

# Stabilization and Reform in Eastern Europe

## A Preliminary Evaluation

MICHAEL BRUNO\*

*Common issues emerging from the recent experience with IMF-supported programs in Hungary, Poland, Czechoslovakia, Bulgaria, and Romania are analyzed. These comprise the initial price overshooting and output collapse and the financial and structural problems associated with bad loan portfolios and sluggish implementation of privatization programs. Substantial success has been achieved in the initial microstabilization and opening-up effort. But difficulties with fiscal and monetary control may be emerging as a result of social and political pressures and unclear policy signals on the micro issues involving the structural transformation of the productive and financial systems. [JEL E63, E65, F41]*

THE TRANSFORMATION of Eastern Europe from centrally planned to market economies provides an unprecedented challenge for policy-makers in these countries, as well as for the international community involved in financing and monitoring their economic programs. It also poses an unusual challenge for the economics profession, because there

\*Michael Bruno is Professor of Economics at Hebrew University, a Research Associate at the National Bureau of Economic Research, and a former Governor of the Bank of Israel. He holds degrees from Cambridge University and Stanford University. This paper was written while the author was a Visiting Professor at the Massachusetts Institute of Technology and a Visiting Scholar in the IMF's Research Department. He wishes to thank Massimo Russo and Michael Deppler for initiating this study, and many members of both the European I and Research Departments for helpful discussions and comments on earlier drafts. He is likewise grateful to Olivier Blanchard, Mario Blejer, Kemal Dervis, David Lip-ton, Stanley Fischer, and Hans Schmitt.

is little prior experience to draw on for lessons that could be applied to the present context.<sup>1</sup>

The Eastern European countries, according to the customary classification, belong to the group of middle-income countries. Their relative income levels (with suitable correction of relative prices), past growth rates, 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 ex-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 be akin to that of other middle-income countries, such as Brazil, Mexico, or Israel; these countries had enjoyed long periods of growth and relative price stability in the past, but in the course of the 1970s and 1980s they underwent severe structural crises that were either exacerbated or caused by poor response to external shocks such as the oil and debt crises. The delayed effects of some of these same shocks (for example, energy and raw material prices) are only now being felt 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 the adoption of an economic reform whose desired end product was similar to that of other middle-income countries, but the distance between the initial point and the desired goal is not only wider but substantially deeper.

The present discussion is confined mainly to the lessons that can be learned from the aftermath of stabilization and price reform programs adopted in five Eastern European countries—Hungary, Poland, the Czech and Slovak Republic, Bulgaria, and Romania—in 1990 and 1991. By this stage, some institutional reforms had already begun to take effect, such as the breakup of the monobank into separate central bank and commercial banking systems. Privatization, however, was only in the early legislation stage.

How similar are the aims of the reform in Eastern Europe to other recent efforts? One similarity is the attempt to reform and adapt the economic structure for integration into the world economy, which involves opening up the economy and moving from a completely controlled and distorted set of relative prices to relative world prices (for tradable

<sup>1</sup> Hungary started its reform process at an earlier stage, and some of the lessons from this experience are of considerable importance. However, the scope of the reform in the other four countries and the speed with which it was initiated have no precedent in a command economy.

goods). Another similar aim is macroeconomic stabilization, which has to do with the price level, as well as internal and external balances. Stabilization, in turn, implies the elimination of high inflation or hyperinflation, which either already exists or is repressed (by open budget deficits, or soft budget constraints, or monetary overhang), and is bound to erupt once prices are decontrolled. Thus far, the objectives (and even the means of attaining them) are quite similar to those in other reforms (consider, for example, the recent Mexican reform comprising simultaneous stabilization and opening up).

The chief novelty in the Eastern European experience is the revolutionary change that is required in the institutional infrastructure—the financial system (such as the breakup of a monobank system), the fiscal structure, social safety nets, the establishment of private property rights, and the mass privatization effort. One could easily point to many noncentrally planned economies that have either soft budget constraints or a financially repressed business sector, or highly subsidized state enterprises, or combinations of all three. However, their underlying structure is nonetheless market oriented, and private property rights are reasonably well defined. Although a lot can be learned from the reforms that have been applied to the distorted subsystems in these other countries, there is a sea of difference between them and those countries where the whole economy is one centrally controlled, nonmarket, publicly owned and financed system, with no other normative internal reference point, and a market economy has to be created where none had existed before. These circumstances have dictated a more comprehensive approach to the reform process than has ever been adopted to date.

All the reform plans, which were part of International Monetary Fund (IMF) programs, recognized that a simultaneous assault on macroeconomic stabilization, prices, and property rights was necessary from the inception stage of these programs.<sup>2</sup> The programs have been largely “heterodox” in their approach to price stabilization, although they have differed from their predecessors (for example, Israel and Mexico) in several respects, such as the way wages were controlled. But the programs have been much more far-reaching and ambitious in their attempt to move at great speed from the initial production equilibrium of the old system to the desired new market-based structure.

<sup>2</sup> It is important to point out that unlike many past cases, IMF programs in Eastern European economies thus far have typically been self-imposed, drastic adjustment programs, to which the IMF has given its blessing rather than having been the primary initiator. (See Table 2 for comparative details of IMF programs in Eastern Europe.)

The initial stabilization results have been impressive by and large, even though the initial price shock in all countries was larger than expected, leading, in most cases, to persistent inflation. Likewise, the observed balance of payments improvements may in some cases turn out to be transitory. The main surprise for policymakers, and the major departure from the IMF's initial forecasts, was the speed with which the old productive system responded to the new price and incentive signals. The collapse of the Council for Mutual Economic Assistance (CMEA), which, in a sense, was an exogenous event from the point of view of each country, had disastrous consequences on output in almost all countries; but this is probably not the whole story. While a private, small enterprise sector was developing, both demand and supply factors played a much larger-than-expected role in sharply contracting the output of the large state-owned enterprises (SOEs). Although some of this contraction may be endemic to the process of stabilization, in virtually all cases the more problematic issues were the slow tempo of structural adjustment and the sluggishness of the privatization effort.

Although this paper is addressed to issues common to all the countries involved, one should not ignore differences in performance, some of which originate from the considerable diversity in initial conditions that the countries faced at the start of the present reform process. Section I begins with a brief survey of these initial conditions as well as a general outline of the IMF-supported programs.<sup>3</sup> Section II follows with a general discussion of the concept of economic reform, based on previous experience with relative speeds of adjustment in different markets and spheres of economic behavior. A distinction is drawn between stabilization of prices and exchange rates, which can be achieved fairly rapidly, and the responses of production structure, investment, and ownership patterns to sharp changes in *relative* prices, all of which tend to be extremely slow. Market failure may indeed persist for a long time, which raises the vexing issues of sequencing and the need for, or extent of, residual government involvement in the transition stage.

Price overshooting and the output collapse, and their relation to the choice of policies, are taken up in Sections III and IV, respectively.

<sup>3</sup> A more detailed discussion of developments in each country can be found in individual country surveys published by the Organization for Economic Cooperation and Development (OECD) and the IMF (Demekas and Khan (1991) and Aghevli, Borensztein, and van der Willigen (1992)). Recent papers on Hungary (Dervis and Condon (1992)), Poland (Berg and Blanchard (1992)), and Czechoslovakia (Dyba and Svejnar (1992)) were presented at a February 1992 National Bureau of Economic Research (NBER) conference on transition in Eastern Europe.

