Finance Minister of Czechoslovakia Speaks on Economic Reform

The keynote address to the World Bank’s Annual Conference on Development Economics (April 26-27, Washington D.C.) was delivered by Dr. Vaclav Klaus, Minister of Finance of Czechoslovakia. His address on Czechoslovakia’s transition process was received with great attention, especially since other countries of the region face similar problems in sequencing the transformation.

Towards a market economy

Noting that Czechoslovakia was one of the founders of the Bretton Woods Institutions, Dr. Klaus emphasized the wish of his country to resume membership in the IMF and in the World Bank. He affirmed the desire of his government to transform Czechoslovakia from a centrally planned economy to a market economy. “In this respect, our intentions are quite clear, and we don’t want to repeat our attempts in the 60s to introduce some hybrid system between central planning and market economy. We are not interested in a third road,” he said stressing the importance of the private sector and the need for real changes. “There are still those who dream that it’s possible to muddle through, to revise just some segments of the existing system,” Dr. Klaus cautioned.

“How to unfold the process of economic transformation, how to sequence it, how to preserve the momentum of the reform, how to build and keep the necessary political and social consensus in the country, how to preserve the credibility of the reform policy, and how to avoid crossing the tolerance limit of the population?” asked the Finance Minister, summarizing the most profound problems of transition. He stressed the need for expertise and help to be provided by international institutions, including by the World Bank in collaboration with Chinese researchers, is expected to respond to the question to what extent have specific enterprise reforms contributed to industrial productivity and efficiency in various Chinese enterprises that have emerged during the reform process (page 6).

What’s inside...

Eastern Central Europe: The Human Challenge

The transition to a market economy in Eastern and Central Europe will involve the challenge of adaptation to a new way of economic life. The World Bank is assisting the new governments in planning important reforms in the social sectors, for which sustained investments over the medium-term will be required (page 3).

ED’s Colloquium on Socialist Economic Reform

The colloquium for the Executive Directors of the World Bank was organized by the Socialist Economies Unit. Nine sessions covered such diverse topics as macroeconomic stabilization, enterprise reform and privatization, financial system reform, international economic relations, agricultural reform, labor markets, health and social issues, and the role of the Bank Group (page 5).

Conference Diary (page 5)

Major Research Project on Chinese Enterprise Reform

A major research project, undertaken by the World Bank in collaboration with Chinese researchers, is expected to respond to the question to what extent have specific enterprise reforms contributed to industrial productivity and efficiency in various Chinese enterprises that have emerged during the reform process (page 6).

Milestones of Transition (page 7)

Vietnam: Failure of a Gradual Approach and Lessons Learned

Serious monetary destabilization, the slowdown of economic growth, and the worsening balance of payments situation were the three main symptoms of the failed reform program of 1985-1988. However, measures adopted in the spring of 1989, together with measures of late 1988, represented perhaps the most comprehensive and radical set of reforms of any socialist country at that time (page 8).

On the World Bank/IMF Agenda (page 10)

New Books and Working Papers (page 11)

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the World Bank, especially in teaching the fundamentals of economics for market-based systems.

Experiences learned

Referring to the reforms in Central and Eastern Europe in the last two decades, the minister summarized the experiences in five main points:

• First, fragmentary reform might be worse than no reform at all;

• Second, there is no sense delaying a comprehensive reform program until every detail is clarified;

• Third, the most crucial reform steps must be taken in proper sequence, even without knowing the full sequence a priori and the outcome in detail. "When we play chess we have to know the opening strategies. But it's impossible to foresee the situation on the chessboard after the 25th move. I stress this because it is very difficult to explain the situation to politicians in Eastern Europe who are still used to detailed future plans," Dr. Klaus said.

• Fourth, to avoid what Dr. Klaus views as the "trap of decentralization," although the idea of decentralization would seem appealing. Nevertheless, it is a trap, he observes, because it brings more problems than solutions — unless the fundamentals of the system are changed also.

• Fifth, a major obstacle to a successful economic transformation is the lack of transparency in the economy. For example, the architects of the reform do not have a clear picture of existing property rights and prices.

Dr. Klaus told the conference that the rapid and orderly transformation of property rights during the early phase of reform is absolutely crucial to prevent further chaos in the privatization process and for the reforms to succeed in Czechoslovakia. Therefore, a Board for the Temporary Administration of State Property and its Privatization was established recently under the Ministry of Finance. This body has already prepared the basic concept of privatization. In the first stage, state-owned enterprises will be transformed into joint-stock companies. In the second, their shares will be sold mainly to the public at auction. "Because of the lack of domestic capital, it will be necessary to augment the wealth of the population by distributing a part of state property for free in the form of vouchers to the population," Dr. Klaus declared, adding that his intention is to privatize large segments of the economy in a few months. His view on price reform was similarly radical: "All prices must be changed at the very early stage of the reform."

