IMF WORKING PAPER

WP/90/28

INTERNATIONAL MONETARY FUND

European Department

Market-Oriented Reform of Foreign Trade in Planned Economies

Prepared by Thomas A. Wolf*

Authorized for distribution by Massimo Russo

April 1990

Abstract

This paper reviews the main features of market-oriented foreign trade reforms in planned economies. It considers reform initiatives aimed at expanding enterprise autonomy and breaking up the state monopoly of foreign trade, modifying the exchange rate system, and reforming the domestic price structure and ultimately the price system. The study emphasizes that the success of foreign trade reform, and therefore of a trade policy aimed at fundamental integration of planned economies into the world economic system, ultimately depends as well on the successful implementation of compatible reforms in the domestic economy as a whole.

JEL Classification Numbers:

027, 052, 431

---

*An earlier version of this paper was presented to a conference organized by the International Economic Association and the U.S.S.R. Academy of Sciences in Moscow, U.S.S.R., March 28-30, 1989. It will be published in O. Bogomolov (ed.) Market Forces in Planned Economies (London: Macmillan, in press). The author has benefited from comments on the earlier version from G. Bélanger, J. Boorman, A. Boote, A. Cicin-Sain, H.M. Flickenschild, P. de Fontenay, M. Nuti, U. Plowiec, J. Prust, G. Szapary, and M. Tardos. The views expressed herein, however, are his own and do not necessarily reflect those of the International Monetary Fund.

Contents

Summary

The paper reviews certain features of foreign trade reforms in planned economies undertaking broader programs of market-oriented reform. In particular, the study considers, first, initiatives aimed at expanding enterprise autonomy and breaking up the institutional monopoly of foreign trade, second, modification of the exchange rate system, and third, the reform of the price structure and of the price system itself.

During the transition, reforms in these three areas have, as a practical matter, tended to be less than complete, although policymakers have made various institutional adaptations designed to promote increased openness of these economies. These adaptations include the elaboration of new supplementary financial incentives for exports and institutional innovations aimed at partially decentralizing the allocation of foreign exchange, such as retention accounts for exporting enterprises and officially sanctioned foreign currency auctions.

The paper stresses the inherent interconnectedness of the different reform elements. The success of foreign trade reform, and therefore of a trade policy aimed at fundamental integration of reforming planned economies into the world economic system, ultimately depends as well on the successful implementation of compatible reforms in the domestic economy as a whole. It is highly unlikely that a comprehensive, market-oriented foreign trade reform can successfully be grafted onto a basically traditional system of central planning. By the same token, the pace and even the extent of domestic economic reforms, including the scope for expanded competition and price liberalization, will generally also depend on the pace and degree of reform of the foreign trade and exchange systems.

I. Introduction

It has long been evident that greater integration of centrally planned economies (CPEs) into the world economy depends on fundamental reform of their foreign trade systems. In several CPEs, reforms designed to end their insulation from international markets, particularly for manufactures, have involved initiatives to dismantle the traditional institutional monopoly of foreign trade, to provide individual enterprises with both the autonomy and incentives to participate more actively in foreign markets, and to link the domestic price system more fully with the structure of prices prevailing abroad. 1/ Planned economies undertaking particularly ambitious foreign trade reforms include China, Hungary, Poland and, relatively recently, the Soviet Union.

This paper reviews certain features of the foreign trade reforms undertaken in these economies. Its purpose is not to compare or to evaluate these reforms, but rather to examine some difficult issues that tend to arise in the course of their implementation. The focus will mainly be on reforms aimed at stimulating expanded and more efficient trade with market economies; the complex mechanisms for trade with other planned economies, and in particular economic relations within the Council for Mutual Economic Assistance (CMEA), are appropriately left for separate study. In several instances, however, the influence that the CMEA trading system may have on market-oriented foreign trade reforms is noted. 2/

The paper emphasizes the desirability of formulating a coherent reform strategy and complementary policies that take into account the inherent interdependencies of the different facets of market-oriented foreign trade reform. These elements, considered in turn in Sections II-IV, include initiatives aimed at expanding enterprise autonomy and breaking up the institutional monopoly of foreign trade, adapting the exchange rate system, and reforming the domestic price structure and ultimately the price system. To the extent that reforms in these areas have proven to be less than complete in the transition, various policy and institutional adaptations have been made by policymakers which are nevertheless designed to promote increasing openness of the economy. These include the development of supplementary financial incentives for

---

1/ For a survey of the institutional and policy factors that tend to insulate CPEs from world markets, particularly in manufactures, see Wolf (1988a, Section 2).