Section V discusses the fiscal balance and, in particular, its sustainability in view of the inevitable erosion of the state enterprise tax base and persistent pressures for additional social expenditures (replacing the old subsidies). Section VI addresses 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 VII raises the question of interim production, trade, and financial regimes for the state enterprise sector during the uncertain ownership and control period. Section VIII offers concluding remarks.

### I. Initial Conditions and Country Programs

Although almost all the countries in question had embarked on partial structural reform in the 1960s, only in Hungary did these reforms not subsequently grind to a halt. The reform process in Hungary, although gradual and beset by many setbacks, persisted over a period of 20 years, and even though the objective of that reform was not a market-based economy, Hungary emerged better prepared on the institutional economic front than the other countries for the dramatic political liberalizations of 1989–90. Reforms had already led to price and trade liberalizations<sup>4</sup> and developments in the small-scale private ownership sector and Hungary had also introduced a two-tier banking system, a tax reform, and a corporate law before 1989.

In Poland, which has always had a private agricultural sector,<sup>5</sup> there were also some private sector developments prior to 1989. Both countries, however, suffered from an initial external debt overhang (see Table 1, which details initial preprogram conditions), and both showed practically no growth in the 1980s. Unlike Hungary, Poland's imbalance prior to 1989 was also internal, the result of a large monetary overhang that the partial price liberalizations and ensuing hyperinflation of 1989 helped to eliminate, or at least reduce substantially, before the January 1990 program.

<sup>4</sup> 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. On the Hungarian economic reform process since 1968, see Boote and Somogyi (1991). For a good account of the more recent economic developments, see the OECD Survey on Hungary (OECD (1992b)).

<sup>5</sup> Also, in Poland the weakening of state control had already started 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. Poland's other institutional reforms, however, lagged behind Hungary's. See Lipton and Sachs (1991).

Table 1. *Eastern Europe: Initial Conditions*

Indicator	Hungary	Poland <sup>a</sup>	Czechoslovakia	Bulgaria	Romania
1. Population <sup>b</sup> (In millions, mid-1989)	10.6	37.9	15.6	9.0	23.2
2. GNP per capita <sup>b</sup> (In 1989 U.S. \$)	2,590	1,790	3,450	2,320	2,290
3. GNP growth <sup>c</sup> (Average annual rate in percent at constant prices) 1970s 1980s	4.5 0.5	5.5 -0.7	4.6 1.4	7.0 2.0	9.3 1.8
4. Administered prices (In percent of total)	15	100 (Excluding food prices)	100	100	80
5. State ownership (In percent)	90	70	Economy-wide	Economy-wide, except 15 percent of agriculture	Economy-wide

6. Money (M2)/GDP, 1990	0.4	0.9	0.7	1.3	0.6
7. External debt/GDP (1990, in percent)	65	80	19	50	3
8. External debt- service ratio (1990)	57 <sup>d</sup>	56	23	116	—
9. Exports to CMEA, 1990 <sup>e</sup> (In percent of total exports)	43	41	60	69	—
(In percent of GDP)	16	14	25	34	—

<sup>a</sup> M2/GDP and exports to CMEA in percent of total exports are 1989 figures.  
<sup>b</sup> World Bank (1991); IMF staff estimate for Romanian GNP per capita. All of these data are highly sensitive to the choice of exchange rates.

<sup>c</sup> Vienna Institute for Comparative Economic Studies, *COMECON Data* (1990); net material product.

<sup>d</sup> In percent of merchandise exports.

<sup>e</sup> Estimates are tentative since 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 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.

In the absence of an explicit measure of the monetary overhang, the estimate of the ratio of money to gross domestic product (GDP) (line 6 of Table 1) gives a rough indication. If 0.4 can be considered the norm, there was no overhang in Hungary at the start of the reform process; it was large in Poland (in 1989 and probably even larger before 1989) and Bulgaria and smaller in Czechoslovakia and Romania.

It is interesting that during the 20 years following the spring of 1968, Czechoslovakia reverted to the most orthodox centrally planned economy (see Table 1) and was thus, in a structural sense, much less prepared for the big change. Yet, on the eve of the January 1991 reform, Czechoslovakia not only enjoyed the most favorable initial internal and external macroeconomic balance, but it also had only a small monetary overhang and an extremely low ratio of external debt to gross national product (GNP).<sup>6</sup>

Bulgaria 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 confined to exports to the former 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 the country 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 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. (See Table 2 for a comparison of programs.) The main breakaway from their past was 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. The choice of exchange rate regime differed, with Czechoslovakia, like Poland in 1990, adopting a peg as a nominal anchor (after several devaluations in the preceding months,

<sup>6</sup> In an interesting recounting of economic developments in these countries in the precommunist era (Solimano (1991)), Czechoslovakia stands out as having had a prudent macroeconomic tradition. It also had the most developed industrial structure by the time communism took over. Major subsequent development took place in Slovakia, which has undoubtedly had repercussions on Czechoslovakia's present structural reform process and interrepublican political and social problems.



Table 2. *Eastern Europe: Comparison of Fund Programs*

Indicator	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 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 <sup>a</sup>	1987	1990	1990	1989	1990

<sup>a</sup>The establishment of a two-tier banking system ended direct central bank involvement in commercial banking.

which almost doubled the exchange rate). Lacking foreign exchange reserves, Bulgaria and Romania both floated and let the interbank market determine a considerably depreciated exchange rate, thereby tripling the previous official rate (Figure 1), although the phasing of the exchange rate reform was more gradual in Romania. In all four countries the external reform program included substantial trade liberalization with current account convertibility and 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, a considerable stepping-up of the previous gradual move from 56 percent in 1985), and restrictive fiscal, monetary, and incomes policies. The program, which was more ambitious than previous programs, also included a substantial further liberalization of imports and another set of structural adjustment and privatization measures.<sup>7</sup>

The programs for Poland, Czechoslovakia, Bulgaria, and Romania were obviously conceived as "big bang" moves. The underlying theme 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 productive systems were slated for rapid privatization, so as to minimize the uncertainties of operation under public ownership and controls.

In all five countries the initial price liberalization was expected to involve a substantial price shock, to be followed a few months later by relative price stability. The actual results are discussed in Section III.

