Stabilization Efforts in Poland and Yugoslavia — Early Lessons

In late 1989, dissatisfied with past economic performance and concerned about accelerating inflation, the governments of Poland and Yugoslavia put in place extensive stabilization and restructuring programs. Both programs were launched at approximately the same time (December 18, 1989, in Yugoslavia and January 1, 1990, in Poland). Both are designed to stabilize inflation at low levels and to change economic policies drastically.

In the first few months, both programs managed to reduce inflation substantially without recourse to widespread price controls (as shown in Figure 1). By late 1990, however, in both Poland and Yugoslavia, inflation had resumed and economic activity had contracted.

Experience indicates that structural reforms, particularly privatization, are necessary to support the stabilization program. Macroeconomic policies cannot be relaxed, particularly in view of the negative external shocks associated with the increase in oil prices and the collapse of CMEA trade.

Characteristics of inflation

The history of inflation in the two countries has been quite different as a consequence of their diverging course of economic management. Poland’s economy was centrally planned until the 1980s; Yugoslavia instituted a system of self-management to replace central planning in the early 1960s. Inflation in Yugoslavia was not only higher than in Poland but also accelerated during the 1980s. Poland’s inflation was restrained by price controls, and the underlying inflation rate, consistent with fundamentals, was lower. The nonfinancial public sector in Poland ran moderate deficits throughout most of the 1980s, while enterprises ran small surpluses. In Yugoslavia, however, the nonfinancial public sector ran small surpluses in the 1980s, but businesses...
and the central bank recorded large domestic imbalances. In addition, a
sharp drop in external financing flows forced Yugoslavia to run increased
current account surpluses after 1983, while Poland ran current account
deficits until the end of the decade.

In 1989, inflation reached 640 percent in Poland and 2,700 percent in Yugo-
slavia. Yugoslavia enjoyed a more comfortable external position because
the large ($2.4 billion) current account surplus and successful debt resched-
uling permitted an increase in foreign reserves (to $6.1 billion). Poland ran a
current account deficit of $1.8 billion in 1989 and at the end of the year
recorded reserves of only $2.5 billion.

Both countries faced problems with redundant personnel in the enterprise
sector. In Poland, unemployment was virtually zero throughout the 1980s.
Unemployment in Yugoslavia was about 14 percent in 1989, close to the
13 percent average for the decade, but surplus personnel accounted for 20
percent of the labor force in 1988.

Common aspects

The programs have common ele-
ments:

• An income policy, comprising a
temporary (one-year) freeze in the
exchange rate; wage controls (with a
freeze in Yugoslavia, and partial in-
dexation at very low rates in Poland);
and a temporary freeze of prices in
the public sector in both countries.
• Fiscal adjustment amounting to
7 percent of GNP in Poland and 5
percent in Yugoslavia. (In Poland the
adjustment was designed to close the
fiscal deficit. In Yugoslavia it was
intended to cover nontraditional ex-
penditures such as the operations of
the central bank, transfers to imple-
ment bank restructuring, social pro-
grams, and funding for some enter-
prises in arrears.)

- Strict targets on the growth of
net domestic assets, and monetiza-
tion of inflows of foreign exchange.

• Substantial relaxation of for-
eign exchange and trade controls.
(Yugoslavia introduced full currency
convertibility; Poland restricted it to
current account transactions.)

- Implementation of measures to
force inefficient enterprises into
bankruptcy. (Yugoslavia established
a 60-day limit for arrears; Polish en-
terprises were required to pay divi-
dends to the government, based on
the book value of capital.)

Despite these efforts, neither country
had a clear strategy for restructuring
enterprises, and neither was precise
about the role of privatization. After
the initial successes, the monthly in-
flation rate increased to 5 percent in
Poland in the second half of 1990; it
has reached 8 percent in Yugoslavia
in recent months.

Officially-measured output declined
in both countries from January-Sep-
tember 1990. The drop was 30 per-
cent in Poland and 10 percent in Yu-
goslavia (see Figure 2). Because the
recession in Poland was more severe,
the trade balance shifted to a surplus,
while in Yugoslavia the trade balance
worsened as the deficit increased.
These differences reflect Poland's
more radical devaluation, more re-
strictive monetary policies (as indi-
cated in Figures 3 and 4), and the
more severe supply shock after the
quadrupling of energy prices early
last year. Although base money from
foreign exchange inflows increased
substantially in both countries, Po-
land suffered a more severe credit
crunch.

One consequence of Yugoslavia's
monetary restraint was a surge in
enterprise failures. During the first
half of 1990, 7,000 enterprises were
unable to repay bank loans, 3,000
accumulated arrears of 30 days, and
350 were declared bankrupt. Many
enterprises were reported to have
missed wage payments to postpone
bankruptcy. The government acquir-
Poland and Yugoslavia
Real M1 Indices (1988.4-100)

Poland
Yugoslavia

Poland and Yugoslavia
Real M3 Indices (1988.4-100)

Poland
Yugoslavia

escended to mounting pressures after June to relax monetary policy. This led to an increase in wages and contributed to the revival of inflation. Relaxation also kept loss-making enterprises afloat, thus slowing down significantly the expected shake-out of the industrial sector.

The response in Poland was even milder; there were no bankruptcies at all. The dividend tax, which was the trigger for declaring bankruptcy, was set at only 7 percent of enterprise assets — too low to force firms to restructure or declare bankruptcy. Polish enterprises paid the dividend tax rather than make payments to banks and suppliers. Neither creditors nor banks initiated bankruptcy procedures, suggesting the possibility of some collusion. Finally, credit policy eased in the second half of 1990, allowing real wages to increase.

Pending issues

In both countries the exchange rate appreciated in 1990. Yugoslavia devalued the dinar by 30 percent early in 1991 and faces potential inflation in the absence of adequate supporting policies. Indeed, the lower exchange rate under a scenario of wage decontrol, enterprise losses, and easy monetary policy could trigger hyperinflation again. Only a return to the earlier consistent policies will correct this imbalance.

