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Stabilization and Reform in Eastern Europe:
A Preliminary Evaluation

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Abstract

The paper analyzes common issues emerging from the recent experience with Fund-supported programs in Hungary, Poland, Czechoslovakia, Bulgaria and Romania. These comprise the initial price-overshooting and the output collapse, fiscal sustainability as well as the financial and structural problems associated with bad loan portfolios and sluggish implementation of privatization programs. Substantial success, in varying degrees, has been achieved in the initial macro-stabilization and opening-up effort. At the same time mounting difficulties with fiscal and monetary control may be emerging, as a result of social and political pressures and insufficiently clear policy signals on the micro-issues involving the sharp structural transformation of the productive and financial systems.

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Summary

The paper examines the lessons that can be learned from the stabilization and price reform programs adopted with IMF support in five Eastern European countries--Hungary, Poland, Czechoslovakia, Bulgaria, and Romania--during 1990 and 1991. While the paper addresses common issues, it also discusses variations in performance, particularly if these reflect disparities in initial conditions. Unlike Hungary, which had already made considerable strides in the reform and opening-up of its economy, Bulgaria, Czechoslovakia, and Romania followed the earlier "big bang" approach of the 1990 Polish program. That is, besides following the "heterodox" approach to stabilization (as Israel and Mexico had in earlier programs), their programs were also very far-reaching and ambitious in their attempts to move quickly from the initial production equilibrium of the old system to the desired market-based productive structure.

The initial stabilization results have been impressive, although the price shock has turned out to be larger than expected, occasionally leading to inflation persistence. Likewise, in some cases, the balance of payments improvements may be transitory rather than permanent. Moreover, a fiscal problem has emerged within a year of the start of all programs because of the erosion of the enterprise profit tax base and increasing social pressures on the expenditure side.

The main surprise to policymakers and to the initial IMF forecasts has been the sluggish response of the productive system to the new price and incentive signals. The collapse of the Council for Mutual Economic Assistance led to a massive decline in output in almost all countries, but the contraction of internal demand and supply also helped to depress economic activity. The response on the supply side may, in turn, be related to the slow speed of structural adjustment and the sluggishness of the privatization effort--both crucial to the timing of the output and employment rebound.

In this connection, the analysis suggests that price and exchange rate levels can be stabilized relatively rapidly. The adjustment of the production structure and of investment and ownership patterns to sharp changes in relative prices is of necessity much slower. Moreover, market failure may persist for a while, raising the vexing problems of sequencing and the need for residual government involvement in the transitional stage. In this context, issues relating to the financial fragility of the enterprise and banking systems as well as to the appropriate production, trade, and financial regimes for state-owned enterprises during the transition are also discussed.

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I• Introduction 1/

The transformation of Eastern Europe provides an unprecedented challenge for policymakers in these countries as well as for the international community involved in the financing and monitoring of their economic programs, especially the IMF. It is also an unusual challenge for the economics profession, mainly because there is hardly any prior experience from which the lessons could be learned for the present context. 2/

The East European countries, by the customary classification, belong to the group of middle-income countries. Their relative income levels (with suitable correction of relative prices), their past growth rates, their levels of education and health, all put them in this class. Their political and economic crisis came in the wake of increasing maladjustment of the whole Soviet bloc to the changing world growth and trade environment. In that superficial respect the adjustment and structural reform problem of Eastern Europe would seem to belong to the class of reforms in middle-income countries, such as Brazil, Mexico, or Israel, which had enjoyed long periods of growth and relative price stability in the past but in the course of the 1970s and 1980s underwent severe structural crises which were either exacerbated or caused by poor response to external shocks such as the oil and debt crises. Some of these same shocks (e.g., energy and raw material

1/ This paper was written at the request of Massimo Russo, Director of the European I Department, IMF, during my stay as Visiting Scholar at the Research Department of the Fund in December 1991 - January 1992. A draft of the paper was used as the background document for a staff seminar that was held in Paris in February 1992, in which the chief negotiators from the Eastern European countries in question participated. While the paper was written during my brief stay at the Fund it should by no means be considered as reflecting anything other than my own views.

In the preparation of this paper I benefited from numerous memos, very useful discussions, and helpful comments on earlier drafts from many individuals. Without implicating any of them, I wish to thank Bijan Aghevli, Caroline Atkinson, Gérard Bélanger, Olivier Blanchard, Mario Blejer, Guillermo Calvo, Jeremy Carter, Kemal Dervis, Michael Deppler, Stanley Fischer, Morris Goldstein, Mohsin Khan, Anthony Levitas, Leslie Lipschitz, David Lipton, Michael Mussa, Massimo Russo, Hans Schmitt, Anoop Singh, Gyorgy Szapary, and Emmanuel Zervoudakis. I have also benefited a lot from conversations with several of the key policymakers and experts in these countries to whom I am very grateful. Finally, I am indebted to Caroline Atkinson for providing general help, and thanks go to George Anayiotos for preparing some of the tables and charts.

2/ Hungary started its reform process at an earlier stage, and some of the lessons from her experience are of considerable importance. However, the scope of and speed at which the reform in the other four countries was initiated has no precedent in a command-type economy.

prices) have only now been having a delayed effect in Eastern Europe. The difference, however, is not only one of timing or of degree. Here it is the whole political and economic framework that has collapsed. Far-reaching political reform was followed by adopting an economic reform whose desired end product is similar to that of some other middle-income countries, but the distance between the initial point, at which the reform impinges, and the desired goal, is substantially larger in a systemic sense.

The present discussion is confined mainly to the lessons that can be learnt from the aftermath of stabilization and price reform programs adopted with Fund support in five East European countries--Hungary, Poland, Czechoslovakia, Bulgaria, and Romania--in the course of 1990 and 1991. ^{1/} By this stage the beginnings were already evident in some institutional reforms, such as the breaking up of the monobank into separate central bank and commercial banking systems. Yet privatization was only in its early legislation stage.

How similar are the aims of reform to those that we have recently observed elsewhere? One is the attempt to reform and adapt the economic structure for integration into the world economy. This part involves the opening-up move from a completely controlled and distorted set of relative prices to relative world prices (as far as tradable goods are concerned). The other is the macroeconomic stabilization objective, having to do with the price level, as well as internal and external balances. This, in turn, implies the elimination of high or hyper-inflation, which either already existed at the point of departure or was bound to erupt once prices were decontrolled because of the initial repressed inflation situation (due to open budget deficits or soft budget constraints, monetary overhang, etc.). Thus far the objectives (and even the means) are quite similar to those in other reforms (consider, for example, the recent Mexican simultaneous stabilization and opening-up reform).

The main novelty is in the revolutionary change in the required norms of economic behavior--in the financial system (such as the breakup of a monobank system), in the fiscal structure, in social safety nets, in the establishment of private property rights, and in the mass privatization effort. One could clearly point to large segments of the noncentrally planned economies that have either soft-budget norms of behavior and/or a financially repressed business sector and/or highly subsidized state enterprises. However, they differ in that their underlying structure is nonetheless largely market oriented and private property rights are reasonably well defined. While there is a lot to learn from the reforms applied to distorted sub-systems in the other economies, it makes a sea of difference when the whole economy is one centrally controlled, nonmarket,

^{1/} Several of the issues to be addressed here have already occupied the Fund in its interim assessment of the 1990 programs (in an internal document, March 1990), but at the time the 1991 programs had only just gone into effect.

publicly owned and financed system, with no other normative internal reference point and a market economy has to be created where it had not existed before. This dictated an even more comprehensive approach to the reform process than ever adopted to date.

The need for a simultaneous approach to macroeconomic stabilization, price reform, and property rights reform was recognized in the Fund approach to these programs at the inception stage. ^{1/} While the programs have been largely "heterodox" in their approach to the stabilization of the price level, they differed from their predecessors (e.g., Israel and Mexico) in several respects, especially in the way in which wages were controlled. But the programs were much more far reaching and ambitious in the attempt to move at great speed from the initial production equilibrium of the old system to the desired new market-based productive structure.

As we shall see, the initial results on stabilization have by and large been impressive, even though the initial price shock has in all countries been larger than expected, leading to inflationary persistence in most economies. Likewise, the balance of payments improvements may in some cases be of a transitory rather than a permanent nature. The main surprise from the point of view of both policymakers and the Fund's initial forecasts was the estimated speed of response of the productive system to the new price and incentive signals. The collapse of the CMEA, which in a sense is an exogenous event from the point of view of each country taken by itself, had disastrous consequences on output in almost all countries, but this is probably not the whole story. While a private, small enterprise sector is developing, both demand and supply factors have played their respective roles in sharply contracting output of the large state-owned enterprise (SOE) sector by more than was expected. While some of the latter may have to do with the nature of the stabilization, the more problematic issues are the slow speed of structural adjustment and the sluggishness of the privatization effort in virtually all cases. The latter will be of particular importance in the timing of an output rebound.

While this paper is addressed to common issues, one should not ignore differences in performance, some of which originate from the considerable diversity in the initial conditions that the various countries faced at the start of the present reform process. We start our discussion in the next

^{1/} See "The Role of the Fund in Assisting Eastern European Countries," internal document, February 1991. The comparative details of the various programs are given in Table A1 in the Appendix to this paper.

It is important to point out from the outset that unlike many of the cases that the IMF has been confronted with in the past, Fund programs in Eastern European economies thus far have typically been self-imposed drastic adjustment programs, to which the Fund has given its blessing, rather than having been the primary initiator. Even in these cases, however, the Fund missions played an important role in the design and detailed formulation. Fund technical assistance has been crucial in the implementation phase.

section (II) with a brief survey of the initial conditions as well as the general outline of the Fund-supported programs. ^{1/} This is followed in Section III by a general discussion of the concept of economic reform, based on what is known from previous experience with relative speeds of adjustment in different markets and spheres of economic behavior. A distinction is drawn between the stabilization of the price and exchange rate levels, which can be achieved fairly rapidly, and between the responses of production structure, investment and ownership patterns to sharp changes in relative prices, all of which tend to be extremely slow processes of adjustment. Market failure may indeed persist for a long time, naturally raising the vexing issues of sequencing and the need for, or extent of, residual government involvement in the transition stage.

