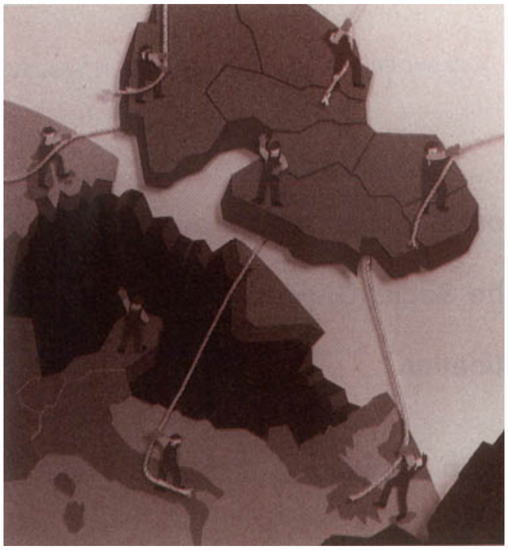

The Challenge of Economic Reforms in Eastern Europe

As countries attempt to dismantle antiquated controls and revive their economies, they are turning to the World Bank and other donors for help

Willi Wapenhans

The historic changes in the countries of Eastern Europe pose new challenges to their governments and the international community. Following a long period of slow growth, these countries—Bulgaria, Czechoslovakia, Hungary, Poland, Romania, and Yugoslavia—are dismantling the old centrally planned system and starting to create the environment needed for a market economy. These massive reforms often must be carried out at the same time as countries address large fiscal and balance of payments deficits and heavy debt burdens. Systemic reform and stabilization, in turn, give rise to large social costs, for which the existing social support systems were not designed. All this is taking place in parallel with, and it could be argued, is only possible because of, radical internal political transformation and changes in global power relations.

Since macroeconomic stabilization and systemic reform are needed more or less simultaneously, everything on the reform agenda of Eastern Europe could be considered urgent. This raises serious questions about how to best manage the transition. At issue are the speed, the combination, and the sequence of measures that would lead to a strong and sustainable market-based supply response and rekindle growth. In addition, the long-term development issues—the prime concern of the Bank—must be tackled. Five broad areas are critical: reforming the enterprise system, developing new institutions of economic governance, modernizing infrastructure, strengthening the social safety net, and rehabilitating the environment. Given the daunting nature of this agenda, substantial external support will be needed, requiring the coordinated efforts of bilateral donors and regional institutions (such as the newly founded European Bank for Reconstruction and Development), as well as the World Bank Group and the IMF.

The transition

To provide an appropriate framework of relative prices for market-oriented reform, macroeconomic stability must be assured and, in particular, inflationary tendencies controlled, through fiscal and monetary discipline. In addition, an appropriate exchange rate policy must be followed. But stabilization programs alone will not be enough. Experience, for example from Yugoslavia, suggests that such programs fail in the absence of significant reform of the old public enterprise structures and financial institutions.

During the initial stages of reform, price liberalization tends to lead to price increases, as competition does not exist and the pent-up demand for all types of goods brings suppressed inflation into the open. In many cases, both inflation and inefficiency have been fed by subsidies to enterprises, through direct operational support and unrestrained access to credit at negative real interest rates. This has enabled enterprises to increase wages and fuel inflation without concern about efficiency or their survival. But in an economic context marked by severe rigidities (i.e., where production is still dominated by monopolistic state firms and very limited mobility of both labor and capital), stabilization measures are likely to have a short-term negative impact on output and employment. In Poland, for example, the government's recent reform program involves a significant hardening of firms' budget constraints and a tightening of demand through monetary and fiscal stringency. This has already resulted in a sharp reduction in production and rising unemployment levels.