There is still time for both countries to introduce a new wage policy while labor markets are undeveloped and ownership rights are unclear. It is important to steer a path between the excess influence of workers' councils and the inefficiencies of general wage controls that impede expansion of the more competitive enterprises.

Restructuring the productive sector is urgently needed to provide a positive supply response and sustain reform. While the fiscal adjustment did close the deficit in Poland and absorb the central bank's deficit in Yugoslavia, the expenditure cuts do not seem consistent with a serious restructuring program in either country. For instance, if unprofitable enterprises in Yugoslavia had been forced into bankruptcy, the government's social safety net would have been largely inadequate.

One important question is who will be in charge of restructuring and under what system of incentives? Centralized restructuring that excludes privatization not only may prove too slow to implement but also may produce an undesired selection of enterprises. Therefore, a more rapid move toward privatization may be required to minimize the risks of wasting resources during the restructuring process and to enhance the prospects of a sustained supply response.

Although forcing inefficient enterprises into bankruptcy is an important step, in the absence of well-functioning labor and capital markets it could create a large pool of unemployed workers. The issue of privatization comes up again, as it is impossible to develop a true labor market without simultaneously developing a market for capital. Policymakers should also address the issue of housing ownership and financing, a notorious obstacle to labor mobility in socialist countries.

The response to these structural problems has been slow in both countries. A failure to provide prompt solutions could jeopardize the early results of their stabilization programs.

Fabrizio Coricelli and Roberto de Rezende Rocha
The World Bank, CECMG
The article is based on the authors' paper presented at conferences in Poland and France in October and November, respectively, of 1990.
Study on the Soviet Union
Interview with John Holsen

TRANSITION Vol. 1, No. 9, reported that the World Bank, the IMF, the OECD and the EBRD have issued a study on the Soviet economy, recommending a radical economic reform program. We asked John Holsen (Senior Staff Resources Program — PADSS), leader of the World Bank’s team participating in the project, to explain the research and predict the possible results of this unique venture.

Q: As we learned, the 50-page summary and recommendations are just the tip of the iceberg. Three volumes of edited background materials will be published by the OECD in February. How did you obtain such a huge amount of information?

A: Our Soviet partners were extremely cooperative. They were even willing to do special computer runs to meet our requests. As a result we obtained previously unavailable information and statistical data on a number of areas, such as output, investment, balance of payments, external debt, and fiscal accounts. There was only one area that the government was unwilling to discuss: foreign exchange and gold reserves.

Q: How did you manage to coordinate the four organizations?

A: Four personal representatives and four team leaders coordinated the project in a series of meetings in Paris, Washington, and Moscow. Each agency appointed 15 or 20 staff members or consultants to a team. Flexibility was important; in some cases a team could borrow staff from other organizations. Each organization was in charge of certain areas of the Soviet economy, assisted by experts from other agencies. The World Bank took the lead on systemic reforms, including price liberalization, privatization, management of state enterprises, financial sector reform, and the legal framework of the market economy. The Bank also analyzed the agricultural, manufacturing, and housing sectors. The Fund was in charge of macroeconomic analysis, that is, fiscal and monetary sectors, the balance of payments, and the near-term outlook. The OECD team focused on energy, the environment, trade, foreign investment, the medium-term projection of the economy, the social safety net, and labor policy. The EBRD surveyed the role of information, the distribution system, and the transport and telecommunication sectors.

Q: What was the most remarkable finding?

A: The degree of disruption in the economy is, I believe, much greater than in Eastern Europe or in China. There is a shift to barter, to “dollarization,” as well as much hoarding. The internal movement of goods is increasingly restricted — people simply do not want to take rubles for goods. This makes the problems look somewhat different from other socialist economies. My impression is that the situation is getting worse — it certainly deteriorated during the three months I was there, between September and December.

Q: What is the remedy? Some critics note that the suggestions in the study are too general and can be applied to any country in the world.

A: The summary of recommendations inevitably looks a little general. The background papers, however, include a great deal of country-specific information. For Soviet officials, the most controversial proposal, I think, was to move rapidly with price liberalization. That recommendation stems directly from the breakdown of the ruble economy. We think the government should go ahead quickly introducing market-clearing prices. Right now, what the Soviet Union needs is simply to make the ruble a medium of exchange once again. That will be the case if more resources are allocated by market-clearing prices. We did not recommend confiscating the financial assets held by households and enterprises, which would make current rubles worthless. We believe that the monetary overhang could be absorbed partly by the price increases that are expected this year, partly by selling state assets to the private sector (small enterprises, retail stores, trucks, service industries), and partly by restricting application of funds held by enterprises. If other appropriate measures are taken, radical monetary reform is not necessary. If fiscal and monetary policies are not strengthened, even radical monetary reform will not solve the problems.

[The day after the interview, the Soviet government withdrew from circulation all 50- and 100-ruble notes. Citizens can exchange those bills for the equivalent of their average one-month salary, up to 1,000 rubles. To exchange more than the specified amount, citizens must apply to a special commission and must document the origin of their banknotes. Withdrawals from savings accounts have also been severely curtailed.]

Q: We learned that the Bank group met three categories of Soviet officials: those who support radical reforms; those who wish to keep the central

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authority but realize the need to streamline the system; and finally those who reject any change of the status quo.

A: This is more or less true, though it is very difficult to categorize different opinions. For example, most of the Soviet officials welcomed the assessment of the high economic cost of failing to maintain an all-Union economic market. The report argues that the republics of the Soviet Union are economically interdependent in a great many ways, and it would be very costly if the all-Union market broke down. That view was accepted even in the republics, though not necessarily shared by everyone. Many officials were more concerned about the decentralization of political authority than about economic reform. Almost all of them agreed, however, that the report should be translated into Russian and discussed as part of the dialogue on economic reform. The EBRD is putting out a version in Russian, which we hope will be widely distributed in the Soviet Union.

Q: Some comments object to the radical approach of the study, which is unacceptable to the present leadership. They suggest that the authors should have come up with a second-best recommendation, taking into consideration the sensitivity of the central authorities.

