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Issues in the Introduction of Market Forces in Eastern European Socialist Economies

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April 1990

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ISSUES IN THE INTRODUCTION OF MARKET FORCES IN EASTERN EUROPEAN SOCIALIST ECONOMIES

BY

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April 1990

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ABSTRACT

This paper reviews the issues faced in introducing market forces in Eastern European socialist economies. It centers the analysis on the problems created for the functioning of markets in the absence of a substantial private sector. After analyzing the attempts at creating decentralized socialist economies in Hungary, Poland and Yugoslavia, it reaches the conclusion that markets cannot function without extensive private ownership of means of production. This means that the substitution of market forces for Government intervention in the allocation of resources requires a rapid privatization of the enterprises now in the socialized sector. Also, it requires an improvement in the management of the enterprises that would remain in the socialized sector. The paper then reviews the issues faced in accomplishing these objectives and their consequences for the design of both stabilization and structural reforms programs.

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ISSUES IN THE
INTRODUCTION OF MARKET FORCES IN EASTERN EUROPEAN
SOCIALIST ECONOMIES[1,2]

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MARCH 1990

I. THE REFORMS IN THE 1980s

A. INTRODUCTION

1.1. The fundamental issue in the reforms in Eastern Europe is whether it is feasible for a socialist economy to work under a market-like form of organization.[3] That is, Can market forces lead to an efficient allocation of resources without extensive private ownership of means of production? This paper deals with this issue and concludes that the answer to such question is no. The main argument to support this conclusion is that, by forbidding private ownership of means of production, the socialist mode of organization eliminates two markets that are essential to the functioning of market economies, those of factors of

1 The findings, interpretations and conclusions contained in this paper are entirely those of the author and should not be attributed in any manner to the World Bank, to its affiliated organizations, or to members of its Board of Executive Directors or the countries they represent.

2 This paper benefits from ideas presented both verbally and in papers by several EMTTF staff members, especially Roberto Rocha, Fernando Saldanha and David Tarr. They and others, especially Branko Milanovic (EM4CO), also provided substantial comments to an earlier draft. The remaining mistakes are mine.

3 The word "socialism" is used in this paper meaning a system that forbids the ownership of means of production by private individuals in order to achieve an equal distribution of income. Countries like Sweden, where private ownership exists, are not socialist under this definition, even if they have achieved more uniform income distribution than some socialist countries.

production. A corollary of this argument is that the introduction of market forces in these economies should be centered on large-scale privatization of means of production.

1.2. The paper discusses this fundamental issue, focusing on the introduction of prices as the main signals for the allocation of resources; on the establishment of mechanisms to ensure that economic agents will react to those signals in their decisions; and on the achievement of macroeconomic stability. The first two Chapters look at the ways in which these objectives can be met within the economic regimes existing in Eastern Europe. After coming to the conclusion that ownership reform is needed, the paper explores summarily in the next two Chapters some options open to carry out such reform while implementing other needed structural reforms and stabilizing the economy.

B. BACKGROUND

a. The Introduction of Central Planning

1.3. The prohibition of private ownership of means of production has always been a fundamental tenet in countries organized in the Marxist tradition. However,the question of whether the economy should be managed in a centralized or a decentralized way (with prices having a leading role in the allocation of resources) has appeared and reappeared ever since the first writings of Marx and Engels.[4] The issue was settled for decades by the decision that the Soviet Union took in the late 1920s to go for a centrally planned economy. It resurrected

4 Marx predicted the ultimate disappearance of the state in the ideal socialist state but mentioned the need for a transitional period (subsequently called the dictatorship of the proletariat) in which the state would play a decisive but largely undefined role in the management of the economy. Lenin took this line in State and Revolution (1916) and led a radical move toward centralization in the early years of the revolution. Shortly thereafter, however, he sponsored the introduction of the decentralized New Economic Policy described in the following paragraphs.

again in the early 1980s, when Poland and Hungary started reforms aimed at decentralizing their economies while still keeping the socialist nature of their economies.

1.4. This, however, is not the first time that decentralized socialism has been tried. The Soviet Union went through a decade-long period of decentralization known as the New Economic Policy (NEP), right after the nationalization of agricultural land and industry that took place during the civil war of 1917-1921.[5] During the NEP period, although the Government kept on intervening in the economy, prices were largely liberalized and profit-making in a basically open market became the criterion to judge the performance of socialized enterprises.[6] Before the NEP, the Government had used the expropriation of the farmers' surplus (the appropriation of all that was left after filling the vaguely defined basic needs of farmers) to extract resources from agriculture. With the introduction of NEP, the Government replaced expropriation with a fixed tax, which allowed farmers to sell a good part of their surpluses in the local markets.

1.5. The Government decentralized the management of the nationalized industries using several schemes, including "one-man control of state-owned enterprises" (which gave power to individual managers appointed by the state), contracting-out the management of a large portion of small-scale socialized firms and even the privatization of a small portion of small firms (giving back enterprises to their former owners).[7] The Government also offered foreign capitalists the opportunity of investing in the Soviet Union under concession

5 The description of this period follows Chapters 2-8 of Alec Nove, **An Economic History of the USSR**, Penguin Books, London, Second Edition 1989.

6 The Government made several attempts to control prices, but these were largely ignored. In 1922, the Government established a system of suggested prices.

7 The large-scale enterprises were organized in conglomerates, called trusts, which had to be profitable and had no obligation to sell to the state (except for trusts in strategic activities, which were subject to a rudimentary central planning).

arrangements. Private agents working under this system came to be called "Nepmen." During the height of this period, they dominated commerce and produced most of the agricultural output.

1.6. The NEP was not unsuccessful in terms of output. Production grew fast, mainly as slack capacity was put to use. However, the authorities reckoned that keeping the market rules in place would impair the establishment and sustaining of a true socialist economy, mainly as a result of the inconsistencies between market prices and the socialist objectives of the Government. One problem was that Nepmen were obtaining profits that created income differences that were considered incompatible with a socialist economy. Another problem was unemployment, which increased sharply and stayed high after the NEP's emphasis on profits led to the elimination of many surplus jobs.

1.7. A third problem was that the Government's priority objective of developing a large industrial sector was not being accomplished. While, for most of the period, prices and taxes were extracting the surplus of agriculture, they were not channeling those resources into investment in heavy machinery. Actually, there was little incentive in the system to do that for, without private ownership of means of production, the Nepmen had no incentive to invest their profits in capital goods. Throughout the NEP, most of the investment was carried out by the state.

1.8. Moreover, relative prices were not satisfactory for the socialist objectives of income distribution, both because product prices were deemed excessive in relation to wages and because the relative prices of agricultural

versus industrial goods fluctuated wildly.[8] These problems became more acute at the end of the NEP, when the Government introduced a policy of price cuts in the official market, which led to conflicts with farmers, increasing scarcities and the development of informal markets.

1.9. By the end of the 1920s, the NEP gradually gave way to the highly centralized Five-Year Plans. In the early 1930s, farms were collectivized and the Government reaffirmed its control of industry and transportation. The extraction of agricultural surplus and the overall restriction of consumption needed to finance the creation of industrial capital was accomplished through direct allocation of resources. Thus, the first attempt to use market forces was abandoned in favor of central planning because markets were considered to be incompatible with the advancement of socialist objectives.

b. Central Planning and Relative Prices

1.10. Socialist Governments, however, kept on manipulating prices as a means to control income distribution. Imposing distributional objectives on the pricing system created conflicts between the price that should be charged for specific products in order to cover production costs and the price that should be charged so that the targeted population could buy them. In cases where the products in question were deemed as essential, the second price was charged. In practice, most prices were either set on this basis or were distorted by the direct or indirect effects of the pricing of essential materials. As a result, prices did not reflect production costs.

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8 The early years of the NEP witnessed what was called the "Scissors Crisis". In October 1923, industrial prices were 276% of those of 1913, while agricultural prices were 89%. This crisis was largely caused by the interaction of liberalized prices with the monopolistic structure of industry and the more competitive rural structure of production. Government intervention and improved efficiency in the industrial sector brought agricultural prices back to more reasonable levels. However, throughout the period, relative prices kept on moving substantially, endangering either the survival of the farmers or the development of the industrial sector. See Alec Nove, op-cit, pp. 83-86.

1.11. The inconsistency between selling prices and production costs, however, is not important for the allocation of resources in a centrally planned economy. In market economies, prices should be consistent because prices are the signals from which producers deduct the volume and composition of effective demand, which then they try to meet according to their costs of production. In centrally planned socialist economies, the Government establishes the goals regarding the overall volume and the distribution of current and future consumption. In this setting, no signals from the population are needed.

1.12. The role of prices is further weakened by the complex system of taxes and subsidies common to most, if not all, centrally planned economies. Most centrally planned countries have a policy of "Flexible Tax Rates," which allows them to tax differently different firms with identical characteristics. Taxes are flexible because their objective, besides mobilizing resources for the normal functioning of the Government, is to extract savings away from enterprises, which then are reallocated for investment. Thus, taxes have to be different for savings vary from enterprise to enterprise. When enterprises make losses, they receive subsidies to turn them back into profitability.[9]

c. **Prices and International Trade**

1.13. The large distortions in relative prices make it necessary to isolate socialist economies from international markets. Tariffs are not useful for this purpose, because the distortions are so large that the structure of tariffs and exemptions needed to produce the desired effects would be impossible to estimate. For this reason, socialist countries tend to have very low import tariffs, about

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9 The policy of "Flexible Tax Rates" is being gradually abandoned in the reforming countries. Hungary, especially, has moved a long way in this direction through the establishment of income and value added taxes. However, the subsidization of loss-makers, both from the budget and from the financial system, is still pervasive, despite the fact that its reduction or elimination has been part of every stabilization program attempted in the last decade in Yugoslavia, Hungary and Poland.

5-10%, but quantitative restrictions to trade are pervasive. These restrictions are sometimes explicit and sometimes implicit in the institutional arrangements. Very frequently, only certain agencies are allowed to import.

1.14. The isolation from international markets gets even more complicated as a result of the Council for Mutual Economic Assistance (CMEA), the multilateral arrangement that Eastern European countries established to trade among themselves.[10] Trade in the CMEA takes place at quite distorted prices, which do not necessarily coincide with those prevailing in the domestic economies, and its balances are cleared in a non-convertible unit of account.

1.15. On the exports side, prices have not played an important role, except in Yugoslavia and, recently, in Hungary and Poland. A common institution in socialist countries has been the "Equalization Fund," which taxes away profits from profitable exporters to subsidize unprofitable ones. This institution was created in many countries to compensate for the disequilibrium created by trade with the CMEA, but has functioned with exports to the convertible currency area as well. Even recently, in Poland for example, incentives were set in such a way that enterprises exported to get foreign exchange (and thus, the possibility of importing), rather than for price reasons. Several enterprises made losses in their exports.

d. Price Manipulation, Excess Demand and the Overhang

1.16. Besides distorting relative prices, the use of pricing as a mechanism to distribute consumption is at the root of the existence of excessive wages and the creation of the monetary overhang so common in socialist countries. To meet the objectives of a socialist economy, the minimum income should be sufficient for everybody to buy the basket of goods that the country considers essential

10 The CMEA includes three non-European countries (Cuba, Mongolia and Vietnam), in addition to Bulgaria, Czechoslovakia, the German Democratic Republic, Hungary, Poland, Romania and the Soviet Union. Yugoslavia is not a member.

and affordable given the stage of economic development. However, the basket of essential goods varies with people: a family with teenagers needs books while one with toddlers needs milk. Through life, married people need smaller houses initially, larger ones after a while, smaller ones again after children leave. How to ensure that all of them have a comparable life standard, not more and certainly not less than the average?

1.17. One solution would be to tailor salaries individually, so that the purchasing power of each individual would be exactly exhausted when buying what is supplied for them (that is, salaries would correspond exactly to the sum of the official prices of the articles the Government thinks the individual needs). This solution is not practical.

1.18. Another solution is to make currency a kind of money that can be spent only when used in conjunction with another specie, rationing entitlements. Rationing entitlements can be estimated outside the monetary system, so that the objecti`.` of directing and limiting the consumption of individuals can be achieved without disrupting the administration of enterprises. In order to function as desired, the system in fact requires that the supply of the monetary component of the composite money should exceed the supply of rationing entitlements. If not, some people, having the entitlement, would not be able to make it effective for lack of money. Thus, with money flows always exceeding the rationing flows, the accumulation of a monetary overhang is an unescapable consequence of the attempt to divorce consumption possibilities from the income of production factors through the pricing mechanism.

1.19. In some countries, rationing has taken a form more subtle than cards and lines. Governments have been able to produce basic goods in quantities sufficient to avoid their rationing but at the cost of restricting the variety of goods and services freely available in the economy. In those cases, people cannot spend the cash remaining after fulfilling the basic needs targeted by the

Government, even if there is no explicit rationing. Also, enterprises become used to what is called "forced substitution" of inputs for lack of availability of many of them. Of course, the quality and variety of available goods improves with economic development.

1.20. Some socialist countries have tried to set prices at levels that resemble market prices and have not accumulated excessive monetary balances. In most of the countries that have accumulated them, such balances have not remained idle. Instead, they have nurtured the development of informal markets. The type and depth of these markets vary with the easiness of conducting transactions outside the official market.

1.21. The demand and supply of rationed commodities traded in informal markets clear through these markets, as they do in market economies. However, they clear in a way that is inefficient because a gap is created between the price paid by the consumer and the price received by the producer. The informal market seller extracts a rent that is the sum of part of the consumer surplus from the buyer and the economic losses of producers. The fact that the consumer is willing to pay prices higher than the official is not transmitted to the producers, who then see no reason to invest in increasing production. The results of this dynamics are quite negative.[11] It creates a class of rentiers who have higher real incomes not because they contribute to production but because they have privileged access to entitlements.

e. Enterprise Management

1.22. In the classical centrally planned economy, the enterprise is a means to deliver products in accordance with the plan. In this vein, enterprises depend from Branch Ministries, which receive orders from the Planning Office and convey them to the enterprises through "Associations," groups of firms operating

11 See David Tarr, "The Welfare Effects of Foreign Exchange Restraints, Shortages and Subsidies in the Polish Auto, Color TV and Butter Markets," EMTTF, 1989.

in the same or related fields. Managers are appointed by the state and, in varying degrees, share powers with the representative of the Communist Party and with local authorities.

1.23. Although their overriding concern is delivering the required volume of production, enterprises are supposed to meet other objectives as well, such as helping in ensuring full employment. In the late stages of central planning, operating profitably has been one of the objectives. However, this objective has been difficult to achieve for several reasons, among them price inconsistencies, the priority given to deliveries at all costs and the pervasive shortages of raw materials and intermediate products.

C. THE PROCESS OF REFORMS

1.24. For years before the start of the reforms, socialist economies had shown signs of severe inefficiencies. For example, their rates of growth were very low when compared with their high rates of investment, which were on the order of 35-40% of GDP. Also, rationing of essential goods, which was supposed to be only a temporary sacrifice, became a permanent feature of the system. The quality of goods produced in these countries was also quite inferior to what could be obtained in the international markets.

1.25. Yugoslavia in the 1960s, and Poland and Hungary in the late 1970s, identified the rigidities of central planning for these inefficiencies. These countries decided to start a program of structural reforms aimed at decentralizing decisions on resource allocation, increasing the roles of both prices and the financial system in those decisions. In the early years of reform, the Governments of those countries wanted to move away from central planning but still wanted

to keep the socialist nature of the economy. They aimed at designing a system that would decentralize enterprise management without allowing unrestricted private ownership of capital goods.[12]

1.26. Countries moving away from central planning but wanting to keep the socialist nature of their economies are trying to change the role of prices in such a way that they provide efficient signals to producers but do not disrupt the equalitarian distribution of wealth and income that is their objective as socialists. The main way to do this is to liberalize prices (sacrificing the equalization of welfare across people with different needs but getting rid of rationing) and to decentralize enterprise management, while equalizing incomes by keeping most of the enterprises under social ownership. The feasibility of this is the main issue at stake for these countries.

1.27. The history of reforms in Eastern Europe concerns mainly Yugoslavia, Hungary and Poland. Although the initial model used in these countries, central planning, was roughly uniform across countries, and although the trend on all countries is to decentralize, reforms have created substantial differences among each of the reforming countries and between them and the rest of the region. Thus, a discussion of their problems necessarily has to be based on the stylized facts that are common to them, annotating some of the most important differences along the discussion. This is the approach taken in this paper.

a. The Initial Stages of Reform: The Search for Decentralized Socialism

1.28. Running a decentralized economic system without private ownership of means of production requires delinking the ownership of enterprises (which is

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12 The Soviet Union also made an attempt at partial decentralization in the 1965 industrial planning reforms, which aimed at scrapping gradually the system of material allocation. Managers would gain autonomy and part of their income was to be determined on the basis of managerial bonuses linked to profitability and sales. The 1965 reforms, however, were abandoned quite rapidly, mainly because of the inconsistencies of the mixture of the still strong central control with decentralized management. See Alec Nove, op-cit, pp. 367-368.

supposed to be kept by the Government on behalf of society) from their management (which is transferred to the either the workers, to independent managers or both). As initially envisaged, enterprises should become self-governed and self-financed, meaning by the former that their management should be decentralized, and by the latter that they should not rely on subsidies but on their own revenues to operate and grow. There are two main varieties of the decentralized enterprise. One is that managed primarily by Worker's Councils. The other one is that managed by independent managers.

i. The Self-Management System

1.29. Theoretically, the objective of the enterprises under this system would be to maximize their workers' income, which in turn is linked to profits based on market signals. Under self-management, the Government transfers the management of the socialized enterprises to the workers, organized in Worker's Councils. Within those enterprises, the Workers' Councils have the final word in decisions concerning the appointment of the managers, the design and implementation of the business plans (including wages) and the allocation of the enterprise profits (which also can be turned into wages or other forms of compensation for workers). With those powers, Workers' Councils effectively run the companies and decide on the distribution of income out of production.[13]

1.30. To provide incentives for efficiency, the model links workers' compensation with profits, so that wages and other workers' benefits can formally be increased only when the operation yields profits. Also, it introduced a rudimentary concept of the cost of capital in the form of a "dividend," a fixed annual payment that socialized enterprises would have to make to the Government based on the value of their socially-owned capital stock. This system existed

13 In reality, as it is discussed later, the state and the Communist Party also have a strong influence in the management of enterprises and in the appointment of managers.

in Yugoslavia and still exists in Hungary and Poland. It existed for a short while in the Soviet Union in the mid-1960s. It exists in a more flexible form in China, where firms negotiate with the Government the portion of profits that they would have to remit to the state.

1.31. The "dividend," however, became weaker with time. It was abolished in Yugoslavia in the 1970s. In Poland, the "dividends" are paid only on the stock of capital existing at a date established by law, December 1983. As a result, the importance of the original stock of capital in their total capital diminishes as enterprises keep on investing. This effect is accentuated in Poland because the original stock of capital is not adjusted for inflation and the "dividend" is equal to the Central Bank's rate of discount, which in 1989 was 46% per year while the rate of inflation was about 55% per month. As a result, the enterprises are increasingly becoming the owners of themselves, a phenomenon that has already occurred in Yugoslavia and, to a large extent, in Hungary.

ii. The Trend Toward Self-Management

1.32. Although in Hungary and Poland the system of independent managers was predominant in the initial stages of reform, workers have gradually asserted their control over the enterprises--both formally and de-facto--to the point that the generic term self-management is applied specifically to the labor-management system.[14]

1.33. The Polish enterprise reform of the early 1980s established the three "S": enterprises should be self-governed (decentralized and independent from the Associations); self-managed (controlled by the workers); and self-financed (profitable). Initially, the Government appointed most of the managers and,

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14 This is the usage followed in this paper. The term self-management is used to refer specifically to the system where enterprises are controlled by their workers.

together with the Party, effectively controlled the enterprises. Workers' Councils in each enterprise were given consultative powers on several issues and decisive powers on the approval of the firms' financial plans and on the distribution of profits. With time, however, self-management (labor control) was asserted throughout most of the economy. Current exceptions tend to be strategic enterprises.

1.34. Hungary went through a similar transformation. Under the decentralization reforms undertaken prior to 1985, managers were supposed to be autonomous but they were appointed by the Branch Ministries. The 1985 reform introduced full-fledged self-management in 80% of the socialized enterprises. There are two types of these. In the large and medium-sized enterprises, workers elect an Enterprise Board, which, in turn, elects the managers. In the small enterprises, the workers elect their managers directly. The remaining 20% of the enterprises (mainly utilities, transportation and defense) has remained administered directly by the state.

1.35. Another recent example of deliberate transfer of control to the workers is the reforms program announced in the Soviet Union in 1985-1987, a blueprint for the elimination of central planning. The program included demokratizatsiya, the election of managers and foremen by the enterprise workers, which effectively would give control of enterprises to workers. This is the basis for the decentralization of Soviet enterprises. It is unclear to what extent the system has been implemented in the Soviet Union, but the trend toward self-management in that country is evident.[15]

1.36. Thus, pursuing the decentralization objective, Eastern European countries are moving, both formally and de-facto, toward some variation of the self-management system invented in Yugoslavia more than three decades ago.