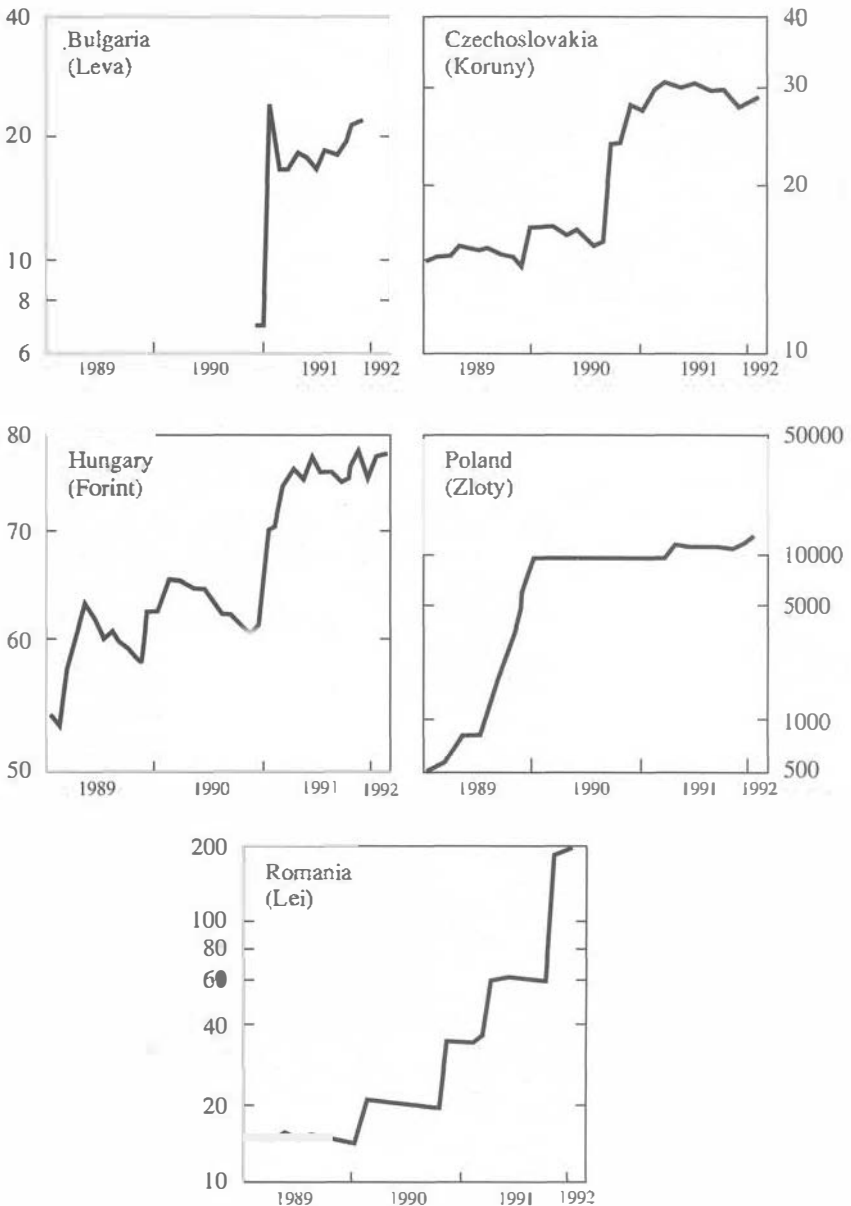
## II. Concepts of Economic Reform—Big Bang and Gradualism

The key question that has to be asked at the outset of any major reform process is whether to adopt the big bang approach or gradualism in the move from the distorted equilibrium of the prereform period to the desired new quasi-equilibrium. The answer to this question is not at all clear. Cumulative experience from hyperinflation and high inflation episodes (say, at least three-digit annual inflation rates) points only to the

<sup>7</sup>The average tariff dropped from 18 percent in 1985 to 16 percent during 1986–89 and to 13 percent in 1991. The share of imports liberalized rose from zero to 16 percent in 1989 and 37 percent in 1990, to reach 72 percent in 1991; see Dervis and Condon (1992).

Figure 1. *Exchange Rates, 1989-92*

(End of period: local currency/U.S. dollar, in log scale)



Sources: National authorities and IMF staff estimates.

clear advantage of the big bang approach at the inflation stabilization stage (recent successes have been Bolivia, Mexico, and Israel).<sup>8</sup>

In the recent successful stabilizations in Israel and Mexico, credibility, expectation signaling, and the problem of nominal synchronization (that is, avoiding sharp changes in relative prices) dictated a multiple anchor, or “heterodox” approach. The initial hyperinflation outburst prompted Poland and Yugoslavia to follow this approach in the 1989–90 stabilizations. Czechoslovakia, Bulgaria, and Romania also chose a big bang approach in 1991, even though their inflation rates were relatively low.<sup>9</sup> The potential for inflationary outburst, given the repressed prereform system, may have justified their choice, which enabled them to avoid the hyperinflation that would have erupted in the price liberalization stage in the absence of tight macro policies.

These choices, however, apply only to price 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, do trade liberalization and a move to convertibility, let alone privatization, necessarily require a big bang approach? The answer is much less clear *ex ante*, and is even less clear given the results. Trade liberalization, for example, can give the right long-term signal from the start, but its execution could, in principle, be gradual. (This question will be taken up in the discussion of output collapse in Section III.) Similar examples in either direction can be cited, such as the opening up of internal and external financial and capital markets. The United Kingdom opted to go cold turkey, while other European countries chose to move more gradually and nonetheless achieved their targets. Israel applied shock therapy to inflation but opened up its financial, capital, and foreign exchange markets gradually (as it successfully did with trade liberalization in the 1960s).

A closely related issue is the speed of adjustment of markets to changes in signals and the credibility that agents attach to announced signals of future market environments that are not yet evident in today’s markets. It is well known that the speed of adjustment in asset markets is extremely

<sup>8</sup> Chile’s 1970 stabilization is the only successful example of the gradualist approach (the trade liberalization, interestingly enough, was done relatively quickly). The social cost, however, was extremely high, and the strategy would probably not be feasible in an open democracy. For a comparative analysis of the stabilization and reform experience in Latin America and Israel, see Bruno (forthcoming, 1993). Fischer and Gelb (1990) were among the first to discuss the phases of reform for Eastern Europe.

<sup>9</sup> Hungary could afford gradualism, because, as noted earlier, its opening up and structural reform process had been going on for much longer—in a sense, since 1968.

high; the response is often instantaneous because the adjustment costs are low. However, adjustment in commodity and labor markets, let alone the production response that follows from new investment, is considerably slower, often lasting three or four years. Any reform such as privatization of large-scale enterprises or the introduction for the first time of a value-added or income tax that requires complicated legislation, the introduction of new accounting procedures, and new implementation or monitoring mechanisms may take at least as long as that.

It is important to stress that these long adjustment lags do not occur solely in hitherto centrally planned economies. Structural adjustment is a slow process even in a most advanced market-based economy—even when the reform is credible. This was true of the reconstruction effort in Europe after World War II and of structural adjustment efforts following upon a successful major stabilization (such as in Israel in the wake of the 1985 stabilization). Even in a country like Finland, the collapse of the CMEA caused a substantial drop in GDP. In all of these cases adjustment was or will be prolonged, even though the underlying structure is market based.

Therefore, the advocate of a big bang has to make clear which particular portion of the policy package is implied. Also, the argument for a big bang beginning may rest on a special political opportunity, as in Poland. But there may also be an intertemporal political trade-off: overly costly programs might lead to political reversal at a later stage, as “adjustment fatigue” sets in or social aspirations, such as employment opportunities and living standards, are frustrated. Have policymakers sufficiently considered these questions at the inception stage of the program?

