THE TRANSFORMATION OF ECONOMIES IN CENTRAL AND EASTERN EUROPE
Issues, Progress, and Prospects

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# Table of contents

## Introduction 1

1 The socialist legacy 2
   - Traditional central planning 2
   - Reform socialism 3

2 The task of economic transformation 6
   - The elements of transformation 7
   - The current stage of system transformation 8

3 Preliminary lessons of experience 11
   - The political dimension 11
   - The phasing of reforms 12
   - Macroeconomic reforms 12
     - Internal balance 12
     - External balance 15
   - The costs of stabilization 15
     - The interaction of stabilization and system transformation 17
   - Price and market reform 17
     - The market for goods 17
     - International trade 18
     - The market for labor 19
     - Financial markets 19
   - Private sector development, privatization, and enterprise restructuring 20
     - New investment 20
     - Privatization 21
     - Restructuring 23
   - The role of the state 24
     - Institutional reform 24
     - The legal framework 25
     - Fiscal reform 26
     - The social safety net and social services 26

4 Conclusion: The challenge to industrialized countries 29
Annexes

1 Reform of the trade and payments system
2 Privatization of state enterprises
3 Agriculture
4 Financial system reform
5 Fiscal policy
6 Income distribution, poverty, and social safety nets
7 The World Bank Group’s support for economic transformation in Central and Eastern Europe

Tables

1 Economic indicators for CEE countries, for selected years, 1970-91
2 Social indicators for selected countries, in the 1980s
3 Economic elements of system transformation

Figures

1 Growth in per capita output in Central and Eastern Europe, 1990-2000
2 Phasing of reform over a 10-year period

Boxes

1 Points of debate on phasing
2 Economic developments in east Germany after economic union
3 Issues in housing reform
4 World Bank support for private sector development: The example of Hungary
5 Enterprise privatization in east Germany
6 China’s economic reform
7 Cleaning up the environment in CEE countries
8 The key role of pensions in economic reform
9 How the World Bank’s first Structural Adjustment Loan supports system reform in Poland

Annex tables

1.1 Structural dependence in the CMEA
1.2 Convertible currency trade indicators for CEE countries, 1988-90
1.3 Estimates of Soviet subsidies through the CMEA
2.1 State-owned sector as share of value-added in selected countries, in the mid-1980s
3.1 Per capita average food consumption, 1985
6.1 Gini coefficients for selected countries and regions
7.1 Status of Bank Group operations in Hungary
7.2 Status of Bank Group operations in Poland
7.3 Status of Bank Group operations in Yugoslavia
7.4 Selected cofinancing operations

Annex figure

5.1 Consolidated government expenditures in Eastern Europe as share of GDP, 1982-90

Annex box

2.1 A recent privatization plan for Poland

Endnotes

References
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Introduction

The countries of Central and Eastern Europe (CEE) are now in the midst of a unique and historic transformation. Having replaced authoritarian regimes with pluralist democracies, they are intent on moving rapidly from more or less centrally planned socialist economies to largely private market economies. The road is perilous — economically and politically — and largely untrodden, although many individual elements of reform have been confronted before in other countries. Still-fragile political systems must address the challenges of complex economic and institutional reforms in an external environment more difficult than originally envisaged and, in some cases, amid rising ethnic and regional tensions. Widespread initial euphoria after political transitions in 1989 has been replaced by a more sober assessment of the task ahead.

This paper first reviews the legacies of the previous economic systems and analyzes the task of transformation toward a private market economy. Against this backdrop, it then surveys important issues that have arisen and lessons of experience to date in the transformation process. Six annexes explore selected topics — trade, privatization, agriculture, the financial sector, fiscal policy, and poverty and social safety nets — in greater depth. Annex 7 summarizes World Bank Group activities in the CEE countries. While the entire paper draws heavily on the extensive experience of the World Bank Group in the CEE countries, the paper is intended to look “outward” to the challenges facing the countries rather than look “inward” to assess the World Bank’s role. Although the emphasis is on the countries of Central and Eastern Europe, other experiences are cited where appropriate. Any conclusions must be regarded as tentative, because post-socialist system transformations are still at an early stage and many important issues remain unresolved. Nevertheless, experience to date, especially in the more advanced reformers, does provide insights useful in designing policies and assessing prospects for the future.
The socialist legacy

The current configuration of Central and Eastern Europe emerged in the aftermath of World War I, which saw the collapse of the German, Hapsburg, Czarist, and Ottoman empires. The interwar years were a period of considerable economic turbulence for much of the region, which needed extensive reconstruction and suffered terms-of-trade shocks with the onset of the Great Depression. Except for Czechoslovakia, the countries had a largely agrarian economic structure (particularly in the Balkans, where agriculture generated over half of output on average), and incomes per capita were well below those in much of Western Europe.\(^2\) The region traded mostly with Western Europe, in particular Germany.

World War II imposed enormous losses of population, infrastructure, and equipment on most of the countries, and Hungary was the only one to return to its prewar territorial status. Communist parties achieved dominance under the influence of the USSR, and the economies of Central and Eastern Europe were reorganized along the lines of the centrally planned Soviet economic system. By 1950, this process was largely completed, private sector activities had been marginalized, and almost the entire means of production had come under state ownership. Remaining private activities were small-scale, and agriculture was widely collectivized everywhere except Poland and Yugoslavia. In most countries, housing was the major private asset other than financial savings, although private rental of housing was illegal.

Traditional central planning

In theory, central planning was a top-down process whereby detailed physical plans for state enterprises were formulated at the center, typically by the state planning commission, to allocate inputs and outputs to their various uses. In practice, however, the center invariably had less information than the enterprises about production possibilities; thus there resulted a hierarchical bargaining process involving central and branch ministries and state enterprises. To facilitate control, production and employment were concentrated in large firms with highly oligopolistic or monopolistic market structures.

These systems relied little on markets, which, where present, were highly distorted. Enterprises emphasized plan fulfillment rather than profitability. Product markets were distorted by pervasive production, price, and trade controls that effectively insulated domestic prices from international ones. Asset and capital markets were almost nonexistent, with financial flows responding passively to the demands of the plan. Labor markets were distorted by narrow administered wage structures and the prohibition of dismissals, so that labor movements only partially responded to market scarcities.

Despite planners' desires to promote efficiency and productivity growth, the incentive framework of central planning was in fact inimical to both. Growth was "extensive," relying on forced
savings and high investment levels. Severely distorted input and output prices divorced resource use from resource costs. Plans overemphasized heavy industry and energy sectors at the expense of consumer goods and services, and subsidized prices encouraged the overconsumption of their products. Distorted price structures were sustainable because of the relative autarky of these economies within their protected Council for Mutual Economic Assistance (CMEA) market. Compressed and arbitrary wage structures, job security, and extensive in-kind benefits poorly linked to productivity inhibited worker motivation. Yet with no "bottom line," managers typically hoarded labor (as all other inputs) at the firm level, so that open unemployment was negligible. Managers and workers had few incentives for process or product innovation, resulting in slow technological progress. Finally, open discrimination against, if not prohibition of, private activity inhibited entrepreneurship. Small firms were relatively few, and entry and exit of firms rare; the planned economy lacked the "creative destruction" characteristic of dynamic market systems. As a result of these factors, the planned economies experienced a broad secular decline both in competitiveness (as evidenced in part by declining exports, particularly of manufactured goods, to industrial countries) and in the growth of their net material product (NMP), from a reported 9.6 percent in the recovery period of the 1950s to 6.7 percent in the 1960s and 5.2 percent in the 1970s. Growth rates continued to fall in the 1980s, as shown in table 1.

Economic policies also undervalued natural resources and placed little value on environmental safeguards, which contributed to serious environmental degradation. The emphasis on heavy industry and low energy prices resulted in a level of energy use per dollar of national income two to three times that of market economies at comparable income levels, and over three times that of Western Europe. Much of the energy was derived from highly polluting and environmentally dangerous sources; for example, coal (much of it low-quality) accounted for more than 80 percent of Poland's primary energy use in the 1980s, compared with less than 25 percent in industrial countries. Water use and water pollution in the CEE countries were also high compared with those of market economies.

With full employment, narrow wage and pension differentials, heavy subsidies on basic goods, and little income from property, real incomes were relatively equally distributed in the socialist economies. Education and health levels were low compared with industrial countries but quite high compared with middle-income countries (table 2). Extensive maternity and child-care benefits facilitated high female participation in the labor force. While housing appeared inadequate by the standards of industrial countries, these countries avoided the urban poverty and homelessness seen in many market economies at similar income levels. Nevertheless, social indicators improved more slowly in the CEE countries over the past three decades than in most comparable market economies, and in recent years some may actually have deteriorated. For example, from the early 1960s to 1990 the (unweighted) average of life expectancy at birth rose in the CEE countries from 68 to 71; during the same period it rose on average from 71 to 76 in five industrial country comparators and from 59 to 67 in upper-middle-income comparators.

Finally, a very important part of the planning legacy common to all countries was the absence or weakness of core market-oriented institutions, both inside and outside of government. Legal and accounting institutions were weak, standards did not conform to those generally accepted in market economies, and there was no tradition of independent audit. Enterprises were profoundly shaped by planning; for example, they lacked marketing and strategic planning capabilities and effective inventory controls, and they had little information on the relative profitability of the various products they were ordered to produce. CEE governments had little expertise in indirect regulatory instruments, such as monetary policy, taxation, competition policies, and the prudential supervision of financial institutions. Without such instruments, macroeconomic balance essentially rested on the sum of many microeconomic decisions.

Reform socialism

A major impetus behind reforms within socialist systems was the slowdown in growth. Some "reforms" aimed merely to improve the planning process by streamlining the bureaucracy, but others recognized the serious deficiencies in the vertical information flows required for planning and attempted to decentralize decisionmaking and
Table 1 Economic indicators for CEE countries, for selected years, 1970-91

<table>
<thead>
<tr>
<th>Country</th>
<th>GDP (billions of dollars)</th>
<th>Growth rates (percent)</th>
<th>Inflation (percent)</th>
<th>Current account/CDP (convertible currency)</th>
<th>External debt/CDP (convertible currency)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bulgaria</td>
<td>22.4</td>
<td>7.0</td>
<td>4.4</td>
<td>-1.4</td>
<td>-10.2</td>
</tr>
<tr>
<td>Czechoslovakia</td>
<td>46.5</td>
<td>4.7</td>
<td>2.0</td>
<td>1.3</td>
<td>-3.5</td>
</tr>
<tr>
<td>Hungary</td>
<td>32.1</td>
<td>4.5</td>
<td>1.3</td>
<td>-0.9</td>
<td>-6.5</td>
</tr>
<tr>
<td>Poland</td>
<td>62.3</td>
<td>5.4</td>
<td>1.0</td>
<td>-0.5</td>
<td>-14.0</td>
</tr>
<tr>
<td>Romania</td>
<td>35.5</td>
<td>9.3</td>
<td>4.7</td>
<td>-5.8</td>
<td>-10.2</td>
</tr>
<tr>
<td>Yugoslavia</td>
<td>58.9</td>
<td>5.7</td>
<td>0.4</td>
<td>-7.2</td>
<td>-7.2</td>
</tr>
</tbody>
</table>

a. Official statistics in the past are believed to have overestimated growth rates. Output statistics for 1990 may be biased downward due to the failure fully to include the small but growing private sector.
b. 1991 projected current account as a share of 1990 GDP.
c. Does not include effect of Paris Club debt relief.
Source: World Bank data.

replace some of the command system with market-oriented incentives. Yugoslavia decentralized decisionmaking with worker self-management and relatively few price controls in the mid-1950s. Hungary (after 1968) and Poland (in the 1980s) also substantially decentralized decisionmaking concerning production and investment, albeit with more extensive price intervention. While reforms in Hungary and Poland initially delegated control to enterprise management, some degree of worker control via enterprise councils eventually evolved in about 70 percent of larger industrial firms. Bulgaria, the CSFR, and Romania maintained stronger central controls, as did the GDR.

The major lessons of reform socialism in Central and Eastern Europe were negative. Efforts to increase efficiency and productivity through decentralization and heavier reliance on market forces met with only limited success in the absence of ownership reform or capital markets. Failure to dismantle the traditional bureaucracy reinforced the reluctance of the authorities to abdicate their influence on microeconomic decisionmaking. "Indirect" regulation of firm behavior continued, through the selection of managers, price controls, and highly selective fiscal and credit policies that resulted from continued hierarchical bargaining. Profits were redistributed between firms to preserve existing jobs and protect firms from exit. Pre- and post-redistribution profits were essentially unrelated, and the incentive for financial discipline was therefore weak. Pervasive shortage persisted and reduced the incentives for firms to raise product quality and service. Incentives to innovate were weak, and technology levels fell farther behind those of the industrial countries. Rather than being clarified, property rights became obscured as some of the prerogatives of ownership were decentralized to managers and workers. An important lesson to emerge from this phase of "market socialism" is that increasing autonomy without making real reforms to define ownership rights, increase competition, and enforce financial discipline will have only limited success.

At the same time, these reforms exacerbated macroeconomic imbalances. Imbalances are more likely to occur in a decentralized socialist system in which enterprises have more autonomy to spend without market-based accountability, and governments tend to accommodate with monetary expansion to avoid unemployment. Internal imbalance can result in either open or repressed inflation (the latter associated with the emergence of a "monetary overhang" depending on the extent and firmness of price controls). Poland and Yugoslavia embarked on their post-socialist reforms with the most severe open internal imbalances, as evidenced by inflation rates of 640 and 2,800 percent, respectively, in 1989. An underlying cause of inflation in both cases was the subsidization of loss-making enterprises, in Poland through the banking system and the budget (lead-
Table 2  Social indicators for selected countries, in the 1980s
(most recent estimates)

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Bulgaria</th>
<th>Czechoslovakia</th>
<th>Hungary</th>
<th>Poland</th>
<th>Romania</th>
<th>Yugoslavia</th>
<th>Fed. Rep. of Germany</th>
<th>United Kingdom</th>
</tr>
</thead>
<tbody>
<tr>
<td>Populationb</td>
<td>9.0</td>
<td>15.7</td>
<td>10.6</td>
<td>37.8</td>
<td>23.1</td>
<td>23.7</td>
<td>424.3</td>
<td>7.6</td>
</tr>
<tr>
<td>Labor force participation ratec</td>
<td>n.a.</td>
<td>78.9</td>
<td>72.4</td>
<td>78.0</td>
<td>79.6</td>
<td>55.8</td>
<td>n.a.</td>
<td>65.9</td>
</tr>
<tr>
<td>Total</td>
<td>789</td>
<td>72.4</td>
<td>78.0</td>
<td>79.6</td>
<td>55.8</td>
<td>46.9</td>
<td>9.9</td>
<td>7.6</td>
</tr>
<tr>
<td>Female</td>
<td>n.a.</td>
<td>73.6</td>
<td>61.7</td>
<td>70.6</td>
<td>n.a.</td>
<td>42.9</td>
<td>n.a.</td>
<td>51.5</td>
</tr>
<tr>
<td>Health care</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Infant mortality rated</td>
<td>15.0</td>
<td>13.1</td>
<td>17.0</td>
<td>25.0</td>
<td>25.4</td>
<td>46.9</td>
<td>9.9</td>
<td>7.6</td>
</tr>
<tr>
<td>Early 1960s</td>
<td>30.8</td>
<td>25.5</td>
<td>38.8</td>
<td>41.7</td>
<td>44.1</td>
<td>71.8</td>
<td>101.1</td>
<td>28.3</td>
</tr>
<tr>
<td>Life expectancy (years)</td>
<td>72.1</td>
<td>71.2</td>
<td>70.2</td>
<td>71.4</td>
<td>70.2</td>
<td>71.3</td>
<td>67.2</td>
<td>74.1</td>
</tr>
<tr>
<td>Early 1960s</td>
<td>69.4</td>
<td>68.7</td>
<td>69.5</td>
<td>69.3</td>
<td>67.8</td>
<td>65.8</td>
<td>58.8</td>
<td>69.6</td>
</tr>
<tr>
<td>Education</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Primary educatione</td>
<td>103.0</td>
<td>100.9</td>
<td>98.0</td>
<td>101.0</td>
<td>97.0</td>
<td>87.0</td>
<td>103.5</td>
<td>100.0</td>
</tr>
<tr>
<td>Secondary educatione</td>
<td>100.0</td>
<td>81.5</td>
<td>70.0</td>
<td>80.0</td>
<td>76.0</td>
<td>82.0</td>
<td>57.8</td>
<td>79.0</td>
</tr>
</tbody>
</table>

a. Includes upper-middle-income countries in Europe, the Middle East, and North Africa region with per capita income levels comparable to those in Eastern Europe.
b. 1989 estimates, millions.
c. Ratio of the economically active population (employed plus unemployed) to the working-age population (between 15 and 65 years). The estimates represent early to mid-1980s.
d. Per thousand live births.
e. Percentage of school-age group.


ing to a budget deficit of 8 percent of GNP in 1989) and in Yugoslavia through the banking system. Polish inflation was exacerbated by sharp increases in controlled prices in late 1989. Hungary avoided high inflation through somewhat tighter macroeconomic management, heavier reliance on price controls, and continued access to external finance; its inflation rate was around 10-20 percent in the late 1980s. The CSFR, Bulgaria, and Romania adopted fewer reforms toward “market socialism” and maintained even more extensive price controls. Major macroeconomic imbalances did not arise in the CSFR; Bulgaria and Romania experienced some degree of repressed inflation. On the external front, macroeconomic imbalances, as evidenced by high foreign debt, were most pronounced in Poland, Hungary, and Bulgaria (annex 1, table 1.2).

The limited success of experiments with “market socialism” and the growing macroeconomic imbalances they created helped to push CEE governments in the new direction of post-socialist reform. The experience with “market socialism” complicates current reform efforts because of the pressures of vested interests, particularly those of worker-managers. However, it also provides the advantage of greater familiarity with market processes, including more extensive international trade with market economies.
Levels of income and physical and human capital differed considerably among CEE countries at the beginning of the process of transformation to free market economies in 1989 (table 1). Relative levels were not much different from those in 1937 (see endnote 2) except for Yugoslavia, which improved its position. Income estimates confront methodological difficulties, but GNP per capita in Central and Eastern Europe is above that of Latin America and far below that of Western Europe. Purchasing power per capita in the CSFR is estimated at two to three times that in Romania, with other countries falling in between. Physical infrastructure is better in the richer countries, particularly the CSFR and Hungary, but much capital is either deteriorated or obsolete. Human capital endowments, when measured in education and skill levels, are also higher in the richer countries. Romania appears to be the most lacking in both physical and human infrastructure.

As shown in table 1, the persistent slowdown in growth that has marked the last two decades sharpened in 1989, with GDP falling in all of the CEE countries except the CSFR and inflation rising to high levels in Poland and Yugoslavia. Official measures of output contracted further in 1990, with GDP falling in all CEE countries and Poland, Bulgaria, and Romania suffering declines of over 10 percent. It is important to note that these official measures may overstate the drop in output somewhat because they do not fully account for the vibrant growth in private sector activity, albeit from a small base. Despite the data inaccuracy, however, most observers believe that the fall in output in 1990 was precipitous. Price levels increased in those countries where inflation had formerly been low, partly because of price liberalization and cuts in subsidies; for example, in Hungary prices rose by 30 percent in 1990, up from 10 percent in 1987. While the current account position improved in some countries, the external environment for trade and capital flows has worsened recently, as discussed in the section on price and market reform and in annex 1. The initial years of the post-socialist transition are therefore ones of economic crisis for the CEE region.

The growth prospects for the CEE countries depend on several factors—the consistency with which they pursue their reform programs, the impact of exogenous developments (including the end of the CMEA trading system, discussed further in the section on price and market reform), and the response of the industrialized countries in providing technical assistance, finance (including debt relief for some countries) and an open trading environment (see chapter 4). Recovery and growth are expected to be quite slow in the near term because of the fundamental systemic and institutional changes needed. In figure 1, the middle line shows the projected evolution of per capita output averaged for the six CEE countries over the decade 1990-2000. Following the sharp drop in 1990, it is projected to decline further in 1991 and stay level in 1992 before the recovery begins in 1993. Growth in per capita output is expected to improve to 3-4 percent in the second
This partly reflects the time needed to reestablish market-based institutions and build the associated skill base. But it also reflects inherent limits on investment capacity. Enormous investments are needed to rehabilitate, modernize, restructure, and augment physical capital stocks in the CEE countries, especially considering the prospect of major changes in trading patterns with the demise of the CMEA. Most analysis done to date suggests that a speedier transition (say, over 10-15 years) would require annual investments far above feasible levels in terms of either resource availability (discussed in chapter 4) or absorptive capacity of these economies.\textsuperscript{14}

Second, system reforms are unlikely to proceed smoothly, especially considering their complexity and highly political nature. Setbacks can be expected and should not be prematurely interpreted as failure of the entire reform process. It will be important in the years ahead to maintain political will, patience, and a long-term perspective.

The elements of transformation

All of the CEE countries have crossed a critical hurdle—defining the ultimate goal of reform. All are now committed to changing their economic systems to predominantly private market economies similar to those of Western Europe. The elements of such system transformation can be grouped into four broad analytical categories, all of which interact strongly in the process (table 3) and all of which are being supported by Bank Group programs in the CEE countries. The first concerns internal and external macroeconomic stabilization. This involves tightening fiscal and credit policies for governments and enterprises, and addressing imbalances created by a monetary overhang or large bank losses.

The second is the introduction of competitive markets and attendant price reform. In the first instance, price reform typically involves decontrolling and broadening markets for goods and services, which in turn requires a restructuring and demonopolization of the trade and transport sectors. The creation of factor markets, for both labor and financial resources, is also essential. Reform of international trade and payments systems is considered an integral part of price reform and competition policy.\textsuperscript{15}

The third category of reform is enterprise reform and restructuring. A first important step in

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{figure1}
\caption{Growth in per capita output in Central and Eastern Europe, 1990-2000}
\end{figure}

Source: Official country data and World Bank projections. Note the data limitations indicated in the text.
Enterprise reform involves clarifying public ownership rights (and separating them from the regulatory functions of government) and implementing more effective control over the management of existing firms, in part through widespread privatization. Establishing secure private property rights and facilitating the growth of new private firms is also critical. Enterprise restructuring may involve breaking up large monopolies, removing operations and disposing of their assets, reassigning redundant labor, closing loss-making operations, or other actions aimed at improving the efficiency of existing enterprises.

Finally, the fourth category of reform (closely related to the others) involves reorienting the role of the state in the economy, away from direct ownership and control over production and toward an indirect regulatory role that promotes adjustment and private economic activity. This challenge has many dimensions. Privatization will help reduce the role of government in direct production. Concurrent reforms are needed in the central institutions of government, including the central bank, tax administration, the expenditure budget and control system, and policymaking bodies. Another important role for the state is to redesign the social safety net to reduce the need for enterprises to perform wider social functions, to make benefits "portable" to facilitate labor reallocation, and to cope with rising unemployment as firms become subject to greater financial discipline. The state also needs to provide a suitable legal framework for collective bargaining and private sector activity and to develop legal institutions to implement and enforce it.

The current stage of system transformation

Poland, Hungary, and Yugoslavia were the first to begin the transformation process and have gone quite far in the first two categories. In 1990, Poland and Yugoslavia embarked on drastic stabilization programs that were particularly significant because their methods also involved important elements of structural reforms. Hungary also implemented a determined stabilization compatible with a shift toward a private market economy. All three countries have liberalized most product prices. Trade reforms have complemented price liberalization, replacing quantitative controls with low to moderate tariffs and instituting current account convertibility at a unified exchange rate. To complement the shift to the market, Hungary reformed its tax system extensively in 1988 and 1989, and Poland and Yugoslavia are planning to do so soon.

In the other areas, reforms in these three countries are at an earlier stage. They have lifted explicit restrictions on private activities, and this has resulted in an impressive growth of small private business. They have also progressed with small-scale privatizations; for example, in Poland at least 50,000 small shops have been privatized. They have only begun to privatize larger enterprises (see annex 2) and to undertake reforms in the agricultural sector (see annex 3). The Polish government has privatized only five large enterprises through public offerings and several more through private placements, and the Hungarians are also proceeding on a relatively slow, case-by-case basis. While numbers are uncertain, some 10-15 percent of nonagricultural production might now be in private hands.

Although progress has been made in revising the legal framework for enterprise activity, governments have not yet progressed far with enterprise restructuring. Some firms have taken such initiatives themselves, often through joint ventures with foreign partners. The increasing number of firms facing liquidation proceedings in all three countries suggests that financial discipline is beginning to take hold. However, restructuring activities are not yet at the levels needed for structural reforms in any of the three countries. As discussed later and in annex 4, the pace of restructuring affects the pace for resolving the portfolio problems of banks; the latter is thus still in the early stages, although some aspects of banking and financial sector reform are well advanced, particularly in Hungary. Unemployment has risen to only moderate levels, and wage controls are still needed pending enterprise reform. Effective factor markets are clearly some way off.

Activities to transform the role of the state have intensified in these three countries over the past two years. They have made substantial progress in many areas of legislation and economic regulation and in reshaping public institutions. For example, all have set up privatization agencies, abolished or downgraded planning ministries, and instituted programs to address unemployment. However, there are still many gaps, and institutional capacity to implement the new legislation is severely constrained by the shortage of experience and relevant skills. Programs to augment the skill base (for example, by training bank
Table 3  Economic elements of system transformation

1. Macroeconomic stabilization and control

- Implementation of stabilization programs:
  - Government and enterprises: Fiscal tightening
  - Tight credit policies
  - Addressing existing problems (money overhang, bank losses)
  - Expenditure-switching measures for external balance

2. Price and market reform

- Goods and services: Domestic price reform
  - International trade liberalization
  - Distribution systems (transport and marketing services)
  - Housing services
- Labor: Liberalizing wages and labor market
- Finance: Banking system reform
  - Other financial markets
  - Interest rate reform

3. Private sector development, privatization, and enterprise restructuring

- Facilitating entry and exit of firms
- Enterprise governance
- Establishing private property rights
- Clarifying and allocating property rights: Agricultural land
  - Industrial capital
  - Housing stock and commercial real estate
- Sectoral and enterprise restructuring, including breakup of monopolies

4. Redefining the role of the state

- Legal reforms: Constitutional, property, contract, banking, competition, and so on
  - Reform of legal institutions
  - Regulatory framework for natural monopolies
- Information systems (accounting, auditing)
- Tools and institutions for indirect economic management: Tax system and administration
  - Budgeting and expenditure control
  - Institutions of indirect monetary control
- Social areas: Unemployment insurance
  - Pension, disability
  - Social services: health, education, and so on

supervisors and potential members of enterprise boards in Poland) are under way but will take time to have full effect.

The CSFR has recently taken several important steps toward system transformation and is now about on par with the more advanced reformers in the areas of macroeconomic stabilization and price and trade reform. It raised some food, transport, and petroleum prices in 1990 (with direct compensation to consumers for the food price increases) and removed most price controls on January 1, 1991. Its currency was devalued for a second time in January and made convertible for current account transactions, and most international trade was liberalized. Legislation passed in 1990 put the private sector on an equal legal footing with state enterprises, and the government has begun to auction small shops to private owners. Like the other three more advanced reformers, the CSFR has not moved as far in the latter two areas of reform, but the government is actively reviewing many options and is likely to take major steps in 1991.

Bulgaria and Romania began their transformation processes more recently. Bulgaria took major steps in February 1991 to curb inflation (which
had risen from 6 percent in 1989 to about 60 percent in 1990) and promote structural change in the economy. It unified exchange rates and moved to a floating currency, liberalized most retail and producer prices, adopted tight control on wages in the public sector, and liberalized most foreign trade (replacing quantitative restrictions with moderate tariffs). The government is also taking important steps to redefine its role, in part through reforms in the budget and tax systems. Like the other CEE countries, it has made less progress in enterprise restructuring and privatization.