The best approach is to rapidly implement policy reform packages that increase both competition and supply through, for example, import liberalization, private sector development, and antimonopoly actions. But experience tells us that most components of such reforms require institutional and behavioral changes—and these tend to be slow. At the same time, the question of social resilience and adaptation must be faced, as social protection and the provision of safety nets ranks as a critical component of transition management (see article by Julian Schweitzer in this issue). Two issues arise in this context: First, programs of unemployment compensation or income maintenance are needed to provide short-term relief without impairing labor mobility; however, adequate institutions for the provision of such relief do not exist and social security entitlements are often tied to the place of work, without necessarily being transferable. Second, such programs quickly become political and fiscal liabilities, unless accompanied by early measures that both genuinely widen work opportunities and speed the adjustment of the real economy to market conditions.

The strategic challenge thus becomes how to design a short-run reform that sets a demanding pace for market-oriented change, while avoiding the main risks of (l) being politically and economically undermined by the failure of the real economy to respond adequately and quickly to large macroeconomic changes, or (2) having the reform slowed down by the erosive effects of the old and entrenched system.

But the implied degree of some central control during the transition naturally raises the difficult issue of how to ensure that controls are sharply different in kind from those of the old system and are genuinely transitional and supportive of the process of transformation. Unfortunately, experience offers little guidance on the appropriate make-up of this "minimum" package of reforms, their appropriate sequencing, and the size of related social costs. Then, too, given the speed of changes these days, decisions often have to be made before options can be properly researched and analyzed.

Systemic transformation

The reform agenda, of course, extends well beyond the issues of stabilization and transition management. For all of the Eastern European countries, the task is not merely to dismantle the discarded command system but to fashion—virtually from scratch—the overall structure and core components of modern market economies.

Enterprise reform. The state enterprise system is the heart of the command economy, and its successful transformation is central to the overall success of reform in industry, agriculture (see article by Wayne Ringlien in this issue), and services. The scale of reform called for is colossal: the process involves stimulating private sector development, breaking up monopolies, closing nonviable units, restructuring the financial sector, and introducing proper accounting systems and modern managerial expertise. Experience has also shown that reform of the financial sector is especially important in order to support enterprise restructuring and provide a sound basis for future private sector growth. For most of the countries, it is clear that private investment will, in time, emerge as the leading force for growth. To stimulate and accelerate the process, however, privatization of existing productive structures is essential, so that the private sector is spurred to quickly supplant the state as the main economic actor in the productive sectors.

In the short term, enterprise reform stands to play a pivotal role by stimulating supply and production, and in the long term, it holds the key to improved resource allocation. But the supply response will not be forthcoming, and resources will not be reallocated, unless capital and labor mobility is enhanced. A variety of measures would contribute to increasing factor mobility, including establishing retraining programs and reducing the housing constraints. However, the critical factor is ownership, as without clear ownership rights, capital cannot move and resources can only be reallocated at the margin. Moreover, clear accountability of management to ownership is critically important for enhanced incentives and efficiency.

The actual shape and pace of enterprise reform in these countries will also be influenced by the changes underway in the Council for Mutual Economic Assistance (CMEA, or Comecon), which has governed their regional trade and payments arrangements for the past 40 years (see "Whither Comecon?" by Martin Schrenk, *Finance & Development*, September 1990). The importance of this trade varies among members, but all Eastern European countries must contend with a substantial restructuring problem—both to increase trade in convertible currencies and to overcome the inefficiencies and inferior quality production that have developed within the CMEA system. Unraveling this situation will not be easy, owing to distorted prices and an elaborate system of cross-border, joint production arrangements, as well as trade links. Enterprises sheltered by this trade regime have enjoyed an inherently large measure of protection that once removed will threaten their survival. At the same time, changing over to settling international accounts with the Union of Soviet Socialist Republics in convertible currencies would result in significant terms-of-trade losses.

Economic governance. The macroeconomic objectives of reform include the establishment of trade, monetary, financial, and fiscal and prudential regimes, which will provide a stable basis for markets to operate and a radical extension of the role of market-determined prices in governing economic activity. For these objectives to be fully realized, countries will have to build new institutions of economic governance.

In the narrower sense, the institutions of economic management have to be established or greatly strengthened: a diversified banking and finance system, in which the functions of the central bank are distinct from those of the commercial banks and the government; a properly functioning tax system, trade and customs administrations appropriate to a liberal regime, and so on. The basic tools of a modern information and management system are not present, and the statistical, accounting, and auditing standards and capacities need upgrading urgently.