The rest of the paper takes up a series of pertinent issues emerging from the Eastern European stabilization and reform experience so far. The price overshooting and the output collapse, and their relation to the choice of policies, are taken up in Sections IV and V, respectively. Section VI discusses the fiscal balance and, in particular, its sustainability in view of the inevitable erosion of the state enterprise tax base while pressures persist for additional social expenditures (replacing the old subsidies). In Section VII we address the problems of financial reform, bad loan portfolios, interenterprise credit arrears, and the need for a major cleanup and capitalization of the weak commercial banking sector. Section VIII raises the question of interim production, trade, and financial regimes for the state enterprise sector during the ambiguous ownership and control period.

The subsequent Section IX discusses the choice of exchange rate, monetary, and incomes policies to maintain relative stability during the transition period. The paper ends (Section X) with a few concluding remarks.

II. Initial Conditions and Country Programs

While almost all the countries in question had at some stage embarked on partial structural reform in the 1960s, in all but one--Hungary--these reforms ground to a halt. Hungary pursued a very gradual reform process, beset with many setbacks, over a period of 20 years. While the end objective of that reform process had not been a market-based economy, Hungary emerged better prepared than the other countries on the institutional economic front for the dramatic political liberalizations of 1989-1990. This shows up in the extent of earlier price and trade

^{1/} A more detailed discussion of developments in each country can be found in individual country surveys published by OECD and in IMF working papers. Recent papers on Hungary [Dervis and Condon (1992)], Poland [Berg and Blanchard (1992)] and Czechoslovakia [Dyba and Svejnar (1992)] were also presented at a February 1992 NBER conference on transition in Eastern Europe.

liberalizations, 1/ and in an earlier start in the small-scale private ownership sector. Before 1989, Hungary also put in place a two-tier banking system, a tax reform, and a corporate law. Some private sector developments prior to 1989 characterized Poland, notably it always had a private agricultural sector. 2/ Both these countries, however, suffered from an initial external debt overhang (Table 1), and both showed practically no growth in the 1980s. Unlike Hungary, Poland's imbalance prior to 1989 was also felt on the internal front, having had a large "monetary overhang," which the partial price liberalizations and ensuing hyperinflation of 1989 helped to eliminate, or at least reduce substantially, before the January 1990 program.

In the absence of an explicit measure of the monetary overhang, the estimate of the money/GDP ratio (line 6 of Table 1), gives a rough indicator. An order of magnitude of 0.4 or thereabouts could be considered the norm, a higher ratio points to the extent of possible overhang, which was large in Poland (in 1989, and probably even larger beforehand) and Bulgaria, smaller in Czechoslovakia and Romania, and by this measure there was none in Hungary.

It is interesting to note that during the 20 years after the spring of 1968, Czechoslovakia reverted to a most orthodox centrally planned economy (see the relevant measures in Table 1) and was thus, in a structural sense, much less prepared for the sharp change. Yet it enjoyed the most favorable initial internal and external macroeconomic balance. It had only a small monetary overhang and an extremely low external debt-to-GNP ratio on the eve of the January 1991 reform. 3/

1/ By 1982 over 50 percent of consumer goods were free of control, the percentage gradually increasing to 80 percent by 1990 and (to over 90 percent in 1991). Trade liberalization proceeded more slowly. For the Hungarian economic reform process since 1968 see Boote and Somogyi (1991). For a good account of the more recent economic developments see OECD Survey on Hungary (1991).

2/ Also, in Poland the weakening of state control started already in 1981 with two solidarity-induced laws that gave a measure of autonomy to firms and induced the beginning of a private sector outside agriculture. The other institutional reforms, however, lagged behind Hungary's.

3/ In an interesting recent recount of these countries' developments in the pre-communist era (Solimano, 1991), Czechoslovakia stands out as having had a very prudent macroeconomic tradition. As is well known it also had the most developed industrial structure by the time communism took over. The major subsequent development in that respect took place in Slovakia, with the relevant repercussions for the present structural reform and inter-republican political and social problems that Czechoslovakia undoubtedly has.

Table 1, Eastern Europe: Initial (pre-program) Conditions

	Hungary	Poland <u>1/</u>	Czechoslovakia	Bulgaria	Romania
1. Population <u>2/</u> (In millions, mid-1989)	10.6	37.9	15.6	9.0	23.2
2. GNP per capita <u>2/</u> (1989 US\$)	2,590	1,790	3,450	2,320	2,290
3. GNP growth <u>3/</u> (Average annual rate in percent at constant prices)					
1970s	4.5	5.5	4.6	7.0	9.3
1980s	0.5	-0.7	1.4	2.0	1.8
4. Administered prices (In percent of total)	15	100 (Excluding food prices)	100	100	80
5. State ownership	90%	70%	Economy-wide	Economy-wide, except 15% of agriculture	Economy-wide
6. Money(M2)/GDP, 1990	0.4	0.9	0.7	1.3	0.6
7. External debt/GDP (1990, percent)	65	80	19	50	3
8. External debt service ratio (1990)	57 <u>4/</u>	56	23	116	--
9. Exports to CMEA (1990) <u>5/</u>					
In percent of total exports	43	41	60	69	—
In percent of GDP	16	14	25	34	--

1/ M2/GDP and exports to CMEA in percent of total exports are 1989 figures.

2/ World Bank: World Development Report, 1991; IMF staff estimate for Romanian GNP per capita. All of these data are highly sensitive to the choice of exchange rates.

3/ The Vienna Institute for Comparative Economic Studies: COMECON Data, 1990; Net Material Product.

4/ In percent of merchandise exports.

5/ Estimates are highly tentative as they are very sensitive to distortions in intra-CMEA prices, and exchange rates. Data for exports are based on estimated world market prices (considerably above the official traded prices); however, the GDP data are based on actual official prices. For Romania export data are only available at official prices which would tend to underestimate the weight of CMEA trade; on this basis, CMEA exports were 39 percent of total exports and equivalent to 6 percent of GDP.

CHART 1
Eastern Europe
EXCHANGE RATES, 1989-92

(Local Currency per US Dollar, in log scale)
(End of Period)

Sources: National authorities and IMF staff estimates.

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Bulgaria stands out in having had the most extensive industrial development in relation to its starting point (with some 60 percent of the labor force in that sector, compared to a mere 20 percent in the 1930s), much of it export-confined to the U.S.S.R. (see line 9 in Table 1). In the years since 1985 Bulgaria incurred a sizable external debt as its foreign finances faltered and it faced a severe foreign exchange constraint by the time the reform started, as well as a substantial monetary overhang. Romania, which had no external debt at all, and was less dependent on CMEA trade, was nonetheless plagued by very severe internal economic, social, and political problems on top of specific supply problems in the oil market.

At the beginning of 1991 three of the countries--Czechoslovakia, Bulgaria, and Romania--adopted programs that essentially resembled the Polish program of 1990: the main breakaway from the past consisted of an almost complete price liberalization and a substantial elimination of price subsidies, with the aim of achieving fiscal balance coupled with the establishment of strict monetary targets and wage ceilings. With respect to the exchange rate, Czechoslovakia, like Poland in 1990, adopted a peg as a nominal anchor (after several devaluations in the preceding months which almost doubled the exchange rate). Bulgaria and Romania, for lack of foreign exchange reserves, floated and let the interbank market determine a considerably depreciated exchange rate, thereby tripling the previous official rate (Chart 1). The two countries did, however, differ in the phasing of the exchange rate reform, which was more gradual in the case of Romania. In all these countries the program included substantial trade liberalization with current account convertibility, and various other measures and institutional changes pertaining to structural adjustment and privatization.

Hungary adopted a gradualist program in January 1991, involving a much smaller devaluation (15 percent), a further liberalization of prices (up to 90 percent of the consumer basket by the end of 1991, having previously moved gradually from 56 percent in 1985), and restrictive fiscal, monetary, and incomes policy. This program, which had been preceded by other, less ambitious, programs, also included a substantial further liberalization of imports and another set of structural adjustment and privatization measures. ^{1/}

The programs for the first four countries (excluding Hungary) were obviously conceived as "big bang" moves. The underlying motto was that the price and trade systems, with few exceptions, had to be liberalized all at once, under the umbrella of fiscal, monetary, and incomes restraint. At the same time new financial institutions were being put in place and the

^{1/} The average tariff dropped from 18 percent in 1985 through 16 percent during 1986-89 to 13 percent in 1991. The share of imports liberalized rose from zero to 16 percent (1989), 37 percent (1990) to reach 72 percent in 1991. These figures appear in Dervis and Condon (1992).

productive systems were slated for rapid privatization, so as to minimize the uncertainties of operation under public ownership and controls.

In all countries the initial price liberalization stage was expected to involve a substantial price level shock, to be followed a few months later by relative price stability. The actual results are discussed in Section IV. The prior assessment of output response is discussed in relation to actual outcomes in Section V. First we digress on the more general philosophy of economic reform.

III. Concepts of Economic Reform--Big Bang and Gradualism

The key question for policy choice in any major reform process, and certainly in the present case, is the critical mass of reform steps that have to be undertaken at the major starting point or, in other words, the choice of big bang or gradualism in the move from the pre-reform distorted equilibrium to the desired new post-reform quasi-equilibrium. The answer to this question is not at all clear ex ante. Cumulative experience from episodes of hyperinflation and high inflation (say, at least three-digit annual inflation rates) only point to the clear advantage of taking the "cold-turkey" approach at the inflation stabilization stage (recent successes have been Bolivia, Mexico, and Israel). 1/

Credibility, expectation signalling, and the problem of nominal synchronization (i.e., avoiding very sharp changes in relative prices) dictated a multiple anchor, or "heterodox" approach, in the recent successful stabilizations of Israel and Mexico. Given the initial hyperinflation outburst, this approach was also followed in the 1989-90 stabilizations of Poland and Yugoslavia. Czechoslovakia, Bulgaria, and Romania in 1991 also chose a big bang approach, even though inflation before the opening stage was relatively low. 2/ The potential inflationary outburst, given the repressed pre-reform system, may have justified this approach, which enabled these countries to avoid the hyperinflation that would have followed in the price liberalization stage, in the absence of tight macro policies. We return to this question in Section III.

