

## IV The Experience of Eastern European Countries

This section reviews the experience with exchange arrangements of five Eastern European countries—Bulgaria, Czechoslovakia, Hungary, Poland, and Romania—that initiated extensive market-oriented reforms in 1990–91.<sup>26</sup> Discussion of proposals for a multilateral payments system among Eastern European countries to replace the former CMEA created a consensus against such a mechanism, mainly because existing trade was small (except with the former U.S.S.R.) and because such an arrangement would discriminate against trade with market economies.<sup>27</sup> Instead, all five countries have by now established a fairly generalized current account convertibility, either in a “big bang” fashion or in a gradual but still quite speedy way, and have continued to liberalize remaining restrictions. However, the degree of flexibility of the exchange rate systems has varied across countries and over time, ranging from pegged exchange rates to fairly cleanly floating exchange rates. While trade liberalization has generally supported the achievement of balance of payments objectives and the expansion of trade with market economies, trade between Eastern European members of the former CMEA and the former U.S.S.R. collapsed in 1991. Among the reasons for this collapse were difficulties in carrying out trade under hard currency settlements.

### Convertibility

The reforming economies of Eastern Europe acted very quickly to remove restrictions on access to foreign exchange for current account transactions.<sup>28</sup> In contrast, access to foreign exchange for capital account transactions—such as acquiring for-

foreign assets—remains very restricted, and exporters are required to surrender their foreign exchange earnings to prevent them from increasing their holdings of foreign assets in that way. Bulgaria,<sup>29</sup> Czechoslovakia, and Poland instituted this version of current account convertibility in a “big bang” fashion in conjunction with the liberalization of domestic prices. Hungary and Romania took about one year from the time of substantial domestic price liberalization to remove licensing and other requirements (including limited access to the official market in Romania) for most imports.

While, from an institutional point of view, the PCPEs could be considered not mature enough to support current account convertibility, some crude policy instruments were used to sidestep the institutional deficiencies. Because undeveloped financial markets precluded the use of indirect instruments—such as reserve requirements or a discount window—direct ceilings were imposed on commercial bank credit. Wage controls were instituted to reinforce monetary stringency and prevent a decapitalization of enterprises. Regarding fiscal policy, little flexibility exists until tax reform is implemented; however, an initial windfall gain in profit tax collection generally occurred, which provided considerable initial respite. This windfall gain resulted from the price “jump” at the outset of the reform program, which sharply increased accounting—but generally not economic—profits for enterprises.

Moreover, most PCPEs adopted current account convertibility with only a precarious level of international reserves, typically equivalent to a mere one month of (convertible currency) imports.<sup>30</sup> Although access to international financial markets and to official financial support varied, there was little margin to withstand negative balance of pay-

<sup>26</sup>This section was drafted in early 1992 and covers developments until that time, that is, the first one or two years of reform in this group of Eastern European countries.

<sup>27</sup>See, for instance, Kenen (1991) and Polak (1991).

<sup>28</sup>The removal of restrictions was certainly not complete; for example, residents leaving the country for tourism are usually granted very limited access to foreign exchange.

<sup>29</sup>The surrender requirement does not apply in Bulgaria, where exporters can hold foreign currency-denominated deposits at domestic banks.

<sup>30</sup>Poland was an exception: it had reserves equivalent to about 3½ months of imports, as well as a stabilization fund that was financed externally.

ment shocks. Therefore, it was feared that a surge in imports—stemming from consumers' appetite for Western goods that had been unavailable for decades—could jeopardize current account convertibility even if generally sound policies were followed. However, after convertibility, imports from non-CMEA countries either declined or were at least roughly matched by the increase in exports to those countries (Table 1). To some extent, this was a reflection of tight financial policies and a competitive exchange rate, but it was also related to the decrease in income experienced at the beginning of the reform process. It still remains to be seen, therefore, whether, as income recovers and access to international financial markets strengthens, an excessive switch of spending toward imported goods will jeopardize the maintenance of current account convertibility.