Romania has also undertaken significant reforms in the past few months. It freed many retail and producer prices in November 1990 and adjusted many administered prices upward in April 1991. It has ended foreign trade monopolies and removed most quantitative restrictions on trade, and it is expected to adopt a transition dual exchange rate mechanism as an intermediate step toward a unified exchange rate. Like all CEE countries, it has removed restrictions on private activities and is working hard to define an appropriate legal framework for private sector activity. Although little progress has been made with enterprise restructuring or privatization, the broad outlines of a privatization plan are being finalized, and a privatization law is expected soon to be sent to Parliament. Significant privatization of agricultural land previously owned by cooperatives has already taken place. The governments of both Romania and Bulgaria are strongly committed to the reform process but still need to concentrate, more than in the other CEE countries, on consolidating political reforms and gaining public support for difficult economic measures.

The former GDR is undertaking many of the same reforms as the others but with several significant differences. Price reform was almost immediate upon creation of the economic and monetary union and subsequent unification with the Federal Republic of Germany (FRG), as was the change in the role of government. The country imported the FRG's legal and regulatory framework, along with massive technical assistance to implement it. The inflow of skills and financial assistance (estimated to amount to some $3,000 per person per year) relaxes severe constraints on the speed of reform. Nevertheless, enterprise privatization and restructuring, though proceeding relatively rapidly, promise to be a lengthy process.
Preliminary lessons of experience

The political dimension

The events in Central and Eastern Europe are first and foremost a historic political revolution, and the new political environment is still unsettled. It is clear that the entire process of economic transformation depends crucially on political developments. On the one hand, political legitimacy and cohesion are clearly necessary for sustainable economic transformation; for example, the major reforms undertaken by the first elected Solidarity government in Poland (with its relatively cohesive public support and strong legitimacy) contrast sharply with the paucity of reforms in the USSR. But the complex and tumultuous process of political change often constrains economic reform. Rather than setting out an optimal reform path, economic analysts continually need to develop feasible reforms that avoid moving into politically driven dead ends.

Tension has emerged in most of the reforming countries between the strong central leadership needed to push through difficult reforms and the broad participation and compromise needed to ensure widespread support for the program. Central executive authority has been discredited by past experience, and a new model of strong government with a legitimate role in a market system has not yet emerged. In fact the pendulum in several countries is swinging in the opposite direction, toward greater decentralization and autonomy for provincial and local governments; this is likely to complicate reform efforts in the short run. The difficulty of carrying out political and economic liberalization simultaneously has been noted in analyses of reform in other countries. In the case of the CEE countries, proximity to Western Europe and the desire to integrate with it will help to set standards for both political and economic reform.

Regional disputes over power sharing can further threaten cohesion, compromise legitimacy, and impede the economic reform process. In the CSFR, the division of authority between the federation and the two republics over policymaking and budgetary control is still unclear. The problem is magnified in Yugoslavia and the USSR, where reaching consensus on the political relations and distribution of power among the center and republics is likely to be a prerequisite for large-scale reforms and macroeconomic stability. Regional disputes do not reflect lack of consensus on economic policy as much as long-simmering ethnic tensions that have become more open with political liberalization.

The difficulty of sustaining political and economic reform will be exacerbated by the difficult international economic environment faced by the CEE countries. Temporarily higher world oil prices, economic problems in the USSR, the transformation of the CMEA trading system, and the disruption of trade with Iraq (a significant trading partner, especially for the CSFR and Bulgaria) have all placed extra strain on economies already burdened with the short-term costs of reform. The public will find it difficult to separate the impact
of reform from the impact of these external shocks.

The course of reform will not only depend on political developments but may influence them. A crucial variable in this respect may be speed. Political pressures that tend to arise in the course of a "go slow" approach argue for as rapid a process as possible. "Shock therapy" as in Poland institutes a large set of reforms before strong opposition can coalesce, and possible resistance to reform by "old guard" managers and bureaucrats is often cited as an argument for rapid enterprise reform. While the high costs of rapid adjustment may cause political instability if a quick and demonstrable payoff is not forthcoming, a slower approach also has political risks. Failure to pursue reforms vigorously will be extremely costly in both economic and political terms. The experience of other countries suggests that reforms may be easier to undertake the worse the prereform situation; this would argue that short-run costs would be borne more readily in Poland than, say, in the CSFR. One can only speculate on these issues at this point; it is still too early to gather lessons from experience.

The phasing of reforms

The task of system transformation differs considerably from that of policy reform within an established economic system. The issue of sequencing of individual reforms within a broad system transformation has aroused extensive discussion. Most analysts now agree that, although country-specific factors will influence the pattern of reforms, some components must precede or occur in tandem with others. It has also become increasingly clear that the components are tightly interlinked, and that clearly articulating a long-term strategy and starting along many fronts is important from the beginning.13 Because some reforms take longer than others, tensions are inevitable. Certain reforms are only appropriate late in the process, when market forces are well enough developed to replace administrative controls. In any case, although early reforms may yield some immediate benefits (such as an increase in the availability of goods), rapid and sustainable economic growth should not be expected until many reforms are implemented on a significantly large scale, which is likely to take several years. All of these propositions gain force from the indifferent performance of the CEE countries in their earlier phases of partial reform.

It is widely agreed that macroeconomic stabilization is a prerequisite for structural reforms, and that it should be followed quickly (or concurrently) with price and trade reform (including current account convertibility) to enhance competition and promote foreign investment. Also following quickly should be tax reform and the introduction of a system of unemployment insurance. Tax reform is needed to help maintain government revenues while eliminating the ad hoc redistribution of profits that destroys enterprise incentives, while unemployment insurance (and more general reform of the social safety net) offsets social and political pressures to slow down the reform process and contributes to its political sustainability. Measures to encourage small private businesses and small-scale privatization can and should proceed rapidly, since a growing small-scale sector is needed to help free up the distribution system, offset the impact on employment of restructuring the larger state firms, and strengthen domestic competition. Responsibility for corporate governance should be clarified and strengthened as soon as possible. Restructuring and privatization of medium-sized and larger firms can begin early in the process but will take time, particularly for less viable firms. The same holds true for effective institutional, legal, and regulatory reforms. While institutional and regulatory reform in the banking system start early, full financial liberalization requires the restructuring of bank portfolios, which will typically accompany enterprise reform (annex 4). Similarly, the pace of wage liberalization is set by that of enterprise reform, which is needed to insure adequate controls on the wage-setting process. Finally, full convertibility of the capital account can come later in the reform process. A stylized phasing of reforms along these lines, shown in figure 2, indicates also the degree to which reforms need to be carried out simultaneously on many fronts.19 Debates concerning this pattern of phasing are discussed in box 1. In any case it is clear that no exact pattern is preordained; country-specific factors will clearly influence the exact course taken in any particular case.

Macroeconomic reforms

**Internal balance.** The experiences of Poland and Yugoslavia show that stabilization measures can reduce inflation, at least in the short run. Poland's monthly inflation during the six-month period
Figure 2 Phasing of reform over a 10-year period

<table>
<thead>
<tr>
<th>Category</th>
<th>Intense</th>
<th>Continuing</th>
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<tbody>
<tr>
<td>Macrostabilization</td>
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<td>Price and market reform</td>
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<tr>
<td>Goods and services:</td>
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<tr>
<td>Price reform</td>
<td>Most goods</td>
<td>Some necessities (including housing)</td>
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<tr>
<td>Trade reform</td>
<td>Remove QRs</td>
<td>Adjust tariffs to moderate levels</td>
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<td>Distribution</td>
<td>Privatization, demonopolization</td>
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<td>Labor market</td>
<td>Deregulate</td>
<td>Liberalization of wage bargaining</td>
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<td>Autonomous banking system</td>
<td>Preparation</td>
<td>Implementation</td>
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<tr>
<td>Other financial markets</td>
<td>Preparation</td>
<td>Implementation</td>
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<tr>
<td>Restructuring and privatization</td>
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<tr>
<td>Small-scale privatization and private sector development</td>
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<tr>
<td>Foreign investment</td>
<td>Revise regulations</td>
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<tr>
<td>Large-scale: Corporate governance</td>
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<tr>
<td>Redefining role of state</td>
<td>Intensive (tax reform, basic property, and commercial law)</td>
<td>Continuing (other)</td>
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<td>Institutional reform</td>
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<td>Unemployment insurance</td>
<td>Emergency</td>
<td>Institutionalization</td>
</tr>
<tr>
<td>Other social areas</td>
<td>Intensive</td>
<td>Continuing</td>
</tr>
<tr>
<td>Time (years)</td>
<td>0 1 2 3 4 5 6 7 8 9 10</td>
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Box 1 Points of debate on phasing

While the phasing of reforms shown in figure 2 probably attracts the greatest consensus within and outside reforming countries (including within the Bank), there has been intensive debate on several points:

Should price reform come before or after enterprise reform?

Before: Enterprise reform and privatization will not succeed if the market cannot judge efficiency and value because prices do not reflect true costs; budgets cannot be "hardened" before introducing market prices.

After: Freeing prices in the presence of monopolies will lead to excessive prices and profits, thereby undercutting political consensus for reform; domestic competition policy should be in place before price liberalization.

Should trade liberalization come early and fast or later and slower?

Early: It supports price reform by importing the world price structure and heightens competitive forces.

Later: It shocks the economy, in the right directions but with excessive costs, and is risky until the economy is stabilized.

Should large-scale privatization be "quick and dirty" or slower and more careful?

Quick: Rapid privatization is of utmost importance. It raises efficiency, speeds restructuring, and establishes a constituency for further reforms, and weakens the traditional power centers opposing reform.

Slow: Sales revenues are needed by the government, and preserving fairness in the process is vital for public support; thus restructuring should precede privatization and firms should not be given away hastily.

Must full-scale financial sector reform go hand-in-hand with enterprise reform, or can it come earlier?

Hand-in-hand: Competitive financial markets require clean loan portfolios, and enterprise reform and bank portfolio restructuring are best accomplished simultaneously; cleaning up loan portfolios is futile without enterprise reform.

Earlier: Only independent financial institutions and liberalized financial markets can play the critical role of allocating capital as enterprises are restructured.

from March through August 1990 was about 4 percent, compared to 30 percent in the last months of 1989. Yugoslavia's inflation fell from 64 percent in December 1989 to 10 percent for the entire six-month period from March through August 1990. As in market economies, internal stabilization in reforming socialist economies hinges on tight fiscal and credit policies. Yugoslavia maintained a budget surplus and allowed no growth in the nominal stock of net domestic assets of the central bank. Poland turned its budget deficit of 8 percent of GNP in 1989 into a surplus of over 5 percent in the first nine months of 1990 and kept credit extremely tight in the first half of 1990 through strict limits on the nominal growth in net domestic assets.

In addition to tightening fiscal and monetary flows, stabilization may also require defusing the inflationary pressure of excessive stocks of money — the "monetary overhang." Excessive money balances can be eroded through rapid inflation (as in Poland) or reduced in nominal terms through confiscatory currency reforms or blocking (as in many European countries after World War II); some excessive balances can also be absorbed through the later sale of public assets. Germany implemented a currency reform in 1990, when wages and pensions denominated in East German marks were converted 1:1 to Deutschmarks, and most financial claims and liabilities were converted 2:1. A currency reform may be preferable to high inflation if the latter is avoidable, although high inflation may create a sense of urgency and thus a strong political consensus for change.

Socialist economies must also resort to administrative controls where markets are lacking. Wage controls in particular are needed in public enterprises because firms without active owners have little built-in incentive for wage restraint. Indeed, those working in such firms may face incentives to decapitalize them, particularly once reinvestment in private activities is permitted. In January 1990, Poland implemented a high tax on any increase in the total nominal wage bill of an enterprise beyond a preset percentage of the inflation rate in
the previous month, while Yugoslavia froze nominal wages for six months at the start of its stabilization program. Early experience points to the pressures to raise nominal wages that will result in the course of stabilization and that may derail reform efforts. In Yugoslavia, for example, official estimates of real wages fell some 45 percent from November 1989 to February 1990 but rose 25 percent in the three months after the nominal wage freeze was lifted in June. The resulting monetary accommodation, including renewed financing of enterprise losses, led to a jump in inflation in the third quarter of 1990. In the GDR, the absence of effective wage restraint allowed negotiated wage settlements to rise by over 25 percent in the summer of 1990, far out of line with productivity. Official estimates of real wages in Poland fell 47 percent in the first half of 1990 before rising somewhat in the second half to end the year 30 percent down.

**External balance.** On the external front, stabilization may well require devaluation (whether to a fixed or floating exchange rate) to complement tight expenditure-reducing policies and trade liberalization. Hungary’s 1990 stabilization included a 15 percent devaluation of the forint in addition to tight fiscal and monetary policy. Poland and Yugoslavia devalued sharply at the beginning of 1990. Poland by 46 percent and Yugoslavia by 20 percent, establishing fixed exchange rates that held as nominal anchors for their stabilization programs throughout 1990. The experience in all three countries shows that exports can increase significantly in response to such measures. In Hungary, convertible currency export volume grew by 10 percent and the current account was virtually in balance in 1990 (an improvement of some 5 percent of GDP over 1989). With a 37 percent growth in export volume, Poland’s trade surplus for 1990 reached about $3 billion, in contrast to the $800 million deficit expected at the start of the program. Yugoslavia’s exports grew rapidly in the first half of 1990 but slowed thereafter as inflation eroded the real exchange rate. Imports grew even faster as a result of real exchange rate appreciation during 1990, leading to a deterioration in the current account balance from a surplus of more than 3 percent of GDP in 1989 to a deficit of about 2 percent in 1990.

The outlook for trade and current account balances is darkened by the costs expected to result from the demise of the CMEA system as of 1991 and the possible collapse of the Soviet market due to internal difficulties. These and other trade shocks are discussed below and in annex 1. How to finance the current account deficits that are expected if growth is to resume is among the most critical issues facing the CEE countries (see chapter 4).

Stabilization may also require addressing a heavy overhang of domestic and external debt. On the domestic side, the magnitude will emerge in the course of restructuring the balance sheets of the banking system and interenterprise credits. Various options for dealing with the domestic debt overhang exist, as discussed in annex 4. On the international side, Poland, Bulgaria, and Hungary took on heavy foreign debt burdens in the 1970s and 1980s. Poland has recently benefited from extensive official debt relief, and Bulgaria has suspended interest payments and is likely to begin debt negotiations soon with commercial creditors. Yugoslavia has actually reduced its debt burden significantly through debt buybacks, from a high of $21 billion in 1987 to $16.3 billion by the end of 1990. A debt overhang raises uncertainty and reduces additional foreign capital flows. Continued international cooperation to alleviate debt burdens is needed for some CEE countries (see chapter 4).

**The costs of stabilization.** Experience with stabilizations to date (as accompanied by adjustment measures) suggests that a large short-run decline in output is unavoidable. Poland’s official measure of output fell 14 percent in 1990, Yugoslavia’s fell 3 percent, and Hungary’s fell 6.5 percent, with further declines expected in 1991 (table 1). This high cost of stabilization (combined with adjustment measures) results in part from the absence of effective factor markets, which prevents macroeconomic pressures from rapidly being translated into efficiency improvements.

Official data miss part of the picture, however. While official measures of output and real wages fell dramatically in 1990, these data do not fully account for the vibrant growth in private sector activity, albeit from a small base. Furthermore, it has been argued that the standard of living of the average Pole fell less than wage data would suggest because price reform eliminated queues and black markets. Governments should make the costs of stabilization clear from the beginning to avoid unrealistic expectations, but they should monitor the economy closely to avoid results being painted blacker than they actually are.
The level of the exchange rate affects both the costs of stabilization and the speed (and resulting short-term costs) of adjustment. Poland's experience shows that a large devaluation, while perhaps helpful in achieving external balance, may raise the short-term costs of stabilization while slowing adjustment. A larger devaluation causes the real money supply to contract more sharply, leading to a tighter credit squeeze and a larger fall in total output. In addition, it reduces international competition and leaves more scope for moderate inflation to continue to the extent that healthy domestic firms—often monopolies—have room to raise prices. Some observers now believe that Poland devalued too much in January 1990, a lesson of experience that may prove useful to other CEE countries. Poland's 1990 fall in output was much greater than expected and is attributed in large part to the severity of the initial devaluation and the subsequent credit crunch that arose due to nonaccommodating monetary policy. Furthermore, Poland has continued to experience inflation since early 1990 of between 3 and 8 percent per month, as domestic prices of traded goods have had room to move upward toward international prices, and as prices of nontraded goods have soared. The large devaluation provided "breathing space" for healthy Polish firms, which did not feel intense competitive pressure as rapidly as many expected.

The case of the GDR presents a sharp contrast to that of Poland (see box 2). Most believe that the implicit and fixed "exchange rate" set at the time of economic union with the FRG was too high. The immediate opening to international competition thus put heavy pressure on domestic firms, leading to enormous short-term declines in output and employment. The GDR's experience was unique, in that due to union with the FRG it did not have to achieve internal and external balance; its decline in output was due to pressures of adjustment rather than stabilization. The other CEE countries do not have this option.

Yugoslavia's experience was between these two extremes. It did not depreciate its real exchange rate as sharply at the beginning of its reform. Firms were squeezed by the stabilization measures while imports provided competitive pressure to hold down prices. By mid-1990 about 30 percent of Yugoslav firms reported difficulties, with many on the verge of bankruptcy. However, the absence of "breathing space" put early pressure on the government, which relaxed monetary and credit policy after June and began financing enterprise losses once again. Inflation rose to over 7 percent in both September and October, before being slowed again by tight credit policies in November. Even after the 28 percent devaluation at the beginning of 1991, Yugoslavia's currency is now considered to be significantly overvalued due to the cumulative inflation in 1990 of 119 percent.

Both the Polish and the Yugoslav experiences point to the difficulty of sustaining stabilization with an open trading regime in the absence of real adjustment in the underlying economy. Whether immediate breathing space is provided or not, sooner or later enterprises will feel the pinch of international pressures. If they are not rapidly

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**Box 2 Economic developments in east Germany after economic union**

East Germany underwent the most extreme "big bang" with its economic union with West Germany on July 1, 1990. Prices were liberalized, the economy was opened to international competition, a fixed "exchange rate" was introduced, and factor markets were created overnight. The economic consequences of the sudden switch to an open market economy were more severe than expected. Consumers switched from east to west German goods to a far larger extent than anticipated. Industrial production in east Germany slumped by 50 percent (even more in light industry) in 1990, and is expected to fall even more in 1991. GDP declined by an estimated 20 percent in 1990. The one-to-one conversion of east German to Deutschmark wages combined with high (25 percent and more) collectively negotiated wage increases in the summer of 1990 led to relatively high unit labor costs. This, combined with unclear property rights, poor infrastructure, and uncertain environmental liabilities, makes investment in the region even less attractive. GDP is expected to drop a further 15-20 percent in 1991. Unemployment rose steadily to 750,000 (about 9 percent of the labor force) in January 1991 and could climb to as high as 2 million later in the year. In addition, the number of short-time workers rose to 1.9 million in 1990 and is also expected to increase. The "full-time equivalent" unemployment rate in 1991 could reach 40 percent. As a result of the sharper than expected recession, public revenues are falling and government spending on social services is rapidly rising. Spending on the order of 50 percent of east German GDP—some $3,000 per east German resident—is expected in 1991, two-thirds to be covered by fiscal transfers from west Germany and the rest to be raised elsewhere. Given that east German wage rates are unlikely to fall dramatically and may in fact continue to rise, continued fiscal transfers and a strong regional development policy are needed to stem further migration and increasing economic disparity between east and west.
restructured to improve productivity, they are eventually threatened with massive layoffs and bankruptcy. Resulting political pressures can compromise the government's commitment to stabilization.

Firms react initially to the pressures of stabilization policies by seeking other "safety valves." Interfirm credits, for example, grew dramatically after stabilization measures were taken in Poland and Hungary. The combination of a weak legal framework to enforce credit obligations and the lack of true ownership interests in firms means that there are few endogenous constraints on the growth of these credits. They weaken the enterprise sector in the medium run and raise the risk of cascading bankruptcies over time. Governments need to regulate interfirm credits in order to have true control over the money supply and prevent profitable firms from being dragged into bankruptcy by unprofitable ones.32

The interaction of stabilization and system transformation. The goals of stabilization and system transformation are often mutually supportive. Price realignments to market levels lower consumer subsidies, while cuts in subsidies to loss-making firms, whether through the budget or the banking system, speed adjustment by forcing enterprises to close or restructure. Replacing quantitative restrictions with tariffs raises revenues while helping to import a rational price structure from abroad. More generally, stabilization is not sustainable without real underlying adjustment, as noted above.

Sometimes, however, stabilization and adjustment goals can conflict. One example is the need to maintain public sector wage controls through the stabilization phase despite the distortions this prolongs in the labor market and the disincentives it can create — noted in Poland — to increase output. Also, the needs of system transformation can conflict with those of stabilization in the area of tax policy, as revenue requirements confront the need for more transparent and less burdensome tax rules to spur private sector development. The resolution of this dilemma requires a comprehensive tax reform, as noted in annex 5.

Price and market reform

The market for goods. Expanding the market for goods requires at a minimum free entry for producers and distributors, freedom of buyers and sellers to negotiate market-clearing prices, and expanded access to the variety of goods available on international markets. Price reform is the key step in this process. For goods that are traded on international markets, price reform means moving to world market prices and liberalizing the price-setting mechanism, either simultaneously or sequentially. Such price reforms will typically result in large increases in the official prices of "necessities" (such as staple foods, meat, and energy) heavily subsidized under central planning, although it may also result in decreases in unofficial, or "black market," prices.33

While Yugoslavia had gradually liberalized most prices over many years prior to 1990, Poland adopted the "big bang" approach by freeing about 90 percent of all prices simultaneously at the beginning of 1990. Romania freed about 50 percent of prices on October 1, 1990, and Bulgaria freed prices covering some 90 percent of turnover on February 1, 1991. The CSFR adjusted some administered prices upward in mid-1990 and liberalized most prices (covering some 85 percent of production) on January 1, 1991. Its mid-1990 reduction of price subsidies on food was compensated by an across-the-board direct payment to households based on average consumption levels, rendering these subsidy cuts approximately budget-neutral. Hungary followed a somewhat more gradual process of price reform as the domestic pricing regime was progressively liberalized after 1988. By the end of 1990, about 90 percent of consumer prices were free of government control.34

Experience to date shows that freeing prices and allowing free entry in distribution can elicit an immediate and dramatic increase in the availability and variety of goods in the market. In the space of a month or two after price reform, much of the retail trade in Warsaw had moved from government shops to the less formal curbside market, often operating out of trucks parked on main streets. Queues had practically disappeared, and government shops, progressively supplemented by private retailers, started to offer a wider variety of goods for sale. Direct interfirm transactions increased at the expense of the previous distributors, both domestically and internationally.

The freeing of prices needs to be accompanied by the development of competition policies to offset the tendency of monopolists to raise prices excessively. International competition may constrain monopolists' behavior if trade is liberalized concurrently with price reform, if imports supply a sizable share of the domestic market, and if the
exchange rate is roughly competitive. This is unlikely to be sufficient in all cases, however, especially in larger countries (such as Poland, Yugoslavia, or particularly the USSR) where imports play less of a role. Domestic competition policies designed to break up monopolies (in part through appropriately structured privatization) and control unfair trading practices should complement international market forces.

For nontraded goods, price reform may entail reducing subsidies and eventually freeing the price-setting mechanism. Many of these goods — including housing and certain services such as medical care, child care, and education — have long been considered as entitlements, and major price adjustments may need to be compensated by raising cash wages, effectively shifting a larger part of consumption onto a market basis. There is high social and political resistance to these price increases, and no country has yet made extensive reforms. CEE governments have long allocated state-owned housing bureaucratically (with subsidies typically in the range of 3-6 percent of GDP), and some have also subsidized private housing through low-interest loans. Private ownership has generally been limited to one or two dwellings; a very small private rental market exists in Poland and Hungary, but owners' rights are limited. Rents for state housing typically averaged only 2-5 percent of family income in the 1980s, and those in the Soviet Union have not changed since the 1920s. Although raising rents (and cutting credit subsidies) over time is an important — and politically divisive — step in the reform process, housing reform touches on many other issues as well (box 3).

International trade. In small or medium-sized countries such as those in Central and Eastern Europe, price reforms for traded commodities can be introduced quickly by establishing currency convertibility and opening the economy to foreign trade. As noted above, this enables countries to "import" not only the international price structure but also the benefits of international competition, lessening the need for domestic antimonopoly controls. A realistic exchange rate (whether fixed or floating) is a minimum prerequisite for such a move. If the exchange rate is to be fixed, adequate reserves are needed to defend it. Official reserves in Poland, for example, equalled four and a half months' imports in January 1990. Bulgaria, with very low reserves (as low as two weeks' cover in mid-1990), opted for a floating rate when it moved to liberalize trade in February 1991. Trade reform can accompany stabilization (as in Poland and Yugoslavia) or be introduced more gradually (as in Hungary, which has progressively removed import licensing restrictions since 1988).

Unfortunately, the opening of these countries to international trade is taking place in an atmosphere of intense and somewhat unpredictable change in their trade regime with each other and the USSR — the CMEA system. CMEA trade shifted from bilateral clearing at administered prices to multilateral trade at world prices on January 1, 1991. Although this shift is a logical counterpart to domestic market-oriented reforms, it is expected to impose substantial terms-of-trade losses on the smaller CEE countries in favor of the Soviet Union. Estimates of these losses require judgments on the expected quality discount on East European manufactures and are sensitive to the price of oil; recent estimates based on an oil price of $21 per barrel suggest a terms-of-trade shock of $11.4 billion for the five CEE countries excluding Yugoslavia, equivalent on average to 4.4 percent of their GDP (see annex 1). Difficulties in the Soviet economy also make it harder to conclude contracts with Soviet counterparts. Simultaneously, the GDR — in merging with West Germany and adopting the Economic Community's Common Trade Policy — has moved

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Box 3 Issues in housing reform

Housing sectors in CEE countries have been marked by severe shortages that inhibit labor mobility and by ever-expanding public subsidies that strain public budgets and financial systems. Housing reform encompasses many issues in addition to rent and subsidy reform and accompanying wage adjustment (as discussed in the text). Establishing a market for housing requires, for example, an overhaul of the system of housing finance, with major implications for the financial system in general. It also requires privatizing a substantial portion of the public housing stock, which relates to broader privatization and macroeconomic policies. Housing markets require extensive legal and institutional reforms to enact and enforce zoning and building codes. Finally, extensive reform and restructuring is needed in the construction industry to reorient incentives and improve productivity.
The reforming countries are beginning to make progress in reducing controls on labor markets and establishing principles of collective bargaining. Yugoslavia, for example, enacted a new labor code in 1989 that established the right of firms to transfer or release workers under conditions that are progressively being liberalized. Several countries have seen an increase in redundancies. However, the process is too new to draw lessons.