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15 See Alec Nove, op-cit, Chapter 14, pps.379-380.

iii. The Creation of Commercial Banks

1.37. Under central planning, the banking system is an extension of the Treasury. The Central Bank combines monetary functions with those of commercial banks. The system usually includes also an agricultural bank and a savings bank. The role of these institutions is totally subordinated to the central planners. Financial resources follow the allocation of real resources, providing little more than a unit of account. In order to isolate the flows related to production from the more volatile flows of the population, the Government keeps two separate "monetary circuits." Savings banks operate only with the population and the small number of small private enterprises, while the rest of the banking system operates only with the socialized sector (state enterprises and cooperatives). Transfers of resources between the two circuits are not allowed.[16]

1.38. All countries moving toward decentralization have started a financial reform, aimed at turning the financial system into the main mechanism to allocate resources across the economy. The Central Banks have created several commercial banks by splitting their loan portfolios, while they have become specialized on monetary control. Banks are supposed to introduce financial discipline in the management of enterprises by extending credit only to profitable enterprises.

1.39. In Yugoslavia, banking reform was carried out in the 1970s. All banks in Yugoslavia operate as financial agencies of their owners, which in all cases are enterprises (called the "founding members"). Under this arrangement, the objective of financial institutions is not the maximization of their own profits but the provision of financial resources to its founding members at minimum cost. Financial institutions cannot accumulate profits. After meeting operating costs and setting aside the mandatory reserves, banks must distribute their surpluses among members and among other entities that make use of the banks' services.

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16 In Hungary, they are still formally prohibited by a provision deemed to be temporary.

As a counterpart, founding members are theoretically jointly and severally liable for their bank's obligations. This arrangement was supposed to give flexibility to enterprises while imposing financial discipline on the owner-borrowers. However, after 20 years, financial discipline does not exist in Yugoslavia and most, if not all, banks are insolvent.

1.40. The Governments of Poland and Hungary decentralized their banking systems in 1987-1988. They kept the ownership of banks while decentralizing management, under a model that resembles that used in the enterprises. The control of banks, however, has not been given to workers but to managers, who are appointed by the Government or the Central Bank and are accountable to the Government for the profits and losses of their institutions.[17]

1.41. These reforms are still under implementation. The operation of commercial banks in Poland is still hardly distinguishable from their previous operations as branches of the Central Bank. Hungarian banks seem to be more autonomous. In both countries, however, the operations of banks are still determined by the portfolios they inherited from their Central Banks. Given the concentration of industry in a relatively few enterprises, these portfolios are highly concentrated, to the point that some banks have most of their assets invested in only one or two large conglomerates. Also, although there is no reliable information on the quality of the portfolios, it seems that the share of sub-standard loans (unrecoverable and recoverable but contracted at very low and fixed interest rates) is substantial.

b. The New Ownership Laws: The Creation of Mixed Economies

1.42. Recently, the Governments of Yugoslavia, Poland and Hungary moved forward with the Reform and introduced new ownership laws. These laws, which are remarkably similar, removed the most of the obstacles that had constrained

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17 In Hungary, the Government has kept 50.5% of the ownership of banks. The rest is widely distributed among enterprises and other bodies.

the private ownership of capital goods and had, therefore, confined the private sector to own only small enterprises. Since these laws were enacted, private entrepreneurs in each country are allowed to create firms of any size, compete against each other and against firms in the socialized sector and acquire as many capital goods as they need.[18]

1.43. While this reform has theoretically turned the three countries from socialist to mixed economies where privately and socially owned firms could compete for resources and markets, the three economies remain largely socialist because most of the productive sector is still socially owned. Although privatization of existing socialized enterprises is being discussed, no official credible plan to carry it out has been proposed. By ignoring the subject, it seems that official economic plans assume that most enterprises will remain socialized in the foreseeable future.[19]

D. Macroeconomic Instability

1.44. The reforms process has been accompanied by a substantial increase in the inflation rate in at least two of the forerunners, Poland and Yugoslavia. In these countries, monetary policy has been overly expansionary to cover deficits not in the fiscal budget but in the enterprise and banking sectors, which have accumulated heavy loses in the last several years. Although these loses have

18 Hungary still restricts the size of private enterprises to 500 employees. This restriction, however, is likely to disappear in the near future.

19 Eastern European economists, however, have been conscious of this problem for several years and they have proposed several privatization plans. See, for example, Stefan Kawalec **Privatization of the Polish Economy**, and Janusz Lewandowsky & Jan Szomburg **Property Reform as a Basis for Social and Economic Reform**, both published in Communist Economies, Vol. 1, No. 3, 1989; Grzegozr Jedrzejczak and Wlodzimierz Majcherczac **Privatization of the Polish Economy in View of the Creation of Capital Market**, paper presented in the Polish American Capital Market Workshop in Warsaw, November 1989; Marek Dabrowski **Privatization: What is Feasible and What is Not**, Zmiany No. 31, December 1989, reprinted in the December 5 Polish News Bulletin of the British and American Embassies, Warsaw; and Professor Jan Winiecki **Privatizing Soviet-type Economies**, mimeo.

become apparent only in the 1980s, they arose as a result of the highly distorted economic environment that has prevailed in Eastern Europe for several decades in both the centrally planned countries and in Yugoslavia.

3.45. Such distortions led to investment in capital goods that were not consistent with the countries' comparative advantages and their products could not sell at a profit in the international markets or in an unprotected domestic market. Therefore, those investments were a source of losses from the very beginning and resulted in an excess of expenditures over income for the country as a whole. Such losses, however, were masked with protection and could be sustained without a decline in the standard of living through large external borrowing.

3.46. When international lending stopped, and the cash outflows of debts could not be covered with further borrowing, Poland and Yugoslavia had to increase its foreign exchange revenues. However, with uncompetitive firms, this was very difficult. Rather than reducing the rate of growth of nominal domestic demand, the Government's efforts to subsidize the losses of enterprises actually increased it. With foreign borrowing no longer an alternative, the effects of excessive demand turned from large current account deficits to higher rates of inflation and then to hyperinflation.

1.47. The possibility of higher inflation rates also appearing in Hungary and other reforming countries cannot be discounted. In 1989, Hungary is already highly indebted, is running a current account deficit in the balance of payments and is experiencing an inflation rate of about 20%, which suggests that excess nominal domestic demand is substantial. Also, although figures are unreliable, it seems that losses in the Hungarian enterprises and banks are massive. The more recent estimates put the stock of Central Bank losses from external debt

valuation differences at about 30% of GDP. If, to avoid further foreign indebtedness, the current account is balanced, Hungary might experience rapidly escalating inflation unless excess demand is checked.

E. THE TREND

1.48. The economic reforms in Eastern Europe have mainly consisted of institutional measures: the decentralization of management, the creation of decentralized banking systems, and the removal of restrictions on private ownership of means of production. Now, the emphasis is turning toward the liberalization of prices (which have remained quite distorted throughout the reforms process) and the reduction of the macroeconomic instability that has accompanied the reforms. There seems to be a perception that, with a good implementation of these measures, Eastern European countries will become something equivalent to market economies. Under this view, price liberalization, complemented with the decentralization of management and the still incomplete creation of decentralized commercial banks, is expected to create a sustainable market economy.

1.49. Placing so much hopes on price reforms at this stage seems puzzling, however. Without ownership reform, price reforms would move these economies toward a model that has failed in practice in Yugoslavia. Yugoslavia has achieved the highest degree of decentralization among socialist economies. Also, although prices in Yugoslavia are still quite distorted, they are much less so than in other Eastern European countries. Thus, if the other countries succeed in their price liberalization, they will become something close to Yugoslavia.

1.50. Still, Yugoslavia cannot be called a market economy. Actually, Yugoslavia shares with other Eastern European countries most of the problems normally associated with central planning. Yugoslav savings have been invested in volumes as big and in ways as inefficient as those of the centralized socialist economies. Overstaffing is as pervasive in Yugoslavia as in Poland and Hungary before and after these countries' move towards decentralization. After more

than 20 years of reforms, enterprises are as much of loss-makers than their counterparts in other Eastern European countries. Also, although Yugoslavia is not as overindebted as Poland, it suffers from similar macroeconomic instability. Furthermore, one of the most important differences between Yugoslavia and the other countries, the establishment of a fully decentralized financial system, has ended in total disaster. Rather than being a vehicle for a better allocation of resources, the financial system of Yugoslavia has become a central part of the country's economic problems. So, what would be the rationale of turning the other countries into something closer to Yugoslavia?

1.51. The experience of Yugoslavia seems to suggest that the root of the problems of the unreformed economies is not central planning, and that distorted prices are not the main source of the problems of the reforming ones. Instead, it seems that the source of both kinds of problems is the objectives imbedded in socialism, which, in turn, require either central planning, or Government intervention to distort prices, or both, in order to be attained. The next Chapter discusses how the mechanism used to decentralize decisions cannot function without heavy Government intervention.

II. CAN THE MARKET WORK WITHOUT OWNERS?

A. THE PROBLEMS OF THE SELF-MANAGEMENT SYSTEM

2.1. In the absence of central planning, the financial system becomes the center piece of the allocation of resources. However, the financial system is essentially a capitalist mechanism. To allocate resources efficiently at the margin, it relies on modifying incentives to owners of capital, i.e., raising or lowering the marginal productivity of real capital accruing to them through modifying the cost of its financing.

2.2. The owners of capital react to changes in those incentives in ways that affect both the demand for capital goods and the labor market. Their reactions are transmitted to the labor market through shifts in the real wage, which come about as a result of changes in both demand for labor given a production technique and changes in such technique. The effects on the labor market then blend with the direct effect on owners to influence the size (total value) and composition (relative prices) of overall domestic demand.

2.3. Thus, the efficacy of the financial system in affecting economic behavior is as good as its ability to influence factor markets. And that ability relies primarily on affecting owners first, then laborers. But there are no owners in the self-managed socialized enterprises. In effect, having socialized enterprises owning themselves means that nobody owns them. Thus, there is no direct advocate for capital in these enterprises. Workers are supposed to be the surrogate advocates, but they have little interest in preserving and increasing their enterprises' capital.

2.4. On the contrary, as it is discussed in the following sections, workers have a vested interest in decapitalizing their enterprise and, without Government intervention, they have the power to do it. What are the implications of this kind of enterprise organization for the functioning of the market? The following paragraphs explore this question.

a. The Lack of Factor Markets

2.5. The lack of an advocate for capital in the self-management system means that there are no capital markets, which, in turn, means that there is no market for labor.[20] This presents at least three difficult problems. First, how to ensure that investment takes place in the right amounts and in the right activities. Second, how to avoid free rider problems, both within enterprises

20 The lack of labor market is in fact inherent in the self-management system.

and among them. Third, how to avoid wide divergences in the wage level for similar activities and skills in different enterprises, which would contradict the income distribution objectives of the system.[21]

i. The Investment Problem

2.6. The problem of investment has two dimensions. One is the share of investment in GDP. The other is the allocation of investment among competitive possibilities. In centrally planned economies, the Government sets both, normally forcing a high rate of saving and investment. In a pure self-management system, the population and enterprises should be able to substitute for the Government in determining both dimensions. However, as it is explained in the following paragraphs, the incentives prevailing in the self-management system make Government intervention necessary on both aspects of investment.

2.7. In capitalist economies, investors are entitled to enjoy the returns independently of whether they work in the company or not. They can sell their entitlement in case of necessity, transforming their claims on real capital into cash, and they can transfer its ownership to their heirs. That is, they have an assurance that the capital formed with investment, and its returns, would benefit them or their heirs.

2.8. Such an assurance does not exist in the self-managed system. Under that system, workers have access to the rents of capital through their power to decide on the allocation of the surplus of production. However, they do not own the capital. This makes an extremely important difference. Incumbent workers run a very high risk that they will not be able to enjoy the benefits of today's proposed investments because they cannot cash in their claims to future benefits

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21 For an excellent and more rigorous discussion of the problems of self-management see Fernando Saldanha, "Self-Management: Theory and Yugoslav Practice." EMTTF, October 1989. Several of the ideas presented in this section come from that paper.

in case of necessity and there is no way in which workers can transfer their entitlement to the rents of capital to their heirs. Moreover, workers can enjoy the benefits of investment only as long as they remain in the company (a condition that they can fail to meet as a result of death, restructuring of the enterprise or other causes).[22]

2.9. Thus, while workers can immediately appropriate the rents of capital, they cannot be sure that they will be able to do that in the future. Between certainty and uncertainty, the choice is clear.[23] Moreover, if workers choose investment, they would have to devote time and efforts to monitor the investment performance, for which they not only lack preparation but also motivation because their share of the new capital would be too small to care about. As a result, the temptation to increase current individual earnings (cash on hand) at the expense of the enterprise investment (hopes) is very strong.

2.10. Taken to the extreme, this incentive could push workers to appropriate not only the rents of capital but also the entire stock of capital of the enterprise. They could increase their wages to a point where the enterprise makes losses and is decapitalized. The only limit to the level to which they could increase their wages and benefits would be the size of the enterprise capital stock. The volume of the annual transformation of the stock of capital into wages would be given by the speed at which capital loses its productive capacity. That is, the enterprise would disappear when the last key machinery

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22 The difference between the incentives for workers under self-managed enterprises and those prevailing in enterprises totally or partially owned by their workers is fundamental but is frequently ignored. When workers own the enterprise, they become capitalists and act accordingly. Under self-management, there is no capitalist.

23 The fact that it does not pay to invest in non-owned assets is recognized in Eastern European literature and is called the Furubotn-Pejovic effect.

breaks down.[24] If borrowing is allowed, the best course of action would be to borrow to pay higher salaries until the enterprise becomes insolvent. Thus, there are strong incentives encouraging self-liquidation in the self-management system.[25]

2.11. In reality, self-liquidation has not taken place. This can be partially explained by the fact that, even without Government intervention, there are other forces at work in the system. One is that, in a strictly socialist economy, there are not many opportunities to invest outside enterprises because the private ownership of capital goods is not tolerated. In these economies, people tend to invest their savings in as many inventories of consumer goods as they can get. These goods at least can be expected to maintain their real value, which is not generally true of local monetary holdings. Another favorite among these ways to store savings is hoarding foreign exchange.

2.12. Thus, although workers would be able to increase their consumption substantially through the period of decapitalization of the enterprise, and would be able to provide for some future consumption by buying consumer durables, they would not be able to invest their high wages in other activities to ensure their survival once the enterprise, and their jobs, disappear. So, it is in their

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24 The optimal path would include some investment to ensure that the maximum value is extracted from the total capital stock. For example, if a key piece of machinery breaks down while a substantial stock of machinery is still useful, it could be optimal to replace it.

25 This mode of behavior exists in capitalist economies in cases, such as that of many Savings and Loan Associations in the United States, where enterprises are controlled by people who do not own the assets of the enterprise. Such situation may arise when the formal owners realize that their enterprise is bankrupt, so that they have lost their equity and, therefore, no longer own it. The company still has assets, but their owners are the creditors of the enterprise (depositors, in the case of the Savings and Loan Associations). Very frequently, if this situation is not known to creditors or regulators, the formal owners vote themselves huge dividends or large unsecured loans to appropriate the assets of the enterprise before it collapses. This practice is severely penalized in market economies, most frequently with jail.

interest to make sure that the enterprise somehow survives as long as they work in it. Also, although managers are subordinated to workers, they are influential and they may push for investment to increase their power vis-a-vis other enterprises.[26]

2.13. Within such an environment, and without Government intervention, the level of investment would be determined by the resolution of a conflict of several forces only vaguely related to the economic variables that should shape an efficient investment strategy for the enterprise. The net result would be levels of investment well below both the optimal and the Government expectations. Also, a substantial portion of savings would be stored in unproductive assets. The ownership structure leads workers to multiply the expected returns of investment in their enterprises by a probability lower than one to estimate the returns that they would obtain from such investment. This probability varies inversely with their age. As a result, the appeal of investment in enterprises declines both relative to consumption and to other ways in which workers can store their savings, which, by definition, can be only unproductive assets.

2.14. Recognizing this, the Government intervenes to foster investment in all three reforming countries. It does so by forcing firms to set aside for investment a part of the net income, either directly (taxation of profits combined with subsidization of investment or direct investment) or through incentives and regulations (forcing enterprises to allocate a portion of their income to

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26 The managers' drive to invest is obviously more important in the Hungarian enterprises controlled by the Enterprise Boards, but is also significant in the self-managed enterprises in Hungary and elsewhere.

investment funds).[27] This intervention determines the volume of investment, but in an arbitrary way. It also distorts the other aspect of investment, its allocation.

2.15. Taxation combined with subsidization gives back to the Government the power to decide on both the overall level and the allocation of investment, making this solution equivalent to central planning in what regards investment. The alternative solution, forcing enterprises to invest a portion of their profits, gives back to the Government a lever to control the overall level of investment while leaving with the firms the power to decide on the allocation of such investment.

2.16. The second type of intervention may result in even more rigidity in the allocation of resources than central planning. It tends to leave the resources in the activities where they were generated. Enterprises tend to invest in the fields they operate because that is the activity managers and workers know. Thus, their personal welfare depends on the development, or at least the maintenance, of that activity. Also, it is easier for workers to appropriate the rents of capital if it is invested in their own company.[28] This dampens

27 Vanek in 1970 wrote that the Furubotn-Pejovic effect does not affect the overall level of investment but only its financing. That is, workers would invest only in fully leveraged investments. However, private banks cannot be expected to consistently finance highly leveraged projects. That is, Government intervention in financing is needed to keep investment going. In fact, Governments have found it necessary to subsidize investment as well.

28 Enterprises could become interested in investing in other fields if they could still appropriate the rents of capital. That is, if they invest in firms that are not self-managed. If this happens, it would mean that the currently self-managed companies would become the future big capitalists of socialist countries, with their workers extracting the rents of capital of their own firms and their subsidiaries. In Poland, the Government is thinking of introducing a rule that would force the self-managed parent companies to invest all the profits they get from a non-self-managed firm in the same firm. This would be yet another restriction to the mobility of capital introduced just to avoid the appropriation of profits as wages.

substantially the mobility of capital and distorts the allocation of investment at the margin. The immobility of capital tends to be confirmed by the work of Fernando Saldanha, who shows that, in Yugoslavia, there is no flow of capital from low- to high-performance manufacturing branches.[29]

2.17. The lack of an advocate for capital has created a serious problem of decapitalization in the enterprises in the three countries. In both Poland and Yugoslavia, the subsidization of enterprise existing or potential losses (that is, losses that are prevented by the subsidies) is at the root of the hyperinflation problem. In Poland, the inflation tax transferred resources equivalent to 10% of GDP to the enterprise sector in 1988. This transfer was on top of the explicit subsidies granted through the fiscal budget, which were on the order of 10% of GDP.[30] These transfers were probably higher in 1989, when hyperinflation accelerated. In Yugoslavia, the transfer effected by the inflation tax to enterprises in 1988 was roughly 8%, while arrears in the banking system were mounting.[31] In both countries, wages were going up faster than inflation while losses mounted.

2.18. Up to 1987, at 20% of GDP, Hungary was the country with the highest explicit subsidies to industry among the three reforming countries. These subsidies have been drastically reduced, so that currently only a few sectors receive explicit subsidization. However, the problem of arrears of enterprises with the banking system, which already existed, has aggravated seriously in the interim. Most enterprises are not repaying their debts. Yet, they keep on increasing their wages and fringe benefits. This problem is frequently interpreted as a crisis of temporary illiquidity in the enterprises. Nevertheless, enterprises

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29 Saldanha, op. cit.

30 See Fernando Saldanha, **Interest Rates Subsidies and Monetization in Poland: The Year 1988**, mimeo, EMTTF, January 1990.

31 See Roberto Rocha, **Structural Adjustment and Inflation In Yugoslavia**, EMTTF, May 1989.

have enough liquidity to increase wages. The illiquidity appears only when it is time to repay debts. This problem is remarkably similar to that of Poland and Yugoslavia before the acceleration of inflation.

ii. The Free Rider Problem

2.19. Government intervention to ensure that the enterprises would survive removes at least some of the restraint that workers may show as a result of their fear that the enterprise would go bankrupt. The fact that almost no company has failed in Eastern European countries reinforces this effect. The implicit signal, which the workers seem to have understood only too well, is that, no matter how unrealistic the compensation increases they grant to themselves, the Government will always step in to avoid the bankruptcy of the enterprise. The more enterprises act under this assumption, the better the chance that the assumption is right.

2.20. Furthermore, the incentives in the self-management system not only motivate workers to extract resources from the enterprise but also to devote as low an effort as possible to their work. Although, in theory, workers have an incentive to monitor the efficiency of others, their share of the benefits of increased efficiency is much smaller than the benefits they can extract from inefficiencies, such as not coming to work. Thus, absenteeism, shirking and lack of initiative are pervasive in the self-managed enterprise.

