Macropolicies in Transition to a Market Economy: A Three-Year Perspective

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Countries in transition to market economies have had to implement macroeconomic stabilization programs at the same time that they were engaged in massive changes of their political institutions and the systemic frameworks of their economies. What has been the interaction of stabilization with economic liberalization and deep institutional reform in the countries of Eastern Europe, in particular, the relations among initial conditions, political developments, reform strategies, and outcomes? Experience in Eastern Europe suggests that when there is a political breakthrough (as in the countries under review) a radical stabilization-liberalization strategy is probably the least risky approach to reform and will not constrain output or structural reform over the medium term. Even stabilization that is initially successful in containing inflation will later come under pressure because of social policies and the structural transitions impelled by reform. Several factors are identified that affect the credibility of reforms, and lessons are derived for countries that have stabilized and those that yet face this task.

The collapse of party and state domination of society and the economy left the countries of Eastern Europe and the former Soviet Union facing a daunting dual challenge: to move toward competitive market economies while at the same time maintaining and strengthening newly gained democracies. The economic transition in these countries is viewed here as having three elements: macroeconomic stabilization; liberalization of prices, markets, and entry; and deep institutional change. This article focuses on the problem of achieving macroeconomic stability and sustaining macroeconomic balance through the transition.

Countries in transition must implement stabilization policies in the midst of deep changes in political institutions and in the systemic frameworks of their economies. In the context of such large changes outcomes usually ascribed to macroeconomic policies can strongly influence systemic and political developments. Conversely,

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Macropolicies can have a large impact on outcomes traditionally attributed to structural or institutional policies. We therefore emphasize the pattern of interaction between macropolicies, systemic changes, and political developments—rather than the details of individual programs and outcomes, which are, in any event, subject to unusually large measurement problems. The core countries in the analysis are those in Eastern Europe with longer post-1989 reform experience—Bulgaria, Czechoslovakia and its successors, Hungary, Poland, and Romania—but comparisons are made with other countries as appropriate.

"Destroyed Capitalism": Initial Conditions and Measurement Problems

"There's no use trying," she said, "one can't believe impossible things."

"I daresay you haven't had much practice," said the Queen ... "Why, sometimes I've believed as much as six impossible things before breakfast."

—Lewis Carroll, *Through the Looking Glass*

The Common Legacy...

After forty or more years of communism the "destroyed capitalism" of Eastern Europe and the Soviet Union differed from both the temporarily "suspended capitalism" of postwar Germany and the "distorted capitalism" embraced by Latin American and other dirigiste economies. In the economies characterized by destroyed capitalism, institutions reflected a fundamentally different system of organization and incentives (Kornai 1992). With few exceptions private activity was severely repressed, and private ownership of assets was limited to savings deposits and part of the housing stock.

The restricted role of the private sector had important implications for economic institutions, including the operation of factor markets. Medium-size and large state enterprises dominated output and employment. Industry was overbuilt, especially machine building and heavy industry; services, particularly trade and distribution, were underdeveloped and highly constrained. Government played a major financial role, intermediating between enterprises and between households through subsidies and transfer programs, and spending accounted for more than half of gross domestic product (GDP). Much of the revenue base was provided by the enterprise sector, where surpluses were concentrated among relatively few firms (in contrast, in market economies state enterprises are usually a fiscal drain).

The features of destroyed capitalism shaped many institutions and professions, including those of the legal system. Statistical systems were not adapted to dealing with large numbers of small firms or individual taxpayers, and enterprises had primitive marketing and accounting capabilities. But nowhere was the legacy of destroyed capitalism more pronounced than in the financial sector. Banking systems may have been "deep" (as measured by the ratio of balances to output), but finan-
cial flows accommodated decisions on the real economy. There was no experience of indirect, market-based monetary policy. Payments systems were primitive. Passive, monopolistic state banks lacked the capability to evaluate creditworthiness, and risk was socialized.

Foreign trade was dominated by a few monopolistic organizations. Autarkic trade patterns emphasized bilateral exchange between the members of the Council for Mutual Economic Assistance (CMEA), with increasingly adverse implications for product quality, as shown, for example, by the low prices of Soviet automobiles on Western markets (Roberts 1993). Relative prices were distorted; prices of energy and essential goods and services were heavily subsidized so that cash wages (subject to centralized norms) could be kept low and investment levels high. Official trade margins were tightly controlled.

Repressed inflation was widespread, reflecting an absence of broad commodity markets and a "shortage" economy, where demand for goods (and labor) often exceeded supply at controlled prices. Queuing, rationing, and hoarding were common responses, although use of these practices differed among countries and over time. The prevalence of "seller's markets" had profound implications for behavior. Enterprise managers set production goals to meet the requirements of bureaucratic bargaining processes (including spurious quality improvements) rather than those of markets and clients. Parallel prices often were multiples of official prices. Input stocks were hoarded, and inventories of unfinished investments were large.

...and Its Implications for Measurement

Even in established market economies standard statistical data provide only an incomplete description of economic reality, but in countries in transition data deficiencies and biases are much more serious (for more extensive discussions, see Lipton and Sachs 1990; Berg and Sachs 1992; Berg 1993a,b; Bratkowski 1993; and Balcerowicz 1993a). The statistical system inherited by the transition countries focuses on the contracting public sector rather than on the expanding private sector, and while output was overreported before transition, now there are strong tax incentives to underreport. Conventional statistics fail to reflect the sharp improvement in the quality and range of goods and in the composition of output stemming from market-oriented reform, instead applying the same "welfare weights" to pre- and postreform aggregates. And when prices are freed, conventional statistics overstate increases in the price level relative to an initial situation with unsatisfied demand at official prices. This bias distorts all deflated variables, particularly wages, which appear to fall more, relative to a consumer price index (CPI), than do real purchasing power and consumption. And conventional statistics do not measure welfare gains from the elimination of queuing, which may be considerable.

Reported unemployment data also are problematic. They are heavily influenced by incentives to report and typically are smaller than true labor redundancy, including that hidden within enterprises; indeed, the relation between unemployment and redundancy may vary a great deal among countries.1 Cross-border transactions are
poorly reported, giving rise to sometimes massive errors in trade data; there is still no perfect way to compare ruble and hard currency trade, and so to distinguish the impact of the collapse of CMEA markets from that of the reforms themselves. Reported fiscal deficits can seriously understate true consolidated government deficits, particularly where the central bank supports enterprises with cheap credit (although, at the same time, enterprises may assume some functions of government, including providing unemployment benefits and social services) for an extended period. Finally, such basic statistics as stock-building and enterprise markups and profits are severely distorted by inflation and rapid disinflation, and bank profits can be spurious because of inadequate loan-loss provisioning.