2/ It should be observed that the lack of reform in CMEA trading mechanisms will in general constrain the process of market-oriented reform in planned economies and possibly their full integration into the world economic system.

exports and institutional innovations aimed at partially decentralizing the allocation of foreign exchange. Both of these facets of the reform process are briefly discussed in Section V. Some concluding remarks are contained in Section VI.

II. Expanding Enterprise Autonomy in Foreign Trade

The institutional monopoly of foreign trade in the CPE, comprised of essentially noncompeting state-owned foreign trade organizations (FTOs) mainly subordinate to the Ministry of Foreign Trade and evaluated according to their fulfillment of detailed foreign trade plans, 1/ has effectively separated and indeed isolated domestic producers and consumers in the CPE from foreign markets. The decentralization of foreign trade decision-making and the ending of the isolation of producing enterprises has therefore necessitated the breaking up of this particular type of foreign trade monopoly. Important initiatives in this regard have been taken by a number of CPEs, and have involved, inter alia, the easing of profile restrictions for FTOs (thereby promoting some competition among them), expanding the range of foreign trade intermediaries from which a producing enterprise could choose, and granting direct foreign trade rights to selected producing enterprises for a specified range of products. In some cases, a system of general licenses has been established, meaning that enterprises with foreign trade rights can in principle now trade in any product not specified on a general negative list. In at least one case enterprises are now in principle authorized to engage in foreign trade in any product not contained on a negative list merely by registering with the authorities and making a declaration to the effect that they have adequate infrastructure and personnel with which to conduct foreign trade operations. 2/

Enterprise autonomy in foreign trade, however, requires more than simply the dismantling of the institutional monopoly over foreign trade. More fundamentally, it is dependent on the extent to which enterprises have achieved greater autonomy within the domestic economy more generally. 3/ For example, the right to engage in foreign trade in any product not on a negative list may be of little value to an enterprise that is narrowly restricted in terms of what it can produce or

---

1/ The salient features of the state monopoly of foreign trade in the CPE are examined in Wolf (1988a).

2/ Details on ongoing institutional reforms in the foreign trade of these countries appear, inter alia, in Ivanov (1987), Lavigne (1988), Plowiec (1988), Salgó (1986), Shagalov (1988), and three recent studies (1989) carried out at the International Monetary Fund.

3/ Also of growing significance in many planned economies is the liberalization of restrictions on the operation of joint ventures with foreign participation. This is another topic that deserves treatment in a separate paper.

sell on the domestic market. Or the right to export a given product will have limited meaning if one or more of the inputs needed for its production are in excess demand in the domestic economy and subject to formal or informal rationing. In some cases, of course, the authorities may continue for balance of payments reasons to "direct" that certain products be exported and in a certain quantity. In other cases, exports may effectively be restricted by the authorities so as not to exacerbate domestic imbalances in a general environment of excess demand. Export commitments to other planned economies under intergovernmental trade agreements, with attendant priority allocations of scarce material inputs and investment funds, may likewise have a constraining effect, in practice, on the freedom of enterprises to command resources in the market for export to the convertible currency area. The prevalence of soft-budget constraints 1/ for inefficient enterprises will also indirectly affect the autonomy of firms in foreign trade, as the subsidization of such enterprises--whether directly by the budget, by intermediate level industrial associations, or by the banking system--will effectively limit the extent to which a profitable export-oriented enterprise can command increased investment and other resources through the market. Limitations on enterprise autonomy in importing are also likely to persist in the transition (see Section V).

It is indeed significant that successive reform programs in planned economies have stressed the importance of expanded enterprise autonomy in general, and not just in foreign trade. 2/ The struggle for expanded enterprise autonomy is a long one, however, and has by no means been irrevocably decided in any planned economy. In addition to the obvious interest of the traditional bureaucracy in circumscribed enterprise independence, the domestic macroeconomic environment will also be a crucial determinant of the pace at which enterprise autonomy can develop. As long as the underlying rate of inflation in the economy exceeds the tolerable rate of open inflation, price controls will be employed and goods and services will at least partly be allocated through formal and informal rationing mechanisms. As noted above, this is bound to constrain the freedom of enterprises to engage in foreign

---

1/ On the concept of the soft-budget constraint, see Kornai (1980).