2.21. Thus, although the self-management system is decentralized, its solution to the investment problem is as rigid as that of central planning. In practice, Governments of decentralized countries have set investment volume targets not as high as those of the centrally planned economies, but still very high in comparison with the investment rates of comparable market economies. The results in terms of growth are also similarly disappointing.

iii. The Income Distribution Problem

2.22. In market economies, one of the main results of the free interaction between capital and labor markets is the trend to equalize both the wage and the

profit rates (return on assets) across the economy. Although it is true that in capitalist economies employees working in capital intensive firms or activities are likely to negotiate higher wages than their counterparts in less capital intensive activities, the counterbalancing force of investors able to transfer their resources to activities producing higher returns on assets keep to a minimum the differences between wages paid to workers with the same skills. Also, some of the differences are explained by variables difficult to observe in aggregate data, such as differences in skills for jobs with the same tittle and differing policies to motivate personnel.[32]

2.23. In contrast, in the self-managed system, wages depend on the ratio of the absolute level of profits before wages to the number of workers in the enterprise (called net operating income). This ratio varies from firm to firm depending on their capital intensity. As a result, there is no possibility of wage equalization in the self-managed system. Since the remuneration for labor is mixed with the rents of capital, workers with the same skills can have widely different wages, depending on the current level and the rate of change of the capital intensity of their firm. In short, the fact that there is no uniform price for capital means that there is no uniform price for labor either. Therefore, there are no economy-wide factor markets. If these key markets are missing, the transmission of market signals is interrupted at the core of the economic system.

2.24. To moderate the wide differences in wages for the same skills that would prevail in an unconstrained self-management system, the Government intervenes to equalize profits in all (or most) enterprises through tax reliefs and subsidies, pricing policies, quantitative restrictions to trade and privileged

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32 A common occurrence is that of firms highly intensive in capital (human or physical, or both) paying higher wages than their industry average not only to those people with special skills crucial to the success of the enterprise but to other workers as well. This seems to be a way to keep internal harmony necessary for a successful operation.

access to inputs and foreign exchange. Firms take advantage of this policy to request tax and other reliefs when they are running losses or have below-average profits as a result of wage increases. Given the Government's concern with income equalization, enterprises know that the Government is quite likely to oblige.

2.25. Cross-subsidization is substantial in all the reforming countries. In the case of Poland, for example, at around 10% of GDP, the amount of explicit subsidies alone (ignoring price advantages and other subsidization conveyed through indirect instruments, such as negative real interest rates) is extremely high and close to the level of profits after taxes of the consolidated socialized sector (Figure 1).[33] That is, in the aggregate, it is as if the whole volume of profits were reshuffled fiscally. In its efforts to avoid the appropriation of the rents of capital, Governments actually appropriate most of them to reallocate the proceeds among enterprises. In Hungary, subsidies to enterprises represent the largest item in the budget. In Yugoslavia, the profit-makers are taxed to subsidize loss-makers, or forced to finance them.[34]

2.26. In spite of these interventions, wage differentials remain. In the case of Yugoslavia, these differentials are wide and are widening. The coefficient of variation (standard deviation divided by mean) of wage rates in 33 manufacturing

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33 This figure includes all subsidies for which payments are made from the budget to enterprises. This treatment differs from that in the budgetary accounts, where a distinction is drawn between subsidies to the enterprise sector and subsidies to the population; the latter are subsidies from which the population is the direct beneficiary even though the corresponding budget disbursement may be to an enterprise. This distinction is not relevant for the current analysis because all these subsidies affect the profits of enterprises, and, therefore, the wages they can pay. The figure underestimates the amount of subsidization because it does not include subsidies intermediated to enterprises by financial institutions. Source: IMF.

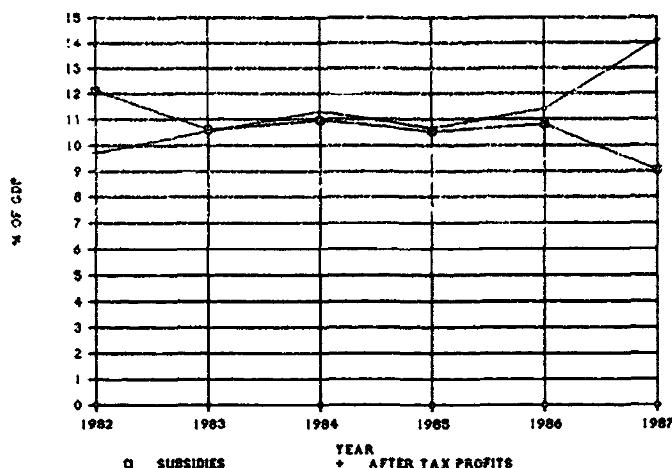
34 See Vladimir Konovalov, Yugoslav Industry: Structure, Performance, Conduct, Industry Development Division, PRE November 1989. This is an excellent analysis of the state of Yugoslav industry.

FIGURE 1

POLAND: SUBSIDIES TO ENTERPRISES C^^MPARED

WITH AFTER TAX PROFITS

(% OF GDP)



SOURCE: IMF

branches went from 0.30 in 1985 to 0.32 in 1986 and to 0.81 in 1987.[35] The rapid increase in 1987, a year in which the rate of inflation went up substantially, suggests that the Government's grasp on the enterprises' allocation of their surpluses is weakened by macroeconomic instability. There are at least three reasons to explain it. One is that not all wage contracts are signed the same month, which can make for important differences in highly inflationary economies. The second one, related to the former, is that high inflation leads to greater relative price variability, including wages. The third one is that workers are able to appropriate more of the rents of capital of their enterprises as a result

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35 See Fernando Saldanha, op. cit.

of the dilution of taxation caused by inflation. Since taxes and subsidies are the main instruments that Governments have to equalize wages, the weakening of taxation results in higher wage differentials.

2.27. This tendency is confirmed by the fact that, in Yugoslavia in 1985-1987, the real wage stayed approximately constant while the enterprises' net operating income per worker fell by 29% in the same period. In 1988, the manufacturing system as a whole had losses, as the wage bill exceeded the enterprises' net operating income. This could be a reversible trend. But it also could be a manifestation of a system that is capable only of unstable equilibrium. That is, a system that can be controlled when close to an original equilibrium, but which become less controllable the more it moves away from that original state.

b. The Resulting Rigidities

2.28. The lack of economy-wide factor markets cause strong rigidities in the economy. There are strong incentives for incumbent workers to oppose hiring new staff because they would dilute profits and would cause a fall in the income of all workers. Therefore, labor lacks mobility, and workers laid off have little chance of being hired by other enterprises. To counteract this effect, Central and Local Governments (and the Communist Party) intervene to force enterprises to hire new recruits. Such intervention results in pervasive overstaffing in at least Poland and Yugoslavia, which, in turn, causes losses to enterprises and provide a good argument for workers to ask for subsidies.[36]

36 Thus, the final effect is a combination of the incentives of the self-managed enterprise with Kornai's soft-budget constraint. However, it should be noted that the self-management system cannot subsist without the soft-budget constraint, not only because of the employment problem but also because of the tendency to decapitalize the enterprise and the other problems sketched in the previous Sections.

Still, although substantial, overstaffing does not solve the problem. In Yugoslavia, where estimates of overstaffing reach 30% of the employed, the unemployment rate is 16%.[37]

2.29. Also, once the profits have been distributed and the size of investment has been set, the system used to determine the remuneration of labor biases enterprise investment decisions in favor of capital intensive techniques, which provide more profits in absolute terms, cause lesser dilution of profits by requiring less additional hiring of personnel, and, therefore, result in higher wages for the existing working force. Also, incentives bias investment in favor of projects that maximize short-term returns.

2.30. The lack of differentiated labor and capital markets embodies another particularly damaging rigidity. Self-management is not conducive to investment in the creation of new firms and activities. Potential entrepreneurs have nothing to gain from their efforts to establish new enterprises because they cannot enjoy the returns from capital. Furthermore, since the remuneration of labor is higher in capital-intensive firms (which tend to be the old ones), workers do not have incentives to move out of old firms to become partners in new ventures. The existing firms are in operation because they already existed when their control was given to the workers.

2.31. Moreover, since the Government avoids getting involved in small companies because state management tends to be less efficient the smaller the size of the enterprise, past restrictions on the establishment and the size of private firms have resulted in an industrial structure comprising mostly large socialized enterprises, small scale private workshops and almost nothing in

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37 Roberto Rocha has found that Okun's Law (the rate of change in the unemployment rate is inversely proportional to the rate of growth of output) does not hold in Yugoslavia. The relationship between those variables follows a random pattern, which suggests that non-economic forces are strong in shaping it. See Roberto Rocha, **Inflation and Stabilization in Socialist Countries: Lessons from Yugoslav Experience**, EMTTF mimeo, forthcoming.

between. As a result, these countries lack the basis of medium scale enterprises that in other economies facilitates the mobility of real resources, both because smaller firms react more flexibly than larger ones when a shift in the allocation of resources is needed and because they are more easily created and destroyed than their larger counterparts.

B. THE PROBLEMS OF INDEPENDENT MANAGERS

2.32. The inefficiencies that socialized ownership has produced in its application in Eastern Europe are attributed to the fact that managers in socialist countries have never been truly autonomous. This is frequently contrasted with the experience in other countries--mainly OECD--where many Government-owned enterprises have been successful under the management of largely autonomous executives. Based on those experiences, the appropriate course of action would be to seek ways to ensure the true autonomy of managers under schemes similar to those used in successful countries.

a. Lack of Factor Markets

2.33. However, the conditions existing in countries that have been successful in managing their public enterprises can hardly be reproduced in socialist countries. Their success depends to a large extent on a delicate balance between a strong assertion of the ownership rights of the Government (which retains control over major decisions, including investment and disinvestment as well as overall control over borrowing) and decentralized day-to-day management (which is exercised by managers). Governments do not have to get involved in day-to-day management (which would be very inefficient) because they can judge the performance of managers by comparing it with that of private enterprises. This delicate balance is possible because the public enterprises coexist with a strong private

sector, which provides the signals against which public enterprise performance is benchmarked. The price of production factors is among the most important of those signals.

2.34. That is, in OECD countries public sector enterprises exist in an environment in which the price of factors of production and other basic prices are established by the competition existing in the private sector.[38] This is not true in socialist economies, where the majority of enterprises are owned by the Government. One owner does not make for a capital market. Without the possibility of benchmarking, the allocation of income out of production becomes again--as in centrally-planned and self-managed economies--a variable that can be changed for each enterprise. Thus, if managers are told to make profitable the enterprise, which level of profits should be acceptable? What should be the wage level? The answer to these questions can only be arbitrary, and only the owner, the Government, could provide them.

2.35. It can be said that there may be a way to establish reasonably good benchmarks through international comparisons, brought about directly (through foreign competition) or indirectly (through direct mandate from the Government). Theoretically, it should be possible. The Government could take an average of the returns on capital in countries with comparable development situations, adjust the figure for risk and demand from managers to extract at least this return from their capital. The wage rate would be a residual. In practice, however, such an exercise is impracticable for several reasons, among them the problem of valuing the capital goods on which the return would be extracted. Valuing capital goods requires assumptions on both the economy-wide rate of return on capital and wage rates, which are the variables to estimate. Arbitrary

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38 Competition for production factors and other inputs exists even if the publicly-owned enterprises are not in the same line of business than the private ones.

assumptions would result in serious distortions in the choice of techniques, which would be appropriate, not for the country's comparative advantage, but for the arbitrary setting of factor prices and everything that derives from them. The valuation of capital and labor requires the existence of factor markets.

2.36. In a nutshell, an economy cannot mimic something that does not exist. Although international mobility of capital and labor affect domestic factor prices substantially, international prices cannot be used to estimate the levels that these prices should reach in each economy. They depend on an extremely complicated interrelationship of factor endowment and institutional and country-specific forces that cannot be replicated in a workable model. Thus, in an environment where most enterprises are owned by the same owner, factor prices and incentives to managers can only be arbitrary. Being arbitrary, they can easily be changed through political means.

b. Accountability and the Unstable Autonomy of Managers

2.37. Moreover, although the system of independent managers has been tried several times, it has never existed for long. There have been at least four attempts to give autonomy to managers in Eastern Europe: In the Soviet Union during the New Economic Policy and in the mid-1960s; and in Poland and Hungary in the 1980s. However, the independence of managers has not survived for long in none of these cases. In the first two cases, the managers' autonomy was replaced by the assertion or re-assertion of central planning. In Poland and Hungary, it gave way to control by workers, excepting a minor percentage of the enterprises.

2.38. The failure of this system to survive as designed in socialist economies is often blamed on the specific circumstances prevailing in each of these cases, which allow other forces to take control of the enterprises. That is, the system

would be successful if only the Government, the Party or the workers did not interfere. Achieving this, however, would require actions much more complex than just stating the desirability of doing it. It may be impossible.

2.39. The instability of the system seems to be the result of the isolation of the manager as a representative of an absent and silent owner. Under a system where the owner (the Government) has explicitly agreed not to intervene in the management of the enterprises, managers are left alone against powerful forces that quickly fill the void left by the absent owner. Rather than facing these forces, managers accommodate them. These forces are primarily political. As Tamás Bauer puts it, ..."Enterprise managers as bosses in all forms feel themselves politically weak in reformed planned economies. Thus, they are inclined to give in quickly in any labour conflict, since a strike may endanger their position as subordinates of local (regional) party organs first."[39] This trend to accommodate workers' demands renders the system of independent managers equivalent to the self-management system.[40]

2.40. The pressures to fill the vacuum left by the owner, eliminating the autonomy of managers, comes from two complementary forces. One is the general perception that managers cannot be totally autonomous. They have to be accountable

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39 See Tamás Bauer, **The Microeconomics of Inflation Under Economic Reforms: Enterprises and Their Environment,"** mimeo presented in the Seminar on Managing Inflation in Socialist Economies, held in Laxemburg, Austria, on March 6-8, 1990, page 16.

40 Bauer, op-cit, quotes Janos Gács's **"The Passive Purchasing Behaviour and Possibilities of Adjustment in the Hungarian Economy,"** Acta Oeconomica, Vol. 28, Nos. 3-4, pps. 337-349, 1982, which uses the term "control by consent" to describe the management of these firms, where managers disregard efficiency in order to please pressure groups.

to someone for their actions.[41] If not, they can do undesirable things, among them stealing the enterprise.[42] The second is that the power of managers--as different from that of the Government, trade unions or owners in regimes organized on the basis of private ownership--is not autonomous. The owner and labor will always exist, and their respective interests will not change, even if their individual identity changes. Thus, when there is a conflict over compensation, the parties of the conflict are the owners and the laborers. Managers, by contrast, represent the interests of others and, therefore, can be changed at the whim of their master. The interests of the owners or laborers cannot be changed so easily.

2.41. As a reflection of this situation, managers do not have command over powerful instruments to advance their interests in case of serious conflict. Both labor and owners command such instruments. Workers can strike. A top manager that strikes is likely to be replaced immediately. An owner can close a company, or refuse to invest further in it if wage demands are too high. A manager cannot be expected to do such things without consulting the owner. Furthermore, a decision to close a company leaves the owners with at least the net assets of the enterprise, which can be sold. The capitalist can invest the proceeds in other activities. By contrast, the manager taking such a decision

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41 Quite frequently, the system of independent managers is taken as an equivalent of the system prevailing in many large capitalist corporations, where professional managers control enterprises for absent (and frequently unknown) owners. This equivalence, however, is misplaced. In capitalist economies, the managers are clearly accountable to the owners (directly or through the price of the shares in the stock exchange), and a committee of owners with relatively high exposure in the firm exercise firm control on the managers through the board of directors. This is true even of public sector enterprises in OECD countries. Enterprises where owners do not exert control exist in these countries, but the lack of control does not last for long.

42 For further discussion on this possibility, see next Section, on the coexistence of the socialized and private sectors.

becomes unemployed. Thus, the only weapon that managers can use in serious conflicts with the Government or the trade unions is to threat to resign, which the parties opposing them can accept only very gladly.

2.42. Without weapons of their own, independent managers caught in serious conflicts between capital and labor would tend to side with the more powerful of the conflicting parties. This party is likely to be labor in socialist economies, for at least three reasons.

1.43. One reason is that in these countries the owner is a political body, sensitive to the political pressures that workers can exert. If a manager antagonizes workers, it is easier to get rid of the manager than to support him or her. A second reason, that reinforces the first, is the intellectual stream in socialism that stresses the role of workers in the conduction of enterprises. This stream is manifest not only in theoretical writings throughout the history of socialism but also in official programs, such as those of Yugoslavia, Poland, Hungary and the 1987 program of reforms in the Soviet Union. The third reason is that in most of these countries the exercise of ownership rights by the Government is seen as a manifestation of the centralism that is blamed for the inefficiencies of the system. As a result, the Government becomes quite timid in exercising its ownership rights.[43] That is, the system has not ensured the existence of an advocate for capital and is unlikely to do it.

C. THE COEXISTENCE BETWEEN SELF-MANAGED AND PRIVATE ENTERPRISES

2.44. As a result of the new laws eliminating the restrictions previously imposed on private enterprises, the problems described in the preceding Sections

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43 A fourth reason is that, in wage disputes, the interests of managers tend to be closer to those of labor than to those of owners. If a union of managers were to strike over compensation, probably it would do it against the owners rather than against the workers (except when the workers are also the owners). Also, while owners frequently close enterprises temporarily to fight wage increases, it is quite improbable to have managers striking against wage increases demanded by the workers.

do not apply to the whole economy but only to the socialized sector. However, the rigidity they impose on factor mobility negatively affects the growth prospects of private enterprises. The rigidity of the self-management system restricts the flow of resources not only within the socialized sector but also the flow from the socialized toward the private sector. Since the socialized sector i‹ overwhelmingly larger than the private sector, and commands most of the capital stock, the availability of resources for the private sector cannot be taken for granted.

2.45. Recently, there has been some transfer of resources from the socialized to the private sector. These transfers, however, have been mostly in the shape of highly technical personnel. They move to the private sector because the wages that private firms are willing to pay for their skills are more attractive than the combined income that socialized enterprises can offer to them (a clear sign of higher efficiency). The transfer of human capital, however, is likely to be constrained by the rate of transfer of physical capital resources, which has been much smaller.

2.46. The Government's assumption has been that banks will solve this problem. The assumption is that they will be able to intermediate funds both within each sector and between them by receiving deposits from all sectors and offering them to the highest bidder, regardless of sectors. Yet, it is unlikely that the banks will be able to carry out this intermediation. There are several obstacles.

2.47. The financial system cannot be expected to perform its role unless interest rates are freely determined in the market and financial discipline is introduced through the elimination of subsidies and the enforcement of bankruptcy. Forced to pay market interest rates, and without access to Government grants, firms would have to constrain both their wage increases and their demand for credit in order to survive.

2.48. However, these conditions are necessary but not sufficient to ensure a positive supply response. Under the self-management system, the incentives for enterprises to ignore interest rates, even without subsidies, are strong. This is because self-managed enterprises do not have a natural instinct for survival in an environment where private ownership is allowed.

2.49. As it was discussed before, in an environment where private ownership of capital goods is not allowed, the incentives for workers to decapitalize their enterprise are tempered by the fear of losing their jobs without getting a substitute source of current income. In an environment in which private ownership of capital goods is allowed, however, workers could invest the proceeds of the decapitalization of the enterprise in other activities where they could appropriate the full benefits of their investment. They could buy capital goods and establish their own enterprises. Furthermore, if the socialized enterprise had access to credit, it could borrow to increase wages and benefits, so that workers would not have to wait for the real stock of capital to break down in order to appropriate its value.[44] In this way, they would "privatize" the stock of capital of the socialized enterprises. Resources would flow from the socialized to the private sector. The unstable nature of self-management would lead to its own dissolution.

2.50. This, however, is not a healthy way to privatize the socialized sector and this is not the kind of factor mobility that the Government would like to see. It would create a serious fairness problem because it would be equivalent to transfer to enterprise workers a stock of capital that is formally owned by all citizens, regardless of where they work. Equally importantly and perhaps more dramatic, such "privatization" would be incredibly expensive in terms of economic and financial disruption. These countries cannot afford the spontaneous

44 Borrowing to decapitalize an enterprise is not as bizarre as it sounds. This is precisely what happens when firms finance losses with credit, a phenomenon common to all countries in financial distress, including Poland, Hungary and Yugoslavia.

self-liquidation of the enterprises controlling most of its productive capacity. This back-door style of privatization is already taking place. It seems surprising that more cases are not yet happening, or at least reported.

2.51. The appropriation of socialized enterprises' capital has not been circumscribed to just the enterprises controlled by the workers. In Hungary, several enterprises controlled by the managers have gone through what has come to be called "spontaneous privatization," the transference of the enterprise's assets to a new private company at very low prices. Those transfers have been carried out in various forms, most frequently by both selling the socialized enterprise's inventories and leasing the equipment to the new firm at nominal prices. Managers agreeing to do this get compensation by getting stock of the new company, highly paid management positions or both. The Hungarian Government is considering the introduction of measures aimed regaining control of socialized enterprises to stop spontaneous privatization. The same phenomenon has taken place in Poland, where it is called "uwlascenie nomenklature." The new Government has stopped it.

