Per Jacobsson Foundation

Economic Transformation

The Tasks Still Ahead

A Symposium

Jan Svejnar
Oleh Havrylyshyn
Sergei K. Dubinin

Washington, D.C.
Sunday, October 8, 1995

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Foreword

On Sunday, October 8, 1995, the Per Jacobsson Foundation organized a symposium on "Economic Transformation: The Tasks Still Ahead" at the Omni Shoreham Hotel in Washington, D.C. Jan Svejnar, Distinguished Service Professor of Economics at the University of Pittsburgh, Oleh Havrylyshyn, Alternate Executive Director of the International Monetary Fund, and Sergei K. Dubinin, professor at Moscow State University, participated in the symposium. Sir Jeremy Morse, Chairman of the Per Jacobsson Foundation, presided over the meeting, the proceedings of which are presented in this publication.

The Per Jacobsson lectures are sponsored by the Per Jacobsson Foundation and are usually held annually. The Foundation was established in 1964 in honor of Per Jacobsson, the third Managing Director of the International Monetary Fund, to promote informed international discussion of current problems in the field of monetary affairs.

The lectures are published in English, French, and Spanish and are distributed by the Foundation free of charge. Through the courtesy of other institutions, other language versions are also issued from time to time. Further information may be obtained from the Secretary of the Foundation.

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Opening Remarks

Sir Jeremy Morse

On behalf of the Per Jacobsson Foundation, represented as usual by Jacques Polak and myself, welcome to this year's lecture. Today's program is a somewhat unusual one for the Foundation, and I would therefore like to take two minutes to introduce it.

Since 1980, the world economy has become more integrated, and at the same time we have seen a marked shift toward market forces. This has challenged practically every country to adjust, reform, and transform its economy. Six years ago, in 1989, we devoted our meeting in this very hall to two countries that at that time had moved courageously ahead in this process—Ghana and New Zealand. I am happy to note that both continue to do well.

Ever since that session, we have been looking for the right moment to hold a similar session on the progress of economic transition in the now 25 countries of Eastern Europe and the former Soviet Union. This year, we felt that the time had come. A lot has been done, and the problems of the region are very evidently no longer at the core of the Annual Meeting agenda. But outside observers, including banks, remain cautious, and it is a common experience that the attention of the press moves away just when the problems are deserving of serious study.

In particular, the transition process in the countries of Central Europe, in Ukraine, and in the Russian Federation seem, in their different ways, to have passed a point of no return. We are therefore very fortunate to have with us this afternoon three outstanding contributors from that region: Professor Svejnar, from Charles University in Prague; Professor Havrylyshyn, who is from Ukraine and is now on the Board of the IMF; and Professor Dubinin, from Moscow State University.

By the way, although all three are professors, each of them, as you can see from the program, has held important positions in his own country other than the purely academic. So perhaps, in the manner of the IMF, I will address each of them as "Mister" from now on.

Because much still remains to be done, we have asked our speakers—and I apologize if this makes things more difficult for them—to direct their remarks especially to what we have called "the tasks still ahead." Each has been allotted 15 minutes, so that we may then have time for our usual question-and-answer session. For the order of speakers, I suggest that we move across geographically from West to East. Mr. Svejnar, may I invite you to speak first.

Economic Transformation in Central and Eastern Europe: The Tasks Still Ahead

Jan Svejnar

It is a great honor and pleasure to be able to share with you my ideas about the tasks ahead for the economic transformation in Central and Eastern Europe. It is a region of the world that has undergone unprecedented changes over the last six years. In my lecture, I will first briefly review the principal outcomes of the transformation and then deal with the challenges that lie ahead. My focus will be on the Czech Republic, Hungary, and Poland, although I will refer to other economies in the region as well. As you will note, some of the developments have been quite systematic, while others have varied across the Central and Eastern European countries.

I. The Principal Outcomes

The systematic developments—those that are similar across countries—are the transformation of these economies from centrally planned to essentially market economies; the relatively successful macroeconomic stabilization (exemplified by the countries' ability to contain initial inflationary pressures); the opening up to world trade and the reorienting of trade from East to West; the rapid creation of a large number of small and medium-sized enterprises; the significant reduction in state subsidies to firms, together with the creation of a significant social safety net; and the creation of laws, institutions, and practices conducive to the functioning of labor, capital, and goods markets.

Outcomes that have varied across these countries include the extent of the privatization and restructuring of state enterprises, the rates of unemployment and duration of unemployment spells, the ability to contain budget deficits and foreign indebtedness, and the perceived effectiveness of reforms as measured by the inflow of foreign direct investment, the foreign trade performance, and the rates of economic growth.

Let me briefly elaborate on each of these outcomes.

The Systematic Developments

The most notable outcome of the first six years of the transition in Central and Eastern Europe is the virtually complete transformation of these economies from disintegrating central planning into an imperfect but vibrant market system. Broadly speaking, these economies now operate on market principles. Most prices are free and reflect relative scarcities of resources. The economies are open to international trade, and they are composed of a dynamic and rapidly growing sector of new private firms, together with a heterogeneous but generally shrinking sector of the old (in some countries, former) state enterprises.

Also, as may be seen from Table 1, the initial bout of 60–600 percent inflation associated with the launching of transition or the collapse of the old regime has been contained. Most Central and Eastern European economies now operate with an annual inflation rate of less than 30 percent (for example, the Czech Republic, Hungary, Poland, and Slovakia, as well as Albania, Croatia, and Slovenia). The most successful ones (the Czech and Slovak Republics) have for the past four years been struggling to reduce their stable 10–13 percent annual inflation rates to the levels of advanced market economies.[1] The ability of the core countries to stabilize their inflation contrasts markedly with the less successful attempts observed so far in Bulgaria and Romania.

The other systematic developments are equally impressive. Eager to dismantle the CMEA (Council for Mutual Economic Assistance) trading system that existed within the Soviet bloc and faced with a collapsing Soviet market, the Central and Eastern European economies have dramatically reoriented their trade. While all of them had traded for decades primarily within the

[1]Inflation rates temporarily jumped to the 21–23 percent annual range in 1993 as these two countries introduced value-added taxes.

Table 1. Consumer Price Indices in Selected Transitional Economies
(Average annual percent change)

	1990	1991	1992	1993	1994	1995[1]
Czech Republic	9.7	56.6	11.1	20.8	10.2	9.5
Slovak Republic	10.4	61.2	10.1	23.2	13.4	. . .
Bulgaria	26.3	333.5	82.6	72.8	87.0	. . .
Hungary	28.9	34.8	22.8	22.5	18.8	28.0
Poland	585.8	70.3	43.0	35.3	32.2	20.0
Romania	37.7	222.8	199.2	295.5	61.7	40.0
Russia	. . .	193.0	1090.0	900.0	320.0	. . .

Sources: European Bank for Reconstruction and Development; World Bank; and IMF.
[1]Estimated data.

CMEA, the European Community had by 1993–94 replaced the ex-CMEA region as their principal trading partner. This achievement is notable for two reasons: (i) few observers had expected these countries to be able to penetrate substantially the advanced Western markets, and virtually no one had expected them to do so in such a short time interval; and (ii) the reorientation was carried out to a large extent by state enterprises before any privatization took place. Major currency devaluations, reductions of subsidies to firms, and the opening of trade have been the factors driving the observed transformation in this area.

Another salient feature of the transition process in Central and Eastern Europe is the massive creation of new private enterprises. Brought about by varying combinations of spontaneous efforts of new entrepreneurs, restitutions of property, and supportive credit policy, the creation of these firms has provided important dynamism to the transitional economies in the first half of the 1990s. This transformation has been perhaps most visible in the Czech Republic, where, in 1989, small and medium-sized firms accounted for a mere 0.8 percent of the total number of manufacturing firms and less than 0.1 percent of value added in manufacturing. By 1993, they accounted for 90 percent of all manufacturing firms and 11 percent of their value added (see Zemplinerova and Stibal (1995)).

Finally, in rapidly undertaking bold transformation measures, the Central and Eastern European countries have been equally quick in providing relatively complete and generous social safety nets. Unemployment benefits were originally set at high levels and remain adequate, even after rounds of reductions in the midst of reforms. A broadly defined welfare system providing welfare, pension, and health care benefits was also put in place, and so far it has allowed these countries to prevent the emergence of major income inequality and poverty.

The Diverse Outcomes

While the emergence of new private firms has been characteristic of all these economies, the privatization of state enterprises has proceeded very unevenly. In the Czech Republic, for instance, most state-owned enterprises have been privatized. Poland and Hungary have placed less emphasis on privatizing the state-owned firms so far. In fact, the emphasis in Poland has been shifting from privatization to commercialization of state enterprises. Interestingly, when measured by indicators such as labor productivity or unit labor cost (Table 2), Hungarian and Polish enterprises have restructured more than those in the Czech Republic.

As may be seen from Table 3, unemployment was a new phenomenon in most Central and Eastern European countries at the start of the transition, and its subsequent evolution was dramatic. In particular, all the Central and Eastern European economies except the Czech Republic have witnessed their unemployment rates rise from zero to double digits within the first three years of the transition. Moreover, outside of the Czech Republic, one-half of all the unemployed have experienced long-term (one year or longer) spells of unemployment. Unemployment has thus become a major problem with significant political ramifications: in all the Central and Eastern European countries except the Czech Republic, the ex(former)-communist parties were returned to office, this time by popular vote. The Czech case is truly intriguing. While experiencing inflow rates into unemployment that are similar to those observed in the other Central and Eastern European economies, the Czech Republic has maintained unusually high

Table 2. Unit Labor Cost

(Average annual percent change, in U.S. dollars)

	1990	1991	1992	1993	1994
Czech Republic	−17.3	−14.8	32.8	25.8	9.5
Hungary	14.2	34.3	6.4	−9.0	−4.4
Poland	−8.9	6.4	−8.7	8.8	−4.6

Source: European Bank for Reconstruction and Development.

Table 3. Unemployment in Selected Transitional Economies
(In percent; end-of-year rates)

	1990	1991	1992	1993	1994	1995[1]
Czech Republic	0.7	4.1	2.6	3.5	3.2	3.8
Slovak Republic	1.5	11.8	10.3	14.4	14.8	. . .
Bulgaria	1.5	11.1	15.3	16.4	12.9	. . .
Hungary	2.5	8.0	12.3	12.1	10.4	. . .
Poland	6.1	11.8	13.6	15.7	17.2	. . .
Romania	. . .	3.0	8.4	10.2	10.9	. . .

Sources: European Bank for Reconstruction and Development; World Bank; and IMF.
[1]Estimated data.

outflow rates from unemployment and thus kept its unemployment rate at around 3 percent (far below the 6–7 percent OECD average) throughout the first half of the 1990s (see Ham, Svejnar, and Terrell (1995a) and (1995b)).

The transitional economies in Central and Eastern Europe have also displayed different degrees of control over budget deficits (Table 4). While the Czech Republic has maintained a balanced budget since 1993, Hungary has struggled with deficits exceeding 5 percent of GDP. Poland, after experiencing a deficit larger than 6 percent in 1992, succeeded in bringing the deficit down to below 3 percent in 1993 and 1994.

At 72 percent and 42 percent, respectively, Hungary and Poland also registered in 1994 the highest ratios of foreign debt to GNP in the region. In contrast, the Czech Republic's ratio remains below 25 percent—and well below 10 percent when the debt is calculated net of the Czech banking system's extensive foreign exchange reserves.

In view of Hungary's relatively precarious economic situation, it is interesting to note that the country has attracted by far the

Table 4. Government Budget Surplus in Selected Transitional Economies
(In percent of GDP)

	1989	1990	1991	1992	1993	1994	1995[1]
Czech Republic	–2.8	–0.1	–2.0	–3.3	1.4	1.0	—
Slovak Republic	–2.8	0.1	–2.0	–13.1	–6.8	–1.5	—
Bulgaria	–1.4	–12.8	–14.7	–15.0	–15.7	–7.0[1]	. . .
Hungary	–1.4	0.5	–2.2	–5.6	–6.4	–8.2	–4.0
Poland	–7.4	–3.1	–6.5	–6.7	–2.9	– 2.5	–3.1
Romania	8.4	1.2	0.6	–4.6	–0.1	–3.0[1]	–2.0
Russia	. . .	. . .	–31.0	–18.8	–7.6	–9.9	–5.7

Sources: European Bank for Reconstruction and Development; World Bank; and IMF.
[1]Estimated data.

most foreign direct investment in the region. Between 1989 and 1994, the inflow was over $7 billion in Hungary and $3.5–4 billion each in the Czech Republic and Poland, even though Standard and Poor's credit rating of the Czech Republic by 1994 was BBB+, for example, as compared to Hungary's BB+. Obtaining investor confidence by relative latecomers is clearly an arduous and long-term process.

Although the Central and Eastern European countries all succeeded in reorienting trade from Eastern to Western partners, their foreign trade performance has been diverse in the last few years. Except for a slowdown in 1993, Poland and, to a lesser extent, Hungary have registered solid growth of exports in 1994 and 1995. The Czech Republic, in contrast, recorded export growth from 1992 to 1994 and is experiencing stagnation in 1995; meanwhile, its imports continue to rise rapidly. As the dollar unit labor cost data in Table 2 indicate, the Czech Republic has been gradually falling behind Poland and Hungary in terms of competitiveness. This outcome has been in part brought about by the reliance of the Czechs on a fixed and unchanged exchange rate, in contrast to the Hungarians and Poles, who repeatedly devalued their currencies and eventually adopted a crawling peg system.

Finally, the countries have experienced varying patterns of economic growth. As the data in Table 5 indicate, Poland registered a relatively deep decline in 1990 and 1991 but rebounded as early as 1992; it has been the fastest growing economy in the region since then. The Czech Republic, Hungary, and Slovakia went through a more protracted period of decline from 1990 to 1993 and achieved economic growth only from 1994 onward.

Table 5. Real GDP in Selected Transitional Economies

(Average annual percent change)

	1989	1990	1991	1992	1993	1994	1995[1]
Czech Republic	4.5	– 1.2	– 14.2	– 6.6	– 0.9	2.6	4.0
Slovak Republic	1.1	– 2.5	– 14.0	– 7.0	– 4.1	4.8	6.5
Bulgaria	– 3.3	– 9.1	– 11.7	– 7.7	– 5.0	– 8.4	. . .
Hungary	0.4	– 3.3	– 10.2	– 5.5	– 1.5	2.0	. . .
Poland	0.2	– 10.5	– 7.5	1.5	4.0	5.0	6.5
Romania	– 5.8	– 5.6	– 12.9	– 13.6	1.0	3.4	3.0
Russia	. . .	– 2.0	–13.0	– 19.0	–12.0	–15.0	–7.0

Sources: European Bank for Reconstruction and Development; World Bank; and IMF.

[1]Estimated data.

II. TASKS AHEAD

The developments to date point to a number of challenges for the Central and Eastern European economies in the near future. The foremost challenge is how to generate *high and sustained rates of economic growth*.

This challenge has several underpinnings, which I will discuss presently. However, a principal aspect is the political one, namely, that economic growth and the trickle down of its benefits are prerequisites for maintaining the momentum in transition. The early postrevolutionary euphoria has evaporated, and it is increasingly difficult for politicians to secure consensus for major restructuring. There are, of course, differences across countries. The Czech Government has faced a relatively cooperative population, as compared to the Hungarian, Polish, and Slovak societies. However, the new reality in the region is that pushing through restructuring is harder now than it was five years ago. Of course, there is a chicken-and-egg problem here: the cooperation of the people is needed for restructuring and growth, but growth is needed for inducing cooperation. Fortunately, growth, however moderate and fragile, has appeared in most Central and Eastern European economies.

The fundamental question is whether these economies can generate long-term GDP growth of 8 percent or more. With per capita GDP in Central and Eastern Europe at about 15–30 percent of the Western European average, these are the GDP growth rates that will have to be achieved and sustained if these countries are to start closing the relative income gap with Western Europe. This is a truly formidable challenge. The following tasks constitute the building blocks for meeting this basic challenge.