All five countries, however, maintain restrictions on capital account convertibility at this stage of the reform process, mainly owing to concerns that speculative capital movements might disrupt foreign exchange markets and international trade. Restrictions include unavailability of foreign exchange in the official market for the acquisition of foreign assets by enterprises and households; a surrender requirement for exporters; and restrictions on holdings of foreign assets by enterprises. However, there is little evidence at this stage that restrictions on capital outflows are actually binding; the small—and generally shrinking—premiums on black markets seem to indicate no widespread desire on the part of residents to obtain foreign exchange for purposes other than those allowed under current account convertibility. Adequate returns on domestic assets, credible exchange rate policies, broadening domestic investment opportunities created by privatization, and the expanded availability of imported goods through legal channels are the main reasons for the absence of any generalized tendency toward capital outflows, but the generally shrinking stock of private assets (in real terms) may also have contributed. While, *ex post*, the small parallel market premiums may indicate that capital controls were unnecessary, they also indicate that the restrictions probably did not create large distortions affecting private (including enterprise) economic decisions. Moreover, by removing the threat of a sudden speculative attack, capital account restrictions may have supported stability in foreign exchange and financial markets.

## Exchange Arrangements and Domestic Stabilization

The exchange rate arrangements applied by the countries of Eastern Europe since their economic

reforms started in earnest in 1990–91 cover a broad spectrum: they comprise pegged exchange rates (in Czechoslovakia and, initially, in Poland), a pre-announced crawling peg (in Poland since October 1991), an adjustable crawling peg (in Hungary), a floating exchange rate system (in Bulgaria and, since November 1991, in Romania), and a dual exchange rate system with one fixed and one floating rate (in Romania, initially).

Czechoslovakia and Poland pegged their exchange rates—after very substantial depreciations—at the same time as they implemented major price liberalizations, removed most price subsidies, and substantially adjusted administratively set prices. Although these measures were expected to generate a large increase in the general level of prices on impact, it was considered essential that this price jump not be allowed to put in motion a process of runaway inflation. In both countries, the role of a stable exchange rate as a nominal anchor for prices and in fostering confidence in financial markets was believed crucial at this initial stage of reform.

The policy of using the exchange rate as a nominal anchor seems to have generally supported domestic price stabilization in the two countries. In Poland, inflation, although still relatively high, has fallen considerably (converging to the range of 2–3 percent a month only in the second half of 1991), while in Czechoslovakia—although it might still be too early to judge—inflation appears to be heading to a level similar to that in industrial countries.

A pegged exchange rate regime requires an adequate level of international reserves to cushion against volatility in foreign exchange transactions. Poland's reserve position was boosted by a stabilization fund facility that could be drawn upon if necessary. The stabilization fund, which amounted to \$1.0 billion—equivalent to roughly 1.2 months of imports of goods and nonfactor services—was, in fact, never drawn upon. In Czechoslovakia, initial international reserves were very precarious at just over one month of imports at the end of 1990. There was, however, some external financial support—in addition to that provided by the IMF and the World Bank—in the form of balance of payments financing from the Commission of the European Communities and the Group of 24.

The nominal anchor strategy is not, however, without trade-offs. While a more depreciated exchange rate can be expected to be held for longer and to grant, at least initially, higher credibility, it also brings about a larger price increase on impact. In fact, the exchange rate depreciation—together with the increases in administered prices, many of which are directly related to the exchange rate—was one of the major determinants of the price

**Table 1. Eastern Europe: Trade with CMEA and Non-CMEA Areas**

(Millions of U.S. dollars)

	1989	1990	1991
<b>Bulgaria</b>			
Exports:			
Non-CMEA	3,138	2,615	1,817
CMEA	7,953	5,843	2,070
Total	11,091	8,458	3,887
Imports:			
Non-CMEA	4,337	3,372	2,007
CMEA	9,104	4,554	1,845
Total	13,441	8,031	3,852
Balance:			
Non-CMEA	-1,199	-757	-190
CMEA	-1,151	1,289	225
Total	-2,350	427	35
<b>Czechoslovakia</b>			
Exports:			
Non-CMEA	6,476	6,531	7,120
CMEA	7,735	5,207	3,080
Total	14,211	11,738	10,200
Imports:			
Non-CMEA	6,217	7,345	6,740
CMEA	7,848	5,892	4,160
Total	14,065	13,237	10,900
Balance:			
Non-CMEA	259	-814	380
CMEA	-113	-685	-1,080
Total	146	-1,499	-700
<b>Hungary</b>			
Exports:			
Non-CMEA	5,628	6,501	7,412
CMEA	4,045	3,049	1,749
Total	9,673	9,550	9,161
Imports:			
Non-CMEA	5,352	5,691	7,343
CMEA	3,512	2,930	2,681
Total	8,864	8,621	10,024
Balance:			
Non-CMEA	276	810	69
CMA	533	119	-932
Total	809	929	-863
<b>Poland</b>			
Exports:			
Non-CMEA	7,575	11,257	11,146
CMEA	538	3,757	2,063
Total	8,113	15,014	13,209
Imports:			
Non-CMEA	7,335	8,839	10,677
CMEA	652	2,086	2,136
Total	7,987	10,925	12,813
Balance:			
Non-CMEA	240	2,418	469
CMEA	-114	1,671	-73
Total	126	4,089	396
<b>Romania<sup>1</sup></b>			
Exports:			
Non-CMEA	5,726	3,231	1,939
CMEA	4,761	2,539	921
Total	10,487	5,770	2,860
Imports:			
Non-CMEA	3,299	4,703	2,862
CMEA	5,138	4,411	1,322
Total	8,437	9,114	4,184
Balance:			
Non-CMEA	2,427	-1,472	-923
CMEA	-377	-1,872	-401
Total	2,050	-3,344	-1,324