Financial markets. The challenge of financial market development in the CEE countries is to create independent, market-oriented banks able to mobilize savings, evaluate risk, and allocate capital along efficiency criteria. As previously noted, the absence of a market-based financial system is costly even in the early stages of macroeconomic stabilization, because no effective channel exists to assure that macroeconomic policies — in particular the tightening of credit — support microeconomic adjustment. Although all reforming countries recognize the importance of starting immediately with financial system reform, it cannot be done overnight. Most countries have already broken up monolithic banking structures into two-tiered systems consisting of a central bank and several commercial banks. Central and commercial bank legislation has been drafted and is being revised as reform progresses. However, developing fully functioning and independent banks requires extensive training and technical assistance in complex areas, many of which are new for the countries concerned. Banks must learn how to attract deposits, manage liquidity, evaluate risk, and carry out payments functions for commercial transactions, while bank regulators must be taught how to oversee asset portfolios, evaluate liquidity, and judge the adequacy of bank procedures and management. Market-oriented accounting systems must be developed concurrently. Institutional and skill development is proceeding apace in all the countries but will take time. Certain issues concerning the new systems, such as the ownership of banks and the desirable scope of their activities, are not resolved (see annex 4).

Before banks can function independently and competitively, their portfolios must be restructured and their capital bases restored. As long as a large segment of client enterprises continues to generate losses, the banking system will find it difficult to avoid taking on more bad debt. Re-
Box 4 World Bank support for private sector development: The example of Hungary

The World Bank group has been intimately involved in advising and supporting CEE governments with private sector development. In the latter half of the 1980s in Hungary, for example, there was extensive dialogue on liberalizing trade, expanding the scope for small-scale private activities, increasing enterprise autonomy, liquidating loss-making enterprises, facilitating foreign investment, implementing a modern company law, and ultimately transforming state enterprises into companies with mixed or private ownership. This dialogue was supported by substantial Bank direct technical assistance as well as several Bank loans for the industrial sector, and it helped lead to rapid transformation of the framework for private sector activities.

The dialogue has continued during 1990 and 1991. The first Structural Adjustment Loan has supported trade liberalization, major subsidy reduction, tightened financial discipline for enterprises, key actions toward enterprise privatization, the development of a modern accounting and auditing framework, and a strengthened macroeconomic framework. In addition, an Enterprise Restructuring and Privatization adjustment loan is being appraised that will support a comprehensive government program for ownership reform (including the transformation of all state enterprises into company form and improved government exercise of ownership rights and duties), the government's ambitious privatization program, and the selective restructuring of state enterprises. Other Bank activities include the 1990 Financial System Modernization Project and other efforts to further involve recently created commercial banks in lending to the private sector.

Private sector development, privatization, and enterprise restructuring

New investment. The most important spur to economic growth is likely to be the growth of new private businesses. Experience to date shows that new private small-scale business can develop rapidly in a supportive environment. In 1989 and 1990 all of the countries of Eastern and Central Europe lifted their highly restrictive controls over private sector activity. New laws sought to place private enterprise on an equal footing with public firms by equalizing tax treatment, removing restrictions on private firms' size and activities, freeing private procurement and distribution, and reducing bureaucratic requirements for establishing new firms. The response was immediate. Over half a million new sole proprietorships and 30,000 incorporated companies registered in Poland in 1990; of the latter, about 20 percent were in manufacturing and the rest in trade and services. In the CSFR, more than 500,000 potential entrepreneurs have registered for licenses (primarily in trade and services) with the newly formed Employers' Association since the new private enterprise legislation was passed in April 1990. Hungary has been liberalizing private sector activity since 1982 and now has some 300,000 private sole proprietors and several thousand private limited liability companies. The share of workers employed in the private sector in Hungary has risen from 0.1 percent to an estimated 10 percent; however, more than half of those working in the private sector do so while also maintaining their jobs in the state sector. Although private enter-

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prise has been permitted (with limitations) for a long time in Yugoslavia, a more liberal Law of Private Business was passed in mid-1989. Nine thousand new limited liability companies were formed in the first half of 1990 alone, most in trade and services but a growing number in production.

Private sector development continues to be constrained by many factors, however, including burdensome rules and regulations, limited credit due to poorly functioning financial systems and limited collateral assets, weak domestic demand due to tight stabilization policies, legal and political uncertainty (including that regarding land ownership), high taxes, and the de facto preferences that continue to be enjoyed by public sector firms. Private manufacturing firms are still confined to niches (often themselves monopolized) carved out in the few areas not dominated by state enterprises. Despite growing private activity, competition is still weak. There is a strong case for broad measures actively to encourage private firms until the dominance of public enterprises is eliminated.

Foreign investment is also growing. In 1990 the number of registered joint ventures in both Hungary and Poland doubled from about 1,000 to more than 2,000. In the CSFR, registrations increased from only 60 at the beginning of 1990 to 500 by October 1. Enterprises in CEE countries are actively seeking joint venture partners, which offer market access, technology, and capital, seen as keys to survival. However, in terms of financial flows, foreign investment is unlikely to play as large a role as many expected at the outset of the reform process. Investors are wary of political and economic risks and the uncertain legal and procedural frameworks. The average investment is quite small; in Poland, joint ventures account for less than 2 percent of sales and employment, and most investors are emigres. Although average capital per joint venture is somewhat larger in Hungary, foreign capital — mostly from Germany, Austria, the United States, and Switzerland — is still generally small, usually less than half of total capital. However, foreign capital is not the only goal; management expertise, familiarity with export markets, and access to advanced technology are also major benefits from foreign involvement. Development of a well-structured legal framework and the institutions to support and enforce it (discussed in the section on the role of the state) is critical to the growth of both foreign and domestic private investment.

Privatization. Revitalizing the enterprise sector will require restructuring and privatizing many existing enterprises, whether small or large, industrial, agricultural, or service-oriented. Experience over the past 10 years suggests that the two are intertwined — successful restructuring will require extensive privatization. State-owned enterprises can work efficiently in an economic system in which most enterprises are privately owned. But when the vast majority of enterprises are publicly owned, the institutional and competitive framework that stimulates efficient behavior is missing. Socialist firms in essence have no owner to defend the interests of capital and actively demand a good return on investment. A small minority of firms and some moderate ownership share in the remainder can stay in public hands, but for both economic and political reasons a majority interest in a majority of firms needs to be transferred to the private sector in the course of system reform. This will by necessity entail massive privatization in the CEE countries, where between 65 and 90 percent of GDP is accounted for by state enterprises, as compared with about 10 percent on average in industrial countries and 15 percent in developing countries.

Yet ownership reform is proving to be perhaps the most contentious challenge in the entire reform process. While rapid privatization is the goal in almost all cases, an important intermediate step (sometimes referred to as “corporatization”) is to establish tangible ownership rights and corporate governance, possibly on behalf of the state itself. This confronts years of decentralization of control to managers and/or workers’ councils, particularly in Yugoslavia, Poland, and Hungary, which have bestowed de facto ownership rights that are politically difficult to reclaim. Legitimate claims of previous owners can complicate the picture still further. In Hungary, the CSFR, Poland, and the former GDR, for example, those who owned enterprises, land, commercial real estate, and housing prior to the nationalizations of the 1940s and 1950s are claiming rights to these assets.

If these immediate constraints can be handled, the general shape of a consensus on the means of privatization is now beginning to emerge (see annex 2). Rapid privatization will need to rely on a multitrack approach; no single approach can provide the answer. It is clear from recent experience that privatizing small-scale firms, particularly in trade and services, is relatively easy. They
can be auctioned off by local governments (and in some cases returned to former owners) quite quickly and successfully. About one-half of Poland's state-owned shops were transferred to private hands in 1990 alone. Hungary and the CSFR have passed laws on "small privatization" and have begun to privatize retail trade and services through auctions to the highest bidder.

Large industrial firms present a more complex challenge. The one thing that is clear is that privatization of these firms is a very complex, imperfect, and time-consuming process. Three means of privatizing—"spontaneous" privatization (or sales of firms or their assets "from below"), public sales (directed from "above" and possibly combined with liquidations), and free mass transfer—are all likely to play a role, although with a different mix in each country. Profitable firms are the most prone to privatize "spontaneously"—that is, by issuing their own shares to insiders with greater access to information and power—as cases in Hungary, Poland, and Yugoslavia have shown. While previously sanctioned by law, and still regarded by some as the easiest means to an important end, spontaneous privatization has suffered prominent cases of abuse, and the belief that many insiders were "nomenklatura" of the old regime has led to public outcry. Only Hungary still plans to rely heavily on this means, which will be closely supervised by its State Property Agency.

The two main alternatives to spontaneous privatization for large firms are sales by the government to the highest bidder and free distribution of shares to citizens. The two are not mutually exclusive; some firms can be sold by the government while others are distributed free. Many analysts have argued that sales are preferable to free transfer, both because they lead to clearer corporate control by interested "real" owners and because they add to public revenue. Yugoslavia intends to rely primarily on public sales. Hungary is supplementing spontaneous privatizations with a program of "active privatization," or direct sales, by the State Property Agency. Poland plans to privatize many of its largest enterprises through individual sales. Germany is relying exclusively on public sales to privatize the state enterprises in the east (see box 5).

Recently, however, the difficulties with extensive public sales have become more and more evident. The first is valuation. The experience of 1990 has led many to believe that accurate valuation is virtually impossible given the absence of capital markets. The second barrier is capital. Domestic capital is inadequate, and sales to foreigners are limited by political factors. The third barrier is equity: "nomenklatura," black marketeers, or beneficiaries of current market distortions are seen as being likely domestic buyers. Because of the depressed condition of the economies and the high perceived risks, acceptable prices may be low and these buyers may reap "windfall" gains. The fourth barrier is time. Hungary has some 2,000 state-owned firms, and Poland over 7,500. Hungary's first program in

Box 5 Enterprise privatization in east Germany

The process of privatizing state enterprises of the former GDR has encountered serious difficulties since its inception in mid-1990. It relies exclusively on sales to "qualified buyers"; no firms will be sold through the existing stock exchange (where diluted share ownership or "unqualified" buyers might emerge) or given away to citizens at large (although any "residual" from the entire privatization program will be distributed to east Germans). As of January 1, 1991, the state privatization agency (the "Treuhandanstalt") had concluded about 500 deals, almost exclusively negotiated case-by-case with west Germans and foreign buyers. Some deals involved entire firms, while others involved spinoffs of the 8,000 or so large enterprises to be privatized. In addition, a third of the 11,000 small- and medium-sized enterprises nationalized in 1972 had been returned to their previous owners, and some 7,000 small shops had been leased to private individuals as a step toward privatization.

Experience to date offers several lessons. Valuation has proved very difficult, leading to widespread use of "incomplete" contracts that provide for later determination of the purchase price. Buyer interest has been limited, particularly for firms producing tradable goods. This reflects the low competitiveness of east German industry due to backward technology, inadequate infrastructure, and high wages set by the high valuation of the East German Mark and by recent collective bargaining agreements. Uncertain property rights and contingent environmental liabilities resulting from the application of west German environmental standards also dampen buyer interest. It is now clear that there will not be any interested buyers for a large number of enterprises. Many will have to be financially and organizationally restructured to make them more attractive, and liquidation and sale of assets will have to play a larger role than expected. The Treuhandanstalt is willing to consider a negative purchase price, that is, paying a buyer to take on an unwanted state enterprise. Even with hundreds of top west German managers drafted from other companies, privatization is going to be a slow and complex process.
September 1990 involved 20 firms; Poland sold only five firms in its first public offering in January 1991, compared with an initial target of 150.

Given these drawbacks, the view is emerging that giving away a large share of state assets to the public may be the fairest and quickest means to widespread privatization. The most discussed means of giving away assets is to issue citizens vouchers that can be exchanged for the assets of their choice. The CSFR first advocated such a plan in early 1990, and Poland and Romania later turned in that direction. All three countries hope to implement such a scheme in 1991.

Mass transfers have at least three major potential drawbacks. The first is the fiscal cost associated with forgoing sales revenues; this once seemed paramount but now may be somewhat less important, in part because the alternative of sales also appears unlikely to raise as much revenue as initially hoped. The second is the fear that the resulting ownership would be so widespread and diluted that owners could not effectively assert control over management. The third is the concern that the public would lack the information wisely to "invest" vouchers. Various plans attempt to tackle the latter two problems by proposing intermediaries to hold and "own" assets in trust for the public. The intermediaries—whether domestic or joint venture holding companies, mutual funds, or soon-to-be-privatized banks or pension plans—would own relatively large blocks of shares in enterprises and would therefore have a greater ability and incentive than individual citizens to play an active ownership role.

The various voucher plans have many attractive features and could well play a positive role in speeding up and promoting fairness in the privatization process. However, the plans are still incomplete in many details. For them to be effective, it is imperative that they be designed and implemented to insure effective corporate governance and to facilitate further sales of firms by intermediaries.

Several countries are moving to privatize state-owned or cooperative farms. Both Bulgaria and Romania recently passed land reform laws that provide for the breakup of collective farms and the return of land to private ownership. In each country claims of prior owners will be honored, although the land returned will not necessarily be that taken away at collectivization. Although the need to restructure collective farms and redefine property rights in land is clearly an important issue (see annex 3), there has not been widespread discussion on how to coordinate land reform and the more general privatization of state assets. While the approach to property rights in land should be consistent with property rights in other assets, land should not be owned by widely dispersed absentee shareholders as industrial enterprises would be under the various voucher plans under consideration. Therefore, neither state nor collective farms should be included in the portfolios of any intermediaries established to hold shares on behalf of the public.

Restructuring. Whatever the means chosen, many firms will remain in public hands for a long time, and many of these will need to be restructured or closed. Some restructuring will be required prior to privatization, even if only to "prepare" enterprises for privatization. Before privatizing individual firms, for example, governments need to break up large monopolies, tackle sector-wide issues of excess capacity (especially in heavy industry and sectors affected by the demise of the CMEA system), and address the politically tricky problem of mass redundancy. Experience in Great Britain and elsewhere suggests that these steps are easier to accomplish in public hands (perhaps with private-sector managerial assistance), especially if all parties know that privatization is imminent. Governments may also need to "clean up" the balance sheets of some public firms prior to privatization, although they should resist bailouts when firms are clearly financially inviable in the longer run. Physical and managerial restructuring may also be needed, although incoming private managers can usually handle this better than the government if near-term privatization is feasible.

The challenge in the CEE countries is on a scale far larger than has ever been faced elsewhere. How can CEE governments, with limited expertise and resources, undertake so challenging a restructuring policy? The key challenge is institutional. Institutions and criteria are needed to provide restructuring advice and finance, with appropriate safeguards to preclude bailout. Poland and Yugoslavia recently established restructuring agencies to provide technical assistance in designing and evaluating restructuring programs. Specialized financial institutions have been created to help these and other programs in Poland. The other countries have not yet begun to tackle the problem in earnest. Experience in east Ger-
many, where thousands of west German experts are
available to help with restructuring, shows that the process will be long and hard even in the
best of circumstances and suggests that many firms will have to be closed. In the other reform-
ing countries, where resources are scarcer, the road is likely to be even longer and harder. As
with privatization, one should expect a slow and imperfect process at best.

Price, tax, and trade reforms facilitate the re-
structuring process of both public and private
firms by improving incentive structures. However,
the experience in Poland and Hungary indicates
that the supply response of public sector firms to a change in the incentive structure is likely
to be relatively slow. Not only is capital and
technology often deficient but attitudes of manag-
ers, workers, and government bureaucrats do not
change immediately. To reiterate an earlier point,
privatization and restructuring are integrally in-
terlinked and must go hand-in-hand.

Agriculture presents some of the most chal-
lenging issues in restructuring and in reforms
more generally. As noted in annex 3, some issues
in this sector are common to most CEE countries,
while others vary due to diversity in climate, natural resources, and organizational legacies.

Two politically sensitive but necessary measures
are the removal of food subsidies and the restruc-
turing (whether breakup or consolidation) of land
ownership. Producers are hostage to the pace of
change in processing, marketing, and distribution,
and reforms in these sectors (including delinking rural services from productive units)
have high priority. While the potential payoff is
high, agricultural reform is more complex in the
CEE countries than it was in China and is not
expected to have the same power to lead overall
reform. This and other comparisons of the East
European and Chinese experiences are further
noted in box 6.

The role of the state

One of the most pressing challenges facing re-
forming socialist economies is to redefine the role
of the state. Its former all-encompassing role must
be “unbundled” into separate ownership, financ-
ing, and regulatory roles. The first two must be
reduced through privatization and financial sec-
tor development and the third strengthened.
Governments have essential functions in market
economies — to supply “public” goods such as
national defense, infrastructure, and a legal frame-

Box 6 China’s economic reform

China’s reform program, initiated from the late 1970s on,
led to dramatic improvements in economic performance
from a low base toward levels more characteristic of East
Asian market economies. During 1965-80 China’s GDP
grew at 6.4 percent per year; this rose to 10.4 percent per year
in 1980-88. Improvement in per capita incomes and living
standards was especially marked in rural areas. Employ-
ment growth accelerated and, under the “open door” policy,
the dollar value of foreign trade rose five-fold from 1978 to
1988, with exports increasing from roughly 5 percent to 13
percent of GDP.

Despite some similarities, there are very significant dif-
fences between reform experiences in China and the CEE
countries. Unlike several CEE countries, China did not have
to initiate a determined macroeconomic stabilization effort
at the start of its reform (though it did later face a similar
problem of maintaining macroeconomic balance in a decen-
tralized socialist system). Its debt burden was low, and it
maintained a high savings rate. It also did not face the
disruption of trading relationships and terms-of-trade shocks
that now loom so large in CEE. In addition, the current
reforms in CEE countries go well beyond those initiated in
China in most dimensions, including price and market
reform, introducing domestic and international competi-
tion, private sector development, and fundamental changes
in the role of the state. In the state enterprise sector, China’s
reforms are more akin to earlier CEE moves toward market
socialism, which sought to decentralize decisionmaking
without dismantling state ownership. China moved farther
in agriculture and rural industry, where de facto ownership
rights were granted to individuals, albeit usually subject to
extensive local government intervention. In sum, China has
not faced many of the challenges the CEE countries are now
trying to address.

A further distinctive feature of China’s reforms was the
role of agriculture as a leading sector. With the restoration
of family-based farming and more favorable prices, agricul-
tural productivity and farm incomes rose sharply. The
demand for consumer manufactures increased at the same
time that release of surplus farm labor and a growing pool
of savings made possible the establishment of rural town-
ship-village enterprises (TVEs). TVEs accounted for one-
third of the growth of total material production in 1980-88,
provided 90 million jobs, and by 1988 provided one-fifth
of total exports. Reform of agriculture, and especially of
agroindustry, is a high priority in the CEE countries, for
reasons that include its potential for exports and for creating
jobs in associated trade and service activities. However, the
sector cannot play the leading role in the CEE countries that
it did in China’s reforms.
work; to correct for monopolies, "externalities" (such as environmental costs), and other market failures; to provide basic social services and a safety net to alleviate hardship; and to finance these activities through the collection of taxes and other levies.

**Institutional reform.** Governments in Central and Eastern Europe face daunting institutional challenges as they attempt to reorient their role to fit the needs of a market economy. Not only must they alter the administrative structure of government, but in many cases they need to reduce its overall size, retrain many remaining civil servants, and maintain if possible augment the small cadre of well-qualified policy analysts and decisionmakers. They must also face politically touchy questions concerning the devolution of powers to regional and local levels. Most have made a start. For example, most CEE governments have downsized or abolished their former planning offices, consolidated single-industry ministries into a smaller Ministry of Industry, and established privatization agencies. Many are setting up training programs for civil servants, often with international assistance. Top-level managers have generally been replaced, although some mid-level managers with vested interests in the former regime remain.

Institutional concerns pervade every aspect of reform, and numerous examples appear throughout this paper. Three specific issues — legal reform, fiscal reform, and reform of the social safety net and social services — are summarized below.

**The legal framework.** One of the most pressing needs is to design a legal framework for market activities. Property laws should set clear rules of ownership and control. Contract laws and related procedures for dispute resolution need to establish a framework for commercial bargaining and ensure the fair enforcement of private contracts. Company and foreign investment law should provide for relatively easy entry of new enterprises into the market, while bankruptcy law needs to establish a procedure for exit. Regulatory laws should correct for market failures, whether inhibiting the distortions of unregulated monopolies, forcing firms to disclose information needed by the market (as, for example, in the case of securities regulation), or providing incentives to "internalize" external environmental costs (see box 7). Labor law should set basic ground rules for employment and industrial relations. Local government legislation needs to define the role and powers of local governments vis-à-vis higher levels of government and the private sector. And well-functioning legal institutions need to ensure that these laws are enforced reasonably reliably and efficiently.

The reforming countries, especially those more advanced, are making substantial — albeit somewhat ad hoc — progress in drafting new laws. New constitutions, property laws, and company and foreign investment laws have been or are being drafted in all countries. These laws essentially permit full private ownership (including, in some cases, 100 percent foreign-owned investment) and attempt to put it on an equal legal

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**Box 7 Cleaning up the environment in CEE countries**

CEE countries all suffer massive pollution that compromises public health and imposes heavy economic losses. Air pollution (primarily from coal-burning and metallurgy) causes high rates of chronic bronchitis and asthma, and contaminated soil may affect food supplies. Much water is unfit for human consumption, and large areas of forests have been irreversibly damaged. CEE countries all suffer massive pollution that compromises public health and imposes heavy economic losses. Air pollution (primarily from coal-burning and metallurgy) causes high rates of chronic bronchitis and asthma, and contaminated soil may affect food supplies. Much water is unfit for human consumption, and large areas of forests have been irreversibly damaged. CEE countries all suffer massive pollution that compromises public health and imposes heavy economic losses. Air pollution (primarily from coal-burning and metallurgy) causes high rates of chronic bronchitis and asthma, and contaminated soil may affect food supplies. Much water is unfit for human consumption, and large areas of forests have been irreversibly damaged. CEE countries all suffer massive pollution that compromises public health and imposes heavy economic losses. Air pollution (primarily from coal-burning and metallurgy) causes high rates of chronic bronchitis and asthma, and contaminated soil may affect food supplies. Much water is unfit for human consumption, and large areas of forests have been irreversibly damaged. CEE countries all suffer massive pollution that compromises public health and imposes heavy economic losses. Air pollution (primarily from coal-burning and metallurgy) causes high rates of chronic bronchitis and asthma, and contaminated soil may affect food supplies. Much water is unfit for human consumption, and large areas of forests have been irreversibly damaged.

- In east Germany alone, it has been estimated that $100 billion would be needed to achieve west German environmental standards over 15 years.
- Governments must establish mechanisms to assess alternatives and set priorities, looking carefully for those investments that can achieve the most environmental protection at least cost. One obvious need is for investment to switch away from coal and toward natural gas as a major energy source and to clean up existing coal-burning facilities and improve the safety of nuclear plants or in some cases decommission them. Responsibility for past environmental liabilities must also be clearly assigned to avoid inhibiting new buyers from purchasing privatized firms.

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footing with state ownership. The countries are also adopting modern antimonopoly and bankruptcy laws, often drawing on industrial country models.

However, these countries have paid insufficient attention to the institutional structures needed to bring the laws to life. Courts in socialist economies have traditionally concentrated on criminal and noncommercial civil cases (such as family law), and few judges or lawyers are trained in commercial matters. Neither domestic nor foreign investors consider the formal legal process competent to handle complex commercial problems. Although arbitration exists as an alternative, the lack of a clear and reliable legal framework, ably enforced by competent institutions, is a major constraint to investment.

Some outside observers recommend that the countries of Central and Eastern Europe “adopt” well-tried legal and institutional structures wholesale from other industrialized countries, particularly Western Europe. This would ensure compatibility with the EC, an advantage for future possible membership. Such an approach may work well in selected technical areas (such as negotiable instruments or value-added taxation) but is not suitable across-the-board. Laws in industrialized countries can themselves have serious flaws and are often tied to particular historical events or cultural attitudes. Even if these laws suffice on paper, they will have no real meaning in the CEE countries unless they are internalized through the law-making process — through trial-and-error, learning, debate, and consensus-building. Many developing countries have borrowed industrial country laws only to have them ignored in practice; this degrades the role of law and impedes the development of appropriate laws. Rather than borrowing wholesale, the reforming countries should develop their own laws, drawing from first principles, their own prior statutes (often pre-World War II), and models from other countries where clearly appropriate.

Fiscal reform. Both spending priorities and means of financing government need major overhaul as reforms proceed. The two should be linked through a fiscal plan; medium-term tax and expenditure planning is needed even though comprehensive central planning is discredited. Public spending — both capital and current — needs to be reoriented to supply social services, infrastructure, and other public goods that are complementary to private investment (see annex 5). Privatization of the bulk of state firms producing goods for potentially competitive markets will help to reorient public spending, as will price reform and the resulting decline in consumer subsidies. There is a danger that, in reaction to the past, the need for public investment will be underemphasized. In fact, the public sector has a very important role to play in improving the network of roads, ports, water and sewer systems, telecommunications, and other infrastructure needed for private firms to function, even if some of these functions can be partially privatized.

The tax changes needed to adapt to a market economy are fundamental and systemic. While socialist taxes were relatively rudimentary tools to capture surplus and were applied in a highly discretionary manner, new tax systems need to be transparent, predictable, and well-enforced. Tax design must balance several conflicting goals. Stabilization programs require tight fiscal policies to control budget deficits. Meanwhile, revenue needs could climb with unemployment and the resulting demands on social spending. Yet high tax rates are inimical to investment and growth, and privatization will put an end to the old, reliable sources of revenue, the state-owned firms. In the early stages of reform and privatization, as the old revenue system is dismantled and before a new system is fully operative, there is a danger that revenues will fall sharply just when most urgently needed. To avoid this, tax bases must be broadened and changed to be more compatible with a market economy (for example, reducing company income tax rates while changing from turnover to value-added taxation), and administration must be reoriented to deal with hundreds of thousands of private firms and individuals. This requires techniques of selective auditing and tax enforcement, standard accounting practices, and a reliable and objective legal framework for dispute resolution. Countries must also resolve complex and often divisive issues of fiscal federalism with regard to both taxing and spending authority (see annex 5), and they must strengthen municipal and provincial fiscal systems as they strengthen national ones.

Hungary was the first to reform its tax structure, moving to a fairly traditional system of company, individual, and value-added taxation in 1988 and 1989. Despite the comprehensiveness of its reform, Hungary introduced many exemptions and exceptions that will be difficult to change.
given the vested interests that have formed. The other CEE countries are in earlier stages of tax reform. There are strong arguments to move early to reform the tax structure, both to set clear "rules of the game" for future investors and to avoid pressures from vested interests created through expanded private ownership. As with other legal reforms, changing tax law is much easier than changing tax administration. It is clear that none of the reforming countries has adequate administrative capacity. Because techniques are quite standard across countries, technical assistance from industrial countries in tax administration is especially valuable.

The social safety net and social services. One of the major accomplishments of the socialist systems of Central and Eastern Europe was the relatively equal distribution of income they attained (see annex 6). Low income inequality stemmed primarily from guaranteed employment and low wage differentiation in the state sector, as economic and social goals were often combined in socialist firms. In contrast, economic and social goals are typically separated in market economies. Firms pursue profits and pay wages accordingly, whereas the state helps those left out of the economy. The transition to a market economy is virtually certain to lead to higher open unemployment. Moving toward an economy-wide safety net — thereby leaving firms to restructure to pursue efficiency — is an important task for the state in the transition. Such a safety net would include unemployment insurance, social security (old-age and disability insurance), and retraining services.

Despite relatively equal incomes, there is evidence that poverty — particularly in urban areas — increased in several CEE countries during the economic slowdown of the 1980s. Income distribution is likely to widen and poverty (particularly in urban areas) to grow as these countries adopt market systems and cut subsidies on essential goods. Generalized cash-based welfare systems for the poor will thus also be needed.