D. NEEDED REFORMS

2.52. Solving the problems of self-management requires at least four actions. One, the Government should regain control of the self-management enterprises, "renationalizing" them. Two, although giving day-to-day autonomy to managers, it should establish a centralized system to manage the allocation of resources among these enterprises. Three, it should privatize a substantial portion of them. Four, the big conglomerates that exist in these countries should be broken into smaller companies. Annex I expands these recommendations, explaining their rationale and giving some ideas on how to implement them. The following paragraphs briefly summarize the rationale and some of the ideas.

a. Improving the Management of Socialized Enterprises

2.53. Regaining control of socialized enterprises is clearly a prerequisite for privatization and for improving the management of the enterprises remaining as part of the public sector. The establishment of a centralized allocation of resources for public enterprises is likely to be a more controversial recommendation. However, the mechanisms to give mobility to capital in the socialized sector can only exist if the Government assumes the role of the owner and takes the decisions required to shift resources across enterprises.

2.54. Mobility of capital comes precisely from the owners' decisions on whether to invest the profits of their enterprises in the same enterprise or take them away to invest in other activities; on whether to liquidate or restructure loss-making firms; on whether to sell firms or not. These decisions can only be taken by an agent external to the enterprise whose fate is being decided. That is, by the owner, which should decide how much to invest and in what activity and enterprise. Thus, centralization of investment decisions for socialized enterprises cannot be avoided if at least some mobility of capital is desired.

2.55. Also, the role of socialist enterprises should be changed from providing specific goods and services to the economy to that of maximizing the return on the capital they use. The Government should look at the socialized enterprises as means to obtain income,[45] and, as such, should keep on investing only in those promising higher incomes and should liquidate those promising only losses. Consistently with this objective, the Government should not expect from socialized enterprises any help in implementing macroeconomic or other general policies nor in supplying particular goods. Conversely, it should not grant any privileges to its enterprises.

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45 There may be some exceptions to this general approach, as the Government may choose to keep ownership of some industries deemed as strategic. These industries should be treated as exceptions in ways that minimize the distortions they introduce in the economy.

2.56. Thus, managing a large number of socialized enterprises would entail two levels of management, both of them concerned with obtaining the highest yield from the capital they manage. One kind of managers is needed at the enterprise level, responsible for making their enterprise profitable and for convincing investors (both public and private) to put resources on it. The other level, which could be organized as a holding company, would be needed to provide mobility of resources across the socialized sector and between it and the private sector. Thus, at the enterprise level, managers would work within a capital budget constraint, which they would be able to lift only by being profitable and by convincing the holding company that future operations will be more profitable than the alternatives open to the holding company. The two levels of management should be integrated so that they operate under the command of only one set of rules and, possibly, of only one institution.

2.57. Given the considerable opportunities for fraud and other crimes that the management of a large number of big enterprises would present to the employees of the holding company, a supervisory agency is also needed. Such agency should be totally independent from the holding company and also should report directly to the Prime Minister. Its primary tasks would be to ensure that transactions between the holding company and the enterprises, and between the holding and the private sector, are conducted at arms-length and on market terms; that the books of the holding company reflect the true value of the Government's capital; and to measure the performance of the holding by comparing the returns it obtains from its capital with the overall returns on capital in the private sector.

2.58. The Government also should reform the corporate tax structure as part of a wider tax reform, whose scope goes well beyond the subject of this paper. Certainly, it should eliminate ad-hoc taxation, establishing uniform tax treatment. Also, as the structure of ownership is reformed, the Government will be able to reduce to zero the subsidization of enterprises. This would give

room to reduce corporate income taxes to levels that would allow shareholders (including the Government in the case of socialized enterprises) to extract a good yield from their capital, thus providing natural incentives to investment.

b. Privatization

2.59. Also, it is necessary to reverse the relative sizes of the socialized and private sectors, making of private enterprises the majority. Even if the self-management system is replaced with a more efficient form of organization for the socialized enterprises, the enormous relative size of the socialized sector seems to be hardly conducive to factor mobility. The diversity of responses to shifts in market signals, the entrepreneurial spirit so essential for a fast supply response, would still be missing. Given its gigantic size, the Government would not tend to be a price taker in the market, even if it grants no privileges to its enterprises. Also, as it was pointed out before, the management of public sector enterprises becomes extremely difficult if the private sector is not predominant. If a quick development of factor mobility is desired, rapid privatization of a substantial portion of the socialized enterprises is necessary.

2.60. There are some proposals aimed at keeping the self-management system in place while improving factor mobility and incentives, among them making people pay for the right of working in an enterprise and thus enjoy the rents of its capital. These systems present problems of their own. Although paying for the right to work has been successfully applied in some individual cooperative enterprises inserted in market economies (such as Mondragon in Spain), it is difficult to think of a whole economy working in that fashion. In Mondragon, workers hold participations in the firm's capital. Nobody can own capital without working in the enterprise, nobody can work in the enterprise without owning its share. Requiring each new worker to buy shares of the enterprise to be able to get a job, and to sell it when leaving, seems impractical in an economy-wide scale.

2.61. More important, however, is the fact that Mondragon is a voluntary organization. Forcing companies from the top to become Mondragon-type organizations would give the wrong signal to their participants, who would then believe that their presence in the organization is indispensable. This would worsen the problem of firing people that is inherent in the Mondragon organization, potentially generating again Kornai's soft-budget constraint if the Government is committed to have the economy based exclusively on this model. Of course, this does not mean that Mondragon-type of enterprises should not be allowed to exist. If people want to organize in that fashion, they should be allowed to do it.

2.62. However, it seems improbable that many would be created. The fact that Mondragon has remained an isolated successful case for decades, when nothing would have prevented its replication in Spain and in other countries, suggests that conventional private enterprises are more practical forms of organization. Some reasons that could explain this fact are the problems involved in organizing enterprises from scratch (who will risk the initial capital if all members of the cooperative should have equal rights as capitalists?), the lack of incentives for innovation, and the difficulties in creating new ventures in other places and in managing conglomerates diversified geographically.

2.63. Thus, privatization, turning enterprises into conventional joint-stock companies, seems to be unavoidable if true decentralization of economic decisions is to be achieved. Privatization through selling enterprises, however, would take decades to create the critical mass needed to have a functional market. The alternative is aiming at a fast privatization through transferring the ownership of enterprises without payment. There are many options to do it, some of which are sketched in this paper and Annex I. Probably, if the Government chooses to pursue this approach, the best solution would be to implement a mix of those options.

i. Transfer Without Payment

2.64. Privatization does not necessarily have to be carried out through selling the enterprises. In fact, the population already owns the firms through the Government. Thus, the Government should charge for the transfer of shares only if the enterprises are given to a subset of citizens, (these citizens would have to pay for the enterprises in order to compensate the rest of their fellow citizens for the capital stock they are taking away from them). However, if the enterprises are given to all the citizens, they would have to pay nothing because all of them would acquire in shares what they already notionally have.

2.65. Giving away the enterprises to all citizens is an appealing solution because it would solve three serious problems that would hinder the sale of the enterprises. First, since capital markets do not exist, the value of the enterprises, and therefore the price of their shares, is not known. Second, privatization can be carried out in a relatively fast way. Selling the enterprises would have to wait for the completion of liberalization. If not, the possibility of misleading investors would arise because the value of enterprises would change significantly with the planned liberalization of the economy. A third problem is the perception that the population has not enough purchasing power to buy the enterprises, or that, if it exists, is unevenly distributed.

2.66. If the titles to the ownership of the enterprises are transferred without payment to the population, the problem of lack of purchasing power disappears. Also, if privatization takes place through distributing shares to all the citizens, there is no need to value the stock of capital. The shares distributed to the population would represent the right to a fraction of the net worth of the enterprise and to the profit it generates. The price of that share would change with time, as the value of the firm changes as a result of the success or failure of its operation. The problem of creating deep financial

capital markets also could be solved if enterprises are transferred to the population. If a large transfer is effected, trade in shares can be expected to be heavy from the very beginning.

2.67. Transferring ownership without payment, however, presents two serious problems. First, the difficulties involved in transferring the shares in a way that is both fair and practical. Second, and more fundamentally, a completely dispersed private ownership would present problems similar to self-management. Without a controlling shareholder, management would be free to do with the enterprise according to its wishes, and the result could be chaos.

2.68. Regarding the first problem, the fairest solution would be to allocate shares of all enterprises to each citizen, to each citizen registered to vote or to each family. The transfers would involve complicated operations to identify the potential recipients, tracking them down and handing them the shares. However, there are in place mechanisms that could be used for the distribution, including the system to allocate rationing cards. The logistics of distributing the shares to the population would not be different to that used for each rationed commodity.

2.69. The other problem would be the lack of the controlling interest needed to discipline managers that would accompany the dispersion of ownership. One option would be to aim at a mixed solution, comprising both the transfer of ownership without payment in an initial phase and the sale of shares in a subsequent one.

2.70. For example, the Government could distribute 80% of the shares of the first few sets of enterprises to the population, retaining the remaining 20% to keep control of their management. That 20% would be sold to a controlling interest (domestic or foreign) after trading on the distributed shares had determined their prices. Since this sale would convey control, the Government

may charge a premium on that price (the alternative for the entrepreneurs seeking control would be to buy more than 20% from the population, a transaction that would be more costly).

2.71. The transfer of shares could be organized through the holding companies recommended above for public enterprise management. There are many alternative ways in which the holding companies, transformed in mutual funds, could be used for this purpose. For example, the initial transfer could take place in the form of distribution of the shares of the mutual funds, which could subsequently be exchanged for shares of the enterprise themselves or of other mutual funds. Another possibility would be to create pension funds covering all or most of the working population, and endow them with the shares of the enterprises. The pension funds would be able to trade shares with each other and with the population.

2.72. This solution presents several advantages in addition to providing more incentives to the new shareholders to care about their investments. First, it would use the institutional setting built to manage the public sector enterprises. This would not only economize in terms of the creation of institutions but also would facilitate future privatization decisions. Second, this solution would establish the basis not only for the development of individual trading in shares but also would establish a parallel track of institutional investors.

2.73. A source of legitimate concern in all schemes involving the creation of financial capital markets is that many people can suffer heavy capital losses in an environment where information on the earnings potential of enterprises is almost non-existent. This is almost unavoidable in reforming socialist economies, not only because information about enterprises do not exist but also because much of this information will become irrelevant as a result of the reforms. The result of initial trading would almost unavoidably be a substantial shift in the countries' distribution of wealth.

2.74. Giving away the shares reduces the risk of people losing part of their current personal wealth in the inevitable turmoil. However, as a result of the initial distribution and the trading of shares, some people would become quite wealthy while the gains of others would be small and others would not gain anything. To reduce this risk further, trading in shares could be initially restricted to the mutual funds only, which would be closer to the enterprises and could devote time and resources to gather information about them. Once a minimum mass of information had been gathered and published, trading with individuals would be allowed.[46]

2.75. The transfer of shares to individuals without payment has been tried successfully at least in two instances, although not in the scale proposed for Eastern European countries. In Canada, the Government of British Columbia privatized the British Columbia Resources Investment Corporation by offering 5 free shares of the enterprise (worth C$10 each) to each Canadian citizen or applicant residing in the province for at least one year. Those people also could buy up to 5,000 more shares each. In Chile, the two largest banks in the country were privatized by selling share packages to taxpayers under conditions that effectively reduced the price of the shares to zero.

ii. Directing Gross Investment Toward the Private Sector

2.76. Another strategy to privatize the economy would be a variant of that used by South Korea to reduce the size of the public sector in the 1950s. This strategy would consist essentially in stopping the financing in any form (budget or banking system) of the investment of the socialized enterprises. This would liberate the total resources of gross investment in the economy for the use of

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46 This solution was suggested by Jean Tirole from MIT in a seminar held in Washington to discuss a previous draft of this paper.

the private sector.[47] Socialized enterprises would be forced to become self-reliant in their investments, which means that they would have to generate large profits. Otherwise, their absolute size would be reduced by sheer depreciation. Socialized enterprises would have a third option, which would be under the scheme: to find private investors willing to acquire a substantial share of the enterprise' equity capital. With all gross investment going to the private sector, the transformation of the economy into one dominated by the private sector may be relatively fast.

2.77. This scheme is attractive because of its simplicity. Also, it has worked in an economy-wide scale in a successful country. However, it imposes a continued political strain for several years that could break the Government's determination to carry it out. Socialized enterprises can be expected to use all of its power to reverse the situation and become the subject of all financing at the margin. Even if the Government is able to resist initially, it is doubtful that it would resist for several years in the Eastern European context.

2.78. Also, the Eastern European economies are quite different from what South Korea was in the 1950s, even if the relative size of their public sector is similar. In the 1950s, Korea's capital basis was much lower than that of the Eastern European countries of today. Condemning public sector enterprises to decline did not imply losing the enormous installed capacity that Eastern European countries have. If they follow this strategy, they would have to rebuild the entire industrial sector.

iii. Selling the Enterprises to Workers

2.79. Giving away the enterprises to all the population or cutting the access of socialized enterprises to financial resources could be seen as too radical and complex solutions. However, it seems that all solutions are complex

47 This strategy was proposed by Lawrence Iau from Stanford University in a seminar held in Washington to discuss an earlier draft of this paper.

because the problem is quite complicated. For example, one solution that seems to be simple and quick to implement, selling the enterprises to the workers on credit, poses many difficult problems. As in any other scheme involving sale, the main problem is the valuation of assets. Another problem how to ensure a quick concentration of power into a small group of people that would be able to take and enforce decisions that could be unpalatable to many workers. A related problem is to whom the assets should be sold, the workers or their union.

2.80. One possibility to deal with the valuation problem would be to defer the valuation of assets to a moment in the future when a capital market had been established. This mechanism, however, establishes the wrong incentives for the new shareholders, which would quickly realize that they gain by decapitalizing the enterprise before the date of valuation. The more they increase their compensation before that date, the lower the price they would have to pay for the assets existing now. This problem may have no solution.

2.81. Also, selling the enterprise to the union would leave the power of decision in a body that is likely to surrender to political forces, inside and outside the enterprise. If the shares are sold to individuals on an equitable basis (equal number of shares to each worker), the concentration of power needed to take decisive action would not happen, at least not quickly. Concentrating the distribution of shares into a smaller group, such as managers, would create serious political problems, especially because, with control of the enterprise, managers could transfer the value of the assets to themselves before the day of valuation, thus defrauding both the Government and their fellow workers. Any solution contemplating the sale of the enterprises to workers should solve these issues.

c. Breaking Up Conglomerates

2.82. Also, very importantly, the Government should significantly reduce the size of socialized enterprises. Currently, these enterprises are huge

concerns that, if functioning under market rules, would command enormous monopolistic and monopsonistic power. Reducing their size through splitting them into several competitors for each industry is necessary to ensure an efficient functioning of the market. This downsizing should take place for both the firms that would be privatized and those that would stay in the public sector.

d. The Banking System

2.83. The rigidities of the self-management system are not the only obstacles to factor mobility in Eastern European countries. The removal of those rigidities is a necessary but not sufficient condition to introduce flexibility in the economy. The rigidities existing in the embryonic financial system are also important. The existence of these rigidities is not surprising. The banking system played a secondary role in the allocation of resources under the central planning system. It was only when the Governments decided to decentralize economy that they started to develop a financial sector to entrust it with the key responsibility for the allocation of resources in the economy. Chapter III and Annex II discuss some of the problems faced in developing an effective financial system.

e. Establishing A Social Safety Net

2.84. In most Eastern European countries, unemployment causes greater hardship than in OECD countries because of two reasons. One is that there are no unemployment benefits. The other one is that enterprises provide a substantial portion of the social services available in the economy, including housing. As a result, people lose not only their jobs but also access to many social benefits when they become unemployed.

2.85. The stablishment of unemployment benefits and of an independent social security system is urgent. These actions should precede the restructuring of the economy. The initial restructuring of enterprises would most likely result

in a large increase in long-term unemployment. Moreover, factor mobility in these economies would require an increase in the levels of frictional unemployment now existing in Eastern Europe.

E. SUMMARY

2.86. The discussion in this Chapter has centered on the self-management system because this is the model most Eastern European countries are tending to implement. The analysis of the incentives imbedded in the system suggests that self-management is inefficient and unstable. Moreover, to reduce its instability, it requires the Government intervention that it is supposed to replace. Experience in Yugoslavia tends to confirm these results.

2.87. Thus, it seems that, as long as the socialist nature of these countries is kept in place, their Governments will have to face a stark choice regarding what kind of Government intervention they want to have. One possibility would be to reinstate central planning. The other would be to intervene to transfer resources from one enterprise to another, in an ad-hoc way, to keep investment going and ensure an equal distribution of income. In both cases, intervention would preclude the attainment of flexibility and strong growth. Eliminating intervention altogether would most likely result in chaotic situations. If private ownership is allowed, one of the results of this chaos could be a transfer resources from the socialized to the private sector, but in an unfair and disruptive way. Such choices need not exist. It is better to substitute the self-management system with a more efficient form of ownership that could allow for an efficient and smooth flow of resources.

III. THE IMPLICATIONS FOR A STABILIZATION AND STRUCTURAL REFORMS PROGRAM

3.1. As it was pointed out in Chapter I, there are substantial differences among the reforming countries and between them and the other countries in the

region. Thus, as it was done with the diagnostics, the discussion of the options to transform these economies into markets is based on stylized facts common to all or most of them.

3.2. The reforms needed to introduce market forces in the Eastern European countries are manyfold and complex. In addition, stabilization is urgently needed in at least Poland and Yugoslavia. It is very likely that stabilization will be a prime concern in other reforming socialist countries as well. Most of them show signs of excess demand. Moreover, as it is discussed in this Chapter, the reforms process introduces strong pressures on the price level. By increasing the role of prices and money, reforms will shift the symptoms of imbalances from scarcity to inflation and balance of payments problems.

3.3. This Chapter discusses some of the most important linkages between structural reforms and stabilization. It discusses first the shape of a stabilization program ignoring the complications introduced by the structural problems. Then, it analyzes the implications of those problems for the chances of success in stabilizing the economy. Chapter IV discusses the implications of these linkages for the sequencing of a combined program for stabilization and structural reform.

A. THE STABILIZATION PROCESS

a. Enterprise Losses

3.4. Inflation or current account deficits, the symptoms of macroeconomic imbalances, are always means to finance excess nominal domestic demand caused by a deficit somewhere in the economy. As in other economies, the stabilization of Eastern European countries should consist of the elimination of such excessive demand. This elimination can be achieved through substituting non-inflationary

domestic debt for the inflation tax as the way to finance the deficit.[48] In this case, the reduction of nominal domestic demand is achieved through the financial system. Credit to other sectors is contracted in order to finance the deficit that was previously financed with inflation. This solution, however, can be applied only temporarily because, by directing financial savings to cover the deficit, it crowds out other activities, which are not in deficit, in order to finance a deficit. This is a perverse allocation of resources.

3.5. Then, in order to be sustainable, stabilization policies should include measures aimed at eliminating the deficit of real resources that inflation was helping to finance. If the need for those resources is not eliminated, inflation or balance of payments problems are likely to recur. Since in most cases the proceeds of the inflation tax are used to finance fiscal deficits, conventional stabilization packages eliminate the need for inflation taxes by balancing the budget. If any deficit remains, stabilization requires that it should be financed without recourse to monetary creation.

3.6. In Eastern Europe, the accounts that should be balanced are not only those of the fiscal budget but primarily those of the enterprise sector and the banking system[49], which has absorbed a substantial portion of the enterprise losses. The magnitude of those losses is quite significant. In all three

48 External financing can eliminate inflation but not the underlying macroeconomic balance. It changes the symptom of the imbalance from inflation to current account deficits. Once the borrowing is over, inflation returns.

49 The term banking system is used in this paper as comprising both commercial banks and the Central Bank.

countries the stock of losses of the Central Bank alone amount to more than 30% of GDP. These losses have been gradually monetized, leading to high inflation rates in Poland and Yugoslavia and lower but significant instability in Hungary.[50]

3.7. The losses in the banking system are just the reflection of losses in the enterprises. Banks have absorbed such losses in three main ways. First, by absorbing the losses caused by real devaluations on the enterprises' external debts. Banks in Eastern Europe have done this both ex-ante (assuming the foreign exchange risk at the moment of borrowing) and ex-post (picking up the tab after their customers failed to service their external obligations). In most cases, the Central Bank has assumed directly these losses. A second way of absorbing enterprise losses has been the provision of subsidies to enterprises in the form of loans at highly negative real interest rates. Again, Central Banks have played a major role in orchestrating the provision of these subsidies. A third way is the large losses that banks are taking in the form of uncollectible loans. Central Banks have financed the absorption of all those losses through monetary creation.[51]

3.8. In addition to macroeconomic imbalances, financing those losses have resulted in the perverse allocation of resources that typically prevails in financial crises. Bad debtors crowd out potentially good investors out of the credit market. In Eastern Europe, there are at least two types of agents willing

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50 For a more detailed discussion of the effects of enterprise and banking losses in generating instability see Manuel Hinds "Stabilization and Structural Adjustment in Yugoslavia," EMTTF March 1986 and October 1987, and Roberto Rocha, op-cit, May 1989.