Capital Investment

A high rate of efficiently placed investment is a prerequisite for economic growth in the region. In view of past developments, this constitutes a major challenge for the Central and Eastern European economies. With the ongoing transformation to a market economy, the efficiency of capital allocation has improved. The availability of capital remains as the key problem.

While the centrally planned economies historically displayed high rates of investment, the quality of capital goods and the efficiency of capital allocation were relatively low. Edward Gierek's big push to import Western capital into Poland in the 1970s is an example of a major attempt to solve the problem. It resulted, however, in gross misallocation of investment and contributed to Poland's high foreign indebtedness (Terrell (1992) and (1993)).

The 1980s were marked by a decline in investment in the Central and Eastern European economies. Combined with the acceleration of technical progress in the West and the COCOM embargo that was imposed on exports of high technology to the Soviet bloc, this decline resulted in a worsening of the relative technological position of the Central and Eastern European economies. The levels of investment declined further during the first phase of the transition in the early 1990s and only recently have begun to turn around. The countries thus face an acute need to spur investment embodying modern technology.

A major problem in this context has been the limited inflow of foreign direct investment. While the situation appears to be changing, the inflow over the first few years of the transition has been small in comparison to the annual inflows of foreign direct investment in the rapidly growing East Asian economies. One problem is that, in an attempt to reduce budgetary deficits and establish adequate social safety nets, most transition economies have imposed high corporate taxes. This has put a brake on foreign as well as domestic investment. Another problem is that Western investors have not been thinking of the Central and Eastern European economies as natural places for investment. Perceived uncertainty has been high, deriving in part from uncertainty about future developments in Russia and the other newly independent states. As the investment figures cited above indicate, the problem is a general one, affecting even the Czech Republic—the only transitional economy that has a balanced budget, relatively low inflation, and Moody's and Standard and Poor's country ratings above those of Turkey and approaching those of Portugal. The clear lesson is that attracting foreign direct investment is a long and difficult process.

On the domestic front, capital markets have been developing only slowly as an effective source of investment funds. The banking sectors are still highly concentrated and facing only limited foreign competition. Most loans are of a short-term nature because many banks are matching the maturity of loans with that of their deposits. This myopic system makes it difficult for firms to undertake long-term investments on the basis of commercial credit.

Interest rates on loans have been high as banks have kept the spreads between deposit and lending rates high to create reserves. The problem has been especially acute for export-oriented firms in countries maintaining fixed exchange rates, such as the Czech Republic. These firms have faced moderate Western inflation rates in the product markets and relatively high domestic interest rate costs.

After an initial period of easy lending to the small private sector firms, the banks have in recent years restricted lending to small businesses. Collateral requirements for these producers are high, often approaching 200 percent of the value of the project. Given the key part that this sector has played in the transformation so far, it is clear that the future economic performance of these economies will be jeopardized if this sector becomes significantly handicapped.

The situation of loan shortages is partly brought about by the problem of asymmetric information between the banks and entrepreneurs. The banks often report that they have funds but cannot find good projects, while entrepreneurs claim not to be able to get financing for projects with high expected returns.

Many of the above-mentioned obstacles are also related to problems stemming from the still inadequate number of well-trained and experienced loan officers in commercial banks in the transition economies and the generally inefficient operations of those banks. This results in a limited ability to appraise and monitor projects. Yet to lend funds to enterprises whose liquidation values may be very low requires that the banks be able to control and monitor the operations. If this condition cannot be fulfilled because the banks cannot obtain reliable information, the banks prefer not to lend or require very high collateral.

The allocative role of the stock markets has also been minimal. Stock markets have been successfully established in most Central and Eastern European countries, but their trading volumes are low. Transactions often take place outside the stock markets, thus further reducing their effectiveness.

With external funds being limited, firms have naturally turned to internal financing. Yet, with profits generally falling, enterprises were unable to raise much investment capital internally in the first few years of the transition. The well-performing ones have, of course, increasingly done so, and the imposition of hard budget constraints, the liberalization of prices, and the opening up to the world have improved the allocation of resources. There are also signs that Western banks have been increasing direct lending to well-performing enterprises in the region.

Human Capital

One feature that distinguishes the Central and Eastern European economies from many developing countries is the relatively high level of general as well as specific education (Boeri and Keese (1992)). As these economies are also poor in natural resources, investment in human capital is strategically important for future economic development. Yet investment in education, as well as in research and development, has been given relatively low priority during the transition.

Labor Markets and the Social Safety Net

With the notable exception of the Czech Republic, a major challenge for the Central and Eastern European countries is unemployment. The problem has been addressed by putting in place adequate social safety nets and active labor policies, such as training of the unemployed. The problem is that in the high-unemployment economies, microeconomic policies are unlikely to improve labor market efficiency and reduce unemployment. For instance, investing in improving labor mobility across districts would have little effect on reducing unemployment, as the number of unemployed within each district greatly exceeds the number of vacancies, both in general and within each educational category (Munich, Svejnar, and Terrell (1995)). Macroeconomic policies—and, more generally, economic growth—are the more promising solution to the unemployment problem.

The task of reducing unemployment has been complicated by the fact that the provision of social safety nets has been taxing, especially in Hungary and, to a lesser extent, in Poland, where foreign indebtedness and budget deficits are major problems. Hungary, faced with welfare and social services expenditures approaching 30 percent of its GDP and a budget deficit exceeding 8 percent of its GDP, introduced a major austerity program last March. However, the implementation of the program has already encountered severe political obstacles. Containing public expenditures will clearly be difficult in the face of high unemployment and growing dissatisfaction with the social cost of transition.

A particularly challenging task in this context is the reduction in the cost of retirement benefits. The Central and Eastern European countries have entered the transition with publicly funded pension systems, almost universal coverage of the population, low retirement ages, high and growing dependency ratios, high expenditure and contribution levels, high statutory replacement rates, and perverse redistributions. The result of the high dependency ratio is that the system is very costly and yet offers relatively low benefits. With aging populations and pay-as-you-go systems, the tax burden becomes increasingly heavier. Several countries are already moving to raise the retirement age and supplement the public retirement system with voluntary private schemes—a step in the right direction—but more will need to be done. Raising the retirement age is clearly needed on fiscal as well as efficiency grounds, although the short-term effect may be an increase in the already high unemployment rates. Lowering the average wage-replacement rate to the level of OECD countries would also be desirable, especially if part of the benefits of this restructuring could be channeled into a newly established system of private (supplementary) savings for retirement. Shifting the public system to a broader and less distorting tax base than payroll is also desirable on efficiency and distributional grounds.

Corporate Governance

A major challenge lies in the area of corporate governance. The power of managers and workers (insiders) is significant, and neither government nor new private owners provide effective control in many firms. The Polish Government, for instance, had already yielded significant control rights to workers and managers in the 1980s and thus entered the transition with limited powers over enterprises. In contrast, the Czech and Slovak

Governments kept tight control during the mass privatization process, but the new, dispersed owners have not exercised effective control over management in many privatized firms. The problem is all the more serious because the Central and Eastern European economies still suffer from a shortage of managerial skills. Managers of (former) state-owned enterprises tend to underestimate the importance of key activities, such as quality improvement, marketing, and accounting and auditing.

In countries such as the Czech Republic and Slovakia, a problem of conflict of interest has also developed between the banks and the investment privatization funds. With some of the largest funds being owned by the large commercial banks, a bank's desire to initiate bankruptcy of firms may go counter to the interest of the investment fund holding shares of these firms. The phenomenon may be serious enough to account in part for the lower volume of bankruptcies in Slovakia and the Czech Republic than, for instance, in Hungary and Poland.

The European Union

While Western Europe is the principal trading partner of the Central and Eastern European economies, the safeguard restrictions and antidumping procedures used by members of the European Union represent a significant hindrance to exports from, and growth in, Central and Eastern Europe. Studies indicate that the economic impact of exports from Central and Eastern Europe to the Union is very limited, albeit focused in a few areas. The challenge for the Central and Eastern European economies is to find freer access to the European Union markets and eventually to join the Union.

III. CONCLUDING OBSERVATIONS

In the first half of the 1990s, the countries of Central and Eastern Europe carried out a historically unprecedented transformation of their formerly centrally planned economies. Despite many remaining imperfections, these countries now have functioning market economies. They have to overcome major structural problems and meet the high expectations of their peoples. Above all, they face the daunting task of generating resources and governance structures needed to launch high and sustained rates of economic growth.

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Economic Transformation: The Tasks Still Ahead

Oleh Havrylyshyn

I am deeply honored to participate in today's Per Jacobsson symposium, and I am grateful to Sir Jeremy Morse and Jacques Polak for offering an opportunity to speak on this very exciting topic, one of such historical significance that it is indeed a fitting addition to the important series of issues covered in earlier lectures.

The transformation of centrally planned economies into market economies is a historically unique process that we are living day by day. Though the process is far from complete, it is so fast moving that the five or six years since it began already provide much important evidence deserving analysis. In my presentation, I will first give a summary view of what transformation comprises (Section I), then outline the principal achievements so far in different groups of countries (Section II) and give special attention to the late starters in Section III. In Section IV, I turn my attention to the question before us today: What tasks still lie ahead in the transformation process? Section V concludes with some final remarks on key priorities.

I. What Does Transformation Comprise?

While there has been much debate about the speed of reforms, their sequencing, and their integration into the political transfor-

I wish to thank Jacques Polak for his detailed comments at various stages of preparation, as well as Mario Blejer, Anne Krueger, John Odling-Smee, and Onno de Beaufort Wijnholds for useful suggestions on earlier papers exploring some of the ideas contained here. Peter Botousharov assisted in preparing some of the background material, for which I am grateful, and Gudule Theunissen quickly and repeatedly transformed any handwritten text that I gave her into clean typescript—a feat that commands my grateful amazement.

mation toward a democratic civil society, there is remarkably little disagreement on the main economic elements of this process. Indeed, one can do no better than revisit Kornai's classic 1990 work *The Road to a Free Economy* and, with minor modification, list these three elements.

First, there must be a determined effort at *financial stabilization* to control the inflationary pressures, which can be strong enough to threaten descent into the hyperinflationary spiral that nearly all transition economies experienced at the outset of the process.[1] This effort requires a combination of budget tightening (lower expenditures and new taxes), monetary restraint (positive real interest rates and limits on credit expansion), and a move to a stable, essentially convertible currency.

Second, there needs to be a substantial *transfer of ownership*[2] from state to private hands to overcome the lack of economic motivation in the socialist arrangement and introduce in its stead the profit motivation that will contribute to efficiency improvements. Such a transfer, while not necessarily encompassing all state-owned assets, must be substantial and widespread, covering small enterprises in retail and services, housing, and medium-sized and large entities in all producing sectors. Ownership transfer alone will not suffice to stimulate profit-motivated efficiency improvements and must be accompanied by a number of other measures, which comprise the third main element.

The third element involves, generally, a *liberalization of economic activity* through the freeing of prices, the opening up and easing of entry into markets for new enterprises (both domestic and foreign), and the opening up and easing of foreign trade and foreign investment operations. While all the elements of transformation act together, one might consider this third set of actions as having the particular aim of creating an environment of competitive markets.

[1]The possible exceptions were Czechoslovakia and Slovenia, which began the transition with near-balanced budgets. Even in these cases, however, sustained fiscal and monetary tightness was felt needed to prevent sharp deterioration under political pressures for the expansion of social programs and credit supports to the hard-hit, inefficient industries inherited from the socialist period.

[2]I propose to use the more common term "privatization" for the broader concept of increasing the share of privately held assets, which then involves, besides transfer of ownership, the "green field" entry of new entrepreneurs and the closure of inefficient state-owned enterprises.

Together, these three actions would bring a country to the end goal: an economy that is largely privately owned, with free and open markets in a predominantly competitive environment that is broadly open to global markets.

One need only add a word on the role of government to complete the picture. This role would, of course, be much reduced compared to the centrally planned socialist period, though its exact magnitude would, as in existing market economies, depend on societal preferences. Government would fulfill five principal functions:

- ensure general law and order;
- provide the legal basis for clear and secure commercial and economic activity, ownership rights, and the settlement of civil and commercial disputes;
- ensure fiscal and monetary stability for the economy;
- provide a social safety net for both the transition and post-transition period; and
- provide a mechanism for regulating natural monopolies.

II. Transformation Achievements Since 1990

A Staggered Beginning

Observing countries in transition five years after the start is not unlike observing the runners in a marathon early on in the race. It is reasonably clear who are in the group of front-runners, equally clear who are the stragglers at the end, and it is more or less possible to discern some groupings in the middle. One can discern four clear and useful groupings of transition countries, as follows:

- early and succeeding reformers;
- early but stalling reformers;
- lagging reformers that had made substantial starts by mid-1995; and
- lagging reformers that had made at most limited starts.

The countries in each group are listed in Table 1,[3] which also shows growth and inflation numbers for the period 1990–95. The

[3]The groupings and analysis of results by group discussed here are taken from Havrylyshyn and Botousharov (forthcoming), a study that covers 25 countries in Central and Eastern Europe, including the newly independent states succeeding the U.S.S.R.

Table 1. Real GDP Growth and Inflation Performance by Groups of Countries
(Annual percent change)

	Early Reformers			Lagging Reformers	
	Succeeding[1]				
Indicators	First wave	Second wave	Stalling[2]	Substantial start[3]	Limited start[4]
Real GDP					
1990-92	−10.4	−16.6	−9.5	−19.5	−9.4
1993	3.8	−12.2	−2.3	−13.7	−14.7
1994	5.4	2.9	3.1	−17.7	−16.0
1995 (est.)	4.9	5.2	2.9	−3.3	−9.2
Consumer prices (end of period)					
1992	96.8	964.9	80.9	1752.4	1051.6
1993	27.4	407.6	91.5	2807.1	4219.1
1994	18.6	34.2	54.2	1410.8	1091.5
1995 (est.)	10.6	19.2	22.1	44.2	565.5

Source: IMF.
[1]First wave: Albania, the Czech Republic, Poland, and Slovenia. Second wave: Croatia, Estonia, Latvia, and Lithuania.
[2]Bulgaria, Hungary, Romania, and the Slovak Republic.
[3]Armenia, Georgia, Kazakstan, the Kyrgyz Republic, Moldova, Russia, Ukraine, and the former Yugoslav Republic of Macedonia.
[4]Azerbaijan, Belarus, Tajikistan, Turkmenistan, and Uzbekistan.

early reformers moved in two quickly succeeding waves—in 1990–91, and then in 1992 to about mid-1993. While eight of this group can be considered as succeeding well in the stabilization and adjustment process, and comprise the first group, four other countries experienced a stalling or slowing of the process and comprise the second group. Note that none of these countries has slipped so badly as to merit a labeling of reversal. Of those that lagged substantially in beginning reforms, a third group of eight countries stands out as having by mid-1995 made a substantial start, generally sometime during 1994. Finally, five countries comprise the fourth group, in which any reform efforts have been either so limited or so recent as to be unlikely to have yielded clear results.[4]

Thus, the first important observation on achievements since 1990 is that virtually all countries have by now finally taken important steps toward financial stabilization. It should not be a surprise that this beginning was not simultaneous but rather staggered over the six-year period 1990–95. The reasons for this are

[4]One could arguably put Belarus into the third rather than fourth category, as the beginning of stabilization efforts occurred from the end of 1994 to early 1995.