The main "unknowns"

The Minister of Finance also specified some major unknown factors in the transition such as the problem of sequencing in the process of market liberalization, in institutional restructuring, and in freeing the exchange rate. "We don't know whether we can expect a rapid supply response to a set of drastic reforms we are introducing, and I am afraid that the statistical office is unable to measure the growth of the unfolding private sector," he said.

"The problem of how to minimize the ability of individuals to reap enormous rents when the central controls are lifted is a dramatic problem we feel every day," the Minister added. Finally, he told the Development Conference: "I hope that during our closer contacts with the World Bank we will learn a lot, and that the experience of Czechoslovakia will help other reforming countries."

The entire text of Dr. Vaclav Klaus's keynote address will be published in the Proceedings of the Annual Conference on Development Economics, 1990.

Bank Mission in Czechoslovakia

The first World Bank mission in 35 years visited Czechoslovakia this March to lay the groundwork for the country's renewed membership. Eugenio Lari, Director, EMENA Country Department IV, headed the team. While the Bank's Legal and Secretary's departments will be addressing such issues as capital contribution and voting power, this mission went to obtain first-hand knowledge of the government's objectives and, within that framework, to set priorities for Bank assistance. As Mr. Lari explained, the Bank is willing to provide some technical assistance to Czechoslovakia even prior to membership, which is expected to be approved by September in time for the Annual Meetings.

Some of this technical assistance might be financed by bilateral donors or the UNDP, with the Bank as executing agency. Other help might come from the economic and sector studies the Bank will undertake as part of its normal preparatory work for a country's membership. It was agreed that several small technical missions would visit Czechoslovakia immediately to assess priority needs in various sectors and that an economic mission would take place in May.

Three missions took place in late April. One of these explored the infrastructure needs of the country and the major environmental problems in Czechoslovakia. Another mission looked at the reform of the financial system, made recommendations on improving accounting and auditing procedures, and gave advice on the establishment of prudent regulatory procedures. This team addressed the process involved in priority areas of enterprise reform. Another technical mission made a preliminary analysis of issues in the energy sector. The information was fed into the work of the major economic mission, which stayed about three weeks in May, conducted a comprehensive assessment of the economy and discussed alternative scenarios for the reform process. A draft of its report will be sent to the government in July for further discussion with the Bank in August, enabling the document to be finalized and distributed to the Executive Directors and top management before the Annual Meetings.

In addition to the economic and sectorial missions, Mr. Lari offered to have Bank procurement specialists visit Czechoslovakia so enterprises there can learn the necessary procedures to permit them to bid for contracts on Bank-financed projects as soon as membership is approved.

The question of whether Czechoslovakia will be able to borrow from the Bank, should it wish to, will remain open until the precise per capita GNP is calculated.
Eastern and Central Europe: The Human Challenge

The transition to a market economy in Eastern and Central Europe demands human adaptation to a new way of economic life. How, without intolerable hardship, can people be encouraged to move from low-paying, unproductive jobs — which offer little more than lifetime employment security — to productive, fulfilling jobs in a market economy? What should be the role of the state in providing a social safety net for the most vulnerable groups, such as pensioners, single-parent families, the unemployed, and children?

Meeting these human challenges and ensuring long-term growth and prosperity depend on the achievement of a number of social goals. These include:

- transforming the labor market so it supports sophisticated employment services, increased labor mobility, a more market-oriented system of wage determination, and better systems for monitoring employment trends;
- upgrading of training and retraining for the unemployed and teaching new skills to support new investments;
- developing a system of unemployment benefits and social welfare for those most adversely affected by the economic reform process; and
- restructuring the health system to arrest the decline in health services.

These issues are not unique to the Eastern and Central European economies; in fact, they are common to most of the World Bank's middle-income clients. However, the problems here are quantitatively and qualitatively severe because of their neglect over the last forty years. It is not easy, for example, to put in place virtually overnight a functioning employment services system.

Labor Markets

Systemic reform is needed across the social sectors. Rigid labor markets, with central allocation of labor, narrow wage differentials and little open unemployment, have encouraged labor hoarding and other inefficient uses of labor while actively discouraging workers from acquiring new productive skills. In some cases, skilled workers earn more than engineers and, perhaps even more curiously, semi-skilled workers earn more than skilled workers.

Refusing officially to recognize open unemployment in the past, the socialist governments made little effort to develop policies and institutions to encourage reallocation of labor and occupational mobility. Labor mobility is further restricted by the critical shortage of housing. Most crucially, all the Eastern and Central European countries lack the capacity to assist the unemployed adequately with financial benefits, retraining, job counseling and small business creation. Employment offices have existed solely to distribute labor among competing enterprises and, consequently they lack the personnel and equipment to provide services to large numbers of unemployed or to those seeking new work. However, the serious unemployment resulting from the stabilization and adjustment programs — projected at well over one million in Poland, and likely to be significant elsewhere by the end of 1990 — will require that employment offices evolve rapidly to take a central role in these nations' labor markets.