Source: IMF staff estimates.

<sup>1</sup>Data for 1991 are for January–September only.

jump that took place with the price liberalization. Moreover, it has been argued that the resulting large increase in production costs, together with the tight stance of monetary policy, generated a negative “supply-side” shock to the economy that may account, to a large extent, for the output fall experienced since the launching of the reform program (Calvo and Coricelli, 1992).

But the level at which the authorities decide to peg the exchange rate is not entirely a free parameter in that it is closely related to the general stance of financial policies. If fiscal and monetary policies are tight, there is less need for a large initial depreciation to defend the fixed exchange rate, and thus the price jump can be minimized. If fiscal and monetary policies are not sufficiently tight, an initial overdepreciation may be necessary to make the system less vulnerable to unfavorable shocks, in the expectation that maintaining the exchange rate peg for longer can make a lasting contribution to stabilization. In Poland, the exchange rate was pegged at a level considered sustainable for “a few months” (Lane, 1991). This level, which was, in fact, more depreciated than the parallel market rate,<sup>31</sup> permitted a large increase in exports in 1990 and was sustained for nearly one and a half years. In Czechoslovakia, despite preferring to err on the side of overdepreciation in view of the considerable uncertainty (Aghevli, Borensztein, and van der Willigen, 1992), the authorities pegged the exchange rate at a substantially more appreciated level than that which prevailed in the parallel market; nevertheless, the parallel rate gradually converged to the official rate.

While a loosening of policies in the second half of 1990 set back the stabilization effort in Poland to some extent, the different degree of success in price stabilization in Czechoslovakia and Poland may also be attributable to their different starting positions. Poland, with a history of serious distortions, was already experiencing a mix of massive shortages and hyperinflation in the second half of 1989, and the price jump in January 1990 exceeded 100 percent.<sup>32</sup> By contrast, Czechoslovakia, with a history of moderate shortages and disequilibria, experienced a price jump of only about 50 percent, despite a much broader price liberalization. The experience of other countries that have overcome relatively long periods of very high inflation has shown that a residual inflation comparable to that

<sup>31</sup>See Kolodko (1991).<sup>32</sup>According to Lipton and Sachs (1990), when measured from the beginning to the end of the month, the price increase in January 1990 in Poland was 110 percent. The increase in the consumer price index—which measures the average level of prices over the month—was just under 80 percent.

in Poland is very difficult to eliminate. Chile, Israel, and Mexico, for example, are generally considered to apply broadly appropriate economic policies, but their annual inflation remains in the 20–30 percent range.<sup>33</sup> Measured against that standard, the effects of the stabilization effort on inflation in Poland are not atypical.

### Exchange Arrangements and International Competitiveness

Notwithstanding the nominal anchor function, exchange rate policy has its most direct effect on the balance of payments position. In May 1991, after nearly one and a half years of imposing a pegged rate, Poland depreciated the exchange rate parity in response to the appreciation of the U.S. dollar (to which the zloty was pegged) and to the drop in exports to other former CMEA countries. Competitiveness had deteriorated considerably from the level of January 1990. Poland also broadened the peg from the U.S. dollar alone to a basket comprising the currencies of its main trading partners. Some five months later, in October 1991, facing a moderate but persistent deterioration in competitiveness and a less favorable economic outlook, Poland again changed the exchange rate regime to a preannounced crawling peg, that is, a preannounced schedule of monthly depreciation rates of the zloty vis-à-vis the basket of currencies.