All of this, however, applies to price-level stabilization and the achievement of initial internal and external balance. There still remains the question of how much and how fast one should go on a broader reform front. For example, does trade liberalization and a move to convertibility,

1/ Chile's 1970 stabilization was the only recent successful stabilization from very high inflation that took a gradualist approach (while the trade liberalization, interestingly enough, was done in a relatively speedy fashion). The social cost, however, was extremely high and the strategy would probably not be feasible under an open democracy.

2/ Hungary could afford gradualism since its opening up and structural reform process, as noted earlier, had been going on and off for much longer, going in some sense back to 1968.

let alone privatization, necessarily require a "big bang" approach? The answer here is much less clear ex ante and is even less clear given the ex post results. Trade liberalization is an example where the right long-term signal can be given from the start, but execution could, in principle, be gradual. This is a question that will be taken up when we discuss the output collapse (Section IV). Similar examples in either direction can be brought from other areas of reform, such as the opening up of internal and external financial and capital markets. The U.K. opted for a "cold-turkey" approach while other European countries chose to move more gradually and nonetheless achieved their targets. Israel applied a shock therapy to inflation but opened up its financial, capital, and foreign exchange markets in a gradualist strategy (as it successfully did with trade liberalization in the 1960s). It is claimed that even in the communist camp, the examples of Vietnam and China in the Far East or of Hungary in Eastern Europe point to the availability of gradualist alternatives, although it has to be admitted that none of these cases were conceived, at least initially, as moves to a capitalist final state.

A closely related issue is the speed of adjustment of markets to the change in signals and the credibility which agents attach to announced signals of future market environments, which are not yet evident in today's markets. It is well known that the speed of adjustment in asset markets (such as foreign exchange or domestic financial markets) is extremely high; the response is often instantaneous because the adjustment costs are low. On the other hand, adjustment in commodity and labor markets, let alone the production response that follows from the gestation of new investment, is considerably slower, often lasting three or four years. Any reform that requires complicated legislation, the introduction of new accounting procedures, new implementation or monitoring mechanisms etc., such as privatization of large-scale enterprise or the introduction of a value-added or an income tax, where it had not existed before, may take at least as long as that.

It is important to stress that these long adjustment lags are not the sole province of hitherto centrally planned economies. Structural adjustment is a slow process even in a most advanced market-based economy and even when the reform is credible. Such has been the case with the reconstruction effort of European economies after World War II or the structural adjustment effort following upon a successful major stabilization (such as in Israel in the wake of the 1985 stabilization); consider even a country like Finland, where the recent collapse of the CMEA caused a very substantial GDP drop. In all of these cases adjustment has been or will be prolonged even though the underlying structure is market based.

To sum up this point, in advocating a big bang it has to be made very clear what particular portion of the policy package is implied. Also, the argument for putting in a lot more at the beginning may rest on a special political opportunity as in Poland. But there may also be an intertemporal political trade-off--overly costly programs, from a social point of view, might cause a political reversal at a later stage, as "adjustment fatigue"

sets in or social aspirations as to employment and rising living standards are frustrated. Have these questions been sufficiently considered by the policymakers at the program inception stage?

It is not clear whether there were any illusions over the length of time it would take the Eastern European economies to reach the type of competitive market structure, private ownership, and properly functioning financial system of a typical Western economy. But there seems to have been over-optimism, at the onset of the programs, as to the speed of supply response and other behavioral responses that could come in the wake of a drastic change in the economic environment.

IV. Stabilization: Was the Initial Price Shock Necessary?

In all cases except for Hungary, the initial price shock turned out substantially larger than expected, while inflation within six months of the program came down to less than 2-3 percent a month in the case of Poland, Czechoslovakia, and Hungary. As for the other two countries, inflation edged up, after a temporary drop, to an average monthly rate of 4-5 percent in Bulgaria and 10 percent in the case of Romania (see averages in Table 2 and monthly data in Chart 2). Of the first three countries, however, by the end of 1991 only Czechoslovakia and Hungary were running rates of inflation below the 20 percent annual mark ^{1/}, or a monthly rate of less than 1.5 percent, while Poland's rate has been at least twice as high (of the order of 3.0-3.5 percent a month, or 40 percent per annum). Of all five East European countries, the Czechoslovak stabilization was virtually a textbook case--the initial price shock was followed by price stability throughout most of the second half of 1991 (Chart 2 and Table A2).

Differences in initial conditions no doubt played an important role. Poland started its program in the midst of a hyperinflation caused by a series of preceding price hikes which may or may not have eliminated the monetary overhang by January 1990 (this issue seems to be in dispute). At any rate, a price shock of 45 percent was forecast for January 1990 which ended up with an 80 percent increase ex post (for January and February together the respective figures are 67 ex ante versus 122 percent ex post). During the whole of 1990, inflation was expected to be less than 100 percent and ended up at about 250 percent, showing that even the residual inflation, after the initial shock, turned out to be higher than planned, Czechoslovakia, which started from a stable price level and apparently a considerably smaller monetary overhang, planned a price increase of only 25 percent, and ex post had a price level shock of 40 percent in the first

^{1/} This is a convenient reference point as it corresponds to recent rates of inflation in the successful stabilizers from high inflation; Bolivia, Chile, Israel, and Mexico.

CHART 2
Eastern Europe
CPI INFLATION AND EXCHANGE RATES, 1989-91
(Monthly Percentage Change)

Sources: National authorities and IMF staff estimates.

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Table 2. Eastern Europe: Selected Indicators 1990-91

		<u>GDP 1/</u> (Percent change)	<u>Consumer Prices</u> (Year end, percent change)	<u>Nominal Wage</u> (percent change)	<u>Broad Money</u> (percent change)	<u>Budget Balance 2/</u> (Percent of GDP)	<u>Convertible Current Account</u> (Percent of GDP)	<u>Convertible Current Account</u> (In billions of U.S. dollars)	<u>Total Exports 3/</u> (In billions of U.S. dollars)
<u>HUNGARY</u>									
1990	Actual	-4	33	23 <u>4/</u>	29	-0.1	0.4	0.1	8.9
1991	Program	-3	31	...	23	-1.5	-3.6	-1.2	12.6
1991	Estimate	-8 (-8)	32	20 <u>4/</u>	29	-4.1	1.0	0.3	9.6
<u>POLAND</u>									
1989	Actual	--	640	472	236	-7.4	-2.7	-1.8	8.1
1990	Program	-5	94	... <u>5/</u>	87	-0.1	...	-3.0	...
1990	Actual	-12	249	160	122	3.5	1.3	0.7	15.0
1991	Program	3	36	... <u>5/</u>	43	-0.6	-2.7	-2.7	...
1991	Estimate	-8 (-4)	60	54	49	-7.2	-2.9	-2.2	13.2
<u>CZECHOSLOVAKIA</u>									
1990	Actual	--	18	8	1	-0.3	-2.4	-1.1	11.6
1991	Program	-5	30	17	6	0.8	-7.1	-2.5	12.6
1991	Estimate	-16 (-9)	54	14	27	-2.1	0.7	0.2	10.9
<u>BULGARIA</u>									
1990	Actual	-12	64	32	12	-9.2	-16.1	-1.2	5.7
1991	Program	-11	234	146	24	0.1	...	-2.0	6.6
1991	Estimate	-23 (-16)	339	142	25	-3.7	-11.8	-0.9	3.7
<u>ROMANIA</u>									
1990	Actual	-7	5 <u>5/</u>	11 5/	17	-0.5	-8.0	-1.7	5.8
1991	Program	--	104	...	15	-1.5	...	-1.7	5.4
1991	Estimate	-12 (-10)	223	124	66	-3.0	-6.6	-1.3	3.5

1/ Figure in parenthesis provides an estimate of the fall of GDP due to the fall in exports; percentage point contribution of the change in total exports to the percent change in GDP.

2/ For Poland: general government balance. For Czechoslovakia: central and local governments, and extrabudgetary funds, excluding takeover of export credits, and transfers to the banks and foreign trade organizations on account of devaluation profits and losses. For Bulgaria: based on actual external debt service payments; for 1991, after external debt rescheduling and debt deferral.

quarter of 1991, a smaller relative discrepancy than Poland's. Moreover, the residual inflation during the first year was only 10 percentage points higher than expected, after allowing for the first quarter's shock. Both Bulgaria and Romania started off from a much worse initial position, made a number of additional price corrections during the year, and it is probably too early to pass judgment on the success of the initial move as far as price stabilization is concerned, particularly in the case of Romania. The sharp foreign exchange shortage in these two countries, which necessitated a different exchange rate regime at the start and a considerably larger initial exchange rate hike, may also account for the worse subsequent inflation profile. Hungary, as in other aspects, is an outlier. Its initial price shock was small, 10 percent, as expected, and its residual inflation also hit the target (Table 2).

Three questions arise in the face of these initial price developments, after taking due consideration of the fact that price comparisons between a post-liberalization system and a distorted and rationed pre-liberalization stage impart a considerable upward bias to the data. 1/ Why was the price shock in most cases so much higher than expected; what are the implications of the initial shock for the subsequent inflation profile; (the implications for the real system will be discussed later) and was an initial price shock as large as Poland's, say, necessary?