These data biases are not neutral with respect to types of reform program. Although many benefits of reform will be more seriously underreported the faster the economy moves away from the inherited statistical system, the swifter are the reforms the more rapidly will the inefficiencies of the old economic system be revealed. These inefficiencies include hidden unemployment, inefficient investments, excessive input stocks, repressed inflation and the associated costs of queuing, and “purely socialist” output for which demand can be maintained (if at all) only in a socialist economy. Instituting market-based monetary policies will make subsidies and losses more transparent. Invariably, the fiscal budget becomes the repository for the losses of the previous system.

Country-Specific Factors and the Stabilization Problem

Despite the commonalities of their heritage, the transition economies inherited very different macroeconomic, structural, and systemic conditions. These conditions determined the environment in which these countries began reform and thus the relative difficulty of achieving stabilization. The differences in those conditions reflect longstanding differences in policies and in the political developments that preceded—and followed—the breakdown of the one-party state.

Even with conservative macroeconomic policies all socialist countries were plagued by shortages resulting from supply rigidities and forced substitution in demand at administratively fixed prices. Resolving such microeconomically induced shortages is part of the liberalization problem, and a one-time correction of the price level will be needed to accommodate large changes in relative prices, along with sufficient macroeconomic discipline to preserve stability in the liberalized environment. Countries also faced macroeconomically induced imbalances, reflected in a mix of shortages and open inflation (depending on the degree of price control) and, to the extent that overexpansive policies had been externally financed, high external debt.

Only some of the core countries faced an urgent internal stabilization problem at the start of reform. In Bulgaria, Poland, and Romania the weakening of the communist regime was manifested in progressive loss of economic control and increasing macroeconomic imbalances driven by growing consumption. But Czechoslovakia, in keeping with a long tradition of macroeconomic conservatism, preserved spending discipline throughout its political transition. The stabilization problem was also less
urgent in Hungary, where both the political and the economic transitions began in a more stable and liberalized environment and involved far more continuity than the transitions in the other countries. Like Bulgaria and Poland, however, Hungary had accumulated large foreign debts. In contrast, Czechoslovakia was essentially debt-free, and Romania had repaid previously contracted foreign debts by the end of the 1980s.

The magnitude of the initial stabilization problem the core countries faced is suggested by the strength of open and repressed inflation in their economies. Open inflation was most serious in Poland, and repressed inflationary pressures were strong in Bulgaria, Poland, and Romania. Czechoslovakia's economy was macroeconomically balanced yet microeconomically distorted, with key relative prices way out of line and a large foreign exchange premium on a small parallel market.

The core countries faced structural problems of varied seriousness that were reflected particularly by dependence on CMEA trade and the size of industry's share in the economy. Other conditions shaping the reform environment included the extent to which the old economic system had been reformed and the strength of the labor movement after reform: a strong labor movement tended to produce a wage push, which complicated the stabilization effort. In addition to external debt Bulgaria inherited perhaps the most difficult structural problem: its high dependence on CMEA trade implied losses of 16 percent of GDP or more with the collapse of that trade. The trade collapse was a large external macroeconomic shock for all countries, with particularly severe effects for sectors that depended on the Soviet market. Romania's industry was unusually concentrated, with a hydrocarbon-based complex dependent on imports from the Soviet Union. Poland too had serious structural problems, as well as high foreign debt and strong trade unions; however, following reform, its private agricultural sector outperformed state-dominated systems elsewhere. Other than dependence on CMEA trade the main liability of Hungary's relatively open and reformed economy was its high level of foreign debt. At the other end of the spectrum, debt-free Czechoslovakia had a weak trade union movement, and the Czech Republic would later be able to separate away its most serious problems of industrial structure with its split from Slovakia.

Also vital for the reform environment are political developments during economic transition. Hungary has been close to a model of political stability, with a smooth transition and the government freely elected in March 1990 still in power in 1994. Czechoslovakia's far more radical political transition involved elections in June 1990 and June 1992, both held according to a predetermined timetable. The country's split in early 1993 was a serious political shock, resulting in fiscal gains to the Czech Republic and losses to Slovakia, yet in the Czech Republic the same economic team has functioned since December 1989.

The other countries have experienced far less political stability. Poland formed its first noncommunist government in September 1989 and launched its reform program three months later. Following presidential elections in late 1990, a new government was seated in early 1991. Nevertheless, essentially the same basic team was responsible for the economy until December 1991. After the parliamentary elections in October, however, the pace of political change visibly quickened. By April 1994
Poland had gone through three governments and five ministers of finance; three of the ministers resigned. In Bulgaria, where a coalition government initiated an economic program in early 1991, the period up to February 1994 saw two parliamentary elections and three governments. Since early 1991 Romania has had as many governments, and it held parliamentary elections in September 1992. Romania has been the only country in which the government was forced to resign (in September 1991) under the pressure of widespread industrial unrest and riots.

For a stabilization plus transition program, perhaps even more than for stabilization in a nontransition economy, political developments form an important part of the conditions for implementation. Elections in an early stage of implementation tend to raise inflationary expectations and reduce the propensity of state enterprises to adjust because of expectations of a change of direction in economic policy. Frequent turnover of governments and ministers slows the implementation of structural and institutional reforms. Thus the political framework for stabilization has been less favorable in Bulgaria, Poland, and Romania than in Hungary and the former Czechoslovakia. As discussed below, experience shows that the period of "extraordinary politics" that follows a major political breakthrough and the discrediting of the old order can create conditions conducive to effecting a determined stabilization. A vital element of that breakthrough in Eastern Europe (as in the Baltics) was undoubtedly the sense that the long period of Soviet domination was at an end.

Economic Policy and Political Breakthrough

Given initial conditions, whether economic policy can shape outcomes in a controlled way depends on political developments. Extreme political instability may render economic policy uncontrollable, so that the outcome is a product of initial conditions, external factors, and political chaos. With that in mind, consider three important dimensions of economic policy:

- **Launching speed**: the interval between a political breakthrough and the launching of a coherent economic program.
- **Phasing**: the timing of the launching and implementation of the main components of the program.
- **The implementation rate** for each main component.

The importance of launching speed becomes clear when we analyze economic transition from the perspective of political economy. The period following a great political breakthrough, such as those experienced in Eastern Europe and the Baltics, is characterized by a special mass psychology. In the interval between the discrediting of the old political elite and the coalescing of new interest groups, conditions are especially favorable for technocrats to assume positions of political responsibility. There is also a greatly increased probability that the population will accept difficult, normally controversial economic policy measures as necessary sacrifices for the common good (Balcerowicz 1994b). But the experience of Eastern Europe suggests that this period of "extraordinary politics" usually lasts no longer than one to two years. Then, "normal politics" reemerges, when political groups are much less will-
ing to accept such measures—or their distributional implications. The timing of difficult economic measures can therefore be expected to affect their acceptance.