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

### **III. Stabilization: Was the Initial Price Shock Necessary?**

In all cases, except Hungary, the initial price shock turned out substantially larger than expected, but within six months of the program, inflation came down to less than 2–3 percent a month in Poland, Czechoslovakia, and Hungary. Inflation edged up, after a temporary drop, to an average monthly rate of 4–5 percent in Bulgaria and 10 percent in Romania (see averages in Table 3 and monthly data in Table 4 and Figure 2). However,

Table 3. *Eastern Europe: Selected Indicators, 1990-91*

Program/Actual	GDP <sup>a</sup> (Percent change)	Consumer Prices (Year-end percent change)	Nominal Wage	Broad Money (Year-end percent change)	Budget Balance <sup>b</sup> (Percent of GDP)	Convertible Current Account	Convertible Current Account (In billions of U.S. dollars)	
							Total Exports <sup>c</sup>	Total Exports <sup>c</sup>
				<i>Hungary</i>				
1990 Actual	-4	33	23	29	-0.1	0.1	0.1	8.9
1991 Program	-3	31	—	23	-1.5	-1.2	-1.2	12.6
1991 Actual	-8 (-8)	32	20	29	-4.1	0.3	0.3	9.6
				<i>Poland</i>				
1989 Actual	—	640	472	236	-7.4	-1.8	-1.8	8.1
1990 Program	-5	94	—	87	-0.1	-3.0	-3.0	—
1990 Actual	-12	249	160	122	3.5	0.7	0.7	15.0
1991 Program	3	36	—	43	-0.6	-2.7	-2.7	—
1991 Actual	-8 (-4)	60	54	49	-7.2	-2.2	-2.2	13.2

Czechoslovakia									
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 Actual	-16 (-9)	54	14	27	-2.1	0.7	0.2	10.9	
Bulgaria									
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 Actual	-23 (-16)	339	142	25	-3.7	-11.8	-0.9	3.7	
Romania									
1990 Actual	-7	5	11	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	

<sup>a</sup> Figures in parentheses provide an estimate of the fall of GDP owing to the fall in exports; percentage point contribution of the change in total exports to the percent change in GDP.

<sup>b</sup> For Poland, general government balance; for Czechoslovakia, central and local governments, 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.

<sup>c</sup> Including transactions in nonconvertible currencies.

Table 4. *Eastern Europe: Monthly CPI Inflation Rates, 1989-91*  
(In percent)

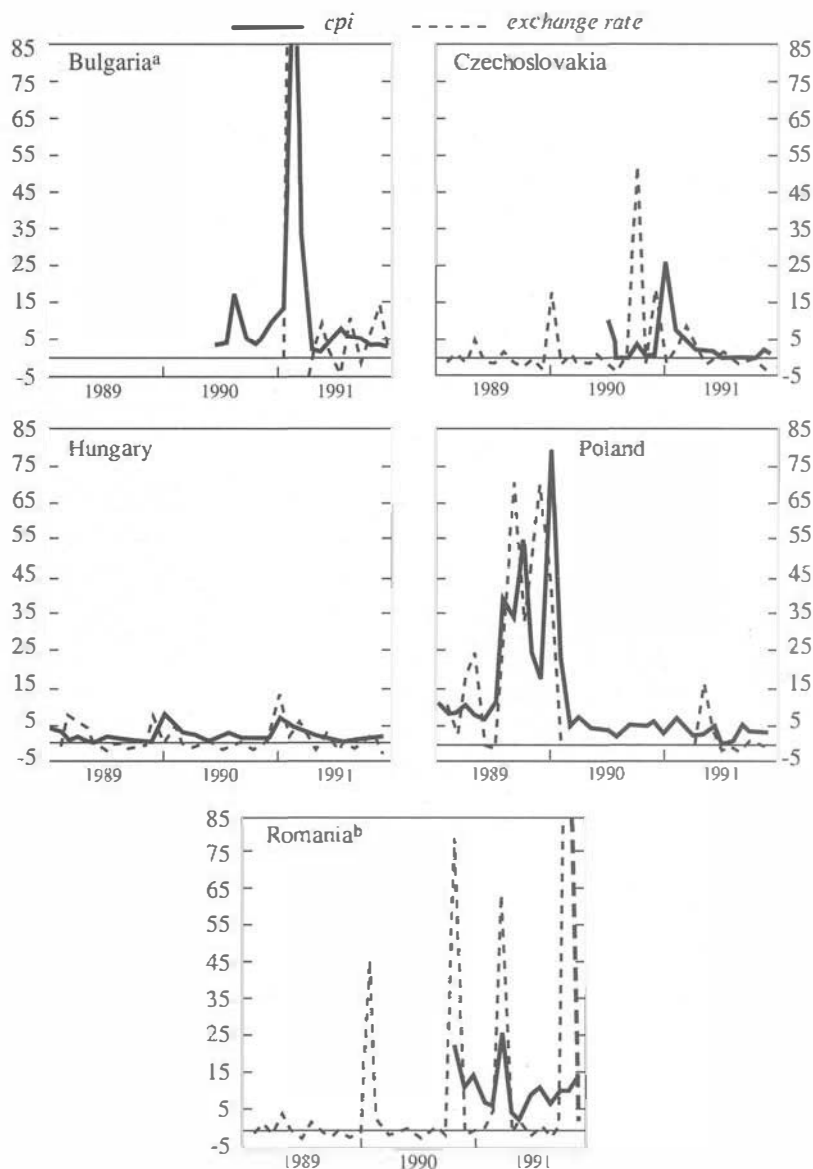
	Bulgaria	Czechoslovakia <sup>a</sup>	Hungary	Poland	Romania
<b>1989</b>					
Jan.	—	—	4.5	11.0	—
Feb.	—	—	3.4	7.9	—
Mar.	—	—	1.0	8.1	—
Apr.	—	—	1.7	9.8	—
May	—	—	0.5	7.2	—
Jun.	—	—	0.4	6.1	—
July	—	—	2.1	9.5	—
Aug.	—	—	0.3	39.5	—
Sep.	—	—	1.0	34.3	—
Oct.	—	—	1.1	54.8	—
Nov.	—	—	0.7	22.4	—
Dec.	—	—	0.8	17.7	—
<b>1990</b>					
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	—
July	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
<b>1991</b>					
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
July	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.

<sup>a</sup> Rates from July-December 1990 are estimates from quarterly data.



Figure 2. *CPI Inflation and Exchange Rates, 1989-91*  
(Monthly percentage change)



Sources: National authorities and IMF staff estimates.

<sup>a</sup>CPI: February 1991 = 105.2; exchange rate: February 1991 = 247.1, March 1991 = 30.5.

<sup>b</sup>Exchange rate: November 1991 = 204.84.

by the end of 1991 only Czechoslovakia and Hungary were running annual rates of inflation below 20 percent,<sup>10</sup> or a monthly rate of less than 1.5 percent, while Poland's rate has been running at least twice as high (about 3.0–3.5 percent a month, or 40 percent a year). 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 (Figure 2 and Table 4).

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 price hikes that may or may not have eliminated the monetary overhang by January 1990 (this issue is in dispute). At any rate, a 45 percent price shock was forecast for January 1990, but the actual outcome was 80 percent (for January and February together; the respective figures are 67 percent forecast and 122 percent actual). During the whole of 1990, inflation was expected to be less than 100 percent and ended up at about 250 percent; thus, even the residual inflation, after the initial shock, turned out to be higher than planned.