Czechoslovakia has made a firmer commitment to maintaining the fixed exchange rate regime. On the one hand, domestic inflation has subsided considerably and can be expected to converge to levels comparable to those countries to whose currencies the exchange rate is pegged. On the other hand, the general policy stance and the orientation of the Government seem more compatible with maintaining a fixed exchange rate. However, it may be premature to draw a sharp distinction between the two countries because Czechoslovakia implemented current account convertibility at a fixed exchange rate on January 1, 1991, exactly a year later than did Poland.

In adopting the preannounced crawling peg system in October 1991, Poland essentially adapted a fixed exchange rate regime to a situation in which it

was recognized that domestic inflation would persistently exceed that in partner countries. The predetermined schedule of daily depreciations precludes any surprise change in the exchange rate.<sup>34</sup> Although not a stated policy intention, the depreciation rates are gradually decreasing in percentage terms, which is consistent with a gradual convergence of inflation to international levels. This system does not, however, appear to be the best suited to recover losses in competitiveness, particularly when inflation expectations appear stubborn, and the commitment of the authorities to impose the necessary financial discipline is not assured.<sup>35</sup> The most similar alternative policy—a fixed exchange rate after an initial depreciation to correct the loss of competitiveness, plus a cushion for further expected losses—would offer the advantage of boosting competitiveness up front and of enhancing credibility. A higher initial inflation rate would also follow, but chances of subsequent stabilization would improve.

Despite the parallels in their exchange arrangements, Poland's external position was boosted more than that of Czechoslovakia. In 1990, Polish exports to non-CMEA markets increased by nearly 50 percent (in current dollars), and they are estimated to have remained stationary in 1991, notwithstanding the appreciation in the real exchange rate. In Czechoslovakia, exports to non-CMEA markets are estimated to have grown by a more modest 9 percent (in current dollars) in 1991, the first year of market liberalization (Table 1). This more moderate increase may have several causes. *First*, the very limited enterprise autonomy before liberalization in Czechoslovakia, including dependence on the now-dismantled foreign trade organizations for all international trade-related activities, may account for a slower or less complete response to market incentives. *Second*, the structure of production, which includes armaments, machinery, and relatively high technology manufactures, may make it more difficult for Czechoslovakia to find markets in Western economies without substantial restructuring of production and commercialization. And, *third*, despite the substantial nominal depreciation and wage restraint policy, increases in raw material and energy prices—owing in part to the change in pricing policies in the former CMEA discussed below—may imply that actual gains in competitiveness were smaller than those in Poland.

<sup>33</sup>An investigation of the reasons for the stubbornness of residual inflation goes beyond the scope of this paper; however, the phenomenon is quite generalized and may be partly explained by lack of full credibility and increasing costs of adjustment. See Agénor and Taylor (1992) and Calvo and Végh (1991). Alternatively, pursuing a real exchange rate target may also lead to a stable but high rate of inflation under some circumstances. See Montiel and Ostry (1991).

<sup>34</sup>There is, however, no explicit commitment as to how long this exchange rate policy will be continued.

<sup>35</sup>The application of a preannounced schedule of exchange rate depreciation in the Southern Cone of Latin America in the early 1980s and, more recently, in Mexico, generated real appreciation of the exchange rate. See Calvo and Végh (1991).

In fact, it is very difficult to assess real exchange rate developments in the five Eastern European countries because of the lack of a meaningful benchmark given the history of price controls and distortions. Chart 1 nevertheless presents the recent evolution of the nominal exchange rate (vis-à-vis the U.S. dollar), and Chart 2 displays monthly rates of inflation.

Whereas Czechoslovakia and Poland have given price stabilization higher priority, the other PCPEs have given greater weight to achieving a comfortable balance of payments position in choosing their exchange arrangements. The adjustable peg system adopted by *Hungary* involves considerably more flexibility; the exchange rate can be adjusted unexpectedly and has been devalued on two occasions to defend the competitiveness of the forint. Hungary's greater concern for balance of payments considerations appears justified by the objective of avoiding a rescheduling of foreign debt, which would be undermined by a deterioration of the external current account, and by a relatively smoother transition to domestic price liberalization than in the other PCPEs. With about 50 percent of domestic prices already freed by 1988, Hungary did not face the same magnitude of market disequilibria as did Poland or even Czechoslovakia. It could, therefore, afford to undertake a more gradual market liberalization, one that would not pose a major stabilization challenge.