With respect to phasing, consider the three sets of policy reform measures: macroeconomic stabilization, microeconomic liberalization, and deep institutional restructuring. Stabilization policy involves fiscal and monetary restraint, exchange rate management, and possibly wage or other controls. Liberalization policy eliminates legal or bureaucratic restrictions on economic activity, including price controls, quantitative restrictions on foreign trade, limits on foreign exchange convertibility, rationing and the command mechanism, and barriers to setting up and developing private firms. Liberalization policy primarily supports a rapid shift toward a market economy and spontaneous growth of the private sector. Institutional restructuring policy, which involves, for example, privatization of state enterprises and reform of legal codes and tax administration, creates the fundamentals of a capitalist economy and makes possible well-functioning financial and labor markets. As discussed below, single policies alone do not determine economic outcomes. Stabilization outcomes, for example, are the result of liberalization and institutional restructuring as well as the stabilization policy.

The implementation rate is the rate at which reformed policies are effected relative to the maximum possible speed for that type of change. We term rapid policies as more radical and more gradual policies as less radical. Gradualism may reflect initial conditions. For example, if a government had earlier undertaken substantial price liberalization or started reform from a balanced macroeconomy, only limited further decontrol or macroeconomic tightening may be needed. Or the initial economic situation may allow radical approaches, but the actual policy may be gradualist by design or because of political drift. Radical reforms, in contrast, are invariably introduced deliberately.

Clearly, stabilization and liberalization policies can be implemented much faster than most deep institutional changes. A radical strategy thus involves a two-stage transition to a market economy. In the first stage the economy is largely "marketized," thanks to liberalization policy, and stabilized, thanks to stabilization policy, but it remains market socialist rather than capitalist. In the second stage, if stabilization and liberalization policies are successful, their gains are consolidated and deep institutional change is completed under macroeconomic stability. Alternative scenarios involve delaying or interrupting stabilization or liberalization, or both, or implementing them over a longer period during which deep institutional change might be effected.

A comparison of the economic reform policies of the core countries, focusing on the speed with which reform packages were launched and the scale of changes achieved, suggests some general observations:

- Bulgaria and Poland responded to severe macroeconomic imbalances with radical programs introduced soon after the political breakthrough (three months afterward in Poland but a year afterward in Bulgaria). Private sector liberalization and institutional change advanced much more slowly in Bulgaria, however, and by the end of 1993 growing fiscal imbalance and rising enterprise losses and arrears threatened to derail reform. Romania, inher-
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...iting a less severe macroeconomic situation, adopted a less consistent, stop-go macroeconomic policy but launched a renewed stabilization and liberalization program at the end of 1993.

- With a far smaller stabilization problem but distorted relative prices, Czechoslovakia implemented radical liberalization safeguarded by tough macroeconomic policy.
- Hungary responded to a moderately difficult macroeconomic situation with more gradualist stabilization and liberalization policies. The response largely reflected initial conditions, including a more liberalized price system, but it was also a deliberate choice; the government could have opted for a more radical program, which the main opposition parties favored. In contrast, Romania's gradualism did not reflect favorable initial conditions but was dictated by political factors.
- The countries that adopted radical stabilization policies also adopted radical price liberalization, raised many administered prices, and largely liberalized foreign trade. In contrast, Romania implemented a much more stepwise liberalization and delayed decisive price and interest rate adjustments.
- Countries undertaking radical reforms also tended to take a radical approach toward external debt inherited from the old regime. Among the heavily indebted countries, only Hungary continued to fully service its debt.

Stabilization Outcomes

What were the outcomes of these moderately heterodox stabilization programs for inflation, internal and external balance, and the restructuring of the economy? None of the countries implemented an orthodox stabilization program that relied solely on fiscal and monetary restraint. The severity of initial distortions ruled out broad reliance on price controls (as in some of the heterodox programs implemented elsewhere). But the dominance of the state sector and the absence of owners who would resist excessive wage pressures called for temporarily maintaining, or even strengthening, inherited wage controls. All countries maintained tax-based wage controls, at least through the initial phase of transition. Among the countries facing severe macroeconomic problems, Poland devalued its currency and pegged the exchange rate, Bulgaria floated its currency, and Romania floated its currency but intervened heavily in foreign exchange markets and restricted convertibility. Czechoslovakia devalued and pegged its exchange rate; Hungary devalued and moved to a crawling peg. Thus there were two variants of the somewhat heterodox programs: one with wage controls and one with both wage controls and pegged exchange rates.

Disinflation and Elimination of Shortages

In Bulgaria, Poland, and Romania, where repressed inflation was strongest, prices and exchange rates might have been expected to overshoot longer-run equilibriums at the start of reform; in the event, initial price increases greatly exceeded projec-
tions (Bruno 1993). Czechoslovakia's price increase also exceeded projections. But perhaps because inflationary expectations had not become deeply institutionalized, except in Romania, the initial inflationary burst lasted only a few months. Nevertheless, only Czechoslovakia—where initial macroeconomic imbalances had been least serious—managed to bring inflation to below 20 percent after a year. Hungary kept inflation moderate in 1990 and 1991 as it further decontrolled its already relatively liberalized price system and raised administered prices.

Continuing to exert upward pressure on price levels, however, were the need to finance fiscal deficits that reemerged after the first year of reform, the introduction of new indirect taxes (notably valued added taxes), and the adjustment of key administered prices (rents, energy, public transport) (Orlowski 1993a,b). Although no country fully adjusted prices in one step, Poland effected especially large adjustments at the beginning; Czechoslovakia and Hungary adjusted prices more gradually. At the end of 1993 most countries still subsidized residential rents and household utilities, however.

Romania's inflation profile was an outlier. Despite an apparently tight macroeconomic program and far slower price liberalization than in the other countries, inflation remained above 200 percent after 1990 and reaccelerated after 1991. An initial phase of decontrol in 1990 stalled and partially reversed in 1991; liberalization was resumed in 1992 but became pervasive only in May 1993 with the lifting of restrictions on trade margins. Romania also maintained a number of export restrictions.

Price and trade liberalization and the elimination of restrictions on private business, combined with restrictive macroeconomic policies, were remarkably effective in eliminating shortages. Agricultural markets in Poland, for example, swung from chronic shortage to excess supply in little more than a month as households and farmers disboarded stocks and food ceased to be used for animal fodder. Food aid and export controls added to food surpluses (Kwiecinski and Quaisser 1993). Business surveys and interviews with managers of industrial state enterprises in several countries suggest that a demand barrier rapidly replaced input shortages as the main constraint on output, at least for established firms. Surveys in Poland show that most managers saw the new environment as credible and not as a short interlude before a return to "business as usual." Sharp increases in nominal interest rates in January 1990 appear to have played an important signaling role, even though real rates did not immediately become positive. Many state enterprise managers began to take initiatives toward restructuring, despite high uncertainty about the macroeconomic outlook, constraints on corporate governance set by enterprise councils and trade unions, and limited information about their options (Gelb, Jorgensen, and Singh 1992; Pinto, Belka, and Krajewski 1993). Whether managers in other countries took such initiatives is less clear.