Education and training

It is sometimes thought that at the very least, the populations of Eastern and Central Europe are relatively well educated, so that these economies are positioned to attract inward investment which can take advantage of low labor costs. However, this is not necessarily the case: for example, the table below shows that enrollments in secondary and, in particular, tertiary education are significantly lower than OECD averages.

The command economy has also focused education and training efforts on the acquisition of narrow occupational skills. Although the general education systems at primary and secondary levels are quantitatively well developed, secondary and higher education lacks broad-based multidisciplinary programs to facilitate occupational mobility and the development of new fields of employment. In Poland, only 20 percent of students in secondary education take general studies while the rest enter narrowly specialized programs. In Hungary, 50 percent of fourteen-year-olds enter apprentice training, which tends to provide narrow occupational training in obsolete skills and only a thin

GROSS ENROLLMENT RATIO IN TERTIARY EDUCATION (1987 or latest)

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<tr>
<th>Country</th>
<th>Ratio</th>
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<td>Austria</td>
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<td>Bulgaria</td>
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<td>France</td>
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<td>Czechoslovakia</td>
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<td>Greece</td>
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<td>Hungary</td>
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<td>Ireland</td>
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<td>Romania</td>
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<td>United States</td>
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Source: UNESCO Statistical Yearbook
vener of further education in core skills (math, science, communications, etc.). In contrast, well-established apprentice training programs in OECD countries such as Germany, Switzerland and Austria begin training at a later age (thus ensuring students have greater maturity before they make career choices) and increasingly emphasize broad skills training and academic education.

Post-secondary education has been neglected in Eastern and Central Europe, with only about 17 percent of the age group participating, compared with 31 percent in OECD countries. Provision of adult education and training varies from country to country but tends to be narrowly specialized, whereas the pressing need is for broader programs to develop occupational flexibility and business skills. Training facilities are frequently overcrowded and their equipment outdated. Although data on the share of public expenditures for education are difficult to compare, education spending in recent years appears to have been low relative to spending in OECD countries.

Poverty

Poverty is a growing problem in many Eastern and Central European countries, with rates varying from 22.7-24.5 percent in Poland and Yugoslavia to 14 percent in Hungary (Table 2). Stabilization and adjustment programs will place new strains on the capacity of social welfare systems to provide a safety net for the most vulnerable groups.

Inflation in these countries threatens to erode the real value of existing cash benefits. In Poland, for example, family allowances have been indexed to cover the subsistence costs of child rearing, but the administration of pensions is cumbersome and slow, and maintaining their real values during the period of high inflation has proven difficult. In addition, the shortage of reliable data on poverty renders the targeting of benefits to particular needy groups difficult. This last issue is especially critical as subsidies on a range of commodities are removed.

Health Sector

Restructuring of the health sector is also of high priority. In the past, the unbalanced public policy undervalued health care compared with other sectors of the economy, resulting in rigid, centralized policymaking, inefficient management of services, chronic shortages in human, physical and financial resources, and deteriorating quality of care. In principle, patients are guaranteed universal access to free and comprehensive services, but in practice under-the-counter payments are routine to supplement the very low official pay of doctors and other health care workers. Illness now poses a considerable financial burden for many patients. All the standard health indicators are well below OECD averages (and in general below those for Portugal and Greece, countries that are perhaps natural standards for comparison). Key indicators of health status have actually been deteriorating in recent years (see figure below). In each country there are wide variations in standards of health care according to region. In less developed and particularly in highly polluted areas the health indicators are strikingly poor.

A critical issue now being debated in Eastern and Central Europe is the role of the private sector in health care. The current situation is problematic due to the lack of a private health insurance industry and the potentially monopolistic position of health care providers.

First steps

Faced with this formidable set of issues, the World Bank is assisting the new governments in planning important reforms in the social sectors, for which sustained investments over the medium term will be required. In Poland, Hungary and, to some extent, Yugoslavia, the governments have already taken major steps to improve the functioning of their labor markets, make training available to the unemployed, and construct social safety nets. Both Romania and Bulgaria have requested technical assistance from the World Bank to create social safety nets.

To provide a safety net for individuals and families, work is beginning in many of the Eastern and Central European countries to consolidate existing arrangements for means-tested cash benefits, family allow-

Infant Mortality Rate Time Series
EDs' Colloquium

A colloquium on Socialist Economic Reform was held for the Executive Directors of the World Bank on April 19th and 20th at the Westfields Conference Center near Washington D.C. The colloquium, organized by the Socialist Economies Unit (CECSE), was designed primarily to introduce the EDs to the broad range of issues surrounding the reform process. The nine sessions covered such diverse topics as macroeconomic stabilization, enterprise reform and privatization, financial system reform, international economic relations, agricultural reform, labor markets, health and social issues, and the role of the World Bank Group.