Institutions to address the problem of emerging unemployment have long existed in Yugoslavia, but first appeared in early 1989 in Hungary and one year later in Poland and Bulgaria. Welfare services to address poverty directly have existed until now only in Yugoslavia, and, to a very limited extent, Hungary. The Polish experience is relevant because of the rapid rise in unemployment in 1990 to some 7 percent of the labor force. Poland initially opted for an open-ended unemployment compensation scheme linked to previous earnings that combined two principles — insurance for workers (being earnings-linked) and welfare for the needy (being unlimited in duration). This proved not only to be expensive but also to create a disincentive to job search for the newly unemployed. A preferable approach — and one recently adopted by Poland in the amendments to its labor law — is to separate the two functions, using earnings-linked unemployment benefits of limited duration for insurance purposes, and a low flat-rate welfare payment of unlimited duration for poverty-alleviation. Unemployment benefits can be financed by a payroll tax on employers, as in industrialized countries, while welfare payments come out of general revenues. Concerning implementation, the number of social centers and workers in Poland proved to be inadequate to handle the problem as it emerged. Furthermore, retraining was neglected, perhaps in part due to the absence of clear employment alternatives. By August 1990, only 0.5 percent of the unemployed were being retrained. All CEE countries need to concentrate more on active labor market policies (including training and job placement), given the extensive movement of labor among jobs and sectors that is likely to be needed over the coming years.

Box 8 The key role of pensions in economic reform

Pensions touch many aspects of system reform. As part of the fiscal system, public pensions are a major item of public spending; the role of public as opposed to private pension systems goes far in determining the size of government. Whether funded by payroll taxes or private contributions, pensions (public or private) impose significant burdens on firms and individuals; minimizing this burden is important for efficient private sector development. As part of the social safety net, pensions provide needed security for workers, yet their design should not inhibit the ability of enterprises to restructure their work forces. As financial intermediaries, pension institutions should play major roles in the development of the financial system and in the privatization of state enterprises. Several countries are considering ways to use privatized assets to partially fund pension systems. Governments must consider these many important dimensions when designing policies concerning the level, eligibility, financing, and institutional control over pension assets.
Pension systems in Central and Eastern Europe touch on many areas of reform (see box 8) and need major overhaul. They have typically been characterized by low retirement ages, easy access to disability pensions (partly because of the absence of other programs for income support), and pension formulas biased toward short careers. These problems are compounded by the increasingly aging population. As a result, the number of pensioners (estimated at up to one-half the number of employees) and their financial burden on the economy (generally 7-10 percent of GDP) are quite high compared with countries at similar income levels. Although various reform proposals are being considered — including switching in part to funded and/or private systems to complement state-run pay-as-you-earn ones — no reforms have yet been implemented.

Privatization presents both problems and opportunities for pension finance. The major problem concerns the loss of their major funding source. Pension systems have until now been financed by very high (up to 50 percent) payroll taxes on state-owned firms. Such taxes would put a heavy burden on — and would be very difficult to collect from — private firms. On the other hand, one possible way to move toward partially funded pension systems would be to put a sizable share of privatized assets in the hands of pension plans. Poland's current privatization plan includes a provision to give 20 percent of all vouchers (and thus of all privatized assets) to the state pension system, to be later divided into private pension plans. An important question, given the demographic profile of the CEE countries, is the share of income and sales receipts from state assets that should be allocated to pension plans. In some industrialized countries, pension systems control more than 50 percent of quoted stocks.

Finally, in addition to the narrow social safety net discussed above, the state should concentrate on reforming the funding and operation of virtually all social services. Heavy subsidization of medical care and over-generous sick leave have resulted in high rates of absenteeism, shortage of medicines, and low quality of medical services. Health statistics are stagnant or declining in almost all CEE countries. As with pensions, part of the answer lies in separating social insurance from social assistance functions and limiting free or heavily subsidized provision to the latter. In the area of education, curricula do not address many skills (such as accounting, management, marketing, and financial services) needed in a market economy. Furthermore, both academic and vocational training are highly specialized beginning at an early age, and this limits labor flexibility and mobility and threatens to exacerbate unemployment problems. Yet there is a real danger that financial stringencies in both public and private sectors could cause health and education services to decline even further before they improve. Addressing the many problems in social service design and delivery will clearly take a long time, and reforms in this area have hardly begun.

There is debate about the effects of economic reform on women and children. Socialist countries promoted increased economic participation by women through generous maternity benefits, extensive child-care facilities, and equal education opportunities. Rates of female literacy, education, and labor force participation were high. Movement to a market economy may lead to a reduction in these benefits. Furthermore, women and younger workers may tend to be the first to be dismissed as firms face increasing market pressures. On the other hand, certain structural characteristics made these societies and economies particularly difficult for women. The wage structure virtually forced families to have two incomes, and part-time work was rare. Women were overrepresented in lower-paying jobs, and they continued to carry the major burden of child care and housework. As reforms proceed, the informal sector may open up new opportunities for women, as may the increasing flexibility in work assignments — particularly increasing availability of part-time work — likely to emerge from market pressures. Furthermore, rising wage levels may allow some families broader choice regarding work and child care options, and the emergence of private education and child-care services may enhance not only flexibility but also quality. Special care might be needed to protect children during the transition, particularly with regard to access to food and medical care.
Conclusion: The challenge to industrialized countries

Although much progress has been made in the CEE countries in the past year and a half in defining goals and designing — and to some extent implementing — reforms, it is clear that the road from socialism to a private market economy is perilous and long. Unfortunately, the difficult external environment compounds the political and economic hazards.

Industrial countries have three important contributions to make in supporting reform efforts and helping integrate CEE countries into the global economy: technical assistance, financial assistance, and trade access. The Group of 24 (G-24) countries has established a number of programs to assist the CEE countries and encourage participation by foreign business. In July 1989 it initiated the Poland/Hungary Assistance for Economic Restructuring (PHARE) program. This program, coordinated by the EC on behalf of the G-24, now benefits all six CEE countries. PHARE includes financial assistance, technical advice, and trade concessions.51 Other multilateral organizations are also active, as are a range of bilateral programs.52 Apart from their financing roles, the G-10 has recently reconfirmed the central role of the IMF and World Bank in designing and applying appropriate economic conditionality.53 (World Bank activity is summarized in annex 7, and an example of its wide-ranging support for system reform is shown in box 9. Some of the Bank's activities also offer opportunities to involve assistance from other sources.) A degree of competition in the provision of assistance may be desirable. It is important that the CEE countries strengthen their own capabilities to coordinate assistance programs.

Prior to the Paris Club decision to grant debt relief to Poland, the current account deficit of the CEE countries was expected to amount to some $10 billion per year over 1991-92. Taking into account the need to increase reserves (partly because of the shift to convertible currency trade with the end of the CMEA regime), total financing flows were projected at about $14 billion per year. The noninterest current account was projected as slightly positive, with deficits for Bulgaria, the CSFR, and Romania offset by surpluses for the other three countries.

Against this financing projection, gross financial disbursements to the CEE countries are expected to total about $14.5 billion per year on average in 1991-92. Most will come from official sources, whose disbursements are expected to total almost $10 billion per year. (World Bank lending is projected at $2.5-3 billion annually, and IMF lending at about $4.5 billion in 1991 and $2 billion in 1992.)

With this level of gross disbursements, net disbursements to the CEE countries (after amortization of debt) will be only about $5.5 billion per year, including about $1.5 billion (corresponding to gross flows of $7.5 billion) to the most heavily indebted countries — Hungary, Poland, and Bulgaria — and $4 billion (gross flows of $7 billion) to the CSFR, Romania, and Yugoslavia. Net disbursements from official sources are expected to
In mid-1990 the World Bank loaned $300 million to Poland for structural adjustment. In addition to supporting an adequate medium-term macroeconomic framework and financing plan, individual SAL conditions were designed to support three components of the government's Economic Transformation Program:

- **Enterprise restructuring, privatization, private sector development:** The loan supported changes in the legal framework (state enterprise, tax, bankruptcy, competition, and privatization laws) and the establishment of institutions for privatization, liquidation, and restructuring.

- **Financial sector reform:** The loan required audits and diagnostic studies for numerous banks as the basis for restructuring, the adoption of adequate prudential regulations and implementation of bank supervision, and the adoption of modern accounting and auditing standards.

- **Social safety net:** The loan helped the establishment of adequate unemployment benefits and the consolidation of existing arrangements for means-tested cash benefits, institutional care, and other benefits in kind.

Box 9 How the World Bank's first Structural Adjustment Loan supports system reform in Poland

be positive, on average almost $8 billion per year. However, net disbursements from private sources are expected to be negative (about -$2.5 billion on average per year), with small positive disbursements to the CSFR and Yugoslavia being more than offset by negative net disbursements to Hungary and Poland. Net transfers (prior to any debt relief) average -$5 billion per year. Direct foreign investment in the CEE region is expected to be about $1.5 billion annually, but this could rise sharply if the environment is stable and hospitable.64

Under this scenario, net disbursements of $5.5 billion and foreign investment of $1.5 billion leave a financing gap of about $7 billion per year for the CEE countries. This "gap" must be filled by changing the assumptions built into the scenario — by a drawdown of (or failure to build up) reserves, a larger trade surplus, larger gross disbursements of foreign financing, or debt rescheduling. In mid-March the Paris Club agreed to grant extensive debt relief to Poland, reducing the net present value of Poland's future debt service payments by 50 percent and reducing debt service even more in the early years (including an 80 percent reduction in interest payments over the next three years).65 As Poland was not servicing its debt, relief will have only a small direct impact on actual international financial flows, but it will sharply reduce the current account deficit and, concurrently, the financing gap. Bulgaria has suspended interest payments and is expected soon to begin negotiations with official and commercial creditors for debt relief. Bulgaria has requested rescheduling of its Paris Club debt (about $2 billion) and is likely to ask commercial creditors for long-term rescheduling and further funds in the medium term for the emerging private sector. Hungary is the only country of the three that has continually serviced its debt, with interest and amortization on commercial loans exceeding commercial borrowing by more than $1 billion annually.66

Resolution of the debt problem is important to encourage private sector development. Debt relief clears away the impediment of a large overhang of public sector debt and thus facilitates new lending to the private sector. In addition, debt-equity swaps can be readily used to facilitate both debt relief and privatization; because the government owns the assets offered for swap, the adverse macroeconomic side-effects that have arisen in some Latin American programs involving private firms can be avoided. Debt relief programs raise the secondary market price of remaining debt and thus the "cost" to the government of debt-equity swaps; it is therefore desirable to consider these components as part of an integrated debt strategy.67

The industrial countries also need to insure market access to support trade and corresponding price reforms. In the long run, a major reallocation of their trade, away from the ex-CMEA countries and toward the industrial countries (particularly in Europe), is likely to be an important element of reform. The European Community and the United States have lowered tariffs — granting MFN or GSP status — on goods from Hungary, Poland, and the CSFR. Trade agreements between the EC and Romania (1981), Hungary (1988), Poland (1989), and the USSR, Bulgaria, and the CSFR (1990) provide for the gradual elimination of all discriminatory quantitative restrictions (outside the textile, agricultural, and European coal and
steel sectors). The PHARE program has gone farther, abolishing all specific quantitative restrictions and even suspending nonspecific quantitative restrictions on Hungarian and Polish products, thereby granting more favorable treatment than that given other GATT trading partners. However, challenges to Western market access remain. For example, the full entry of Spain and Portugal into the EC could increase the pressures on certain exports (particularly agriculture) from CEE countries, while moves toward a unified market in 1992 might result in some trade diversion away from extra-EC imports toward intra-EC trade. While membership of the CEE countries in the EC or EFTA is not likely for some time, new avenues are needed for lowering remaining barriers to trade and capital flows and thus continuing to integrate the CEE economies into the world economy.
Annexes
Annex 1 Reform of the trade and payments system

Until 1991 the trade and payments system of the CEE countries was composed of two distinct regimes. The CMEA or COMECON system covered trade and payments among the CEE countries, the USSR, and several other members (with the exception of Yugoslavia, which was not a member of the CMEA). Systems also existed for so-called convertible currency trade and payments with countries outside the CMEA area. The main immediate concern for the progress of the reforms in CEE is how it will be affected by the essential dissolution of the CMEA system as of the start of 1991.

The legacy of the traditional CMEA system

Although material balancing in the CMEA system never quite represented a complete extension of national planning, the member countries coordinated trade bilaterally. Payments involved bilateral clearing using the transferable ruble (which was not really transferable) as the common accounting currency. Trade composition was set in great detail, often with separate commodity sub-balances, and a major objective (accomplished in part through export quotas) was to avoid unplanned trade surpluses. As the countries decentralized their economies, trade was effected through state orders, and domestic and trading prices were insulated by compensating taxes. The emergence of substantial imbalances in recent years resulted mainly from loss of central control. For pricing, the CMEA generally used five-year moving averages of observed world prices for similar goods, which imparted a bias against producers of "hard" or internationally tradable raw materials (whose prices were rising in the late 1980s) in favor of countries exporting "soft" manufactures of relatively low quality. CMEA strove for regional integration through specialization agreements, which aimed to realize scale economies; thus, Hungary exported articulated buses and imported automobiles, and Bulgaria emphasized electronics. The major exports of the USSR were energy and raw materials. This pattern of specialization established monopolies and removed incentives to upgrade product and process technologies. It also resulted in extreme interdependencies between individual countries and suppliers within the region.

For the CEE five, CMEA membership involved short-term gains from favorable pricing but long-term costs from progressively deteriorating standards, technologies, and marketing skills. This was reflected in a secular decline in exports to convertible currency markets and the evolution of a pervasive structural dependency among the countries (table 1.1). The smaller countries were particularly dependent on the USSR, which in 1990 led the decision to phase out the system. Despite its short-term costs the demise of the CMEA is a logical adjunct to the domestic reforms taking place in the member countries. It represents an important step in breaking away from regional autarky and structural dependency and reaping the gains from participating in global markets.

The convertible currency regime

In January 1990 Poland and Yugoslavia shifted to free trade regimes with moderate tariffs for non-CMEA trade. The CSFR did the same in January 1991. Hungary is moving rapidly in that direction; in January 1991 the share of its industrial production free of trade licensing increased from one-third to more than 70 percent. Bulgaria moved to liberalize trade in February 1991. Most CEE countries have introduced some currency convertibility, with Poland, Yugoslavia, and the CSFR moving to full convertibility (in the Polish and the CSFR cases only for current transactions) and the others adopting some variant of the retention-quota cum auction system. The world price system therefore has a major influence now in most of the countries, at least as far as trade with market economies is concerned. All CEE countries have also abolished the government monopoly on trade, and most have given enterprises full trading rights. Spurred by domestic contraction and exchange rate adjustments, the convertible currency exports of Poland, Hungary, and Yugoslavia rose by an estimated 34, 10, and 12 percent, respectively, in 1990. Table 1.2 presents summary information on trade and payments with the convertible currency area.

The external shocks facing the reforming countries

In addition to the shocks caused by changes in their domestic policies, the countries face simultaneously three external shocks, each of which could
Table 1.1 Structural dependence in the CMEA

<table>
<thead>
<tr>
<th>Region/trade category</th>
<th>1970</th>
<th>1980</th>
<th>1987</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>East European Six</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total trade</td>
<td>6.8</td>
<td>4.5</td>
<td>3.0</td>
</tr>
<tr>
<td>Engineering products</td>
<td>0.8</td>
<td>0.7</td>
<td>0.4</td>
</tr>
<tr>
<td>High and advanced technology engineering products</td>
<td>1.6</td>
<td>1.2</td>
<td>0.7</td>
</tr>
<tr>
<td><strong>Asian NICs</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Engineering products</td>
<td>2.1</td>
<td>9.3</td>
<td>14.7</td>
</tr>
<tr>
<td>High and advanced technology engineering products</td>
<td>1.0</td>
<td>3.9</td>
<td>6.3</td>
</tr>
</tbody>
</table>

a. Bulgaria, the CSFR, East Germany, Hungary, Poland, and Romania.
b. Korea, Taiwan, Singapore, and Hong Kong.

<table>
<thead>
<tr>
<th>Shares of CMEA in CEE exports, 1989</th>
<th>(percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Country</strong></td>
<td>CMEA/Total</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>83</td>
</tr>
<tr>
<td>Czechoslovakia</td>
<td>54</td>
</tr>
<tr>
<td>GDR</td>
<td>42</td>
</tr>
<tr>
<td>Hungary</td>
<td>39</td>
</tr>
<tr>
<td>Poland</td>
<td>35</td>
</tr>
<tr>
<td>Romania</td>
<td>38</td>
</tr>
<tr>
<td>USSR</td>
<td>46</td>
</tr>
</tbody>
</table>

a. Non-CMEA trade includes a sizable portion of trade with developing countries. Although denominated in convertible currency, it is partly conducted under bilateral clearing or countertrade agreements similar to those for CMEA trade rather than on a market basis.
b. Reported data for intra-CMEA trade require adjustments to render them comparable with convertible currency trade data, but the method of adjustment has a large arbitrary element. Column (1) values trade at national transferable ruble/dollar crossrates, and column (2) values trade at a uniform ruble/dollar crossrate of 2.
c. 1985 data.
Source: United Nations data.

1. The CMEA shock. In January 1990 the USSR announced its intention to terminate the CMEA system as of January 1991. The resulting shock has two components:

- **Terms-of-trade effects.** World commodity prices will differ from the five-year moving averages used for CMEA trade. In addition, the "soft-
ness” of manufactured goods will be reflected for the first time in a quality discount relative to world price levels for corresponding products. Estimates of CEE terms-of-trade losses vis-à-vis the USSR are shown in Table 1.3. The estimates for 1990 assume trade volumes at their 1989 levels, although trade volumes are expected to be significantly lower. In any case, the dissolution of the CMEA (particularly given higher world oil prices) represents a major shock.

- Trade volume effects. USSR crude oil exports to the CEE countries are expected to decline dramatically in 1991, because of the USSR’s falling production and its suspected policy decision to consider the CEE area as the residual market. This, combined with lower manufactured export prices, is likely to lead to a sharp contraction in trade volumes. While trade contraction in 1990 was about 10 percent, informal Soviet estimates for 1991 suggest the possibility of trade with the five CEE countries declining to 50-60 percent of the 1989 level, and recent experience suggests the decline may be even greater.

2. The Gulf crisis shock. Iraq and Kuwait are important trading partners of most of the CEE countries. Iraqi debt to the five (excluding Yugoslavia) totalled $4.5 billion in 1990, and imports of the five from Iraq in 1989 exceeded their exports to it by some 70 percent. CEE countries expected repayment through expanded crude oil imports, which would have offset some of the costs of the CMEA dissolution.

3. The impact of German economic and monetary union. The former GDR was the most important supplier of high-technology engineering products and chemicals within the CMEA and an important customer for consumer goods from the five CEE members. German unification means the likely loss of the GDR as a major market for such goods.

Largely because of the above shocks, the outlook for the CEE countries’ balance of payments is not bright. The UN Economic Commission for Europe recently projected an aggregate current account deficit of some $11 billion for 1991, most of which was expected to be financed by the multilateral financial institutions. Bank projections of the deficits of the CEE countries, as shown in Table 1.2, are similar. But the most severe impact of the deteriorating external environment is likely to be on output and employment.

Trade and payments policy in the transition

Two transitions are relevant in considering trade and payments policies — the transition process in trading arrangements within the CMEA area, and the transition within the CEE countries toward the private market economy. Especially following the changes in the CMEA, trade and payments policies need to be approached on an overall basis and within the parameters of system reform.

Because of the complementarity of resource endowments and the structural dependencies (including transportation networks) built up over decades between the CEE and the USSR, maintaining mutual trade among ex-CMEA countries is desirable, especially in the transition period. Although the length of this period is not clear, the USSR would probably prefer the shortest transition, while the five CEE countries could benefit from a slower transition (at least vis-à-vis the USSR). Because of the inevitable slowness of institutional change, the transition is likely to require bilateral arrangements between the CEE countries and the USSR, perhaps through “indicative lists” for product trade. Although ex-CMEA countries are likely to seek rules of settlement that economize on the use of convertible currency reserve balances, proposals for the creation of an East European Payments Union patterned after the European Payments Union of the 1950s are not likely to be adopted.

The experiences of Hungary, Poland, and Yugoslavia in 1990 suggest considerable scope for increasing manufactured exports to Western markets. The importance of access to Western markets is heightened by the impending contraction of CMEA trade. Indeed, access has improved considerably in recent years. Between 1988 and 1990 the EC concluded bilateral agreements on cooperation with each of the five ex-CMEA members, and the EC has begun negotiations with Poland, Hungary, and Czechoslovakia on more far-reaching “agreements of association.” The countries now benefit from MFN status and more recently from the Generalized System of Preferences of both the EC and the United States. Agricultural trade is subject to the rules of the CAP, however, and quotas remain on selected manufactures, although many are nonbinding. There appears to be little immediate prospect of joining the EFTA or the EC.
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</tr>
</thead>
<tbody>
<tr>
<td>Bulgaria</td>
<td>20.3</td>
<td>22.4</td>
<td>3.5</td>
<td>3.1</td>
<td>2.5</td>
<td>-0.8</td>
<td>-1.3</td>
<td>-0.6</td>
<td>8.2</td>
<td>9.2</td>
<td>9.0</td>
<td>1.4</td>
<td>0.9</td>
<td>0.8</td>
<td>-2.0</td>
<td>40.2</td>
<td>360.0</td>
</tr>
<tr>
<td>Czechoslovakia</td>
<td>50.3</td>
<td>46.5</td>
<td>6.7</td>
<td>7.3</td>
<td>7.3</td>
<td>0.1</td>
<td>0.4</td>
<td>-0.5</td>
<td>7.3</td>
<td>7.9</td>
<td>7.7</td>
<td>1.8</td>
<td>2.4</td>
<td>1.2</td>
<td>-2.4</td>
<td>16.6</td>
<td>105.5</td>
</tr>
<tr>
<td>Hungary</td>
<td>29.1</td>
<td>32.1</td>
<td>6.3</td>
<td>7.3</td>
<td>7.9</td>
<td>-0.8</td>
<td>-1.4</td>
<td>-0.1</td>
<td>19.6</td>
<td>20.6</td>
<td>20.0</td>
<td>2.0</td>
<td>1.7</td>
<td>1.1</td>
<td>-1.2</td>
<td>62.2</td>
<td>252.9</td>
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<tr>
<td>Poland</td>
<td>68.4</td>
<td>62.3</td>
<td>8.0</td>
<td>8.3</td>
<td>12.3</td>
<td>-0.6</td>
<td>-1.8</td>
<td>-1.5</td>
<td>39.2</td>
<td>40.6</td>
<td>46.3</td>
<td>2.2</td>
<td>2.3</td>
<td>6.9</td>
<td>-2.5a</td>
<td>74.3</td>
<td>375.8</td>
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<td>Romania</td>
<td>53.5</td>
<td>35.5</td>
<td>6.5</td>
<td>6.0</td>
<td>3.4</td>
<td>3.6</td>
<td>2.9</td>
<td>-1.4</td>
<td>3.1</td>
<td>1.4</td>
<td>2.0</td>
<td>0.8</td>
<td>2.0</td>
<td>0.7</td>
<td>-1.7</td>
<td>5.6</td>
<td>59.6</td>
</tr>
<tr>
<td>Yugoslavia</td>
<td>62.3</td>
<td>58.9</td>
<td>14.3</td>
<td>16.0</td>
<td>18.1</td>
<td>2.2</td>
<td>2.0</td>
<td>-1.1</td>
<td>19.4</td>
<td>17.2</td>
<td>16.3</td>
<td>4.3</td>
<td>7.1</td>
<td>8.9</td>
<td>-0.7</td>
<td>27.6</td>
<td>90.0</td>
</tr>
<tr>
<td>Total</td>
<td>283.8</td>
<td>257.7</td>
<td>45.3</td>
<td>48.0</td>
<td>51.4</td>
<td>3.7</td>
<td>0.7</td>
<td>-5.2</td>
<td>96.8</td>
<td>97.0</td>
<td>101.2</td>
<td>12.6</td>
<td>16.4</td>
<td>19.5</td>
<td>-10.5</td>
<td>39.3</td>
<td>196.8</td>
</tr>
</tbody>
</table>

a. Projected current account for 1991 does not include impact of Paris Club debt relief for Poland.
Source: World Bank data.
### Table 1.3 Estimates of Soviet subsidies through the CMEA (billions of current dollars)

<table>
<thead>
<tr>
<th>Country/group</th>
<th>1982</th>
<th>1987</th>
<th>1988</th>
<th>1989</th>
<th>(A)</th>
<th>(B)</th>
<th>(C)</th>
<th>(C)-(A)</th>
<th>(B) / GDP (percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hungary</td>
<td>2.6</td>
<td>0.1</td>
<td>-0.1</td>
<td>1.0</td>
<td>1.1</td>
<td>1.9</td>
<td>2.6</td>
<td>1.5</td>
<td>5.9</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>3.7</td>
<td>0.2</td>
<td>-0.1</td>
<td>1.4</td>
<td>1.6</td>
<td>2.7</td>
<td>3.7</td>
<td>2.1</td>
<td>12.1</td>
</tr>
<tr>
<td>Czechoslovakia</td>
<td>4.9</td>
<td>0.2</td>
<td>-0.2</td>
<td>1.8</td>
<td>2.1</td>
<td>3.5</td>
<td>4.9</td>
<td>2.8</td>
<td>7.03b</td>
</tr>
<tr>
<td>GDR</td>
<td>5.9</td>
<td>0.3</td>
<td>-0.2</td>
<td>2.2</td>
<td>2.5</td>
<td>4.2</td>
<td>5.9</td>
<td>3.4</td>
<td>—</td>
</tr>
<tr>
<td>Poland</td>
<td>4.3</td>
<td>0.2</td>
<td>-0.2</td>
<td>1.6</td>
<td>1.8</td>
<td>3.1</td>
<td>4.3</td>
<td>2.4</td>
<td>5.0</td>
</tr>
<tr>
<td>Romania</td>
<td>0.4</td>
<td>0</td>
<td>0</td>
<td>0.1</td>
<td>0.2</td>
<td>0.2</td>
<td>0.4</td>
<td>0.2</td>
<td>0.8</td>
</tr>
<tr>
<td>CMEA Six</td>
<td>21.7</td>
<td>1.0</td>
<td>-0.9</td>
<td>8.1</td>
<td>9.4</td>
<td>15.6</td>
<td>21.8</td>
<td>12.5</td>
<td>—</td>
</tr>
<tr>
<td>Excluding GDR</td>
<td>15.9</td>
<td>0.8</td>
<td>-1.1</td>
<td>5.8</td>
<td>6.8</td>
<td>11.4</td>
<td>15.9</td>
<td>9.1</td>
<td>4.4</td>
</tr>
</tbody>
</table>

a. Column (A) is based on an oil price of $15.80/barrel; column (B) is based on an oil price of ($15.80+$26.00)/2 = $20.90/barrel; and column (C) is based on an oil price of $26.00/barrel.

b. Percentage of 1989 GDP.

Source: OECD data.

An assessment of the future place of the CEE countries in the global trading system is outside the scope of this annex. Although the USSR has clear comparative advantage in resource-intensive exports, the major competition in many areas of CEE production appears likely to come from the newly industrialized countries (NICs). Although labor costs in the CEE countries appear to be moderately low relative to the NICs at current market exchange rates, this may not be sustainable in the longer run. One likely longer-run implication of reform is a substantial reorientation of trade flows, away from former CMEA markets and toward Western Europe.
Annex 2 Privatization of state enterprises

Private sector development in reforming socialist economies involves two concurrent changes: autonomous expansion of the private sector and privatization of the existing state sector. Autonomous expansion of the private sector is extremely important and may in the long run prove to be the major engine of growth and transformation in these economies. This annex focuses on the complex question of how to privatize existing state enterprises. The socialized sector accounts for over 80 percent of value added in all of the reforming socialist countries (table 2.1). There are some 2,300 state firms in Hungary, 7,500 state firms in Poland, and 26,000 socialized firms in Yugoslavia. Rapid and massive privatization is essential for the development of a private market economy; there is a real risk that the process could be paralyzed if momentum is lost.