A: The objective was to recommend the essential characteristics of serious and comprehensive economic reform. We were not trying to negotiate an economic program and a financial package to support it. However, we did pay attention to the social and economic circumstances. Thus, we emphasized safety nets and cushions. We suggested that the rationed amount of some essential food items should continue to be subsidized. We also proposed that the transition to world market prices be moderated by export and import taxes in some areas, particularly in the energy sector.

Q: Many well-known reformers left the presidential team, including Alexander Yakovlev, Leonid Abalkin, Stanislav Shatalin, and Nikolai Petrakov. What is your prediction about the future course of Soviet economic policy?

A: It is very hard to predict. There were many changes in the last five months. Some of the senior officials we met are no longer there. I am hesitant to predict what will happen. It is obvious that economic reform needs political consensus. Unless some of the most pressing political problems can be solved, particularly the relationship between the republics and the Union, I see no chance to tackle successfully the closely related economic problems.

Q: Don't you think that the Soviet Union might return to the old system of central planning?

A: Perhaps, but enterprises now widely ignore state orders or turn them down. They say that they cannot provide the output specified since they are not getting the inputs from the state. Because the supply system has broken down so much, it is difficult to go back to a system of state orders and administrative controls. We think it would be easier to go forward to a market system.

Q: Considering the present turmoil in the Soviet Union, the Western reaction to the bloody events in the Baltic, and the uncertain fate of the technical assistance offered to the Soviet Union by the Group of Seven, do you have any hopes that your reform proposals will be implemented?

A: Let's put it this way. First, the study will help those in the Soviet Union seeking solutions to the economic problems. Second, I'm sure the ideas in the report will be tested — if not now, then later, in six months, 12 months, 18 months.
Convertibility for Eastern Europe: How to Get There?

How quickly and by what route should currency convertibility be approached by countries in the process of transformation from central planning to market capitalism? Eastern Europe's creditors see convertibility as a major step toward integration in the world economy. January 1991

The temptation can be dangerous. An excessively low rate is itself inflationary, especially if it provokes nominal wage increases. If there are adequate defences against that, the sharp fall in real wages will affect the labor supply (and stimulate emigration) as well as cause suffering that may be politically destabilizing. Moreover, new domestic entrepreneurs with little working capital may find imported inputs prohibitively expensive.

Commodity convertibility is a prerequisite for current account convertibility. Capital account convertibility must come after current account transactions are freed, not only to avoid capital flight but also to control funds flowing into the country. Newly independent domestic firms, banks, and households might borrow irresponsibly. Excessive capital inflows might in the short run lower the price of tradables and discourage production for export. They might also add to the massive stock of incomplete investments; in the long run they could prove impossible to service. It seems unlikely that inconvertibility on the capital account will be a significant obstacle to desirable investment from abroad as long as current account convertibility permits repatriation of profits.

Intermediate forms of convertibility are not feasible since totally new price systems and a massive injection of competition are essential. It is hard to do this quickly except by opening the economy to trade and permitting current account convertibility at a unified exchange rate. This plan would overcome some of the inherited distortions.
But convertibility is not a panacea — a keystone, perhaps. It cannot deal with the legacy of distortions left by rigid central planning. An open trade policy is not sustainable without domestic macroeconomic stabilization and substantial price responsiveness of import demand and export supply.

Debate on scheduling

The leveling that characterizes centrally planned systems involves not merely subsidizing unprofitable enterprises but also siphoning off excess profits from successful firms. A major problem arises when enterprises have control over these profits. Financial discipline is necessary for convertibility. Current account convertibility is not sustainable if enterprises can borrow unlimited amounts of domestic currency at low real interest rates for purchases of foreign currency.

A fairly conventional sequencing procedure includes:

- Monetary restraint with budgetary discipline
- Free prices to clear markets
- Establish competition by breaking up monopolies
- Institute financial discipline and eliminate leveling
- Cut links between central authorities and enterprises
- Open up international trade at a unified exchange rate
- Current account convertibility
- Capital account convertibility

But some arguments suggest scheduling current account convertibility much earlier. Isn’t the top priority a rational price structure? Why free prices only to establish a closed economy, by distorted monopolistic behavior? How long will it take to break up the monopolies? How much longer will it take to move from the closed-economy equilibrium to something approximating an open economy, and how much damage will have been done in the interim?

Both views reject a wide variety of partial measures, including centrally directed price reform (even using world market prices as a reference point); enterprise retention of export earnings; and restricted foreign exchange markets, particularly auctions in the context of a closed economy not subject to financial discipline. All these intermediate steps are more likely to go backward than forward.

Richard Portes
The author is Director of the Centre for Economic Policy Research, London. The article is based on his forthcoming CEPR Discussion Paper, The Transition to Convertibility for Eastern Europe and the USSR.

Quotation of the Month:

"Go Carefully On Trade"

Thinking on economic reform in Eastern Europe has, up to now, drawn heavily on experience from the third world. A reforming government first needs to “stabilize” its economy — that is, cut its budget deficit and stop printing money to finance whatever deficit remains. After that it needs to open its economy to international trade and, most likely, devalue its currency; this will align domestic prices with prices in world markets and force the economy to use resources more efficiently. This advice makes sense for most developing countries, but is it relevant to Eastern Europe?

In one respect, at least, the answer is no. The standard third-world prescription heavily underplays the role of private property. In most developing countries, private ownership is already the rule. Producers are obstructed by governments in all sorts of ways, but enterprises are, by and large, private. In the ex-communist countries almost all enterprises are still owned by the state; that fact is directly and indirectly linked to just about every economic difficulty these countries face.

Poland... devalued the zloty by 31 percent on January 1, 1990. This approach, according to the standard thinking, should have made Poland’s producers more competitive... The sharp contraction in Poland’s output — despite the fall in the zloty — raises doubts about the efficacy of the devaluation.