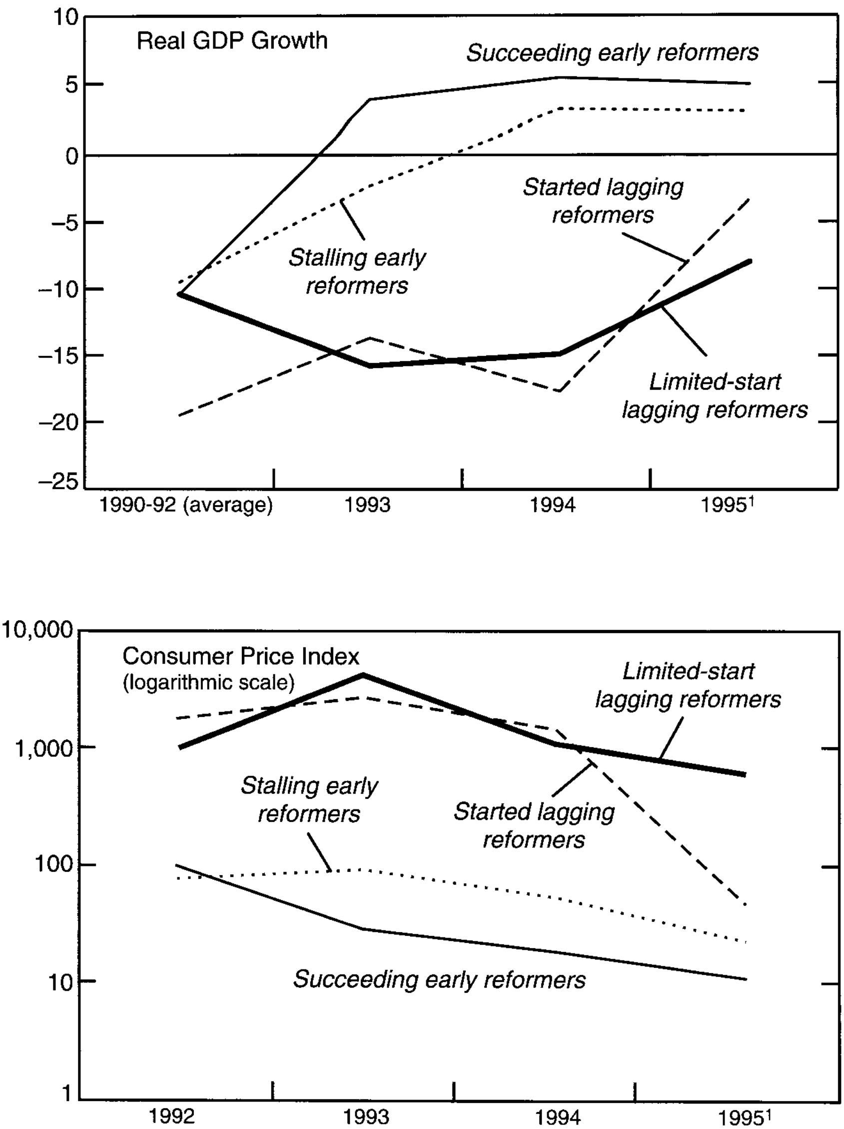
largely political and historical, and have more to do with the political readiness of countries to undertake significant reform measures than with the debates on the superiority of the gradualist or the big bang approach to reform. In a 1993 article, Brzezinski details various factors that result in a grouping of countries with, as he calls it, a "differentiated future" in transformation. Political historians will no doubt soon be providing further explanations for the staggered beginning. One thesis likely to be very popular will be the historical memory of markets, namely, that countries farther east (with less memory of markets) move more slowly than those farther west (with greater market memory). Indeed, in general the timing of the launching of significant reform efforts runs roughly from west to east. Thus, we see in Table 1 that the first (1990–91) wave of early reformers (Poland, Czechoslovakia, Hungary, Slovenia, Bulgaria, Romania, and Albania) includes primarily the westernmost countries in the region. These countries were soon followed in 1992–93 by Croatia, Estonia, Latvia, and Lithuania.

Moreover, the group that we have labeled as the most lagging reformers, which has made little if any serious start, is generally (with the exception of Belarus) the farthest east (Azerbaijan, Tajikistan, Turkmenistan, and Uzbekistan). There are exceptions, such as the Kyrgyz Republic, which began its efforts in the first half of 1993. I do not wish to explore this theme further here but would only add a cautionary note on the interpretation of "market memory." I suspect that its effect is less a matter of people having "forgotten" entrepreneurial behavior and more a matter of the polity (society, people, and governing structures, *together*) being less willing to accept early, quick, and radical changes. When politicians say (as they sometimes do in these countries) that the people are not ready for a market economy, a healthy skeptic will wonder whether perhaps it is the politicians who are not ready for markets.

Results on Inflation and Recovery of Growth

As we turn to consider macroeconomic performance by country groups in Table 1 and Figure 1 (that is, GDP growth and inflation), it is evident that most of the early starters, particularly in Central Europe—Albania, Croatia, the Czech Republic, Slovenia,

Figure 1. Macroeconomic Performance by Country Group
(Annual percent change)



Source: International Monetary Fund.
[1]Estimated data.

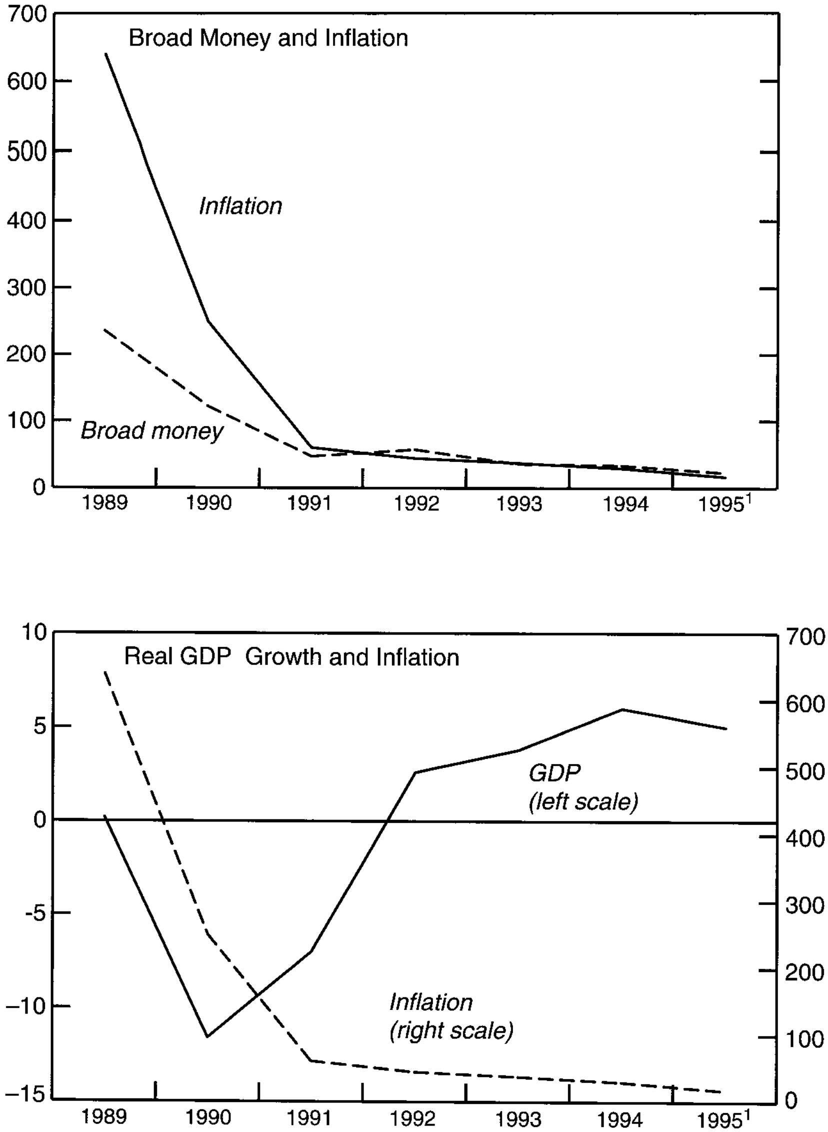
and the Baltic countries—have achieved considerable control over inflation, which averaged about 15 percent in 1995. Many of the early starters have single-digit annual inflation rates, and none have inflation rates much above 20 percent annually. Indeed, moving from left to right in the columns of Table 1 (from earlier and more advanced reformers to the less advanced), there is a clear progression toward higher inflation rates. The bottom panel of Figure 1 illustrates this graphically, while the top half shows that, for all 12 early starters (including even those suffering some slippage in stabilization), control of inflation has been in place long enough for them to have experienced a recovery in growth of GDP by 1994. In Poland, growth recovered as early as 1992 (and was by 1994–95 in the range of 5 percent, higher than in virtually all Western European countries); in other countries, growth resumed in 1993 or no later than 1994. The earlier inflation control began and was sustained, the earlier growth recovery occurred. This is perhaps the most important lesson to be learned by lagging reformers: recovery of growth does not come until there has been solid and sustained control over inflation for at least 18–24 months; one needs to be patient and hold firm with the stabilization program.

Another important lesson is that the impact on inflation of solid stabilization efforts—budgetary and monetary—comes very quickly. The lag between beginning efforts and bringing inflation rates down from 20–30 percent monthly to single-digit monthly levels is a matter of months. This lesson is illustrated by the relationship between broad money and inflation, which is shown in the top panels of Figures 2 and 3.

We see these quick inflation control results not only for early reformers but also for many of the later reformers, including Ukraine, Belarus, Armenia, and Georgia. In Ukraine, for example, inflation rates in the latter part of 1994 were 20 percent a month and more; after six months of a strong stabilization program comprising monetary tightness, sharp fiscal deficit reduction, and the freeing of exchange rate markets in late 1994 and early 1995, these rates have fallen to below 5 percent a month since April 1995. The same results hold true, with a slight lag because of the later start of the process, in Belarus. Armenia and Georgia, which had hyperinflationary levels of several hundred percent a month for parts of 1993 or 1994, were able to achieve inflation levels

Figure 2. Poland: Impact of Stabilization Efforts on Inflation

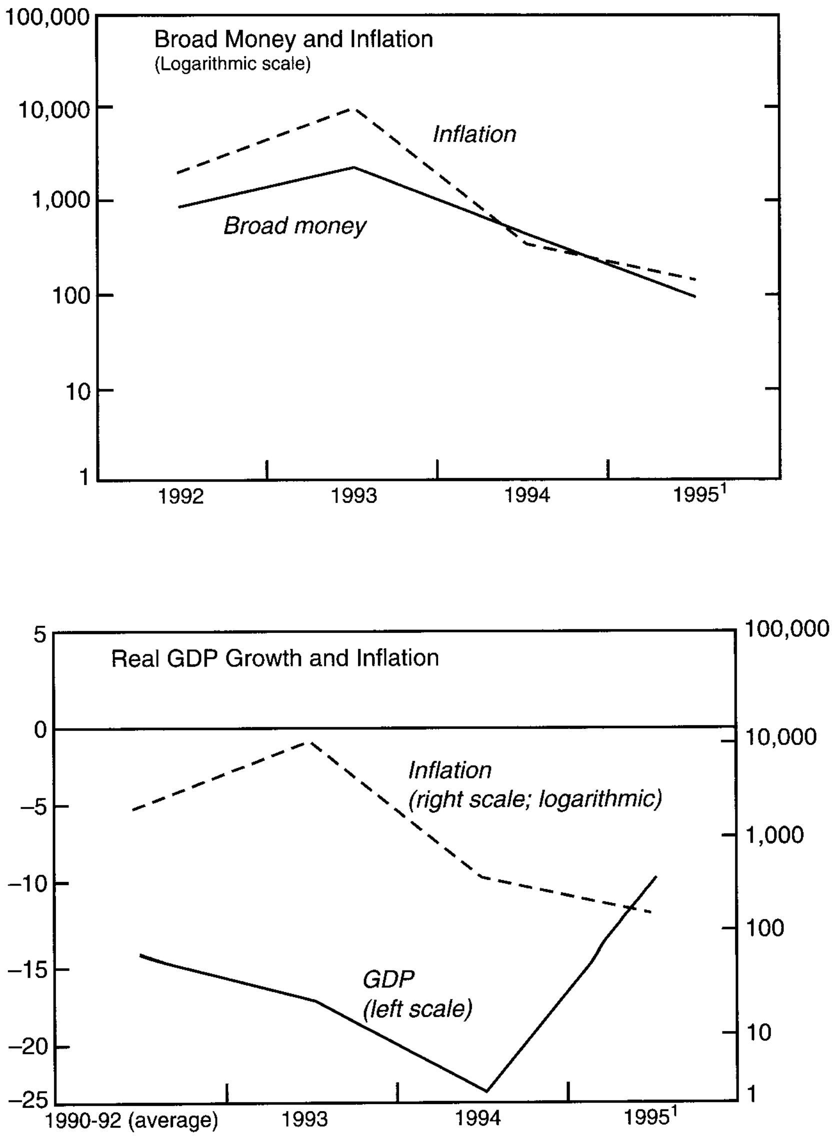
(Annual percent change)



Source: International Monetary Fund.

[1]Estimated data.

Figure 3. Ukraine: Impact of Stabilization Efforts on Inflation
(Annual percent change)



Source: International Monetary Fund.
[1]Estimated data.

well below 5 percent a month soon after they started substantial stabilization efforts. Indeed, if the present levels could be sustained in countries such as Armenia, Georgia, or even Azerbaijan, one could be speaking not of *monthly* inflation rates anymore, but of annual inflation rates of 30 percent, 20 percent, or even less.

But it is worth repeating the most important lesson: although the lag of inflation control (3–4 months) is very short, the lag between inflation control and recovery of economic growth is quite long (18–24 months). The pattern of inflation and growth movements over the transformation period, typified by that observable in the top panels of Figure 2 (depicting Poland, a typical early reformer) and Figure 3 (depicting Ukraine, a typical lagging reformer), is a sort of "scissors effect." Before stabilization is begun, growth declines and inflation rises, and the two curves move into a position that can be defined as hyperinflationary recession. This effect can be seen more clearly in Ukraine's case than in Poland's, as the latter started its stabilization program in 1990. The opening up of the scissors therefore began in Poland before 1989. Once significant stabilization efforts began (Poland's in January 1990, and Ukraine's tentatively in early 1994, then more comprehensively in late 1994), inflation rates started to fall quickly. Poland typifies the situation of all the early reformers: with a lag of 12–18 months, output began to recover, and the two curves crossed over again to move into the more normal and certainly more desirable position of high growth and low or at least moderate inflation. Ukraine, like most others in the group of late starters, has not yet had a long enough period of sustained inflation control to have experienced growth recovery, although the decline in GDP is expected to be far less in 1995. A handful of the countries in this third category of late starters will almost certainly have positive growth in 1995: Armenia, the Kyrgyz Republic, and perhaps Moldova.

Inflation Control and the Washington Consensus

It would be wrong to complete this summary retrospective of transition economies without addressing the question of how inflation control and the subsequent growth recovery are achieved. The simple answer is found in the top panels of Figures 2 and 3, which show the very strong relationship between money supply and inflation in Poland and Ukraine. This relationship is observable for all the other countries in the sample of 25 and affirms the view that, as the high inflation rates of the transition period are largely of a monetary character, inflation control has to be based on a strong monetary tightening. Behind the monetary tightening lies a more complex set of policy measures, including sharp reductions of budget deficits (largely through cuts of expenditures and subsidies), a restriction on "directed" credits to state enterprises (either from or accommodated by the central bank),[5] and a series of price liberalizations, not least of which is the introduction of a uniform, market-determined exchange rate.

In broad terms, this repeats the message of the first transformation measure noted at the outset of the paper; it is also common to what John Williamson has labeled the "Washington Consensus";[6] and finally, it is broadly similar to most IMF stabilization programs. Indeed, in all but one country where stabilization has started, an IMF program has been associated with it. In the exception, Slovenia, budgetary and inflation problems were not severe, and strong measures or external financial support were not needed. In a few other cases—Poland and Croatia, for example—substantial efforts were begun before IMF support was in place, but the measures were not very different from the Washington Consensus, and a Fund program soon followed.