For Czechoslovakia, which started from a stable price level and a considerably smaller monetary overhang, a price increase of only 25 percent was forecast. The actual increase was 40 percent in the first quarter of 1991, a smaller relative discrepancy than Poland's. Moreover, the residual inflation in Czechoslovakia 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 and made a number of additional price corrections during the year, so it is probably too early to pass judgment on the success of the initial move, particularly for Romania. The sharp foreign exchange shortage in these two countries, which necessitated the adoption of 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, was an outlier. Its initial price shock was small, 10 percent, as expected, and its residual inflation also hit the target (Table 3).

Three questions arise in the face of these initial price developments, after due consideration is taken of the fact that price comparisons between a postliberalization system and a distorted and rationed preliber-

<sup>10</sup> This is a convenient reference point because it corresponds to recent inflation rates in the successful stabilizers of high inflation—Bolivia, Chile, Israel, and Mexico. See Bruno (forthcoming, 1993).

alization stage impart a considerable upward bias to the data.<sup>11</sup> 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)? Was an initial price shock as large as Poland's necessary?

Possible sources of the unexpectedly high price level shocks include the 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 in anticipation of the imposition of price controls. In Bulgaria, and partly in Poland, the initial monetary overhang may have played a sizable role, whereas in the other countries (in particular, Poland), the price response to the exchange rate devaluation alone or combined with other factors may have been responsible. Inflationary experience elsewhere has shown 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.<sup>12</sup>

The answer to the second question about the relationship of the initial shock to the subsequent inflation profile depends on whether the source of the shock is indeed confined to an existing monetary overhang. It would then follow that a higher initial price jump would "save" the system from additional inflationary adjustments later on, and there would thus be a positive trade-off between the initial shock and subsequent price stability.

If a monetary overhang is not the cause of the price shock and if there is also a tendency for other nominal magnitudes in the system (money, credit, and wages) to "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. This may have been what happened 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 be made up later, and enterprise managers

<sup>11</sup> An interesting question is whether different initial conditions in the various countries might have led to different relative biases in these price shock estimates.

<sup>12</sup> In Israel this is called the "dentist effect" (because dentists raise their fees by the same rate at which the price of their material inputs rises, even though these inputs comprise only a small portion of the cost of treatment).

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 shock at the beginning? Technically, the answer is yes. Compare these programs to one successful heterodox predecessor: 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 that were then gradually removed. However, there was obviously no monetary overhang, and the relative price levels were certainly not as distorted as those in the Eastern European economies.

Yet, it may be argued that Poland could have chosen a smaller devaluation up front and left price controls at a higher level for three months, say, and only then decontrolled completely, either all at once or gradually.<sup>13</sup> But it could also be argued that with distortions as big as they were and the new government's initial high credibility, it may have been just as well to "chop off the dog's tail all at once."

It is interesting that Czechoslovakia retained some control over its initial price shock through moral suasion and by stipulating maximum prices or trade margins on some key commodities and by requiring prior notification of price increases in some monopolistic sectors. Also in Czechoslovakia and Bulgaria, certain price increases, such as for energy and housing, were delayed.

Do the initial benefits of a big price bang outweigh the subsequent costs of higher inertial inflation as well as other social costs? In pursuit of its devaluation and price liberalization goals, 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 exchange rate may then have had to be realigned earlier than mid-1991, but the cumulative price increase over the two-year period could nonetheless have been smaller. For Bulgaria and Romania, the question arises whether they could afford to opt for a far-reaching relaxation of foreign exchange restrictions when the foreign exchange shortage was (and is) so extreme.

<sup>13</sup> 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 the authorities chose 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.

One counterargument is that the administration of such restrictions would be ineffective.

Ending on a positive note—with all the quibbles afforded by hindsight duly noted—the overriding fact remains that in most of the 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 economic and political risks. Finally, from the consumer's perspective, the qualitative change that has taken place in the market environment probably outweighs the statistical measure of price increase.

#### IV. Was the Output Collapse Unavoidable?

There are several reasons for the large output fall. 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 was 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 other countries that experienced shocks.

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.<sup>14</sup> Both the real wage squeeze and the real monetary squeeze certainly affected consumer demand and thus depressed output on the demand side.

The credit squeeze can also operate on the firm supply side, if the financing of working capital is considered one of the factors of production (see Calvo and Coricelli (1992)). 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<sup>15</sup> (to which they can, and in fact, did adjust through

<sup>14</sup>There is some doubt about the relevance of the -5 percent projected output drop. According to participants in the planning stage, this estimate had been arbitrary and was not based directly on any of the plan parameters.

<sup>15</sup>This information comes from an unpublished World Bank report based on interviews in 75 state-owned enterprises in September 1991.

interfirm credit arrears). However, how much of the output decline, even in 1990, could be ascribed to this factor alone remains an open question.

### Supply Side Shock

In Poland, as well as in some of the other countries, there was a general shock on the supply side, which can be termed a comprehensive “management shock.” Enterprise managers who were used to operating in a command environment where their “market” was assured and their financing was accommodative suddenly had to make their own decisions in a completely transformed environment characterized by tremendous uncertainty. In these circumstances, 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. Evidence points 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. This situation was repeated during much of 1991 in the Bulgarian and Romanian programs. In Bulgaria and Romania (and, earlier, Czechoslovakia) the nominal interest rate was set at a level corresponding to the estimated post-shock rate of inflation, rather than at a level that would ensure a positive real rate of interest in the first month. It is important to remember, however, that in these three countries, unlike the Polish case, there was no preceding hyperinflation to contend with. Therefore, 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 a credit crunch and high real interest rates are a universal problem in the immediate aftermath of sharp stabilizations (as was true for Bolivia, Mexico, and Israel). It could also be argued that the uncertainty about the outcome of stabilization justifies a highly contractionary monetary policy as a support for the exchange rate or wage anchors. Of the 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.

### CMEA Collapse

The collapse of the CMEA was another major contributor to the fall in output. Table 2 provides rough IMF staff estimates of that part of the output drop in 1991 that can be ascribed to the fall in exports caused by

the demise of the CMEA. This estimate was based on the demand side, under the assumption of no short-run market substitutability (which obviously did not hold for Hungary or Czechoslovakia; see Section VII). It did not explicitly take into account the very sharp terms of trade effect of the collapse, which was a substantial exogenous supply shock, 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 that, with the exception of Hungary, the implied unaccountable drop in output shown in Table 3 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.<sup>16</sup>

The CMEA collapse caused the most damage in Bulgaria, the bulk of whose exports had gone to the CMEA. Bulgaria, and also Romania, saddled by their foreign currency restraint, suffered severely from a lack of raw materials.<sup>17</sup> The relatively larger fall in Poland's output in 1991 than seems warranted by its dependence on CMEA trade may have to do with the degree of rigidity in wages. In Poland the real product wage did not continue to fall in 1991, but rather increased by 15 percent, thus exacerbating the effect on the terms of trade.

At any rate, more detailed country studies of the components of the output collapse are needed before we can assess how big a margin needs to be explained over and above the effects of the CMEA collapse in 1991.