Possible answers to the first question (sources of the higher-than-expected price level shock) are: existence of a larger unabsorbed monetary overhang, underprediction of the effects of a large initial devaluation, and monopolistic behavior on the part of state enterprises such as would follow from the anticipated imposition of price controls, etc. In Bulgaria, and partly in Poland, the initial monetary overhang may have played a sizable role, while in the other countries (including most of the effect in Poland) the price shock seems to be associated with one of, or a combination of, the other factors, namely the price response to the exchange rate devaluation. For example, it is known from inflationary experience elsewhere that the exchange rate, in the absence of another reliable measuring rod, often serves as the indicator to which pricing agents attach themselves even when their product is not tradable. 2/

This leads us to the second question--what is the relationship of the initial shock to the subsequent inflation profile? If the answer to the first question is confined to an existing monetary overhang, it would follow that a higher initial price jump would "save" the system from additional

1/ An interesting question is to assess whether different initial conditions in the various countries might have led to different relative biases in these price shock estimates.

2/ In Israel this is called the "dentist effect" (because dentists, for example, raise their fees by the same rate at which the price of their material inputs rises even though they comprise only a small portion of the cost of treatment).

inflationary adjustments later on and thus there would be a positive trade-off between the initial shock and subsequent price stability. If this is not the case and if there is also a tendency for other nominal magnitudes in the system (money and credit, wages) to subsequently "catch up" in line with their initial "planned" positions relative to the price level, then an initial price level discrepancy will also lead, through inertia, to higher-than-expected inflation profiles. This may have been the case in Poland and Bulgaria, but probably not, or less so, in Czechoslovakia. In the second half of 1990, money, credit, and wage ceilings were adjusted upward in Poland, and a similar correction was made in the second half of 1991 in Czechoslovakia and Bulgaria. In Poland the difference between the actual wage and the wage ceiling in the earlier phase could, according to the rules of the game, be made up later and enterprise managers availed themselves of this option paying substantial additional taxes while doing so.

Hence the third question--was there an option of a smaller planned, or a smaller actual, price level shock at the beginning in Poland, for example (or, for that matter, in Bulgaria or Romania)? In technical terms the answer is yes, in principle. Compare these programs to one successful "heterodox" predecessors: Israel in July 1985. With the substantial elimination of subsidies Israel limited its initial price shock to 27 percent by opting for an attenuated devaluation (relative to what the fundamentals seemed to dictate) and introduced temporary price controls which were then gradually removed. It obviously had no monetary overhang and its relative price levels were certainly not as distorted as those of the East European economies. Yet it may be argued that Poland could have chosen a smaller upfront devaluation 1/ and/or leave price controls at a higher initial price vector for three months, say, and only then decontrol completely either all at once or gradually. On the other hand, there is the argument that with distortions as big as they were and the new Government's initial credibility being high, it may have been just as well to "chop off the dog's tail all at once." It is interesting to note that Czechoslovakia did keep some controls on its initial price shock. This was done by stipulating maximum prices or trade margins on some key commodities and by requiring prior notification of price increases in some monopolistic sectors as well as by moral suasion. Also in some cases, such as Czechoslovakia and Bulgaria, certain price increases were delayed (energy, housing). The issue of the size of the desired initial price jump, as well as the fall in economic activity, to which we come next, is really one of intertemporal economic and political tradeoff.

1/ In the Polish case, in the initial absence of alternative inflation-immune financial assets, the free market exchange rate reflected a stock demand and far exceeded the relevant purchasing power parity exchange rate. This was the reason for choosing a smaller devaluation than initially planned. Ex-post it may still have been too high--note that it took a year and a half of substantial inflation until the real appreciation of the exchange rate began to "bite" from a competitive point of view.

Do the initial benefits of a very big price bang ^{1/} outweigh the subsequent costs of higher inertial inflation and/or other social costs that have to be borne as a result of the price shock? As far as the twin issues of devaluation and price liberalization are concerned Poland was probably-right in choosing to abolish price controls at the beginning but it could have devalued by less and thus reduced the initial shock. The result may have been the need to realign the exchange rate earlier than in mid-1991, but the cumulative price increase over the two-year period could nonetheless have been smaller. Czechoslovakia (and Hungary) seem to have chosen the right level, and as far as the other two countries are concerned, the question arises whether one could afford to opt for a far-reaching relaxation of foreign exchange restrictions when the foreign exchange shortage is as extreme as it was (and still is). One counter argument is that the administration of such restrictions would be ineffective.

Ending on a positive note--with all the comments and quibbles that can be made in hindsight--the overriding fact remains that in most cases far-reaching liberalization has been achieved together with a reasonable measure of macroeconomic stability in spite of a highly distorted starting point and immense potential economic and political risks. Finally, it is important to point out again, from a consumer-welfare perspective, that against the statistical measure of price increase one should weigh the dramatic qualitative change that has taken place in the market environment now facing consumers in these countries.

V. Was the Output Collapse Unavoidable?

There are several reasons for the large output fall. Let us start with one channel, not necessarily the most important one, that is directly linked to the price shock. First of all, the anticipation of a sharp price increase stimulates hoarding, which is immediately followed by a substantial reduction in demand. Next, when prices rise by more than planned while money, credit, and wages are kept within their specified nominal ceilings, the obvious result is a considerably larger-than-expected reduction in real money and credit as well as in real wages. This happened in Poland in 1990 and was repeated in the experience of the other three shock cases. How much of the output reduction, which was considerably larger than expected, can be directly linked to this price shock discrepancy? The results for the Polish program of 1990 show a considerable reduction in measured output, of around 12 percent, compared to a considerably lower forecast. ^{2/} Both the real wage squeeze and the real monetary squeeze certainly affected consumer

^{1/} It is worth pointing out that it was the Polish authorities who opted for the toughest of three options suggested by the Fund mission at the time.

^{2/} There is some doubt as to the relevance of the -5 percent projected output drop. According to the participants in the planning stage this had been a very arbitrary estimate, not based directly on any of the plan parameters.

demand and thus depressed output on the demand side. The credit squeeze can also operate on the firm supply side, if we consider the finance of working capital as one of the factors of production (see Calvo and Coricelli, 1991). Another channel through which the credit squeeze operates is the real interest rate if nominal interest rates are initially set at a level that is too high relative to the inflation rate that is expected after the initial price level shock. There is some evidence that the high initial real interest has in fact constrained firms more than the quantity of credit ^{1/} (to which they can, and in fact did adjust, through inter-firm credit arrears). At the same time, how much of the output decline, even in 1990, could be ascribed to this factor alone remains an open question.

In Poland as well as in some of the subsequent programs, in addition to the impact of the CMEA collapse to which we turn next, there was a general shock on the supply side that for want of a better term can be termed a comprehensive "management shock." Enterprise managers who were used to operate in a completely different command environment in which their "market" was assured and their finance was accommodative, suddenly had to make their own decisions in a completely transformed environment in which tremendous uncertainty prevails. The first natural impulse is to adopt a "wait and see" attitude or to continue producing the old stuff for inventory, as long as there is working capital. There is evidence pointing to unfulfilled credit ceilings in the first few months of the Polish, Czechoslovak, and Bulgarian programs, followed by a period in which credit ceilings were effective but wage ceilings were not reached. The latter was the case during much of 1991 in the Bulgarian and Romanian programs. In the latter cases, as well as previously in Czechoslovakia, the nominal interest rate was set at a level corresponding to the estimated post-shock rate of inflation rather than so as to assure a positive real rate of interest in the first month. It is important, however, to remember that in these three countries, unlike the Polish case, there was no preceding hyperinflation to contend with. Therefore the fact that a more moderate interest rate policy did not lead to an inflationary outburst is no proof that this policy should have been pursued in a hyperinflationary situation (such as Russia's).

It is important to remember that the credit crunch and high real interest rates are a universal problem in the immediate aftermath of sharp stabilizations (Bolivia, Mexico, and Israel). It could also be argued that in the ex ante uncertainty about the outcome of stabilization, a highly contractionary monetary policy is justified as support for the exchange rate and/or wage anchors. Of the two types of mistakes that can be made it is better to err on the side of an overly restrictive stance. However, once initial success is achieved, a gradual, though careful, relaxation is called for. A more pertinent problem is that of the high bank interest margins associated with a bad loan portfolio. This issue will be dealt with separately.

^{1/} This information comes from a report by the World Bank resident mission based on Interviews in 75 stated-owned enterprises, September 1991.

Table 2 gives rough internal Fund estimates of the part of the output drop in 1991 that can be potentially ascribed to the export drop owing to the CMEA collapse. This estimate was based on demand side, under the assumption of no short-run market substitutability (which obviously did not hold for Hungary or Czechoslovakia--Section IX). It did not explicitly take into account the very sharp terms-of-trade effect of the CMEA collapse, which was a substantial exogenous supply shock to the economies in question, very much like the effect of the relative rise of energy and raw materials prices on the industrial countries in the 1970s and 1980s. It is interesting to point out that, with the exception of Hungary, the implied unaccounted drop in output in Table 2 seems to be correlated with the degree of prior dependence of the country on CMEA trade (Table 1, line 9), which may be a proxy for the relative size of the potential terms-of-trade shock. 1/

The fact that the discrepancy in Poland in 1991 is relatively larger than would seem to be warranted by CMEA dependence may have to do with the complementary component of an aggregate supply shock, namely the degree of rigidity of real wages. In Poland, the real product wage in 1991 did not continue to fall, but rather increased by 15 percent, thus exacerbating the effect of the terms of trade. The CMEA collapse has caused most damage in Bulgaria, the bulk of whose exports had been to CMEA. Bulgaria, as well as Romania, suffered severely from a lack of raw materials due to the foreign-currency constraint. 2/ At any rate, the components of the output collapse must be subjected to more detailed country studies before we can assess how big a margin needs to be explained over and above the 1991 CMEA effects.

In this connection there is the obvious policy evaluation question--to what extent was this unprecedented output drop unavoidable? Even if the answer to this question turns out to be affirmative, the question remains whether there is enough in the set of policies to facilitate a more flexible output rebound in the near future. Part of the answer lies in the realm of structural adjustment policies and privatization to which we shall turn later. However, even before going into these there are the regional trade issues. A substitute to CMEA in the form of a payments union or trade arrangement could certainly help. Given the financial and political

1/ A recent estimate by Rodrik (1992) of the Soviet trade shock which includes that of the terms-of-trade for Hungary, Poland, and Czechoslovakia is remarkably close to the numbers appearing in the brackets in Table 2 so they may include terms-of-trade affects after all. In any case none of the estimates by either IMF or Rodrik includes Keynesian multiplier effects or the effect of aggregate supply curve shifts under wage rigidity [see Bruno and Sachs (1985)].