After years of failure with market-oriented reforms of state enterprises that essentially permitted greater self-management but failed to impose financial discipline, all of the reforming countries now share the central political goal of widespread privatization. Small enterprises — mostly in retail trade and services — are being privatized rapidly, mainly through local auctions. Few large-scale firms have been privatized to date, although many plans have been proposed and debated and many laws passed. One factor that promises to accelerate the speed of privatization — given the difficulty of directly abrogating acquired rights of self-management — is the imposition of firmer financial discipline on firms. More than 450 liquidation procedures are under way in Hungary, including 35 large industrial enterprises employing 57,000 and 11 large state farms and cooperatives. Large numbers of Yugoslav firms face liquidation proceedings, which are to be triggered after their arrears to banks or other firms reach 60 days.

Privatization has three key economic objectives: to improve efficiency, to spread ownership widely and fairly, and to raise fiscal revenues. Yet in the case of medium and large enterprises, there are clear tradeoffs among them. Sale of assets by the state may raise revenues but is likely to concentrate ownership in a few hands and to be so slow that efficiency gains are modest in the short run. Spontaneous privatization initiated from below (by managers or outside investors) might raise efficiency quickly but does little to spread ownership fairly or raise public revenues. Mass distribution of shares to the public may spread ownership quickly and equitably but may also compromise efficiency and raises no revenue for the government.

Experience to date in the countries of Central and Eastern Europe indicates that they are likely to follow different paths to privatization. This is due in part to differences in their starting points, including the political and social strength of various groups (including workers, the "nomenklatura," and former owners), the existing degree of decentralization, and the history of reform efforts. Not surprisingly, these differences are reflected in the legal frameworks for privatization.

In Hungary, the groundwork for privatization was laid by the October 1988 Law on Economic Association, which allowed state enterprises to "corporatize," that is, convert themselves into joint-stock companies. The Law also allowed enterprises to issue shares and individuals to buy them. For self-managed firms (about 70 percent of all enterprises), the decision to convert rested with enterprise councils. Because councils were generally dominated by management, this led to a spurt of spontaneous privatizations, often at advantageous terms for managers and outside investors they brought in. An interesting political coalition supported this process — economic liberals, who viewed spontaneous privatization as the quickest and easiest way to dismantle the state sector, and "nomenklatura," who saw in the process an op-

<table>
<thead>
<tr>
<th>Country</th>
<th>Share of value-added</th>
</tr>
</thead>
<tbody>
<tr>
<td>CSFR</td>
<td>97</td>
</tr>
<tr>
<td>GDR</td>
<td>97</td>
</tr>
<tr>
<td>USSR</td>
<td>96</td>
</tr>
<tr>
<td>Yugoslavia</td>
<td>87</td>
</tr>
<tr>
<td>Hungary</td>
<td>86</td>
</tr>
<tr>
<td>Poland</td>
<td>82</td>
</tr>
<tr>
<td>France</td>
<td>17</td>
</tr>
<tr>
<td>Italy</td>
<td>14</td>
</tr>
<tr>
<td>West Germany</td>
<td>11</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>11</td>
</tr>
<tr>
<td>Denmark</td>
<td>6</td>
</tr>
<tr>
<td>United States</td>
<td>1</td>
</tr>
</tbody>
</table>

portunity to acquire wealth. The Transformation Law of 1989 was designed to address some of the previous abuses of spontaneous privatization and to establish more rigorous oversight of the process. The State Property Agency was set up with a mandate both to limit undervaluation of assets when the privatization initiative came from below and to initiate privatization from above. By the end of 1990, the SPA had approved 64 of the 77 spontaneous privatizations proposed after September 1990. In addition, in September it presented its first list of 20 state enterprises to be privatized under its own initiative, and in December a second list of 20 enterprises was approved for "active" privatization. By combining supervised spontaneous privatization with SPA-initiated sales and sales initiated by investors, Hungary hopes to privatize up to one-half of state property over the next three years.

Hungary's path is different in two ways from that being proposed elsewhere. First, it is the only country that continues to support and rely heavily on spontaneous privatization from below. The other countries—most notably Poland but also to some extent Yugoslavia and Bulgaria—have tried to curtail the practice after brief experiences with its real and potential abuse. Second, Hungary (along with Yugoslavia and the former GDR) still rejects mass distribution of shares to citizens, relying exclusively on sales of assets. Some eminent Hungarian economists, including Janos Kornai, have argued strongly that the government has not only the budgetary need but also the fiduciary duty to the public to sell state-owned assets at the highest possible price. Opponents of sales argue in turn that valuation is inherently impossible and thus arbitrary, and, more important, that relying on sales will restrict ownership to those with money—primarily former "nomenklatura," black marketeers, or foreigners.

Poland started its privatization drive in a difficult position. Previous reforms in the aftermath of martial law had expanded the role of workers' councils. Ownership rights had become ambiguous; workers and managers argued that autonomous enterprises could enter into any kind of legally permissible contract and could issue their own shares to any investor including themselves. The wave of resulting spontaneous privatizations in 1989 provoked public outcry. In early 1990 the state tried to reclaim legal title to all assets in order to begin privatization from above, but it did not succeed entirely. After several months of parlia-

mentary debate, the State Enterprises Privatization Act was adopted in July 1990. It represents a compromise between different viewpoints: corporatization, and later privatization, can take place only with the consent of workers' councils. This law leaves intentionally vague the procedure of privatization, allowing practically all schemes: sales of entire firms, liquidation and asset sales to private parties, free distribution of shares to citizens, and establishment of holding companies to own shares. The latest Polish plan envisages sales of a number of the largest firms and mass distribution of ownership interests in hundreds more. Whatever the model selected, employees can buy up to 20 percent of shares at 50 percent discount. Foreign investors can acquire up to 10 percent of shares without explicit authorization of the government. A Ministry of Ownership Change has been established to oversee the process and specialized financial institutions set up to facilitate it. The sale to the public of five enterprises, completed in January 1991, was deemed a moderate success. After a three-week extension of the offer period, a total of 100,000 people applied to purchase shares, and the issues for four of the five companies were oversubscribed. A second group of companies to be sold in this manner will be announced shortly. In addition, several large companies have been sold to foreign enterprises, and the assets of some 200 more have been sold after liquidation of the enterprises.

The major challenge in any mass distribution is to spread ownership widely while maintaining some concentrated corporate governance capability. The various means proposed to achieve this in Poland and elsewhere all envision the establishment of some sort of intermediary to hold shares in trust for the public (see box 2.1 for one Polish plan). In the various plans the intermediaries can be either public or private. They are charged with passively managing their portfolios as mutual funds, actively overseeing the firms as holding companies, or restructuring and selling them more in the spirit of privatization agencies.

Although the other reforming countries also support rapid privatization, plans are not as advanced as in Poland and Hungary. The CSFR and Romania join Poland in favoring mass distributions. The CSFR's legislature has just passed privatization legislation that calls for widespread distribution of assets via vouchers as well as some sales of shares or individual assets (upon liquidation). Romania's law, passed by the legislature in
Box 2.1 A recent privatization plan for Poland

One innovative privatization plan for Poland envisions giving away a large share of state assets through several "auctions." For each auction, vouchers would be distributed as follows: 30 percent to the public, 20 percent to the pension system, 10 percent to commercial banks, and 10 percent to workers; 30 percent would be held in reserve by the government. Any intermediary (such as a foreign joint venture) that wanted to enter would be allowed to advertise for vouchers, and citizens holding vouchers would entrust them to the intermediary of their choice. Intermediaries would then use their vouchers to bid for the block of firms offered at that particular auction. To ensure some concentration of ownership, 20 and 30 percent blocks of shares in each company would be bid first. To provide sound incentives to the intermediaries, they would be paid in proportion to the appreciation of the assets they held. Although the public would have little information on which to base a choice of intermediaries in the first round, several auctions would be held over time, providing the public with increasing information on intermediary performance. The intermediaries would develop into financial institutions, and every company would have widespread ownership and yet some locus of oversight and control. Essentially, the task of privatization would itself be privatized, with government removed from the process.

Some observers have criticized this plan as too complex (Sachs 1991). They suggest a simpler variant, in which minority interests in state companies would be equally distributed among several mutual funds. Citizens would then be assigned ownership interests in the funds on a random basis. Remaining shares not distributed to the funds would be given to banks, pension funds, and workers.

September 1990, proposes to distribute 30 percent of enterprise assets to the public at large and sell any remaining assets not specifically designated to remain state-owned. Bulgaria has produced five draft privatization laws, although no clear goals or strategy have emerged. It was previously one of the most centrally planned economies, and changes may proceed relatively slowly.

Yugoslavia has had to deal with the most firmly entrenched worker self-management of all the reforming countries. Its strategy has been to try to remove self-management rights while simultaneously providing firms with the legal means to sell assets, preferably to their work forces (at a discount of up to 70 percent). The 1988 Enterprise Law and the 1989 Law on Social Capital limit self-management rights and allow self-managed firms to be transformed into joint-stock companies at the initiation of workers' councils. Initial results have been disappointing; few sales have taken place and Development Funds supposed to oversee privatization and receive a share of the proceeds are only now being created. The role of these Funds differs widely by republic. The Serbian Fund, for example, intends to concentrate more on restructuring, while the Fund in Slovenia intends to work exclusively as a privatization agency, valuing and selling assets as rapidly as possible.

Claims of former owners have complicated the privatization process, particularly in Hungary, the CSFR, and the former GDR. The ruling coalition in Hungary agreed in July 1990 to a "reprivatization" law for agricultural land, which gave owners dispossessed in 1947 the right to 100 hectares each. It also gave workers on cooperative or state farms the right to buy land at reduced prices. The law was approved by Parliament but was declared unconstitutional because it discriminated against other former landowners. Current plans are to provide compensation in money rather than in kind. In the CSFR, a law passed in late 1990 provides for reprivatization of some 70,000 properties nationalized in the late 1950s, although how to do this is uncertain. The German privatization program is being severely complicated by more than one million property restitution claims filed by private individuals, plus 15,000 filings by local governments.

All of these countries are formulating privatization plans in an environment of tremendous political, legal, and institutional change and uncertainty. Although some of the most optimistic plans call for privatization of up to half of state assets in as little as three years, most observers expect the process to take far longer and to be fraught with difficulty along the way. Sales are inherently slow, and mass distributions, though attractive in principle, may be difficult to implement in practice. It is clear that many enterprises will remain in state hands for some time to come, especially in the troubled heavy industrial sectors. If left alone in this atmosphere of uncertainty, the enterprise sector will do little to restructure. Although traditional state planning and control may be undesirable, active government involvement in operating and restructuring enterprises is clearly needed.
Annex 3 Agriculture

Agriculture presents some of the most challenging issues in the transition. Agricultural sectors in CEE are quite large; for example, the sector employs 28 percent of the Polish labor force. Retail food prices have historically been held down by subsidies deeply embedded in political and economic relations. Changes in agricultural price policies and in property rights over land — another very sensitive issue — will affect income distribution and the future productivity of the sector.

The prereform legacy

The CEE countries constitute a large and diverse agricultural region. In the northern countries grains, roots, livestock, and specialty crops dominate production. In the center, warmth and moisture are adequate for maize, oilseeds, and mixed grain and livestock farming. Farther south, viticulture, orchards, and tobacco become more important, as does irrigation. Although these countries in the past shared a common ideology, differences in inherited agricultural policy, performance, and farm organization are substantial.

Large state and collective farms dominate the region's agriculture. Poland (with 75 percent of land privately owned) and Yugoslavia are exceptions. Although members of the collectives formally hold title to their land, there is in practice little difference between collective and state farms, and both types are protected by soft budget constraints. Most private production takes place on small plots of about one-half hectare with nonlabor inputs and services supplied by the large farm. There is thus a symbiotic, if inefficient, relationship between these two dualistic components of production.

Income per capita in agriculture (including earnings from private activities) is on average relatively high. Yields of grains and field crops are lower than in Western Europe but comparable to those in many parts of the world. Productivity in the livestock sector is often low by world standards. Because of subsidized consumer prices (especially for meat and dairy products), national food consumption is high in relation to per capita income (see table 3.1). Price subsidies have typically equalled about 5 percent of GDP in CEE countries. In the USSR, they account for up to 12 percent of GDP. Because other necessities such as housing are subsidized even more, food accounts for about one-third of household budgets.

Agroindustry is highly concentrated in most countries, and huge state monopolies dominate processing, distribution, and supply of inputs. The degree of vertical integration between processing and production varies; in Hungary, many cooperatives have processing enterprises. CEE agroindustry is hampered by poor incentives, price controls, and low investment levels, and the quality of much processed food is below that required on competitive world markets.

The challenge for reform

Price reform and agroindustry linkages. As in other sectors, reform of agriculture involves liberalizing prices and markets, defining and changing property rights, restructuring at all levels, and defining a new role for government. Price reform involves reducing or removing subsidies and so is consistent with macroeconomic stabilization. Even if compensated partially through transfers, increases in relative food prices tend to reduce demand. Especially because of the monopolistic position of processors, this fall in demand can place pressure on farm incomes, which cannot speedily be alleviated by turning to export markets because of the weaknesses of the processing industry. Producers are hostage to the pace of change in processing, marketing, and distribution, and structural reforms in these areas are therefore of the highest priority. Deconcentration of plants and the introduction of competition (for example, through expanding small-scale private transport) are essential.

Property rights. The definition and distribution of land property rights affects producers' incentives to manage land efficiently and invest in its future productivity. How best to restructure property rights in the case of the large state and collective farms is a complex question. A range of options exists, including transforming them into true cooperatives, expanding individual landholdings while maintaining a cooperative core, or shifting entirely to individual private farming or long-term leaseholds. The need to create smaller commercially viable farming units is widespread (except in Poland and Yugoslavia, where efficient farming may require some consolidation of small
<table>
<thead>
<tr>
<th>Country</th>
<th>Calories per day</th>
<th>Protein (grams per day)</th>
<th>Meat</th>
<th>Milk a</th>
<th>Eggs b</th>
<th>Potato</th>
<th>Grain and bread</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unweighted average for 12 OECD countries c</td>
<td>3,324</td>
<td>98</td>
<td>79</td>
<td>134</td>
<td>14</td>
<td>75</td>
<td>8</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>3,634</td>
<td>106</td>
<td>77</td>
<td>250</td>
<td>10</td>
<td>33</td>
<td>144</td>
</tr>
<tr>
<td>Czechoslovakia</td>
<td>3,473</td>
<td>103</td>
<td>86</td>
<td>239</td>
<td>14</td>
<td>78</td>
<td>111</td>
</tr>
<tr>
<td>GDR</td>
<td>3,800</td>
<td>113</td>
<td>96</td>
<td>-</td>
<td>12</td>
<td>143</td>
<td>99</td>
</tr>
<tr>
<td>Hungary</td>
<td>3,541</td>
<td>102</td>
<td>77</td>
<td>175</td>
<td>13</td>
<td>54</td>
<td>110</td>
</tr>
<tr>
<td>Poland</td>
<td>3,298</td>
<td>102</td>
<td>67</td>
<td>403</td>
<td>9</td>
<td>143</td>
<td>118</td>
</tr>
<tr>
<td>Romania</td>
<td>3,358</td>
<td>104</td>
<td>60</td>
<td>-</td>
<td>12</td>
<td>-</td>
<td>143</td>
</tr>
<tr>
<td>Yugoslavia</td>
<td>3,542</td>
<td>102</td>
<td>55</td>
<td>-</td>
<td>7</td>
<td>51</td>
<td>175</td>
</tr>
<tr>
<td>USSR</td>
<td>3,394</td>
<td>106</td>
<td>62</td>
<td>295</td>
<td>10</td>
<td>104</td>
<td>133</td>
</tr>
<tr>
<td>Average</td>
<td>3,505</td>
<td>106</td>
<td>73</td>
<td>272</td>
<td>11</td>
<td>87</td>
<td>129</td>
</tr>
</tbody>
</table>

a. For OECD countries, excludes processed dairy products. For CMEA countries, includes milk equivalent of all dairy products.
b. For CMEA, converted to weight at four kilograms/100 eggs.
c. Data for calorie and protein intake are for 1984-86.


farms). No single solution is ideal due to the diversity in local conditions across the countries.

Several countries are moving to privatize state-owned or cooperative land. Poland has expressed the desire to restructure its state farms (which account for 25 percent of landholdings) and to break up some and distribute their land to individuals, but procedures for doing so have not yet been worked out. Bulgaria and Romania passed land reform laws in early 1991 that provide for the breakup of collective farms and the return of land to private ownership. In each country claims of prior owners will be honored, although the land returned will not necessarily be that taken away at collectivization. Many questions remain with regard to implementation in each case. Hungary has also recognized claims of prior owners of agricultural land, but they may be discharged through monetary compensation rather than in kind.

There has not been widespread discussion on how to coordinate land reform and the more general privatization of state assets. Although the approach to property rights in land should be consistent with property rights in other assets, land should not be owned by widely dispersed absentee shareholders as industrial enterprises would be under the various voucher plans now under consideration (see annex 2). Therefore, neither state nor collective farms should be included in the portfolios of any intermediaries that may be established to “invest” vouchers or hold shares in individual enterprises on behalf of the public.

Employment. Hidden unemployment in the agricultural sector appears to be substantial. This can be partially alleviated through attrition and retirement, as many workers are older than 55. The reassignment of property rights toward private farms that use more labor would increase both labor intensity and productivity. If the creation of smaller farms and improved incentives (through decollectivization, leasing, or privatization of land) should stall, agriculture will not be able to absorb additional labor. The underdeveloped rural service sector as well as a revitalized processing industry offer longer-run prospects for employment growth. There are ample opportunities for technical assistance in this area, including assistance to develop rural finance and export capability.
Progress to date

Retail food prices were liberalized in Poland in August 1989. As real incomes declined and expenditures shifted, food consumption is estimated to have fallen by 10-15 percent, even though the share of food in total household budgets rose from 39 percent to 45 percent. At first producers withheld stocks from the market because of price uncertainty, but excess supply soon replaced shortage. Polish agroindustry is highly concentrated and its restructuring has barely begun, although the scope of private marketing and transport has increased. The CSFR has undertaken price reforms, but its agriculture, like that of Bulgaria and the former GDR, remains highly collectivized. Its processing sector is monopolized and technologically ill-equipped. Hungary's agricultural sector has undergone many changes over the last three decades but is also still largely collectivized. Its processing and input supply industries are still concentrated and are frequently linked with primary production on large farms. As in other countries, the reorganization of property rights in Hungary requires the separation of most processing and rural services from production in order to foster more competitive markets. Romania's announced plan to privatize agriculture would, if implemented, constitute the most dramatic decollectivization program to date. Yugoslavia has many private producers, but they are constrained by processing and distribution systems that favor the socialized sector. In the region as a whole, there has been little progress to date in land reform.

A comparison with China

Decollectivization of agriculture and the growth of rural industries fueled a period of dynamic economic growth in China's countryside after 1978. Although the potential payoff to agricultural reform in CEE countries is high and the supply response may be substantial, agriculture in these countries cannot be expected to play so dramatic a role as it did in China. One difference is technological. Agriculture in CEE is far more dependent on modern services and processing facilities than in China, and restructuring these areas will take time.

A more fundamental difference arises on the demand side. Reforms in China increased the demand for food. Rural incomes rose sharply, and this added to demand for simple manufactured consumer goods and services. These could be produced relatively rapidly using surplus labor released by the reforms and savings generated by the higher incomes. In CEE, the majority of the population is no longer rural or employed in agriculture, and it is likely that the demand shock caused by the removal of food subsidies will initially dominate productivity effects on the supply side and dampen farming incomes. Land reforms in CEE are therefore more complex than in China, and, because linkages do not operate as strongly — or even in the same direction — as in China, they are not expected to have the same power to generate economic growth.
Annex 4 Financial system reform

In a market economy the financial sector stands at the center of resource mobilization and allocation and the pricing and allocation of risk. In a planned economy intermediation is largely performed through the fiscal system, with a simple and passive financial system ignoring risk and accommodating to the credit demands of the plan. Financial sector reform and development is therefore vital for system reform and must be addressed at the outset. Indeed, all of the CEE countries have placed financial system reform high on their agendas and are actively implementing or designing reforms.

Experience to date suggests that the absence of a market-based financial system is costly even in the initial stage of macroeconomic stabilization, because no effective channel exists to assure that macroeconomic policies — in particular, tight credit — improve resource allocation at the micro level. The limited structural change that has accompanied restrictive demand policies in Hungary, Poland, and Yugoslavia is at least partly attributable to the underdevelopment of their financial systems.

Nevertheless, financial system reform is not an adequate lever to force the pace of overall restructuring of the productive sectors. Fully liberalized financial markets and privatized intermediaries operating under tight budget constraints probably come later in, rather than at the start of, the reform agenda. Financial reform poses a number of unresolved issues, some of which have not been extensively analyzed.

The prereform legacy

The financial systems of most planned economies consisted of a central-cum-commercial bank servicing enterprises, a savings bank accepting household deposits and lending to households largely for mortgages, a foreign trade bank handling all foreign exchange activities, and an insurance company. All were state-owned. Interest rates were typically very low, often lower on the deposit side for firms and on the lending side for mortgages. Surplus funds in the savings bank were normally channeled through the central bank toward the enterprise sector. Risk management and pricing and prudential considerations played no role in the allocation of funds, in regulation and supervision, and in the organization and flows of financial information. Accounting standards did not conform to generally accepted principles, and there was no tradition of independent audit. The legal frameworks covering central and commercial banking activities, securities markets, and the clients of the financial intermediaries were generally inappropriate to a market-driven system.

From the late 1980s the CEE countries began to modify this structure by carving commercial banking activities out of the central bank and transferring them to new commercial banks. These banks are still government-owned except in Hungary, where enterprises hold almost 50 percent of their shares, and in Yugoslavia, where enterprises have a large ownership interest. De facto regional or functional specialization and restriction of clients to the use of a single bank have, in practice, severely limited competition between these banks. Although the new banking laws typically allow the banks wide scope (following the universal model) and permit entry of new banks, financial systems are relatively undeveloped. Poland, for example, has only one bank branch per 40,000 people, compared with one per 10,000-15,000 people in Western Europe. The financial sector accounts for only 0.9 percent of employment, its ability to handle large volumes of transactions is limited, and clearing is slow by the standards of market economies.

Yugoslav banking evolved in a different pattern. The breakup of the monobank system in 1971 led, by 1988, to some 360 banks, usually owned by groups of associated self-managed enterprises that were also their major clients. The central banking system consisted of the National Bank of Yugoslavia and eight regional National Banks.

Foreign exchange deposits grew substantially in the 1980s in Yugoslavia and in Poland. Responsibility for foreign exchange liabilities in the CEE countries generally rested with the central bank or the foreign trade bank, because other banks had no foreign-denominated loans on their books. Devaluations were therefore to impose serious exchange losses corresponding to those liabilities. In Yugoslavia, the valuation losses carried on the books of the National Bank have been estimated at 60 percent of total assets, and those of Bank Handlowy in Poland at some seven times its capital.

Another serious legacy of the past was the accumulation of decades of losses from the enterprise sector and from subsidized household mort-
gage loans in bank portfolios. Those losses arose during periods of slow growth but relatively high investment. Comprehensive estimates of losses are not yet available for any country, and indeed, the full size and distribution of losses will continue to evolve (and almost certainly to worsen) as the economies adjust to reforms (including that of the CMEA system). In certain countries inflation has eroded the burden of domestic debts, but in others the available fragmentary information paints a frightening picture. It is probably safe to assume that proper asset valuation would leave many banks in the reforming countries with negative capital, sometimes several times over, and that in some cases losses could compare to those experienced in major financial crises elsewhere. Considering mortgage finance alone, in 1989 the interest rate subsidy implicit in the stock of low-interest loans in Hungary was 2.3 percent of GDP.

Nonbank finance has been limited in the CEE countries, with the exception of interenterprise credits, which increased in the 1980s with enterprise autonomy. Interenterprise credits grew rapidly through the 1980s in Yugoslavia and exceeded bank credits to enterprises in Poland by mid-1990. They also increased sharply in Hungary when tight monetary policy was implemented after 1988. Although their growth has to some extent reflected that of normal commercial relationships, the absence of risk-based checks to the expansion of such credits (especially because of the prevalence of monopolistic trading links) renders them an impediment to macroeconomic stabilization and to the rationalization of the enterprise sector. They also increase the risk of systemic insolvency. Securities markets began to develop in the late 1980s, but their wider role has been stifled by the absence of clear ownership rules and operational bankruptcy procedures.

A framework for financial sector reform

Financial sector reform in CEE countries is more complex than in market economies, as it involves reshaping and to some degree recreating the sector rather than just liberalizing it. In the area of banking, existing payments systems are technically and organizationally inadequate and need extensive upgrading. Interest rate policies must be revised and the taxation of intermediation reviewed. Instruments to mobilize funds must be enhanced and credit skills developed. Banks and their clients need adequate information systems and independent auditing, as well as a suitable legal framework for debt recovery and other purposes. Governments must develop prudential regulation and supervision for financial institutions that is compatible with competition. Finally, mechanisms to control monetary aggregates are vital during the transition, but it is impossible to have effective macroeconomic control without resolving problems of monetary overhang, government and enterprise deficits, the proliferation of bad debts, and the generation of foreign exchange losses.

Many unresolved issues concern the future structure of the system. Although governments have given much thought to privatization in general, they have given much less to the ownership of banks. Present arrangements, in which the banks are often owned by the central bank or by large clients, are questionable. They conflict with the central bank's regulatory role and promote insider lending and monopolistic practices. The alternative of grouping banks and enterprises together into holding companies (the arrangement in Algeria) could also raise difficulties. It would be preferable for major financial institutions to be owned initially by special investment trusts on behalf of the public, and for these later to be privatized.

Considering the reverse question, the ownership of firms by banks, most of the CEE countries are adopting banking models that permit this more readily than in most industrialized countries. These models require careful consideration; the corporate governance problem is not likely to be ameliorated by granting ownership rights to bankers who have relatively little experience with modern market institutions.

Another issue concerns the separation of banking and other financial services, such as underwriting, trading, and investing in securities and insurance. Historically, the major industrial countries have maintained considerable specialization among intermediaries, although with recent trends universal banks now offer a wide range of such services in about half of the G-10 countries. Allowing banks to provide a broad range of services can be problematic in an emerging financial system, as both the management and supervision are more difficult for universal banks than for specialized institutions.

The banking structures being put in place in certain countries also raise the question of the future contestability of financial markets and the
scale and management quality of intermediaries. On the one extreme, most lending in Czechoslovakia will be concentrated in two regionally specialized institutions. On the other, there are so many banks in Bulgaria and Yugoslavia that good management may be hard to find and scale economies may be lost. A related question is how best to integrate corporate lending and retail deposit-taking. Governments might want to break up savings banks and integrate their branches with the major commercial banks. There are alternative models, and the choice might differ among countries.

The development of securities markets is important given the desire of the CEE countries to privatize ownership, develop competitive financial markets, and fund government and enterprise deficits in a noninflationary way. However privatization is conducted, the initial distribution of shares is likely to be different from the desired longer-run distribution, and well-functioning secondary markets for securities may thus be vital. Furthermore, as individuals assume greater responsibility for their own pensions and disability insurance, efforts should be made to develop contractual savings institutions. This might be linked with the process of privatization, if pension liabilities are assigned to holding companies set up as enterprises are privatized.