To what extent was this unprecedented output drop unavoidable? Even if it could not have been avoided, it is not clear whether other policies—such as structural adjustment policies and privatization—can facilitate a rebound in output in the near future. A substitute for the CMEA in the form of a payments union or trade arrangement would certainly help. Given the financial and political problems of the ex-U.S.S.R., it is not clear how well such an arrangement could have worked during 1991, but even maintaining some of the distorted bilateral arrangements during the transition could probably have softened the blow.

Given the magnitude of the output shock and the long time it takes for the productive system to respond to the new market signals, ways should

<sup>16</sup> A recent estimate by Rodrik (1992) of the ex-U.S.S.R. trade shock, which includes the effect on the terms of trade for Hungary, Poland, and Czechoslovakia, is remarkably close to the numbers appearing in the brackets in Table 3, so they may include terms of trade effects after all. In any case, neither the IMF's nor Rodrik's estimates include Keynesian multiplier effects or the effect of aggregate supply curve shifts under wage rigidity (see Bruno and Sachs (1985)).

<sup>17</sup> 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 ratio of raw materials to GDP.

be found 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. Government intervention in other forms is the likely alternative—extending credit and granting subsidies to ailing enterprises in a particular region or assigning larger budgetary allotments to unemployment relief.

## Exchange and Trade Policies

The wisdom of applying the cold turkey solution to trade liberalization can be questioned, and moving in stages to current account convertibility through gradual reduction of tariff barriers may be a sensible policy (see Greene and Isard (1991), Tanzi (1991), and McKinnon (1991)). There are strong arguments in favor of eliminating import licensing and quotas in one go, but there is no good inherent reason to move all at once to a zero, or very low, tariff. It is true that a gradualist strategy may lend itself to discretionary reversals by governments with low credibility. But when it is credible, the strategy can mitigate the immediate output and employment costs, while continuing to send the right price signals for long-term investment. If the strategy is to be credible, a commitment has to be made to a well-defined time path from a differentiated tariff structure toward a common low tariff within a few years (no more than, say, five). Examples of successful liberalizations that followed a preannounced gradualist path include the European Common Market, whose members agreed to a gradual mutual removal of tariffs in the 1950s and 1960s,<sup>18</sup> and individual countries, such as Israel, whose trade liberalization in the 1960s followed a gradualist path.

Even when the gradual path is chosen, the question remains whether initial tariffs should be differentiated across goods. To avoid political pressures the policymaker may choose, for example, to differentiate only by general category of goods (raw materials, investment and consumption goods) rather than by individual commodity or producer. In the next section, which takes up the fiscal balance, I argue in favor of a flat across-the-board tariff for purely fiscal reasons, until a value-added tax (VAT) is introduced.

A country that has opted for an ambitious trade reform from the start may not want to backtrack at a later stage because of loss of credibility, but it is a lesson to bear in mind for future reference (for example, in the

<sup>18</sup>In the case of the Common Market, it has taken quite a few years to phase out declining industries—for example, coal and steel.



states of the former Soviet Union), and, in fact, Poland eventually introduced a new and higher tariff structure in the second half of 1991. For some countries, however, the introduction of customs duties or tariffs may not be feasible, either because of the complete openness of their borders or the lack of necessary administrative capabilities. Unfortunately, that argument could also hold for any taxation, such as the VAT.

## Future Prospects

Even when the output downturn is reversed, the experience of past reform and structural change (elsewhere, as well as in Eastern Europe) shows evidence of substantial labor shedding and increasing unemployment, even as output rebounds.

Although the public sector's output is collapsing, the small-scale private sector, especially in trade and services, seems to be thriving. However, given this sector's small initial base, even large increases at an early stage cannot affect the overall result unless the country starts off with a larger private sector to begin with. Poland may have been in this situation by 1992, when aggregate GDP started rising; at the time of writing, one can rely only on partial evidence and varying interpretations of the meaning of some numbers—for example, on unemployment. Although unemployment in Bulgaria had reached 10 percent, some have argued that there can be no serious unemployment problem if one cannot even find domestic help willing to work at the minimum wage; other observers have claimed that serious unemployment problems were emerging among the young. Both allegations may be correct, just as zero unemployment in Budapest or Prague can be entirely consistent with very serious unemployment in other heavily industrialized regions. It has also been argued that the Bulgarian state sector could sustain a major reduction in employment with minimum social upheaval because many of these workers could return to family farms or work on their own privately owned plots. For a country with excessive industrialization (60 percent of the labor force!), a shift to small-scale services, trade, and agriculture could be considered a move toward the correct long-run equilibrium composition of output.

For policy planners the most relevant issue is the likelihood of immediate reversals in output and, especially, in the employment downturn, because this outcome will determine the economic and, especially, the political sustainability of the initial set of stabilization policies.

## V. 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 subsidies on goods and services, on the one hand, and an increase in expenditure on the social safety net, on the other. Given the existing tax revenue base, budget balance was assumed to be assured, as the figures for the respective programs show (see Table 3). Keeping the budget in balance always requires careful scrutiny so that transitory changes can be isolated from permanent changes. Although the initial budget outcome seemed satisfactory in most countries, 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, starting with the experience of Poland.

At first glance, the Polish fiscal performance in 1990 turned out to be a surprising success, switching from a deficit of about 7 percent of GDP in 1989 to a surplus of about 3½ percent. As Lane (1991a) showed 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 showed 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 were taken.<sup>19</sup>

The reasons for this outcome are important for future reference. The price surprise led to an unexpected deep fall in real wages resulting in larger-than-expected profits and higher tax revenues. To these revenues was added a tax on capital gains on inventories and foreign currency deposits. Revenue from the latter was an entirely fortuitous one-time effect, resulting from an improper accounting for inflation. Once real wages rebounded and profits were squeezed, returns on the profit tax fell substantially. The profit squeeze has persisted into 1991 and is the more permanent effect of the liberalization process (see McKinnon (1991)).

Czechoslovakia has gone through a similar process: a temporary surplus in the first few months of 1991 and an increasing deficit toward the

<sup>19</sup>The deficit includes 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.

end of the year. Similar problems are also emerging in Bulgaria, which differs from the others by not having had 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 has stayed close to balance. In Hungary's budget, a deficit of close to 4 percent has emerged, despite the new VAT and income tax.

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 5, based on Kopits (1991), gives an average breakdown of general government revenues and expenditures for 1985 in the five Eastern European countries, compared with the ex-U.S.S.R. and the European Community. Although the cut in subsidies may account for a savings of 8–10 percent of GDP on the expenditure side, additional safety net expenditures and unemployment benefits are likely to expand as the process of structural change and labor shedding deepens. Further, the drop in enterprise profit taxes is likely to continue to exceed the net drop in expenditures.

A critical problem in all five countries is the transition from a relatively egalitarian and well-endowed social welfare network to a market system in which all the income and wealth distribution problems, unemployment

Table 5. *Comparative Structure of General Government Budget, 1985*  
(Percent of GDP/GNP)

Budget Item	Five Eastern European Countries <sup>a</sup>	Ex-U.S.S.R.	European Community
Total revenue	<b>56</b>	<b>46</b>	<b>44</b>
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	<b>55</b>	<b>56</b>	<b>46</b>
Current goods and services	20	21	16
Investment goods	3	8 <sup>b</sup>	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).

<sup>a</sup> Unweighted average.