51 The first two forms of transmission of losses to the banking system, absorption of the foreign exchange risk and subsidized credit, have allowed loss-making enterprises to survive, and even to appear as profitable. When estimating the total extent of the enterprise losses, the banking system's losses on these accounts should be added to those of the enterprises. The banking system's loan portfolio losses, however, appear in both the enterprises and the banking system. They should be counted only once when estimating the total losses.

to accommodate the financial needs of insolvent enterprises. One is the Government, which, in addition to imposing interest rate ceilings that are highly negative in real terms, transfers resources in other ways to loss-makers. The subsidized credits get to loss-makers and not to other borrowers because the second agent, the banks, would become publicly insolvent if they do not continue to finance the loss-makers, which would stop servicing their debts to banks if they do not receive more credits. Trying to keep a positive--or at least a non-negative--flow of funds to bad borrowers is typical of financial institutions in distress.

3.9. This perverse allocation of resources has kept on going in Yugoslavia, where interest rates were liberalized. Within the free environment, excess demand for credit from insolvent but still operating borrowers have pushed interest rates to levels much higher than the yields of even the most efficient investments, thus crowding out potential productive investments.[52]

b. Options for Stabilization

3.10. As it was sketched in the previous Sub-section, the stabilization of an economy suffering from a deficit in the enterprise sector is conceptually equivalent to that of stabilizing one with a deficit in the public sector. This has been clearly understood by now. However, when coming to ways to reduce nominal domestic demand, there seems to be a confusion between two different approaches. One approach is to reduce it at the source of excess demand, eliminating the losses. Another, different approach, would be that of producing a surplus in another sector of the economy, the budget, that would compensate for the enterprise losses.

52 Of course, in Yugoslavia, investors able to carry out those investments may fail to appear because of the problems of self-management. But that is a different problem.

3.11. It is easy to think that these two solutions are one and the same if one identifies the subsidies that the Government is providing to loss-makers, directly and through the banking system, as the source of macroeconomic instability. This is not so. Raising taxes or reducing other Government expenditures to cover losses results in the same perverse allocation of resources that is now plaguing Eastern Europe. It is the same perverse allocation that results from reducing instability through crowding out non-deficit sectors in the financial system. It is not sustainable in the long run.

3.12. Thus, transferring current losses to the budget and balancing the budget can be used only as a temporary device to stabilize the economy while losses are being reduced. It can be used also as a device to mobilize public support for the drastic and painful measures needed to reduce the losses. People knowing that they are paying higher taxes to keep in operation loss-making enterprises are likely to exert pressure on the Government to stop the subsidization of the loss-makers. But a sustainable solution requires that losses be eliminated.

3.13. How can the Government reduce those losses? Losses can come from several different combinations of quantities and relative prices, all of them resulting in costs exceeding revenues. Looking at the consolidated statement of income and expenditures of enterprises, losses could arise from excessive financial costs, excessive cost of material inputs (including capital) or excessive wage bill (which could come from excessive wages, overstaffing or both). Loss-makers could be classified according to these three sources of losses. A fourth cause of losses would be the consistent understatement of output prices relative to wages, given all the other variables.

3.14. Eastern European enterprises are suffering losses from all of these sources. They have excessive debts, suffer from serious inefficiencies that result in too high material costs and are overstaffed. In the very short term, however, the Government has only a very limited scope for action. Losses arising

from excessive debts cannot be reduced except by defaulting on them. This would imply defaulting on external creditors, banks' depositors, or both. Governments have refused to do this. They are sustaining the operations of bankrupt banking systems and servicing the external debt without getting the resources to do it from the debtor enterprises or their bankers. A change in this is not likely to happen. Therefore, for stabilization purposes, the best that the Government can do is to finance these expenditures in a non-inflationary way.

3.15. Non-inflationary financing would require including the service of these debts in the fiscal budget and then balancing the budget. To spread over time the impact on the budget, the Government can issue bonds in local currency to recapitalize the institutions that have incurred in losses as a result of the service of the external debt. In Poland, all of these losses are concentrated in Bank Handlowy; in Hungary, in the Central Bank; in Yugoslavia, they are spread among the Central Bank, commercial banks and enterprises. The same solution can be applied to cover the portfolio losses of commercial banks. The monetary impact of this operation on the budget would be the service of these bonds. Thus, Governments should either raise taxes or reduce other expenditures in amounts equivalent to the service of the bonds.

3.16. On the other hand, losses coming from inefficiencies in the use of material inputs and excessive wage bills can be avoided. So, the Government should concentrate its efforts in cutting these losses. Increasing the overall efficiency of enterprises would require a deep structural reform aimed at privatizing a substantial portion of the socialized enterprises and at improving the efficiency of the management of those remaining in the public sector.[53] Although it is essential to carry out these reforms in the medium term to give sustainability to the process, the stabilization of the hyperinflationary economies of Poland and Yugoslavia cannot wait until this process has been

53 See Chapter II and Annex I.

finished. Thus, the only option open to the Government in the short run is to reduce the wage bill through reducing either overstaffing, real wages, or both. Self-management presents serious obstacles to accomplish this.

c. The Problems of Self-Management

3.17. Self-management presents two serious problems for the stabilization of self-managed economies. One is that self-managed enterprises do not have the incentives to react positively to the monetary mechanisms used for macroeconomic stabilization. The other one is that socialist economies lack the mechanisms to avoid the contractionary effects of the reduced domestic demand on the country's production and employment.

i. The Transmission of Stabilizing Forces

3.18. The first problem refers to the feasibility of the stabilization itself. It is very difficult for self-managed enterprises to adjust. In the very short run, enterprises could adjust by either reducing their labor force, reducing their wages or both. Actually, both solutions would result in a lower real wage in the short run in a market economy. People sacked to eliminate overstaffing would look for jobs at a lower wage rate, thus lowering the economy's overall wages. In a self-management system, however, the availability of people offering their work for lower wages does not affect the wage level in enterprises. It does not make sense for employed workers to reduce their own salaries to hire new workers that would take a share of the increased profits.

3.19. As a result, wage resistance is fierce in self-managed enterprises. If forced with macroeconomic instruments to reduce expenditures, workers would reduce investment or decapitalize their enterprises (especially now that private ownership is allowed) rather than reducing their own wages. If workers do not believe in the seriousness of the Government's stabilization program, their best bet is to keep on increasing their wages to maintain or improve their acquisitive power vis-a-vis the rest of the economy. If they become convinced that the

Government is serious, and that their company faces bankruptcy (or that they may be fired), their best bet is again to increase their wages to extract as much as they can from the enterprise before they become unemployed. Since enterprises tend to be grossly overstaffed, individual workers would perceive the risk of being fired as very high, which would strengthen their incentive to decapitalize the firm while they still can.

3.20. Moreover, self-managed enterprises are very rigid concerning the size of their labor force. As much as they are unlikely to hire new people voluntarily, they are also reluctant to sacking redundant workers. Although there are some rules that could be applied to sack a portion of the workers, such as last to come is the first to go, the political difficulties involved in workers firing fellow workers are likely to be substantial. It has never happened.[54]

3.21. Moreover, enterprises can go a long way in financing wage increases in the absence of credit from the banking system. As experience in Yugoslavia and Poland shows, enterprises start lending to each other if they cannot get credit from banks. This increases the velocity of money, reducing the effect of contractionary monetary policies.

3.22. But, Why should cash rich companies lend money to loss-makers? Because, as a result of the rigid economic organization, there is no competition. Monopolies and monopsonies abound. Enterprises cannot function if they do not sell, and if their only customer goes under, they go under too. Thus, it is in the interest of everybody to give credibility to financial paper issued by clearly insolvent companies. Also, the more such credibility is granted, the more an externality effect against the Central Bank is created. By the time the possibilities to trade on paper are ended, the Central Bank faces a situation in which sticking

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54 Recently, there have been substantial layoffs in Poland. These, however, have taken place in enterprises still controlled by the Government. Also, many of the sacked people have been absorbed through increasing the overstaffing of other enterprises.

to contractionary credit would mean the bankruptcy of both profitable and loss-making enterprises, because the former hold large amounts of paper from the latter. At this moment, the Central Bank opens the gates of monetary creation. This is a stylized description of what has happened several times in Yugoslavia. Interenterprise credit is also pervasive and growing in Poland.

3.23. Within this environment, a process similar to spontaneous privatization would most likely flourish. Because of the speed of the process, the transfer of assets to private agents probably would take place in the more chaotic way of wage increases leading to decapitalization rather than through joint ventures transferring the enterprise's assets to private companies. The number of enterprises going bankrupt would be unnecessarily high.

ii. The Supply Response

3.24. The second problem of stabilizing a self-managed economy refers to the possibility of reactivating the economy after stabilization. In market economies, the contractionary effects of reducing the rate of growth of nominal domestic demand are minimized through the shift in the allocation of resources, from non-tradables to tradables, elicited by a real devaluation. Larger exports and increased import substitution provide new markets that compensate for the reduction in domestic demand. For this to happen, however, factor markets should exist. Since factor markets do not exist in self-managed economies, this shift in resource allocation is unlikely to take place, at least within a reasonable period. People laid off would not find new jobs.[55] This can raise the costs of adjustment to extremely high levels in terms of output and unemployment.[56] As

55 This effect would be magnified by the labor immobility caused by lack of housing markets. Unemployed people living in city A will not move to city B even if offered a good job because of the impossibility of getting a house there.

56 The costs would be particularly high in terms of unemployment because enterprises are substantially overstaffed. So, they have a wide margin to layoff people before starting cutting production.

a result, the Government's motivation to stabilize the economy may falter.

iii. The Implications for a Stabilization Program

3.25. Thus, self-management presents formidable obstacles to reduce the wage bill with macroeconomic measures. These obstacles would easily derail a stabilization program. Thus, it seems that regaining control of the socialized enterprises is one of the minimum requirement to carry out a successful stabilization program. This would help in overcoming the obstacles even if the Government is not able to establish an ideal way of managing public enterprises. The only thing that is needed for a temporary stabilization is that managers should be able both to fire workers and to control wages in response to restrictive monetary and fiscal measures.[57] Once Government control has been reestablished, the Government should decide on the best way to reduce the wage bill: reducing real wages, reducing overstaffing, or both.

3.26. The best alternative, both for the short and the long term would be to lay off workers, giving them a severance payment as part of a safety net to reduce human costs. This solution has several advantages. In addition to reducing the wage bill, layoffs would increase the overall efficiency of enterprises, which is good in itself and also would facilitate the subsequent restructuring. Also, the sacked people could use the severance payments to establish small businesses, especially in services, which are so badly needed in the Eastern European countries. After the reduction in the wage bill is achieved, the most difficult part of the problem should be faced: how to generate a supply response. It is difficult to see how this would be generated from self-managed enterprises.

57 Obviously, Government moves to regain control over the enterprises, and to exercise it, would be strongly opposed by workers with strikes and other ways of protesting. However, workers would do the same if macroeconomic stabilization measures were effective without renationalizing the enterprises.

B. REFORMING PRICES

3.27. As it was mentioned before, sustainable stabilization programs should include shifts in relative prices to elicit a movement of resources toward the activities that could lead economic recovery. In most market economies, the shift in relative prices that is needed is just a real devaluation because the main price distortion is that of tradables relative to nontradables. However, in socialist economies, price distortions are more pronounced and widespread. Sustainable economic recovery requires both devaluations and substantial price liberalization, which should include trade reforms.

a. The Pressures on the Price Level

3.28. The need for redressing relative prices in reforming socialist economies complicates stabilization substantially. A realignment of relative prices is likely to require a drastic increase in the prices prevailing in the official market. In order to avoid such increase, prices that are too high would have to fall in nominal terms. Since the money value of wages tends to be too high relative to the money value of the supply of goods and services in the official market, the program would have to include a reduction of nominal wages as well as reductions in the nominal prices of many goods. Even fully private enterprises would find it very difficult to force nominal wage reductions and, therefore, would most likely go bankrupt if the price of their product goes down in nominal terms.

3.29. The overhang further complicates stabilization. Because of the overhang, the Government may fail to strike macroeconomic balance while keeping the price level constant by simply stopping monetary creation. Monetary expenditures would remain excessive as a result of the unloading of the overhang.

That is, prices would keep on increasing, fueled not by monetary creation but by an increase in the velocity of money. Prices would continue to increase until real cash balances held by the population declined to an equilibrium level.[58]

3.30. These two problems should not in principle cause an increase in the rate of inflation but only a correction of the price level. In practice, however, the shift in the price level would have to be so large, and its distributional impact so strong, that the danger of accelerating inflation permanently with accommodating monetary policies is very high. This is confirmed by the experience in Poland, where hyperinflation started in 1987-1988 with the Government's attempt to redress relative prices while accommodating an increase in the price level.

3.31. However, the costs in real output of trying to keep the official price level constant while stabilizing seem to exceed the costs of increasing the price level. Moreover, such an approach seems to be unsustainable. Given the downward rigidity of most nominal prices, a price reforms program aiming at shifting relative prices without increasing the price level is likely to result in serious inconsistencies that would eventually derail the reforms program. Furthermore, the removal of such inconsistencies may lead to an explosion of inflation if carried out under the strong political pressures caused by the inconsistencies

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58 Another source of pressures on the price level would be the introduction of check payments that is likely to accompany the creation and strengthening of the banking system. The introduction of check payments will undoubtedly increase the banking system multiplier, increasing the supply of money even if the creation of reserve money is stopped. This problem, however, is not pressing now and will become important only gradually.

themselves.[59]

b. Trade Liberalization

3.32. The economies of Eastern Europe have been able to keep quite distorted structures of relative prices through the extensive use of quantitative restrictions to trade. In the absence of trade liberalization, free relative prices would settle on levels that would still be quite distorted because they would correspond to domestic demand and supply conditions, which surely diverge substantially from those prevailing in the international markets. For example, with a monopolist industrial sector, the price of industrial goods would most likely rise relative to agricultural goods, where competition is higher in most socialist countries.[60] Falling demand for agricultural goods would prompt a decline in the next agricultural season, causing an unneeded aggravation of the food supply problems that plague so many socialist economies.

3.33. Monopolistic pricing also can delay and complicate the effects of a stabilization program.[61] This seems to be happening in Poland in early 1990.

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59 Several countries in Latin America tried to correct the distorted relative prices of currency overvaluation without devaluing in nominal terms in the early 1980s. In Chile, nominal prices of nontradables and nominal wages actually started to decline in early 1982. As a result, inflation during those months was negative, which, combined with a fixed nominal exchange rate, was equivalent to a real devaluation. The speed at which nominal prices were falling, however, was too slow to equilibrate the balance of payments, which continued to be in deep deficit. Also, the contraction needed to force nominal prices to go down caused a 25% drop in real GDP. Eventually, the Government of Chile, as the other Governments pursuing the same strategy, decided to have large nominal devaluations.

60 Damaging shifts of relative prices against agriculture have happened at least twice in price liberalization programs in socialist economies. One instance is the "Scissors Crisis" of the early years of the New Economic Policy in the Soviet Union (see Chapter I). Also, in January-March 1990 in Poland, agricultural prices have stayed or fallen, while industrial prices have increased substantially, for a combined increase in the price level of over 80%. See next paragraph.

61 See Barry Bosworth, **Incomes Policies in Socialist Economies**, paper presented in the Seminar on Managing Inflation in Socialist Economies, Laxemburg, Austria, March 6-8 1990.

There, the Government has been able to control wages while industrial prices have gone up by at least 80%, for a reduction in the real wage of about 33%. The combination has resulted in a sharp contraction of domestic demand that has caused a contraction in real output on the order of 20-30%. If this diagnosis is true, recovery requires a reduction of industrial absolute prices, either spontaneously or as a result of increased imports of industrial goods (thus far, imports remain depressed and the country is running a trade surplus). The success of the program depends on the socialized enterprises' ability to do it while becoming profitable.

3.34. Thus, trade liberalization is an essential part of price reforms. Actual or potential competition from abroad would provide a guidepost for the domestic relative prices of tradable goods. Initially, trade reform should consist of replacing quantitative restrictions to trade with uniform tariffs roughly equivalent, in their aggregate effect on the balance of payments, to the replaced restrictions. Subsequently, the tariffs should be reduced according to a pre-announced schedule. This would give some time for enterprises to adjust their operations to the newly competitive environment and would reduce the pressure on the exchange rate (and therefore, on domestic prices) that a sudden liberalization would exert. This process has to be coordinated with the dismantling of the CMEA scheme, which is starting to take place.[62] All these actions would help in setting relative prices closer to their international levels. However, trade liberalization by itself would not eliminate the need for a jump in the price level and would not reduce the inflationary pressures of the price reforms process.

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62 The dismantling of the CMEA scheme will bring about several important issues, among them a shift in the countries' terms of trade. Discussing these effects goes beyond the scope of this paper.

c. Minimizing the Price Level Adjustment

3.35. Therefore, it seems that an increase in the official price level is unavoidable. However, it should be minimized to reduce the risks of subsequent inflation. The increase needed to eliminate the excess of nominal money income (that is, mainly wages) over the nominal value of supply of goods and services cannot be avoided. The overhang can be managed by extracting the excess nominal money balances in two ways. One would be a lump sum tax. Lump sum taxes were used in several countries in the 1920s to fight hyperinflation. They have not been used recently because, by being a tax on capital, they could go against incentives for investment if people believe that they can be imposed again. However, in the environment of socialized enterprises they would make sense. They would have the advantage of also increasing the leverage of enterprises, thus making them more dependent on banks and monetary policies.

3.36. Another way of reducing the excess nominal money balances would be selling non-monetary assets to the population and sterilizing the proceeds (that is, not spending nor giving credit with the proceeds of the sale).[63] These assets could be financial or non-financial. Selling financial assets to the population would be the faster solution. However, it would be more expensive for the Government than the sale of non-financial assets. This is so because the Government would have to pay interests on the financial assets. On the other hand, selling houses, land or enterprises would not entail loss of revenue because the Government does not receive any income from the ownership of these assets.[64]

3.37. Selling the stock of housing to the population would be much cheaper but would take a long time to be done. Two serious problems must be solved

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63 This possibility would be conceptually equivalent to the open market operations used in market economies to regulate liquidity.

64 The Government receives mainly taxes from the users of those assets, which would still be collected.

before proceeding. First, in many of these countries, people enjoy tenure of their housing units even if they do not own them. As a result, the incentive to purchase is not there. Second, if the incentive is created through revoking existing legislation, the government has to accept that people who do not buy and refuse to pay higher rents to the new private owners of their dwellings would be evicted. That is, people would have to accept that getting a dwelling would no longer be a right but a possibility contingent on generating an income sufficient to pay for its costs.[65]

3.38. Another possibility could be to sell other real estate and productive assets to the population: land and office buildings as well as enterprises. The legal and technical problems of selling land and office buildings are as serious as those found in selling housing units. The problems of selling enterprises are much larger and deep. They were treated in Chapter II.

3.39. Yet another possibility would be just to liberalize interest rates, allowing them to go to levels that would equilibrate the demand and supply of monetary assets. This strategy would be risky, however, because credit would increase as much as deposits, with both variables led by a higher multiplier of the banking system. Equilibrium could come only after considerable instability. Moreover, the liberalization of interest rates presents problems of its own.

C. INTEREST RATE LIBERALIZATION AND UNIFICATION

3.40. Interest rate policies are fundamental to a process of stabilization. There are two aspects to problems involving interest rates in Eastern Europe. The first is that the market is fragmented, so that economic agents face different

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65 The right to get a dwelling has not been even nearly enforced in these countries, largely because the supply of housing is chronically insufficient. As a result, the population is divided into two groups. Those that have almost free housing and those that cannot obtain housing at any price. The two groups, however, are mixed because the homeless move to live in dwellings of their fortunate relatives, improving their lot but ruining that of the relatives. Generally, housing units dwell more than one family in these countries.

marginal prices depending on their identity, their size, geographical location, and on the activity they carry out. The second problem is that the weighted average of the marginal prices they face does not clear the market, so that macroeconomic instability develops.[66]

3.41. There are two basic strategies to approach a unified marginal pricing that clears the market. One is to liberalize market segments in sequence. The other one is to unify the market first, and then liberalize. Superficially, it seems that the first strategy is easier to implement. The burden of reform can be placed on the groups that are weakest politically, i.e., the ones that operate in the least protected markets, which is reckoned as "the market." In the financial markets, this includes mostly short-term credit to non-preferred activities, which finance both working capital and fixed investment with such credit. Also, this strategy seems to be convenient because it can be applied opportunistically, following the rule that whenever there is an opportunity to liberalize the interest rate to any group of agents, do it.