Twenty countries in our sample now have or have had stand-by programs with the IMF. Certainly, not all can be considered as successful in stabilization. At least four countries—or five if Russia with its first 1992 stand-by arrangement is included—have seen some degree of stalling; this is the second group of countries defined earlier. Furthermore, transformation efforts in seven countries have begun too recently for one to be certain about their sustainability, although in all cases early results on inflation control are quite good. Thus, while one might conclude that a Fund program is not a sufficient condition for successful stabilization, the tentative conclusion, looked at another way, can be much more

[5]In many transition economies, off-budget support of state enterprises became in 1993–94 a far greater part of the deficit to be monetized than the budget deficit itself. For this reason, it is not useful to seek a statistical relationship between inflation and budget deficits alone. See Tanzi (1993).

[6]Williamson (1994, Chap. 2).

positive: a Washington Consensus program (often associated with a Fund program) is a *necessary* condition for successful stabilization. Even the preliminary but positive early results of stabilization in the third group of late-starting countries, all of which have Fund programs, underscore the view that such a package of policies appears necessary for successful stabilization.

Progress on Ownership Transfer and Liberalization

For the other two broad elements of transformation, ownership transfer and liberalization, latecomers have also done much catching up in the past year. However, in general, both for them and for the leading reformers, the degree of progress achieved is not as great as in the area of macroeconomic and financial stabilization. The European Bank for Reconstruction and Development (EBRD) publishes annually a *Transition Report*, which provides excellent evidence on the progress made in the microeconomic and structural reform areas. Table 2 summarizes some of this evidence in a synthetic index valued from 1 to 5, with 5 representing "the standards and norms typical of advanced industrial economies."[7] The indices for different policy areas are somewhat subjective, contain a margin of interpretation, and are not necessarily additive; however, despite all these shortcomings (which the EBRD emphasizes), the indices provide a workable framework for assessing the state of transition. In Table 2, therefore, I have ignored the injunction of the *Transition Report* not to average the indices reported for the individual countries, as I consider that the results give a reasonable picture of the state of transition.

What do we see in this picture? First, the same progression observed for financial stabilization holds for structural reforms: the earlier the start, the greater the advancement. Second, however, the state of transition achieved even by the *first* wave of succeeding reformers still leaves a long way to travel. The private sector share in GDP for these countries averages 59 percent. Also, out of a possible value of 5, the ownership transfer index is still well below 4, as is the formal price liberalization index. Meanwhile, competition policy and financial sector reform average well below

[7]European Bank for Reconstruction and Development (1995, p. 12).

Table 2. Index of Progress in Transition: Microeconomic and Structural Reforms

(As of mid-1995)

	Early Reformers			Lagging Reformers	
	Succeeding[1]				
Indicators	First wave	Second wave	Stalling	Substantial start	Limited start
Private sector share in GDP (%)	59	56	51	33	20
Enterprise restructuring and ownership transfer[1]	3.5	3.2	3.1	2.5	1.7
Price, trade, and foreign exchange system liberalization[2]	3.9	3.5	3.9	3.1	2.3
Competition policy	2.3	2.0	2.3	1.6	1.4
Financial sector reform and capital markets development[3]	2.6	2.5	2.6	1.9	1.5

Source: European Bank for Reconstruction and Development (1995).

[1]This is an average of three indexes: large-scale privatization, small-scale privatization, and enterprise restructuring. For consistency with the semantics of the text, I have taken the liberty to label this as "ownership transfer." The broader perspective of private sector development is better captured in the first row.

[2]This an average of price liberalization and liberalization of trade and foreign exchange system.

[3]This is an average of banking reform and interest rate liberalization, and development of securitites market and nonbank financial institutions.

3. The rest of the countries are, of course, even farther behind on these reforms, as Table 2 clearly demonstrates.

In fact, the indices on price and trade liberalization may overstate the degree of progress, inasmuch as the still low degree of competition reflected in the fourth row may be the binding constraint in the area of market liberalization.[8] Similarly, a high degree of ownership transfer (for large-scale enterprises, higher in Russia than in Poland) may overstate transition progress because in many cases[9] the emphasis placed on privatization by insiders raises the problem of governance and impedes improvements in efficiency.

[8]The *Transition Report* itself (p. 15) notes the danger "that competition policy may become a surrogate for widespread price controls." Because of the possible binding character of competition policy, I think it more useful to show it separately from price liberalization in Table 2.

[9]The *Transition Report* mentions, for example, Russia, Lithuania, and Uzbekistan (p. 16). The problem applies in various degrees to other countries.

In the area of structural reforms there is probably more diversity, and there are more exceptions to the rule than in the first broad area of transformation, stabilization. As already mentioned, Poland ranks behind Russia on large-scale privatization, but better governance through an enforced "hard budget" and greater competition has resulted in Poland's far superior performance on exports and GDP growth. So too, less advanced large-scale privatization has not prevented solid recovery in Croatia and Slovenia. If these countries proceed in 1996 with their plans for accelerated sell-offs, they would likely experience another surge of growth.

There is also great diversity in land reform, with much of agriculture now in private hands, not only in the early starters (the first and second groups of Table 1) but also in such lagging reformers as Armenia and Moldova. In other newly independent states, this process has barely begun.

An element of great importance and common to most, if not all, transition economies is the very limited progress made on financial sector reforms, often reflected in liquidity problems or even crises of confidence in the banking system. Even some of the early starters, well advanced in other respects, have felt the braking effect upon reforms of this problem—for example, Hungary, as noted below. Many other countries have felt or are still threatened by the overhang of nonperforming loans and confidence problems.

An important reason for bearing these burdens is the alleged desire to keep production afloat, avoid unemployment, and postpone the social pain of adjustment. Postponing or stretching out the social pain of adjustment is also a large motivating factor behind the delays in the fiscal stabilization efforts. The *Transition Report* provides a disarmingly simple but very powerful piece of evidence on the effectiveness of such a gradual approach. Observing changes in birth and mortality indicators since 1989, the report identifies five early starters (the Czech Republic, Hungary, Poland, Slovakia, and Slovenia) and concludes that social indicators for this group improved somewhat while deteriorating for all the others. The deterioration was especially strong for those with much later starts or with slippages from earlier starts.[10] Comparing the new

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[10]That is, as listed in Table 1, for countries in the third and fourth groups, plus Bulgaria and Romania in the second group.

mortality rates to those existing before 1989, the report calculates that, where reforms were delayed, the number of deaths *in 1994 alone* were about 500,000 more than they would have been if these countries had followed instead the trend observed in the early starters. This finding needs no additional comment.

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Reviewing transition achievements so far, one can say that, on balance, while progress on financial stabilization is incomplete, it is nevertheless substantial, with all transition countries apparently now beyond the risk of hyperinflation that was so much noted even a year ago, and with annual inflation levels ranging from single digits in several cases to rates of a few hundred percent at most. Progress on ownership transfer is slower than on stabilization and more mixed in character. Some leading transition countries, such as Poland, are farther behind on large-scale privatization than Russia. The lags and the range of progress made on various liberalization measures across countries are even greater.

III. SPECIAL PROBLEMS OF LATE STARTERS

In the four groupings of countries discussed here so far, a key criterion has been when reforms started. It may be worthwhile to return to this matter more deeply and say a few words about the possible reasons for—and consequences of—a later start. In the literature on the historical process of economic development, there is the well-known thesis of Alexander Gerschenkron (1952) on the advantages of economic backwardness. Gerschenkron wrote initially about the late start of industrialization in Czarist Russia in the 1880s and 1890s, but the thesis came to be applied to other late starters. The thesis holds that countries industrializing later—for example, Japan or South Korea, compared with the nineteenth century industrialization process in England, the United States, Germany, and other countries—have the advantages of much more advanced technology, better transportation systems, and a much bigger world market in which to find niches, which enable them to use exports as a tool of development.

In the transition process of the 1990s, although there may be some value to a late start in being able to learn the lessons of those countries that started earlier, the consequence of coming later may *not* be advantageous, on balance. Indeed, the thesis here might unfortunately be opposite to Gerschenkron's: the later a country starts the transformation process, though this is better than never, the more difficult it becomes. The reason is quite simple. The fall of communism provided a historically momentous opportunity to make large societal changes, not only in the economy but also everywhere else in the society—a moment that Leszek Balcerowicz has labeled a period of "special politics," or the "honeymoon period."[11]

Where the moment was seized, a country was able to move ahead quickly, because people expected large changes, and—as happy or unhappy as they may have been, as burdened as they may have been with those changes—they accepted them. Where the transformation process is delayed, the intervening period provides an opportunity for those who fear or even explicitly oppose reform (bureaucratic and other vested interests) to reassess their position and regroup into an opposition. The bureaucratic and other vested economic interests in agriculture, industry, and goods distribution networks may not favor the transition process to start with. Delay gives them time to rebuild strength.

From this realization follows a very important implication of the challenge ahead for the latecomers: the later the process is started (and one must inevitably start), the harder it will be to move forward.

This is why one sees in countries farther east, where the start of the transformation was late, that, although they achieve quick stabilization results, they begin to suffer after a period of about six or nine months or so from what I will call a neo-Keynesian virus. Given the sharp output decline in the transition and the widespread (albeit often superficial) knowledge of the Keynesian revolution's answer to the depression of the 1930s, it is understandable that there is susceptibility to arguments that say: "Well, we have achieved a certain measure of inflation control; it is now time to think about the goal [that Jan Svejnar has mentioned] of promoting economic growth and stimulating recovery. We must now ease up on monetary and fiscal policies in the traditional

[11]As described in Balcerowicz (1994).

Keynesian fashion and stimulate growth by implementing policies of budgetary and of monetary expansion."

I speak of this as a virus because it is a piece of policy advice that is bad; the situation is not similar to the Keynesian problem of high unemployment owing to insufficient demand. It is better described by what Kornai (1994) has labeled "transformational recession": a country in transformation must first go through a supply-based recession, in order to squeeze out the negative value added (the "bad" production) and reallocate production more efficiently by correcting the central planning errors. Indeed, a country cannot get to the recovery phase until it has done such squeezing. It is tough, but it is inevitable. Only after the supply-side corrections are done should a country even consider demand stimulation as a policy.

In the case of some countries farther east in the region, like Armenia, Georgia, Ukraine, and others that I am closely familiar with, I will describe how this process of a "late-but-better-than-never start" occurred and what challenges lie ahead.

From the time of independence in 1991 through the next three years or so, Ukraine, Georgia, and, to a lesser extent, Armenia undertook at best limited but not substantial efforts at economic reform (or, in some cases, only financial stabilization). All three had very high inflation rates in 1992 and 1993 of up to 10,000 percent annually.

The lagging reform efforts of these countries can be explained perhaps by three factors—all of which, by the way, are common to the newly independent states. First, there were intellectual debates about the approach that should be taken: gradualism versus rapid reform. Second, the new government of the new country tended to put priority on nation-building tasks and paid less attention to economic matters. In Ukraine, this was a very important factor, as political historians have already written.[12] In Georgia and, to a lesser extent, in Armenia and Moldova, the military conflict and general regional instability dominated other considerations. Third, and particularly important as the delay went on, was the problem of the vested interests, who found that the halfway house between central planning and a full market was perhaps a convenient place to stay—a situation that is very

[12]Kuzio and Wilson (1994).

reminiscent of Latin America and certain other parts of the world in the 1960s and 1970s.[13]

In other words, markets have been created in these countries with many private ownership and profit opportunities—albeit opportunities that are restricted by the administered economy to the more privileged few and therefore not opportunities for competitive capitalism. Various interests, including bureaucratic ones, will naturally do everything to avoid further reforms and keep the transition process frozen in this halfway stage.

In terms of the three major steps needed for transformation, as noted at the outset, this danger of a frozen transition may be put as follows. The new pseudo-capitalist elite will eventually see the first step of financial stabilization as needed because excessive inflation eats away at the production potential of the economy and the base from which they make their profits.[14] Traditional Soviet bureaucrats can easily envision fiscal and monetary inflation control as the intellectual equivalent of a strong administrative hand and will thus also eventually accept the first step, financial stabilization. Ownership transfer of existing state assets—the second step—can be easily arranged in such a way that it enhances the economic status of the new capitalists, and opposition to it should therefore not last long. But much more resistance will be put to the third step, liberalization, because it means sharply reducing the administered intervention of government and, hence, sharply reducing the opportunity for special privileges in production or trade. Liberalization also means opening up these privileges to full competition from new, small private entrepreneurs and from the world economy. These steps, of course, would undermine the hold of the new capitalists on the monopolized markets. Grigoriy Yavlinsky (Passell (1995)) has called this state of affairs a post-Soviet monopoly capitalism, and Andrei Shleifer, referring to Russia but surely intending to cast the net wider, speaks of the big worry that "Russia will turn into Latin America of 30 years ago."

It is not impossible to break out of this deadlock if a new political opportunity presents itself, perhaps in the form of a new,

[13]Others have written of similar tendencies in Russia and elsewhere, as is noted below.

[14]Or better, their "rents." In the sense that the profits are based on lobbying efforts and privileged administrative rights given by governments, this behavior is exactly akin to the "rent seeking" defined in the trade and development literature (see Krueger (1974)).

vigorous leader intent on pushing forward the reform agenda. The stabilization of the Caucasian region in 1993–94 set the stage for Armenia and Georgia to try again; in the latter case, the presence of a strong new leader—Eduard Shevardnadze—was also a critical factor. Similarly, in June 1994 the situation changed radically in Ukraine. Happenstance provided a new opportunity to replace the moment that had been lost three years earlier, and, with another election, a new President, Leonid Kuchma (who succeeds Leonid Kravchuk), very resolutely began the effort of attacking these various problems. Indeed, as I described earlier, a solid stabilization effort begun in the fall of 1994 gave very quick and immediate results in terms of, among other things, inflation control and stabilization of the exchange market. Ukraine and a number of other countries are now at that stage of the process where one needs to worry that the potential backlash of the neo-Keynesian virus could slow down the transformation—with the vested interests that were built up during the period of delay joining in the effort to apply pressure for a temporary freeze, or at least a slowing down of the transition process.

IV. The Challenges and Tasks Still Ahead

Having defined the goals of transformation and summarized the progress achieved so far, I will now turn to the main theme of this year's Per Jacobsson symposium: the tasks still ahead for transition economies. It will be useful to consider first the early reformers, setting forth a list of things as yet undone; here, I will necessarily repeat some of the points already made by Jan Svejnar. For the later and still-lagging reformers, the list will naturally be longer, including tasks already done by the earlier reformers, some future tasks common to both, and some challenges that are unique to this group.

The Early Reformers

The very *first* task for the early reformers—and a continuing permanent one—is to sustain the financial stability already achieved and not allow slippage. As we have seen in some of the countries of Central Europe and Southeastern Europe (Bulgaria, Hungary, Romania, and Slovakia), slippages or lags do have a cost in terms of higher inflation and lower growth than is observed in countries that have sustained stabilization efforts. The countries that have already gone a long way in transforming their economies have in general achieved a considerable reduction not only of the budget deficit, but also of the size of budget expenditures as a share of GDP (ranging for this group from 30 percent to 45 percent). These countries have as well undertaken many of the tax changes needed, such as the replacement of turnover taxes by taxes on profits, personal income, and value added. Though the above changes are not entirely completed, the remaining tasks on the revenue side are perhaps less important than the need to transform social program expenditures and avoid the future risk of excessive burdens on the budget.

The problem of assuring a social safety net in the transformation period is not to create anew social and support programs, but to change them from the previous system. Social expenditures accounted in fact for a very large part of these economies' government budgets, such as virtually free schooling and health care; low-cost communal services with very high implicit subsidies, including for housing, utilities, transportation, and vacations; and comprehensive and early retirement pensions. What needs to be done and is still far from complete is to rationalize this too generous and too comprehensive system, reducing its overall fiscal burden but focusing the support where it is most justified—on the truly indigent, the disabled, and the unemployed. A typical problem is that caused by pensions, which allow retirement as early as 55–60 years of age and result in a ratio of pensioners to labor force that is approaching, as in Poland today, one-third. An optimist would summarize this fiscal problem of the early reformers as one so similar to that facing many industrial countries that this by itself is a sign of how far the transformation has gone!