2/ In theory, of course, it could be argued that trade liberalization and greater integration into the world economy could be achieved by simply leaving the existing institutional structure intact but undertaking an administered price reform that removed price distortions vis-à-vis the world market and by subjecting enterprises to financial discipline, i.e., a hard budget constraint. This is unlikely to work in real world CPEs because the authorities cannot possess sufficient information on which to set efficiently all prices, world market relative prices will in any event constantly fluctuate, and the imposition of financial discipline will be more difficult in an unreformed institutional environment.

trade solely in response to the prevailing set of price incentives. Moreover, price controls are likely to distort the incentives for engaging in foreign trade in the first place.

III. Reform of the Exchange Rate System

Market-oriented reforms in planned economies seek to enhance the role of profits as the success criterion for enterprises, whether socialized or private. This is believed to induce enterprise managers to become more competitive, improve product quality, and increase efficiency. To ensure that this profit incentive will lead enterprises to operate in ways that are also efficient from society's point of view, enterprise profits are intended to reflect a price structure that in turn mirrors the underlying pattern of relative scarcities. For policy-makers who are truly serious about the efficiency of resource allocation, the relevant pattern of scarcities will now be expanded to include world market opportunity costs as well as prevailing domestic cost and demand structures. The mechanisms that permit such a comprehensive evaluation of relative scarcities are of course the exchange rate and domestic price systems. In theory all such comparisons could be made on the basis of shadow prices and shadow exchange rates, but the reform experience of most of the CPEs, particularly in the past decade, has been to move away from this approach toward the use of prices that directly affect the financial position of enterprises. 1/

The classical CPE was characterized by strict separation of more or less fixed administered domestic prices and foreign currency prices for tradables. The latter were converted into so-called valuta or deviza values at external exchange rates typically based on obsolete gold parities. Profits and losses of the FTOs, determined by the differences between the valuta or deviza prices in foreign trade and the structure of administered domestic producer prices, were effectively neutralized by the system of so-called price equalization taxes and subsidies. With time, various internal exchange rates were formulated for different product groups in an attempt to provide a calculative bridge between these valuta or deviza prices and those prevailing domestically, and to provide a basis for more efficient foreign trade decisions. For various reasons, however, including the fact that domestic prices frequently bore little relation to actual domestic costs or demand, these internal rates or coefficients were not notably successful in raising the efficiency of foreign trade decisions (Wolf (1985)). These internal exchange rates were typically also not used as the basis for settlements between the FTOs and domestic producers.

1/ For a discussion of some of the problems involved with the calculation and use of shadow exchange rates, see Wolf (1985).

Fundamental reforms of this traditional system have tended to accompany attempts to broaden and make more direct the participation of producing enterprises in foreign trade (Section II). 1/ One approach has been to fold together the external exchange rate and respective commodity-specific internal rates into differentiated so-called foreign trade multipliers (coefficients) that are actually used as the basis for domestic settlement of the foreign trade transactions of some enterprises. 2/ A further step has been the combining of the external and internal exchange rates into a central foreign trade multiplier or commercial exchange rate to reflect, say, the average domestic cost of earning one unit of foreign exchange through exporting. This new exchange rate would then be used to calculate the so-called transaction price for each traded product, which in principle would also be the price at which actual foreign trade transactions would be settled domestically. 3/ The system of price equalization would also in principle be eliminated in foreign trade, although as a practical matter it might be retained as long as all foreign trade settlements were not made at these transaction prices. This commercial exchange rate might also be "unified" with the noncommercial rate for settlements with the convertible currency area. 4/

Although reform of the exchange rate system in planned economies has usually been accompanied by a sizable de facto depreciation of the exchange rate, 5/ it is nevertheless also the case that none of these economies has yet set its exchange rate at a level that would permit the elimination of import restrictions and/or exchange restrictions, given the present stance of macroeconomic policies. 6/ One reason would appear to be that currency depreciation is viewed by the authorities in many of these countries as mainly inflationary. The extent to which an increase in the exchange rate is translated into an increase in the overall domestic price level depends, of course, on the degree to which

---

1 It should be noted that no two planned economies have approached exchange rate reform in exactly the same way. On different exchange rate systems in some CMEA countries, see Wolf (1985).

2/ This approach was experimented with in Poland in the late 1960s, and has apparently applied to part of Soviet foreign trade since the beginning of 1987. See Plowiec (1988) and Shagalov (1988).

3/ In the Polish case a "submarginal" exchange rate concept has been employed in the 1980s (Plowiec (1988)).

4/ Unification of commercial and noncommercial exchange rates for settlements with the convertible currency area was achieved by Hungary in 1981 and Poland in 1982.