The exchange rate system chosen by Hungary has, so far, been effective in maintaining external balance. Exports to the traditional convertible currency area have increased by more than 40 percent cumulatively during 1990 and 1991 (in current dollars), debt rescheduling has been avoided, and access to private international financial markets has been maintained despite some downgrading of the bond rating. Inflation, however, remained slightly above an annual rate of 30 percent in 1990–91, partly because of the gradual price liberalization and adjustment of administered prices (Chart 2).

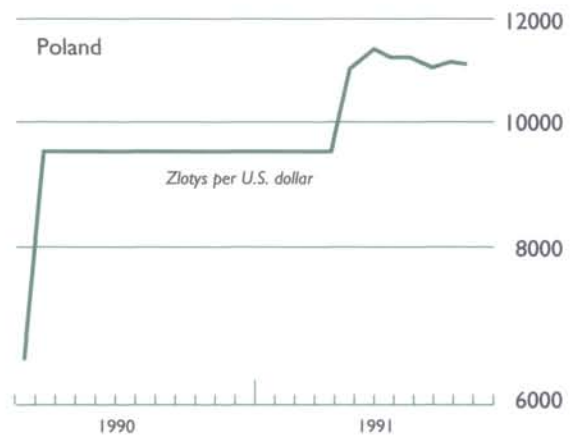
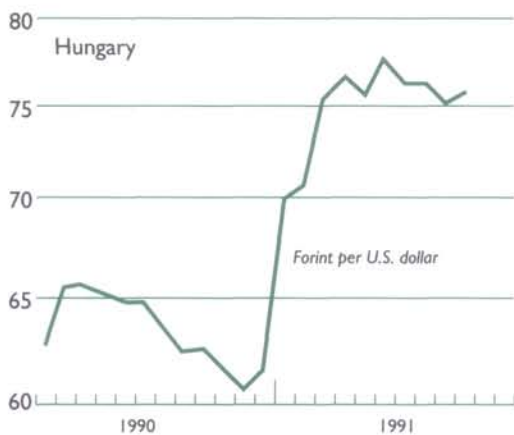
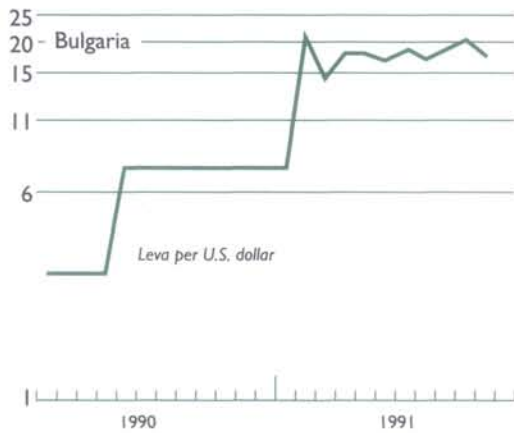
Unlike the other countries, *Bulgaria* adopted a freely floating rate, with relatively limited central bank intervention in the foreign exchange market. Its choice of regime was governed principally by uncertainty about the equilibrium level of the exchange rate together with critically low foreign exchange reserves and lack of access to foreign financing—partly owing to the difficult foreign debt position. Except for a large initial overshooting, the market has not been excessively volatile, with foreign exchange trading in a margin of about 6–8 percent on either side of the lev's average value against the dollar. With an active interest rate policy to support the lev, there has not been strong

downward pressure against the currency, and central bank intervention has, in fact, been mostly on the side of buying foreign exchange. The level at which the exchange rate stabilized is still substantially more depreciated than it was before floating started and price liberalization was enacted in February 1991 (Chart 1), and, although precise unit labor cost data are not available, the real exchange rate is widely believed to be still very competitive despite its considerable appreciation since floating started.

Despite the apparently adequate level of competitiveness during 1991, Bulgarian exports to non-CMEA markets fell sharply relative to 1990 largely because of shortages of oil and oil products owing to disruptions in trade with the former U.S.S.R. and to difficulties in obtaining external trade financing. In addition, in view of their very limited experience under market conditions and the high investment needed to transform their distorted production structure, enterprises have not been very successful in redirecting and expanding production for export markets. Inflation, moreover, has not been easy to control, although the floating exchange rate system, while it does not provide a nominal anchor, does not appear to have aggravated the price spiral.