The *second* task is to finish off the still large agenda of privatization. Part of this task entails the de jure transfer of ownership, and part of it entails the broader encouragement of privatization by easing the entry of new, green field entrepreneurial activities and investments, ensuring a climate of competition, and opening up the economy. The Czech Republic may be farthest advanced in all of this, and perhaps one could say that it has almost completed the job; however, in many of the other countries, even some of the early reformers, a large job remains to be done.

While the risk of substantial reversals is minimal, the risk of further slowdown is still large.

Let me elaborate somewhat on some of the key components in this second task: transferring state assets, easing new entry, providing access to assets for new private investors, and bringing competition into the market.

The concept of privatization has unfortunately been equated to selling off state assets; it would be more useful to think of it as promoting the expansion of the private sector, in effect, increasing its share in output. This expansion, of course, can be achieved through a combination of four changes: selling or transferring state firms to private owners; selling individual physical assets of state firms to private owners; putting state firms into bankruptcy and writing off unsalable assets; and allowing new private firms to enter the market with green field investment. One could add a fifth element that can increase the private sector share in output, namely, a faster productivity growth in private (or newly privatized) firms, compared with state firms. Seen in this broader perspective, it becomes clearer why ownership transfer alone, even at the magnitudes seen in the Czech Republic and Russia, is not always enough to create a rapid turnaround in efficiency and output growth. In the Czech Republic, all the five elements mentioned have been present, as well as a high degree of external openness, which has ensured a high degree of competition. In Russia, some of these elements are present (substantial transfer of ownership, both small and large scale, and de jure ease of entry for new producers), but some others are less completely in place (for example, de facto ease of entry remains encumbered by bureaucratic inertia, and external openness is growing but far from liberal).

In Poland, the only element that is not yet present is the de jure transfer of ownership for large-scale firms. Despite this, output growth and efficiency improvements in Poland are by all indications far greater than in Russia or even other Central European countries. The explanation may be as follows: in Russia, state assets were transferred to private hands before the market was brought to the economy; in Poland, even though ownership was not transferred, the market was brought to state enterprises. With an insistence by Polish governments (including the present one) that state firms behave on a "commercial" basis, the delay in ownership transfer has not precluded market behavior. Indeed, the shedding of workers and some assets by the firms that remained state owned has played an important role in making room for the growth of the new private enterprises. Nevertheless, let me emphasize that I would not be in favor of delaying ownership transfer in Poland much longer or keeping its coverage limited. I cannot imagine an eventual successful transformation without a very large degree of ownership transfer, but I can imagine a large degree of ownership transfer without eventual success in transformation.

The main lesson here is twofold. Those countries that have still not transferred ownership fully (including the lagging reformers) need to do so, but the transfer should be accompanied by the various steps of market liberalization to bring the market more fully into the economy. Those countries that have gone further in transferring ownership should speed up the pace of market liberalization, to ensure the efficiency gains private ownership was meant to bring.

One particular aspect of this market liberalization deserves special emphasis as the *third* main task, namely, dealing with the fragility of the new banking system. In the past years, banking problems or even crises have occurred in several countries, including Poland in 1993–94 and Russia and Latvia this year. Two principal factors have put many banks in a fragile financial state: the inherited burden of old Soviet-period loans, and the mushrooming of smaller new banks that are beyond the supervisory capacities of the central banks. Banks of the central-planning period were essentially only regional or sectoral accounting departments of the central planning agency, accepting and conveying transfers of the financial values behind the plan's production and delivery program. As part of this exercise, these banks would be instructed at regular intervals to "lend" appropriate amounts of funds to enterprises to fulfill their plans, as well as for wages, other working capital, and investment. As the economic situation deteriorated during the hyperinflationary recession and the discipline of central planning collapsed, repayments fell far behind; yet inertia and political pressures ensured a continuation of credits to enterprises. Nonperforming loans held by banks and arrears of interenterprise payments accumulated substantially, thereby creating latent banking liquidity problems.

The second development contributing to the risk of banking crises was the too easy and poorly supervised process of establishing new banks. The number of these banks has mushroomed, reaching 40–50 in the small countries (for example, the Baltics) and well over 100 in the larger countries. The newness of bank supervision tasks for the central banks, plus the justifiable priority that the central banks place on basic efforts to tighten monetary policy, has resulted in many instances of poor banking practices, owing to both inadequate rules and the inadequate supervision of existing rules.

The task of cleaning up the banking situation is a delicate one, for, unlike the industrial sector, where the occurrence of bankruptcies is a good signal of hard budget discipline, a bankruptcy in the banking sector, even where needed, can at least temporarily send the wrong signals. In Latvia, for example, the recent closing of the Latvija Banks for malpractice leading to illiquidity, while justified, came at the cost of setting back the growing trust that the Latvian people had begun to develop in the banking system. It is probably true that the alternative of rescuing the bank would have sent a different wrong signal of even greater cost: the moral hazard signal that banks will be rescued by the government no matter what. There is no simple magic formula here, except that financial prudence, improved supervision of deposit insurance, and a delicate but firm judgment on when to apply disciplining measures—including bankruptcy—are needed.

The Lagging Reformers

Among the lagging reformers, the *first and most immediate* task faces the handful of countries in the fourth group, which have made at most a limited start at stabilization efforts: Azerbaijan, Uzbekistan, Tajikistan, and in particular Turkmenistan, where the 1995 inflation rate prospects are not in the low hundreds, but close to or even over 1,000 percent. These countries must not delay any further the steps necessary to begin financial stabilization.

For the third group of countries, which have made substantial starts in transforming their economies, the main task is to persevere and to resist the pressures of the neo-Keynesian virus to ease tight fiscal and monetary policies. To help resist these pressures, two important facts described in Section II need to be used more effectively in public and political debates: the evidence from the late starters themselves on how much and how quickly inflation has been controlled; and the evidence from the early reformers on the inevitability of a lag of 18–24 months between the beginning of inflation control and the recovery of output. Populist arguments in this connection emphasize the pain of transformation: the higher prices of formerly subsidized goods and services, and the increasing unemployment. The stabilizers' counterarguments should emphasize the gain, including an explanation of how reduced inflation rates benefit lower-income segments most. However, given the less obvious nature of this point, the counterarguments should give equal if not greater emphasis to the measure of economic health most popular in these countries: monthly wages in U.S. dollars. Because stabilization almost always means some reversal of capital flight into the U.S. dollar and exchange rate appreciation, it results typically in a rise in monthly wages, expressed in U.S. dollars. In Ukraine, for example, monthly wages nearly doubled from about $25–30 in late 1994 to $50 in July 1995.

In terms of the fiscal details, the job to be done by the lagging reformers (in reducing expenditure and modernizing the tax system) is far greater than that required of the early reformers, as much of the ground already traveled by the latter group still has to be covered by the former. In addition, the lagging reformers will also face the task of rationalizing the inherited social programs.

The *second* category of tasks for lagging reformers involves implementing the entire package of measures that I have characterized earlier as promoting the expansion of the private sector, starting with—but by no means stopping at—ownership transfers. The challenge for governments in both the third and fourth groups is far greater than for early reformers for three reasons. First, for most of the countries in the third and fourth groups, the degree of ownership transfer (of both small and large enterprises) is even today far lower than for early reformers; Russia and Armenia are important exceptions. Second, for all but Armenia, private ownership of land is even farther behind, with many countries (Belarus, Russia, and Ukraine) still bound by landownership laws limiting rights to an owner's lifetime. The impact of this situation on the credibility of these governments' procurement of secure ownership rights needs no commentary.

Third, the inertial disadvantages of being a lagging reformer (as described in Section II) and the inevitably stronger resistance to reforms makes the political challenge for reform-minded leaders especially difficult in this group of countries. I will not repeat here the nature of this problem but will only draw a few summary implications:

- reform leaders presented with any new opportunity for a "fresh start" must take full advantage of this and move quickly;
- although the first task remains as in all cases financial stabilization, much greater priority needs to be put on market liberalization in those countries where lags in reform have allowed the buildup of vested interests opposed to reform; and
- lagging reformers may be less able to afford gradualism in liberalization than early reformers, which have progressed far enough to have weakened (and, hence, converted!) such vested interests.

These last arguments give particular importance to the *third* group of tasks confronting late reformers, namely, the liberalization measures that will complete the transformation from stabilized but mixed market economies cum administrative interventions to stable, competitive open market economies. The details noted in this regard for the early reformers apply as well to the late reformers, but (not surprisingly) in greater degree. There are also some differences in kind worth noting.

First, the problem of stronger vested interests puts an especially great burden on liberalization as a tool to reduce the strength of those interests. I would note here one area that may deserve greater attention than it has received in the past—the liberalization of external trade relations. Postponing such liberalization (which came early in the countries farther west) only fosters rent seeking and associated corruption, generates opportunities for capital flight, and provides a fertile ground for growth of those vested interests that see the optimal arrangement as a frozen transition, with stabilized inflation and highly concentrated private ownership, but limited openness to new competition from inside or outside, and a still large role for government to administer (that is, distribute) various trading and production rights.

The fact that most of the late starters began with low or almost nonexistent tariffs is as much a part of the problem of noncompetitiveness and inward orientation as it is a solution to it. It is well known in the theory and practice of protectionism that nontariff measures as a substitute for tariffs (or export taxes) are as unlimited in number as the legal and bureaucratic imagination and, because of their nontransparency, are far more damaging than explicit tariffs or taxes. A potential trade-off early in the stabilization process faces governments (and the international financial institutions supporting them). On the one hand, attempting to go much beyond the unquestionably essential first steps of financial stabilization to a rapid liberalization of external markets may overburden the capacity of governments and undermine the implementation of the stabilization effort. On the other hand, delay provides the opportunity for the vested interests to strengthen their opposition; although, as argued earlier, they would not necessarily oppose continued stabilization, they would most likely resist any subsequent efforts to complete the liberalization.

In this connection, a buttressing argument with no political economy content concerns the prospects of overcoming large balance of payments deficits. These deficits, which affect most transition economies, make them archetypical candidates for short-term adjustment assistance from the IMF. The lessons of the past 30-40 years are that a more open economy is in general needed to stimulate export growth, and that export growth is crucial to overcome balance of payments problems, as well as to promote recovery. If resistance to external liberalization persists, the needed export expansion may either not come or be insufficient. The stabilization efforts will then be undermined and may eventually fail, and the growth recovery will be stunted.

Another difference in kind relates to the coincidence that most of the later reformers are in the region of the former U.S.S.R. and continue to suffer the costs of that highly inward-oriented economy. Central European economies have rapidly reoriented their trade from one in which the share of COMECON bloc trade ranged from two-thirds to three-fourths to a more normal structure in which the very large neighboring economies of Western Europe account for from one-third to three-fourths of all trade. The Baltic countries have made the necessary degree of reorientation, but progress in the countries of the Commonwealth of Independent States has been much more slow.[15] The implication and risk for transformation policies is double: there has been less integration with the global economy and, hence, fewer of the benefits of competition; and there remains a greater inclination to follow a path of least resistance, that is, to revive the U.S.S.R. trading relationships. This last danger can be seen in the continued efforts to establish groupings of free trade, customs unions, special clearance arrangements, financial industrial groups, and a continuing series of bilateral trade agreements among these countries.

Third, and also sometimes underestimated, is the inertial tenacity of the "domicile permits" that every individual must still have to live in a given locale, especially in many of the late-starting countries. These permits are, of course, both an effect and a cause of the still limited private ownership of dwellings. Their cost to the transformation process is both the economic inefficiency of restricting labor mobility (which obviously is so much needed in reallocating production) and the political and psychological signal it sends that the society remains far from an open, civil, and democratic one. There is also a spillover effect on the general credibility of the reform measures of these countries and the motivation behind them.

V. Concluding Comments

I will not attempt to repeat the main conclusions of the paper but will instead make a brief commentary on the road still left to travel by selected countries in the transition economy group. I will start with the countries that face the biggest challenges and end with those that have gone the farthest in the transformation.

By now, almost all countries have begun the process, although the start made at financial stabilization and market-oriented reforms remains very limited in Tajikistan and Turkmenistan, and only slightly farther advanced in Azerbaijan and Uzbekistan. For these countries, the tasks ahead remain at least as large as they

[15]See Winters, Kaminski, and Wang (forthcoming). The collapse of trade among the old U.S.S.R. republics, as of trade outside this group, is evidence of the view that the U.S.S.R. dissolution per se was not the "cause" of trade collapse. If it were so, one should have seen the trade shares changing as absolute declines within group trade occurred at the same time as lesser declines in other trade.

were five years ago and even more difficult, as the time passed has permitted a consolidation of the vested interests opposed to reforms.

Many other countries delayed significant reforms but have started the process sometime in 1994 or early 1995. For example, countries such as Belarus, Georgia, Kazakstan, Russia, and Ukraine started well during this period but are likely to continue with negative GDP growth in 1995. Russia stands out in this group through the quantitative indicator of ownership transfers achieved, but many observers agree that the efficiency of governance of the very large, privately owned firms remains far from that expected in a competitive market environment. For Russia, ensuring competition in the market may be the highest-priority task in the near future. Armenia, Macedonia, Moldova, and the Kyrgyz Republic have on balance gone the farthest both in consolidating inflation control at levels close to 1 percent a month, and in pushing ahead with private sector development and the general liberalization of markets. These four countries are likely to end 1995 with positive or near-positive GDP growth.

Well ahead of this last group are the countries that started the transformation process very early, in 1990–91 (Bulgaria, Hungary, Romania, and the Slovak Republic), but then suffered some slowdown, as well as the countries that have gone a long way despite a slightly later start in 1992–93 (Croatia, Estonia, Latvia, and Lithuania). For these countries, accelerating the process of private sector development and resolving banking sector problems stand out as key priorities.

Hungary is *sui generis*. It is as far advanced as any transition country in establishing the role of the private sector, competitive and open markets, and maturing market institutions. All these factors no doubt explain its commanding lead in the region in attracting foreign investment.[16] However, long-postponed social program reforms in the fiscal area and banking sector bailouts have led to backsliding on growth, inflation, and the balance of payments. Perhaps paradoxically, Hungary has to go back to the very first task, financial stabilization, and complete the job long left undone.

[16]Of the $17.7 billion invested in the region between 1989 and 1994, $6.9 billion went to Hungary (European Bank for Reconstruction and Development (1995, p. 87)).

Farthest along in the transformation process are the Czech Republic, Poland, and, in different ways, both Albania and Slovenia. For Slovenia, which has virtually achieved single-digit annual inflation and a growth rate well over 5 percent, a still-lagging private sector share poses the main challenge to moving ahead. Albania's start from a low level is part—but only a part—of its success story; to have single-digit inflation, a 6–7 percent growth rate, and a predominantly private sector economy does not come to all countries at low levels of development, especially one further encumbered by a socialist legacy. Jan Svejnar's thorough discussion of the Czech Republic's situation allows me to leave it without comment and speak of Poland last. This is fitting, as it was the first to begin the transformation process in early 1990. Poland has to be counted among the leaders because of its early and strong growth recovery, and its vibrant green field private sector, despite two shortcomings: its still-stubborn inflation rate of 20 percent or more, and the substantial amount of state ownership in large-scale industrial firms. These two problems, if well handled, should not stand in the way of Poland's continuing to rank among the handful of leaders in the transformation process and as "a model for reforms in other parts of Eastern Europe."[17]

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[17]Sachs (1993, p. 1).

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Macroeconomic Stabilization in Russia: The Lessons of 1992–95 and the Outlook for 1996–97

Sergei K. Dubinin

I. Adaptation Period

The entire history of economic reform in Russia during the 1980s and 1990s has been one of debates over the strategy of change. In a simplified form, the principal sticking point came down to the following: Should financial stabilization be achieved before embarking on structural transformation, or should structural problems be tackled first to lay the stage for financial stabilization and subsequent transition to tight anti-inflationary policies?

The arguments erupted when a number of economic reform programs began to be drawn up in the Soviet Union and reached a crescendo during the drafting and discussion of a document that came to be known as "Five Hundred Days." Most experts, while insisting on quick progress toward a market economy, were nevertheless adamant that such decisive moves as price liberalization must be preceded by a series of institutional alterations, including the restructuring of economic organization and management methods.