In a book to be published soon, The Order of Economic Liberalization: Financial Control in the Transition to a Market Economy, Ronald McKinnon of Stanford University suggests a dis-
Response: "These arguments . . . are false"

Your recent article urging a very slow retreat from the extreme protectionism of Eastern Europe is a rehash of the discarded structuralist doctrines once so ruinously applied to Latin America: that devaluation does not promote exports but only raises the prices of imported inputs; that trade liberalization wipes out manufacturing jobs; and that protectionism should be pulled back only slowly. These arguments were false for Latin America, and they are false for Eastern Europe...

On January 1, 1990 Poland removed the anti-export bias in its policies by devaluing and unifying the overvalued exchange rate, ending foreign-exchange rationing and cutting tariffs. As a result, exports to the West boomed, rising from $8.5 billion in 1989 to $11.4 billion in 1990. This increase was across the board: in electrical machinery, metal products, chemicals, processed foods and agriculture. At the same time, imports fell, partly because Poland's state enterprises economized on raw materials when "soft budget constraints" on the enterprises were tightened up...

In fact, of Poland's 5,006 state industrial enterprises, only 432 (accounting for just 3.7 percent of employment) reported they lost money in the first eight months of last year. No doubt the accounting leaves much to be desired, and rising prices for energy and raw materials from the Soviet Union will push many more firms into the red—but the assumption that free trade has pushed a big portion of industry into loss is wrong... The widely reported output statistics are based entirely on production within the state-owned industrial sector. The statistics include neither private firms nor non-industrial ones...

Free trade is especially vital in Eastern Europe. It is the single most effective way — perhaps the only way — to instill real competition in the industries of Eastern Europe, which are otherwise too concentrated, too politically powerful, and too small to generate domestically-based competition. Free trade will allow Eastern Europe to "import" a rational price structure. It will provide the principal source of contacts between Eastern European and Western firms—contacts that are vital for improved product quality and technologies. And a rapid growth of exports to the West, best served by free trade, is essential to shift exports away from the collapsing Soviet market.

Of course free trade will cause some firms to shrink or fail — and that number will increase if wage restraint breaks down. Some firms will even be "value subtractors," as your article called them, where input costs net of labor at world prices exceed output values. But protecting such firms is unjustified. Not only would it frustrate the movement of resources to new sectors, but in the extreme it would actually cause the country to lose foreign exchange for every unit of production that receives protection. It would cost less to pay workers to do nothing than to protect value-subtracting firms.

Jeffrey Sachs, Harvard University, responding in a letter in The Economist
Milestones of Transition

In mid-January, Poland's chief debt negotiator said his country expected to reach a comprehensive agreement with major Western creditors in April concerning debt reduction. Poland owes $46.1 billion, including about $35 billion to the Paris Club of major Western governments. Deputy Finance Minister Janusz Sawicki added that Poland can service only 12.5 percent of its annual interest. Last year Poland repaid only $700 million of the $6.8 billion interest due. The current practice of periodic rescheduling of service charges will increase the debt to $100 billion by the year 2000. The only solution to the problem, Sawicki argued, is the government's proposal to limit payments to 2 percent of the annual nominal charges. This would mean an effective 80 percent reduction of the total debt. At their last steering committee meeting, which took place in London in January, Poland's commercial creditors could not agree on the possible write-off of Polish debt. Austrian, French, and German banks are willing to write off all or most of the $10.6 billion owed to commercial creditors, but British and U.S. banks feel that forgiveness would set a dangerous precedent committing them to write off the debts of Brazil and Mexico. The U.S. and British banks want Poland to reschedule its debt under the Brady Plan.

In his first policy speech to parliament, Polish Prime Minister Jan Krzysztof Bielecki promised free-market policies and a speed-up of privatization, with a stock exchange in operation by the end of 1991. Salaries will be unfrozen gradually to stimulate production while inflation is kept under control. The privatization program would concentrate on small firms and push ahead with banking reform. The rural economy will be helped as farmers gain easier access to credits. Bielecki promised foreign investors full freedom to transfer profits abroad and equal treatment with Polish companies.

When the first five Polish state companies were sold off under the government's privatization program, demand exceeded the supply of shares, announced the Polish Ministry of Property Transformation. The five companies were offered to the public in November. Private investors' subscription orders exceeded their allocation by up to 20 percent. Property Minister Janusz Lewadowski announced that Poland plans rapid privatization of the 7,000 state-owned enterprises, which still account for 90 percent of Poland's economy, mainly by distributing free shares. There will also be sales to strategic investors, both domestic and foreign.

The German government has abolished property and trade taxes on companies in eastern Germany in an effort to speed economic recovery there. Raising personal tax exemptions will allow most employees effectively to pay no income taxes. A worker with a spouse and two children and earning less than DM25,000 a year, a good factory income in eastern Germany, would be exempt from taxes, for example.

The Romanian government will make 60,000 workers redundant in the mining and engineering industries as a consequence of closing most unprofitable companies during the next few months. Another 135,000 workers will be reassigned. A government spokesman said that the restructuring would first affect those companies that waste energy and raw materials. In another development, Romanian Prime Minister Petre Roman has given the go-ahead for foreign currency auctions as a first step toward making the national currency convertible. The National Bank of Romania has authorized banks and agents in Romania to hold foreign currency auctions.

The federal government of Yugoslavia disclosed in early January that the Serbian Republic illegally authorized an 18.2 billion dinar ($11 billion) currency issue. According to the government, the move threatens Yugoslavia's currency reserves as well as the stability and convertibility of the dinar. The currency issue, amounting to about half of the federal government's planned credit expansion in 1991, was allocated to subsidize money-losing industrial behemoths, pay pensions, and support farm prices. In response, the National Bank has suspended transfers to the republic and has government support for tightening monetary control over all the republics.

A joint meeting of the two Soviet parliamentary chambers has adopted the USSR budget for 1991. Revenue is set at 250.2 billion rubles and expenditures at 276.8 billion. The budget earmarks 97 billion rubles for defense spending, 5 billion for the KGB, and makes major reductions in foreign aid.

The New 5 percent sales tax should generate 36 billion rubles; transfers from the republican budgets are expected to bring 41.6 billion rubles. The all-union economic forecast projects a 1 percent fall in GNP in 1991.