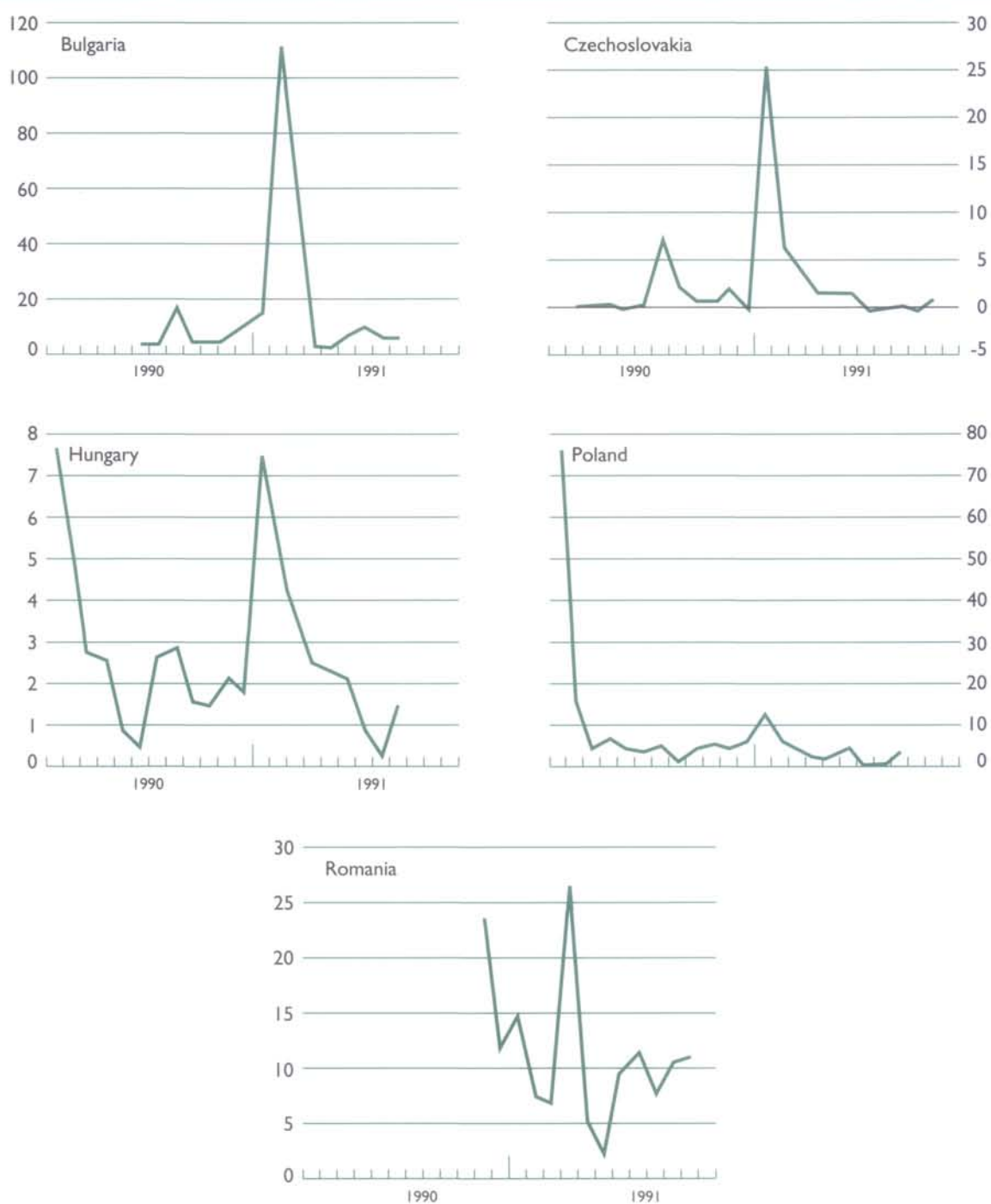
*Romania* initially adopted a dual exchange rate system, but one in which a floating interbank market played a substantial role. An official exchange rate, at which 50 percent of most export proceeds had to be surrendered and at which imports of raw materials for industrial use were available in limited quantities, operated side by side with a freely floating interbank rate at which current account transactions could be carried out virtually without restriction. The reluctance of the authorities to move directly to a unified floating rate with full current account convertibility originated in fears of excessive volatility in this market, particularly in view of the inexperience of enterprises in dealing with flexible prices in general, and a level of reserves that was deemed too low to allow significant official intervention in foreign exchange markets.