Professor Janos Kornai opened the colloquium by presenting a broad framework for thinking about the transition process. Other outstanding presentations were given by Dr. Zbigniew Brzezinski (“The New Era, its Promise and its Risks”), Prof. Jeffrey Sachs (“Macroeconomic Stabilization, Speed and Sequencing of Reforms”), and Dr. Harry Harding (“China: Lessons from the 1980s and Prospects for the 1990s”). Dr. Jozef von Brabant (U.N.) spoke about CMEA trade; Mr. Bertrand de Largentaye (EC) reviewed Western European initiatives to promote reform; and Prof. Michael Marrrese gave an overview of issues in agricultural reform.

World Bank speakers included Messrs. Stanley Fischer, Eugenio Lari, Shahid Javed Burki, Anil Sood, Manuel Hinds, Vijay Chaudhry, Avishay Braverman, and Julian Schweitzer. The conference facilities were superb, and speakers and participants alike seemed to enjoy the opportunity to share ideas on these important and timely questions. We present a summary of Mr. Schweitzer's remarks in this issue (pages 3-5) and hope to summarize Prof. Kornai's presentation in the next.

Conference Diary
Forthcoming Conferences and Workshops

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<td>&quot;Eastern Europe on the Brink of the 90s&quot; organized by the Russian and East European Center, will be held within the framework of the 1990 Summer Research Laboratory at the University of Illinois, Urbana, IL 61801; Telephone: (217) 333-1244</td>
<td>Inaugural conference of the International Association for Communist Studies on “Reform and Resistance to Reform in Marxist-Leninist States,” in Harrogate, England. For information: Stephen White, Dept. of Politics, U. of Glasgow, Glasgow G12 8RT, Scotland; David Lane, CREEES, U. of Birmingham, Birmingham B15 2TT, England; or Bogdan Szajkowski, School of Administrative Studies, U. of Wales, Cardiff CF2 3AS, Wales</td>
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<th>July 21-26, 1990</th>
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<td>The IV World Congress for Soviet and East European Studies will convene in Harrogate, England. For information: J.D. Morison, Dept. of Russian Studies, U. of Leeds, Leeds LS2 9JT, England; Telephone: 0532-333288</td>
<td>The 22nd National Convention of the American Association for the Advancement of Slavic Studies (AAASS) will be held in Washington, D.C. Participation in the convention program is limited to members of the AAASS, with the exception of foreign scholars and invited panelists. For more information: AAASS, 128 Encina Commons, Stanford University, Stanford, CA 94305-6029. Telephone: (415) 723-9668. Fax: (415) 725-7737</td>
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Measure by growth rates, China’s industrial sector has performed remarkably well during the past four decades. But much of this growth is believed to have come from large increases in investments. Policy makers have realized that such high rates of investment cannot be sustained over the long run. The main objective of the reforms, therefore, has been to raise the productivity of Chinese enterprises. Yet the conclusions of most observers regarding the overall impact of reforms on productivity are conflicting.

What observers do agree on is that there are enormous regional and industry-wide differences — in the way in which reforms have been implemented, in the type of industrial organizations that have emerged, and the impact of the reforms on growth and productivity. In spite of this, there has been surprisingly little quantitative work concerning the productivity performance in key industrial sectors and major regions in the country. No systematic analysis, by either Chinese or foreign scholars, has been undertaken to identify those sectors within which specific reforms are succeeding or failing in increasing industrial productivity.

Innovative Modeling Approach

A major research project, undertaken by the World Bank in collaboration with Chinese researchers, is expected to respond to a central question of industrial development in China: to what extent have specific enterprise reforms contributed to industrial productivity and efficiency in different types of Chinese enterprises that have emerged during the reform process?

An innovative modeling approach is planned during the research to evaluate the impact of specific policy reform instruments — prices, quotas, tax rates and profit and wage retention rules — being introduced in the industrial sector, during the reform process.

The central objective of the research is to gain an understanding of the factors affecting the productivity and efficiency of Chinese enterprises of various types and to evaluate the impact of selected ongoing reform measures. There are three key issues on industrial reforms and their relationship to industrial productivity in China that will be addressed:

- Analysis of total factor productivity (to what extent and in what industries have reforms brought about substantial increases in total factor productivity?)

- Linking institutional change, reforms and productivity (what sorts of enterprises behave best from an economic point of view in the Chinese context?)

- Linking specific policy reform instruments and enterprise behavior (how do specific indirect policy instruments influence the production and investment behavior of enterprises?)