2/ This is a clear case in which the short-run marginal product of additional infusion of foreign capital inflow is very high. Given excess capacity in complementary factors of production, the marginal GDP product of foreign exchange equals the reciprocal of the raw material to GDP ratio.

problems afflicting the ex-U.S.S.R., it is not clear how much such an arrangement could have worked during 1991. Keeping some of the "distorted" bilateral arrangements during the transition could probably have softened the blow. An example is the revival of some trade between Bulgaria and Russia under a clearing arrangement (applying a disagio on the Bulgarian export rate) which was finally carried out in August 1991 but could, in principle, have been implemented earlier. The point is that given the magnitude of the output shock and the long time-lag of response of the productive system to the new market signals, there is no escape from looking for ways to soften the blow to output and employment in the interim period even if they may seem "distorted" from the long-run point of view, providing the long-term signals are clearly made. The alternative is not the first best but very likely government intervention in other forms--extending credit and granting subsidies to ailing enterprises in a particular region or assigning larger budgetary allotments to unemployment relief.

On the question of the speed of trade liberalization, the wisdom of the "cold turkey" solution could be questioned. A move to current account convertibility can be envisaged also with a more gradual reduction of tariff barriers (see also Greene and Isard, 1991; proposals by Tanzi, 1991; McKinnon, 1991). There is a strong argument in favor of the elimination of import licensing and quotas in one go. However, there is no good inherent reason to move all at once to a zero, or a very low, tariff. The objection to a gradualist strategy is clear, since it may lend itself to discretionary reversals by governments with low credibility. Its advantage when credible, however, is the attenuation of the immediate output and employment costs, while the right price signals for long-term investment are nonetheless retained. A commitment has to be made to a well-defined time path from a differentiated tariff structure toward a common low tariff within a short span of years (no more than, say, five). There are positive examples in the history of trade liberalization which have successfully followed the pre-announced gradualist path (e.g., consider the formation of the Common Market by a precommitted gradual mutual removal of tariffs in the 1950s and 1960s, ^{1/} as well as individual country cases such as Israel's trade liberalization in the 1960s).

Even when the gradual path is chosen there remains a question of whether there should be substantial differentiation of initial tariffs across goods. To avoid political pressures one may, for example, differentiate only by general category of goods (raw materials, investment and consumption goods) rather than by individual commodity or producer. In the next section, in discussing the fiscal balance, we shall argue in favor of at least a flat across-the-board tariff, for purely fiscal reasons, until VAT is introduced. This in itself would not, of course, allow for a differentiated speed of adjustment across groups of goods.

^{1/} In the case of the Common Market it has taken quite a few years to phase out declining industries, e.g., in the area of coal and steel.

A country that opted for an ambitious trade reform from the start, may not want to backtrack at a subsequent stage because the cost in terms of loss of credibility but it is a lesson to bear in mind for future reference (e.g., in the new Commonwealth countries). On the other hand, objections have been raised to the introduction of any customs duties or tariffs in some of the countries, either because of the complete openness of borders or for the lack of necessary administrative capabilities. Unfortunately, that argument would also hold against any taxation like the VAT. The fact is that Poland eventually introduced a new higher tariff structure in the second half of 1991.

Even if there is a reversal of the output downturn in the course of 1992 (which remains to be seen) past reform and structural change experience shows (elsewhere as well as in Eastern Europe) that there is substantial labor shedding and increasing unemployment even while output rebounds.

The sources of the output collapse are obviously very important subjects for further scrutiny. No less important is getting a better handle on the actual numbers. While the public sector's output collapses, the small-scale private sector, especially in trade and services, seems to be thriving. Given the small initial starting base even very large increases at this stage cannot overturn the aggregate result. Unfortunately, one can only rely on partial evidence at this stage. One even gets very different interpretations of the meaning of the unemployment numbers. While unemployment in Bulgaria is already around 10 percent, one is told that there can be no serious unemployment problem if one cannot even find cleaning help willing to work at the minimum wage; at the same time other observers claim that serious unemployment problems are emerging for the young. Both facts are probably correct, just as zero unemployment in Budapest or Prague may be entirely consistent with very serious unemployment in other heavily industrialized regions. It is also argued that one reason why a major employment reduction in the Bulgarian state sector could take place with minimum social upheaval is the fact that many of these workers can return to family farms or work on their own privately owned plots. For a country in which industrialization has been excessive (60 percent of the labor force!) a shift to small-scale services, trade, and agriculture could be a move toward the correct long-run equilibrium composition of output.

From a present policy planning point of view, however, the most relevant issue is an assessment of the likelihood of immediate reversals in output, and especially the employment downturn. It will determine the economic and, in particular, the political sustainability of the present set of stabilization policies into 1992 and 1993.

VI. Is the Fiscal Balance Sustainable?

A key feature of the initial stabilization phase in all cases has been the balancing of the budget, primarily through a substantial permanent cut in government expenditure on goods and services subsidies. As against that, a certain increase in expenditure on the social safety net was envisaged.

Given the existing tax revenue base, budget balance was assumed to be assured, as the figures for the respective programs show (see column 5 in Table 2). The budget balance always requires careful scrutiny to isolate transitory from permanent changes. While the initial budget outcome seems satisfactory in most countries, the subsequent developments (usually starting in the second half of the first year) point to the emergence of serious problems for the second and third years of the programs. Let us consider the various causes and implications of these developments, using the experience of Poland to start with.

At first glance, the Polish fiscal balance in 1990 turned out to be a surprising success. It switched from a deficit of about 7 percent of GDP in 1989 to a surplus of about 3 1/2 percent. As Timothy Lane (1991) shows in detail, it was initially expected that the budget would follow a U-shaped profile over the year, with a shortfall in revenue in the first part of the year and an approximate balance over the year as a whole. In actual fact, the balance followed an inverted U-shape with an increasing surplus in the first two quarters of 1990 turning into a drop in the surplus in the third quarter and a deficit in the fourth quarter of 1990. The estimates for 1991 point to a deficit of 7.2 percent for the year (compared to a planned approximate balance), with the prospect of an even larger deficit for 1992 if no corrective action is taken. ^{1/} The reasons for this outcome are important for future reference. As a result of the price surprise there was an unexpected deep fall in real wages resulting in larger-than-expected profits and higher tax revenues. To this was added a tax on capital gains on inventories and foreign currency deposits. The latter element is an entirely fortuitous one-time effect which resulted from the lack of proper inflation accounting. The profit tax element subsequently fell substantially once real wages rebounded and profits were squeezed. It is the latter element which has persisted into 1991 and is the more permanent effect of the liberalization process to which McKinnon (1991) has recently drawn attention.

Czechoslovakia has gone through a very similar process: a temporary surplus in the first few months of 1991 and an increasing deficit toward the end of the year. Similar problems are emerging in Bulgaria, which differs from its precursors by not having its enterprises' initial capital gains taxed away. Bulgaria showed a large increase in its deficit along with the output and import collapse. Romania's budget was close to balance. In the case of Hungary, a deficit of close to 4 percent has emerged, even though it already had the new VAT and PIT in place.

As was shown by Tanzi (1991) the Eastern European countries typically enjoyed a profit tax revenue of about 15-20 percent of GDP, compared to a 3 percent average for the OECD. Table 3, based on Kopits (1991), gives an

^{1/} Deficit including arrears to the nonbank public and unpaid obligations of the government to the domestic banking system. The cash deficit for 1991 is estimated at 5.7 percent.

Table 3. Comparative Structure of General Government Budget, 1985
Eastern Europe, U.S.S.R. and EEC

(Percent of GDP/GNP)

	5 East European countries <u>1/</u>	U.S.S.R.	EEC
Total revenue	<u>56</u>	<u>46</u>	<u>44</u>
Enterprise taxes	17	18	4
Personal Income tax	4	4	9
Social security	11	4	13
Trade taxes	2	6	--
Expenditure taxes	16	12	11
Other	6	2	7
Total expenditures	<u>55</u>	<u>56</u>	<u>46</u>
Current goods and services	20	21	16
Investment goods	3	8 <u>2/</u>	3
Subsidies and transfers to enterprises	19	18	4
Transfers to households	12	8	15
Interest payments	1	--	5
Other	--	1	3

Source: Based on Table 2 in Kopits (1991).

1/ Unweighted average.

2/ Includes some investment transfers to enterprises.

average breakdown of general government revenues and expenditures for 1989, compared with the U.S.S.R. and the EEC. While the cut in subsidies may account for 8-10 percent of GDP saved on the expenditure side, there are now additional safety net expenditures and unemployment benefits which are likely to expand as the process of structural change and labor shedding deepens. As against that the drop in enterprise profit taxes is likely to continue to exceed the net drop in expenditures.

A crucial problem in all of the countries is the transition from a relatively egalitarian and well provided social welfare network into a market system in which all the income and wealth distribution problems, risks of unemployment, and other objectionable social side-effects of free capitalism suddenly emerge. There is likely to be social and political pressure to continue with the existing generous social security services and to correct for their recent erosion through the sharp price level increases. There is a very large percentage of voters who are pensioners. Currently in Hungary, male employees retire at 60, females at 55, and 25 percent of the population are pensioners; in Bulgaria they are estimated to account for 35 percent of the voters. The relative number of people receiving pensions in Poland has recently exceeded 40 percent. In Czechoslovakia, pressure may also come from the higher-than-average unemployment rate in Slovakia (over 11 percent by the end of 1991 and rising, compared with only 4 percent in the Czech Republic, having been virtually zero only a year earlier). As against these elements there is also room for streamlining the social welfare framework, e.g., privatization of some of the health services, charging for medication which is presently very wasteful, progressively taxing child allowances (Hungary) etc.