The policy of applying an appreciated official rate to a portion of trade limited the price jumps that followed the partial price liberalizations implemented in November 1990, April 1991, and July 1991. The interbank market operated at a substantial premium—about 500 percent of the official rate initially and some 200 percent later—following a devaluation of the official rate and an appreciation of the free rate. Significant leakages between the two markets subsequently emerged. The feared excess volatility of the foreign exchange market did

**Chart I. Eastern Europe: Exchange Rates***(End of period: log scale)*

Source: IMF staff estimates.

**Chart 2. Eastern Europe: CPI Inflation Rates**  
(Monthly percentage change)



Source: IMF staff estimates.

not materialize, and the market expanded further as new smaller intermediaries, such as travel agencies and foreign exchange bureaus, were authorized to participate. In November 1991, the two markets were finally unified and most restrictions lifted, with the authorities pursuing a managed float policy to support the very significant depreciation of the real exchange rate that occurred after the onset of the reform program.

While the dual system makes it even harder to assess the degree of competitiveness afforded by the exchange rate, the fall in Romania's exports to non-CMEA markets cannot be explained solely by exchange rate developments. Most of that fall was concentrated in petroleum products, whose production declined owing to inadequate financing for imports of crude oil, which now required convertible currency settlement. Moreover, domestic supply problems, including those arising from breakdowns in the payments system, which was related to the inter-enterprise arrears situation, also contributed to the weak export performance. As in Bulgaria, even after accounting for the impact of price liberalization, the inflation rate in Romania remained high, at an average underlying rate of 7–8 percent a month.

## CMEA Trade and Payments

While exchange rate policies have played a generally favorable role in fostering exports to convertible currency areas, they have not offset the collapse of exports to the CMEA area that followed its dismantling on January 1, 1991. Trade among CMEA member countries previously accounted for a high proportion of the total trade of these countries, in particular, trade between the U.S.S.R. and the East European CMEA countries (Table 2). Within the Eastern European bloc, however, the degree of dependence on CMEA trade, particularly trade with the U.S.S.R., differed significantly. In 1989, for example, over 57 percent of Bulgaria's exports went to the CMEA area, and nearly 50 percent went to the U.S.S.R. Romania, at the other extreme, sent only 20 percent of its exports to CMEA countries and a little less than 14 percent to the U.S.S.R. (Table 2).

Two aspects of the CMEA trade regime were particularly damaging to the PCPEs. The first was the underlying pattern of trade and its concentration in foreign trade organizations, which meant that producers did not find it necessary to develop a marketing infrastructure for exports. Guaranteed exports under the umbrella of bilateral treaties undermined incentives for enterprises to improve the quality of manufactured goods. Bilateral trade

planning—in the context of protocols that fixed the quantities and prices of the products to be traded—imposed limitations on a country's ability to adapt the structure of its exports to shifts in the composition of world demand.

The second aspect concerned access to low-cost imports of raw materials from the former U.S.S.R. While this shielded CMEA economies from exogenous shocks, it had several undesirable side effects, including promoting energy inefficiency and maintaining energy-intensive industrial activity with uncertain prospects in non-CMEA markets. With a move to world prices for energy products in 1991, industrial enterprises often faced costs for imports at world prices higher than the corresponding world market value of the goods produced.

The CMEA countries agreed, at their 1990 meeting in Sofia, to trade with one another in convertible currencies and at world market prices beginning in January 1991; the CMEA itself was, however, subsequently disbanded. A collapse in the volume of trade ensued in 1991 (Table 3). Whereas this trade contraction to some extent resulted from the inefficiency of CMEA trade flows arranged under central planning and from the decline in the level of economic activity in both Eastern Europe and the former Soviet Union, the agreed change in rules was also an obstacle to the continuation of trade flows, in view of a scarcity of reserves and of foreign trade financing.