Legal and institutional changes to address many of these areas are under way. Governments are rewriting central and commercial banking laws and establishing the infrastructure to regulate and supervise the new commercial banking systems. Major investments in human capital are needed, both in prudential regulation and supervision and in commercial banking (particularly credit analysis). Institutes to provide training in these areas have been established in Hungary, Poland, and Yugoslavia, in all cases with foreign involvement. Governments and consultants are revising information systems, introducing standard accounts, and initiating independent audits. Hungary, the most advanced of the CEE countries in financial sector reform, is creating an interbank clearing system with major investments in information technology.

Reform requires fundamental changes in attitude and extensive development of scarce skills. These take time to implement and therefore should be addressed from the outset of the reform program. To the extent possible, they should be pursued through the periods of setbacks and reversals that inevitably will accompany the reform process. Foreign banks are extensively involved in assisting institutional reforms, primarily on a consulting basis although some joint ventures exist.

One of the most pressing transitional issues is how to address the problem of existing portfolio losses. Bank and portfolio audits as well as institutional diagnostic studies are well advanced in Hungary and are proceeding in Poland and Yugoslavia. In the interim, progress has been slow in dealing with problem loans, due partly to the lack of incentives for intermediaries to recognize loan losses. A range of holding actions can be mandated to limit growth in the banks' exposure to problem borrowers. However, long-term solutions are dependent on further progress in the broader economic reform program. If banks are placed under a hard budget constraint (or privatized) before they are adequately capitalized, perverse incentives will result. Yet the restructuring of loan portfolios and recapitalization of banks cannot be finalized prior to reforms in the productive sectors and adjustment to major shocks (such as the end of the CMEA system), as these will have a large impact on the ability of firms to service loans in the future. In the meantime, there is little social value in pushing any of the state-owned banks into bankruptcy, given their crucial role and the need to expand financial services. Furthermore, caution is needed on the entry of new or foreign intermediaries while existing banks carry a heavy burden of bad debt that limits their ability to compete.

Three important issues arise with regard to the handling of problem loans during the transition. The first is the role of banks in debt recovery. In most versions of financial restructuring, problem loans are carved out of the bank portfolios and replaced by interest-yielding government bonds, thus transferring the loss to the treasury. The loans themselves are either placed in a special trust, staffed by specialists who will recover bad assets, or left (below the line) with the banks, which then act as agents of the treasury to recover assets. Each option has advantages and drawbacks, and the choice will depend on a variety of country-specific legal and institutional factors, as well as on the availability and distribution of scarce skills in the area of workouts and restructuring. The outcome of the process is a “clean” bank, which, when adequately capitalized, can compete actively and possibly be privatized.
The second near-term issue is the distribution of the losses, which represent a quasi-fiscal deficit. There are five choices: (1) monetary reform, involving confiscation of a portion of financial claims, (2) money creation, (3) tighter fiscal policy, (4) public borrowing, and (5) the sale of public assets. In practice, some mixture of these last four will probably be used. The likely extent of the losses may justify earmarking government revenues from asset sales rather than including them in general revenues.29

The third issue involves finance in the interim. Until the banks have hard budget constraints and are responsive to competitive pressures, they might not have the incentive to seek out and develop new clients, particularly in the rapidly emerging smaller-scale private sector. Yet the experience of other countries suggests that these smaller private clients will be the most vulnerable to tightening credit policy. Addressing this problem without segmenting financial markets may become an important issue as private sectors develop, and the experience of other countries should be reviewed to determine the most appropriate ways of dealing with it.

Real interest rates have been raised to positive levels in most CEE countries, but the experience of financial sector reform elsewhere suggests that full interest rate liberalization requires reasonable macroeconomic stability, a sound and competitive financial system, and an effective system of prudential supervision and regulation. Guidelines such as minimum deposit and maximum loan rates are likely to be needed for some time after price liberalization, and these should be carefully monitored to maintain savings incentives and reasonable intermediation spreads.
Annex 5 Fiscal policy

The CEE countries face enormous challenges in reforming fiscal policy. They need to maintain fiscal balance for stabilization while reducing and reorienting both public spending and taxation. Public spending should focus less on potentially competitive activities in industry and agriculture (most of which will in time revert to the private sector) and more on the provision of public goods, including basic infrastructure, social services, and well-functioning legal and regulatory institutions. Taxation should be more transparent and should create incentives for efficient production and consumption. Although the overall size of the public sector should shrink, some central institutions of government — including those in charge of budgeting and tax collection — need to be strengthened.

Size and balance of the government budget

Because of their large budgets, central governments were the major financial intermediaries in the CEE socialist economies. During the 1980s the consolidated state budgets accounted on average for roughly 60 percent of GDP in these countries, except in Yugoslavia, where the consolidated budget accounted for roughly 35 percent of GDP. However, official budget data convey only partial information on the pervasive role of government, since public intermediation and redistribution can also be accomplished through the banking system or direct regulation (such as price and wage controls or regulation of enterprise investment).

Several CEE countries experienced deteriorations in their fiscal balances in the late 1980s, and all have taken recent steps (primarily subsidy reductions and in some cases revenue increases) to improve them. Because of rising subsidies and declining real revenues during hyperinflation, Poland’s 1989 deficit was almost 8 percent of GDP, compared with less than 1 percent during 1983-88. After stabilization in 1990, the budget went into surplus. Hungary’s deficit was about 3 percent of GDP in 1986 and 1987, before falling to only about 1 percent in 1988 and 1989 (due to increasing revenues in 1988 and subsidy cuts in 1989) and being more or less in balance in 1990. Bulgaria’s deficit rose to over 6 percent of GDP in 1988, before falling to about 3 percent in 1989. The CSFR faced a more modest but still significant deficit of 1.5 percent in GDP in 1989 but expected to register a modest surplus in 1990. Only Yugoslavia and Romania consistently achieved fiscal surpluses in the late 1980s.

Budget deficits were only one of several factors affecting macroeconomic stability in these countries. In Yugoslavia and Poland, for example, enterprises were extensively subsidized by the banking system through low-interest loans. These subsidies, although contributing to monetization and thus inflation in the economy, were outside the budget altogether. In fact, in 1989 Yugoslavia managed to have hyperinflation and a budget surplus at the same time.

Public spending

Investment. One of the key features of socialist economies was the high share of fixed investments in GDP, typically exceeding 30 percent and sometimes as high as 40 percent. The great bulk — 80-90 percent — was controlled by the public sector, whether government or state enterprises. Although not all of this investment went through the budget, the government was often involved in major investment projects of state enterprises. Indeed, one of the main advantages of socialist systems was considered to be their ability to realize high planned saving and investment levels and thus lay the groundwork for rapid growth. High investment was also stimulated by the “investment hunger” of semiautonomous enterprise managers with access to cheap credit and with little fear of bankruptcy if investments turned out to be unprofitable.

Many public investments were of poor quality. Projects were usually large, took a long time to complete, and often suffered cost overruns in part due to waste and pilferage. Investments were oriented toward heavy industry; social infrastructure, consumer durables, agroindustry, housing, and services were relatively neglected (although investment in these areas, particularly housing, increased somewhat in the 1980s).

The major challenge of public investment reform is to reorient spending and improve its efficiency. While investments in potentially competitive sectors can be increasingly left to the private sector, public investment is urgently needed to upgrade deteriorating basic infrastructure, including roads, ports, public transportation, telecommunications, irrigation facilities, and other rural systems. Investment is needed to increase energy efficiency and to switch progressively to
cleaner and safer sources than the high-sulfur coal and nuclear power on which the CEE countries now depend. There is a risk that these countries will overreact to the centralization of the past by reducing much-needed investments in "public goods" that complement private investment.

Subsidies. Subsidies to consumers and enterprises typically accounted for a large share of budgetary spending in socialist economies (see figure 5.1). In 1989, direct budgetary subsidies equalled 11 percent of GDP in Poland and Hungary, 16 percent in the CSFR, and 15 percent in Bulgaria. Consumer subsidies in CEE countries were generally on basic commodities (bread, milk, meat, sugar, heating fuel, pharmaceuticals) and services (rental housing and mass transport). For example, in the late 1980s Polish consumers had to pay only one-fifth of the production cost of milk, central heating, and state-owned rental housing; the price of medicines did not change between 1971 and 1989. Enterprises received both input-specific subsidies (for example, on coal) and ad hoc grants. Export subsidies were also common.

Figure 5.1 Consolidated government expenditures in Eastern Europe as share of GDP, 1982-90

Note: Figure shows unweighted averages for Bulgaria, the CSFR, Hungary, and Poland.
1 Includes pension, maternity benefits, sick pay, and the newly introduced unemployment benefits.

oriented either to CMEA trade (to assure the fulfillment of centrally negotiated contracts) or to convertible currency trade (to compensate for overvalued exchange rates).

A major objective of consumer subsidies was to provide basic goods at low cost and thus reduce disparities in real income. Indeed, some subsidies on basic goods modestly furthered this goal. However, the benefits of certain subsidies, including those on railway transport and culture, tended to be skewed toward higher-income groups, and the high-priced black market trade that accompanied price controls generated its own income differentials. The negative effect of subsidies on resource allocation has also been widely documented. The low cost of energy, for example, encouraged overconsumption, which led to environmental degradation and overinvestment in the energy sector. Furthermore, low prices led to long queues, hoarding whenever cheap goods were available, and forced financial savings (if unable to purchase subsidized goods) that reduced work incentives.

Poland was the first CEE country to take decisive moves to eliminate consumer price subsidies, reducing most food subsidies in August 1989 and trimming or eliminating subsidies on many other goods and services (including transportation, energy, and housing) in early 1990. The share of subsidies in GDP decreased from 14 percent in 1988 and 11 percent in 1989 to an estimated 6 percent in 1990.

Hungary has also moved quite rapidly since 1989, when the government adopted a four-year schedule to phase out consumer price subsidies and transfers to enterprises. In 1990 total subsidies equalled about 9 percent of GDP, down from about 13 percent in 1989, and a target of 6.8 percent is included in the 1991 budget. The CSFR eliminated most consumer subsidies with its price liberalization on January 1, 1991, and Romania took steps in October 1990 to reduce subsidies by freeing some consumer prices. Subsidies to loss-making firms still exist, however, in most CEE countries.

While most CEE governments are strongly committed to further cuts, some subsidies are likely to remain for some time. Phasing out housing subsidies is particularly difficult in the short term; renters cannot easily shift to other housing given the thin housing markets, and compensating an increase in rents with direct cash transfers presupposes the existence of a functioning welfare system. Phasing out subsidies to firms ("hardening" their budget constraints) should proceed in tandem with enterprise restructuring and privatization.

Social services. Social indicators in CEE countries are low compared with Western Europe but relatively high compared with other countries at
similar levels of per capita income. However, health statistics have been deteriorating in recent years, and poverty-related diseases such as jaundice and tuberculosis are on the rise. Furthermore, educational curricula have been overly specialized (sometimes on obsolete skills), as dictated by a planned system. Many subjects indispensable to a market economy, such as accounting, management, marketing, and finance, have been neglected.

The CEE countries need to reorient public spending on social services both to increase quality and to improve incentives. In the area of health, for example, medical insurance systems should be developed, subsidies on pharmaceuticals reduced, and eligibility for sickness benefits (liberally granted in the past) tightened. The development of private alternatives in service delivery and funding for both health and education should be encouraged.

Taxes

Taxes had no independent role in traditional centrally planned economies. The government set prices of inputs and outputs and wage rates. Taxes (primarily on turnover, company "profits," and payroll) transferred any surplus to the state. As socialist firms gained greater autonomy in the 1960s and 1970s, taxes began to take on an independent role as needed to induce greater efficiency or substitute for the reduction in central controls. Profit tax rates became somewhat more uniform in an attempt to spur efficiency, and turnover taxes became more differentiated as tools to regulate prices. Taxes on capital (or "dividends") tried to simulate capital markets by requiring a certain rate of return on assets, and taxes on "excess" wages tried to impose wage discipline in the absence of private owners and a fully functioning labor market. Similarly, special taxes captured rents arising from CMEA trade. Any incentive effects of these various taxes tended to be muted, however, by the ad hoc, discretionary, and individually negotiated nature of tax liabilities.

The discretion of authorities to change tax rules at will — often after profits had been made — was both a major cause of the soft budget constraint of firms and an important disincentive to improved performance by firms.

Tax reform is closely intertwined with economic reform. On the one hand, reforms tend to eliminate many of the traditionally important sources of revenue. Changing relative prices affects turnover tax revenues. Increased domestic and international competition reduces monopoly rents and the tax revenues that result from them. Privatization reduces government control over once-captive taxpayers and may require a reduction in formerly confiscatory tax rates. To avoid a precipitous fall in revenue, governments must compensate for these effects by broadening their tax base. On the other hand, many tax instruments common in market economies are not useful until reforms occur. A value-added tax makes little sense when prices are controlled, and a personal income tax has little purpose when wage scales are set by the state. Similarly, rate-specific corporation taxes have little meaning in the presence of soft budget constraints.

Early tax reform is crucial now that the CEE countries are seriously pursuing broad economic reforms. Poland, Yugoslavia, Hungary, the CSFR, and (to a lesser extent) Romania have freed most producer and consumer prices. It is now both possible and desirable to introduce a broad-based VAT that will replace the distortionary and complex turnover tax system and serve as the "workhorse" of the revenue system, compensating for declining company taxes as firms are privatized. Hungary already introduced a VAT in 1988 (albeit still with extensive price controls). Poland is now in the process of designing a VAT, and the CSFR hopes to introduce one in 1992 or 1993.

Private sector development is being encouraged in all reforming countries. Reforms of income taxes become increasingly important as the private sector grows — to insure equal treatment, to set clear "rules of the game," and to make the tax system more transparent, predictable, and nondistortionary. Hungary reformed its personal and company income tax system in 1988 and 1989. Poland amended its company income tax law in 1989 to insure equal treatment of public and private firms, and it plans to introduce a global personal income tax in 1991. The CSFR and the USSR both introduced new company income taxes in 1990, the former to be phased in by 1992 and the latter to have taken effect in January 1991. Yugoslavia recognizes the need for tax reform, but plans are complicated by federal-republic disagreements about taxing authority. Romania and Bulgaria are beginning to consider tax reform options.

All of these countries must face the trade-off between revenue needs and the goals of efficiency and private sector development. The tax laws put in place so far have relatively high effective rates,
whether because of high statutory rates (for example, the 25 percent basic VAT rate in Hungary) or because of limits on deductions. Although these high rates protect revenues, high income tax rates can discourage investment and dampen economic activity. These countries must also face the trade-off between rate levels and targeted tax incentives; tax incentives sacrifice revenues unless compensated through higher general rates. All of Hungary's new taxes contain many targeted incentives (whether exemptions or reduced rates) to encourage certain activities or to protect certain types of income or consumption. These incentives are difficult to eliminate once granted; other countries would be wise to adopt the broadest possible tax bases and lower rates from the start.

Although tax reform is important early on, institutional constraints are likely to limit its effectiveness in the short run. The reforming countries are poorly equipped for the modern tax administration called for in a market economy. In socialist systems, tax administrators are part of the ownership and control structure of government, and they have unrestricted access to enterprise books and records. State enterprises are few and large, and the number of registered taxpayers tends to be relatively small. Tax administration in a market economy with many independent firms calls for different skills — for example, in accounting, selective auditing, dispute resolution, and tax enforcement — that will take some time to develop in the reforming countries.

Intergovernmental fiscal relations

The rise in regional political tensions in most of the CEE countries is mirrored in the difficulties they are now encountering in resolving pressures for fiscal decentralization. Local and regional authorities are seeking authority over an ever-increasing share of general government revenue. This is most pronounced in Yugoslavia, where the federal government controls only about one-third of general government revenue, primarily from indirect taxes and tariffs, and where some republics are now refusing to turn over indirect taxes collected by them. Bulgaria, the CSFR, Hungary, Poland, and the USSR are also facing increasing pressures for greater local fiscal autonomy. This issue has not been clearly resolved anywhere, although various concrete proposals are emerging. Hungary is perhaps the most advanced; its proposed reform involves transferring one-half of personal income tax revenues to the localities where they originated and shifting most revenue-sharing onto a capitation grant system based on a predefined formula. While some degree of fiscal decentralization is warranted, it is important to set clear and objective rules and to assure that local administrations have adequate budgetary and expenditure monitoring capacity. Some central safeguards (such as limits over foreign borrowing) are also needed to ensure macroeconomic stability.
Annex 6 Income distribution, poverty, and social safety nets

The socialist legacy

Perhaps the major accomplishment of the socialist systems of Central and Eastern Europe was the relatively equal distribution of income they attained. As indicated by the Gini coefficients in table 6.1, income distribution in Hungary, Poland, the USSR, and China was more equal than in market economies except Scandinavia in the 1970s and 1980s, and much more equal than in most middle-income developing countries. Yugoslavia's income distribution was slightly less equal than in the other socialist economies, mainly because of the great variation among republics. Within Yugoslav republics, income equality resembled that in the other socialist economies.

Low income inequality in socialist economies stemmed primarily from guaranteed employment and low wage differentiation in the state sector. Soft budget constraints and the tendency to hoard inputs, combined with government prodding to provide jobs, led firms to hire workers even when they had little use for them and to rely less on part-time jobs (which typically account for a sizable share of low-paid labor) than in market economies.

Low wage differentiation in the state sector (which, together with state pensions, accounted for 60-75 percent of total income) resulted from elimination of both very high and very low wages. At the top of the income scale, the relative pay of highly skilled professionals was lower than in market economies. For example, earnings in some professions that are among the highest paid in industrial countries — including doctors, engineers, and lawyers — were state-controlled and were notoriously low in socialist economies. Furthermore, the absence of a truly entrepreneurial role meant that one of the functions most strongly rewarded in market economies, entrepreneurship, was absent. Wage rates were generally guided by government-determined norms that imposed maximum ratios between pay of different grade levels or professions. Wages within worker-managed firms were influenced by the firm's labor force, whose dominant coalition generally preferred reduced wage dispersion. Profit equalization between firms reinforced egalitarian tendencies already present within firms to insure relatively equal wages throughout the economy.

The primary objective of enterprises in market economies is to maximize profits, while those individuals who for any reason remain outside the system become the responsibility of the state. In essence, firms in socialist economies fulfilled both economic and social functions. Even when firms gained more autonomy in Yugoslavia, Hungary, and Poland, they still had a social role, a "duty" to provide employment to alleviate social problems in their respective regions. Firms took an active role in providing social services to employees. Government's social protection role consisted primarily of administering state-run pension systems and generous programs of sick and maternity pay, and providing welfare benefits to marginal social groups, such as single mothers, the handicapped, and the chronically ill (including alcoholics and drug addicts). Such benefits were often provided in kind (such as hot meals, home nursing care, or clothes), as frequently happens with charities in market economies. Cash-based welfare systems were not well-developed.

Although rarely admitted by socialist governments, "cradle-to-grave" state paternalism failed to eliminate poverty. As economies slowed in the 1980s, a progressive decline in real wages and, to a lesser extent, real pensions led to growing poverty, especially in urban areas. Between 1977 and 1988, the percentage of people living below an unchanged, inflation-indexed official poverty line in urban areas increased from 8 to 21 percent in

Table 6.1 Gini coefficients for selected countries and regions

<table>
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<tr>
<th>Country or region</th>
<th>Gini coefficient</th>
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<tbody>
<tr>
<td>Hungary</td>
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<tr>
<td>Poland</td>
<td>24.3</td>
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<tr>
<td>USSR</td>
<td>25.6</td>
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<tr>
<td>China (urban)</td>
<td>23.9</td>
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<tr>
<td>China (rural)</td>
<td>23.1</td>
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<tr>
<td>Czechoslovakia</td>
<td>20.7</td>
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<tr>
<td>Yugoslavia</td>
<td>32.1</td>
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<tr>
<td>Eastern Europe</td>
<td>25.4</td>
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<tr>
<td>Latin America</td>
<td>49.5</td>
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<tr>
<td>South Asia</td>
<td>42.8</td>
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<tr>
<td>Asian NICs and Japan</td>
<td>38.3</td>
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<tr>
<td>Western Europe</td>
<td>31.4</td>
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<tr>
<td>United States</td>
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<tr>
<td>Sweden</td>
<td>20.5</td>
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<tr>
<td>Norway</td>
<td>24.3</td>
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both Poland and Yugoslavia, and from 10 to 17 percent in Hungary. The share of urban poor in the total poor population increased in Poland during the 1980s from 48 to 70 percent, and in Yugoslavia from 25 to 50 percent.

Reforming the social safety net

The transition to a market economy is virtually certain to lead to higher unemployment and somewhat greater income inequality. This requires a redefinition of the social safety net, in essence an "unbundling" of the economic and social roles previously assigned to enterprises. The main objective of enterprises should be efficient production, which not only generates economic growth but also protects existing jobs and creates new ones. Governments should be responsible for protecting vulnerable groups — whether the unemployed, the elderly, the disabled, or others left out of the productive economy — and providing (directly or indirectly) basic social services such as health and education. Individuals should in turn be responsible for finding jobs (with some assistance from the state) and keeping them through satisfactory performance.

Unemployment benefits. The most pressing immediate need is for government programs of unemployment compensation and retraining to ease the social costs of enterprise restructuring and privatization. Each country must choose among three basic concepts for calculating unemployment compensation: income-tested, earnings-related, or flat-rate. If income-tested and open-ended in time, unemployment compensation is essentially no different than other types of poverty relief. It is clearly targeted to those in greatest need and is therefore the cheapest alternative in terms of benefits provided.97 If earnings-related and limited in time, unemployment compensation resembles insurance.98 It protects newly unemployed individuals from a precipitous fall in living standard in the short run, and the time limitation avoids any disincentive to look for new work. It also avoids the "poverty trap" whereby other members of a household may decide not to take a job if it means a loss in unemployment benefits. However, because of the time limitation, it addresses primarily frictional or cyclical unemployment and not the kind of structural and long-term unemployment that may arise in the reforming countries (especially as heavy industry is restructured). Flat-rate benefits limited in time are favored by many observers because they avoid the disincentive effects of income-tested schemes and are the easiest of the three approaches to administer.

Of all the socialist economies of Central and Eastern Europe, only Yugoslavia has had a long history (dating back to the 1950s) of open employment and official unemployment insurance. Institutions to address the problems of newly emerging unemployment appeared in Hungary in January 1989, and one year later in Poland and Bulgaria. In all cases, the earnings-related insurance approach was chosen.

Polish unemployment rose from almost nothing to some 7 percent of the labor force during 1990, compared with rates of 1-2 percent in Hungary and Romania and less than 1 percent in Bulgaria and the CSFR. Only Yugoslavia's 9 percent rate was higher. In Poland, unemployment benefits were first offered in January 1990 as part of the reform package. They were open-ended in duration and were calculated as a declining function of the duration of unemployment. Although many of the "unemployed" were actually new entrants to the labor force (whether recent graduates or formerly nonworking spouses), almost all were by law eligible for unemployment benefits. Total income-maintenance and training expenditures amounted to 0.6 percent of GDP in 1990 — still low by Western European standards — and were financed by a special 2 percent wage levy and direct budget subsidies.

The Polish experience illustrates the problems accompanying the initial introduction of unemployment compensation in the reforming countries. First, the number of unemployed was underestimated, and the number of social centers and social workers has been inadequate from the beginning.99 Second, retraining was neglected due to its complexity. Labor offices concentrated almost entirely on registration of the unemployed and distribution of benefits; by August 1990, only 0.5 percent of those registered were undergoing training. Third, the initial design mixed the insurance and assistance principles by providing compensation linked to previous earnings (insurance) but open-ended in time (welfare). Proposed amendments in the Labor Law limit the duration of benefits to one and one-half years. A separate welfare system to be developed will in principle provide a minimum means-tested floor income open-ended in time. A similar solution was also
adopter in Hungary, where unemployment benef-

The introduction of unemployment compensa-
tion in Poland triggered a revision in the defini-
tion and role of the minimum wage and the social
minimum (or "poverty line"). Before 1990 the
minimum wage was purely an accounting con-
cept used for the establishment of wage scales.
Recently it has been raised to equal the official
social minimum (for one person in a four-person
household) and, as in mature market econo-
mies, has been set as an obligatory floor wage for
both the state and the private sector. The social
minimum, previously only an accounting con-
cept, has also gained new significance as the basis
for welfare claims.

The reforming countries need to avoid an overly
generous level of benefits that both discourage
active job search and create an enormous potential
budgetary burden. The generosity of some of the
existing plans may in part reflect political con-
straints, as the public may still not fully accept the
view that a reduction in job and income security is
an unavoidable part of the move to a market
economy. For example, in one Yugoslav republic
the benefit is 100 percent of the previous wage for
three months and thereafter 60 percent plus 1
percent per year of service (to a maximum of 90
percent). In another republic, the benefit is 80
percent of the previous wage. Workers can re-
ceive these benefits for up to two years — and
indefinitely after 25 years of service.

Welfare. Of all the CEE countries, Yugoslavia
has the most comprehensive social welfare scheme
targeted specifically at eliminating poverty.\textsuperscript{102} Although some other CEE countries (most notably Hungary) have established welfare programs in recent years (often at the local level), these programs are not true entitlements, that is, based on
transparent criteria, with assured funding of all
who qualify, and with regular administrative and
appeals procedures. In all CEE countries, other
social programs — whether unemployment compen-
sation, pensions, sick pay, and maternity leave — are all bearing some excessive burden that
should ideally be handled through poverty-ori-
ented welfare programs. Furthermore, pockets of
poverty untouched by any program remain. Given
the likelihood that unemployment will be high for
several years, and that income distribution will
worsen in the move to a market economy, broad-
ening the social safety net to include a more com-
prehensive income-tested scheme is an important
challenge for the future.

Pensions. Reform of old-age and disability pen-
sions is another critical complement to enterprise
restructuring and budgetary control. At present
all the reforming countries have state-run pay-as-
you-earn (PAYE) schemes in which pensions are
financed out of current contributions. Pension
expenditures are quite high, necessitating high
contributions,\textsuperscript{103} in part due to the demographic
profile and in part due to generous eligibility
criteria. The retirement age in most of the reform-
ning socialist countries is 60 for men and 55 for
women, compared with the OECD average of 64
for men and 62 for women. In addition, pension
formulas are biased toward short careers, and
pensions are granted generously for invalidity or
early retirement, often in response to labor re-
trenchment (in lieu of unemployment benefits).\textsuperscript{104}
The total number of pensioners in the CEE coun-
tries has been estimated at approximately half the
total number employed, and real spending on
pensions is growing. Pension reform should be-
gin by tightening eligibility (including gradually
raising retirement ages) and by revising the pen-
sion formula along actuarial principles.

Several countries are considering supplementing
their PAYE systems with either funded public
pension schemes (whereby individual contribu-
tions are directly linked to pensions) or manda-
tory private pension plans along the model used,
for example, in Switzerland and Chile. Develop-
ing a funded system can be problematic; in the
beginning current employees must both pay for
current pensions and build up the fund from
which their own pensions will later be paid. Pri-
atization may present a unique avenue to miti-
gate part of this problem, if a substantial part of
the ownership of privatized firms can be vested in
pension funds as a source of funding.\textsuperscript{105}
Annex 7  The World Bank Group's support for economic transformation in Central and Eastern Europe

Evolution of Bank Group activities

The World Bank Group’s involvement with Central and Eastern Europe (CEE) dates back many years. The CSFR, Poland, and Yugoslavia were founding members of the Bank and the Fund at their creation in 1945; however, the CSFR and Poland ceased to be members within a few years. Romania joined the Bretton Woods institutions in 1972, Hungary in 1982, and Poland rejoined in 1986. In the fall of 1990, the CSFR rejoined, and Bulgaria became a new member. In addition, Romania, which had stopped borrowing from the Bank in 1982 and prepaid its debt by early 1989, restored full relations with the Bank and became a member of the International Finance Corporation (IFC) in 1990. In January 1991, Albania applied for membership in the IMF, the World Bank, and the IFC. An initial IMF mission to ascertain conditions for membership took place in March 1991.