5/ The comparison being made is between the new commercial exchange rate and the previous implicit rate, equal to the product of the external rate and the average internal rate.

6/ It is also possible, of course, that various trade restrictions may represent micro-level distortions that would not be totally removed by devaluation. The issue of convertibility, in all its facets, is left for consideration in a future paper.

the financial policies of the authorities "accommodate" the price effects of the devaluation (Wolf (1988c)). In a planned economy it also depends on the extent to which the price system permits the passthrough of increases in transaction prices to domestic prices in the first place, a point to which we return in the next section.

Other reasons for an overvalued exchange rate have included the aversion to marginalism inherited from the classical CPE, including the reluctance to reward intramarginal firms with abnormally high profits from foreign trade activities, but this aversion appears to carry progressively less weight in many planned economies. Another consideration may be the scope that an overvalued exchange rate gives for continued central intervention in foreign trade activities (Kozma (1981)). Moreover, various activities of high priority in the eyes of the authorities, including possibly some exports to CMEA countries based in part on inputs imported from the convertible currency area, are implicitly subsidized by central allocations of foreign currency at the overvalued official exchange rate (Török (1988)).

IV. Reform of Prices and the Price System

Reform of the level and structure of domestic prices is no less important than reform of the exchange rate system, if a comprehensive and coherent mechanism is to be developed for the evaluation by enterprises of relative scarcities. Yet price reform, not to mention reform of the actual system for setting prices, has thus far proven to be far less tractable in planned economies than has reform of the exchange rate system. This is not surprising, however, for price reform directly threatens the traditional patterns of domestic production and (frequently subsidized) consumption, as well as the distribution of real income and, indirectly through the industrial dislocations it may induce, full employment and job security.

These obstacles to price reform in planned economies are well-known, and will not be examined further here. It is also not the purpose of this study to describe and evaluate the fairly complex price systems prevailing in the different planned economies. Instead, this section will focus briefly on several issues that arise in connection with price reform and its relation to the foreign trade of these countries.

An important policy issue is the sequencing of price reform and the abolition of controls over trade and/or foreign exchange (hereafter: trade-exchange controls). Centrally planned economies embarking on reform typically--but not necessarily--are characterized by four types of price distortions: (1) the equilibrium price level may exceed the official price level (i.e., aggregate excess demand for output of the

socialized sector); 1/ and (2) the existing structure of official domestic prices may differ from (a) the structure of domestic equilibrium prices, given the prevailing controls on trade and/or foreign exchange, (b) the structure of actual domestic costs, and (c) the structure of world market prices.

If full price liberalization were socially and politically feasible at the outset of the reform process, the sequencing problem might be rendered fairly insignificant. Insofar as foreign trade is concerned, the optimal policy in this case would be also to abolish simultaneously all trade controls. Indeed, to delay acting on these controls in this case would mean achieving domestic equilibrium (at both the micro and macro levels) while domestic prices would in general continue to be distorted from world market price relatives. This is because the trade controls would block international commodity arbitrage, which is the mechanism by which domestic and world market relative prices are equalized. 2/ As long as trade controls were maintained, the new structure of prices would encourage a reallocation of domestic production and consumption that would not in general correspond to the economy's true comparative advantage.

In reality, complete or even a moderate degree of price liberalization has not accompanied the early phases of market-oriented reform in planned economies. 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, both the overall price level and the different relative price relationships are likely to remain distorted for an extended period. In this event, the sequencing issue becomes more complicated. For example, if all relative price distortions were to disappear through an administered price reform but there were still excess demand for output of the socialized sector at the prevailing official price level (and exchange rate), there would be a possibly unacceptably high drain on the country's international reserves if trade-exchange controls were eliminated.

1/ Portes (1983) has emphasized that of course what may appear as an aggregate excess demand problem may well be the perceived "aggregate" of shortages at the micro level that coexist with excess supplies in other markets.

2/ International commodity arbitrage refers to the foreign trading activity that, in the absence of trade controls, would arbitrage price differences between domestic and foreign markets and tend to reduce these differences to a level no greater than the associated per unit transaction costs. Only by sheer coincidence would domestic price liberalization lead to a domestic relative price structure similar to that on international markets, in the absence of free trade.