Eastern Europe quickly moved to freely determined prices and to current account convertibility, but access to foreign exchange in the former U.S.S.R. was seriously rationed and was simply unavailable for many importing enterprises in the states of the former Soviet Union. However, since the trade collapse, bilateral trade agreements have been made between the Eastern European PCPEs and the Soviet Union, and, more recently, with the states of the former U.S.S.R. individually. Agreements that have been concluded or are in the process of negotiation include "indicative lists" of tradable goods with some kind of clearing arrangement (with settlement generally in hard currency), clearing arrangements with settlement in domestic currencies, and barter deals. These arrangements have allowed some recovery in exports to the former Soviet Union, and the actual decline in trade in 1991 was not as dramatic as initially feared.

## Lessons from the Eastern European Experience

Although the PCPEs have limited control over economic policy instruments, and state enterprises do not respond to market incentives as quickly as

**Table 2. Eastern Europe and the U.S.S.R.: Shares of Exports to Former CMEA Countries in Total Exports, 1989**  
(In percent)

Exporter	Importer						Total CMEA	Total Non-CMEA
	Bulgaria	Czechoslovakia	Hungary	Poland	Romania	U.S.S.R.		
Bulgaria	—	3.3	1.0	2.7	1.5	48.8	57.3	42.7
Czechoslovakia	2.0	—	3.6	7.1	1.6	26.5	40.9	59.1
Hungary	0.7	5.3	—	2.9	1.5	25.4	35.8	64.2
Poland	1.9	7.0	2.2	—	1.3	27.2	39.7	60.3
Romania	1.0	1.9	1.6	1.8	—	13.6	19.9	80.1
U.S.S.R.	12.8	14.3	9.3	12.7	6.1	—	55.3	44.7

Source: Kenen, Peter B., "Transitional Arrangements for Trade and Payments Among the CMEA Countries," *Staff Papers*, International Monetary Fund, Vol. 38 (June 1991), Tables 2 and 3. The calculation of these shares is sensitive to the exchange rate used for the transferable ruble, which is assumed here to be \$0.50/ruble.

**Table 3. Eastern Europe: Annual Changes in the Volume of Exports, 1991**  
(In percent)

	To Ex-CMEA	Of Which: U.S.S.R.	To Convertible Currency Area <sup>1</sup>
Bulgaria	-64	-57	-30
Czechoslovakia	-68	-63	-11
Hungary	-67	-69	15
Poland	-71	-74	-1
Romania	-60	-60	-33

Sources: National authorities and IMF staff estimates.

<sup>1</sup>Excluding convertible currency exports to former CMEA countries.

could be desired, Eastern European countries have been able to institute current account convertibility. Because of undeveloped markets, some crude policy instruments—such as wage controls and ceilings on bank credit—have had to be used instead of the normally more efficient indirect instruments. But with the aid of those instruments, current account convertibility has been possible, and, with it, the external sector has played an important role in providing competition and market incentives for domestic firms as well as enlarged consumption opportunities.

The experiences of Czechoslovakia and Poland indicate that a pegged exchange rate regime can be credible and can contribute to domestic price stabilization in the initial phase of price liberalization. Accompanied by trade liberalization, the pegged exchange rate served not only as a nominal anchor for the level of domestic prices but also as a guideline enabling individual market-clearing prices to be achieved quickly across a range of tradable goods. However, a large initial depreciation—required to hold the pegged rate for a sufficiently long period—implied a larger price jump on impact, which could create a supply-side output contraction and run the risk of setting in motion an inflationary spiral. If financial policies are sufficiently tight, the required initial depreciation is much smaller.

While, ultimately, disciplined and credible financial policies are the basis for both price stability and external balance under any exchange rate system, a pegged exchange rate can make an important contribution to stabilization during a massive price liberalization. This requires, however, a sufficiently high level of foreign reserves or external support, in the absence of which greater exchange rate flexibility may be inevitable. A pegged exchange rate should not, moreover, be maintained for too long in circumstances in which the economy cannot fairly quickly achieve an inflation rate commensurate with that of its trading partners. More flexible exchange rate systems have been operated successfully in several countries despite rudimentary financial sectors.

As concerns trade with other former CMEA members, the unequal pace of economic reform and

the shortage of hard currency have become serious obstacles to maintaining trade flows that are otherwise justified by comparative advantage. This situation may be reproduced among the states of the former Soviet Union that abandon a common currency and attempt to settle trade in convertible cur-

rencies. Bilateral clearing agreements are being used to re-establish trade between the states of the former U.S.S.R. and the Eastern European PCPEs, although the large number required and the distortions that they may introduce underline the advantages of a multilateral payments system.