**Fiscal Deficits, External Financing, and Monetary Policy**

Reform initially led to sharp reductions in reported fiscal deficits, particularly in Bulgaria and Poland, where deficits had been large before reform. The largest turn-
around, more than 10 percent of GDP, came in Poland, which ran a sizable surplus in 1990. In 1992, however, large fiscal deficits reemerged in all the countries except Czechoslovakia, which, along with Hungary, initially maintained a conservative fiscal stance. But Hungary’s deficit widened sharply in 1992 and 1993, to more than 7 percent of GDP. The increase reflected mainly an unexpectedly large decline in corporate taxes—a surprising result considering that Hungary had by far the most reformed tax system. Bulgaria saw its deficit explode to 13 percent of GDP in 1993. The reemergence of serious fiscal deficits reflected depressed economic activity, as well as longer-run processes of systemic change and costly social policies.

Current accounts, like fiscal balances, were at first unexpectedly strong. Bulgaria, Czechoslovakia, Hungary, and Poland all ran surpluses in the early stages of reform, although Bulgaria and Poland would not have been able to had they been fully servicing their foreign debts. By 1993, however, for all but the Czech Republic (which gained a fiscal benefit of some 4 percent of GDP on the separation from Slovakia), current accounts had swung back into deficit. The deterioration was especially sharp for Bulgaria and for Hungary, which in 1992 had been able to finance its deficit domestically because a sharp rise in household financial savings coincided with a sharp fall in net domestic credit to enterprises.

Romania again followed a different pattern. A demand explosion combined with a contracting economy to worsen the current account by 14 percent of GDP between 1989 and 1990. Current account deficits continued through 1993 even though the budget was in ostensible surplus until 1992; current account deficits and sharply higher inflation therefore preceded an open fiscal deficit by three years. Romania’s failure to stabilize after 1990 reflected mainly a self-fulfilling monetary policy failure that helped to undermine the credibility of the reform program and made subsequent stabilization far more difficult. At the start of reform Romania had a command, rather than a market-socialist economy, and strong ties between industrial ministries and enterprise managers continued after 1990. Far more than in the other countries, industrial lobbies, representing heavy and petrochemical industries and regies autonomes (strategic sectors that were not to be commercialized) exerted great political power, as did the agricultural lobby. Firms continued to have access to credit at interest rates far below inflation. Real rates on bank loans averaged about -58 percent in 1991–93, and National Bank rediscounlights were available even more cheaply until the end of 1993. National Bank losses contributed to a real consolidated government deficit of about 21 percent of GDP in 1992, which was financed in part by monetary expansion.

In Romania, as in the other countries, deflated monetary aggregates and credit to enterprises contracted at the start of reform. The enterprise sector responded to the cut in real bank credit by increasing interenterprise borrowing, which soared to 190 percent of bank credit by the end of 1991. Surveys of Romanian enterprises left little doubt about their payment priorities: wages first, suppliers last (Calvo and Coricelli 1993). That ranking of priorities suggests that weak credibility—not involuntary lending—caused the credit explosion. In contrast, interenterprise credit actually declined relative to bank credit in Poland in 1990, as the credibility of the
hardened budget constraint and the high real cost of borrowing made enterprises less inclined to extend such credits. Interenterprise credit was contained at 20 percent of bank credit in Czechoslovakia and Hungary. At the end of 1991 Romania eliminated the overhang of interenterprise debts, which had made evaluating creditworthiness impossible, through a global compensation scheme. Canceling out the net debt required the injection of heavily subsidized credits from the National Bank, which added to inflationary pressures and undermined the credibility of future stabilization policies. Further compensations have since been needed, suggesting a "low-discipline arrears equilibrium.".

In addition to continued credit subsidies from the National Bank, Romania's inflation in 1992 reflected the need to finance an open fiscal deficit of 7 percent of GDP. This deficit was caused in large part by fiscal subsidies, which increased from 8.6 percent of GDP in 1991 to 11.4 percent in 1992 (subsidies in the other countries had by then been cut to an average 3.6 percent of GDP). By 1993 fiscal balance ostensibly had been restored by sharp spending cuts, but off-budget interventions were still significant, and the inflation tax was being levied on rapidly shrinking leu balances. Romanians were building up foreign exchange deposits (a third of M2 by early 1994) and fleeing the leu. Until initiation of its stabilization program in late 1993, Romania's monetary policy, and the erosion of its financial balances, was not unlike that of Russia after 1992 (Easterly and Vieira Da Cunha 1994). Both countries formally "deregulated" deposit rates, but their state- and enterprise-dominated banking systems have temporarily benefited from inflationary expropriation of householders' deposits.

In contrast, the radical stabilizers that raised deposit rates to positive real levels soon after the first shock of price liberalization saw sustained remonetization and conversion of foreign exchange deposits into domestic assets as their currencies reappreciated from initially very devalued levels. The cumulative dollar return on Bulgarian deposits for the two years after May 1991 was about 60 percent.

Stabilization and Restructuring

What did the financial side of stabilization imply for the restructuring of the real economy? In the three radical reformers—Bulgaria, Czechoslovakia, and Poland—real interest rates were negative during the sharp initial spike of price liberalization, so that the real burdens of domestic debt were suddenly written down (much like external debt in Bulgaria and Poland). In Hungary, where price liberalization had been under way far longer and reform involved more gradual adjustment in the price level, the writedown was more modest and was soon reversed, but external debt service was sustained, at heavy fiscal cost. Real borrowing rates subsequently averaged about 15 percent in Poland and Hungary and 8 percent in Czechoslovakia.

With modest growth in deflated credit volumes net of enterprise deposits and large interest rate spreads, the net resource transfer from banks to enterprises (defined as the expansion of net credit less the net interest bill due from the enterprises to the banks) was negative. Enterprises therefore had to proceed with physi-
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cal restructuring in a highly resource-constrained financial environment and to rely on cash flows for new investments. The main question about the banking system, then, is how it redistributes scarce resources between firms: efficiently—toward profitable, growing (private sector) firms—or perversely—rolling over loans to loss-makers and postponing adjustment? This question is taken below.

Net transfers followed a different pattern in Romania. Negative real interest rates offset the contraction of real credit, particularly in 1991, the year of the global compensation. The net resource transfer from banks to firms was therefore positive but unsustainable because of the erosion of leu deposits.