<sup>b</sup> Includes some investment transfers to enterprises.

risks, and other adverse social side effects of free capitalism suddenly emerge. Policymakers will face strong social and political pressures to continue the existing generous social security services and to correct for their recent erosion brought about by the sharp price increases. A large percentage of voters in these countries are pensioners. In Hungary where 25 percent of the population are pensioners, male employees retire at 60, and females, at 55. In Bulgaria pensioners are estimated to account for 35 percent of the voters, and 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 the Slovak Republic (over 11 percent by the end of 1991 and rising, compared with only 4 percent in the Czech Republic, and virtually zero a year earlier). Despite these pressures, there is room for streamlining the social welfare framework—for example, through privatization of some of the health services, charging for medication, and progressively taxing child allowance.

One way or another, the net budget outcome is likely to be a permanent imbalance, unless output, sales, and the profit base rebound quickly or new taxes are imposed. Past experience shows that the introduction of a VAT takes at least three years in a country with reasonably organized enterprise accounts, and 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 an urgent need to plan for temporary substitutes. For example, if trade liberalization were coupled from the beginning with a considerably larger tax on imports (even at a flat rate, say), the revenue from this source could have temporarily closed the gap, at least in part.

In the absence of a tax alternative, the pressure to balance the budget usually leads to expenditure cuts in areas where political opposition is light but the long-term economic cost is high, namely investment in infrastructure (roads, communications). This is the one area where 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 gradations in the urgency of the problem in the different countries (probably less crucial in Hungary and Czechoslovakia, more so in the other economies), but there is a minimum requirement in all of them, quite apart from the common need to cope with the inherited environmental damage.

This discussion leads to two important policy considerations. First, should some fiscal deficit be allowed for the interim period (until the 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 in the context of each economy. The first and most important point is that, given the time-phasing nature of the problem, it is important that the annual budget plan should be embedded within a well-specified medium-term framework (of three years, at least). Ideally, the country should precommit itself to a budget 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 of GDP, say, 4 or 5 percent. The financing of this deficit should not come from the central bank,<sup>20</sup> 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 help to prevent the adverse inflationary or crowding-out effects that a protracted deficit would otherwise engender.

Should infrastructure investment be treated differently? A textbook solution is to distinguish between the total deficit and the concept of government (dis)saving. The latter is more relevant for gauging the internal balance (although the former will still be important for financial planning). In this case, infrastructure investment could appear "below the line" as part of a separate capital budget that need not be financed by taxes. The objection to this "pure" solution is that it leaves the way open for potential abuse. Anything, so practical wisdom says, can be called "investment," be it teachers' salaries, defense expenditures, or retraining for the unemployed. These loopholes can be closed, however, by adopting strict definitions of what constitutes direct government investment; limiting the percentage of GDP allowed (say, no more than an extra 3–5 percent); or not allowing for separation of budgets but raising 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. Earmarking specific foreign lending (for example, by the World Bank) does, of course, ease matters.

There are no universal rules governing these considerations; they must of necessity be geared to each economy's specific risks or past record.

<sup>20</sup> In theory, once there is positive real growth of GDP, the money supply could be increased, assuming stable velocity, at the rate of real growth. However, this decision had best be left to the discretion of monetary policy and an independent central bank and should not be built in as a potential source of deficit financing. Otherwise, political pressures on the central bank to accommodate a deficit may become ruinous. Recent developments in several of the countries in question bear out the importance of this caveat.

## VI. 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 that have continued to mount and have been stacked in the portfolios of the commercial banking system. The stringent stabilization programs, the credit crunch, and the collapse of the ruble zone export market have exacerbated the problem, as has the mounting interenterprise debt. In the early stages of stabilization this problem was in most cases put off to one side. Unfortunately, the problem usually does not go away while waiting to be attended to, but, on the contrary, gets worse and may interfere with the process of stabilization and structural adjustment. The existence of a large bad loan portfolio on banks' balance sheets is one of the causes of the persistent large gap between deposit and lending interest rates. It may also 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, the issue of bad loan portfolios is best dealt with up front in the context of a broader currency reform. When loan cleanups are included in the initial package, there is a better chance of avoiding the severe moral hazard problems that any such cleanups entail. In practice, no such provisions were included in the original packages. Even if they had been, the problem would have lingered on, because much of the outstanding bad debt continued to accumulate in the poststabilization phase. When the problem is confronted, experience has shown that extreme solutions should be avoided. One extreme is to leave the issue out of the central government's budgeting perspective altogether by "letting the banks deal with the problem," which seems to have been the prevailing view in Czechoslovakia at one point. If this approach is followed, quite apart from sending out the wrong price signals in the credit markets, it would eventually lead to a banking crisis, and the government would have to step in, and on a much larger scale than would be required otherwise. The other extreme solution is to yield to the cumulative political pressures from the debt-ridden enterprise sector and pass blanket debt-cancellation laws, which was the approach taken in Romania. Besides being indiscriminate, this solution invites serious moral hazard, reinforcing bad borrowing behavior by setting up the expectation that next time around enterprises will be bailed out again.

Outstanding bad debt is estimated at 15–20 percent of total bank debt in Hungary and Czechoslovakia, and about 30–40 percent in Poland and Bulgaria. The ideal solution would be a credible, one-time cleanup of the

books, with the government buying up debt through the commercial banks on a case-by-case basis, cleaning an enterprise only on the basis of a clear recovery plan, with strict conditionality and a strictly enforced budget constraint.<sup>21</sup> However, this solution is probably unworkable for most of the countries and enterprises and banks in question, unless it were introduced during privatization as part of a sale bargain. In any event, those enterprises that can be identified as total failures should be phased out as quickly as possible. In Hungary this procedure was recently used for the coal mining industry.

A major problem is the large number of enterprises whose future is uncertain but which have some potential for restructuring. Some policy-makers in these countries are resisting across-the-board cleanups, citing an inherited lack of credibility with which the new governments have to contend. In their view, 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 argument, instill the right discipline.

In general, the problem has been tackled through a gradual institutional and political bargaining process. 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 deducted from the annual profits for tax purposes (this implies an implicit participation of the state budget of 40 percent). This solution is politically attractive, because it reduces the apparent profits of the banks (which have recently been exorbitant, given the large interest rate margins), while appearing to conceal the implicit cost to the budget. In Czechoslovakia the government 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 working (see below), especially since Czechoslovakia's internal debt is small. It remains to be seen whether

<sup>21</sup> This 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 were in 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 because of noncompliance and political pressure, and a new one has yet to be instituted.

Czechoslovakia and Bulgaria can also introduce a bank provisioning and tax participation scheme similar to the one adopted in Hungary.

Another major problem is how to prevent enterprises from continuing to borrow to survive rather than to adjust. Recapitalizing the banks and letting them handle the problem would seem to be the best policy, provided the banks are equipped to make the proper economic analysis and are able to take into account the interests of the bond issuers, namely the government or the taxpayers (who implicitly cover the tax losses). Unfortunately, the financial interests of commercial banks and the long-run economic viability of the enterprise do not necessarily coincide; 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), and is further compounded by the fact that the commercial banking system itself is not yet financially independent of the central bank, leaving part of the quasi-fiscal deficit open ended.