A final objective, which is of equal importance to the substantive research objectives outlined above, is to help Chinese researchers to undertake quantitative analysis based mainly on modern techniques and to use more effectively the vast amounts of data being collected on the industrial sector. Although in China there is strong training in institutional research and a firm grasp of institutional realities, the in-country re-
search has been mainly qualitative in nature. Recently, however, Chinese experts have started collecting vast amounts of very useful quantitative material at the industry and enterprise level.

The research-cum-training component will result from substantive involvement of the Chinese in the research project. It will include not only training and direct involvement with outside researchers, but the dissemination of research methods through replication of key components of the research by the Chinese institutions involved.

The final research study will be based on three substantive and detailed fresh and processed foods, although some control will remain during the transition.

- **Milestones of Transition**

  - On April 24 the governments of West and East Germany set July 2 as the target date when the D-Mark will be introduced as East Germany’s currency. Both sides emphasized they would do all they could to forge the arrangements for the economic, currency and social union of the two Germanies as soon as possible.

  - The parliament of Algeria approved sweeping changes to joint ventures regulations on March 26. The new bill allows up to 100 percent foreign ownership of investment projects (previously the Algerian partner had a minimum stake of 51 percent) and full repatriation of profits; allows joint ventures by foreign companies with Algerian private firms (previously this was limited to the public sector); and allows foreign banks to set up representative branches in Algeria. The remaining limits and controls on foreign investment are minimal. The new law marks a radical break with the protectionist philosophy which has dominated Algeria’s economic policy since independence.

  - In Bulgaria a package of economic reforms was enacted at the end of March: the upper limit of 10 persons to be employed by a private enterprise has been relaxed; individuals will be permitted to purchase shares in joint-stock companies, and firms are to be given more rights to trade with foreign companies. In addition, the privatization of state and municipal property is to be legalized, and foreigners will be able to buy into such enterprises. As of May 1, prices of imported non-food items, luxury foods, and dwellings were completely deregulated. Price controls have already been removed from a number of commodities and a 13-year ban on private banking and funds management was lifted.

  - **Czechoslovakia**'s parliament in April approved changes to the constitution permitting the expansion of private enterprise and the establishment of joint-stock companies. The new laws stipulate that anyone can establish a business in most industries without seeking official permission. There are no limits on the number of employees or capital involved, and private business is allowed in all spheres except in the handful of “state monopolies”. The new measures permit the issuing of shares to individuals, groups and companies and make easier the participation of foreign capital in the Czechoslovak economy. Foreign ownership is allowed, even 100 percent, and unlike the previous joint venture law, the new legislation requires only registration. The parliament abolished the state’s monopoly on foreign trade and approved legislation clearing the way for the privatization of state-owned enterprises. In a separate new law the government permits privatization in the agricultural sector as well.

  - **Ethiopia** opened key sectors to private investment in a government decree issued in early May. It has lifted a 13-year ban on private banking and now offers tax breaks for up to five years for those willing to invest in Ethiopia’s economy. Investment in electric power, tobacco processing, banking, insurance and water supply will require the prior authorization of the Council of Ministers, the government decree said.

**Dissemination Plans**

The study results will be disseminated through interim and final reports (in both English and Chinese) and an integrated research monograph. Shorter reports also will be written for policymakers and the World Bank staff, using less technical language and highlighting major findings and their policy implications. Similarly, two seminars (in Beijing and Washington) will be organized with the content and style appropriately tailored.

The project is directed and coordinated by I.J. Singh, Principal Economist CECSE. The research director for the project is Professor Gary Jefferson from the Department of Economics, Brandeis University. Other consultants participating in the project include V.K. Chetty (Indian Statistical Institute), Zvi Giliches (Harvard), and Richard Day (University of Southern California). The collaborative research on the Chinese side will be done by a core team of well known Chinese economists led by Zhang Xuejun (Institute of Economics) and Luo Xiao Peng and Dr. Ying (Research Center for Rural Development). The institutional and administrative coordination of the Chinese side will be done by Lin Qingsong, Deputy Director of the Institute of Economics of the Chinese Academy of Social Sciences.
Serious monetary destabilization, a slowdown of economic growth, and a deteriorating balance of payments situation were the three main symptoms of the failure of Viet Nam’s reform program of 1985-1988. The reasons for the failure were several, including the design of the program, its timing, and its synchronization with other measures.

The main emphasis of the reform was on microeconomic policy changes while the stabilization effort focused on mobilizing external financing. Although it minimized costs of adjustment, this policy postponed necessary adjustment. Furthermore, severe limitations on external financing from Viet Nam’s traditional partners forced the government to restrict imports and seek imports from the convertible currency area. Convertible currency imports had to be financed by increased exports, which diverted supplies from the domestic market and strengthened inflationary pressures.