Exchange Rate Outcomes

Although the three radical reformers pursued different exchange rate management, their exchange rate profiles after reform showed strong parallels. The initial devaluations in Czechoslovakia and Poland set their newly unified rates at about 4 times the purchasing power parity (PPP) level; Bulgaria, with low reserves, saw the freely floating lev briefly devalued to almost 10 times PPP. Nevertheless, independent of whether exchange rates were pegged or floating, real rates converged within a year toward levels of between 1.8 and 2.5 times PPP, with Czechoslovakia maintaining a more competitive rate than Poland. The lev reappreciated strongly toward a market to PPP ratio of 2 until October 1993, when the widening fiscal imbalance and an increasingly chronic buildup of tax, social security, and interest arrears helped to provoke a foreign exchange crisis and a series of devaluations that halved the lev’s external value. The expected ratio of market to PPP rates for countries with real per capita incomes comparable to those of Eastern Europe is about 2, according to 1985 data of the United National International Comparison Programme (Ahmad 1992); in this sense the exchange rates were converging toward “normal” levels.

Hungary’s real exchange rate had slowly depreciated by 25 percent over the period 1985–90. More so than the other countries, Hungary pursued a deliberate exchange-rate-based stabilization after 1990. It encouraged foreign borrowing and foreign direct investment to offset its heavy debt service burden and at the same time to build reserves. Hungary’s policy of limiting devaluations considerably dampened inflation, particularly for industrial goods (Solimano and Yuravlivker 1993), but resulted in steady real appreciation, with the forint reaching a value of 1.6 times PPP by early 1993.

In real exchange rate movements Romania again displayed a distinctive pattern. With continued heavy intervention in goods and foreign exchange markets, the exchange rate moved erratically, and the official rate tended to depreciate relative to PPP rather than to firm at levels close to expected longer-run values. By 1993 the official rate was still more than 3 times PPP. Grey and black foreign exchange markets were active, however, with the National Bank allocating limited foreign exchange on a pro rata basis on the official auction and with premia between 25 percent and 40 percent. The real effective exchange rate was therefore even higher than the official rate. Strong depreciation of the leu reflected the partial and contradic-
tory nature of Romania’s reforms, particularly the subordination of monetary policy to cushion loss-making firms rather than to reestablish confidence in the currency. In late 1993 Romania initiated renewed stabilization efforts, including sharp increases in interest rates to positive real rates and exchange rate unification. These efforts led to a substantial decline in inflation, to 5 percent a month by early 1994, and a considerable firming of the leu.

**Was Radical Reform Too Radical?**

Monetary and fiscal policies thus have been powerful tools in containing inflation and stabilizing exchange rates, possibly because inflationary processes were not deeply institutionalized at the start. But were the radical programs too tough? Not only were the initial price increases higher than projected, but deflated credit aggregates and measured output levels were lower, and current accounts considerably stronger, than expected (Bruno 1993). Considering data lags and the uncertainty accompanying the programs, deviations from projections are not surprising. How should policies have responded to new information? Should they have been relaxed to take advantage of space on the external account? Or should they have been maintained (or tightened further) to reduce the likelihood that the unexpectedly strong surge in prices would translate into sustained high inflation?

Such conundrums are endemic in stabilization programs. Both options have risks that cannot be considered in isolation from the political situation. Policies could indeed appear too tough to be credible, particularly if there is no major political breakthrough. But relaxation poses risks of rising inflation, progressive indexation, loss of credibility, and costlier (and politically less acceptable) stabilization in the future. The transition economies generally were not highly indexed; that could argue for speedy relaxation once the initial price spike had dissipated. But maintaining macroeconomic stability in a liberalized economy requires fundamental changes in behavior, particularly for enterprise managers long used to an accommodating budget constraint and a passive banking sector. This problem is compounded by the inevitable lag of institutional reforms, including privatization, behind radical stabilization and liberalization. Because the phase of current account improvement was short, and because all the countries (with the possible exception of Czechoslovakia) faced an external balance constraint again by 1992, the risks of relaxation far outweighed any temporary benefits.

**Liberalization, Relative Prices, and Competition**

After price and trade liberalization, most relative price ratios appear to have approached world levels relatively rapidly in Bulgaria, Czechoslovakia, Hungary, and Poland (Berg 1993a). In some cases policy slowed the transmission of international prices; in other cases, notably agricultural marketing and input supply, domestic monopolies in processing and distribution prevented a full pass-through of world prices. Although the ratio of market to PPP exchange rates is only a rough indicator,
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it suggests that prices for a wide range of goods should have converged to close to their long-run levels within about a year of the start of radical reforms; comparative costs would then play a more important role in determining real exchange rates. The elimination of temporary "exchange rate protection" exposed firms to the full pressures of domestic and international competition, squeezing industrial enterprises' margins and creating pressures for selective protection (Schaffer 1993; ACED 1993).

The persistent undervaluation of the leu seems to have limited competitive pressure from abroad in Romania; although data are inadequate, the pattern of reported profitability in the regies autonomes and the commercialized sectors suggests that price controls were more important than foreign competition in determining markups and profits.

Large formal devaluations did not simply imply a relative price shift in favor of sectors producing traded goods. Exchange rate unification reduced the relative prices of many goods (especially high-quality consumer durables and foreign travel) that had been obtainable only through parallel exchange markets with high premia. Not surprising, consumption of high-quality consumer durables increased sharply at the same time that the corresponding domestic industries faced a demand barrier. Thus consumers benefited from unification, while state enterprises that had purchased commodities at official prices and sold at artificially high market prices lost.

Interpreting inflation rates and exchange rate movements in transition is further complicated by the divergence between consumer and producer prices in most transition economies. In Bulgaria, Hungary, and Poland consumer prices rose more rapidly than industrial producer prices, while Romania showed, if anything, the opposite tendency. In addition to indirect taxes and technical factors that can cause price indexes to diverge, the relative rise in consumer prices appears to reflect two transitional processes. First, relative prices of previously heavily subsidized essential services are realigned, and second, trade and distribution margins widen from previously repressed levels as the service sector is privatized and Western marketing patterns take hold. Indeed, the service sector has often led to CPI inflation. In contrast, service prices lagged behind the CPI in Romania until May 1993, when margins were freed. Romania was also the only country in which budgetary subsidies increased as a share of GDP after reform. These important differences in pricing policies show up in household budgets, where the share of nonfood essentials rose sharply in the other countries after 1989 but fell in Romania despite a possibly deeper decline in living standards (Cornia 1994; UNICEF 1993).