One way or another the net outcome, after taking into account the various factors, is likely to be a permanent imbalance unless the output, sales, and profit base rebounds quickly or new taxes are imposed. Past experience shows that the introduction of VAT takes at least three years in a country with reasonably organized enterprise accounts. It is unlikely that this period can be effectively shortened. In the first year in which a VAT is introduced and existing taxes are replaced there tends to be a reduction in revenues anyway. There is thus urgent need to plan for temporary substitutes. For example, had trade liberalization been coupled from the beginning with a considerably larger tax on imports (even at a flat rate, say) this could at least in part temporarily close the gap.

In the *absence of a tax alternative*, the pressure to balance the budget usually leads to expenditure cuts where the political opposition is least but the long-term economic cost is highest, namely investment in infrastructure (roads, communications). This is the one area in which government intervention is usually essential and the positive externalities for the long-term growth of the private enterprise sector may be highest. There may be differences in the urgency of the problem in different countries (probably less crucial in Hungary and possibly in Czechoslovakia, more so in the other economies), but there is a minimum requirement in each

of the countries, quite apart from the common need for coping with the inherited environmental damage.

This discussion leads to two important policy considerations. First, should a certain fiscal deficit be allowed for the interim period (until tax reform is fully in place)? Second, should infrastructure investment be treated as part of regular government expenditure?

The answers to both questions should be considered very carefully in the particular context of each economy. The first and most important general point is that, given the time-phasing nature of the problem, it is of utmost importance to embed the annual budget plan within a well-specified medium-term framework (of three years, at least). Ideally, the country (and the Fund) should endorse a precommitted budget framework trajectory for each of the coming years with full budget balance to be regained within, at most, three years and the deficit in no year exceeding a certain percentage GDP, say, 4 or 5 percent., as a safety margin. The finance of this deficit should not come from direct central bank money creation ^{1/} but should be the responsibility of the Ministry of Finance, which must finance it from foreign or domestic private sector borrowing, depending on the country's initial internal and external debt situation. A clear signal of precommitment along these lines may perhaps help to avoid the bad inflationary or crowding-out effects that a protracted deficit would otherwise entail.

Should infrastructure investment be treated differently? A textbook solution would be to distinguish between the total deficit and the concept of government (dis)saving. It is the latter which is the more important concept for gauging the internal balance (although the former will still be important for financial planning). In such a case infrastructure investment could appear "below the line" as part of a separate capital budget which need not be financed by taxes. The objection to a "pure" solution of this kind comes from the potential abuse of such a procedure. Anything, so practical wisdom says, could be redefined as "investment," be it teachers' salaries, defense expenditures, or the retraining of the unemployed. The way out would be to use very strict definitions of what could legitimately be defined as direct government investment, limit the percentage of GDP allowed (say, no more than an extra 3-5 percent) or not allow for separation of budgets but raise the allowable total deficit by 1 percent, for example, for each 2 percent of planned additional infrastructure with a total ceiling of no more than 5-6 percent, say. Earmarking of specific foreign lending

^{1/} In theory, once there is positive real growth of GDP, money supply could be increased, assuming stable velocity, at the rate of real growth. However, this had best be left to the discretion of monetary policy and an independent central bank and not be built in as a potential source of deficit finance. Otherwise political pressures on the central bank to accommodate any deficit may become ruinous. Recent developments in several of the countries in question point to the prime importance of this caveat.

(e.g., by the IBRD) does, of course, ease matters. There are no universal rules for these kinds of considerations, and they must of necessity be geared to each economy's specific risks or past record. There remains the issue of the fiscal treatment of financial restructuring of enterprises or banks, and the proceeds of privatization. These will be discussed under the respective headings of the next two sections (VII and VIII).

VII. What to Do with Bad Loan Portfolios and Enterprise Arrears?

In all of the Eastern European countries the previous economic and financial regimes left a legacy of bad enterprise debts which have since mounted considerably and have been stacked in the portfolios of the commercial banking system. The sharp stabilization programs, the credit crunch, and the collapse of the ruble-zone export market have exacerbated the problem and so has the mounting interenterprise debt. In the early stages of stabilization this problem was in most cases put aside. Unfortunately, the problem usually does not go away while waiting but, on the contrary, gets worse as time proceeds, and may interfere with the process of stabilization and structural adjustment. On the one hand, the existence of a large bad loan portfolio in the banks balance sheets is one of the causes of the persistence of large gaps between the deposit and lending interest rates. On the other hand, it may distort the relative creditworthiness of enterprises in a way that is not necessarily correlated with their potential profitability or long-run solvency in the new market environment.

In theory this is one of the issues best dealt with upfront in the context of a broader currency reform. When done in the context of the large initial package there are better chances of avoiding the severe moral hazard problems that any loan cleanup entails. Anyway, it was not attempted in the first stroke; even if it had been, since much of the outstanding bad debt continued to accumulate in the post-stabilization phase, the problem would still linger on. In the absence of an upfront cleanup of bad debt either of two polar "solutions" should be avoided. One extreme is to ignore the issue completely in the central government's budgeting perspective by "letting the banks deal with the problem." For a while this seemed to have been the predominant view in Czechoslovakia, for example. If such an approach were fully followed, quite apart from giving the wrong price signals in the credit markets, it would eventually lead to a banking crisis in which the government has to step in, and on a much larger scale than would be required otherwise. The other extreme is to yield to the cumulative political pressure of the debt-ridden enterprise sector and pass blanket debt-cancellation laws. The latter seems to have been the recent approach in Romania. The trouble with that solution, besides being indiscriminate, is that of a serious moral hazard. It preserves the bad borrowing behavior of the past, in the expectation that next time around enterprises will be bailed out again.

The size of the outstanding bad debt is estimated at 15-20 percent of total bank debt in Hungary and Czechoslovakia and may be of the order of

30-40 percent in Poland and Bulgaria. The ideal textbook solution would still be to effect a one-time cleanup of the books, provided it is credible, having the government buy up the debt through the commercial banks and go on a case-by-case basis, cleaning an enterprise only on the basis of a clear recovery plan and with strict conditionality attached and an overall strictly enforced budget constraint. ^{1/} Such a scheme does not seem to be workable for most of the countries and enterprises and/or banks in question, unless it is done at the time of privatization as part of the sale bargain. At the other extreme, those enterprises which could be identified as total failures should be phased out as quickly as possible. Such was the recent procedure in part of the Hungarian coal-mining industry.

The biggest problem is the large share of enterprises whose future is as yet uncertain but have at least a potential for restructuring. A weighty argument against across-the-board cleanups, brought up by some policymakers in these countries, rests on what is perceived to be an inherited lack of credibility with which the new governments have to contend, and announcing in advance that something is to be done "once-and-for-all" amounts to threatening with an unloaded gun. Only a slow process of rejections and tough bargaining will, according to this view, gradually instill the right discipline.

In practice one observes that the problem is tackled in different countries through a gradual institutional and political bargaining process, in several half-hearted ways. In Hungary, for example, the Government recently guaranteed 50 percent (Ft 10 billion) of the bad debts inherited by the banks from the previous regime. The remaining bad debt that has accumulated mainly as a result of the CMEA collapse, will be provisioned by the banks over a three-year period, with the implicit understanding that it will be taken off the annual profits for tax purposes (this implies a 40 percent implicit participation of the state budget). From a public image or political point of view this seems a favored solution since it reduces the apparent profits of the banks (which have recently been quite exorbitant, given the large interest rate margins), while appearing to conceal the implicit cost to the budget. In Czechoslovakia, the Government recently decided to allow the National Property Funds, the recipients of the proceeds from privatization, to issue Kcs 50 billion in bonds to be used to write off old enterprise debt and to provide a direct capital injection to the banks. This solution actually seems to be going in the right direction (see below),

^{1/} Such a procedure was followed in Israel in recent major debt-rescheduling schemes for the Histadrut-owned (trade union federation) industrial conglomerate (Koor) and in the settlements belonging to the Kibbutz movement. Both groups suffered severe financial straits in the aftermath of the 1985 stabilization programs. The Kibbutz movement's cumulative debt had reached some 15 percent of total GDP before the financial restructuring plan was implemented. In another group, the Moshav (cooperative) movement, an earlier scheme had to be shelved for lack of compliance and political pressure, and a new one is not yet in place.

especially since Czechoslovakia's internal debt is small anyway. It remains to be seen if Czechoslovakia and Bulgaria can follow a bank provisioning cum tax participation solution of the kind adopted in Hungary.

The bigger problem is how to avoid enterprises' continued borrowing to survive rather than to adjust. Recapitalizing the banks and letting them handle the problem would seem to be right, provided the banks are sufficiently well equipped to make the proper economic analysis, and that they could also take into account the interests of the bond issuers, namely the government, or that of the taxpayers (who implicitly cover the tax losses). Unfortunately, the commercial banks' financial interests and the long-run economic viability of the enterprise do not necessarily coincide and ideally the existing owner of the asset, namely the state, should participate in the process. This is part of the more general problem of enterprise control in the transition period (see next section). This is further compounded by the fact that the commercial banking system itself is in most cases not yet financially independent from the central bank, leaving part of the quasi-fiscal deficit in ambiguity.

How should one treat the public finance of bank capitalization and enterprise restructuring? It is important to recognize that this type of public expenditure, if it takes the form of a once-and-for-all stock adjustment, should not be reckoned as part of the regular tax-financed budget. It is best to include it as part of the privatization accounts (as is done by the Treuhandanstalt in East Germany or, implicitly, in the recent Czechoslovak financial injection). Even if there is an initial net debt position this could be financed by issue of domestic bonds and/or external financial aid. Alternatively, it could be made part of a broader capital account budget from which infrastructure investment could also be financed (see previous section). Monetary injection through this source should be taken into account within the financial planning done by the monetary authorities, but a one-time stock adjustment, if it is done credibly, should not be looked upon in the same way as a permanent rise in the money and credit growth rates. 1/

1/ One simplified way of looking at it from a monetary point of view is that in a situation of a monetary crunch, where the velocity of circulation has risen substantially, such injection is at least in part a one-time replacement of M for V in the $MV=PT$ equation. As for the residual growth in MV, this may hopefully enable a rise in T without raising P, since the complementary capacity and the underemployed workers exist, while the commodity market has become competitive. This argument does not apply to a permanent increase in the rate of change of M, since the latter usually affects the inflation rate and inflationary expectations directly or indirectly (through the exchange rate).

