turn on decisions made regarding the sequencing of the introduction of reform initiatives. More specifically, it is probably important to ensure that the pace of retail price revisions and price liberalization, together with wage decontrol, do not significantly outrun attitudinal changes and modifications in institutional arrangements that would radically improve financial discipline. Included in these changes would be the acceptance of the principle and implementation of positive real rates of interest, a "policy" decision that would appear to be critical both to the efficient operation of a more market-oriented economic system and possibly to its sustainability. The macroeconomic challenge facing the authorities in MPEs, and therefore the threat to the sustainability of reform, is likely to be greater, the larger the degree of excess demand prevailing at the time that a market-oriented reform program is launched.

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