On the other hand, if the administered price reform had absorbed all aggregate excess demand, 1/ but distortions remained at the micro level, the elimination of trade controls might not constitute a major problem if combined with appropriate demand management and exchange rate policies. 2/ They also might not lead to a pattern of trade flows that would remove the distortions, however, particularly if these distortions involved a structure of domestic prices different from that prevailing on world markets. (Observe that even if the authorities had managed through changes in official prices to equate the structures of domestic and border prices, this would presumably be only a transitory achievement as the structure of border prices would almost certainly change within a very short period.)

If changes in official domestic prices are to be the main vehicle for price alignment within some transition period, possibly the authorities should at least attempt to set out a general timetable for these modifications. The objective would not be to specify in advance what the exact level of each price would be at some future period because this level, which would be intended ultimately to equal the transaction price, would inherently be a moving target. Instead, a useful approach might be to announce the general goal of achieving a relative domestic price structure for tradables equal to that for border prices by some specified future date (at which time these prices would be liberalized) 3/, and gradually moving official prices in that direction in the interim. If this transition period were not too long, enterprises and consumers would increasingly be induced to focus their attention on the likely future movements in these border prices, and investment would presumably be undertaken accordingly.

As long as domestic prices are largely administered (and here, for simplicity, we include in this category so-called contract prices that may be closely controlled), 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 passthrough, presumably so as to avoid the inflationary consequences of a devaluation. In this case the devaluation could be expected in principle to have an expenditure shifting effect, as the higher transaction prices received by exporters induce them to shift production

---

1/ Other measures could also be taken to reduce or eliminate aggregate excess demand, including a currency reform and raising interest rates to positive levels in real terms.

2/ A trade deficit (and therefore a loss in reserves) could, however, exist in this case if there were net dissaving by the budget in the form of a net price equalization subsidy that financed the existing level of trade at distorted prices. See Wolf (1980).

3/ Although see below the problem raised by domestic monopolists, at least in the transition before trade is liberalized.

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. 1/

Although the foregoing suggests that the trade balance impact of the devaluation may be positive, there will be other effects as well. The devaluation in this case could be expected to lead to increased excess demand pressures, for at least three reasons: (1) the devaluation would increase the profits of enterprises and thus the level of wages they could afford to pay, and the higher level of money incomes would not be offset by a higher price level; (2) excess demand for the goods actually exported would increase as supplies were diverted from the domestic market while their domestic relative price, the price level and hence their demand remained unchanged; and (3) to the extent that the heightened incentive to export led to a shift in output toward exports, the supply of other goods available to domestic users, at unchanged prices, would also decline.

There are reasons to believe that these excess demand pressures might lead to responses that could effectively offset much of the trade balance effect intended by the devaluation. For example, there is the likelihood, in a planned economy, that the authorities will react to increased excess domestic demand by exerting various informal and formal pressures on exporters not to divert supplies from the domestic market (Kornai (1982)). "Forced substitution" (Kornai (1980)), by which consumers, faced with excess demand for nontraded goods caused by the shift in output toward exportables (point (3) above) would attempt to substitute the latter for the former, would not be a plausible outcome in the case of incomplete passthrough, because in this case enterprises are not indifferent as to whether they sell to the foreign or domestic market and if unconstrained by the authorities would have the incentive to increase their exports after a devaluation. Forced substitution is a more plausible outcome in the event of exchange rate passthrough combined with fixed prices for nontradables (Wolf (1988b)).

The other basic possibility is full passthrough of the exchange rate change into domestic prices. In this case the scope for expenditure shifting is different, and possibly less than in the case of no or incomplete passthrough. 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. The incentive for exporters in this case to switch supplies of these goods from domestic markets will therefore be diminished, 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 lessened.

1/ The sensitivity of firms to changes in relative prices is a hotly debated issue in planned economies; see Wolf (1988b, 1988c).

The passthrough of the exchange rate change into the domestic prices of traded goods (tradables) will raise the domestic price level, however, and 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, 1988c)). Broadly speaking, the choice for the authorities in formulating their policy on passthrough when following an active exchange rate policy in the transition is between (i) improving the trade balance but aggravating excess demand pressures (with no passthrough), and (ii) inducing a higher level of domestic prices which in itself, assuming nonaccommodative financial policies, will actually reduce excess demand in the economy while at the same time improving the external position (complete passthrough).

In a target solution of domestic price liberalization combined with the elimination of trade-exchange controls, both the level and structure of foreign trade transaction prices would be consistent with external and internal balance and a domestic allocation of resources that is efficient from both a domestic and international point of view. During the transition, however, the question arises as to what should be the proper role for transaction prices. If used as a price ceiling for domestically traded goods, transaction prices roughly simulate the price effects of international commodity arbitrage. This would certainly be desirable from the standpoint of enhancing the use of prices to convey information about full opportunity costs. Transaction prices could also serve as effective price benchmarks for monopolistic producers selling on domestic markets. 1/ In practice, however, the high degree of product differentiation that characterizes markets for manufactured goods may make it difficult to administer such a price ceiling system.