More broadly, a framework of law, economic regulation, and public and private institutions will have to evolve to underwrite the new social contract now emerging in these countries. The role of law is especially important in establishing a secure basis for private economic activity. The establishment of a regulatory framework in place of direct control is likely to be a difficult process, but essential both for the accountability of newly autonomous state enterprises and for reorienting government institutions toward new roles. The establishment of a new set of institutional relations between individuals, groups, and the government will also underscore the need for a new framework in the area of public administration. Individuals at the local level must be adequately represented, and decentralized autonomous structures at the municipal and provincial levels must be set up.

Infrastructure development. The modernization and renovation of the physical infrastructure—especially in the areas of transport and communications—will require massive efforts. At this point, much of the infrastructure is outdated, seriously rundown, and inefficient, and major investments in this area would serve as an essential underpinning for development of the private sector. In addition, Eastern European countries will have to reassess their energy use. Energy efficiency is low, too much energy is generated, and little attention has been given to industry's role as a source of massive environmental pollution.

Social protection and human resource development. The challenge here is to develop a modern system of responsibilities and relationships among the government, enterprises, and individuals. Social benefits should be financially affordable and leave economic incentives undistorted, while providing adequate support and protection to the most vulnerable population groups. Tasks in this area include the need to scale back and target the system of pervasive consumer subsidies, reform health and education services, develop an efficient housing system that allows for labor mobility, provide unemployment compensation, and establish social security systems compatible with the need for labor mobility in a market economy.

Environmental rehabilitation. The environment is integral to system reform, as it relates directly to the quality of life and to the political perception of social progress under reform. A large part of the catastrophic environmental damage in Eastern Europe was in effect inflicted by "the system" itself—a good example of where the market (and political accountability) is more benign environmentally than is a command system. This occurred through unbridled investments, gross inefficiencies in the use of physical resources—especially energy, and the emphasis on meeting physical output targets, regardless of costs or side effects. The severity of environmental degradation means that environmentally benign incentives and behavior must be built into the reformed economic system from the start (e.g., into pricing policy in energy and transport), and the costs of rehabilitation must be regarded as an integral part of the costs of system reform.

Role of external support

Faced with these formidable challenges, Eastern European countries will require a great deal of outside help if they are to accomplish this transformation and restore sustained growth. The needs will vary from country to country, as well as over time—the key variables being debt loads, creditworthiness, the nature of the reform policies implemented, the supply response to such policies, the external economic picture, and access to foreign markets (especially the European Community). But throughout, support will be needed in several critical areas.

All Eastern European countries need infusions of modern technology to raise the productivity of their industry and agriculture, and greatly expand and improve the efficiency of their service sectors (including communications, banking, insurance, finance, and trade). These countries also face enormous shortages of knowhow in business management, as well as in the design and administration of institutions in accounting, auditing, tax collection, and social security, and in the legal framework needed for the operation of competitive markets. Finally, they could use advice and counsel in the design and administration of instruments of economic policy and economic governance.

Private direct investment stands to make a unique contribution to the development of Eastern Europe. Besides facilitating the transfer of technology and managerial knowhow, it could help accelerate the process of privatization and market development. But for foreign private investment flows on the

The role of the World Bank Group

The World Bank has responded to the increasing demands from Eastern Europe for assistance by mobilizing additional resources for priority areas—such as enterprise and financial sector reform, modernization of industry and infrastructure, protection of the environment, the setting up of adequate social safety nets, and the support of macroeconomic adjustment programs. The International Finance Corporation, the affiliate charged with promoting private sector development, has also been actively financing projects and providing advice and technical assistance so far to Hungary, Poland, and Yugoslavia. And the Multilateral Investment Guarantee Agency, the affiliate that encourages investment flows to developing countries, has started working with its members in the region, currently Czechoslovakia, Hungary, and Poland.