To date, World Bank lending commitments to the region total a little more than $10 billion. Since 1945, Yugoslavia has received 99 loans from the Bank for a commitment of $5.3 billion. Romania had obtained 33 loans for $2.2 billion before it stopped borrowing from external sources and started prepaying its foreign debt in 1982. Total commitments to Hungary have slightly exceeded $2.8 billion for 30 projects. Since the beginning of 1990, Poland has obtained seven loans for $1.22 billion.

Except for the FY83 Yugoslavia SAL, the FY88 Hungary Industrial Sector Adjustment Loan, and quick-disbursing components under the FY86-87 Industrial Restructuring loans to Hungary, all pre-FY90 Bank lending to CEE was project-specific, with the bulk of loans supporting investment in infrastructure, industry, and agriculture. While it is true in all countries that the effectiveness of project lending is hampered by distortions in macroeconomic and sector policies, this is particularly relevant in CEE countries, where shortcomings in economic performance have had a deeply rooted systemic dimension. In spite of a multiplicity of reform efforts in individual countries during the 1970s and 1980s, the systemic root causes of economic difficulties were not addressed anywhere in a comprehensive way before 1989-90. The main weakness of the policy framework was lack of competition, financial discipline, and a clear exercise of ownership rights at the enterprise level, which obviously did not provide the necessary signals for economic restructuring and behavioral change.

The IFC has been active in Yugoslavia since 1968, in Hungary since 1985, and in Poland since 1987. In Yugoslavia, there has never been a centralized ownership, management, and investment planning system. Instead, investment plans have been generated by the operating enterprises and financed by a banking structure with some competitive elements. Within this institutional context, the IFC has made 36 transactions for a total commitment of about $700 million. As several of these transactions were package loans through local banks, IFC funding has gone to several hundred enterprises. In Hungary, the IFC has undertaken eight transactions for $100 million (of which $22 million was in equity), including five joint ventures in the productive sector, an agency line of credit for small- and medium-scale private enterprises in cooperation with a local Hungarian bank, a joint venture bank, and an internationally distributed investment fund. In Poland, the IFC has undertaken three operations with a total commitment of about $55 million: an export-oriented, cooperative agro-processing enterprise, a flagship hotel joint venture, and an agency line of credit for small- and medium-scale private enterprises in cooperation with a local Polish bank. It has also provided advisory support to the government in three key areas: privatization, capital market development, and the framework for foreign investment.

The transformation process and Bank Group support

With country-specific variations in terms of speed and scope of effort, the reforming countries in CEE have decided to move toward market economies with private ownership and the reduction of the state to a facilitating role. Long drawn-out reform efforts in Yugoslavia and Hungary and to some extent Poland, which essentially aimed at decentralization without exposing enterprises to financial discipline from owners, creditors, or competitors, suggest that gradual reforms — as opposed to more radical systemic transformation —
are not effective. Bank lending into environments of partial reform in Hungary or Yugoslavia has also been of only limited effectiveness.

With the region's political events of 1989-90, the climate for a switch in economic policies has dramatically changed toward comprehensive systemic transformation. The Bank has begun to implement substantial programs of assistance to facilitate the transition. Over the next three years, the Bank proposes to lend an estimated $7.8 billion covering all six countries. To place this in perspective, two years ago Bank lending was limited to Hungary and Yugoslavia and amounted to roughly $500 million. In FY90, the Bank lent a total of $1.8 billion to Hungary, Poland, and Yugoslavia (see tables 7.1, 7.2, and 7.3 on the status of Bank Group operations in those three countries). In the current fiscal year, the Bank expects to lend about $2.5 billion to the three and to the new members, Bulgaria and the CSFR, and possibly to Romania. The Bank opened a resident mission in Warsaw in July 1990.

The World Bank has undertaken substantial economic and sector work (ESW) in support of a large and growing lending program. ESW included country economic memoranda, with emphasis on macroeconomic issues for most countries, including members the CSFR and Bulgaria; trade analyses for Hungary and Poland, with emphasis on CMEA issues; financial sector assessments in Hungary, Poland, and Yugoslavia; industrial sector work in Hungary and Yugoslavia; environmental studies for Hungary and Poland; and far-reaching analyses of social sector issues in Hungary and Poland. Moreover, in Poland a number of joint Bank-government task forces covered strategic issues in agriculture, housing, health, and the legal and regulatory basis for the financial sector. Future ESW will pursue similar priorities, with coverage expanding to the new countries. For Bulgaria and Romania, work on trade and public expenditures is planned, given the severe shortage of both foreign exchange and government revenues. In Romania, work will also focus on the social safety net.

The Bank's financial assistance during CY1989-90 went to (1) supporting fairly comprehensive transformation programs through structural adjustment loans (SALs) typically focused on policy and institutional measures to foster the private sector, a competitive environment, the financial sector, and a social safety net; (2) promoting a supply response through restructuring and progressive privatization of the existing productive base and creating an enabling environment for development of new enterprises, particularly small- and medium-sized enterprises; (3) fostering the development of a modern, efficient infrastructure in telecommunications, roads, and railways; (4) improving the efficiency of energy resource use and developing an adequate environmental policy framework; (5) modernizing and restructuring the banking sector; and (6) facilitating the redeployment of labor and the development of a modern human resource base. This will also be the thrust of the assistance strategy in the new countries.

The Economic Development Institute (EDI) has also expanded its activities in the region, focusing on macroeconomic and public sector management, industrial restructuring, labor market and social protection, and environmental management. To stretch the EDI's limited resources and protect institutionally weaker countries elsewhere, great emphasis is put on cooperative arrangements in the region and funding from other (nontraditional) sources.

Both the need for and the interest in financial and technical assistance from the IFC and the FlAs have greatly expanded with reforms. In FY91 the IFC opened representative offices in Warsaw, Budapest, and Prague. In conjunction with the IFC's joint venture investment operations and related dialogue on foreign investment laws and procedures, its capital markets group has assisted in the creation of new financial sector institutions (banks, insurance companies, leasing companies, and venture capital funds) and has provided advice on the legal and regulatory infrastructure for securities markets. The IFC's corporate services group has advised on restructuring and privatization in Poland, Hungary, and the CSFR, and the IFC has established a Business Advisory Service in Poland where small- and medium-scale private enterprises can get advice.

MIGA's focus, of course, is facilitating foreign investors by providing political risk insurance on equity investments in these countries, and it is interesting that, relatively speaking, the highest demand for its services is emanating from CEE. To date, only one insurance transaction has taken place in CEE: a $30 million reinsurance for an investment project in Hungary. However, a number of projects in Poland and Hungary are under
Table 7.1 Status of Bank Group operations in Hungary

<table>
<thead>
<tr>
<th>Loan number</th>
<th>Fiscal year</th>
<th>Borrower</th>
<th>Project</th>
<th>Gross commitments (millions of dollars)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Cross commitments (less cancellations)</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Loan</td>
<td>Undisbursed</td>
</tr>
</tbody>
</table>

Five loans and six B-loans fully disbursed
Of which SECALS, SALs, and Program Loans:

<table>
<thead>
<tr>
<th>Loan number</th>
<th>Fiscal year</th>
<th>Borrower</th>
<th>Project</th>
<th>Gross commitments</th>
<th>Repaid</th>
<th>Now held by the Bank</th>
<th>Undisbursed</th>
</tr>
</thead>
<tbody>
<tr>
<td>2965</td>
<td>1988</td>
<td>NBHb</td>
<td>Industrial Sector Adjustment</td>
<td>200.00</td>
<td>-</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>3228</td>
<td>1990</td>
<td>NBH</td>
<td>SAL I</td>
<td>200.00</td>
<td>-</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>2317</td>
<td>1983</td>
<td>ROHc</td>
<td>Industrial Energy Conservation</td>
<td>109.00</td>
<td>0.10</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>2510</td>
<td>1985</td>
<td>NBH</td>
<td>Integrated Livestock</td>
<td>80.00</td>
<td>11.10</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>2557</td>
<td>1985</td>
<td>ROH</td>
<td>Transport (Rail/Road)</td>
<td>75.00</td>
<td>2.80</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>2697</td>
<td>1986</td>
<td>ROH</td>
<td>Power</td>
<td>64.00</td>
<td>24.20</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>2700</td>
<td>1986</td>
<td>NBH</td>
<td>Industrial Restructuring I</td>
<td>100.00</td>
<td>14.20</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>2709</td>
<td>1986</td>
<td>NBH</td>
<td>Industrial Energy Conservation II</td>
<td>25.00</td>
<td>3.90</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>2738</td>
<td>1987</td>
<td>NBH</td>
<td>Crop Production</td>
<td>100.00</td>
<td>11.10</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>2834</td>
<td>1987</td>
<td>NBH</td>
<td>Industrial Restructuring II</td>
<td>150.00</td>
<td>51.00</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>2847</td>
<td>1987</td>
<td>NBH</td>
<td>Telecommunications</td>
<td>70.00</td>
<td>18.80</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>2936</td>
<td>1988</td>
<td>NBH</td>
<td>Agroprocessing Modernization</td>
<td>70.00</td>
<td>50.70</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>2966</td>
<td>1988</td>
<td>NBH</td>
<td>Technology Development</td>
<td>50.00</td>
<td>31.10</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>3020</td>
<td>1989</td>
<td>NBH</td>
<td>Industrial Restructuring III</td>
<td>140.00</td>
<td>120.80</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>3032</td>
<td>1989</td>
<td>ROH</td>
<td>Transport II</td>
<td>95.00</td>
<td>76.80</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>3055</td>
<td>1989</td>
<td>NBH</td>
<td>Energy Development-Conservation</td>
<td>10.00</td>
<td>7.90</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>3056</td>
<td>1989</td>
<td>OKGTd</td>
<td>Energy Development-Oil and Gas</td>
<td>100.00</td>
<td>91.90</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>3191</td>
<td>1990</td>
<td>NBH</td>
<td>Financial System Modernization</td>
<td>66.00</td>
<td>61.00</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>3229</td>
<td>1990</td>
<td>NBH</td>
<td>Integrated Agricultural Exports</td>
<td>100.00</td>
<td>81.50</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>B1010</td>
<td>1991</td>
<td>ROH</td>
<td>Expanded Cofinancing Operation</td>
<td>200.00</td>
<td>200.00</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>3264</td>
<td>1991</td>
<td>HTC</td>
<td>Telecommunications II</td>
<td>150.00</td>
<td>140.00</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>3313</td>
<td>1991</td>
<td>ROH</td>
<td>Human Resources Development</td>
<td>150.00</td>
<td>150.00</td>
<td>-</td>
<td></td>
</tr>
</tbody>
</table>

Total gross commitments: 2,642.92
Of which repaid: 263.39
Total now held by the Bank: 2,530.14
Total undisbursed: 1,099.46

a. Approved during or after PY80.
d. National Oil and Gas Trust.

active consideration, and inquiries from the CSFR and Yugoslavia are numerous.

The thrust of Bank Group activities in selected areas

Macroeconomic policies toward stabilization and adjustment. The Bank has extended quick-disbursing balance-of-payments support through SALs to Yugoslavia ($400 million), Hungary ($200 million plus $200 million in cofinancing), and Poland ($300 million) during CY1990. There are some common factors but also significant differences in individual programs and the Bank's support. Yugoslavia and Poland faced hyperinflation in 1989, which was attacked through heterodox shock stabilization programs, with the exchange rate and wages as nominal anchors. Hungary's economic difficulties were of a more traditional nature, with a growing balance-of-payments deficit but only moderate inflation as a result of expansionary monetary and fiscal policies. The stabilization
Table 7.1 Status of Bank Group operations in Hungary (continued)

<table>
<thead>
<tr>
<th>Fiscal year</th>
<th>Obligor</th>
<th>Type of business</th>
<th>Gross commitments (millions of dollars)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>Loan</td>
</tr>
<tr>
<td>1987</td>
<td>Unibank</td>
<td>Capital markets</td>
<td>–</td>
</tr>
<tr>
<td>1987</td>
<td>Agrofrem Hungarian-Japanese Fermentation Industry Ltd.</td>
<td>Food aid</td>
<td>8.55</td>
</tr>
<tr>
<td>1988</td>
<td>Salgotarjan Glass Wool</td>
<td>Insulation material</td>
<td>3.44</td>
</tr>
<tr>
<td>1989</td>
<td>Dunamon Poliesterollovoyarto Ltd.</td>
<td>Chemicals</td>
<td>28.38</td>
</tr>
<tr>
<td>1990</td>
<td>Dexter Mold</td>
<td>General manufacturing (plastic)</td>
<td>3.26</td>
</tr>
<tr>
<td>1990</td>
<td>Tetra Pak</td>
<td>Packaging material</td>
<td>8.03</td>
</tr>
<tr>
<td>1990</td>
<td>First Hungary Fund</td>
<td>Capital markets</td>
<td>–</td>
</tr>
<tr>
<td>1990</td>
<td>FIIA</td>
<td>Capital markets</td>
<td>–</td>
</tr>
<tr>
<td>1991</td>
<td>NMBB</td>
<td>Capital markets</td>
<td>–</td>
</tr>
<tr>
<td>1991</td>
<td>FAHIC</td>
<td>Insurance</td>
<td>–</td>
</tr>
<tr>
<td>1991</td>
<td>Agency Credit Facility</td>
<td>Small and medium business</td>
<td>21.60</td>
</tr>
<tr>
<td>1991</td>
<td>Magyar Suzuki Automotive</td>
<td>–</td>
<td>0.70</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>103.95</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Less cancellations, terminations, exchange adjustments, repayments, write-offs, and sales</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Total commitments now held by the IFC</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Total undisbursed</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Total disbursed</td>
</tr>
</tbody>
</table>

program, accordingly, relied on fiscal and monetary restraint. All three programs also included important structural adjustment elements to address systemic root causes of economic difficulties (pervasive subsidies and price distortions, massive nontariff barriers to trade, blurred enterprise ownership, lack of financial discipline, and guaranteed full employment). The most comprehensive and rigorous approach was followed in Poland, with virtually complete price and trade liberalization, important measures to tighten the financial discipline of enterprises, financial sector reform, the start of privatization, demonopolization of key industries, and the establishment of a rudimentary social safety net. Hungary’s program tackled a similarly broad range of systemic problems, but price and trade liberalization has not yet gone quite as far. Yugoslavia’s program, after a promising start, became a victim of political difficulties that prevented wage discipline and energetic action in the enterprise sector. The Bank has encouraged comprehensive transformation programs that require macroeconomic stabiliza-

**Marketization:** Trade and price liberalization and competition policy. “Marketization,” that is, transformation from a command to a market economy, is at the center of reforms in all CEE countries. But in some countries there is still debate or confusion as to the meaning and scope of a market economy in practice. In such an economy, resource allocation is driven by relative prices rather than central government decisions. It requires the free setting of prices under reasonably effective competition and factor (labor and capital) mobility. (In key areas such as energy, a possible intermediate step may be the adjustment of administrative prices toward efficiency levels before full liberalization.) The Bank has been supporting market reforms in
Table 7.2 Status of Bank Group operations in Poland

**Statement of Bank loans**  
(as of March 31, 1991)

<table>
<thead>
<tr>
<th>Loan number</th>
<th>Fiscal year</th>
<th>Borrower</th>
<th>Purpose</th>
<th>Gross commitments (millions of dollars)</th>
</tr>
</thead>
<tbody>
<tr>
<td>3166</td>
<td>1990</td>
<td>National Bank of Poland</td>
<td>Ind. exports development</td>
<td>260.00</td>
</tr>
<tr>
<td>3167</td>
<td>1990</td>
<td>National Bank of Poland</td>
<td>Agroind. exp. development</td>
<td>100.00</td>
</tr>
<tr>
<td>3190</td>
<td>1990</td>
<td>Republic of Poland</td>
<td>Environment management</td>
<td>18.00</td>
</tr>
<tr>
<td>3193</td>
<td>1990</td>
<td>Republic of Poland</td>
<td>Transport</td>
<td>4.75</td>
</tr>
<tr>
<td>3194</td>
<td>1990</td>
<td>Polish Railway Corp.</td>
<td>Transport</td>
<td>145.00</td>
</tr>
<tr>
<td>3215</td>
<td>1990</td>
<td>Polish Oil &amp; Gas Corp.</td>
<td>Energy resources development</td>
<td>250.00</td>
</tr>
<tr>
<td>3247</td>
<td>1991</td>
<td>Republic of Poland</td>
<td>SAL I</td>
<td>300.00</td>
</tr>
</tbody>
</table>

Subtotalb 1077.75 949.83
Of which repaidc 0.00
Total now outstanding 1077.75
Amount sold 0.00
Total now held by Bankc 1077.75
Total undisbursed 949.83

**Statement of IFC investments**  
(as of March 31, 1991)

<table>
<thead>
<tr>
<th>Fiscal year</th>
<th>Obligor</th>
<th>Type of business</th>
<th>Gross commitments (millions of dollars)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1989</td>
<td>Hortex</td>
<td>Horticulture</td>
<td>17.12  17.12</td>
</tr>
<tr>
<td>1990</td>
<td>Export Devt. Bank</td>
<td>Export credit</td>
<td>31.66  31.66</td>
</tr>
<tr>
<td>1991</td>
<td>Bristol Hotel</td>
<td>Hotel development</td>
<td>10.06  10.06</td>
</tr>
</tbody>
</table>

Total gross commitments 58.84 0.00 58.84
Less cancellations, terminations, exchange adjustments, repayments, write-offs, and sales 2.12  2.12
Total commitments now held by the IFC 56.72  0.00 56.72
Total undisbursed 42.15  42.10
Total outstanding 14.57  0.00 14.57

*SAL, SECAL or “Program Loan.”

a. Two loans for one project.
b. Excludes loan of $120 million for a telecommunications project that was approved by the Executive Directors on April 23, 1991, but has not yet been signed.
c. Prior to exchange adjustments.

many developing countries, particularly through trade liberalization as the most effective means to create competition and stimulate efficiency in small economies. What makes CEE special is the high concentration of enterprises and the overwhelming ownership role of the state with blurred ownership rights (see the enterprise section below). Price and trade liberalization have been key elements of all adjustment programs in the region supported through Bank SALs, in CY1990. The most radical approach was followed by Poland, where prices for 90-95 percent of sales were liberalized and the trade regime completely changed, with immediate abolition of all nontariff barriers to imports and the establishment of relatively low tariffs (these were actually suspended for a wide
### Table 7.3 Status of Bank Group operations in Yugoslavia

#### Statement of Bank loans
(as of March 31, 1991)

<table>
<thead>
<tr>
<th>Loan number</th>
<th>Fiscal year</th>
<th>Borrower</th>
<th>Project</th>
<th>Gross commitments (in millions of dollars)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Loan</td>
</tr>
<tr>
<td>Eighty-four loans fully disbursed</td>
<td>3,402.84</td>
<td>–</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Of which SECALS, SALs, and Program Loans:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2326</td>
<td>1983</td>
<td>Udruž. Beogradska Banka</td>
<td>Structural Adjustment Loan I</td>
<td>275.00</td>
</tr>
<tr>
<td>2410</td>
<td>1984</td>
<td>Vodjvodjanska Banka</td>
<td>Fertilizer Sector Loan (SAP)</td>
<td>275.00</td>
</tr>
<tr>
<td>Subtotal of SECALS, SALs, and Program Loans</td>
<td>275.00</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2307</td>
<td>1983</td>
<td>Udruž. Beogradska Banka</td>
<td>Serbia Regional Development</td>
<td>94.00</td>
</tr>
<tr>
<td>2336</td>
<td>1984</td>
<td>Four Railway Orgs.</td>
<td>Sixth Railway</td>
<td>106.30</td>
</tr>
<tr>
<td>2338</td>
<td>1984</td>
<td>Eight Power Orgs.</td>
<td>Third Power Transmission</td>
<td>115.00</td>
</tr>
<tr>
<td>2467</td>
<td>1985</td>
<td>Investiciona Banka</td>
<td>Montenegro Regional</td>
<td></td>
</tr>
<tr>
<td>2527</td>
<td>1985</td>
<td>Elektroprivreda Bosnja</td>
<td>Visegrad Hydropower</td>
<td>125.00</td>
</tr>
<tr>
<td>2595</td>
<td>1985</td>
<td>INA-Naftaplin</td>
<td>Petroleum Sector</td>
<td>55.00</td>
</tr>
<tr>
<td>2596</td>
<td>1985</td>
<td>Naftagas</td>
<td>Petroleum Sector</td>
<td>35.00</td>
</tr>
<tr>
<td>2715</td>
<td>1986</td>
<td>Privredna Banka Sarajevo</td>
<td>First Highway Sector</td>
<td>124.50</td>
</tr>
<tr>
<td>2790</td>
<td>1987</td>
<td>Ljubljanska Banka</td>
<td>Industrial Energy Conservation</td>
<td>90.00</td>
</tr>
<tr>
<td>2878</td>
<td>1988</td>
<td>Four Road Organizations</td>
<td>Second Highway Sector</td>
<td>125.94</td>
</tr>
<tr>
<td>3068</td>
<td>1989*</td>
<td>Four Railway Orgs.</td>
<td>Seventh Railway</td>
<td>122.20</td>
</tr>
<tr>
<td>3069</td>
<td>1989</td>
<td>Istria Water Works and Pula Water Works</td>
<td>Istria and Slovene Coast Water Supply and Sewerage</td>
<td>28.00</td>
</tr>
<tr>
<td>3070</td>
<td>1989</td>
<td>Rizana Water Works</td>
<td>Istria and Slovene Coast Water Supply and Sewerage</td>
<td>32.00</td>
</tr>
<tr>
<td>3187</td>
<td>1990</td>
<td>National Bank of Yugoslavia</td>
<td>Second Structural Adjustment Loan</td>
<td>400.00</td>
</tr>
<tr>
<td>3220</td>
<td>1990</td>
<td>Road Org.-Bosnia-Herz.</td>
<td>Third Highway Sector</td>
<td>55.00</td>
</tr>
<tr>
<td>3221</td>
<td>1990*</td>
<td>Road Org.-Croatia</td>
<td>Third Highway Sector</td>
<td>75.00</td>
</tr>
<tr>
<td>3222</td>
<td>1990*</td>
<td>Road Org.-Macedonia</td>
<td>Third Highway Sector</td>
<td>22.00</td>
</tr>
<tr>
<td>3233</td>
<td>1990*</td>
<td>Road Org.-Serbia</td>
<td>Third Highway Sector</td>
<td>55.00</td>
</tr>
<tr>
<td>3234</td>
<td>1990*</td>
<td>Republic of Slovenia</td>
<td>Third Highway Sector</td>
<td>60.00</td>
</tr>
<tr>
<td>3235</td>
<td>1990*</td>
<td>Road Org.-Vojvodina</td>
<td>Third Highway Sector</td>
<td>25.00</td>
</tr>
<tr>
<td>Total gross commitments</td>
<td>5,121.28</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Of which repaid</td>
<td>2,288.27</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total now held by the Bank</td>
<td>2,833.01</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total amount sold</td>
<td>9.20</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Of which repaid</td>
<td>9.20</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total undisbursed</td>
<td>934.6</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

a. Approved during or after FY80.
b. Not yet effective.
c. Not yet signed.

array of products during the second half of 1990 to increase competitive pressure). Hungary and Yugoslavia have also gone quite far in dismantling quantitative restrictions, and Hungary will virtually complete the liberalization process during 1991. However, with high vertical and horizontal concentration of enterprises and numerous regulatory constraints, deregulation and competition policy also become important complements. In the Polish program, demonopolization of some

61
Table 7.3 Status of Bank Group operations in Yugoslavia (continued)

<table>
<thead>
<tr>
<th>Fiscal year</th>
<th>Obligor</th>
<th>Type of business</th>
<th>Gross commitments (millions of dollars)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>Loan</td>
</tr>
<tr>
<td>1970</td>
<td>International Investment</td>
<td>Development finance</td>
<td>–</td>
</tr>
<tr>
<td>1970</td>
<td>Zastava</td>
<td>Motor vehicles and accessories</td>
<td>12.40</td>
</tr>
<tr>
<td>1973</td>
<td>Bellace-Bel</td>
<td>Pulp and paper</td>
<td>70.86</td>
</tr>
<tr>
<td>1974</td>
<td>Zelezarana</td>
<td>Iron and steel</td>
<td>10.00</td>
</tr>
<tr>
<td>1977</td>
<td>Tvoronica Kartona Cazin</td>
<td>Pulp and paper</td>
<td>19.77</td>
</tr>
<tr>
<td>1977</td>
<td>Frkom RO Industrija</td>
<td>Food processing</td>
<td>5.51</td>
</tr>
<tr>
<td>1978</td>
<td>Soko Most</td>
<td>Hermetic compressors</td>
<td>7.00</td>
</tr>
<tr>
<td>1980</td>
<td>Investicional Banka Titograd</td>
<td>Hotel rehabilitation</td>
<td>21.00</td>
</tr>
<tr>
<td>1980</td>
<td>Radioj Dakic</td>
<td>Construction equipment</td>
<td>18.70</td>
</tr>
<tr>
<td>1980</td>
<td>Eight regional Yugoslav banks</td>
<td>Small-scale enterprise finance</td>
<td>30.23</td>
</tr>
<tr>
<td>1980</td>
<td>FAP FAMOS</td>
<td>Motor vehicles and accessories</td>
<td>16.30</td>
</tr>
<tr>
<td>1980</td>
<td>RMK</td>
<td>Machinery</td>
<td>50.00</td>
</tr>
<tr>
<td>1982-87</td>
<td>Institute Dr. Simo M. Igalo</td>
<td>Physical medicine</td>
<td>19.15</td>
</tr>
<tr>
<td>1983</td>
<td>Ljubljanska Banka</td>
<td>Development finance</td>
<td>31.43</td>
</tr>
<tr>
<td>1984</td>
<td>INA-Naitaplin</td>
<td>Chemicals and petrochemicals</td>
<td>37.78</td>
</tr>
<tr>
<td>1985-89</td>
<td>SOZD Iskara</td>
<td>Telecommunications</td>
<td>33.88</td>
</tr>
<tr>
<td>1985</td>
<td>SOUR Energoinvest</td>
<td>Power transmission</td>
<td>15.18</td>
</tr>
<tr>
<td>1985</td>
<td>Jugobanka</td>
<td>Development finance</td>
<td>35.80</td>
</tr>
<tr>
<td>1985</td>
<td>Ljubljanska Banka</td>
<td>Development finance</td>
<td>69.84</td>
</tr>
<tr>
<td>1986</td>
<td>Unial-TGA</td>
<td>Nonferrous metals</td>
<td>35.60</td>
</tr>
<tr>
<td>1986</td>
<td>TAM/DEUTZ</td>
<td>Motor vehicles</td>
<td>35.98</td>
</tr>
<tr>
<td>1988</td>
<td>Sava Semperit</td>
<td>Tires</td>
<td>26.20</td>
</tr>
<tr>
<td>1989</td>
<td>Vojvodjanska Banka</td>
<td>Development finance</td>
<td>87.00</td>
</tr>
<tr>
<td>1989</td>
<td>Saloni Anhovo</td>
<td>GRP pipes</td>
<td>11.96</td>
</tr>
<tr>
<td>1990</td>
<td>Anhovo</td>
<td>Pulp and paper</td>
<td>5.23</td>
</tr>
<tr>
<td>1991</td>
<td>Delo</td>
<td>Printing press modernization</td>
<td>4.64</td>
</tr>
<tr>
<td>Total gross commitments</td>
<td>722.07</td>
<td>7.77</td>
<td>729.78</td>
</tr>
<tr>
<td>Less cancellations, terminations, exchange adjustments, repayments, write-offs, and sales</td>
<td>383.68</td>
<td>7.71</td>
<td>391.39</td>
</tr>
<tr>
<td>Total commitments held by the IFC</td>
<td>338.39</td>
<td>–</td>
<td>338.39</td>
</tr>
<tr>
<td>Total undisbursed</td>
<td>25.54</td>
<td>–</td>
<td>25.50</td>
</tr>
<tr>
<td>Total disbursed</td>
<td>312.85</td>
<td>–</td>
<td>312.85</td>
</tr>
</tbody>
</table>

Key industries has been an integral part from the outset, while competition legislation and the corresponding institutional framework have been lagging in other countries. Regarding trade and price liberalization, the Hungary and Yugoslavia SALs include explicit commitments with respect to exposure of domestic industry to import competition and the share of free prices. With the complete dismantling of quantitative restrictions and the virtual abolition of price controls in Poland, the Bank-supported program has focused more on the further rationalization of tariffs, without formal conditionality. Romania and Bulgaria have undertaken initial price liberalization mea-
sures, and both are committed to further steps as part of their reform programs to be supported by the Bank and the Fund.