3.42. However, the first strategy has several flaws, some of which have become painfully clear in recent experiences. The first one is that, trying to stabilize an economy raising the interest rates on just the freer segment of the market, interest rates go through the roof. This is the natural result of the logic of weighted averages. If, for instance, the weighted-average interest rate that is required to clear the market is 65% and 70% of borrowers pay 20%, the remaining 30% of borrowers must pay 170%.

66 In a country with 50% inflation rate, for example, 30% of the borrowers pay 20% interest rates while the rest pays 40%. One aspect of the problem is that the marginal cost of credit is different for different agents, which leads to an inefficient allocation of resources. The second problem is that the weighted average of interest rates, 34%, is quite negative in real terms and does not clear the market.

3.43. The other flaws of this strategy are related to the first. One of them is that when interest rates on the freer segment of the market become unrealistically high, distress borrowing develops among those forced to pay them and adjustment fails to take place because credit demand fails to decline. Rather, it increases because, once such high rates are present, avoiding bankruptcy becomes the primary purpose of borrowing and, with higher interest rates, borrowers need more credit to service their previous obligations. This phenomenon is already present in at least Yugoslavia and Poland (although in Poland demand for credit is also fed by the negative real rates of interest).

3.44. A third flaw is that, even in a hypothetical country where borrowers were able to service debts at such high interest rates drawing on their wealth (low-leveraged firms), the strategy would have perverse effects. In such economy, the adjustment would take place with a contraction of credit in the freer segment, mostly at the expense of the portion of investment that reacts to market signals. That is, the kind of investment that should take place will fall while the other one, the one carried out on subsidization, will fall less, if at all.

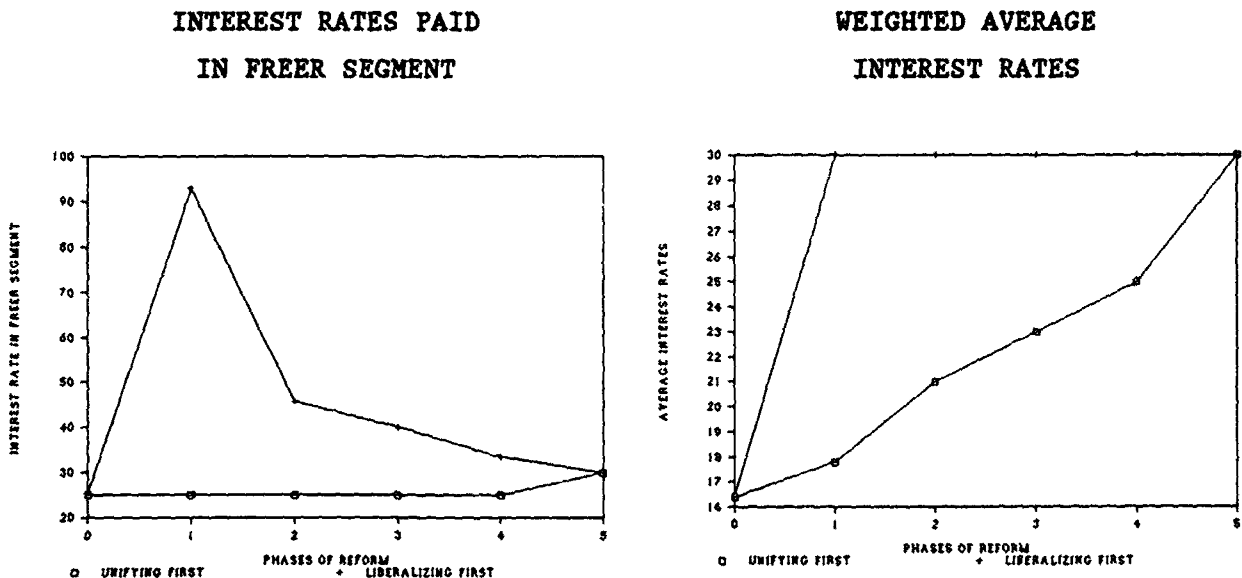
3.45. The second strategy, going first for unification and then for liberalization, avoids such problems. Similar to the first strategy, it accomplishes the objective of stabilizing the economy though raising the weighted average of the marginal interest rates faced by economic agents. However, it does so by reducing the dispersion between the different marginal rates rather than concentrating on increasing the marginal rates for a certain segment.

3.46. Thus, in each of the stages of a phased program, two objectives are obtained. One is that the weighted-average interest rate increases. The other one is that dispersion is reduced both in terms of sectors and in terms of differences in interest rates. Since changes in the interest rates paid by different sectors before and after unification would be smaller, distress would be lesser than in the first strategy and the appeal of moving toward more

subsidized sectors would be smaller. Once a reasonable degree of unification is achieved, the now general interest rate can be increased to a market clearing level. The shock created by the needed increase would be smaller than in the first strategy.

3.47. Figure 2 shows the results of a numerical example. It is assumed that there are five equal segments in the market, paying from 10% to 25% interest rates. The market-clearing interest rate is 30%. A unified market paying such rate is achieved in five stages using the two strategies described above. The trade-off is clear. While the first strategy achieves the required weighted-average interest rate faster, it does so at the cost of raising the rate in the freer segment of the market to 93%. On the other hand, the second strategy takes longer to achieve the clearing interest rate but does so minimizing disruption.

FIGURE 2
TWO STRATEGIES TO LIBERALIZE
INTEREST RATES



3.48. The second strategy--unifying first--would require either the maintenance of overall credit ceilings or financing from abroad until the very last step to either control or meet the excess demand for credit that would arise from a weighted average interest rate that is too low to clear the market. This seems to be a disadvantage vis-a-vis the other alternative. However, credit ceilings are likely to be needed in the other alternative as well because, as it was discussed earlier, excessively high interest rates fuel demand for credit instead of reducing it. The difference is then which of the two situations is more sustainable. Clearly, the dynamics of extremely high interest rates, distress borrowing and associated speculation and capital flight is extremely difficult to control. Since, as it will be discussed later, financial distress will appear anyway in any true structural adjustment, it is better to minimize the reasons leading to it.

3.49. Based on these reasons, it seems that a strategy that aims at unifying first and then liberalize the interest rates would be superior. The implication is that the emphasis of reform should shift from liberalizing interest rates right away to reduce the dispersion of interest rates. This can be done starting from both ends: unifying the lowest with the next-to-lowest at the latter level, while raising the next-to-highest to the level of the highest.[67]

D. RECAPITALIZATION OF BANKS AND RESTRUCTURING OF ENTERPRISES

3.50. Given the bad condition of the banking system's portfolio in Eastern Europe, the Governments will eventually have to decide on whether allowing failing banks to declare bankruptcy or invest in their restructuring and recapitalization. Keeping the current strategy, providing subsidies to banks and debtors to make

67 This approach to interest rate liberalization is similar to that of the IMF regarding multiple exchange rates. In case of conflict, the objective of unification overrides that of balancing the economy. That is, the IMF does not accept a program that achieves macroeconomic balance through the weighted average of multiple exchange rates. It requires unification first.

up for their losses, would perpetuate the problem. The condonation of losses would give the wrong signal to managers and economic agents in general. Losses would be acceptable and there would be an incentive to turn to the Government for help when they appear. This would weaken the Government's efforts to reduce subsidization of enterprises. Nothing would have changed. The bad quality of the banks' portfolio would have other negative effects in addition to weakening managerial discipline. It would make them uncreditworthy, creating a major obstacle for them to engage in operations with foreign banks. Experience in other countries also shows that the losses absorbed by the Treasury when bad portfolios are not removed from banks far exceed the costs of removing them in a one-step operation.

3.51. To avoid locking the economy in inefficient activities, the Government should force the restructuring and recapitalization of the banking system, which will imply a restructuring of the real sector: liquidation of inefficient enterprises and restructuring of those that could become efficient through some adjustments. Such adjustments include both financial and real actions. This can be very costly, but should be done if sustainable growth is an objective.

3.52. The best solution to this problem would be to take the bad portfolio out of the banking system, delinking it from the liabilities that originally financed it (the banks' deposits and obligations with the National Bank). To do that, the Government would purchase the problematic loans with long-term, floating rate bonds and would pay the banks to administer the loans. The bonds would provide banks with incomes commensurate with the increased cost of their liabilities.

3.53. The Government would then absorb the losses through recapitalizing the banks--which basically would consist of the Government purchasing the bad portfolio at face value, paying for it with long-term bonds. In this way, the banking system would serve as a collector of losses for the Government.

3.54. The process of enterprise restructuring would require a realistic projection of the cash flow that the enterprise can generate in a given period, say ten years, at economic prices. Depending on the results, the firms would be classified as unviable, inefficient but viable or in good condition. Unviable firms would be liquidated, selling their assets to pay as much as possible of its liabilities and extinguishing the remaining ones. The capital losses would then be transferred to the banks.

3.55. Inefficient but viable firms would normally require several actions. First, if overstaffed, they should layoff the excess labor. Second, they may require a substitution of modern for obsolete equipment. Third, they may require a reduction of their financial liabilities. Excess labor should be eliminated immediately. The substitution of efficient for obsolete equipment could be carried out through time, replacing the most inefficient first, if the company can manage to do it on its own. The estimation of the required reduction of financial liabilities could be done by subtracting from the net cash generated by the enterprise--current revenues less current costs, including a normal return on capital--the amounts needed for investment to substitute the obsolete equipment and to provide for normal growth. The remainder is what the enterprise can allocate to service existing debts. The present value of the annual remainders is the debt that the enterprise can repay. If the existing loans are higher, the difference should be written off by the bank, thus transferring the loss to the bank.

3.56. Restructuring of enterprises would be best effected if carried out in a decentralized fashion by private entrepreneurs. Restructurings managed by state agencies are likely to result in mistakes similar to those of the restructurings and investments of the 1970s. Private entrepreneurs are more likely to have the initiative and the flexibility needed to carry out successful restructurings, which may require quick decisions regarding inviting or accepting

new partners, selling off or closing parts of the enterprises as well as changes in its financing. For these reasons, the sequencing of stabilization and structural adjustment proposed in Chapter IV of this paper proposes carrying out first the privatization of socialized enterprises and then their restructuring.

3.57. To keep fiscal balance while absorbing the banking system's losses, the Government should either raise larger revenues or reduce expenditures in amounts equivalent to the difference between the expenditures incurred in servicing the bonds used to recapitalize the banks, and the revenues obtained from the purchased portfolio, which probably would be very close to zero. This difference is the current cost of the subsidies granted in the past through low interest rates, and cannot be avoided.

3.58. Failing to remove the substandard portfolio from banks would not reduce the overall cost to the budget because the Treasury would be forced to subsidize the banks if a wave of bank failures is to be avoided. Those subsidies are likely to represent a higher cost than that represented by the removal of the bad portfolio because, while the latter would be a once-and-for-all operation, the former would amount to an open-ended commitment to subsidize the banks. To conceal this cost by not increasing interest rates would only increase the overall economic cost of the subsidy. To burden the loss on the Central Bank without a counterbalancing reduction in the fiscal deficit would be inflationary.

3.59. Thus, it should be clear that, if properly implemented, a recapitalization of weak banks would not increase monetary creation because the banking system's losses already exist and are being financed with the monetary expansion used to keep insolvent firms in operation. Instead of financing the insolvent firms, a comprehensive program of recapitalization of banks would finance the needed write-offs. This action would cut the links that currently force banks to lend to inefficient enterprises, thus stopping the growth of losses and turning weak banks into profitable institutions. The resources now being used to finance

current losses, would be available to finance the restructuring of the viable firms. If successful, such a program would eliminate one of the main sources of both misallocation of resources and macroeconomic instability.[68]

E. THE EFFECTS OF FINANCIAL SECTOR ADJUSTMENTS

3.60. Careful consideration must be given to the short-term consequences of the measures needed to carry out an interest rate liberalization, even if the strategy of unifying the markets first is followed. Excessively high and destabilizing real interest rates may prevail if liberalization is not paced with other measures to curtail the rate of expansion of net domestic demand, such as the reduction of the fiscal deficit, as well as with a sustainable real exchange rate policy. In particular, if the government continues to rely on the inflation tax to finance the fiscal deficit, liberalizing interest rates may result in an overwhelming pressure to increase the rate of inflation in order to make ends meet. Rather than stabilizing, interest rate liberalization would become destabilizing.[69] Therefore, interest rate liberalization should always be combined with reduction of excess demand creation and, if needed, adjustment of the exchange rate, and should be carried out in the context of broader measures for financial sector development (see Chapter IV for recommended sequencing).

3.61. Similar care is needed when considering measures to reduce spreads. High reserve requirements may help finance the government's deficit. If reserve requirements are reduced, other sources of funds must be found to finance the deficit. Furthermore, when legal reserve requirements are reduced, the banking system's multiplier rises, increasing the effect of a given increase in base money creation on demand.

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68 For a more detailed discussion of the problems created by financial crises and of their solutions, see Manuel Hinds, **The Economic Effects of Financial Crises**, PPR Working Paper Series WPS-104, The World Bank, October 1988.

69 This was the case in Yugoslavia in May 1988.

3.62. In order to ensure the success of market oriented interest rate policies, new instruments may have to be created, such as variable-interest-rate loans and certificates of deposit and money market instruments. Also, the creation of instruments suitable for the inter-bank market could be useful in several countries. These measures can be complemented with the reduction or removal of controls on capital flows and with the opening of the financial system to new entrants.

F. SUMMARY

3.63. In summary, the enterprise deficits that have to be financed have two components. First, there are current losses, incurred by keeping in operation activities with costs higher than their revenues. Second, there are capital losses that were incurred in the past but are being realized through time (mostly losses caused by devaluations in the stock of foreign exchange debt, which are realized only when payments are due). While the first kind of losses can be stopped, the second cannot because they have already occurred.

3.64. The Government should absorb fiscally, in a non-inflationary way, the realization of the losses already incurred. The best way of doing this is to recapitalize the banking system with bonds, the service of which should be covered by either increasing taxes, reducing other expenditures or both. The Government should use the same kind of bonds to buy the bad portfolio of banks, thus completing the recapitalization of the banking system.

3.65. To make the stabilization sustainable, the Government also should reduce the losses in the enterprises. To do that, it should reduce the wage bill by both controlling wages and eliminating overstaffing. Macroeconomic measures aimed at these objectives should be complemented with the Government's takeover of enterprise management, thus eliminating the resistance to these actions that the self-managed enterprises would oppose.

3.66. Also, the Government should allow an initial jump in the price level to redress relative prices. To minimize this jump and the possibility of ensuing inflation, the Government should reduce excessive nominal cash balances through imposing lump sum taxes on capital and selling assets to the population, preferably real estate and housing. To minimize the possibilities of getting to damaging high real levels of interest rates, the Government should integrate the financial markets, so that everybody pays the same rate.

IV. THE SEQUENCING OF A STABILIZATION AND STRUCTURAL REFORMS PROGRAM

A. LOOKING FOR THE SIMPLE IDEA

4.1. Successful stabilizations of countries with hyperinflation have taken place in a relatively short period. Several of them seem to have been the result of the application of a simple idea, like raising legal reserve requirements in Italy in 1947. However, in all of these cases, the quick successful attempt took place after several others had failed.[70] One way of interpreting these facts is to think that a simple idea can bring hyperinflation to a halt. The implication would be that it is necessary to look for the simple idea that would bring stability to Poland and Yugoslavia. Another interpretation is that

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70 See, for example, Rudiger Dornbusch and Stanley Fisher Stopping Hyperinflations Past and Present, Journal of the Kiel Institute of World Economics, 1986.

eliminating hyperinflation is a cumulative process that takes a long period to gain momentum, and that, once this momentum exists, success can be obtained by carrying out the simple action that was still missing.[71]

4.2. Trying to decide which is the right interpretation goes well beyond the scope of this paper. However, since the problems of stabilization are so complex in Eastern Europe, it seems that trying to build up a chain of cumulative effects could prove to be a useful approach. If several ideas will have to be tried before striking into the right one, it could be useful to try them in a sequence that could become cumulative. This is the approach taken in this Chapter.

B. SEQUENCING

4.3. At the very least, an economic program to achieve sustainable and stable growth should contain the four major items discussed in Chapter III. First, ownership reform. Second, price reform. Third, stabilization. Fourth, the creation of a solid and independent banking system. The linkages between all these required actions are so complex that the ideal solution would be to carry out all of them at the same time.

4.4. Doing everything simultaneously, however, is not feasible. The time frames of the different activities needed to complete the process are different from each other. It seems that Governments have two options open. One is to attempt a conventional sequencing, stabilizing the economy first and then carry out the structural reforms. Given previous experiences, and the problems that Eastern European economies present for stabilization, the probability of failing

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71 Of course, there are countries where the process is cumulative but backwards because the actions that Governments take tend to accelerate rather than reduce the rate of inflation. The cumulative interpretation refers to successful cases of stabilization, not these.

is very high. The other option is to attempt a combination of stabilization and structural reform, which would imply accepting beforehand that the economy would remain unstable for quite some time.

4.5. The optimal sequencing would be that which allows for the maximum sustainable rate of economic growth during the transition period. In practical terms, it would be that sequencing which minimizes the fiscal expenditures, thus leaving the maximum of resources available for investment and production. The previous analysis suggests that, to achieve those objectives, the Government should maximize the speed at which it carries out the reduction of losses through enterprise and bank restructurings, as well as the substitution of non-inflationary for inflationary ways in the financing of the incurred but not realized losses.

C. THE SIZE OF THE FISCAL EXPENDITURES

a. The Dynamics of the Fiscal Expenditures

4.6. The size of the fiscal expenditures is affected by at least three factors. First, the speed at which restructurings of banks and enterprises take place. Second, the way in which thes restructurings are carried out. That is, how the burden of their cost is allocated and the sequencing in which they take place regarding banks, on the one hand, and enterprises, on the other. Third, the speed at which inflation is reduced.

i. The Speed of Restructuring and the Fiscal Expenditures

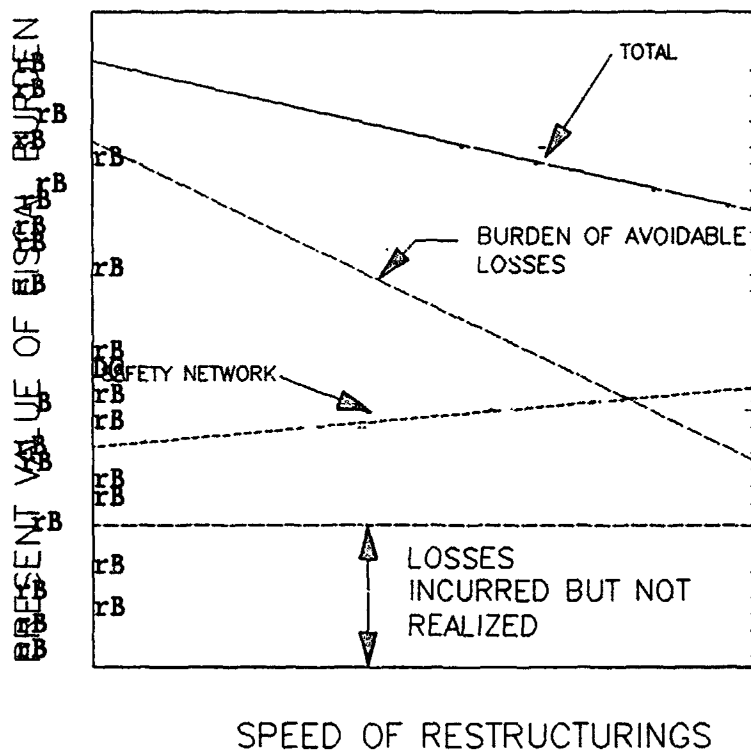
4.7. The fiscal expenditures of the transition period would be affected by the speed of the process. Once losses already incurred had been transferred to the budget and financed in a non-inflationary way, reductions in the current losses at the enterprise level would allow the Government to further reduce inflationary financing and to restructure the banking system, bringing the economy into stability. The faster the elimination of the losses, the lighter the fiscal expenditures needed to absorb them.

4.8. At the limit, an instantaneous elimination of the loss-makers would minimize the fiscal expenditures because fiscal resources would be used to finance only the losses already incurred, while the avoidable ones would be eliminated at the onset of the process. However, since restructurings would lead to a substantial increase in unemployment, the Government will be forced to spend in the establishment of a safety net to reduce human suffering. The cost of such net would increase the fiscal expenditures by amounts, which, although lower that the reductions in fiscal needs achieved through the restructurings, would still be substantial.

4.9. The trade-off between speed of restructurings and total fiscal expenditures is illustrated in Figure 3, where the present value of the total fiscal expenditures over the years is shown in the y-axis as the sum of the financing of the losses already incurred plus the burden of avoidable losses plus the cost of the safety network. The x-axis represents the speed of the process (not time). The line representing the cost of the safety network has been drawn in such a way that it increases at a slower pace than the rate of decrease of the burden of losses as the speed of the process increases. With such assumption, the faster the restructurings, the higher the unemployment but the lower the overall fiscal expenditures.