Lack of adjustment

The reform program mobilized domestic resources very poorly. Most seriously, it has failed to mobilize savings in the public sector. This, together with the desire of the authorities to protect consumers from the impact of adjustment, has resulted in large accumulation of cash balances by enterprises and households, fueling existing inflationary pressures.

The only effective real adjustment undertaken by the authorities was in the least painful policy variable — a number of deep cuts in public investments. However, the government’s attempt to respond to domestic demand by cutting budget deficit was short-lived and ineffective. At the same time, the persistent policy of protecting domestic consumption only increased the need to restrain aggregate demand through further cuts in public investments.

In addition to its failure to control aggregate money demand, the program did not stimulate a dynamic supply response, a sine qua non of a successful stabilization program. This was partly due to exogenous factors, but the main reason was a seriously flawed overall incentive structure which stifled production. Incomplete price liberalization left a wide range of commodity prices subject to administrative controls. Exchange rates continued to be fixed by the authorities and remained highly overvalued throughout the period. Interest rates stayed negative in real terms. No serious attempt was made to introduce proper pricing of capital and land. Wages were fixed, and export incentives were distorted by export duties levied on many commodities. Import substitution was encouraged by a highly rigid system of quantitative import controls and import duties.

Institutional support remained weak. The slow introduction of regulations to define clearly the scope of operations in the private sector and legislate its rights and obligations hindered the expansion of private initiative, both in agriculture and in other sectors. Nevertheless, the emergence of a stronger private sector and a good agricultural performance in 1988 were the only apparent bright spots on the supply side during this period. Foreign exchange transactions remained extremely regulated and centralized, as did export and import flows due to quotas and licenses. The banking sector did not separate central banking from commercial banking functions (the so-called “monobank”), and it was not until July 1988 that a two-tier banking system was established. Autonomy of financial and non-financial enterprises was highly restricted. Enterprise autonomy, although increased, was still limited in many areas such as investment planning, employment and wage practices, and use of profits.

Rigid interest rate policy

The range of policy instruments to stabilize the economy was very narrow until the more radical reform of 1989. An extremely rigid interest rate policy has greatly circumscribed the effectiveness of monetary policy. While there was a move towards decentralization of non-financial public enterprises, no corresponding autonomy was given to banks. The Central Bank (i.e. the State Bank of Viet Nam) had virtually no instrument to mop up excess liquidity—even assuming that authorities were prepared to do so. The control of the banking system was also extremely loose, based on the so-called credit and cash plans, which had an inflationary character and distorted credit allocations.

Both monetary and fiscal policies have been highly inflationary. Once the subsidies to public enterprises were cut and many enterprises found themselves in a financial squeeze, monetary policy was all too accommodating in satisfying their demand for credit. Financially strapped and loss-making enterprises were maintained through generous provisions of credit. Those enterprises free to increase prices after the price liberalization did so to offset the loss of subsidies from the budget. Rising incomes financed by monetary expansion thus fueled inflation, and prices in the official market quadrupled in one year (1986). In sum, monetary policy continued to be expansionary, mainly because monetary authorities needed to augment bank resources to finance credit to public enterprises. Otherwise they would have been unable to continue their normal operations.
The inflationary impact of fiscal policy resulted from a combination of factors. As noted above, the authorities were unable to control the budget deficit except in 1986, and government banking became another significant source of rapidly expanding demand for credit. The budget deficit, which rose as authorities failed to control expenditure in such areas as defense, was exacerbated by a misguided policy of wage indexation and a poor tax effort. Tight limitations on external credit forced authorities to finance the deficit from domestic sources. However, in the virtual absence of financial and money markets, the growing demand for credit could be satisfied only through central bank financing and money creation.

By the end of 1988 it became evident that the current macroeconomic policy was no longer sustainable. Inflation was completely out of hand, threatening not only the course of economic reform and production for the market, but also the fabric of the society itself. The government saw clearly that more radical reforms were required to stop the hyperinflation, encourage domestic production and savings, and provide an overall economic environment that would be more conducive to economic reform at the level of enterprises and households. The new government reform proposals have been formulated as part of a new package now the subject of discussions with the IMF.

**Radical measures**

The package of measures adopted in the spring of 1989 was impressive. Together with measures adopted at the end of 1988, the package represented perhaps the most comprehensive and radical set of reforms undertaken by any socialist country at that time. The authorities dramatically reversed their past practices of neglecting macroeconomic management. They imposed tight credit ceilings by controlling the growth of reserve money, introduced cash reserve requirements and liquidity ratios, and increased interest rates to highly positive levels in real terms. Access to state bank credit by commercial banks was restricted. This was to be supported by strict control of the budget deficit and government borrowing from the State Bank. Reduction of the budget deficit was to be achieved by both expenditure restraint and revenue mobilization supported by improved tax administration and new tax measures.