Enterprise reform, privatization development, and privatization. As mentioned before, attempts to decentralize decisionmaking and some degree of "marketization" were made during the 1970s and 1980s in Hungary, Poland, and the CSFR, and this has been a guiding principle of Yugoslav economic management since the 1950s. However, none of these attempts was effective because greater enterprise autonomy in practice translated into blurred ownership rights and a lack of financial discipline — or in Kornai's famous term, a soft budget constraint — which in Yugoslavia and Poland was an important cause of hyperinflation. The Bank has been supporting Hungarian enterprise reform and restructuring for a number of years through industrial restructuring loans, but under inadequate macroeconomic conditions prior to 1990 and without adequate enforcement of financial discipline through bankruptcy procedures and privatization. The process has thus been slow and its success limited. Even before the events of 1989/90, the Bank supported important legislative changes in various countries to prepare the ground for ownership change, financial discipline, and — ultimately — behavioral change. Legislative and regulatory measures, as well as specific actions toward enterprise restructuring, ownership reform, and privatization development, have become integral parts of the SAL-supported programs in Yugoslavia, Hungary, Poland, and — in the near future — in the CSFR and Bulgaria. This will soon be followed with more specific sector operations in Hungary and Poland. The legislative framework for privatization and competition in Bulgaria and Romania is currently under preparation. The Bank has also supported the development of small- and medium-scale enterprises in Hungary and Yugoslavia and is planning similar projects in Poland.

The IFC's individual transactions related to privatization have shown that overcoming existing obstacles is a time-consuming, complex undertaking. Instability in the legal fabric requires that each operation's contract have a self-contained legal framework to substitute for the broad business law framework and judicial systems relied upon in market economies. Added to the legal problems are issues of ownership rights, including the transferability and mortgageability of land, buildings, and other physical assets, the rights and privileges of enterprise employees, and the difficulties inherent in valuing assets of an enterprise operating in a highly distorted domestic market and a rapidly changing foreign market. Superimposed on the complexity of these issues is the scarcity of human resources in enterprises and government with the training and understanding to agree on a package of compromises that will allow a deal to go forward. Finally, on the foreign side, investors are reluctant to risk a substantial equity commitment given current uncertainties, while on the local side there is reluctance to sell local assets of a previously public sector activity to foreign interests. An extended period of testing and adjustment will be required, with, at best, only partial success for some time to come. What is evident is that continued debate without action is unlikely to produce better results.

Social safety net and human resources development. The social safety net and human resources development are also central elements in the Bank's policy dialogue and lending activities in CEE. The social safety net encompasses programs and funds to provide income transfers to the old, the poor, and the unemployed; employment services; training and job creation and promotion activities; and funding and provision of adequate health services. One would also add housing as an important dimension with important implications for the functioning of the labor market. Human resources development also entails the efficient provision of education services with adequate financing arrangements. These concerns are addressed through sector work and project lending, but also in the context of the above-mentioned SAL, where the adequacy of the social safety net has been an important concern.

During CY1990, sector studies and lending activities for the social safety net and human resource development were initiated in Hungary, Poland, Bulgaria, and Romania, and a new division for this work was set up in the country department. Free-standing loans were recently approved for human resource development for Hungary and for employment services and promotion for Poland. Important analytical work has also been done on the housing sector in Poland and Hungary, and lending is underprepa-
### Table 7.4 Selected cofinancing operations

<table>
<thead>
<tr>
<th>Fiscal year</th>
<th>World Bank</th>
<th>Cofinancing</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Yugoslavia:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Highway sector loan</td>
<td>292</td>
<td>190 — EIB</td>
</tr>
<tr>
<td>Poland:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Railways project</td>
<td>153</td>
<td>30 — EIB</td>
</tr>
<tr>
<td>Hungary:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>SAL I</td>
<td>200</td>
<td>200 — Japan EXIM Bank</td>
</tr>
<tr>
<td>1991 (planned)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Poland:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Telecom I</td>
<td>120</td>
<td>80 — EIB</td>
</tr>
<tr>
<td>District Heating</td>
<td>250</td>
<td>80 — EIB</td>
</tr>
<tr>
<td>Hungary:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Telecom II</td>
<td>150</td>
<td>100 — EIB Japan</td>
</tr>
<tr>
<td>SAL II</td>
<td>200</td>
<td>Japan EXIM Bank</td>
</tr>
<tr>
<td>CSFR:</td>
<td>450</td>
<td>Japan EXIM Bank</td>
</tr>
</tbody>
</table>

Note: Before FY90, the EIB and the Bank participated regularly in parallel financing to Yugoslavia for infrastructure. Six B-loans to Hungary contributed $1.2 billion with a Bank participation of $135 million. In FY91, the Bank, through the expanded cofinancing instrument, helped Hungary to mobilize $200 million.

The Bank's assistance, however, is part of a broader effort by the international community. The Bank Group and the international financial community. Financial assistance by the Bank Group has to be seen in the context of the six countries' overall external financing requirements and a likely financing gap of several billion dollars per year. Bank Group assistance has to be subject to sound banking principles. Poland's and Bulgaria's creditworthiness are impairs by huge debt overhangs and debt servicing difficulties (which in the case of Poland have persisted for a decade). Comprehensive solutions to the debt problem have to be an integral part of the respective adjustment program; the Paris Club debt workout for Poland is an important step in that direction. In other countries, particularly Hungary, adequate burden sharing between the Bank and other creditors is a major concern.

After the 1989 Paris Summit Meeting, the G-24 — coordinated by the EC Commission — began to extend significant financial and technical assistance to the reforming countries in CEE. The Bank is closely coordinating its activities with those of multilateral organizations (the EC, IMF, EIB, OECD, and EBRD). As a result of its collaboration with the IMF, the governments of Hungary and Poland prepared medium-term frameworks with joint input from IMF and Bank staff.

There have also been substantial amounts of cofinancing. The Hungary SAL was cofinanced with the Japanese Export-Import Bank (JEX), and the European Investment Bank (EIB) has cofinanced infrastructure projects in Yugoslavia (for many years) and, more recently, in Hungary and Poland. More operations with the JEX and the EIB as well as the new EBRD are expected in the future. An important cofinancing effort was made through the Expanded Cofinancing Operation (ECO) to Hungary, which facilitated subsequent issues in the Japanese bond market in the second half of 1990 (see table 7.4 on cofinancing operations). The Bank is also closely coordinating with bilateral donors (such as the UK Know-How Fund, the United States, and others) as well as with the Pentagonal group, covering a wide array of areas and forms of assistance.

In addition to broad aid coordination, there are specific efforts in energy (through the Central and Eastern Europe Regional Energy Program) and in environment (through the Task Force set up by the Baltic Sea riparian countries and the Environmental Program for the Mediterranean).
Endnotes

1. In this paper, the term “Central and Eastern Europe” is used to refer to Bulgaria, the Czech and Slovak Federal Republic (CSFR), Hungary, Poland, Romania, and Yugoslavia. The former German Democratic Republic (GDR) is also relevant, although its transformation process is shaped by distinctive circumstances. The GDR or East Germany and the Federal Republic of Germany (FRG) or West Germany refer in this paper to the countries before their unification, east and west Germany to the regions of Germany after unification.

2. All dollars in this report are U.S. dollars or equivalent. In 1937, nominal national income per capita was estimated at $440 in Great Britain, and at $400, $340, $330, $306, $265, and $190 in Sweden, Germany, Belgium, Netherlands, France, and Austria, respectively. The corresponding estimates for Czechoslovakia, Hungary, Poland, Romania, Yugoslavia, and Bulgaria were $170, $120, $100, $81, $80, and $75, respectively (Solimano 1991).

3. Yugoslavia was not a CMEA member. In certain countries, notably China, Yugoslavia, and the USSR, there was also a tendency to encourage regional self-sufficiency.

4. Estimates of hidden unemployment in the CEE countries varied, but visitors to industrial enterprises suggested estimates of 20-30 percent.

5. The official growth rates reported by some countries were controversial, and there are reasons to believe that they overestimated actual growth.

6. For a brief comparison with China, see box 6.

7. Open unemployment existed only in Yugoslavia, in large part due to the greater autonomy of its self-managed firms.

8. That the problem was systemic rather than narrowly technological is shown by the disappointing results from importing Western equipment (Terrell, forthcoming).

9. If price controls prevent excess demand from driving up prices, inflation is said to be “repressed.” The involuntary accumulation of money that results because there is no way to spend it is called the “monetary overhang.”

10. The newfound acquiescence of the Soviet Union was of course a sine qua non for the transformation.

11. Income levels reported on a purchasing-power parity (PPP) basis normally exceed exchange-rate-based measures by a margin that shrinks as the level of income per capita increases. The margin appears to be especially large for socialist countries because of the extensive subsidization of important nontraded goods, and possibly also because of quality differences in the tradables sector that are not fully captured in PPP estimates.
12. It should be stressed that these projections are highly tentative due to the data inadequacies noted earlier.

13. Exchange-rate-based per capita incomes may fall even further in the southern countries than indicated in figure 1 as Romania and Bulgaria open their economies and take concurrent steps (already taken by the northern countries) to devalue their currencies.

14. Any such estimates are, of course, highly uncertain because they depend on assumptions on the present quality of capital, future productivity growth rates, and the income level after restructuring. CEPR (1990) and Collins and Rodrik (1991) estimate that a relatively speedy transition (10-15 years) to West European income levels would require investment levels on the order of $200-$400 billion per year, approximately equal to the entire GDP of the CEE countries. Such investment levels are clearly impossible, from the view of either resource availability or absorptive capacity. The unfolding experience of East Germany, though shaped by distinctive factors, appears to confirm the magnitude of the task ahead.

15. Because of its implications for the terms of trade, the demise of the CMEA in 1991 also has an important macroeconomic linkage with external balance (see annex 1).

16. Although moving rapidly to open trade, Hungary still has quantitative restrictions covering some 30 percent of its production, and it has not yet introduced full currency convertibility on current account.

17. The combination of large price increases and limits on nominal wages led to an estimated fall in real wages of 40-50 percent in the first month of the program.

18. In contrast, the usual prescription for policy reform within an established economic system is to address distortions sequentially (the most severe first), so as not to overload the reform process.

19. As noted in the section on the current stage of transformation, the CEE countries are at different stages of this process. Poland made particularly impressive strides in 1990 in starting or accomplishing the major tasks indicated for the first year in figure 2.

20. Inflation accelerated somewhat in both countries after August.

21. Because of the sharp devaluation on January 1, 1990 and the strict credit limits, the real money supply actually fell by some 44 percent in the first quarter of 1990.

22. The need to adjust relative prices may argue for a substantial rise in the price level, and this may reduce the need for currency reform.

23. Thirty percent in January, 20 percent in February through June, and 60 percent thereafter.


25. Domestic economic contraction in the CEE countries and the lowering of trade barriers in the industrial countries also helped spur these increases in exports in 1990.

26. Industrial output fell 30 percent.

27. Furthermore, because of fixed exchange rates, the wage rates of both Polish and Yugoslav workers rose considerably in dollar terms during 1990 (from low starting points), allowing them to purchase more imported goods.

28. It is important to keep in mind that choosing an appropriate exchange rate is extremely difficult ex ante, and that a substantial devaluation may be important for the credibility of a program. Some advisors to the Polish government recommended an even greater devaluation than the one actually taken.

29. Assuming that prices may be "sticky" downwards, this moderate inflation does provide a means for a needed realignment in relative prices. In Poland, for example, prices of consumer durables have increased relatively more than prices of most other goods, and prices of services have increased the most of all, resulting in a significant realignment of relative prices.

30. In fact, profit margins on sales actually increased for many state-owned Polish firms in
1990. This was particularly true in heavy industry, where domestic sales prices rose faster than costs, and where firms were able to increase exports dramatically because of the favorable exchange rate.

31. By October about 800 enterprises had been pushed into bankruptcy, compared to some 200 during all of 1989.

32. Yugoslavia has instituted payments rules to control interfirm credit. Under these rules, made possible by a central clearing system among enterprises and banks, any firm that is 60 days overdue in its payment obligations can be declared bankrupt. It is not clear to what extent these rules are being enforced in practice.

33. Controls on a few basic goods, such as bread or home heating fuel, may need to be phased out more slowly for social reasons.

34. The political and administrative difficulties associated with gradual price reform in an environment of highly distorted prices and large macroeconomic imbalances led the joint Soviet Study team to recommend a modified “big bang” approach. Gradual price reform is likely also to promote hoarding, putting upward pressure on prices, while rapid price liberalization encourages the liquidation of marketable inventories, putting downward pressure on prices.

35. Given their legacy and the enormous challenge of labor realignment they face, CEE governments are likely to follow the more interventionist model of Germany and Scandinavia rather than the less interventionist model of the United States and Canada. Some active labor market policies are discussed in the section on the role of government later in the paper.

36. These might include, for example, not only the elimination of unnecessary regulations but also indicative targets for credit expansion, advisory and information services, and active measures to involve private firms in government contracting and to provide access to business premises.

37. Corporatization includes establishing a clear equity structure, clearly vesting the government in ownership of those shares, and appointing suitable boards of directors to oversee the activities of the firms. The goal is to identify a clear-cut owner who will ensure that enterprises are run as profit-maximizing commercial companies.

38. This issue of “reprivatization” to former owners is becoming increasingly important and threatens to create a legal and economic quagmire. For example, the CSFR recently passed a law calling for restitution to former owners of property confiscated since 1948. Monetary compensation is an easier route than property restitution in many cases but may confront constitutional challenges, as is now occurring in Germany.

39. However, combining the two modes also presents complex trade-offs. For example, selling the best companies and giving away the worst would clearly tarnish any giveaway scheme. Another alternative — probably preferable but with its own drawbacks — is to give away a minority interest and sell a majority interest in all firms.

40. The results of the few valuations carried out by major international accounting and consulting firms show these to depend on rather arbitrary assumptions.

41. It has been roughly estimated that Poles could purchase only about 10-15 percent of Polish industry (if valued at book) with their existing savings.

42. In fact, concerns over equity are so strong that they threaten to stall the entire privatization process.

43. Fewer than 1,000 firms were privatized throughout the world between 1980 and 1987. The experience of other countries also suggests a tendency greatly to underestimate the time needed for privatization. In addition to the time constraint, Poland’s experience with direct sales in 1990 also suggests that the sale process is costly, with total fees and the like amounting to perhaps 10-15 percent of sale receipts.

44. Fiscal policy may also have to address the potentially inflationary wealth effect that could arise from free distribution of assets.

45. It was initially estimated that some 70 percent of East German industry would be competitive after restructuring, but that number is falling
steadily. This is in part due to the relatively high unit labor costs resulting from the 1:1 monetary exchange and collective bargaining agreements in 1990.

46. On the one hand, the jobs of many civil servants have disappeared; the number of government employees in the former GDR is expected to be reduced by about 50 percent, or one million workers. On the other hand, some of the best civil servants are being lured away from government by well-paying jobs in the newly emerging private sector, and top policymakers are seriously overstretched. These governments badly need more well-trained analysts and decisionmakers.

47. It is not clear to what extent the latter impede reform, although most observers believe that commitment to reform within the overall bureaucracy is high, especially in Poland, Hungary, and the CSFR.

48. Under the old regimes, foreign direct investments were governed exclusively by joint venture contracts negotiated on a case-by-case basis. This contractual mind-set continues to be pervasive and needs to be replaced by a generally applicable legal framework for foreign investment.

49. Even with massive legal and technical assistance (on a scale far exceeding that available to the CEE countries), the west German legal system is now considered too complex to deal with many of east Germany's immediate problems.

50. Income differentials are already widening in Poland, as evidenced by the opening of luxury car showrooms in Warsaw.

51. Among PHARE initiatives are a $1 billion medium-term loan program for Hungary and a stabilization fund for Poland.

52. These include German bilateral programs, in particular to Poland, Hungary, and the CSFR, and the U.S. programs established under the Support for East European Democracy (SEED) Act of 1989. SEED programs include access to Overseas Private Investment Corporation (OPIC) guarantees and enterprise funds to promote investment.

53. The EC, European Investment Bank (EIB), and European Bank for Reconstruction and Develop-
ment (EBRD) also apply political conditionality to their activities.

54. For example, a recent agreement between Volkswagen and Skoda could involve direct investments in the CSFR totalling $9 billion in the 1990s.

55. In addition, individual creditors may provide additional relief or convert part of the debt into local currency obligations through debt-for-equity or debt-for-nature swaps. The United States has agreed on a 70 percent reduction (which includes some debt-for-nature swaps, making straightforward debt relief closer to 60 percent), and the Italian government may do similarly.

56. Hungary's debt has been trading in the 90s on the secondary market, Yugoslavia's in the 50s, and Bulgaria's and Poland's in the 15-20s.

57. For example, debt-equity swaps were included in Mexico's 1989-90 debt relief package. Argentina linked debt-equity swaps with commitments to provide new money.

58. In addition to flows of goods and capital, how to handle movements of labor is an issue that may become more important as reforms proceed. Honekopp (1991) surveys the available evidence on migratory movements from CEE countries to Germany and Austria.

59. The role of world prices within the ex-CMEA area after January 1991 is not clear, due to the chaotic situation that has apparently followed the decision to shift to a convertible currency basis for trade within that area. Trade in raw materials (at least with the USSR) is apparently still handled mostly by central trading organizations. In the case of other commodities, world prices may indeed be playing a larger role.

60. In 1990, for example, the five-year average for oil was only about $17 per barrel.

61. One such list for Hungary-USSR trade anticipates a trade volume of $3 billion for 1991, about two-thirds the level of exports to the USSR in 1989.

62. The CEE countries appear to have a greater divergence between purchasing-power-parity and exchange-rate-based measures of income than
market economies at comparable levels of development, in part because of extensive price controls on important nontradables. They therefore appear in the international context as relatively low-wage countries, at least in the short run.

63. Although exact numbers are elusive, it appears that private entrepreneurship is emerging rapidly as constraints are removed. There may now be one million small businesses (one-person or family operations) and 2,000 to 3,000 larger firms in private hands, as well as perhaps 10,000 joint ventures with foreign firms. However, the share of nonagricultural production in private hands is still small — perhaps 15 percent in Hungary, Poland, and Yugoslavia, and less in the other countries.

64. The USSR has about 47,000 and China about 200,000 state-owned enterprises, most of medium or large size. To appreciate the significance of the number of firms, Chile’s massive privatization program from 1973 to 1989 involved some 470 enterprises producing 24 percent of value added in the economy and employing less than 5 percent of the workforce. Great Britain privatized about 20 firms, accounting for about 5 percent of value added, during Margaret Thatcher’s tenure as Prime Minister. In fact, between 1980 and 1987 fewer than 1,000 firms were privatized throughout the world.

65. In Poland, for example, at least 20,000 outlets have been sold, and about one-half of retail trade is in private hands. In the CSFR, republican governments plan to auction some 100,000 small businesses in 1991-92, with the successful bidders required to maintain services in the same locations for at least a year. Hungary plans to transfer ownership of about 10,000 shops, restaurants, and small-scale service establishments to private hands in 1991.

66. Data on the total extent of spontaneous privatization are scarce. It is believed that slightly less than 5 percent of state assets had been privatized by mid-1990.

67. These roles for intermediaries result in different ultimate ownership patterns. In the first two models, indirect ownership of firms is spread widely; in the case of a mutual fund, control is diffused, whereas it is more concentrated in the case of a holding company. In the privatization agency model, ownership is more concentrated, but the income received from privatization is spread widely.

68. Certain “strategic” industries, such as weapons, power, mining, postal services, and rail transport, are designated to remain in state hands.

69. In July 1990 the CSFR raised food prices an average of 26 percent with limited lump sum compensation.

70. More than 400 new banks have been established in the USSR since 1988.

71. In Poland they accounted for almost two-thirds of M2 by the end of 1989.

72. Accumulated losses in the banking crises of Chile and the Philippines reached about 20 percent of GDP. For comparison, the accumulated losses of the U.S. savings and loan system are perhaps 3 percent of GDP.

73. By early 1989 the capitalization of Hungary’s security markets equalled 10 percent of domestic credit.

74. Only in Germany do banks directly exert significant ownership rights over firms, and even these are restricted. Elsewhere, banks may own firms only through holding companies, with safeguards for the independence of credit decisions.

75. In the United States, for example, a minimum of five years is required to train an examiner capable of dealing with the smallest and simplest institutions. Years of experience are similarly needed for credit analysis, and there are limits to the degree of experience that can be transferred “off the shelf.” Existing training is mainly limited to short courses and is more in the nature of “exposure” than training to international standards. One of the dangers of current curricula is the tendency to include sophisticated topics such as currency swaps when the foundation of basic credit skills is not adequate.

76. These include strengthening credit processing, closely monitoring operating expenditures and efficiency, and introducing appropriate loan classification criteria, guidelines for provisioning, and income accrual and capital adequacy criteria.
77. If a hard budget constraint is applied to the banks while their portfolios have a large share of problem loans, they will be forced to widen spreads to good clients in an attempt to cover the losses on problem loans (as has happened in Yugoslavia); this can lead to disintermediation and a further loss of portfolio quality. With negative capital, there is also little incentive for banks to foreclose on clients. Banks therefore cannot be used to force widespread enterprise restructuring.

78. The experience of the GDR suggests the difficulties of rapid financial sector restructuring. The sole commercial bank, Kreditbank, entered into joint ventures with two large West German commercial banks, leaving its entire portfolio of old loans to a shell holding company with only 250 employees. This resulted in "clean" financial intermediaries ready to serve the region of the former GDR, but they had no direct interest in the repayment of previous loans and there was no adequate institutional structure for their recovery. At the same time, it is reported that the lack of acceptable enterprise audits and legal uncertainties concerning the loans, collateral assets, and securities are hindering the lending activities of the new banks.

79. This is the procedure to be followed in the former GDR.

80. These shares fell somewhat in the 1980s (particularly in Poland, Hungary, and Yugoslavia) as output stagnated, access to foreign borrowing tightened, and many large projects were abandoned or trimmed. As in most countries, investment bore the brunt of spending cuts.

81. The private sector might have a role in providing some basic infrastructure, notably telecommunications.

82. Direct subsidies were only one of many avenues for extensive redistribution within socialist economies. Redistribution began at the level of the enterprise, where individual wages were only loosely related to worker productivity (see annex 2) and where negotiated taxes, enterprise subsidies, and cheap credit reduced differences in after-tax profits. Redistribution continued at the sector level via arbitrary prices, government capital grants, and soft loans. Consumer subsidies represented only one link in the chain.

83. In Poland, for example, subsidies for all products and services except transportation and culture are estimated to have reduced inequality (as measured by Gini coefficients) by some 8.5 percent. Total consumer subsidies in Hungary are estimated to have reduced inequality by some 5 percent.

84. Housing and energy account for most of the remaining subsidies.

85. Hungary is considering adopting a specialized housing allowance program, possibly limited to Budapest (where most public rental housing is located).

86. A prime example is payroll taxes, which have traditionally been levied at very high rates to finance the broad array of social benefits (including pensions, health care, education, travel) provided to workers. In Hungary, Poland, the CSFR, and Bulgaria, social security contributions exceed 40 percent of payroll and are charged primarily to the employer. This level of tax would be difficult to impose on private firms. Reforms in social benefits are discussed further in annex 6.

87. For example, the company income taxes tend to have low straight-line depreciation rates, little allowance for loss carryover, and nondeductibility of some costs.

88. Although company tax reforms in Hungary led to a decline in revenues, the sharply increasing revenues from the new VAT more than compensated.

89. For example, foreign investors are eligible for very generous tax holidays and other tax benefits under the company income tax. The personal income tax exempts an estimated two-thirds of all personal income, including not only a generous tax-exempt amount, but also social security and other transfers, pensions, and most income from farming. The VAT exempts all financial, health, education, sports, and cultural services, and "zero-rates" many goods, including processed foods, medicines and medical equipment, books and periodicals, transportation services, and many sources of energy.

90. The Gini coefficient is the most common measure of income inequality. It varies between 0
(perfect equality) to 100 (all income appropriated by one recipient).

91. The degree of inequality in the socialist countries may be somewhat underestimated due to the omission both of unreported incomes and of some segments of the population, most notably private businessmen and the military in Poland and the USSR. These omissions also occur in market economies but generally to a lesser extent. Furthermore, monetary income alone is an imperfect yardstick in socialist countries where shortages were common and certain social groups had special buying privileges. On the other hand, the fact that many basic necessities were subsidized was in itself a form of social protection, leading to higher real purchasing power for a given level of income.

92. State-owned enterprises in market economies also tend to compress wage distribution by reducing top wages.

93. One of the first effects of reform is likely to be a readjustment in pay scales in favor of skilled professionals.

94. As noted elsewhere, socialist governments used an elaborate framework of largely ad hoc taxes, subsidies, and credit to extract profits from successful firms and prop up loss-making firms.

95. In Poland in the 1980s, for example, about one-fifth of all medical outlets belonged to enterprises.

96. Sickness benefits have generally been provided through social security institutions, with no employer obligations. The number of sick days has far exceeded (often doubled) that in Western Europe. Generous family allowances and lavish maternity benefits (such as birth grants and three years paid leave per child) have also been typical.

97. This approach is taken, for example, in Australia and New Zealand. It may not be the cheapest alternative when administrative costs are taken into account.

98. This approach is taken in most developed market economies.

99. Eligibility criteria were made more restrictive as of January 1991.

100. In general the minimum wage should exceed the social minimum to encourage work effort.

101. Bulgaria's initial benefit is 100 percent, declining gradually to 50 percent in the sixth month. Benefits are limited in time to nine months. Hungary offers initial benefits equalling 70 percent, declining over time; pursuant to new legislation, the benefit period varies between eight months and two years, depending on the length of prior employment.

102. In Yugoslavia, social assistance programs are run at the republic level or, within republics, at the communal level. Although they appear to be reasonably well-designed, funding may become a serious impediment to coverage as long-term unemployment grows, particularly in the poorer communities with smaller tax bases and a larger number of claimants. Greater financial support from the republican and federal governments may be needed.

103. In Hungary, for example, social security taxes paid by public enterprises are about 2.5 times their corporation income tax payments.

104. For example, early retirement was liberally granted during the Polish and Yugoslav stabilizations of 1990, and Hungary and Bulgaria grant full pensions for redundant workers at age 55.

105. The Polish privatization plan, for example, calls for the pension system to receive 20 percent of share ownership in privatized firms. This is a start but is not likely to fund a substantial share of pension liabilities.

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