Bulgaria's Prime Minister Dimiter Popov told parliament in late January that the government will have to pursue a more severe budget policy, maintain higher interest rates, and restrict incomes and the money supply. By the end of February, the government will present a detailed economic reform program to the IMF, he said, and will seek up to $3 billion in IMF funding. The main goals will be to increase output in the second half of the year, curb inflation, and price controls, and cut the budget deficit. Popov said the government intends to start a privatization program and set up the basic institutions of a market economy.

(In 1990 industrial output in Bulgaria fell 10.7 percent from 1989, with oil processing down 41.5 percent. According to the Central Statistical Board, retail prices rose 50.6 percent in the second half of 1990, foreign debt was $11 billion, and the country's solvency had been weakened by the previous government's moratorium on debt payments.) The government will try to restore Bulgaria's creditworthiness and to that end will start negotiations with the Paris Club.

Hungary's State Property Agency is encouraging private investors to bid for state-owned enterprises in an attempt to speed up and streamline the privatization process. Such bids would trigger public auction of targeted companies, even over the objections of the companies' current management. In 1990, 130 enterprises were privatized, and another 60 cases are still in
Milestones
(continued from page 9)

transformation; in 1991, 400 firms are to be privatized. The State Property Agency would judge whether offers serve the long-term interests of companies emerging from state control. The agency will also replace management that does not cooperate in privatization.

The Hungarian government has announced drastic price increases for the first half of 1991. Bread will go up by 38 percent, milk by 21 percent, postal services by 40 percent, water utilities by 100 percent. Rail transportation costs will increase 80 percent, telephone rates will double, and electricity prices will rise by 50 percent. Pensions and family allowances will rise, and wage increases will offset part of the effect of the price increases.

The president of China's central bank has promised to clamp down on the money supply while the country's economic recovery is threatened by renewed inflation and a fiscal crisis caused by crippling losses in state enterprises. Li Guixian told a banking conference in Beijing that tight controls had to be imposed, reversing a credit-loosening in 1990 to boost struggling industrial production. China had ordered the nationwide austerity program in the fall of 1988 when inflation hit a high of nearly 40 percent. Inflation dropped to 3 percent for most of 1990, but economists say inflationary pressure is building up again, with the November rate running at 5.3 percent. China still can expect 12-15 percent industrial growth this year, with imports increasing by 20 percent and exports by a moderate 5-8 percent, claims the London-based Oxford Analytica research group.

Algeria: Developing a Market Economy

Although economic reform in Algeria has been less dramatic than in Eastern Europe, progress continued last year at a steady — and even accelerated pace. The fundamental goal of reform is unaltered: to improve economic performance by developing a market economy.

Reform began in earnest after the collapse of world oil prices in 1986. Early efforts focused on establishing an institutional framework for decentralized decisionmaking. (See "Algeria: Sequencing Liberalization,” Transition, June 1990.) Work continued on adjusting macroeconomic balances and correcting price distortions. Officials are working to liberalize the trade regime and open the economy to external competition in preparation for full convertibility of the dinar — at least for commercial transactions — by 1992.

Early phases

From 1986-89, the government concentrated on putting in place an institutional framework for a market economy. It began to break up state farms in 1987, made public enterprises autonomous in 1988, and adopted a new constitution abolishing the one-party system in 1989. During this period it also focused on reducing the budget deficit, permitting some absorption of high-level liquidity. At the same time, policymakers made substantial progress in correcting price distortions. The adjustment began with devaluation in 1988. Interest rate ceilings replaced fixed interest rates and new regulations liberalized domestic prices.

Economic reform continued in 1990. New legislation firmly established the Central Bank's control over monetary policy and external capital flows. Institutional changes helped sustain adjustment early in the year when oil prices fell and revenues from exports plummeted. After the dramatic price rise, tighter fiscal policy was bolstered by the subsequent oil windfall. This resulted in a substantial budget surplus and helped the Central Bank restrain money growth without cutting off domestic credit. Liquidity remains high, however, indicating persistent excess demand. Inflation has accelerated recently, in response to continuing devaluation and domestic price liberalization.

Algeria initiated key institutional reforms during 1990, including labor relations and a new money and credit law that gives the Central Bank full autonomy in directing monetary and foreign exchange policy. The government, who chairs the key committees on monetary exchange and debt policy, now serves a continuous six-year term. The law sets strict limits on new treasury borrowings as well as a firm schedule for repayment of treasury debt. In preparation for trade liberalization, the law also removed controls on direct foreign investment in most sectors. In addition, 100 percent foreign ownership of new investment projects is permitted, as are unrestricted joint ventures between foreign concerns and the private sector. The Complementary Finance Law — passed last August — authorizes import licenses for specified categories of goods for domestic resale.

The new labor laws lay the groundwork for a more competitive labor market by breaking the legal monopoly of the Union Générale des Travailleurs Algériens (UGTA), until recently the sole trade union. In addition, procedures have been established to resolve labor-management disputes in a collective bargaining framework.

Further adjustments

Because hydrocarbons account for some 95 percent of Algeria's merchandise export earnings and—
through petroleum taxes—some 40 percent of the current revenues, the macroeconomic balance is inevitably linked to oil prices. While there was no dramatic compression of treasury spending or imports in 1989-90, and macroeconomic policy successfully restrained demand, the higher petroleum revenues now can generate budgetary savings and an improved current account.

While data for 1990 are still preliminary, the budget surplus is estimated at more than 3 percent of GDP. As this surplus was used to repay treasury debt to the Central Bank, the banking system was able to retire foreign debt and replenish reserves while slowing money growth. Balance of payments figures show a current account surplus of about 2 percent of GDP, while the end-year stock of broad money as a share of GDP dropped to about 70 percent, down from more than 80 percent a year earlier. This ratio is still very high, even for comparable economies, raising concerns about the inflationary impact of future price liberalization.