The collapse of the centralized Soviet state left the authorities in Moscow, including first the leadership of the U.S.S.R. and then the leadership of the Russian Federation, without any real administrative leverage to influence the course of economic affairs. The breakup of the Soviet Union inexorably resulted in all hopes being pinned solely on the power of self-regulated human economic interests. Orders from the center were not obeyed any longer, nor did there remain, in fact, anybody in a position to issue such orders.

The central role in those conditions unavoidably went to controlling cash flows, as it gave individuals, companies, and authorities the only remaining real possibility of influencing economic processes. Strengthening the Russian financial system became a top priority for economic policymakers.

Following the lifting of price controls in early 1992, the above issue, far from losing its relevance, has become effectively all-important. Can inflationary financing be employed to execute a structural maneuver? Practically all political and social forces opposed to the incumbent Russian leadership are advocating this tactic as an alternative to the economic course steered by the Government.

Although theoretical polemics over the most rational way to implement reform have continued unabated, life has demonstrated that all Russian Governments since January 1992 have given priority to financial stabilization. This is all the more interesting as the opponents of classical financial stabilization have never tired of pointing to those factors that make achieving it in Russia a tough proposition indeed. These factors include, most notably, such economic problems as the oversized military-industrial complex, inefficient agriculture based on nonmarket principles, and uneven natural and economic conditions for development in different regions. These are all hard facts of life. Companies are not adapted to a market environment, and their microeconomic behavior is at odds with market demands. The price pattern existing in Russia before 1990 differed starkly from that on the world market, prompting the usual conclusion that resources should in this situation be redistributed on the basis of a plan and by a central authority, as there is no resource allocation mechanism in place as yet that would be governed by market incentives.

There are also other factors to reckon with, such as the well-developed sectors funded out of the government budget (public education, medical services, the social security system, and the armed forces). These sectors, while being boons per se, require enormous funds to be maintained and developed, and the Government's resources proved insufficient to sustain those expenditures at an adequate level during the transition to a market economy and the fall in production. The slashing of spending in the government-financed sphere called for by classical financial stabilization theory caused a lot of pain.

Why, then, have financial stabilization policies still been so strongly supported by the Government? It is, after all, an open secret that a significant number of the ministers and other cabinet members cannot be rated, say, among the consistent champions of monetarism, let alone among its theorists or connoisseurs. Even such "new-wave" Russian financial policy architects as Yegor Gaidar, Boris Fedorov, and this writer have never regarded themselves as pure monetarists. Gaidar and I have repeatedly admitted our affection for liberal Keynesianism, and Alexander Shokhin is fond of quoting institutional theories and economic growth concepts.

This "cursed" question, apparently, has a very simple answer: no structural change occurred or was at all possible without taking a harder financial line and axing government subsidies to companies, regions, and industries.

In those economic sectors where government financing continued in the largest amounts and where budgetary constraints on companies were the loosest, structural change was the least in evidence. The theoretical postulate that maintaining centralized funding for the economy at a certain level makes it possible at the same time to pull off purposive structural change did not prove itself correct in any sector. Where financial terms were more stringent, the structural adaptation of the economy progressed more swiftly.

One attempt to bring inflation quickly down by means of rigid monetary and budget policies was mounted during the first half of 1992, but the Gaidar Government was compelled to give it up before long, and the first half of 1992 ended with massive financial injections into the economy. The growth rate of the money supply from the middle of that year through its end topped 30 percent monthly. If those infusions came other than directly from the government budget, they came in the form of central bank credits. And that lending was not a decision of the Central Bank, but a concerted action taken by the Government and the Central Bank because companies had proved absolutely unprepared to operate in purely market-based conditions on their own without this kind of financial support.

Since the second half of 1992, the Russian economy has been in a most peculiar transition phase. Subjective declarations and political sloganeering aside, the true hallmark of this period has been the gradual toughening of monetary and budget policies as market forces have matured. More and more companies have adopted market-style strategies and are being privatized; the nongovernmental sector, including mostly the trading, banking, and other nonproductive industries, is taking off, as jobs are becoming available outside state-controlled companies and organizations; and a targeted social security system is taking shape. Russia has come to face the inescapable need to carry out at the same time an anti-inflation program and a program of structural transformation.

The existing financial limitations presented a compelling impetus for such change. Whereas the principal result of 1992 was economic liberalization, including of prices and foreign economic relations, the main outcome of 1993 and 1994 was privatization, along with relatively tight anti-inflation policies. It turned out that, during the transition from a plan-based to a market-oriented economy, we needed a certain adaptation period, when we had to combine what later came to be known as moderately tough financial policies with some structural overhauling. Curiously enough, those moderately tough financial policies were by themselves the primary stimulus behind the restructuring. That period lasted from early 1993 until the end of 1994. Maintaining the above approach had been maintained for those two years made it possible to achieve some practical results, and it is the internal changes accomplished in the Russian economy, the accumulated experience of monetary regulation, and the controls established over the money supply that have made it possible to realistically hope for financial stabilization in 1995.

The monthly percentage changes for consumer goods and services are given in Table 1. On an annual basis, from December to December, the index increased as shown in Table 2.

The average monthly increase in the consumer price index in 1992 was 31.3 percent and dropped to 20.6 percent the following year, while in 1994 the mean rate of inflation had already fallen to about 9 percent a month. To be sure, even that rate of inflation was exceedingly high, but the trend slowdown in the pace of inflation, despite all seasonal fluctuations, is still quite clear.

Table 1. Russia: Consumer Price Index
(Monthly percent change)

	1993	1994	1995
January	26	21	18
February	25	10	11
March	20	9	9
April	19	10	8
May	18	8	8
June	20	5	7
July	22	5	5
August	26	4	4
September	23	7	3[1]
October	20	12	. . .
November	16	14	. . .
December	13	16	. . .

[1]Estimated.

The first year of economic reforms witnessed a palpable decline in the living standards of the population as a result of the price hikes following their liberalization and the subsequent escalation of inflation into a chronic condition. Real incomes of the population in 1992 declined to only 56 percent of the level of the previous year. However, they rebounded to 110 percent in 1993 and edged up again to 114 percent during the first nine months of 1994. The ratio of the public's cash income to the subsistence minimum, according to data from Russia's Ministries of Economics and Finance, rose from 1.91 in 1992 to 2.27 during the first nine months of 1994.

The federal budget deficit in 1992 accounted for 12 percent of GDP and for 9.2 percent of GDP in 1993. In 1994, the federal budget deficit exceeded Rub 65 trillion, which was equal to 44.5 percent of expenditures and 10.4 percent of GDP. The advances made in fighting the financial problem, however, were not limited to the federal level. In order to get a full idea of how the situation stood in terms of inflation, one needs to evaluate not only the federal budget deficit, but also the financial deficit in

Table 2. Russia: Annual Consumer Price Index Increases
(Based on December data)

1991 Compared with 1990	1992 Compared with 1991	1993 Compared with 1992	1994 Compared with 1993	1995 Compared with 1994
2.6×	26.1×	9.4×	3.2×	2.5×[1]

[1]Estimated.

the economy as a whole, which central bank credits covered. The 1992 financial deficit, for instance, was downright disastrous: 30–35 percent of GDP. This was due to a massive outpouring of cash into the economy through central bank credits that had no backing whatsoever. In subsequent years, those items of expenditure that had previously been covered by central bank lending (and which included such items as farm produce purchases and deliveries of necessities to the northern territories) were one by one incorporated into the government budget to become part of its own appropriations, and the federal budget deficit was determined by taking them into account. This was how the overall financial deficit was pared down substantially, which was a key to success in the drive to achieve financial stabilization.

Based on the above developments, the financial environment for enterprises markedly improved. Real interest rates for both deposits and loans turned positive in 1994, providing a reason for economic agents to make savings and then turn them into investment.

The Russian Government's approach has thus been drastically different from the inflationary financial strategy that the opposition has kept trying to foist on it. The Government saw inflationary financing not as a tool for preventing production and employment levels from slipping, but as a grave economic disease. But it sought to cure the problem by therapeutic methods rather than by surgery.

Those members of the Government who were concerned with the economy were fully aware that what had already been achieved was not a financial triumph. Indeed, we had only been coping with tactical tasks in order to subsequently attack the overriding strategic one, as, by hardening financial policies in a phased manner, we continued to subsidize the economy for a while by making certain compromises in the anti-inflation campaign. It was clear from the very outset that those policies had to be short-lived, as they had obvious flaws and defects. These were placed in especially bold relief in 1994 and, more precisely, during the fall of 1994, when the foreign exchange crisis demonstrated all the drawbacks of those policies that had theoretically been known but had proved so hard to avert.

II. MONETARY CONTROL PRACTICES

This period of adaptation yielded tangible results only because the regulation of the economy by the Government (most notably, those agencies that implemented monetary policies) itself underwent an internal transformation. During this three-year period, a number of tools were developed for analyzing inflation-related processes in the Russian economy, and measures were devised to influence inflation.

It was fundamentally important that the Government and the Central Bank themselves learned their lessons and did their homework in those conditions. Only in 1993 were monetary and financial policy tools designed, which the authorities had simply lacked before. Limits began to be set on the growth of the money supply. Also, at the beginning of 1993, the growth of cash emissions into the economy was stemmed by imposing a ceiling on both increases in central bank credit to the Government and central bank refinancing of commercial banks.

Relations with the republics of the former Soviet Union—now independent members of the Commonwealth of Independent States—were drastically changed with the transition from so-called technical credits from the Central Bank, which automatically covered the needs of those countries, to interstate lending involving internationally recognized credit instruments. That channel for injecting money into the economy was likewise taken under control.

The Russian taxation system was stabilized. It still needs to be streamlined, but its basis should remain intact. In 1994, inter-budgetary relations underwent across-the-board reform. Interaction between the federal budget of the Russian Federation and the budgets of its territorial subjects began to be based on the principle of sharing out revenues between budgets at different levels, with the central government no longer having its say on how large lower-level budgets must be or how they should be used.

It proved possible to create virtually from scratch an utterly new financial market for government bonds, which are today the only 100 percent safe financial asset. The scope and pace of the changes were dictated by the acuteness of the crisis and were on the whole attuned to the requirements of life itself.

It took about two years in Russia to establish those financial institutions and arrangements that correspond to the market economy. These days, the monetary and financial systems themselves are providing the Government with new levers to manage the economy by regulating cash flows. Healthy monetary and real market impulses, not deformed by inflation, will furnish a sound base for reasonable government interference in economic processes, with the help of financial rather than administrative instruments.

The Government in 1994 made full use of the range of the newly developed instruments for monitoring the achievement of macroeconomic objectives (Table 3). Quarterly limits were imposed on the growth in net domestic assets of the Central Bank and the Ministry of Finance. Also on a quarterly basis, ceilings were set within those limits on the increase in net credit from the Central Bank to the expanded Government (including the federal, regional, and local authorities). The Government and the Central Bank renounced the practice of subsidizing interest rates on their credits. Neither federal budget funds nor central bank profits were used in 1994 to make soft loans.

The year 1994 saw improvements in the overall financial situation, including not only reduced inflation but also positive interest rates on financial markets. New conditions were created in which it became possible to accumulate savings, and the issue arose of how such savings could be transformed into investment. This question became critical in the second half of 1994, when the credit system revealed an accumulation of considerable uncommitted capital that threatened to turn into "hot money." This capital was looking for the most profitable investment opportunities. Long-term investment was still ruled out, owing to the continued relatively high inflation, while the scope for short-term lending was extremely small, as real interest rates limited banks' lending possibilities on the interbank market and borrowers could not hope to repay such loans on account of the high inflation.

In this situation, limitations appeared that could have been overlooked earlier, when moderately tough policies, sustained for a year and a half, had led to what was, in principle, a favorable situation in which savings could be transformed into capital accumulation. But a mechanism for such a transformation, which

Table 3. Russia: Macroeconomic Financial Indicators in 1994

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Inflation (average monthly growth of consumer prices, in percent)	12.0	7.0	6.0	10.0
Velocity of money	10.6	9.5	8.8	10.9
M2 monetary aggregate (end of period)				
Volume (in trillions of rubles)	41.0	60.4	81.6	91.1
Average monthly growth (in percent)	7.7	13.8	10.5	3.7
Monetary base (end of period)				
Volume (in trillions of rubles)	20.4	30.3	39.6	45.5
Average monthly growth (in percent)	7.0	14.0	9.0	5.0
Net international reserves (end of period, in trillions of rubles)	6.3	8.6	3.4	0.9
Net domestic assets (end of period, in trillions of rubles)	14.1	21.7	36.2	44.6
Central bank credits to the Federal Government (end of period, in trillions of rubles)	18.9	29.6	46.2	53.7
Gross central bank credits to commercial banks (end of period, in trillions of rubles)	10.5	13.1	16.3	18.8

Source: *Budget Planning Policy Guidelines of the Russian Federation in 1995* (in Russian) (Moscow: 1994), pp. 8–9.

would do the intended job in the specific economic conditions of Russia, still has to be created.

The experience of the Russian economy in 1992–95 has revealed consistent seasonal fluctuations in the principal monetary indicators. The inflationary growth of prices matched changes in money supply precisely enough, but with a lengthening lag. In 1992, the lag between an increase in cash supply and the resulting price rise was three months; by the middle of 1993, it extended to four months; and, in the second half of 1994, to six months. The length of the lag varied, depending on inflationary expectations at the grassroots level. Public trust in the Russian Government's stabilization policies in 1994 reached its peak during the summer, when monthly inflation was running at less than 5 percent.

The decline in the velocity of money (V2) at the time could be explained primarily by economic agents' willingness to save. Investment in ruble-denominated financial assets began to yield steady and real returns. The growth of savings in the economy created possibilities for intensified capital accumulation. But neither the existing machinery for investment nor the potential target areas of investment were yet prepared to absorb savings.

Riding on the crest of the savings wave, a whole range of quasi-banking and quasi-financial institutions surfaced in the economy at this time. They enticed the public with promises of exceptionally high yields on deposits, persuading the more gullible that such investment was completely risk free. Virtually all of the the likes of GMM, Tibet, Vlastelina, and MMM were pyramid schemes, with the first depositors ("shareholders," "investors") initially deriving high incomes at the expense of contributions by those joining the financial gamble only later. Such schemes are bound to collapse at some point. The only difference among pyramid structures is in their chosen methods of "self-liquidation." Their masterminds first mount a runaway publicity blitz, advertising themselves to society as wonder financiers and business prodigies. Then, they either vanish into thin air, stealing the assets that they have been able to attract, or declare themselves insolvent and go back on their promises of high deposit interest payments. Unfortunately, neither the Russian governmental watchdogs nor Russian legislators were prepared to protect the interests of individual depositors in such cases. Practical actions by the authorities to prevent private savings from being entrapped in pyramid games were too timid.

Following the resounding fiascos of a host of pyramid structures in the summer and fall of 1994, hard currencies—especially the U.S. dollar—remained the only high-yield, short-term financial asset still trusted by the population. Regrettably, neither Sberbank nor the commercial banks offered attractive enough deposit terms. As long as inflation continued to be sluggish and the ruble-dollar exchange rate depreciated more slowly than prices, the demand for hard currency did not have the nature of panic buying. But when inflation picked up again in September 1994, demand shifted to the U.S. dollar, prompting the ruble crash in early October.

Average monthly inflation growth rates in 1994 declined from 21 percent in January to 4.6 percent in August, but rose again to 7 percent in September. The leap in inflation that fall was due to the expansion of the monetary base and money supply during the second quarter and part of the third quarter. The public trust in the Government's financial policies initially cushioned the negative effects of the inflationary expansion of monetary aggregates, as savings kept burgeoning.