World Bank lending to Hungary, Poland, and Yugoslavia in fiscal year 1990 totaled about $1.8 billion, a rise of over $1 billion from the previous year. The bulk of the increase was channeled to Poland, where the Bank was able to quickly mount a large program based on earlier discussions with the Polish authorities. These projects included two loans totaling $360 million aimed at improving export capacities of enterprises in manufacturing and agroindustries, as well as a modest ($18 million), but innovative, operation that provides technical assistance to the Government on dealing with the serious environmental problems. In Hungary, a $66 million loan was extended to modernize the financial system and support institutional development. In Yugoslavia, a $292 million loan supports efficiency improvements, as well as additional investment in the highway sector. Project activities planned for fiscal year 1991 include an employment services loan to Poland, designed to strengthen the institutions providing social support to the unemployed, and a loan to Hungary aimed at modernizing the antiquated telecommunications system.

Bank lending to Eastern Europe also includes structural adjustment loans for Hungary ($200 million), Yugoslavia ($400 million), and Poland ($300 million). These loans are intended to support the implementation of structural adjustment measures within the context of the reform programs launched by these countries, particularly in the areas of enterprise restructuring and privatization, financial sector development, and the creation of adequate social safety nets.

The strategic challenge now facing the World Bank Group stems from recent developments in Eastern Europe that have resulted in the acceleration of the pace of reforms—as well as increases in their scope and complexity—and the emergence of new countries as potential claimants for assistance. The new governments have confirmed their desire to obtain increasing support from the World Bank Group for two broad reasons: the Group's multinational character provides it with an objective, impartial view of their problems and issues; it is also perceived as having the capacity to help marshal diverse kinds of assistance, including policy-based lending.

In providing such assistance, the Group will be collaborating with other agencies, such as the European Investment Bank, the European Bank for Reconstruction and Development, the European Community, the IMF, and bilateral donors. The time required for the transformation process will vary from country to country, but could well last a decade or more. Over the longer term, the Group's involvement will be oriented toward assisting these countries make the transition to improved creditworthiness and complete reliance on private capital markets for capital inflows.

The Group will need to focus on the priority development issues relating to systemic reform. But in light of the links between systemic transformation and macroeconomic stability, the Group—in collaboration with the IMF—will also need to ensure that the macroeconomic and financial policies support programs in these areas. To implement this strategy in the region, the Group aims to (1) expand its capacity for policy advice, technical assistance, and training; (2) build a balanced portfolio of lending, which includes policy-based and project loans, with a special emphasis on projects; and (3) strengthen private sector development and foreign private direct investment.

requisite scale to materialize, there will have to be political stability, as well as an hospitable domestic, legal, regulatory, and macroeconomic environment, reflecting a public consensus generally supportive of private ownership of capital. Moreover, huge investments will be needed in sectors and activities that either are not likely to attract much private foreign capital, or may only attract sufficient quantities once reforms begin to show signs of success. It cannot be expected that these additional resources will be generated solely from increases in already substantial domestic savings rates or from inflows of private finance. Clearly, public financial assistance will be needed, and in the early days, may even have to shoulder a large share of the overall financial burden in several countries.

Country scenarios

At this stage, future economic developments and financial assistance needs are still shrouded in uncertainty for all Eastern European countries, but it is likely that most of them will be adversely affected by the recent Middle East conflict. Already, output has fallen throughout the region, as the oil shock has exacerbated an already reduced internal demand, the unraveling of CMEA trading arrangements, and the inevitable disruptions that have accompanied the political revolutions. Then, too, there has been a growing vacuum created by the dissolution of economic command structures, while steps are being taken to set up a new institutional order geared toward the needs of a market economy.

These countries have been so vulnerable to the latest oil developments, because their economies are highly energy intensive, and the price paid for oil from the USSR has typically been below international prices, reflecting distortions arising from CMEA arrangements. Increases in the international oil price will result in significant rises in domestic costs and a substantial terms-of-trade deterioration. Moreover, disruption of trade with Iraq—with which a number of them have bilateral trade arrangements—will force them to turn elsewhere. The USSR has already run into difficulties in supplying oil to Eastern Europe, and securing oil from the open market would require payment in hard currencies, which would not be easy to obtain. Thus greater efforts must now be made to conserve energy, adjust energy prices, and make other necessary structural adjustments. At the same time, recent events, including changes within the CMEA, will raise their external financing requirements.