Exchange rate adjustment and price liberalization continued during 1990, contributing to a significant—though still controlled—increase in official consumer price inflation. Rapid exchange rate adjustment between mid-November and end-December brought cumulative annual devaluation to more than 50 percent, reducing the premium on the parallel exchange rate (over the official rate) to less than 300 percent, down from 500 percent a year ago. By July 1990, the prices of goods accounting for almost 50 percent of the official consumer price index had been freed, and annual consumer price inflation jumped from 9 percent to almost 17 percent. A full two percentage points of the increase occurred in December.

As pressure for wage increases mounted, the government struck an agreement with the still-dominant UGTA, nearly doubling the minimum wage and promising to follow up with further increases. Although it is too early to assess the overall effect, the hike will complicate the adjustment process by putting off required real wage adjustment and increasing labor absorption problems. The incident demonstrates the practical difficulties of breaking up a powerful trade union's effective monopoly power, even though the legal barriers to competition in the labor market have been removed.

Future goals

The near-term reform goal is to liberalize the external trade regime by removing administrative controls on foreign exchange allocation. Simultaneously, officials intend to pursue at least two other initiatives:

- Public enterprise restructuring—particularly for the 20 or so “loss leaders” — together with banking sector reform. This strategy should alleviate the debt burden on enterprises and establish more rational criteria for future credit allocation.
- Fiscal reform, including income and profit taxes, value-added taxes, and trade taxes. These measures should improve the tax net's efficiency, reduce its administrative complexity, and increase treasury revenues.

The government is moving ahead with plans to make the dinar convertible—at least for commercial transactions—by 1992. The foreign exchange allocation system, although somewhat more decentralized, rations foreign exchange according to poorly-defined administrative criteria. A system whereby the exchange rate equilibrates foreign exchange supply and demand will promote more efficient allocation of foreign exchange and thus foster non-oil export growth.

Challenges

Trade and exchange liberalization pose major challenges. The persistence of a parallel market premium on foreign exchange indicates that a move to currency convertibility will require further steps to restrain import demand and maintain balance of payments stability. Moreover, to counter inflationary pressures resulting from external liberalization, action in at least two policy areas will be required:

- A tight fiscal stance to generate government savings and amortize the treasury's debt to absorb excess liquidity.
- More effective labor market competition to contain pressures for wage increases.

The evolving domestic political situation represents a challenge for the reform program. The Islamic Salvation Front's victory in last June's municipal elections broke the ruling party's 25-year monopoly on power. Algeria's first multi-party national legislative elections since independence are scheduled for June 1991. The results — especially against the current background of turbulence in the region — are difficult to predict. But all the political parties have voiced broad support for continued economic reform and increased democracy.

Ali Khadr and James Parks
World Bank, EM2CO

Victory

From the Bulgarian magazine Sofia News

Volume 2, Number 1

January 1991
Enterprise Reform and Privatization in Socialist Economies

Barbara Lee and John Nellis


The authors analyze efforts to improve state-owned enterprises (SOEs) in seven socialist countries that are members of the World Bank: Algeria, China, Hungary, Laos, Mozambique, Poland, and Yugoslavia. These countries have long tried to improve SOE performance by restructuring, short of ownership change, with meager results.

Recent political change has broadened the choice of restructuring instruments — adding the options of privatization and liquidation. However, since privatization takes time, how is productivity to be enhanced in enterprises that necessarily must continue to be state owned? Financial, technical, or organizational restructuring is one answer. Increasing the autonomy and accountability of managers by streamlining their relationship with the government is another solution. Allocative efficiency can be improved by creating a market or "market surrogate," thereby introducing a competitive environment.

Chinese Television Industry: The Interaction Between Government Policy and Market Forces

Athar Hussain, Jean Olson Lanjouw, and Le Li


The television manufacturing industry, which is a rapidly growing part of the Chinese economy, is closely monitored by the government. Although complex government controls, such as input quotas and official pricing, affect the industry, market forces also play a part. Television assembly factories, thanks to their relatively low fixed costs, have responded to the government's capacity- and quota-based production targets with a large overcapacity. Manufacturers took advantage of excess demand for television sets and used barter trade to conceal price increases. One implication of this market-oriented behavior is that if government controls are lifted and a freer market is allowed to develop, a rapid response to new opportunities is likely.

The government built assembly lines all over China to prevent concentration of economic growth along the coastal area and economic differentiation among regions. The geographical dispersion of the television assembly industry does not imply a major efficiency loss, however. Output has a low fixed-cost component, and quality is determined almost exclusively by the inputs. Neither economies-of-scale nor ease of quality control argues in favor of concentration in large plants. In addition, the fragmentation of production lowers transport costs. But neglecting specialization and domestic trade might endanger long-term employment.

Socialist Economic Growth and Political Investment Cycles

Heng-fu Zou


Socialist economic growth in Eastern Europe and China has long been characterized by hunger for investment, drives for expansion, and cyclical fluctuation of investment rates. Treating social planners as self-interested bureaucrats, the paper offers a positive model to understand those "norms" of socialist economic growth. Rapid capital accumulation satisfies social planners' own interest, according to the model, and supplies answers to the questions: why is investment hunger the inevitable consequence of the social planners' rational choice, and in what circumstances will the expansion drive result in a permanent shortage of consumption goods? The author — through numerical examples and empirical tests — also provides a framework for analyzing political investment cycles in a socialist economy; high investment rates usually are linked to hard-line political regimes.
Ryszard Lawniczak
POST-CMEA INTEGRATION OF
SOVIET AND EAST EUROPEAN
ECONOMIES — CHALLENGES
AND PERSPECTIVES
Institute of Political Economy, Pre­
print Series, No. 45, Poznan, 1990,
33 p.

The demise of the “old type” CMEA
does not mean that the subregional
integration of Central and Eastern
Europe (the Soviet Union included)
has been terminated forever. The
author envisions a Central European
Payment Union set up by the successor
organization of the CMEA, followed
by a Central European free trade
agreement and, probably after the
year 2000, by the emergence of a Pan
European Economic Space.

Meanwhile, the high degree of struc­
tural dependency among the former
CMEA economies suggests that much
trade during the 1990s will continue
within the subregion.