A widening wedge between industrial producer prices and the CPI has several implications. Part of the CPI inflation in the period following an initial stabilization comes from a relative price adjustment in favor of previously suppressed or heavily subsidized nontraded sectors. This price adjustment increases financial pressures on industry and agriculture—the traditional tradables sectors—which must contend with wage demands boosted by rising consumer prices. Increases in the prices of nontradables offset, in part, the impact of an initial devaluation on competitiveness. To the extent that price increases reflect cuts in consumer subsidies, higher wages represent a progressive monetization of the overall consumption bundle; to the
extent that they reflect growing trade and distribution margins, they are part of the process of shifting resources away from state-dominated industry to build private wealth in the service sectors. For these reasons, as well as the fiscal consequences of systemic changes, it is unrealistic to expect inflation rates to fall to levels typical in OECD countries immediately after initial stabilizations. They need to be sufficiently high for a period to accommodate relative price shifts.

Is Stabilization Sustainable? Feedbacks from Systemic Change

The larger process of transition involves many interrelated transitions: from public ownership toward private, from industry toward services, from an economy dominated by large enterprises to one with many small firms, from seller's markets to buyer's markets (including the labor market, where open unemployment replaces hidden unemployment), and from CMEA product standards toward world market standards (Kornai 1993). Another fundamental change is to transform the financial sector from a passive player to an active one and to desocialize risk-bearing.

Eastern Europe already has seen huge changes along these lines. The private sector's recorded shares in the economy have increased especially rapidly in the Czech Republic and Poland, at first in trade and services but later in other sectors (Rostowski 1993). Little of this private sector growth is directly attributable to the privatization of state enterprises. Although private sector development has lagged in Bulgaria and Romania, thriving private economies have nevertheless arisen in these countries too. The share of industry in output and employment has fallen sharply in all the countries in favor of services and, in Romania, agriculture. Layoffs and breakups are transforming the structure of industrial employment; for example, employment in Hungary's largest industrial firms fell by half between 1989 and 1991 while small firms multiplied.

What do such structural and institutional transitions imply for the sustainability of macroeconomic stabilization? We consider three areas important for the credibility and sustainability of stabilization programs: the supply response, fiscal sustainability, and banking reform.

Supply Response

The asymmetric response of private and public sectors to reform argues for a dual-sector framework for explaining the supply response (Aghion and Blanchard 1993; Berg 1993c; Chadha and Coricelli 1993). Because of the composition of its output the state sector became demand constrained after markets were liberalized, competition emerged, and CMEA trade collapsed. But the private sector has benefited both from demand substitution effects and from the recognition and guarantee of private property rights, which is equivalent to a growth-enhancing supply shock.

Cross-country comparisons suggest two possibly surprising conclusions. First, radical stabilization is not associated with lower measured output over a period of two to three years. Indeed, the association is positive in our sample, where the
largest cumulative contraction is in Romania, the least successful stabilizer, and the smallest in Poland, the most successful stabilizer. Second, stabilization does not seem to slow the transition to a private economy. Indeed, some supply-side stimuli to the private sector have been directly related to the severe financial squeeze on the state sector. In addition to freeing up labor for the private sector, cash-strapped public enterprises have sold and leased assets to private firms. Where state firms have not responded to a tightened budget constraint (as in Bulgaria), the private sector has tended to be crowded out.

These two observations are related. Although Poland shows that state industry can recover under credible hard budget constraints (Pinto, Belka, and Krajewski 1993), one clear message of the past three years is the importance of private sector growth for the initial stage of output recovery and job creation—and hence for the sustainability of stabilization.

**Fiscal Sustainability**

Before reform, fiscal revenues came mainly from three taxes collected through the state enterprise sector: the profits tax, the turnover tax, and the payroll tax, which funded social payments. Together these taxes accounted for almost 80 percent of tax receipts in Czechoslovakia and Poland and about 50 percent in Hungary. Because the enterprise sector concentrated surpluses and employment in large units, governments did not need to develop the capacity to tax large numbers of individuals and small businesses. But with competition, constrained demand, and an end to cheap credit, enterprise sectors could no longer concentrate fiscal resources for governments. Meanwhile, widespread private sector underreporting is encouraged by high profit tax rates and payroll and wage taxes that can cause gross labor costs to be double net pay. As would be expected, transition has eroded tax revenues.

Fiscal sustainability is not essentially a revenue problem, however. For the core countries, excluding Romania (which followed a different fiscal profile), the average ratio of government expenditure to GDP was 61 percent in 1989. Of this, 16 percent represented subsidies and 13 percent social transfers, so that redistributive current spending accounted for half of total government expenditure. Ratios of government spending to GDP normally are far lower for market economies at comparable levels of PPP income: about 21 percent of GDP for revenue and 22 percent of GDP for expenditure (Krumm, Milanovic, and Walton forthcoming). Recent research suggests that, allowing for the level of income per capita, an increase of 10 percentage points in the ratio of fiscal expenditures to GDP is associated with a 1 percentage point drop in the growth rate (Easterly and Rebelo 1993). That suggests a high premium on constraining fiscal spending—beyond simply containing the deficit—during the transition.

Between 1989 and 1992 fiscal expenditure fell relative to GDP only in Bulgaria and Czechoslovakia. The considerable increase in Romania can be attributed to rising producer and consumer subsidies. In the other countries subsidies declined
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... sharply, so that the average ratio of nonsubsidy spending to GDP rose by 5 percentage points. Social spending accounted for almost all of this increase, rising on average from 13 percent to 17 percent of GDP between 1989 and 1992. Although the fiscal costs of registered unemployment have been limited, other social expenditure programs are comprehensive, with pensions by far the largest component. Transition generally has led to a retirement boom; only a small part of the sharp increases in the ratios of pensioners to population after 1989 has been due to demographic factors. Some early retirement has substituted for unemployment, but much has occurred under the many special regimes offering full pensions far earlier than even the low official retirement ages. As the number of pensioners increases, the number of contributors to pay-as-you-go state pension schemes shrinks, raising dependency ratios in Bulgaria to a high of 87 percent by 1992. Ratios of average pensions to wages also have tended to rise; in Poland they climbed from 43 percent to 63 percent between 1989 and 1992.

With minimum wages little above poverty lines and a need to drastically restructure employment, transition countries face a huge challenge in designing affordable social protection systems that avoid perverse incentives for workers. Moreover, because of low retirement ages and slow population growth, pensioners and aspiring pensioners weigh heavily in voting-age populations. No country except Estonia has been able to achieve radical reform of the benefit system, perhaps because reformers did not see it as an early priority.

Transition also raises the issue of intergenerational equity. The time horizons of the older generations since the onset of reform are short, and opportunities to accumulate (nonhousing) wealth largely bypass them in favor of younger entrepreneurs, often well educated, skilled in foreign languages, and able to earn high incomes in the private sector. The age-specific distribution of wealth arising from transition will thus differ markedly from the long-run equilibrium distributions in market economies, where wealth tends to be concentrated among older generations. Transition thus increases the need for intergenerational income transfers through the state for several decades. This need will be greatest in countries that have failed to stabilize, because of the erosion of household savings by inflation.