To date, Hungary and Poland have had the lengthiest experience with reform efforts, whereas Bulgaria, Czechoslovakia, and Romania are just starting down this path. Yugoslavia constitutes a special case, as it long took a somewhat unconventional approach. Shunning the concept of a centrally planned economy decades ago, it has let many prices be freely determined. However, strong regional centrifugal tendencies, an accelerating debt burden in the 1980s, easy bank financing, and continued financing of loss-making enterprises under the complex arrangements of worker self-management have imparted considerable macro instability. This prompted Yugoslavia to adopt a stabilization and reform program in early 1990. The focus is on supporting bank and enterprise restructuring through a fiscal adjustment, and facilitating privatization through the introduction of a new system of property rights.

The next country in the region to undertake reforms was Hungary, with the introduction of a "New Economic Mechanism" in 1968. By and large, the verdict on these reforms, however, has not been laudatory, as central planning—although abolished in one stroke—was replaced by a complex system of bargaining between enterprise managers and bureaucrats (on such items as prices, interest rates, credit, and subsidies). These multiple, numerous, ad hoc interventions have vitiated the positive impact of the original reform impulse, leading many observers, particularly within the country, to conclude that "partial" reforms cannot work.

Hungary's approach to reform has concentrated upon the building of institutions—the first Eastern European country to install a value-added tax and an income tax, and the first (not counting Yugoslavia) to introduce a two-tier banking system, comprising a fully fledged central bank and a set of commercial banks. Over the last year, the pace of reform has accelerated, with a discernible speed-up in price and trade liberalization, and privatization. A stringent stabilization program has been adopted to contain inflationary pressures and prevent the balance of payments from veering into unsustainable deficit, particularly given the large external debt.

For Poland, the reform efforts began in the 1980s, as it progressively phased down central allocation, freed a number of prices, and experimented with providing incentives to enterprises, albeit in a setting of unreformed property rights. But growing debt difficulties and lax monetary policies (in the form of accommodating worker demands for higher wages and enterprise demands for subsidies) led to an accelerating inflation—bordering on hyperinflation—at the end of the decade. Since then, Poland has engaged in a courageous, bold effort to change direction. The "Big Bang" of January 1, 1990, liberalized most prices, instituted a unified and devalued exchange rate, established a balanced budget, and imposed strict controls on the money supply growth. As a result, inflation has dramatically fallen and exports have grown rapidly. At the same time, slow but steady progress has been made in reforming the financial system, instituting unemployment compensation, and crafting privatization legislation. However, domestic output has also fallen and the unemployment rolls have lengthened, as enterprises have begun their long journey toward efficiency and competitiveness.

Conclusions

The commitment of Eastern European countries to a fundamental transformation of their societies poses challenges to the design of economic reforms that go beyond those typically encountered in promoting economic stabilization and structural adjustment, as they also involve simultaneous and unprecedented political and social change. In addition, reforming governments are likely to face difficult implementation issues, because adjustment and stabilization policies usually entail substantial economic and social costs early on, while the benefits, in terms of growth and income, may only emerge in the long term.

Particularly troublesome problems arise in building the institutions needed to support market reforms, in redefining the role of the public sector in the new economic environment, and in the sequencing and phasing of economic reforms. While there are several common policy reform problems—whose resolution could be assisted by experience elsewhere in the region—and some issues that could benefit from region-wide approaches (e.g., trade with other CMEA countries), international assistance and support should be tailored to the circumstances and needs of individual countries. ■

Willi Wapenhans
German, is Vice President of the Bank's Europe, Middle East and North Africa Region. He joined the Bank staff in 1960 and has served in various posts, including Senior Vice President, External Affairs and Administration.