But the situation began to change in the fall of 1994. Seasonal spending out of the federal budget for such purposes as agriculture subsidies to buy farm machinery, make harvest purchases, and ship food and fuel to the far northern areas was financed by unsecured central bank credit. The debacle in the currency exchange at the time changed the nature of inflationary expectations among the general public. The panic atmosphere persisted, and even the moderate monetary policies pursued during the fourth quarter of 1994 failed to result in the anticipated slowdown of inflation during the first months of 1995. In January of this year, for instance, prices went up by 18 percent. The public assessment of the situation was definitely badly affected by military operations in the Chechen Republic: indeed, these operations tended to undermine financial activity and erode public confidence in the economic course proclaimed by the Government.

But, at the same time, the possibility of making the government-drafted economic recovery program for 1995 a reality had not been lost. The average monthly limit on the growth of money supply in the fourth quarter of 1994 was 8 percent. Early in 1995, the Central Bank tightened monetary policy dramatically; money supply in January 1995 shrank and was to have increased during the first quarter of the year by no more than 2–4 percent monthly, on average. It was only during the second quarter of 1995, however, that the contraction of money supply exerted noticeable influence on price movements.

In the existing Russian conditions, it proved insufficient to continue implementing tough financial policies for only two quarters in order to bring average monthly inflation down to 1–1.5 percent. Apart from that factor, the clearly ill-considered decision to increase the issue of treasury obligations (KOs) in the fourth quarter of 1994 to make current budget payments had grave inflationary consequences. Instead of the originally planned Rub 2 trillion, Rub 7.9 trillion were issued in the second half of 1994, and the method of issuance of the KOs turned them into an essentially inflationary factor.

Beginning in September 1994, the Ministry of Finance started issuing KOs in paperless, electronic form. Those securities were used for the partial direct settlement of the Government's obligations to provide planned appropriations. KOs thus were not placed on the financial market to absorb liquidity but were handed directly to various credit-managing agencies (like the Ministry of Defense or the Rosugol Company) as a direct liability of the Government.

In accordance with a regulation governing their issuance, KOs were to be used by their recipients to pay their suppliers and could be used only to pay taxes or be presented for redemption to the Ministry of Finance after changing hands three to five times, pursuant to an established endorsement procedure. Only after completing the chain of payments and required endorsements may KOs be freely traded as a proper security. Naturally enough, the leading role in KO circulation was played by the 14 banks acting as depositaries for the obligations. Gradually, however, there came into being an independent and fairly robust segment of the financial market in which many financial institutions dealt in KOs on their own behalf or for their clients.

The Ministry of Finance's KO placements had reached Rub 7.9 trillion by the end of 1994. It was decided not to widen their issue in 1995. As old tranches of KOs are retired, it is planned to float new tranches in ever smaller amounts, with market-oriented interest rates. In the meantime, KOs will retain their nature as a kind of security distributed and resold throughout Russia. But the Ministry of Finance must not allow their degeneration into a pure payment facility, which would mark the unlawful resumption in Russia of the Treasury's printing of banknotes.

The Russian authorities' loosening of their budgetary and monetary policies in the fourth quarter of 1994 certainly made it more difficult to attain the macroeconomic goals set for 1995. The marked acceleration of inflation during the first months of 1995 to monthly rates of 16–18 percent could have thwarted the entire monetary program of the year. But the strong resolve once again demonstrated by the Government and the Central Bank at the beginning of 1995 in combating inflation makes one optimistic about the final outcome of the processes under way in the Russian economy.

Following lengthy and strenuous debates in the State Duma over budget estimates, the sensible desire for a compromise with the Government on these matters finally took the upper hand when the parliamentary chamber on February 25, 1995 approved the draft of the 1995 federal budget after its third reading. The basic budget characteristics earlier fixed in that instrument—expenditures of Rub 248 trillion and revenues of Rub 175 trillion—were not revised (see Table 4). The Government was able to find a mutual understanding with deputies also on the composition of the federal budget. All this makes it quite realistic to expect the macroeconomic tasks charted for 1995 to be fulfilled.

III. OUTLOOK FOR MACROECONOMIC POLICIES

During the first eight months of 1995, the average monthly rate of inflation was just below 9 percent, which is much lower than in the two previous years. There are, however, no guarantees that the slowdown of inflation will continue, the more so as high

Table 4. Russia: Federal Budget Execution in 1995
(In trillions of rubles, unless otherwise indicated)

	Approved 1995 Budget	Actual Fulfillment as of July 1, 1995	In Percent of Approved 1995 Budget
Revenues	175.2	80.1	45.7
Of which: Tax receipts	127.9	66.4	51.9
Of which: Profit tax	23.8	17.5	73.5
Individual income tax	2.8	1.2	42.9
Value-added tax	49.6	25.4	51.2
Excises	9.7	5.9	60.8
Of which: Nontax takings	32.0	13.7	42.8
Of which: Proceeds from foreign economic activities	11.2	10.0	89.3
Expenditures	248.3	80.1	32.2
Of which: State administration	3.9	1.8	46.2
International activities	21.0	6.9	32.9
National defense	48.6	18.2	37.4
Law enforcement and security	15.0	7.8	52.0
Industry, including the power and construction industries	31.2	11.0	35.3
Agriculture and fisheries	9.3	3.6	38.7

Source: Ministry of Finance of the Russian Federation.

inflation at the level characteristic of 1995 is known to be able to persist. There is no automatic way out of this economic situation. It is possible that stabilization will be achieved and inflation curbed, but that inflation will then surge ahead again. Even the suppression of inflation to zero or close-to-zero rates during a certain stretch of time does not guarantee long-term stability.

The inflation danger in Russia will actually be done away with only if balanced economic growth is secured, as the economy's improved performance will ensure the international competitiveness of its leading sectors and the efficient utilization of resources. Until then, there will remain the risk that the national leadership, eager to alleviate the social consequences of the restructuring of production or seeking other transient political ends, will once again embark on crash budgetary spending and the loosening of monetary policies.

One can conjecture that, after some time, proinflation policies will yet again give way to anti-inflation policies. The Russian economy could then be in for another roller-coaster ride, with periodic ups and downs of inflation. This will represent a great danger to genuine economic growth. In a dithering, palpitating economy suffering from perennial inflation, the depressed state of production and technological backwardness will remain the hallmark of Russian economic affairs for a long time to come.

When prospects for 1995 and the next few years were discussed in the fall of 1994, the peril of inflation entering this kind of listless yet protracted phase was perfectly obvious. It also became clear that in the run-up to the elections of 1995 and 1996 there will remain the real risk of inflation breaking loose yet again and that, once actuated, the pendulum of fluctuating inflation could threaten to block for years Russia's chances of scrambling out of its crisis and depression.

This risk of a deadlock if the policies of 1993–94 were continued was realized by those members of the Ministry of Finance who were directly and closely involved in hammering out macroeconomic policies and preparing and conducting negotiations with international financial organizations. In the summer of 1994, we told the national leadership bluntly that the moderately tough financial policies that we ourselves had previously proposed, advocated, and implemented for some 18 months had, in our opinion, reached their limits. Moreover, we warned, it would in those conditions take just one more lapse in policy for the situation to begin developing along the lines of the fall of 1992, when inflation surged upward, requiring extraordinary efforts in early 1993 to put it back under control.

It has to be stressed that the warning was accepted; despite all the tumult of late 1994, the Government did not cross the precarious point and managed to prevent another lapse toward inflation in the country's economic development. When presenting its federal budget estimates to the Federal Assembly in October 1994, the Government declared:

> The entire logic of developments in 1994 demonstrates that the nature of modern economic policies and the pace of transformation have fallen behind the requirements of the economy itself, the continued development of which hinges on the realization of the following three basic principles of economic policy: low inflation, predictable and real positive interest rates, and a stable national currency. (*Russian Federation Budget and Taxation Policy Guidance for 1995* (in Russian) (Moscow: 1994), p. 4.)

Throughout 1995, the Russian Government has worked stubbornly and resourcefully to carry out the program thought out and formulated in the previous year, with the participation of experts from the Ministry of Finance, the Ministry of Economics, the Ministry of Fuel and Power, and the Central Bank. Significantly, personnel changes did not exert any material influence on the overall direction of government policies. An anti-inflation action program was drawn up by the end of the third quarter of 1994 and proposed for consideration by the Russian Government.

The major elements of the proposed package included the following:

- A tight federal budget was to be implemented in 1995. Projected expenditures were not to surpass 22 percent of GDP. The relative amount of federal spending would thus be preserved at the existing level.
- The federal budget deficit was to amount to 7–8 percent of GDP.
- This deficit was to be financed by means other than credit from the Central Bank. The forswearing of such credit was made the linchpin of the entire anti-inflation blueprint.

• In order to meet the deficit, it was planned to attract funds from the domestic financial market of some Rub 50 trillion by floating government securities, and to obtain about $6 billion in loans from international financial organizations, most notably through the IMF stand-by credit.

• A fundamentally new scheme to restructure foreign debt was proposed in order to trim budgetary allocations required to repay Russia's foreign debts, including the liabilities of the former Soviet Union, to make such payments in even installments, and to ease some of the debt burden. The idea was to determine a feasible long-term limit on annual Russian payments servicing all types of liabilities. Amounts over and above the limit were to be capitalized and added to the amount of the debt to be rescheduled over a longer time.

• The last element of the proposed program was a changeover to rigid regulation of ruble-dollar exchange rate fluctuations. Upon the introduction of this "foreign exchange corridor," the ruble rate was to be established at a level somewhat lower than current quotations and then to be allowed to fluctuate within 12 percent above or below this level. In order to provide a solid reserve for this system, it was considered necessary to utilize a $6 billion stabilization fund, the idea for which had been discussed with the Group of Seven governments as early as 1992.

The impending negotiations with the IMF over the Government's economic program for 1995 dictated the timing and conditions of the drafting work on all aspects of macroeconomic budget and monetary policies. By mid-October 1994, we were fully prepared for the talks.

All the program's components are coordinated. Bringing inflation down to a level ensuring positive interest rates on ruble financial instruments will make it possible to attract individual and corporate funds by luring investors from dollar-denominated assets. The fixing of the foreign exchange rate after keeping it relatively steady will provide further encouragement for investors to opt for the ruble sector of the market. All this will make it possible to distribute government securities in amounts required to cover the budget deficit and, consequently, to safely forgo the Central Bank's unsecured crediting. As a result, inflation will first decelerate appreciably and then come to a stop.

The methods of funding the federal budget deficit in 1995 are thus to be radically altered. As of October 1, 1994, the deficit stood at Rub 45.8 trillion, of which Rub 34.6 trillion (71.2 percent) had been covered by central bank credits, Rub 5.0 trillion out of proceeds from security transactions, Rub 1.6 trillion out of central bank profits, and Rub 4.6 trillion from external borrowing.

For eight months in 1995, the Government was able to maintain a budgetary policy fully consistent with the monetary program. But the growth of money supply (M2) during the spring and summer of 1995 still proved to be much larger than planned, averaging more than 8 percent a month between April and July (Table 5). This was mainly the result of the Central Bank's ruble interventions in the currency exchange to prevent a sharp appreciation in the ruble in relation to hard currencies.

If, however, the issuance of new categories of securities and reasonable increases in individual deposit rates make it possible to tie down the ruble money supply, the Government and the Central Bank will have succeeded in fulfilling their monetary program for 1995, as agreed upon with the IMF. This will pave the way for subduing the inflation that has plagued the Russian economy ever since 1991. The rate of price rises by the end of 1995 will in this case plummet to 1–1.5 percent a month.

One can be confident that consistent policies of financial stabilization will lead to resumed economic growth in Russia in 1996–97. But the coming period is also fraught with formidable

Table 5. Russia: Official Estimates of the Financial Indicators for 1995

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Inflation (average monthly growth of consumer prices, in percent)	4.5	1.5	1.2	1.3
Real GDP (average monthly growth, in percent)	–0.8	–1.5	—	—
Nominal GDP (annualized, in trillions of rubles)	936.0	901.0	926.0	945.0
Velocity of money	9.6	8.3	7.3	6.5
M2 monetary aggregate (end of period)				
Volume (in trillions of rubles)	97.4	108.5	127.3	146.2
Average monthly growth (in percent)	2.3	3.7	5.5	4.7

Source: *Russian Federation Budget and Taxation Policy Guidance in 1995* (in Russian) (Moscow: 1994), p. 11.

risks and difficulties for the Russian leadership, business leaders, and the population at large.

First, *political risks* are posed by the forthcoming series of political campaigns (the parliamentary elections in 1995, the presidential race in 1996, and the elections of governors and heads of regional administrations in a number of areas and republics within the Russian Federation in 1996–97), which can make it much more difficult for the Government to steer a consistent anti-inflation course. The incumbent leadership will be tempted to woo individual categories of voters by handing out newly printed "empty" cash and thus increasing the money supply. The victory of the opposition could also spell a return to the purely inflationary financing of government expenditures.

Second, *the risk of provoking inflationary cycles* is directly connected with the above-mentioned political risks. The ineffectiveness of anti-inflation measures and the scuttling of the stabilization program may send inflation spiraling through the roof. Another go at containing inflation would then become possible only after a number of years when the prerequisite political conditions were once again in place to adopt a tight monetary policy. But the devastation of Russia's economic potential over these several years could prove irreparable.

Third, *the hazards of an inflexible foreign exchange policy and an immature currency market* have already made themselves felt during 1994–95. The tailspin of the ruble rate in relation to the dollar in October 1994, the subsequent abrupt shifts in the ruble rate, and the drop of the dollar vis-à-vis the ruble in May 1995 were predetermined by macroeconomic processes. But those events also reflected the immaturity of the currency market in Russia. The official exchange rate quoted by the Central Bank hinges on transactions made in the narrow MICEX market, where supply ranges only between $50 and $300 million daily. Any concerted action by exchange speculators or the need to convert a large amount of foreign currency into rubles—or vice versa—could provoke substantial variations in the ruble rate.

Under these conditions, it is imperative to proceed toward a regulated floating of the ruble rate with respect to the dollar (or, still better, to a basket of currencies or the SDR unit) throughout the Russian currency market. The Central Bank's official rate should be publicly set for three to four weeks at a time, with due regard for the movements in prices and money supply over the preceding period of similar duration, and any depreciation in the ruble rate should not be allowed to exceed by 0.5 percentage points the growth rate of the money supply. This exchange rate should be used for the taxation of foreign economic operations, including the computation of customs duties.

The Central Bank would be obliged to buy and sell hard currency from and to commercial banks at the announced rate, plus or minus 2.5 percent. This would create a narrow corridor for oscillations in the ruble rate and make it possible to adjust it continually with account taken of price movements. This arrangement will meet the requirements of exporters and importers to a greater extent than the inflexible corridor with limits of Rub 4,300–4,900 per dollar in place today. At the same time, it will require a lesser degree of foreign exchange intervention by the Central Bank.

Fourth, *the risks posed by the underdevelopment of the banking system and financial markets* became clear in late August 1995. Faced with declining inflation and the absence of "surplus money" injections from the Central Bank, most of the 2,500–2,600 commercial banks in Russia began actively to utilize short-term loans on the interbank market to discharge their obligations. Such practices are a shortcut to inevitable bankruptcy. The Central Bank will unavoidably have to take not only financial, but also administrative measures to revamp the entire banking system. It is essential that it does so in cooperation with leading commercial banks. The Central Bank will possibly be required to reorganize directly some banking institutions and unite them in a controlled, government-run holding company.

The federal budget estimates for 1996 currently being drawn up by the Government entail the need for some difficult political and economic decisions in the near future. These will mostly be related to the evolution of the domestic public debt. Estimates by Ministry of Finance specialists show that appropriations to service total liabilities in 1996–97 may reach up to 30 percent of overall federal spending. Debt repayments will have to be secured while keeping stiff limits on the increase in total federal expenditures.

Budget policies in 1996–97 will be implemented against the general background of the Russian economy's slow re-emergence from the crisis. Economic growth can be expected to resume from 1996. But the amount of financial resources controlled by the Government remains very limited, as before, and a sizable share will have to go to honor public debts.