How should the public financing of bank capitalization and enterprise restructuring be treated? 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. Rather, it should be included 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, it could be financed by the issue of domestic bonds and/or external financial aid. Alternatively, it could be included in a broader capital account budget from which infrastructure investment could also be financed. A one-time stock adjustment, to be credible, should not be perceived as a permanent rise in the money and credit growth rates.

Finally, it is essential that enterprises are given the right signal—that financial rescheduling is a one-time conditional act, and not a precedent.

## **VII. Privatization of Large State-Owned Enterprise—What to Do During the (Long) Transition?**

In all five Eastern European countries the privatization of (mainly small-scale) trade and services enterprises has moved briskly, but it is at a virtual standstill for large-scale enterprises, primarily in the manufacturing sector. The reasons for the delay have been legal (restitution problems in Czechoslovakia), political (bad experiences with instant privatization in Hungary and Poland), or practical (lack of foreign or domestic investors). Even with the advanced voucher scheme being im-



plemented in Czechoslovakia, it is not yet clear how a new workable corporate control will emerge. It is clear that in all countries there will be a prolonged interim period during which the state will continue to own a considerable portion of the enterprise sector.

In privatization, as in loan cleanups, extreme solutions (completely discard or continue to embrace the past regime) are not workable and certainly not the optimal solution. The problem is how to instill market-oriented behavior in management and workers without unduly delaying the privatization stage. It appears this problem has not been systematically addressed in any of the countries.

In Hungary an attempt has been made to learn from the failure of the previous government's "spontaneous privatization" episode. The new Law on Economic Transformation moves the state-owned enterprises (SOEs) out of the jurisdiction of enterprise councils and gives them company status, under the aegis of the State Property Agency (SPA). In the transition period, the state becomes the legal owner as audited balance sheets and a board of directors are introduced. Supervision of management is partly subcontracted to approved advisory agencies, which become the agents of the SPA.

Much of the Hungarian privatization has taken the form of "self-privatization," whereby a manager looks for potential buyers who then have to be approved by the SPA or its accredited consulting firms. The process is obviously a slow one. The Czechoslovak Government, in contrast, seems to have opted for speedy privatization, since only the new owners will be in a position to do what is good for the firm. As a result, no systematic thought has been given to how the enterprises in the so-called no-man's land are to be controlled. Although the view is understandable, ignoring the problem does not help, since pressure is mounting for subsidies or cheap credit for enterprises in depressed regions.

Giving into these pressures could result in SOEs staying in state hands forever. Unfortunately, there seems to be no escape from these halfway policies, unless the authorities are willing to take the line that what cannot be privatized instantaneously had better be scrapped. This option, however, makes little economic sense from a medium-run point of view, since a sizable amount of industrial product may be made marketable after marginal investments have been made 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 feasible.

In Poland commercialization as an intermediate step was envisaged as important since it was more likely to free managers from the control of

the workers' councils. Managerial compensation is important 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. A compelling alternative argument, at least for the Polish case (see Dabrowski, Federowicz, and Levitas (1991)), is that the power of the workers' councils is too important a legacy from the communist regime to be easily dissipated. According to this view, the only way to resolve the political stalemate between the workers' councils and the state is mass privatization through giveaway schemes in which the present stakeholders in the enterprise, namely the workers' councils and the managers, will be the major beneficiaries. This would be a form of controlled spontaneous privatization.

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 best fits its political and social framework. But no matter which strategy each country adopts, it is important that it be transparent, sending clear signals to investors, managers, and workers, so as to minimize uncertainty in the transition period. Also, policy framers must not forget that macroeconomic policies alone can achieve only so much and that micro management policies should be integrated into the general policy framework right from the start as well as throughout the program. Privatization is one part of the reform process where the integration of macro and micro policy is essential.

### **VIII. Concluding Remarks**

This discussion of the recent Eastern European experience with stabilization points to broad common denominators in the five countries considered here as well with countries elsewhere. The sharp stabilization approach applies more or less generally, while any differences across countries originate in the varying ability to control the budget or the amount of credit or wage policy, rather than in the underlying conceptual macroeconomic framework. The greatest differences across countries also are the micro foundations of each economy, such as in ownership rights and financial accountability—which have also proved most resistant to change. The general lesson to be learned here is that from the start, the policy reform package has to put even greater emphasis on implementation of the institutions and rules of behavior for the micro units. Otherwise, the stabilization part of the reform could unravel.

Another related issue is the perceived role of government in the transition from a centrally planned to a market economy. In the old days,

communism was often viewed from the outside in highly simplified terms—a minutely detailed central plan and an omnipotent government. Likewise, today, capitalism is viewed simplistically by those who would like to embrace it as a well-oiled system consisting only of private property ownership and pure laissez-faire and self-adjusting market mechanisms, requiring no government interference. However, market failures often occur in the most laissez-faire economies (for example, in financial markets), and governments have to intervene in the microeconomy.

Thus, a hands-off policy during the transition from a centrally planned to a market economy would be most inappropriate. The temptation to resort to the old mistakes under central planning may be strong—for example, in the process of restructuring—but that possibility should not be used as an argument against any government intervention during the transition period. If the necessity for intervention is not acknowledged and guidelines regulating its application and defining its purpose are not established, there will be intervention in practice anyway; but without an overall view of its scope, direction, and implications, intervention will be haphazard and could involve costs that would breach budget constraints and threaten macroeconomic stability.

This discussion has concentrated mainly on issues common to the five Eastern European countries during the past two years. As time passes, the differences among these countries are likely to become more important from a policy perspective, as has usually been the experience of other countries undergoing stabilization and structural reform.

One issue on which economists cannot be of much help is the internal politics of reform. The external observer is struck by the apparent universal acceptance of the drastic changes that have taken place so far, despite the sharp real wage cuts, the fall in living standards, and the rise in unemployment. Although it can be reasonably argued that the official statistics do not really capture reality because of statistical biases, incorrect coverage, and so on, it is also true that numbers, even if inaccurate, are used in the political market place (for example, the consumer price index is used in the wage bargaining process, whether formally or informally). Some recent attempted strikes in Czechoslovakia ran into public opposition, and the policy stance of the government appears to be well understood by the public at large. The government in Bulgaria, with all its difficulties, apparently seems to have public support. In Hungary, however, there seemed to be a contrast between the apparent success of macro policies and the public's negative perception of them, as if the government has been unsuccessful in selling its policy product.

The experience with reforms both elsewhere and across countries in Eastern Europe points to the paramount importance of policymakers not

only being able to spell out government strategies in detail and in terms that can be widely understood, but also to sell their product to the public. The impending internal social problems in all of the countries will no doubt put all the reform efforts to a serious test, as political democratization proceeds and the possibility of bliss recedes. The social element is no doubt the biggest imponderable in each of the countries: what, if anything, can ensure the maintenance of the social consensus over the period of the reform program and its political sustainability in the near future? As one observer has asked,<sup>22</sup> "Are they, in return for true freedom, prepared to give up bread lines for unemployment lines?" The 1991-92 postelection developments in Poland and the separatist movement in Czechoslovakia do not bode well, but in this area, as with many others surveyed in this paper, it is probably much too early to tell.

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<sup>22</sup>The quote, attributed to Susan Marie Szasz, appears in Klaus (1991).

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