It should also be recognized that the use of transaction price ceilings to simulate the price outcome of international commodity arbitrage does not, in the presence of still severe trade-exchange controls, ensure that domestic prices for tradables will be market clearing. The use of transaction price ceilings may therefore still have to be combined with continued central rationing of those products in excess demand during the transition.

1/ Transaction prices in convertible currency trade have played a major role in the Hungarian system of price regulation since 1980, particularly in the use of convertible currency prices for actual or hypothetical imports as a ceiling in the setting by enterprises of "free" prices on the domestic market. A so-called producers differential turnover tax is imposed on energy and raw material imports from the CMEA in order to raise their domestic prices to the level of corresponding transaction prices in convertible currency trade. (International Monetary Fund, SM/89/203).

V. Supplementary Export Incentives and Allocation of Foreign Exchange in the Transition

As noted earlier, market-oriented foreign trade reforms in some planned economies have tended, at least for a transitional period, to be characterized by less than complete price reform and the setting of the official exchange rate at a level below that which would clear the market for foreign exchange. The authorities in these countries, seeking to accelerate the opening up of their economies, have in some cases developed a battery of supplementary export incentives consisting notably of 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 currency for imports, and together with foreign currency auctions, retention accounts are playing an increasing role in some countries in the decentralized allocation of foreign exchange.

1. Supplementary export incentives

Central directives or informal pressures on enterprises to expand exports are of course still not unknown in planned economies embarked on market-oriented foreign trade reforms. Nevertheless, to the extent that the exchange rate has not always provided adequate incentives to enterprises to achieve the authorities' export goals, central directives of the traditional type have increasingly been replaced with a supplementary set of financial incentives. Their configuration and the relative importance of individual incentive arrangements differ considerably by country, and no attempt will be made to deal with them comprehensively. The issue addressed here is why in some instances these instruments appear to be preferred to bolder exchange rate action. Some general factors possibly explaining the reluctance of the authorities to depreciate further the exchange rate were noted in Section II. Here we will simply examine why a particular supplementary export incentive of considerable importance in some countries, tax relief, would appear to be so popular.

Systemic as well as ad hoc reliefs on account of exports are often provided from both enterprise income taxes and from taxes levied on firms for "excessive" wage payments. Such reliefs are frequently said to be highly valued by exporting enterprises because of the direct effect they have on their after-tax profits and, in the case of wage-tax reliefs, on the amount that they can afford to pay in wages. At least two plausible reasons come to mind for why enterprises might prefer this type of export incentive to an equivalent currency devaluation. One reason might be the uncertainty of enterprise managers regarding the possible effective confiscation by the authorities of part or all of the increased profits due to the devaluation through, say, the loss of other

fiscal exemptions already extended to these firms. 1/ In an environment in which intensive bargaining with the authorities over financial exceptions is the rule, the authorities may view the most effective financial incentive on the margin to be yet another exemption which directly affects the post-tax rather than pre-tax profits of enterprises.

In the case of taxes on "excessive" wages, an additional factor could also explain the preference for reliefs. If the tax-free ceiling on wage increases is defined by the center independently of the growth in an enterprise's sales or profit, the firm's employees may not view the export supply response to a devaluation as ensuring an effective increase in their remuneration. In this case, only negotiating a direct relief from the excess wage tax would assure the enterprise's work force of a tangible link between increased exports and higher individual earnings. In this way the widespread lack of financial discipline at the enterprise level, which in part necessitates the maintenance of an indirect mechanism for wage control from the center in the first place, may discourage the use of and partially subvert the effectiveness of uniform financial instruments such as the exchange rate. 2/

2. The allocation of foreign exchange

Foreign exchange retention accounts for exporters to nonruble markets have been established in several planned economies. 3/ For many enterprises these accounts may only replace part or all of their previous central allocations of foreign exchange, but even so the accounts may actually expand these firms' range of choice with respect to the products they may import. In general there has been a tendency over time toward making the retention coefficients more uniform across enterprises. To the extent that differences in rates are maintained, they tend increasingly to be related to the degree of processing embodied in a firm's exports and less to the prevailing import intensity

---

1/ On the scope of such discretionary fiscal redistribution in at least one planned economy, see Kornai (1986).