In support of the above policies, the government also strengthened structural policies and instituted reforms to encourage supply response. The government unified the exchange rate close to the level of the parallel market, and devalued the rouble rate to a more realistic level of the dollar/rouble cross exchange rate. The authorities proposed to introduce a foreign market by establishing trading floors. Traditional foreign trade monopolies were all but dismantled by allowing other public enterprises and private traders to engage in foreign trade transactions. Quotas, previously covering more than 100 commodities, were reduced to apply to only seven export and twelve import commodities. A further extension of price reform, through liberalization of virtually all commodity prices, left only a handful of prices subject to administrative controls. Agricultural contracts have been modified to link output and input prices closely to market developments. Most subsidies in kind were removed from public employees' remuneration packages. Enterprise autonomy was strengthened by reducing the number of compulsory plan targets, the only exceptions being in petroleum, electricity, postal services, and rail and international waterways. Finally, a better system of monitoring performance of public enterprises has been introduced.

**Reduced inflation**

The full impact of these policy measures cannot be assessed so soon after their introduction. There is no doubt, however, that their impact on inflation and output has been impressive. The rate of inflation, running at an annual average rate of about 1,000 percent in the fourth quarter of 1988, dropped virtually "overnight" to 3-4 percent in April 1989, followed by a 5 percent decline in the price index between April and July 1989.

Agricultural output also picked up dramatically, resulting in significant improvement in domestic food supplies. Moreover, the economy has been able to export rice for the first time in years: exports of about 1.5 million tons in 1989 made Viet Nam a major exporter of rice that year and significantly contributed to its balance of payments.

Many issues remain unresolved — weak domestic resource mobilization, extremely low investments, poor financial performance of public enterprises, and serious pressures in the labor market. Nevertheless, starting with the 1989 stabilization program, the government should find itself building on stronger economic foundations.

Zdenek Drabek, AS2CO

**OK, we are free — and so are the prices.**

From the Hungarian Magazine Hicipö
On the World Bank/IMF Agenda

Conable Calls for New Resources

Noting that the extraordinary changes around the world over the past year have "thrown our development mission into sharp relief," World Bank President Barber Conable highlighted the "pyramiding claims" on development resources in his statement to the Development Committee at its May 8 meeting in Washington D.C. "From the reawakening of Eastern Europe to common concern about our environment, from the crisis of government to the pressing burden of debt, from the struggle to curb population growth to realizing the total potential of women, we see pyramiding claims on development resources," Mr. Conable told the Committee. "Our determination to ensure that both provider and recipient get the best value for available money will not falter," he declared. "Nevertheless, new demands often require new resources," the Bank's President added.

Earlier, at the meeting of the Group of 24 ministers on May 6, Mr. Conable gave the assurance that the dramatic events in Eastern Europe "will not divert the World Bank from its ongoing obligations elsewhere."

B.T.G. Chidzero, Zimbabwe's Finance Minister and Chairman of the Development Committee, declared at the May 8 meeting: "The recent proposal for the establishment of a European Bank for Reconstruction and Development, which will focus on private-sector development, is a welcome initiative...We must ensure that this does not lead to the further deterioration of the flow of resources to developing countries."

Environmental and Transport Sector Loan to Poland

Poland is embarking on a major environmental program to be supported by a World Bank loan of $18 million. The project will enable Poland to strengthen environmental management and help to establish the institutional, regulatory and informational basis for immediate action and long-term investments. The project, which will provide technical assistance, training and specialized scientific equipment, will focus on Poland's most polluted areas. Institutional development activities will serve as models for industrial, air and water management that can be replicated throughout the country.

Poland's efforts to modernize its transport sector will be supported by two World Bank loans totaling $153 million. An $8 million loan will support the government's program to restructure the transport system by introducing modern organizational forms, more efficient management information systems and maintenance procedures. Another loan, for $145 million, will support the Polish State Railways' investment program, including rolling-stock maintenance and repair, track maintenance and repair, and investments in signaling and telecommunications systems. The project will also support the activities of the Highway Administration.

Yugoslavia: IMF Stand-By and WB Loan

The IMF approved a stand-by arrangement in March for Yugoslavia, authorizing purchases up to US$598 million over 18 months in support of the government's economic and financial program. The program's primary objectives, to bring inflation down to very low levels within a short timeframe while safeguarding the external position of the economy, relies in the initial phase on the anchors of a fixed nominal exchange rate for the dinar, a strict cap on nominal wages, and a partial price freeze. These anchors are supported by a severely restrictive monetary policy and a major fiscal effort.