Finally, in all of this a crucial issue is that of giving the enterprise the right signal, that financial rescheduling is a one-time conditional act, not a precedent. This is part of a more general signalling problem to which we now turn.

VIII. Privatization of Large State-Owned Enterprise--
What to Do During the (Long) Transition?

Experience to date in all five Eastern European countries discussed here points to substantial success in the privatization of (mainly small-scale) enterprises in trade and services, but a virtual standstill in the realm of large-scale enterprise, primarily in the manufacturing sector. The reasons for delay were partly legal (such as the problem of restitution in Czechoslovakia), political (bad experience with instant privatization in Hungary and Poland), or practical (lack of foreign or domestic investors). Even the most advanced voucher scheme that is being implemented in Czechoslovakia has yet to be tested in practice, mainly as to the extent of corporate control that will emerge. One way or the other, it is now clear that there will be a prolonged interim period in which the state will continue to own a considerable part of the enterprise sector.

Here again, either polar extreme (completely ignore or completely continue the past regime) does not seem workable and certainly is not the optimal solution. The problem is how to introduce a market-oriented behavior on behalf of management and workers while not unduly delaying the privatization stage. The impression one gets is that this problem has not been systematically addressed in any of the countries.

In the case of Hungary, there is an attempt to learn the lessons of the previous government's "spontaneous privatization" episode. The new Law on Economic Transformation moves the state-owned enterprises (SOEs) from the jurisdiction of enterprise councils to a company status, under the aegis of the State Property Agency (a very similar idea is the "commercialization" of enterprises in Poland--see below). This involves the introduction of audited balance sheets, introduction of a board of directors, and the state becoming the legal owner, at least for the transition period up to privatization. Supervision of management is partly subcontracted to approved advisory agencies which become the agents of the SPA (which is too understaffed to handle the whole supervision). Much of the Hungarian privatization takes the form of "self-privatization" whereby a manager looks for potential buyers which then have to be approved by the SPA or its accredited consulting firms. The process is obviously a very slow one (except for the known cases of Tungsram, Ikarus, or Videoton; the latter was purchased by a local capitalist, with considerable bank credit, after using the Bankruptcy Law proceedings) and fraught with political and legal problems.

The Czechoslovak Government seems, in principle, to be taking the view that there is nothing to be done except for very speedy privatization, since only the new owners will be able to do what is good for the firm. As a

result, no systematic thought has apparently been given to the control of the enterprises in the so-called "no-man's land." While the view is understandable, ignoring the problem does not help since in the meantime there is mounting pressure to give subsidies or cheap credit to enterprises especially where regional employment problems arise.

An obvious argument against this line of thought is that it smacks of old-style state intervention and may help to keep SOEs in state hands forever. Unfortunately, there seems to be no escape from such "murky" half-way policies unless one is willing to take the line that what cannot be privatized instantaneously had better be scrapped. The latter option, however, makes little economic sense in the medium-run point of view, since a considerable part of the industrial product may be made marketable after marginal investments in physical and/or human capital, especially on the marketing side. Moreover, because of the huge potential unemployment problem (with employment in SOEs anywhere between 30 percent and 50 percent of the labor force), wholesale "scrapping" is not very likely to be viable.

A key issue on which much more work has to be done is to learn the response of managers in SOEs to the sharp changes that have been taking place. A very interesting beginning was made in a recent unofficial survey of 75 large Polish SOEs by the resident World Bank mission (September 1991). A dynamic picture emerges. Managers find themselves at odds with the workers' councils, with much of the innovation and planned change coming from the managers, while they remain restricted and subordinate to the council. Instead of bargaining with the center on raw materials or credit allocation for investment, the attention of managers now turns to enterprise performance in terms of profit (rather than output) and marketing and financial management (rather than technical production expertise). There is considerable "learning by doing," but there is also obvious room to expedite matters by publicly financed training programs in management, marketing, accounting, and financial matters (the cost to the enterprise is high and the benefit may not accrue to it if the manager is free to move). Commercialization as an intermediate step was envisaged as important as it is more likely to protect the manager from the control of the workers' council. In this context the problem of managerial compensation is crucial, to avoid decapitalization of firms. Such compensation could be given, at least in part, by long-maturity stock options or by including a longer-term profit share in the manager's contract.

There is a compelling alternative line of argument, at least for the Polish case [see Dabrowski, Federowicz and Levitas (1991)] that the power of the workers' councils is too important a legacy left over by the breakup of the communist regime to be easily dissipated. According to this view, the only way to resolve the political stalemate between the workers' councils' control and that of the state's is by mass privatization through giveaway schemes in which the present stakeholders in the enterprise, namely both the workers' councils and the managers will be the major beneficiaries. This would constitute, in other words, some form of controlled "spontaneous privatization."

On the joint issue of debt rescheduling and enterprise restructuring, one could also consider the experience of the Treuhandanstalt in the former G.D.R., which has accumulated the most experience to date in the field of privatization with prior restructuring and financial rescheduling. In the East German case the restructuring is very costly and the management problem is partly solved by co-opting managers from West Germany, both options unlikely to be available elsewhere in Eastern Europe. In the case of the former G.D.R., too, it is claimed that while privatization has proceeded at a more rapid pace during 1991 there has been undue concern over job preservation--only a small number of firms have so far actually been shut, due to the regional employment problems.

The variety of experience across countries suggests that there may not be one best way of resolving the privatization issue and each country must choose the one that fits its political and social framework best. The most important conclusion, however, is that it is important for each country to adopt a transparent strategy and give clear signals to both investors, managers, and workers as to where it is heading, so as to minimize the uncertainty in the transition period. Moreover, the upshot of both this and the previous section is that there is a severe limit to what can be achieved through macro policies alone, and that at any rate, great importance attaches to the integration of micro-management policies with the general policy framework right from the start as well as along the way. This is no doubt one area, even more than in previous adjustment and structural reform experiences, in which the integration of the two approaches is essential. But obviously macro policy retains its importance. We thus return to the macro sphere at this point.

IX. What Should Be the Ingredients of Macro-Policy in the Transition?

In Section VI we discussed the problem of the fiscal balance. We have not considered the complementary problem of current account sustainability, which has so far not presented a serious problem, except for the ongoing severe foreign exchange constraint in the case of Bulgaria and Romania. Looking at Table 2 (column 7) the current account is one area in which programs seem to have overachieved their targets. While this is no doubt an achievement, in the face of the CMEA export collapse and in view of the opening up to competing imports, part of this result could be entirely transitory. In all of the countries the propensity to import raw materials and consumer goods is relatively large and while the opening up must have caused a substantial increase in imports, the income effect must likewise have temporarily depressed them, given the output collapse. Once output and internal demand rebound imports will rise. Current account sustainability, like that of the fiscal accounts, must thus be looked at in a medium-term perspective. Two issues arise--export promotion, and, for some of the countries, the debt strategy. Another related issue is that of foreign investment.

The first and obvious problem is the supply and demand response of exports to hard currency markets. Hungary, in particular, seems to have been most successful in this respect so far; its associate membership in the Common Market and longer experience in market penetration have no doubt helped. Both Poland during its first program year (1990) and Czechoslovakia (in 1991) increased their exports to Western markets. It remains to be seen whether this is merely a one-time switch of goods from a severely depressed domestic market 1/ to export "dumping" in the West, or a serious beginning of the required longer-term trend. Much will depend on the internal structural adjustment process and on the willingness to open markets from the external side. Anecdotal evidence in various countries (Hungary and Czechoslovakia, in particular) points to the steady growth of joint ventures, often relatively small ones, based on restructured public enterprises, using Western marketing know-how, which are directed toward external markets. There is probably also a fair amount of (unrecorded?) exported services across newly open borders, based on large skilled and professional labor cost differentials. But it is too early to assess the scope of these developments and the extent to which they will apply to the countries that are further away from Western markets, like Bulgaria and Romania. 2/

While Hungary's outstanding debt, and lack of a Polish-type write-off, is still exerting an external long-term constraint (the growth rate has yet to exceed the weighted interest rate), it has benefited from very substantial inflows of foreign investment, so that no immediate foreign exchange problem will arise. On the contrary, there may be undesirable pressure to appreciate the exchange rate (see below). Polish foreign exchange reserves fell in 1991. Bulgaria's foreign exchange reserve position improved dramatically in 1991, but it is still in a very precarious position, awaiting the debt rescheduling with the banks and it, more than any of the other countries, could make good use of a stabilization fund, so as to enable it to pursue a more stable exchange rate policy. This brings us to the next and main subject of this section--given reasonable balance in the fiscal accounts, what should be the nominal anchor management of the economies in the transition to sustainable growth?

Whatever the choice of exchange rate regime and incomes policy dictated at the initial sharp liberalization and stabilization stage, there is the issue of the appropriate policy stance and tools for the second stage. Poland, which pegged its exchange rate at the beginning, opted for an exchange rate crawl starting in May 1991, 16 months after the initial program. Czechoslovakia has not had to move from the fixed rate established

1/ Apparently there was no switch of exports from CMEA to the West as these were largely goods that are not competitive at the new relative prices.