2/ Observe that tax reliefs designed to stimulate exports would, ceteris paribus, tend to have the same type of impact on the domestic economy as a devaluation without passthrough, i.e., they would tend to increase domestic excess demand pressures if price controls are pervasive. Marczewski (1988) also shows that even if an exporting enterprise does not actually receive the transaction price for its exports, but tax reliefs are made a function of exports valued in transaction prices (which has been the case in recent years in Poland), then the exchange rate in principle will still directly influence the firm's allocation of its output between the domestic and export market.

3/ Such schemes exist in China, Poland (since 1982), and the Soviet Union (1987). In Poland a retention system for trade in transferable rubles has been experimented with since 1986. In Hungary, there are no retention accounts but foreign exchange for importing is assured to any enterprise that is able to obtain an import license.

of these exports. 1/ In some instances retention accounts are viewed by exporters as their single most important export incentive. While retention accounts with increasingly uniform coefficients represent a positive step away from pervasive "addressed" central allocation of foreign exchange, it must also be recognized that in an economy with pervasive price distortions the existence of a partial retention system will be no guarantee of the efficiency of the structure of its foreign trade. 2/

In some planned economies foreign currency in retention accounts may be transferred by exporting enterprises to their suppliers. Recently, several countries have established various auction schemes which permit an even wider range of nonexporting enterprises to obtain access to foreign exchange. One type of auction provides the possibility for holders of retention accounts to sell their rights directly to other enterprises, and another involves auctions through which the banking system sells foreign currency to enterprises for the purchase of specified groups of products. 3/ These auction schemes in effect provide that the average effective price of foreign exchange in the economy is closer to the underlying equilibrium rate than is the official rate. To the extent that domestic prices of imported goods are allowed to reflect transaction prices, transfers of foreign exchange among enterprises at negotiated rates or its sale in auctions or similar markets will tend to ensure the passthrough of the higher exchange rate on these transactions. Moreover, in at least one case imports purchased directly from retention accounts are also permitted to be sold domestically at prices that reflect the exchange rate at which foreign currency is sold in an organized market setting.

While the proliferation of such auctions, at which exchange rates may not always be determined freely, tends to complicate the exchange rate system, they may play a useful transitional role in providing the authorities as well as enterprises information regarding the true valuation of foreign currency in the domestic economy, and as a basis for eventual unification of exchange rates at a realistic level. The usefulness of such markets in determining an appropriate unified exchange rate will depend, however, on their size and the extent to which they are free to reflect market forces.

1/ Proponents of this shift in criteria view it as encouraging a reduction in import intensity, a change in the structure of imports, and an increase in the domestic value added component of exports.

2/ Also observe that, as in the case of export-related tax reliefs, but to a lesser extent, the successful use of retention accounts as an instrument to expand net exports is likely, ceteris paribus, to increase domestic excess demand pressures.

3/ In the case of China, foreign exchange is bought and sold by market participants in so-called foreign exchange adjustment centers, which have been established in many cities.

Beyond the foreign exchange made available to exporters and their suppliers directly through retention accounts, and by both exporters and the banking system through auctions, in some economies foreign currency continues to be allocated centrally for various priority programs and investments. In some instances, however, the proportion of foreign exchange being allocated centrally is falling quite rapidly.

VI. Concluding Remarks

This discussion of market-oriented foreign trade reforms in planned economies has sought to emphasize the inherent interconnectedness of the different reform elements, including the institutional changes that bear on the ability of producing enterprises to engage directly in foreign trade, modifications in the exchange rate system, and the reform of domestic prices and of the mechanism for setting these prices. The success of foreign trade reform, and therefore of a trade policy aimed at fundamental integration of planned economies into the world economic system, ultimately depends as well on the successful implementation of compatible reforms in the domestic economy as a whole. It is highly unlikely that a comprehensive, market-oriented foreign trade reform can be successfully grafted onto a basically traditional system of central planning. By the same token, it should be emphasized that the pace and even the extent of domestic economic reform, including the scope for expanded competition and price liberalization, may depend as well on the pace and degree of reform of the foreign trade system.

Several planned economies have already initiated quite ambitious programs of foreign trade reform. In some cases progress is being made in dismantling the institutional monopoly of foreign trade and in expanding the de facto freedom of enterprises to engage in foreign trade largely on the basis of market signals (Section II). In several countries these signals are now being conveyed much more clearly than under classical central planning, as the exchange rate system is reformed and steps are taken progressively to link domestic with foreign prices (Sections III and IV). Measures in these areas are frequently supplemented, however, by extensive use of other financial incentives for exporters and by transitional mechanisms for allocating foreign exchange on a more decentralized and in some cases more market-oriented basis (Section V).