Institute of Political Economy: Acad­
emy of Economics, Marchlewskiego
146/150, 60-967 Poznan, Poland, tel:
(61) 699-261, ext. 1760

Robert William Davies (ed.)
FROM TZARISM TO THE NEW
ECONOMIC POLICY

An international team of scholars
compares in detail the tsarist economy
and the Soviet mixed economy of the
1920s. They describe the performance
of the major economic sectors in both
periods, discuss the institutional
continuities and shifts, portray the
process of economic development, and
discuss changes in the social structure,
industrialization's impact on the
peasantry, and the evolution of inter­
nal and foreign trade. The authors
suggest a reconsideration of the ma­
jor controversies both about late
tsarism and the so-called New Eco­
nomic policy, with particular atten­
tion to the economic successes and
stability of each.

The editor is Professor of Soviet Eco­
nomic studies at the University of Bir­
mingham (U.K.).

New Books and Working Papers

David A. Baldwin and Helen V. Milher
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East-West Trade and the Atlantic
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Janusz Beksiak
The Polish Transformation:
Programme and Progress
Centre for Research into Communist

Oleg Bogomolov (ed.) for the Inter­
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Market Forces in Planned
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Macmillan, London (IEA Conference
Volume No. 96), 1990, 308 p.

Roger Boyes
The Hard Road to Market:
Gorbachev, the Underworld and
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Seeker and Warburg, London, 1990,
330 p.

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Kluwer Academic Publishers,

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L. Genovese
Vietnam: An Investor's Appraisal
Business International Asia/Pacific,
1990, 104 p.

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Institute for East-West Security

Leslie Lipschitz and Donogh
McDonald (eds.)
German Unification — Economic
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IMF Occasional Paper No. 75,

Daniel Teffer
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Analyses of the Economy of
Ethiopia
Edwin Mellen Press, New York, 1990,
122 p.
Support to Chinese Cities

On January 8, the World Bank approved the Medium-Sized Cities Development Project to improve the living conditions in Changzhou, Louyang, and Shashi. The World Bank loan of $79.4 million and the International Development Agency credit of $89 million (out of a total project cost of $277.2 million) will finance reforms that improve the use of existing urban facilities and will provide more appropriate financing mechanisms for urban development. Investments will be used to upgrade urban planning and management, improve education and health services, construct infrastructure to expand water supply and sewerage, improve water quality through new pollution-control equipment, and implement national housing reforms. The project — to be completed probably by 1997 — is expected to benefit 1.8 million people.

First Loan to Czechoslovakia

The IMF has approved a $1.78 billion credit package for Czechoslovakia to help in the transition from socialism and to buffer the recent oil price shocks. The loans consist of a standby credit of $883 million over the next 14 months and two advances from the IMF's compensatory and contingency financing facility totaling $900 million. Some $448 million of the special facility can be drawn immediately, and $241 million will be available later; $210 million in contingency credits will become available only if oil prices rise beyond the levels envisaged in the program. This is the first time Czechoslovakia has borrowed from the IMF and the first time the Fund has lent money under new financing arrangements that help developing nations cope with oil shocks. The credit to Czechoslovakia, the largest to any Central European government by the IMF, is likely to be followed by World Bank loans. These will be used to improve the financial and energy sectors and to support the privatization of state-owned industries and other aspects of structural change.

Negotiations in Warsaw

Poland resumed talks with the IMF in late January on a three-year stand-by facility to replace the current agreement that expires in March. (Last year's austerity program was backed by a $715 million credit from the IMF and a billion-dollar stabilization loan from Western nations.) Prime Minister Jan Krzysztof Bielecki, referring to the current IMF mission to Poland, said Fund acceptance of Poland's adjustment plan would be a major achievement that would be the basis for favorable actions by official creditors and would provide proof of Poland's credibility. Poland also expects new World Bank loans of up to $500 million by late June to finance projects in energy saving, industry restructuring, housing, and communications. Warsaw expects another $1 billion loan from the Bank after mid-1991.

IMF Credit to Hungary

The IMF has cleared a $318 million compensatory facility loan for Hungary to help offset the higher cost of oil imports. The IMF also has made provisions for additional credits totaling $171 million for the same purpose and is likely to act shortly on a $1.5 billion three-year extended credit arrangement. These developments follow what the IMF described as the satisfactory implementation of a $210 million standby credit facility for the country in March 1990.

World Bank Mission in Nicaragua

A current Bank mission in Nicaragua is helping the government prepare a plan to stabilize and restructure the economy. IMF and Inter-American Development Bank missions are expected in the country shortly, and the government, hoping to reduce the budget deficit and contain hyperinflation, expects to meet with the Paris Club in March.

Tanzania Fuel Distribution

Tanzania's industries, farms, and households will have greater access to petroleum products as a result of a project being supported by a credit of $44 million from the International Development Association, the World Bank credit affiliate. The credit is part of a $103.6 million program to rehabilitate the country's petroleum distribution network and reactivate the 1986 economic recovery program. The IDA credit will be used to construct petroleum storage depots, upgrade rail transport for petroleum products, and build other distribution facilities. The improvements should reduce petroleum transportation costs and make the oil industry more efficient.

Albania Applies for Membership

Albania has applied for membership in the IMF and the World Bank, according to Niko Glyzari, chairman of the State Bank of Albania. A government spokesman noted that approval from the World Bank's Board of Executive Directors normally takes up to two years but that Czechoslovakia and Bulgaria became members within 10 months of their respective applications.

Negotiations with the Soviets Suspended

Soviet membership in the World Bank is currently not under consideration, according to World Bank President Barber Conable. He added that all discussions with the Soviet Union about technical assistance have been suspended as well. Conable cited two reasons for this cooling of contact: concern among World Bank management over Moscow's recent shying away from a market-oriented economy, and World Bank member countries' reaction to recent events in the Baltic states. An IMF official, citing similar reasons, said the question of Soviet membership is in abeyance. A U.S. government official said U.S. policy toward Soviet assistance is to freeze current activity but not to halt activities that have already been approved.