FIGURE 3

SPEED OF RESTRUCTURING
AND FISCAL EXPENDITURES



ii. The Way and Sequencing in Which Restructurings are Carried Out

4.10. The way in which restructurings are carried out also has an important effect on the size of the fiscal expenditures. In Poland and Hungary, the banks are owned by the Government, so that these Governments do not have recourse

against the shareholders.[72] In Yugoslavia, they are owned by enterprises. In this country, the law imposes on founding members an unlimited liability in cases of bank insolvency. That is, the Law empowers the Government to write off the bad of insolvent banks not only against the equity that the founding members invested in the banks but also against the totality of the founding members' net assets. If it wants to reduce the fiscal expenditures, the Government should take advantage of this legal provision.

4.11. Another aspect of restructurings that has an important effect on the size of the fiscal expenditures is the way in which bad loans to borrowers other than the founding members are collected. In an environment of financial crisis, even debtors with full capacity to repay may refuse to service their debts. Also, collections from restructured enterprises could be lower than possible. The Government should pay close attention to this problem.

4.12. The sequencing in which restructurings and liquidations are carried out (banks first, then enterprises or the other way around or simultaneously) also affects the size of the fiscal expenditures. This is an extremely important factor that should not be ignored by the Governments. The reduction of the fiscal expenditures caused by restructurings comes primarily from the elimination of the losses at the enterprise level. When simultaneously restructuring the banks and their debtor enterprises, the elimination of the losses in the enterprises reduces the fiscal expenditures while the simultaneous issuing of bonds to recapitalize banks substitutes one way of financing the remaining losses for another. The net effect is a reduction of the fiscal expenditures.

72 In Hungary, there are shareholders different from the Government. The possibilities of getting them to pay for the losses, however, are slim, because these shareholders can argue that the banks were already bankrupt when the Government transferred the shares to them (January 1988).

4.13. If, however, bank restructurings take place before enterprise restructurings or liquidations, this reduction of the fiscal expenditures would not occur. Instead, the present value of the fiscal expenditures would increase. In these cases, the Government would issue bonds to recapitalize banks but would have to keep on financing the losses of the enterprises until these are restructured.[73] That is, the Government would have to both service the bonds and subsidize the loss-makers. This would duplicate the flows coming from the Government. The service of the bonds would be used to finance new activities while the old ones would still be getting financing, increasing the inflationary pressures in the economy. If the Government is not able to absorb the burden of the service of the bonds in a non-inflationary way, the rate of inflation would go up.

4.14. The decision on whether to restructure banks at the same or a faster pace than the enterprises is a very important one. Restructuring of banks should precede that of enterprises only if the Government is able to mobilize the resources needed to service the recapitalization bonds in a non-inflationary way. Otherwise, the inflation rate would rise. If this is the case, it is better to delay the banks' restructuring (and the economic recovery) until it can be paced with the elimination of the losses coming from enterprise restructuring.

73 The fiscal budget would be affected because the loss-makers would keep on making losses, which would eventually be covered by the Government. The timing in which these losses would affect the budget would depend on the financial situation of the loss-makers. Most likely, it would be immediately. Given the magnitude of the problem, most loss-makers are probably having negative cash flows close to the volume of their losses.

iii. The Effect of the Reduction of Inflation on the Size of the Fiscal Expenditures

4.15. Inflation has both positive and negative effects on the net fiscal expenditures.[74] The main positive effect is the reduction of real expenditures caused by delays in paying Government expenditures. The negative effects are the reduction in real Government revenue caused by delays in tax collections as well as the subsidies transferred through fixed-interest-rate loans granted at low nominal interest rates. We do not have reliable information on the net result of these two effects in Eastern European countries. However, evidence in other countries shows overwhelmingly that the Government budget loses substantially in real terms as a result of inflation. Thus, a reduction in inflation would improve automatically the budget situation. Some warnings are due in this respect. One is that several countries attempting stabilization have grossly overestimated such gains, among them Brazil and Argentina during the Cruzado and Austral Plans, respectively. It is better to err on the conservative side when making this estimation.

4.16. Another warning is that the potential gains in reducing the subsidization of already granted loans is very minor because, at the current inflation rates of Poland and Yugoslavia, the real size of such loans declines to almost zero in a very short period. A third warning is that gains in the reduction of subsidization to loss-making enterprises through newly-granted loans at fixed and low nominal interest rates could be cashed only to the extent that these enterprises are either restructured or closed, so that their losses, and therefore the need for subsidies, disappear. If the Government is not prepared to take

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74 These effects should not be confused with the revenues obtained by the Government from the inflation tax, which are a way to finance the fiscal expenditures. Here we discuss the effects that inflation has in the other sources of fiscal revenue and on the Government expenditures.

those actions at the moment in which a program to reduce inflation is implemented, the subsidies would have to be conveyed in other ways. Therefore, these gains could be obtained in some other kind of subsidized loans, such as housing loans.

D. ALTERNATIVE PATHS

4.17. It is very hard to know what will finally break the back of hyperinflation in Eastern Europe. Certainly, the fundamentals in terms of reduction of the rate of growth of nominal domestic demand should be there to enable a trick to function. But what is needed to do in different stages of the hyperinflation process almost certainly changes with time. Thus, it would be pretentious to design two03Xothree alternative programs and then decide on which is the best one at any moment. However, what can be done is to compare what would be the best approach, in terms of generating positive cumulative effects, between a series of stabilization-first and a series of combined stabilization and structural adjustment approaches. The following paragraphs make a comparison between two of these programs as they can be foreseen now.

a. Stabilization First: The Shock Treatment

i. The Components of the Strategy

4.18. The Government should start by planning an increase of budget revenues over expenditures enough to compensate for the losses in the enterprises. This would provide the fundamental reduction in nominal domestic demand. To minimize the negative effects of the self-management system on the efficacy of a stabilization program, the Government should regain control of self-managed enterprises. After that, the Government would allow prices to increase over the wage level. Then, the Government would introduce heterodox measures to bring down the inflationary momentum and constrain wage and price increases. These measures could include the temporary establishment of nominal anchors such as a fixed

nominal exchange rate, wage and price controls. Such nominal anchors have been successful in cases where the fundamentals of inflation fighting were right, such as in Israel and Mexico.[75]

4.19. The mechanism would be expected to work in the following way. The reduction of nominal domestic demand would put pressure on the enterprises, which should react reducing their expenditures, mainly in their payrolls.[76] The main mechanism to reduce the payroll under this option would be wage reductions. The newly appointed managers would fire as many redundant workers as they could. However, since restructurings would take place only after stabilization, many loss-makers, probably the majority, would remain in operation. These loss-makers should be isolated from the rest of the economy to avoid the distortions introduced in the credit markets introduced by distressed borrowers. One possibility of isolating them would be to establish an "enterprise hospital," an institution in charge of restructuring and liquidating loss-makers, and of financing their operations while undergoing restructuring or waiting for it.

4.20. It should be stressed that heterodox measures can provide a powerful help if the orthodox fiscal and monetary measures are enough to remove the fundamental causes of inflation. If, however, the Government is not prepared

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75 The fact that Yugoslavia has accumulated substantial foreign exchange reserves could help in financing the eventual outflow of foreign exchange that would take place during the period of fixed nominal exchange rate (a sizable risk even if an over-devaluation is carried out right before the stabilization period).

76 Unemployment has to rise or real wages have to fall, even if no full restructurings are taking place. These are the only ways in which the reduction of fiscal expenditures would be turned into a reduction in nominal domestic demand. If these variables do not change in the required direction, the reduction in monetary creation caused by reduced fiscal expenditures would be compensated by an increase in the velocity of money, leaving the rate of growth nominal domestic demand unchanged. Of course, this effect also can be partial. Insufficient reduction in the wage bill would lead to an increase in velocity that, although not compensating fully for the reduction in monetary creation, would dampen its effects. Given distress borrowing, velocity can increase even when real interest rates are rising.

to carry out the totality of such adjustment, using these measures would surely backfire. With sizable inflation still fueled by monetary policies accommodating enterprise losses, fixing the nominal exchange rate would rapidly lead to an unsustainable drain of international reserves and would penalize exports. Also, at the end of the fixed wage and prices period, an explosio*pl72[illegible]ation would follow. This was the experience of Argentina and Brazil with the Austral and Cruzado plans, respectively.

ii. Risks and Advantages

4.21. This strategy presents several advantages. The most important one is that, by delaying restructurings and liquidations, it would limit the growth of unemployment. A second advantage is that the Government may concentrate on achieving only one major objective, while combining restructuring with stabilization may dilute objectives, thus reducing effectiveness. A third advantage is that restructurings are better carried out in a stable environment. It could be too risky to attempt restructurings in an unstable environment. Yet another advantage is that, if the Government is successful in making it well understood to the population that taxes are high and financial resources scarce because the Government is subsidizing loss-makers, it would be able to muster strong political support to liquidate or restructure the loss-makers.

4.22. This sequencing, however, poses some difficult problems, among them how to finance the loss-makers once their banks have already being recapitalized. Preferably, they should not be financed by the banking system. The objective of restructuring and recapitalizing the banks is precisely to get rid of them, so that banks are free to lend to profitable activities.

4.23. The "hospital" could be a way to convey the financing of the loss-makers. However, the number of enterprises that could need such attention could be too

large to be managed simultaneously by one institution. Also, the amount of resources absorbed by the loss-makers probably would be too large to be managed outside the banking system.

4.24. Thus, it seems that to keep on financing these enterprises through the banking system cannot be avoided. At best, the Government may try to minimize the damage to banks. How to do this, however, is elusive. Once banks start to lend to these enterprises, their links with those enterprises are restablished and the banks become, again, hostages to the bad borrowers. The Government could try to reduce this effect by guaranteeing the loans to loss-makers, but that would nullify the efforts to impose financial discipline. Alternatively, the Government may convey a subsidy just enough to cover a predetermined and declining level of losses of inefficient enterprises, allowing the banks to finance the rest.

4.25. The implementation this arrangement, however, would be very risky because it keeps in place the structure of incentives that led to unrestricted accommodation of losses. As experience shows, enterprises know how to lobby the Government to get their ways. The Government may try to contain the subsidization through overall ceilings on the subsidies. However, this would create a strong temptation for the Government to conceal the total amount of subsidization by forcing banks to finance larger amounts. Experience shows that this is very likely to happen. Without a change in the structure of incentives, it is difficult to conceive that behavior will change.

4.26. If the Government loses control of the subsidization of the loss-makers, the economy can still be temporarily stabilized if the Government keeps on rising taxes and reducing its expenditures. However, even this temporary alleviation seems implausible to happen. The fiscal expenditures would be much too large,

especially because wage increases would not be limited to loss-makers but would include all others as well. Much more likely, the Government would loose its nerve and would accommodate the creation of excessive nominal domestic demand.

4,27. If the program fails in reducing the wage bill, the gain for the cumulative process would be the regained control of enterprises and the reduced overstaffing in enterprises. The reduction in nominal domestic demand initially achieved through budgetary measures would be wiped out at the end of the process.

b. Stabilization and Structural Reforms Combined: The Gradual Strategy

i. The Components of the Strategy

4.28. The alternative path would be identical to the first except for two major points. The first point is that stabilization and structural reform would be seen as two aspects of the same problem. Thus, the sequencing of policies to achieve both of them would have to be closely coordinated. Option One assumes that the economy can be stabilized quickly and focuses all the efforts in achieving this goal. Structural reforms are relegated to second priority in the initial program. If the same approach of stabilization first is consistently maintained in subsequent attempts, no cumulative effects on the reduction of the losses will ever take place. This is happening now in the plans for the stabilization of both Poland and Yugoslavia. The combined strategy, on the other hand, would lead at least to incremental advances in the reduction of the losses, facilitating the subsequent attempts.

4.29. Another difference is that policy makers would not expect that inflation would be reduced to zero or close to it. Rather than a short battle, they would expect a long war. This also would affect the sequencing of measures. For example, it would affect the timing of the use of heterodox measures. Heterodox measures are useful mainly as a way to change expectations. They cannot be used over and over again because they lose credibility. Therefore, it seems that,

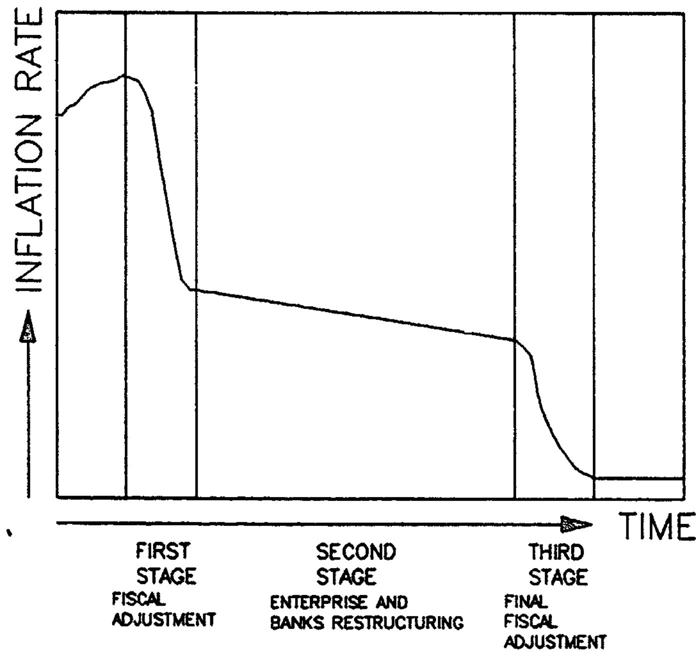
if heterodox measures are used, they should be reserved for the final assault on inflation (the fact that lower but still substantial inflation would remain in place after the first stage would destroy the credibility of the measures).

4.30. This paper cannot get into all the sequencing problems that would be faced in a combined program of structural adjustment and stabilization. It can give only a stylized description of how the sequencing of one of the many possible approaches could be. A simple modality would be for the Government to approach the economic program in three stages. Stabilization in the first stage would rely solely on the fiscal adjustment that the Government is willing to undertake combined with actions to reduce the wage bill taken inside the enterprises by managers appointed by the Government. The Government could give managers targets for wage bill reductions. In the second phase, enterprises would be restructured and their ownership reformed. Then the Government could execute a second program aimed at further reducing inflation. The path in three stages is shown in Figure 3.

4.31. In the first stage (six months), the Government would aim at a drastic reduction in the rate of inflation, based mainly on a budgetary adjustment while restructuring the most insolvent banks. The rate of inflation at the end of this stage would be much lower than the current rate but would still be considerable. In the longer second stage, the Government would concentrate on further restructuring of banks and real enterprises while carrying out price reforms. This would not only reduce the fiscal expenditures (and therefore the rate of inflation given a certain level of fiscal revenues) but also would prepare the way for a healthy economic recovery. Also, in this stage the Government would carry out a fiscal reform to improve the effectiveness and efficiency of taxation. It is quite possible that at the end of this stage, even if further reduced, inflation would still be excessive as a result of still inadequate budgetary balances. The third stage would fix that.

FIGURE 3

A POSSIBLE THREE-STAGE PATH OF ADJUSTMENT



ii. Risks and Advantages

4.32. There are two main advantages to this approach. First, inflationary financing would decline at approximately the same pace as the source of the need for inflation is reduced. Second, the mechanisms to force economic agents to react to restrictive monetary policies would be gradually put in place, improving the grasp of such policies through time. Third, flexibility in the allocation of resources would improve, facilitating economic recovery.

4.33. This approach, however, also has substantial risks. The first stage faces the same kind of risks as the alternative of going for stabilization first, aggravated by the fact that heterodox measures to break inflationary expectations

would not be used. With inflationary expectations running so high, the only way to enforce the necessary contraction of nominal domestic demand could be to send to immediate bankruptcy those companies that get into liquidity problems as a result of the credit contraction. This would give credibility to the program, introducing wage and price discipline, and would interrupt the process of spontaneous privatization. Of course, the pressure not to do that could be overwhelming. Central Banks could eventually be forced to print money to keep those companies going, nullifying the effects of the program.[77]

4.34. Another risk is that price and ownership reforms, and enterprise restructurings, may not be possible to carry out in a highly inflationary environment. Also, in a long process, the probabilities of the Government losing the motivation and political support for stabilization are very high.

E. REFORMS AND STABILIZATION IN COUNTRIES STARTING THEIR REFORMS

4.35. Up to now, the discussion has centered on countries where hyperinflation is present and are already advanced in the path of reform. This Section discusses a sequencing for countries that are just starting their reforms. With some modifications, this sequencing can be used for Poland and Yugoslavia in what was called Stage II in Figure 3, the stage of structural adjustment in their fight against hyperinflation. The needed modifications vary with countries, but are mostly in the area of price liberalization, which has already been advanced in Poland, Hungary and Yugoslavia. However, the basic ordering of privatization, then restructuring suggested in the following paragraphs can be applied to them.

4.36. Countries starting their reforms should avoid the mistakes committed by the pioneers. They should refrain from establishing self-management or other decentralized management approaches unaccompanied by ownership reform. They

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77 In the recent past, the only successful case of eliminating hyperinflation without heterodox measures has been Bolivia. It was successful because huge layoffs took place while the program was executed.

also should be conscious, from the very beginning, of the fact that their macroeconomic imbalances will translate into high rates of inflation, balance of payments problems or both as their economies become monetized and the direct controls associated with central planning are removed.

4.37. At the simplest level, the challenge in Eastern Europe comprises the solution of five problems. One is that prices are distorted. A second one is that enterprises do not react appropriately to prices because of the perverse set of incentives existing in the system. A third one is that enterprises make economic losses causing widespread misallocation of resources. Some of these losses are apparent but many other are hidden beneath the distorted price system. The fourth problem is that these losses cause not only misallocation of resources but also inflationary pressures as a result of the continuous subsidization of the loss-makers. A fifth problem is the lack of a financial system capable of mobilizing and allocating resources efficiently.

4.38. An equally simple approach to solve these problems would be to first reform enterprises so that they can react to market mechanisms, and then use market mechanisms to solve the other problems. This activity requires three tasks: facilitating the creation of new private enterprises, privatizing a majority of the now socialized enterprises and devising a mechanism to manage the remaining public enterprises in a way that mimics private enterprises. Just establishing a better method to manage public enterprises would not substitute for privatization of a majority of the firms because an efficient simulation of private entrepreneurship in the public sector requires a strong private sector establishing the signals and the competition needed to mimic them.

4.39. Thus, for example, the huge problem of restructuring and modernizing the enterprise sector can be better accomplished by private entrepreneurs than by state agencies. Private forces can carry out the needed closures and layoffs

with less political pressures than the Government. Equally, private entrepreneurs are more likely to take the right decisions on the refurbishing of their factories than Government officials.

4.40. This simple approach suggests the sequencing shown in Figure 4. First, after a period of preparation, it is necessary to privatize a large portion of the socialized enterprises rapidly, thus creating a critical mass of private enterprises that would react appropriately to prices (Phases I and II in the Figure). Second, once this has been achieved, and only then, prices can be liberalized. This liberalization, (the "Big Bang" at the end of Phase II), would include domestic price liberalization coupled with the substitution of tariffs for quantitative restrictions to trade. The tariffs would be reduced subsequently under a clearly defined schedule. Third, with most enterprises in private hands and free prices, financial discipline--the removal of subsidies and the enforcement of financial contracts--can be introduced (Phase III). In this way, the test of prices and financial discipline is imposed when the set of incentives at the enterprise level is right.

4.41. Enterprise restructurings would bring forward the losses now hidden in the portfolios of the banks. After writing off the bad loans, the Government can proceed to recapitalize the banks and then to privatize them (Phase IV). To keep inflation at manageable levels while still subsidizing the loss-makers (Phases I, II and III), the Government would have to run fiscal surpluses. If these surpluses fall short of the losses in the enterprises, some inflation would be unavoidable.

4.42. To minimize the rate of inflation in these circumstances, it would be better to maintain moderately negative real rates of interest (Phases I and II).[78] This would allow the Government to collect inflation taxes from all

78 Interest rates, however, should be unified in Phases I and II, eliminating preferential credits.

FIGURE 4

SEQUENCING OF REFORMS

AND STABILIZATION

	PHASE I PREPARATION	PHASE II PRIVATIZATION	PHASE III FINANCIAL DISCIPLINE	PHASE IV PRIVATIZATION OF BANKS
ENTERPRISES	HOLDINGS CREATED, DOWN-SIZING	GIVING AWAY ENTERPRISES CREATING NEW MANAGEMENT SYSTEM FOR SOCIALIZED	BANKRUPTCIES RESTRUCTURINGS	
PRICES	CONTROLLED		LIBERALIZED	
INTERESTS	CONTROLLED		CONTROLLED	LIBERALIZED
BANKS	STATE-OWNED		STATE-OWNED WRITEOFFS RECAPITALIZATION	PRIVATIZED
BUDGET	SURPLUS		DECLINING SURPLUS	BALANCED
MONETARY POLICY	RESTRICTIVE		NOMINAL ANCHORS	ACCORDING TO DEMAND

BIG BANG (between Phase II and Phase III)

deposits in addition to currency and demand deposits. If interest rates are positive in real terms, a higher inflation rate would be needed to collect the

same real revenue from the inflation tax (the introduction of positive real interest rates in Yugoslavia caused a large increase in the rate of inflation in 1989 for this reason).