The existing foreign trade and exchange arrangements of each of these economies must be viewed as transitional and as not yet representing totally internally consistent foreign trade systems. Nevertheless, in some cases these arrangements constitute a fundamental break with the system of foreign trade that characterized classical central planning. That this break has not yet been reflected in significantly deepened integration into the world economy is perhaps not too surprising given the relatively short history of most of these reform efforts. It probably also reflects, however, the need to push these reforms, as well as those in the domestic economy more generally, even

more boldly so as to create more stable conditions for enterprises to have both the incentive and the ability to command resources through the market on the basis of more realistic price signals.

References

International Monetary Fund, Asian Department, "Economic Reforms in China Since 1978," SM/89/205, October 1989.

_____, European Department, "Economic Reform in Hungary Since 1968," SM/89/203, October 1989.

_____, European Department, "Economic Reform in Poland Since 1981," SM/89/204, October 1989.

Ivanov, I.D., "Restructuring the Mechanism of Foreign Economic Relations in the U.S.S.R," Soviet Economy, 3(3), 1987, 192-218.

Kornai, J., Economics of Shortage, 2 vols. (Amsterdam: North-Holland, 1980).

_____, "Adjustment to Price and Quantity Signals in the Socialist Economy," Economie Appliquée, 35(3), 1982, pp. 503-524.

_____, "The Hungarian Reform Process: Visions, Hopes and Reality," Journal of Economic Literature, 24(4), 1986, pp. 1687-1737.

Kozma, G., "The Role of the Exchange Rate in Hungary's Adjustment to External Economic Disturbances," in Paul Hare, et al, Hungary: A Decade of Economic Reform (London: Allen and Unwin, 1981), pp. 205-220.

Lavigne, M., "Comments on the Devaluation of the Ruble," manuscript, December 1988.

Marczewski, K., "Polityka realnego kursu walutowego w Polsce i Wegrzech w latach osiemdziesiatych," Handel zagraniczny, No. 8, 1988, pp. 11-15, and 31.

Plowiec, U., "Economic Reform and Foreign Trade in Poland," in J.C. Brada, E.A. Hewett and T.A. Wolf (eds.) Economic Adjustment and Reform in Eastern Europe and the Soviet Union: Essays in Honor of Franklyn D. Holzman (Durham, No. Caro.: Duke University Press, 1988), pp. 340-369.

Portes, R., "Central Planning and Monetarism: Fellow Travelers?", in P. Desai (ed.) Marxism, Central Planning, and the Soviet Economy (Cambridge, Massachusetts: MIT Press, 1983), pp. 149-165.

Salgó, I., "Economic Mechanism and Foreign Trade Organization in Hungary," Acta Oeconomica, 36(3-4), 1986, pp. 271-287.

Shagalov, G., "Novy mekhanizm vneshneekonomicheskikh sviazei i mezhdunarodnogo sotrudnichestva," Voprosy ekonomiki, 5(1988) pp. 138-148.

Török, A., "Stabilization and Reform in the Hungarian Economy of the Late 1980s," manuscript, 1988.

Wolf, T.A., "External Inflation, the Balance of Trade and Resource Allocation in Small Centrally Planned Economies," in E. Neuberger and L.D. Tyson (eds.), The Impact of International Economic Disturbances on the Soviet Union and Eastern Europe: Transmission and Response (New York: Pergamon, 1980), pp. 63-87.

_____, "Exchange Rate Systems and Adjustment in Planned Economies," in International Monetary Fund, Staff Papers, 32(2), 1985, pp. 211-247,

_____, Foreign Trade in the Centrally Planned Economy, vol. 27 in the series Fundamentals of Pure and Applied Economics (London: Harwood Academic Publishers, 1988a).

_____, "Devaluation in Modified Planned Economies: A Preliminary Model for Hungary," in J.C. Brada, E.A. Hewett and T.A. Wolf (eds.), Economic Adjustment and Reform in Eastern Europe and the Soviet Union: Essays in Honor of Franklyn D. Holzman (Durham, N.C.: Duke University Press, 1988b), pp. 30-71.

_____, "The Simultaneity of the Effects of a Devaluation: Implications for Modified Planned Economies," Acta Oeconomica, 39(3-4), 1988c, pp. 301-320.