Romania and the IMF Package

Romania expects to receive a $1 billion credit package from the IMF shortly. The package would include a 12-month standby agreement of 380.5 million SDRs ($544 million) plus 247.6 million SDRs ($354 million) in oil import assistance under the Compensatory Credit Finance Facility. Under the same facility, Romania would be eligible for a further 131 million SDRs ($187 million) if oil and gas prices rise above a certain level. National Bank governor Mugar Isarescu said currency convertibility would occur within months rather than years and added that Romania has pledged to keep the underlying rate of inflation down to 10% in 1991. Romanian officials expect the first IMF funds in April.
Conference Diary

From Cold War to Cooperation: Dynamics of a New World Order
January 23-25, Washington, D.C.

International Development Conference on the new world order, organized with the Society for International Development. Topics include: a new world order—the issues the U.S. must face; perestroika and pluralism Southern-style; and changing East-West rivalry to East-West cooperation with the South.

Forthcoming Conferences

Privatization in Eastern Europe—The European Horizon
February 8, Leuven, Belgium

Conference at the Catholic University will review progress and problems of privatization in the eastern part of Germany, Poland, Hungary, and Czechoslovakia and the impact on integration into the European economy. Experiences of the German Treuhand and the privatization agencies of the individual countries will be reviewed.

Information: Professor Marvin Jackson, Director, Leuven Institute for Central and East European Studies, Blijde Inkomststraat 5, B-3000 Leuven, Belgium. Tel.: 32-16-285340, fax: 32-16-285344.

Workshop: Economic Transformation in Eastern Europe

Organized by the Center for Economic Policy Research for participants of the CEPR-administered program. Topics will include Hungarian tax reform, the industrial restructuring in Eastern Europe, and privatization.

Transformations in Eastern Europe
March 1-2, Gettysburg, PA

A two-day international interdisciplinary conference at Franklin and Marshall College, co-sponsored by the Central Pennsylvania Consortium. Topics include: transition to a market economy, social issues, interaction of East and West Europe, nationalism and minorities.

Information: Central Pennsylvania Consortium, Gettysburg College, Box 421, Gettysburg, PA 17325. Tel.: (717) 337-6141.

Doing Business in Central and Eastern Europe
March 5, College Park, MD

One-day seminar at the University of Maryland. Topics include: business opportunities in Czechoslovakia and Hungary, joint venture opportunities in the Eastern bloc, and “Getting Started Doing Business Overseas.” Co-sponsored by the Michael Dingman Center for Entrepreneurship and the Suburban Maryland Technology Council, the seminar will bring together representatives from Hungary and Czechoslovakia as well as Americans working to facilitate business interaction.

Information: Sandra Hirsch, Dingman Center, College of Business and Management, University of Maryland, College Park, MD 20742-7215. Tel. (301) 405-2144.

Transition to a Market Economy in the Emerging Democracies of Eastern Europe
March 24-27, Prague, Czechoslovakia

Jointly sponsored by the Institute of Policy Reform and the Project on Institutional Reform and the Informal Sector at the University of Maryland. Topics will include: property rights and privatization, institutions for a competitive private sector, housing, the speed and sequencing of transition. Finance minister Vaclav Klaus will address the conference. Participants will include experts from the World Bank, high-level government officials from the U.S. and Europe, and leading representatives of the U.S. academic community.

Public versus Private Enterprises
April 4-5, Liège, Belgium

International conference of CIRIEC (Centre International de Recherches et d’Information sur l’Economie Publique Sociale et Coopérative) at the University of Liège. Three working groups will discuss privatization issues; performance measures and comparisons; and incentive schemes and mixed markets, respectively.

Annual Bank Conference on Development Economics
April 25-26, Washington D.C.

Organized by the World Bank/PRE. Topics will include the transformation process in socialist economies and the role of governance in economic development.

Housing Policy Reforms in Eastern Europe
May 6-9, Prague, Czechoslovakia

High-level housing policy seminar organized by the Economic Development Institute and the EMENA Technical Department of the World Bank, co-sponsored by the French Caisse des Dépôts et Consignations, Paris. About 30 participants: ministers, officials, and senior civil servants from Bulgaria, Czechoslovakia, Romania, Hungary, Poland and Yugoslavia. Topics to be discussed include:

* Adjusting the direct role of the state to achieve a market-oriented housing system (Western European experiences, privatization techniques, rental techniques, management of rental stock, and redesigning of housing subsidies).

* Creating an enabling environment for a sustainable housing sector (developing financial instruments and intermediaries, savings, mobilization and affordability issues, enhancing the role of local governments, facilitating the emergence of developers, rental stock managers, and builders).

* Sequencing the reforms: interactions of the housing strategy components and the social costs of reform.

The Baltic: Gateway to the Soviet Union?
May 10-13, Middlebury, VT

Seminar will discuss the Baltics’ evolving role as a bridge between the Soviet Union and its foreign investors and trading partners. Among the 40 guests invited are the prime ministers of Estonia and Latvia, the president of the Georgian Republic, and the vice president of the Russian Republic.

Information: George Bellrose, Director, Geonomics Institute, 14 Hillcrest Avenue, Middlebury, VT 05753. Tel. (802) 388-9619.
BIBLIOGRAPHY OF SELECTED ARTICLES *

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TRANSITION (formerly Socialist Economies in Transition) is a regular publication for internal use of the World Bank's Socialist Economies Unit (CECSE) in the Bank's Policy, Research and External Relations complex. The findings, views and interpretations published in the articles are those of the authors and should not be attributed to the World Bank or its affiliated organizations. Nor do any of the interpretations or conclusions necessarily represent official policy of the World Bank or of its Executive Directors or the countries they represent. Richard Hirschler is the editor and production manager. Design and desktop work are by S. Gerard in the PRE Dissemination Unit. To get on the distribution list, send your name and address to Richard Hirschler, Room N-6027, The World Bank, 1818 H Street NW, Washington, D.C. 20433 or call (202) 473-6882. Information on upcoming conferences on socialist economies, indication of subjects of special interest to our readers, letters to the editor, and any other reader contributions are appreciated.