In 1996–97, the Government must confront the following tasks:

- It must secure the most favorable possible conditions for foreign debt restructuring, and to make sure that further outside credits are made available on advantageous terms. After using up the IMF's stand-by facility of $5.5 billion in 1995, Russia will find it difficult to count on further foreign loans of this size.
- It must continue efforts to raise the rate of tax collection in the federal budget of the Russian Federation and the budgets of its territorial subjects. In 1993–94, tax proceeds to the federal budget accounted for 11–13 percent of GDP. But the complete enforcement of tax legislation can theoretically increase tax receipts to up to 20 percent of GDP. Gradually increasing tax returns to 15–16 percent of GDP is thus an extremely urgent but realistic task for the Government.
- It must reduce the federal budget deficit to 3–5 percent of GDP by restraining budget spending and increasing tax revenues. This level of deficit financing can be achieved by tapping the domestic financial markets and by drawing moderately on external credits while stopping the central bank credit altogether.

This budget policy scenario can guarantee long-term financial stability in two decisive respects: first, the rate of inflation during 1996–97 can be kept as low as 0.3–0.5 percent a month; and second, the real exchange rate in relation to hard currencies will appreciate substantially. Russia will be able to get down to tackling its new economic problems, namely, those of ensuring rational economic growth, increasing the efficiency of production, and making production competitive on world markets.

Russia will be able to proceed on this path only if it maintains rigid self-restraint in the budgetary and monetary spheres. During the next four to five years, the level of budgetary spending in real terms must remain effectively unchanged, while central bank credits to meet the federal budget deficit must be an unquestionable taboo. Periodic crises in the financial sphere must not result in the Government's reversing its anti-inflation course.

The steadfastness demonstrated by the Government and Central Bank in steering the charted course in 1995 has preserved the possibility for positive economic developments. The growth of ruble savings protected against inflation-driven devaluation, and the simultaneous lowering of nominal lending rates and a slowdown in price increases should lead in 1996–97 to a shift in capital from the sphere of financial and commercial transactions into production. This turn of events will make it possible to hope for resumed economic growth in Russia on the basis of investment activity in 1996–97.

Questions and Answers

Following the formal presentation, Mr. Svejnar, Mr. Havrylyshyn, and Mr. Dubinin answered questions from the audience.

SIR JEREMY MORSE: Thank you to our three speakers, who have given us a very varied view of this scene.

The first question I have is for Mr. Svejnar: Is the old-fashioned administrative and legal infrastructure responsible partly for the slow growth of foreign private investment in the Czech Republic? And, if so, what is being done to overcome this drawback?

JAN SVEJNAR: If we look at where the weaknesses in the transformation of the Czech Republic have been so far, the legal infrastructure is indeed one of the main sore points.

Somehow, the changes there have not been rapid, and the accompanying administrative machinery is also very stodgy. So a lot of investors from the West are complaining that this is a major unfinished problem.

The Government has been moving swiftly on this issue within the past year and is still hoping to enact some legislation before the parliamentary elections next spring or summer. But I think it's fair to say that this is one of the hindrances that has prevented a greater influx of Western capital.

A related point is that the Government has been pretty adamant about not giving special deals to any investors, and about keeping a level playing field, which probably is right in the long run as a strategy; in the short run, it has put the country at a disadvantage relative to some of its competitors in the region.

SIR JEREMY MORSE: There is a written question for the other two speakers, Mr. Dubinin and Mr. Havrylyshyn. Neither of you has mentioned the abuse of public office for private gain or the problem of corruption. Do you see this as an impediment to progress, and, if you do, how do you expect it to be resolved?

OLEH HAVRYLYSHYN: Yes, corruption is a very serious problem, but corruption per se is, in a sense, a symbolic tip of the iceberg of the problem of various economic interests having a preference for the in-between kind of economy that I spoke of: an administered economy in which the government dispenses favors—licenses to operate and trade and so on. Naturally, this kind of an economy induces corruption. If nobody is in the forest to hear the tree fall, there is no noise. If there is no government privilege to hand out, is there corruption?

Let me just make another point about corruption, and that is that one shouldn't get confused by historical analogies of robber barons in the nineteenth century, and one shouldn't get confused by moralist arguments. Wherever there is an opportunity to make a buck through corruption, there will always be somebody jumping at it. So one needs to remove those opportunities and move ahead with that last stage of transformation, liberalization. The situation of monopoly capitalism in this in-between phase is very different from that of nineteenth century robber barons. Then, the economies were ones in which governments were tiny, without many favors to disburse. Any monopoly capitalism that we see today—and I'm not saying that we see it throughout the region, or that it can't be gotten rid of—comes primarily because of the existence of large government.

So the main lesson is to continue the process of transformation, of reducing the role of government as an administrative intervenor in the economic process, and you will do a great deal to eliminate corruption.

SIR JEREMY MORSE: Thank you, Mr. Havrylyshyn. Do you want to add anything, Mr. Dubinin?

SERGEI K. DUBININ: Certainly, I agree with my colleague, Mr. Havrylyshyn, that this is a typical situation for some economic models. Corruption really is a very big danger today in our countries, for this is a transformation of a large part of the political power of an elite into economic power of the same elite.

During this transformation, a very big equity can move from one hand to another hand, and it's perhaps inevitable to see some negative results—moral, economic, and political—of such a process. But the other side of this process is that this too-big government does not have enough power to control such a situation.

Liberalization has its own dark side, maybe, from this point of view—political liberalization, for example—for corruption under KGB control certainly was more limited than it is nowadays without such a rigid control.

The only solution is to hasten the transformation and to finish this transition as fast as possible.

SIR JEREMY MORSE: Thank you, Mr. Dubinin. I think there was a commonality of answer to that question.

RAYMOND LLOYD: Surprisingly, no speaker has mentioned the recent disemployment and similar marginalization of women in the economies of Central and Eastern Europe. How would the panelists plan to realize such potential economic assets as are found in female education and work experience and the entrepreneurial and professional skills of half of Eastern Europe's human population?

JAN SVEJNAR: I think this is a difficult issue, so I will say right away that I don't have a straight answer for you. Let me, however, give you the background of this issue.

The Central European economies have had some of the highest women's participation rates in the world, so what we've seen in the first few years of transition is a significant decline in the labor force participation of women. It is very difficult—this is where the difficulty comes in—to see whether this is a natural adjustment to some kind of longer-term equilibrium that can be observed in other economies, or whether this is indeed a very undesirable social phenomenon, indicative of marginalization or discrimination.

On the one hand, part of the problem is structural in the sense that, in Central Europe, where we've studied this problem, women have often worked in those parts of enterprises where most labor redundancy has occurred. The women were not necessarily worse workers than the male workers, but they happened to be employed in the administrative areas, which could be—and had to be—downsized the most. Therefore, they were right in the line of fire.

On the other hand, there are many examples, for instance, in the textile industry in the Czech Republic, where women have basically restructured enterprises, and these have started exporting very effectively to the West—western Germany in particular.

Therefore, a panoply of different outcomes is possible, and we still don't know very well what is going on. In terms of the unemployment studies that I myself have participated in, there really isn't that much difference between women and men, for instance, in exiting from unemployment once they have become unemployed.

JAMES DURANT: I have a question for Mr. Dubinin. I am concerned about the problems with off-budget funds in Russia. The Russian pension fund is falling behind in the resources needed to pay pension benefits in a timely manner, and to administer the health system and the unemployment and retraining funds.

I find information on this issue very hard to come by, and I would appreciate your comments on this very serious problem.

SERGEI K. DUBININ: I can only say that it's very difficult for anyone outside the Government—even Russian investigators—to obtain real information about these problems for the Russian society. It's really a bad situation, which must be changed.

But I can tell you that the amount of these off-budget funds is huge. The revenues and expenditures are about one-half of the federal budget. These funds are part of our tax system, and they account for about 7 percent of GDP.

These funds are not being used as effectively as we would like in the current situation, when a large part of the population is receiving pensions. They also pose a political problem, for it is a temptation for political parties to try to increase these pensions to win the support of this part of the population.

So the Duma, as well as the previous legislative body, the Supreme Soviet, has received one resolution after another to increase the pensions. It is very difficult politically to tell the people that the Government cannot distribute this money, and that this fund is facing bankruptcy.

About one-third of the pensions nowadays are paid, not from the pension fund, but from the federal budget. This is an extra, unplanned expenditure of the federal budget. Clearly, the off-budget funds represent one of the most complicated problems in the Russian financial system.

SIR JEREMY MORSE: Thank you, Mr. Dubinin. I have two written questions about the role of banks, addressed particularly to Mr. Svejnar and Mr. Havrylyshyn.

The first question notes that the first two speakers were critical about the role of banks in the transformation process. As the banks need to get their money back, what kind of bank behavior or banking system do Mr. Svejnar and Mr. Havrylyshyn advocate?

In view of the seriously impaired assets in many of the newly created private sector banks in the countries under discussion, the second question is, What can be done to sustain broad public confidence in the banking system?

OLEH HAVRYLYSHYN: I first want to correct perhaps a misunderstanding of my position vis-à-vis banks. I signaled the existence of a serious problem in the banking sector, composed of some one or two elements, but it was not meant as a criticism of banks and the role that they would normally play as intermediaries between those who save funds in banks and those who borrow from banks.

Banks, indeed, play an extremely important part in making the transformation process a success and contributing to a newfound efficiency in the system. Unlike in the old system, in which resources were allocated by the central plan according to priorities, we expect the banks in the new system to be playing the role of reallocating resources. Indeed, the fact that they need their money back is a good thing, because they will then be forced to look for good, solid investments that will provide a return.

The nature of the problem, however, is now twofold. First, the banks that have arisen are very new, and second, the banks that have simply carried on from the previous banking system have not yet adequately developed new capacities. Under the old system, banks did not check out the effectiveness of the investments of their borrowers, and it is taking some time for them to be ready to lend for potentially solid investment opportunities, as is the case in more normalized market situations. The tremendous institutional effort aimed at speeding up this process is helpful, although in this situation learning by doing has no substitute.

In this connection, the government has to be prepared to be a little bit tougher with the banks. Perhaps too many new banks have been set up with inadequate supervision by central banking entities, and with inadequate establishment of the rules and regulations that assure financial stability. The price that will perhaps have to be paid is that some banks may have to close in the future.

The government, however, also has to take into account the burden of loans that the large banks, in particular, inherited. The banks were essentially directed to loan by governments that were profligate in their thinking about credit expansion. That behavior has created a large portfolio of nonperforming assets, which governments must address in the near future to transform their banking systems into more equilibrated and efficient mechanisms.

JAN SVEJNAR: I was not critical of banks per se; my point was that there are not enough banks. In other words, the banking sector is not yet fully developed and is not performing as well as one hopes it will when it's more mature.

In the meantime, the banking sector has some monopolistic tendencies, which, while good for the banks—for instance, in amassing reserves, which they desperately needed to position themselves vis-à-vis some of the bad loans—has created distortions from the enterprise standpoint. So I fully agree that we basically need more development of the banking sector. We need some bankruptcies, as happened, for instance, in the Czech Republic. However, as far as public confidence is concerned, I think that, in all these countries, the governments would step in if their banking sectors were severely threatened, and I think most individuals and enterprises know that.

SIR JEREMY MORSE: Thank you, Mr. Havrylyshyn and Mr. Svejnar. I think that we have time for one more question.

CHRISTOPHER STOREY: The first speaker correctly stated that almost all the countries in Eastern Europe were communist. The second speaker mentioned the fall of communism. The correct Leninist description of the state of affairs that has arisen in the communist countries is, in fact, state-controlled capitalism.

I put it to you that this is the stage at which the governments concerned intend the transformation to rest. Do you agree with that?

SIR JEREMY MORSE: Mr. Dubinin, you touched on the influence of vested interests in your remarks. Do you want to comment on this? Does the Russian Government want to rest at this point?

SERGEI K. DUBININ: Certainly, there exists some self-interest for the government mechanism on the part of the bureaucracy.

These people prefer to have more control of the process. However, I can tell you that the main impulse of this transformation in Russia came from the government mechanism, and not from the entities, for example.

From a management point of view, the country was not ready for market development. Therefore, this situation is not always so simple in many countries undergoing this transformation.

JAN SVEJNAR: What I was referring to in my presentation was really more of a postcommunist situation. The voters, sensing unhappiness, anxiety and so forth, have voted back people whom they thought might be softer and more humane, and who might go more slowly with the transition.

This is fully understandable. But if the goal is really to complete the transition, what I was saying is that the rapid rise of high unemployment has in fact prevented this goal from being achieved. In some countries, of course, a major transition has taken place. For instance, in the Czech Republic, the share of state-owned enterprises in the economy fell from 98 percent to 20 percent over a period of three to four years.

I think that your point is correct, however, that in what I call the postcommunist, or, if you want, the state-controlled capitalist societies the government, by definition, wants to retain significant control. Moreover, I would say that in some of the economies, especially those further south, you will see even more of this tendency.

SIR JEREMY MORSE: I would like very much to thank our three speakers for the windows that they have opened on this vast scene. The full text of Mr. Dubinin's lecture, of which he gave a shortened version, is already available, together with the Per Jacobsson lecture given in Madrid last year by Guillermo de la Dehesa.

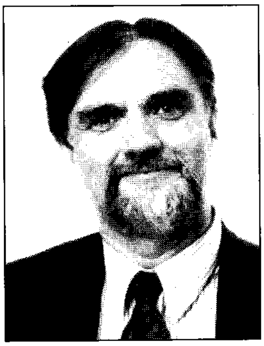
The whole presentation, with all three speakers' contributions, will be distributed to you in due course in the usual way.

I would ask you now to show your appreciation of our three speakers by applause.

Our speaker next year, in this room, will be Jacques de Larosière. We look forward to seeing you again then.

Biographies

Professor Jan Svejnar is Distinguished Service Professor of Economics at the University of Pittsburgh, Chairman of the Executive and Supervisory Committee, Center for Economic Research and Graduate Education at Charles University, Prague, and Director of the Economics Institute at the Academy of Sciences of the Czech Republic, also in Prague. Educated at the Université de Genève, Cornell University, and Princeton University, he has had a distinguished career as a teacher and as a consultant, and has published widely.



Professor Oleh Havrylyshyn is currently an Alternate Executive Director of the IMF. Before that, he was deputy Minister of Finance of Ukraine in the first Government of Ukraine formed at independence. Educated at the Massachusetts Institute of Technology, Mr. Havrylyshyn taught at Queen's University in Kingston, Ontario and at the George Washington University in Washington D.C., and has been advisor to several governments and international institutions. He has published widely.

Professor Sergei K. Dubinin was a senior official in the Ministry of Finance of the Russian Federation in 1991–94, including a period as Acting Minister of Finance. Educated at Moscow State University between 1968 and 1976, Mr. Dubinin taught at that university from 1976 until joining the Ministry of Finance in 1991, and again in 1994-95. In November 1995, he became Chairman of the Central Bank of the Russian Federation.

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1976 *Why Banks Are Unpopular.* Lecture by Guido Carli; commentary by Milton Gilbert (Basle).

1977 *The International Monetary System in Operation.* Lectures by Wilfried Guth and Sir Arthur Lewis.

1978 *The International Capital Market and the International Monetary System.* Lecture by Gabriel Hauge and Erik Hoffmeyer; commentary by Lord Roll of Ipsden.

1979 *The Anguish of Central Banking.* Lecture by Arthur F. Burns; commentaries by Milutin Ćirović and Jacques J. Polak (Belgrade).

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Capital Flows to Emerging Countries: Are They Sustainable? Lecture by Guillermo de la Dehesa (Madrid).

1995 *Economic Transformation: The Tasks Still Ahead.* Symposium panelists: Jan Svejnar, Oleh Havrylyshyn, and Sergei K. Dubinin.

Copies of the Per Jacobsson lectures in English and—except for the 1995 symposium—in French and Spanish are available without charge from the Secretary, the Per Jacobsson Foundation, International Monetary Fund, Washington, D.C. 20431. Site of the lecture is Washington D.C., unless otherwise shown