The Yugoslav reform process is supported by a $400 million World Bank loan. The reforms, among others, will promote private-sector initiative, will increase competition, and will improve the allocation and use of resources. Interest rates will be set at positive levels, a market for foreign exchange will be established, and foreign-trade and domestic-pricing regimes will be liberalized. The program will also help make public enterprises more financially viable, strengthen the country's financial sector, and streamline the process for identifying and selecting investment projects. The program includes measures to close public enterprises that are not capable of operating without subsidies.

China Upgrades Vocational and Technical Education System

China will improve and expand its vocational and technical education (VTE) with the help of the World Bank Group. IDA is supporting the project with a credit of $50 million. Fifty-nine secondary vocational and technical schools will be made into "centers of excellence" that will serve as models for developing other vocational training centers. The $91 million project will include improvements to teacher training, focusing on workshops, curricula and staff development at nine technical-teacher colleges and three university technical-teacher training departments.

Under the project, the government will undertake major reforms, including rescheduling of classes to increase utilization rates, an increase in the weekly teaching hours, improved liaison with industry, and a progressive upgrading in VTE schools not covered by this project. Further, the project will set up one national and two regional VTE research and development centers.

Hungary Strengthens Financial Sector

The World Bank has approved a $66 million loan to support Hungary in modernizing the financial sector. The loan will help finance the services of financial experts, training specialists, and other consultants who will assist in developing a sound supervisory and regulatory framework for banks and securities markets, in streamlining operations of major banking institutions, and in implementing modern accounting and auditing practices in the country. Technical and financial assistance will be provided to the State Banking Supervision Agency, which is in charge of monitoring the country's banks. Under the program, management and operations of several existing banks will be strengthened, and banks will be equipped with modern office technology.
New Books and Working Papers


(BMF working paper: WP/89/36)


Quotation of the Month

"In spite of all the important differences in history, culture, and present political and economic conditions, all these (Eastern Central European) countries have important common properties, and they will share similar difficulties in the forthcoming years. In all of them the public sector plays an overwhelming role, and hence they must overcome similar obstacles if they want to proceed with the privatization of the economy. Although there are sporadic elements of a genuine market mechanism, the institutions, the legal support and, what is no less significant, the culture and ethics of a well-functioning free market are not yet developed. Prices, interest rates, and exchange rates are distorted. These countries are small open economies in dire need of becoming an organic part of the world economy, and yet the composition and quality standards of production are not at all adapted to the demands of the world market. A huge bureaucracy penetrates every cell of the economy’s organism. Albeit in different proportions in the various Eastern European countries, similar malaises weaken the economy: stagnation or recession of real output and consumption, openness and/or repressed inflation, chronic shortages and, in most cases, a huge burden of external debt service. Social tensions threaten the balance of society. In most instances, workers are unhappy with the protracted sacrifices asked for the sake of stabilization, large strata of the population sink deeper into poverty, and at the same time, technocrats, bureaucrats and managers selected by the former regime are afraid of a “change of the guard”."

"The study of contemporary Eastern Europe may help in understanding the difference between reforming socialism and shifting away from socialism; between experiments in stimulating a market by “market socialism” and the introduction of a genuine free market.”

"We have to keep in mind the peculiar initial conditions of the transformation process. The point of departure is the dominance of public ownership and an almighty bureaucracy with millions of hands reaching each business unit, each family, and each individual. These are countries where such desiderata as the sovereignty of the individual, autonomy, private property and private business, political and intellectual freedom, the institutions of democracy, and the rule of law were suppressed fro decades. The fulfillment of these desiderata does not jump out of a box: these principles can only be re-established and generated by a historical process. It is a process which could—and should—be speeded up, nevertheless it will not be finished in a few weeks. We have to learn from Western experience, but selectively; carefully distinguishing examples which can be followed tomorrow from others where the conditions of application must be created by a long-lasting evolution, and finally rejecting certain patterns, institutions, and habits which are not applicable (or not worthy of application) at all. Artificial transplants, hastily forced upon these societies will be rejected by their living organisms.”

(Book Brief)

Branko Milanovic

LIBERALIZATION AND ENTREPRENEURSHIP: DYNAMICS OF REFORM IN SOCIALISM AND CAPITALISM


This book starts from the premise that economic liberalization is the common element in the current trend toward privatization and deregulation in the West and the reform of economic policies and institutions in the East. These developments—all involving a diminished state role—are analyzed within a unified framework. In laying out the conceptual basis for the study, the author specifies the different arrangements under which capital owners, workers, and entrepreneurs interact in the process of production. In particular, he examines the type of economic coordination (centralized vs. decentralized) and on this basis he is able to define rigorously what the liberalization of economic activities means.

In the second part of the book the author focuses on the economic policy of liberalization, identifying the group actors, the conflicts and the likely winners and losers in the liberalization process.

Branko Milanovic is an economist with the World Bank in Washington D.C.

Book Brief

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