Banking Reform and the Enterprise Sector

At the start of stabilization programs banks were typically passive and inexperienced creditors. Rollovers of loans and capitalization of unpaid interest have led to a dual financial system in which loans are heavily concentrated among a few, usually less profitable enterprises. But considerable learning-by-doing in the banking sectors of the more advanced reformers has resulted in a progressive tightening of financial constraints on loss-making firms, although loan quality probably is still deteriorating in the other countries.

In addition to improving banking services, one major objective of financial reform is to resolve the allocation of the stock of bad debt. After stabilization this stock of debt is no longer eroded by inflation but tends to expand because of posi-
tive real interest rates. A second major objective is to ensure that new credits flow to solvent, growing firms, to avoid creating another serious loan portfolio problem.

The two objectives are closely related. Incentives for prudent commercial lending cannot be established in the absence of properly capitalized banks: solving the flow problem requires addressing the stock problem. Conversely, recapitalization, if repeated as part of the process of unearthing and provisioning against bad debt, threatens to undermine the credibility of the hard budget constraint. Some argue for a third objective: to give banks an active role in corporate governance of the enterprise sector—not because they are an ideal choice but for want of other plausible outside strategic owners and because they have the most knowledge of the enterprises—and, through this arrangement, an active role in resolving the bad debt problem.

Countries are addressing this complex set of interrelated problems through various strategies, usually including a mix of debt transfers to special institutions, debt-equity swaps, and bank recapitalization and provisioning financed in part by government and in part by large spreads. The ultimate fiscal costs of resolving problem loans still are not known, but they will be considerable for all countries (Dittus forthcoming; Gomulka 1993). In Hungary, for example, the costs of provisioning against bad loans accounted for 4 percentage points of the 10 percentage point spread between lending and borrowing rates in 1992, and the effect of new provisioning rules on banks' profitability cut profit tax revenues by 2 percent of GDP.

Hardening budget constraints and moving to sound finance is not likely to be achieved quickly. The institutional change in the banking sector and other financial markets needed to fully privatize commercial risk will take time. Risk will remain high, in part because of the preponderance of new firms (including those split off from old firms) without a track record in the new economic environment. In addition, in most countries in transition legal processes still favor debtors over creditors. Necessary yet abrupt measures to fully decentralize risk could encourage banks to hold excess liquidity and lead to the withdrawal of credit from many potentially viable clients. As a practical matter, government budgets therefore probably will have to bear some of the costs of problem loans for some time, if spreads are not to be so large as to inhibit good firms and further weaken bank portfolios.

Ten Lessons

From the perspective of stabilization, postsocialist countries now fall into two groups. Except for Romania, the core countries, together with Albania, Slovenia, and two of the Baltic states, have had some success in containing inflation following price liberalization and now must consolidate macroeconomic stability while deepening institutional reforms. Most of the others, many with new currencies, have not yet succeeded in holding inflation at even moderate levels. The experience of the more advanced reformers offers lessons for both groups of countries.

A general lesson is that, in addition to economic policy, what matters in determining outcomes are initial conditions, political developments, and external factors. On balance, the core countries that faced the most serious macroeconomic problems
may also have inherited the most difficult structural conditions for stabilization, as well as high foreign debt and powerful trade unions. It is not clear that countries that had earlier undergone a phase of market socialism were at an advantage. Their institutions may have been somewhat better adapted to market conditions, but decentralization of management to enterprises created difficult political problems for further reform in Poland, and an apparently less urgent need for reform may have encouraged policy drift in Hungary.

1. **Radical is less risky.** The countries of Eastern Europe and the former Soviet Union that have managed to contain inflation to low or moderate levels have all experienced major political breakthroughs combining democratization and renewed national independence. The record suggests that when there is both high initial macroeconomic imbalance and a major political breakthrough of this kind, a radical approach involving forceful stabilization measures and rapid liberalization is almost surely the least risky option. Initial stabilization has been most successful when radical programs have been launched during an early period of extraordinary politics following the breakthrough. The reversion to normal politics after an initial hiatus complicates further stabilization by raising inflationary expectations, slowing the implementation of structural and institutional reforms, and reducing the propensity of state enterprises to adjust—Bulgaria is an example. Normal politics is especially problematic if it involves extreme political fragmentation. Successful stabilization requires fundamental behavioral and institutional changes in an economy still dominated by state enterprises. One function of radical reform is to signal the need for such change through a fundamental shift in regime. If that change is not achieved, chronic financial indiscipline and mounting arrears can rapidly erode a reform program and destroy the credibility of a financially disciplined equilibrium.

2. **There is no simple link between type of reform and political stability.** Contrary to popular opinion, the degree of political instability does not appear to have a simple relationship to the type of economic program: consider, for example, the Czech Republic and Hungary (both stable but with different political transitions and very different economic programs) or Poland and Romania (both unstable, but one sustaining a radical program and the other not).

3. **Don't fine-tune at the start.** It is better to err on the tight side than to try to fine-tune policies in the early stages to take advantage of the temporary balance of payments relief that appears as inflation is brought under control. Failure to stabilize initially will lead to a need for further attempts, but from weakened economic and political bases and with lower credibility. In any case, the inevitable uncertainty makes successful fine-tuning impossible.

4. **Monetary and fiscal policy can stabilize in transition.** Monetary and fiscal policies can be powerful instruments for containing inflation to moderate levels (very low inflation may be difficult to reconcile with the need for continued price realignment) and for stabilizing exchange rates, possibly because inflationary processes are not deeply institutionalized at the start. Conversely, stabilization can be elusive after initial price liberalization if financial policies fail to support the holding of domestic financial assets. The main failure in Romania (and in Russia and other countries)
has been monetary and interest rate policy; lack of credibility in this area may encourage arrears. Minimum interest rate targets may be needed for an extended period to protect uncompetitive, state-dominated banks from decapitalizing household balances.

5. **Wage controls are vital.** All the countries relied on wage controls, which become important as privatization inevitably lags behind stabilization and liberalization policy. The enterprise sector needs to preserve retained earnings to finance its restructuring and is likely to have to effect a net resource transfer to the banking system as stabilization is consolidated. Some countries, such as Romania and Russia, have temporarily continued positive transfers to their enterprises, but these transfers become unsustainable as financial balances erode. And because the transfers are related to political pull rather than to performance, they also are likely to be inefficient.