2/ For all the countries other markets, such as the Middle East, have also been important, and there is no reason why this should not continue to be the case (the Gulf crisis was a temporary problem in 1990-91).

in January 1991. Hungary has so far managed the exchange rate more flexibly for some time. What would be an appropriate regime for Bulgaria and Romania after the initial float? It would seem that, given the inherent instability of money demand, preference should be given to the exchange rate over monetary aggregates as a nominal anchor, as has been the case in other middle-income countries which are running low or moderate rates of inflation. Also, while credit ceilings for individual banks may be an indispensable tool in the initial stabilization phase, or during limited financial crisis periods, they become a hindrance when a more efficient financial intermediation system has to be developed. 1/

Once a country decides on its targeted inflation rate it can set bounds for exchange rate movements over the planning period, whose average rate would be less than or equal to the expected inflation differential with respect to its trading partner. The option of an explicit crawl or flexibility within a moving band depends on the particular institutional setup such as the degree of development of foreign exchange markets. 2/ Interest rate policy can then be geared to the expected foreign interest rate plus the expected rate of devaluation, also taking into account particular capital inflow or outflow considerations.

Judging from the perspective of a country that is already two years past its initial stabilization program, namely Poland, there is great danger of repeating the inflationary patterns of adjustment exhibited by some middle-income countries in the 1970s and 1980s. Lax fiscal policies might be combined with monetary, exchange-rate and wage-rate accommodation to price increases so as to maintain, at least, stable real exchange rates. The rationale would be to maintain an export supply response, but the cost would be the loss of the nominal anchor, and accelerating inflation and recurrent internal and/or external crises.

Should wage ceilings be maintained? As long as a large public sector persists there is no escape from maintaining rather strict wage ceilings for public sector enterprises, as a support for an exchange rate anchor. In view of the distortions caused to the wage structure these could, of course, be eased up whenever sufficient alternative market discipline on the enterprise level has been assured. In the private sector, a distinction should be drawn between tradable or highly competitive nontradable products and monopolistic nontradable industries. The latter had better also be controlled through price or wage controls (or both). The alternative to wage controls, which are clearly distortive, would be a social compact on incomes policy between the major sectors (government, employers, and

1/ Examples have been cited in some of the countries of banks unwilling to promote additional household deposits because, with given credit limits, there was no additional lending motive.

2/ Such a regime does not preclude the possibility of making larger step-adjustments as needed. However, such adjustments, if made too frequently, get embodied in inflationary expectations and may become counterproductive.

workers' unions) of the kind that has worked in some middle-income (e.g., Israel, Mexico) or industrial (e.g., Scandinavian) economies.

Once foreign investments and other private long-term capital inflows make their way into the countries (as is already happening in Hungary) a Latin American-type real appreciation syndrome may set in. There has been an initial overvaluation in most countries and nontraded goods prices in particular are still very far from world market prices. Given this, and assuming that there are substantial untapped reserves of productivity growth, these economies could afford some real appreciation, providing it takes place within a well-managed macroeconomic framework. No general rules can be applied and it would seem that the choice of regime and the mix of policies must be geared to the conditions of each country separately. In this respect, too, there is no difference between these and other middle-income economies that are at a similar mid-reform stage.

X. Concluding Remarks

Our discussion of the recent East European experience points to broad common denominators both across countries as well as with experience elsewhere in the stabilization part of the reform. The basic monetary and fiscal theory of sharp stabilization seems to apply more generally, and to the extent that there are differences across groups of countries they come from problems in the ability to control the budget or the amount of credit or wage policy but not in the underlying conceptual macroeconomic framework. The area in which the differences loomed larger from the beginning is also the one in which the adjustment turns out to be considerably harder than was expected--the change in the micro foundations of the economy, such as in ownership rights and financial accountability. The general lesson to be learned here is that the policy reform package from the start has to put even greater emphasis on the implementation of the institutions and rules of behavior for the micro units. Otherwise the stabilization part of the reform might also eventually fail.

There is another, somewhat related, issue that has to do with the perceived role of government in the transition from a communist to a market economy. In the old days, communism was often envisaged from the outside in highly simplified, minutely detailed central planning, omnipotent government, terms. Likewise a capitalist economy is often imagined today by those who desire to reach it from afar as consisting only of private property ownership and pure laissez-faire, self-adjusting, market mechanisms in which governments need not interfere. Not only do we know that in the most laissez-faire economies market failures often occur (e.g., in financial markets) and government may have to intervene in the micro economy. There is all the more reason to believe that in the transition a hands-off approach cannot be optimal. The obvious example is that of financial restructuring. The danger of resorting to the old central planning mistakes obviously always exists but it cannot justify avoiding the issue of how best to intervene in the transition. In the absence of this realization there will be intervention in practice but in ways that are not clearly stated and

involving costs that may violate the macroeconomic budget constraints without awareness of its scope and implications.

Our discussion of the various topics tended to concentrate on the issues that seemed to be common to the various countries, during the recent period, even though the differences among countries (not only that of Hungary) were also marked. As time passes such differences are likely to become more important from a policy perspective, as they usually did in other cases of stabilization and structural reform.

There is one issue on which economists cannot be of much help, and that is the evaluation of the internal politics of reform. The external observer is struck by the apparent consensus with which the very drastic changes have been accepted so far, especially in view of **the sharp** real wage cuts, the fall in living standards, and rising unemployment. One meets with the understandable argument that the official statistics do not really capture reality *because of statistical* biases, incorrect coverage, etc. While this appears to be true enough, one cannot help remembering, from the experience of other political democracies, that numbers, even if inaccurate, are used in the political market place (e.g., the consumer price index is used in the wage bargaining process, whether formally or informally). A few recent attempted strikes (by air-traffic controllers, for example) in Czechoslovakia ran into public opposition, and it seems that the policy stance of the Government is well understood by the public at large. Bulgaria, with all its difficulties, seems to show a similar pattern. In Hungary, on the other hand, one is struck by the contrast between the apparent success of recent macro policies and their perception in public opinion, which seems quite negative, as if the Government was unsuccessful in selling its policy product.

Both the experience with reforms elsewhere as well as the more recent comparison across countries in Eastern Europe point to the paramount importance of having government strategies not only being spelled out in detail and in terms that can be widely understood but also in the ability of the policymakers to sell their products to the public at large. The impending internal social problems, in all of the countries, will no doubt sooner or later put all the reform efforts to a serious test, as political democratization proceeds and bliss appears further away. This is no doubt the biggest imponderable in each of the countries: what, if anything, can ensure the maintenance of the social consensus over the reform programs and its political sustainability in the near future? In other words, using a recent quote: 1/ "Are they, in return for true freedom, prepared to give up bread lines for unemployment lines?" The recent post-election developments in Poland, for example, do not bode well on this score. At any rate in this and as in many other areas surveyed in this paper, it is probably much too early to tell.

1/ The quote, due to Susan Marie Szasz, appears in Klaus (1991).

Table A1. Eastern Europe: Comparison of Fund Programs

	Hungary	Poland	Czechoslovakia	Bulgaria	Romania
1. Date	February 20, 1991	February 5, 1990	January 7, 1991	March 15, 1991	April 11, 1991
2. Length	36 months	13 months	14 months	12 months	12 months
3. Exchange system	15 percent devaluation in January, then managed.	Initial sizable devaluations, then fixed.	35 percent devaluation in October 1990, 15 percent devaluation and unification with tourist rate in December 1990, then fixed.	Floating interbank	Official rate-fixed. Floating interbank Convergence of official and interbank.
4. Wages	Tax-based incomes policy.	Tax-based incomes policy.	Tax-based incomes policy.	Real wage cut by 35 percent; implemented by ceilings on wage bills.	Tax-based incomes policy.
5. Interest rates	With the abolition of interest rate ceilings will be market based.	Establish positive real interest rates.	Increase before program and flexible management thereafter.	Very large increase before program; flexible adjustment thereafter.	Complete liberalization CDs with flexible rates.
6. Privatization	Continue in 1991.	Continue in 1991.	Start in 1991.	Start in 1991.	Start in 1991.
7. Two-tier banking system ^{1/}	1987	1990	1990	1989	1990

^{1/} The establishment of a two-tier banking system served to end direct central bank involvement in commercial banking.

Table A2: Eastern Europe: Monthly CPI Inflation Rates, 1989-91

(In percent)

	Bulgaria	Czechoslovakia <u>1/</u>	Hungary	Poland	Romania
<u>1989</u>					
Jan	...	...	4.5	11.0	...
Feb	...	...	3.4	7.9	...
Mar	...	...	1.0	8.1	...
Apr	...	...	1.7	9.8	...
May	...	...	0.5	7.2	...
Jun	...	...	0.4	6.1	...
Jul	...	...	2.1	9.5	...
Aug	...	...	0.3	39.5	...
Sep	...	...	1.0	34.3	...
Oct	...	...	1.1	54.8	...
Nov	...	...	0.7	22.4	...
Dec	...	...	0.8	17.7	...
<u>1990</u>					
Jan	...	...	7.7	79.6	...
Feb	...	...	5.3	23.8	...
Mar	...	...	2.7	4.3	...
Apr	...	...	2.5	7.5	...
May	...	...	0.8	4.6	...
Jun	3.5	...	0.4	3.4	...
Jul	3.6	10.0	2.6	3.6	...
Aug	16.3	--	2.9	1.8	...
Sep	4.5	--	1.5	4.5	...
Oct	4.2	3.4	1.5	5.7	...
Nov	5.3	0.8	2.1	5.0	23.4
Dec	10.2	0.8	1.7	5.9	11.6
<u>1991</u>					
Jan	13.6	25.8	7.5	12.7	14.8
Feb	105.2	7.0	4.9	6.7	7.0
Mar	32.7	4.7	3.7	4.5	6.6
Apr	1.8	2.0	2.4	2.7	26.5
May	1.6	1.9	2.2	2.7	5.1
Jun	5.0	1.8	2.1	4.9	2.0
Jul	7.9	-0.1	0.9	0.1	9.4
Aug	5.1	--	0.2	0.6	11.2
Sep	4.7	0.3	1.5	4.3	7.3
Oct	3.1	-0.1	1.3	3.2	10.4
Nov	3.5	1.6	1.4	3.2	10.4
Dec	3.1	1.2	1.7	3.1	13.7

Sources: National authorities and IMF staff estimates.

1/ Rates from July-December 1990 are estimates from quarterly data.

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