6. **Liberalization reinforces stabilization.** In theory a government could achieve stabilization while retaining extensive state control of the economy. But in practice there has been a close relation between stabilization and liberalization except on the wage front. Policymakers who valued stabilization also valued liberalization. Cutting fiscal subsidies and avoiding large central bank losses due to subsidized credits (a major weakness in Romania and many countries of the former Soviet Union) have been important elements of macroeconomic adjustment. Most fundamental, stabilizing a heavily controlled economy that retains extensive price controls and strong institutional links between government and enterprises is very difficult even for a strong state because the enterprises can blame these controls for their losses. In addition, the enterprises always have better information than the government and can take advantage of their lack of autonomy to claim subsidies. Romania shows how problematic this option is.

7. **The importance of exchange rate pegs depends on the nature of inflationary expectations.** Some of the transition countries pegged their exchange rates to provide another nominal anchor. The experience of Bulgaria, as well as that of Latvia and Slovenia, suggests that the importance of fixing the exchange rate is a more open question than the need for wage controls. It may hinge on whether deeply embedded inflationary expectations concern price increases (as in Latin America) or mostly shortages.

8. **Radical stabilization and liberalization policy encourages recovery and transition to a private economy.** Country experience suggests no adverse medium-run tradeoffs between stabilization (with its accompanying liberalization) and either output or the speed of transition to a private economy. Failure to stabilize wastes valuable time and will delay recovery. Measures to promote private sector development, including privatizing small assets and providing access to commercial real estate, should be essential components of a stabilization package because of their importance for the supply response.

9. **After initial stabilization, credible, sustainable reform will require a strong growth response by the private sector; fiscal reform, especially on the spending side, and probably some external support; and resolution of bad debts without reducing**
the credibility of budget constraints. The inevitable lag of institutional reform behind stabilization and liberalization suggests that an extended phase of fiscal pressure is to be expected in a radical reform program. In theory a fiscal balance condition can set an upper limit to the speed of transition from a public to a private economy. Although this trade-off is appealing, in practice the aim of preserving tax receipts is a poor argument for deliberately slowing this transition because revenues are in any case not sustainable. It is counterproductive to try to maintain fiscal revenues by supporting public enterprises with quasi-fiscal subsidies through the banking system: rampant fiscal deficits will shatter the credibility of reform. On the other hand, very high (actual or anticipated) taxation will slow the private economy, which will need to finance rapid growth mostly out of retained earnings. Slow private sector growth also will undermine reform.

The main fiscal reforms must, therefore, center on spending. Even after the elimination of subsidies, ratios of expenditure to GDP are far above those usual in middle-income countries, largely because of social transfers. Severe resource constraints will prevent economies from rapidly growing out of these ratios, particularly if the budget also has to bear the costs of previously hidden inefficiencies. Spending analyses, including detailed studies of the incidence of social benefits, are needed to show where adjustments will be less painful. But it is difficult to cut expenditures abruptly (especially after the end of "extraordinary politics") when trying to preserve a democratic consensus in favor of reform. Unlike in nontransition stabilizing economies, fiscal deficits in transition economies must be seen in a medium-term perspective, with greater emphasis placed on reducing government spending and improving its composition. In the interim external finance will be needed to allow larger fiscal deficits than conventionally acceptable to be financed without excessive monetary expansion. For the same fiscal reasons, reductions in debt service obligations are critical to the success of radical reform in heavily indebted countries.

Especially because financial systems can transfer few resources to borrowers in the stabilization phase, measures to limit credit rollovers to loss-making state firms and to encourage lending to private firms need to be put in place relatively quickly, even if banks cannot immediately assume a leading role in initiating bankruptcies. It is also vital to "activate" at least part of the banking system as fast as possible, to support the reorganization of the enterprise sector without, however, creating expectations of bailouts that weaken the credibility of reform. How best to resolve the bad debt problem depends on the country’s conditions; the Czech Republic, Hungary, and Poland offer a range of experience suggesting that progress is possible. Across-the-board debt relief is problematic, however, and a simple one-off resolution of the bad debt problem is probably unrealistic.

10. Failure to stabilize at first does not argue against continuing institutional restructuring and liberalization. Consider countries still grappling with major stabilization problems in the absence of a major political breakthrough (or having failed to stabilize initially in the aftermath of a breakthrough). How should these countries proceed? Clearly, their task is difficult because of continued economic weakening and the likelihood that indexation mechanisms will be strengthened. One lesson is
to exploit the credibility imparted by any major political discontinuity to implement a determined stabilization program. Even while not yet stabilized, however, these countries should proceed with liberalization and institutional reforms as rapidly as they can. These reforms will not realize their full potential until macroeconomic stability is achieved. But they can improve the underpinnings for future stabilization and may strengthen a constituency in support of a future stabilization effort.

Notes

1. For example, in 1992 a third of Hungary's registered unemployed workers (12 percent of the labor force) may have been working, but in Russia, where registered unemployment is only 1 percent, actual unemployment has been estimated at 10 percent.

2. For a more detailed breakdown of policies, see Fischer and Gelb (1991).

3. The term radical is preferred to the more emotive big bang because the second term implies a possibility of effecting all changes immediately; see Balcerowicz (1994a,b).

4. The countries that have been forced to resort to global compensation (Romania and Russia) have also achieved less policy credibility for stabilization. Bulgaria's experience in 1993 supports the view that decreased credibility of reform (in Bulgaria's case, the stalling of institutional restructuring after initial stabilization and liberalization) leads to explosive growth of arrears of all types (ACED 1993); if sufficiently widespread, these arrears create a low-discipline equilibrium (see Rostowski 1992).

5. Large spreads in transition countries reflect four factors: limited competition, costly reserve requirements, the banking system's need to generate resources for modernization, and the need to provision against loan losses and recapitalize the banks.

6. Because historical indicators of real exchange rates are not a useful guide to long-run equilibrium market rates, a ratio of nominal exchange rates to estimated purchasing power parity (PPP) rates is used to suggest the level of the real exchange rate.

7. The consumer price index (CPI) is a Laspeyres index, and weighting may be inaccurate; the producer price index (PPI) is a Paasche index, and coverage of industrial products may be limited. The continued divergence between CPI and PPI, especially in Bulgaria, suggests that measurement anomalies are serious.

8. Extensive discussion of the relative importance in explaining output of measurement errors, demand shocks, supply shocks (including those effected through credit contractions), trade disruption, decline in "information capital," and increased uncertainty due to the change in economic system is beyond the scope of this article (but see, for example, Blejer and others 1993).

9. This effect has been somewhat offset in the early stages of reform by cuts in subsidies and deficient inflation accounting, which sustained taxes by decapitalizing enterprises (Schaffer 1993; Barbone and Marchetti forthcoming). For an extensive treatment of fiscal issues in transition, see Tanzi (1993).

10. It is not yet clear how well the strategies have worked; for reviews of the strategies that different countries have adopted, see Pleskovic (1994); Transition (1994); BIS (1993); Dittus (forthcoming).

References