4.43. In Phase III, centered on financial discipline, interest rates would be increased to positive real levels. However, they should still be controlled because, if they are free, distressed borrowers would bid them up to excessive levels. Access of distressed borrowers to credit should be curtailed through regulation and supervision of banks, not through interest rates, which are ineffective for this purpose. Once loss-makers have been eliminated through enterprise restructurings and bankruptcies, interest rates can be liberalized.

4.44. To stabilize the economy, which would be suffering substantial inflationary pressures from the subsidization of losses in Phases I and II, and from price liberalization in Phase III, the Government can combine the imposition of financial discipline in Phase II with nominal anchors and restrictive monetary policies.

4.45. In this sequencing, enterprises are first privatized and then restructured, while banks are first restructured and then privatized. The reason for this asymmetry is that the enterprises are the ultimate source of losses in the economy, and the bankruptcy of unviable firms is necessary. On the other hand, the banks have been passive recipients of losses and their bankruptcy would serve no purpose and would cause considerable damage.[79] After all, the countries would need banks anyway, while they do not need the loss-making enterprises. Thus, the Government would have to recapitalize the banks after the writeoffs

79 Depositors in these countries certainly cannot be blamed for not choosing their banks in a prudent way. In most cases, they did not have a choice. Thus, forcing these banks to go under and then creating others would serve no disciplinarian purpose. On the other hand, having depositors losing their money would undermine the confidence of the public in the nascent banking system.

of the enterprise restructuring. Then, if the banks are privatized before the restructurings, they would have to be nationalized again to be recapitalized, to be then privatized for a second time.

4.46. On the other hand, we want to have the private sector as the engine for enterprise restructurings. The question is, then, How can Governments privatize firms that will go under immediately after privatization? Either entrepreneurs would refuse to buy them, or if they buy them in ignorance of the bad condition of the enterprises, they would surely sue the Government for misrepresenting the state of the enterprises. There are two answers to this question. One is that privatization can be carried out by giving away the enterprises, as it is proposed in Chapter II. The other is that the presence of private entrepreneurs could save enterprises that otherwise would go under.

F. CONCLUSION

4.47. Most frequently, stabilization and structural reforms are treated as separate subjects. If this were possible, using Option One, the shock treatment, would be the preferred course of action. Governments would aim at first stabilizing the economy and then at carrying out the needed structural reforms. Given the problems of self-management, however, it seems that stabilization and structural adjustment cannot be treated in isolation from each other. If this is true, the probability of a noncumulative failure under Option One is very high because the shock treatment does not include any step aimed at removing the structural problems that lurk beneath instability.

4.48. Also, Eastern European countries entering the reforms process should learn from the experience of Poland, Yugoslavia and Hungary. Among the several lessons to learn, the most important one seems to be that decentralized socialism does not seem to work. At least, it is fairly clear that, if socialism can be blended with market forces, self-management is not an efficient way of doing it. Quite probably, markets cannot function if private ownership is not predominant.

4.49. Another lesson is that, in the absence of foreign borrowing, the path to hyperinflation is relatively easy in an economy moving from socialism to market organization and that, in order to avoid it, actions to reduce losses and improve the efficiency of enterprises through reducing overstaffing and the real wage should be taken while the Government is still in full control of the economy.

4.50. Now that financial resources are being amassed to be channeled to Eastern Europe, it also should be remembered that foreign borrowing can be used not only to finance efficient reforms. It also can provide a comfortable way of financing the continuation of inefficient practices, as long as it is available. Once it stops, the adjustment that was supposed to take place with the benefit of foreign funds, has to take place with the handicap of having to transfer resources abroad. The tensions generated lead not only to a reduction of the domestic savings available for investment but also to serious macroeconomic imbalances. This was the case of at least Poland and Yugoslavia.

ISSUES IN THE INTRODUCTION OF MARKET FORCES IN EASTERN EUROPEAN SOCIALIST ECONOMIES

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ANNEX I

ENTERPRISE REFORM ISSUES

I. INTRODUCTION

A.1. The objective of defining ownership and management relationships for socialized enterprises is not to achieve the decentralization of the economy. Such objective would be attained through privatization and the natural development of the private sector. However, as in most market economies, the Government may want to keep full or partial state ownership on some enterprises for various reasons. Also, even if it decides to privatize every enterprise in the country, the privatization process would most likely be carried out in a gradual way, so that a number of firms would remain socially owned for a considerable period. Furthermore, as it is argued in the text, in order to carry out an enterprise reform, the Government will have to regain control of all enterprises, including those that will be privatized immediately.

A.2. Thus, an important part of the solution is the substitution of the self-management system with more efficient ownership and management arrangements for the companies that would remain in the socialized sector. Meeting this objective would require the imposition of a substantial degree of central control

in order to eliminate the current chaotic situation. Another important part of enterprise reform would be the process of privatization. This Annex discusses some possibilities for carrying out both parts of the reform.

II. OWNERSHIP AND MANAGEMENT

ARRANGEMENTS FOR SOCIALIZED ENTERPRISES

A. THE OBJECTIVES OF ENTERPRISES

A.3. The role of socialist enterprises should be changed from providing specific goods and services to the economy to that of maximizing the return on the capital they use. The Government should look at the socialized enterprises as means to obtain income,[1] and, as such, should keep on investing only in those promising higher incomes and should liquidate those promising only losses. Consistently with this objective, the Government should not expect from socialized enterprises any help in implementing macroeconomic or other general policies nor in supplying particular goods. Conversely, it should not grant any privileges to its enterprises.

B. DEFINITION OF OWNERSHIP RIGHTS

A.4. The ownership model chosen for the socialized enterprises should meet the following requirements:

1) It should clearly define to whom the socialized enterprises' capital stock belongs. The current definition, that it belongs to society, is too abstract to be operative in the market. It cannot belong to the enterprise itself, another abstract entity. It should belong to the Government.

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1 There may be some exceptions to this general approach, as the Government may choose to keep ownership of some industries deemed as strategic. These industries should be treated as exceptions in ways that minimize the distortions they introduce in the economy.

2) It should clearly separate the returns from capital from the compensation of labor, thus creating the conditions for the development of a labor market. The managers, acting as Government representatives, should negotiate wages with workers in the same way as an owner would do, knowing that excessive wage increases will turn their firms uncompetitive.

3) It should link ownership with management, giving the Government the right to appoint and fire managers.

4) It should provide for tradeability of capital.

C. EXERTING PROPERTY RIGHTS

A.5. The Government would need to create an apparatus to ensure that managers actually pursue the desired objectives. Such apparatus would consist of a set of rules under which the companies would operate, a set of institutions and a set of incentives for managers.

a. The Set of Rules

A.6. Experience in other countries shows that, although important, the specific set of institutions used to manage public sector enterprises is less important in ensuring efficiency than the set of rules under which they operate. For example, the United Kingdom, Canada and Chile have been successful in improving the management of their public sector enterprises using administrative arrangements quite different from each other. However, the set of rules and incentives is very similar in all three cases. In the three countries, public sector companies are required to generate a minimum return on the Government's capital, in all of them a supervisory agency sets maximum borrowing authority for the enterprises, in all of them public sector companies are expected to compete with the private sector without any privileges and in all of them the Government has carried out painful restructuring and liquidation of inefficient enterprises. These seem to be the key ingredients for success.

A.7. Within such a set of rules, the Government has several options for the administrative arrangements to enforce them. One of the main options is whether to administer these rules in a centralized or decentralized fashion. This option is actually a matter of degree, because having a Government body in charge of establishing profitability targets and supervising their attainment is unavoidable if consistency is to be achieved. However, it is possible to apply the set of rules through either one single institution or a set of related institutions, all of them exclusively dedicated to the management of public sector enterprises, or through existing institutions that exercise the Government's ownership rights in particular sets of enterprises but have other roles as well. These could be the Ministries that were the founding members of the enterprises. The following sub-section reviews these two options.

b. Institutional Setting

A.8. Managing a large number of socialized enterprises would entail two levels of management. One kind of managers is needed at the enterprise level, responsible for making their enterprise profitable and for convincing investors (both public and private) to put resources on it. The other level would be needed to provide mobility of resources across the socialized sector and between it and the private sector. The two levels of management should be integrated so that they operate under the command of only one set of rules and, possibly, of only one institution.

i. Administration Under a Single Institution

A.9. Under this option, the ownership of all socialized enterprises would be given to one autonomous institution, which could be called the holding company, responsible directly to the Prime Minister for the profitability of Government's

holdings in socialized and mixed enterprises.[2] The holding company should care only about maximizing the present value of the Government's stock of capital. Its performance should be benchmarked against the returns on capital in the private sector.

A.10. The holding company's initial portfolio would contain all socialized enterprises, most likely comprising 100% ownership of each of those companies. However, the holding company should be free to sell the shares of those enterprises and get into joint ventures with other firms, private or socialized, domestic or foreign, in its effort to maximize the value of the capital entrusted to it. Also, very importantly, the holding company would appoint and fire enterprise managers as needed to attain its objectives.

A.11. Given the overall objective of allowing the private sector to become the most dynamic force in the economy, the Government should restrict the ability of the holding company to buy shares of private enterprises to only those cases in which joint-ventures are formed. Even if reduced from their current size, the Government holdings would still represent a very large portion of the total capital in the country. It would be relatively easy for the Government holding company to take over private companies by its sheer financial power, which is not what is wanted.

A.12. Given the currently large number of socialized enterprises, the holding company may wish to create subsidiary holdings, each of which would operate under the same rules of the parent and under its command. Under this arrangement, the parent would demand from the subsidiaries the return on capital the Government demands from it, and would transfer resources across subsidiaries, and would appoint managers of those. If this scheme is implemented, it is important that

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2 This institution would be autonomous in the sense that it would be outside the bureaucratic procedures of the Central Government but its manager would be appointed by the Prime Minister and could be fired at any moment by him.

the subsidiaries should not be created to coincide with economic sectors. The psychological tendency to look at socialized enterprises as responsible for the supply of specific sectors should be broken.

A.13. Thus, at the enterprise level, managers would work within a capital budget constraint, which they would be able to lift only by being profitable and by convincing the holding company that future operations will be more profitable than the alternatives open to the holding company.

ii. Decentralized Administration

A.14. Under this option, the first level of management (equivalent to that of the holding company in the previous option), would be decentralized, working in special units within the Ministries that founded the enterprises. As in the case of the holdings, these units should be completely separated from the policy making parts of those Ministries and their only concern would be to maximize the net present value of the enterprises they manage in accordance with the rules established for all Government-owned enterprises. Actually, these units would work in the same way as the subsidiary holdings of the previous option and would have the same kind of relationships with their enterprises. The only difference would be that their owner would be the corresponding Ministry and not the big holding.

iii. The Trade-Offs Between Centralized and Decentralized Options

A.15. As it has been stressed before, both options would fail to succeed if the rules governing the scheme are inadequate. If, for example, the Government keeps on interfering with the management of enterprises in order to obtain political objectives, or gives enterprises social and economic objectives different from maximizing their net present value, the holdings or subsidiary holdings would become only an extra layer in the lines of command.

A.16. If the rules are adequate, it seems that the fully centralized option (one holding with several subsidiary holdings) would be preferable for several reasons. First, independence from political influence would be easier to achieve if the whole stock of public enterprises is managed under a single, powerful institution clearly devoted to maximize the net present value of the Government holdings. Ensuring the autonomy of operation of several units immersed in a variety of Ministries may be more difficult, and violations of autonomy more difficult to identify.

A.17. A second, and related reason, is that, if the objectives of enterprises have been divorced from economic and sectoral policies. there is no reason to leave enterprises in the Ministries in charge of those policies. On the contrary, leaving them there would present a continuous temptation to use enterprises to promote sectoral policies. A third reason is that enterprises should be free to shift their product emphasis in order to increase their net worth, discontinuing inefficient lines and opening new ones. If they depend from a Ministry that emphasizes certain sectors, it would be more difficult for managers to do that. A fourth reason is that privatization would be easier if all enterprises are managed through one single institution. In summary, the centralized option would be better.

iv. Auditing and Control

A.18. Given the considerable opportunities for fraud and other crimes that the management of a large number of big enterprises would present to the employees of the holding company, a supervisory agency is also needed. Such agency should be totally independent from the holding company and should also report directly to the Prime Minister. Its primary tasks would be to ensure that transactions between the holding company and the enterprises, and between the holding and the private sector, are conducted at arms-length and on market terms; that the books

of the holding company reflect the true value of the Government's capital; and to measure the performance of the holding by comparing the returns it obtains from its capital with the overall returns on capital in the private sector.

c. Incentives for Managers

A.19. The provision of incentives for managers of socialized enterprises presents substantial problems. It is probably impossible to create incentives that will identify the manager totally with the interests of the owner. Very frequently, compensation of managers is tied with the yearly ratio of profits to capital. However, the owners' interest is not to maximize profits but the present value of their wealth. Year-to-year profits can be and most frequently are a poor measure of such maximization. Short-term profits can be maximized at the expense of long-term profits and remunerating short-term profits could incentivate managers to chose strategies that precisely do that.

A.20. Managers focusing on short-term profits tend to neglect activities that crucially affect the competitiveness of their firms but only in the long run. For example, they tend to minimize investment in research and development and tend to ignore training to keep their engineers up with technological progress. The introduction of new techniques may also be hindered because of the initially negative effect of training on the short-term profits.

A.21. Also, linking managers' compensation with profits creates an asymmetrical set of incentives for them. If the enterprise gets profits, they get higher compensation. However, if the enterprise makes losses, managers cannot lose more than their salary. The orders of magnitude are such that the net incentive is to take excessive risks. For example, the expected value of an operation that could equally yield 1/2 million of profits and 1 million of losses is -1/4 million for the owner but +1/4 million for a manager that has not put his wealth at stake.

A.22. Because of these problems, owners frequently offer share options as incentives to their managers in developed market economies. These and similar schemes linked with the present value of net worth, however, can function only in a country with a developed capital market and for firms quoted publicly.

23. To approximate that solution, the Government may wish to split bonuses to managers into two kinds. Both kinds would be linked to the returns on capital obtained by the managers, but one would be given annually and the other every five or ten years. Such incentives may be progressive (y% of profits beyond x% of returns, increasing y as x increases). The bonuses could be given to both levels of management, in the enterprises and the holding company. This scheme would also present problems in the valuation of capital. It can be applied meaningfully only after capital markets are in place. Before this happens, the Government may use a formula linking compensation to increases in absolute profits divided by the cost of new investment.

d. Liabilities' Structure

A.24. The liabilities side of the balance sheets of the socialized enterprises would consist of two parts:

a) Previously outstanding debt with the banking system, which would remain unchanged.

b) Equity, which should initially be owned entirely by the Government and could eventually be privatized.

e. Implementation Problems

A.25. Currently, there is no way to know the value of the stock of capital. There are two main obstacles. First, relative prices are quite distorted, so that it is impossible to know the discounted present value of the capital at true market prices. Second, there is no capital market to know the valuation

that markets put on the parameters of the present value calculation. These two problems can only be solved through the development of capital markets, which can be achieved through privatization.

III. PRIVATIZATION

A.26. Privatization of a substantial portion of the socialized enterprises would be the instrument to obtain the desired decentralization of economic decisions. As it has been pointed out in the main text, the market is unlikely to work unless most enterprises are turned into price takers, either because they are private, or because they compete with a large mass of private enterprises.

A.27. Of course, privatization alone cannot be expected to introduce market forces in these economies. Substantial reforms are needed also in trade, pricing, monetary and fiscal policies. Furthermore, privatization should be coupled with a significant restructuring of the country's productive capacity.

A. SALES VERSUS TRANSFERS

A.28. Still, privatization does not necessarily has to be carried out through selling the enterprises. In fact, the population already owns the firms through the Government. From this perspective, the problem of privatization is that of rearranging the ownership titles to the capital stock that already exist rather than the creation of new stock. If the enterprises are given to a subset of citizens, these citizens would have to pay for the enterprises in order to compensate the rest of their fellow citizens for the capital stock they are taking away from them. However, if the enterprises are given to all the citizens, they would have to pay nothing because all of them would acquire in shares what they already notionally have.

A.29. Moreover, selling a substantial portion of the Government-owned enterprises to the public presents three serious problems. First, financial capital markets, in the sense of trading of shares and bonds, do not exist. Second, the value of the enterprises is not known. The price of capital is not

determined precisely because of the lack of financial markets. Also, the possibility of misleading investors would arise because the value of enterprises can be expected to change significantly with the planned liberalization of the economy. A third problem is the perception that the population has not enough purchasing power to buy the enterprises.[3]

A.30. If the titles to the ownership of the enterprises are transferred without payment to the population, the problem of lack of purchasing power disappears. Also, if privatization takes place through distributing shares to all the citizens, there is no need to value the stock of capital. The shares distributed to the population would represent the right to a fraction of the net worth of the enterprise and to the profit it generates. The price of that share would change with time, as the value of the firm changes as a result of the success or failure of its operation. The third problem, the creation of deep financial capital markets where relatively large amounts of shares and bonds are traded, could also be solved if enterprises are transferred to the population. If a large transfer is effected, trade in shares can be expected to be heavy from the very beginning.

A.31. Transferring ownership without payment, on the other hand, presents two serious problems. First, the difficulties involved in transferring the shares in a way that is both fair and practical. Second, and more fundamentally,

3 There is also the opposite perception, that the public has excess purchasing power as evidenced by the existence of the "monetary overhang". This excess purchasing power, however, exist only in relation to the prices in the official market. The liquidity is fully used in the transactions in the black market. If an agent surrenders cash, he loses purchasing power in the black market, even in the extreme cases in which excess cash is useless in the official market because of rationing. Thus, demand for shares would be influenced by the opportunity cost of cash in the black market. The overhang is not a free good for people who hold it.

a completely dispersed private ownership would present problems similar to self-management. Without a controlling shareholder, management would be free to do with the enterprise according to its wishes, and the result could be chaos.

B. ALTERNATIVE WAYS OF PRIVATIZING THROUGH GIVING AWAY THE ENTERPRISES

A.32. The easiest way to transfer the ownership of enterprises would be to give the shares to the enterprise workers. As it has been discussed before, however, this would be unfair because the socialized enterprises are supposed to be owned by the society as a whole and not only by the workers.[4] A way must be found to distribute the shares as fairly as possible. Also, the distribution should be done in such a way that the recipients of the shares are encouraged to start and keep on trading on them, so that the capital market is created.

A.33. Since the precise way in which this distribution could be done is a function of institutional capabilities, and is likely to imply compromises between viability and fairness, it can be effectively designed only by the concerned Government. However, some options are discussed in the following paragraphs.

a. Transferring Shares to Contractual Savings Institutions

A.34. One option that has been widely discussed is to distribute the shares among pension funds or similar institutions, which would trade only among themselves, without being free to sell the shares to individuals. The idea is that the capital market would develop as a result of such trading while ownership would remain collective. An argument used to support this idea is that, in many capitalist countries, a substantial portion of the trade is carried out by institutional investors.

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4 If the shares are given to the workers, workers should pay for them to compensate the rest of society for the appropriation of the social assets. The problem, again, would be the valuation of the assets.

A.35. However, the number of contractual savings institutions is too small in Eastern Europe to really create a market. Transferring permanently the ownership of the whole--or a substantial part--of the socialized enterprises to decentralized pension funds would concentrate too much economic power on the managers of these funds, which would again pose the problem of accountability. Also, limiting ownership to these funds would seriously restrict the development of a capital market.[5]

b. Distribution to Local Authorities

A.36. Another option that has been discussed is having the Government distributing the shares among local authorities and then allowing trading among them and between them and other agents. The purpose of the transfer would not be to decentralize Government ownership to local authorities but to transfer wealth to these Governments, which would then be able to choose whether to keep, exchange or sell them for cash with the objective of maximizing the value of their holdings. That is, this scheme would aim at turning the local Governments into private agents for the purpose of managing the share portfolio. Profits obtained from the portfolio would be transferred to citizens through public goods and services.

A.37. This solution is proposed as equivalent to that of distributing the shares to all individuals from the point of view of fairness. However, it would not be a privatization. Local authorities have political objectives that can easily enter in conflict with the economically rational management of an investment portfolio. Also, the share of each citizen in the benefits of these investments would be to small and indirect to provide incentives for the monitoring of the authorities' performance in the management of the portfolio.

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5 However, a variation of this scheme, allowing for trading shares with individuals, could be a good solution. See Sub-Section on distribution of shares to individuals in this Annex.

A.38. The solution entails other serious problems and risks even if local authorities are allowed to trade with individuals.

First, the acceleration of the development of the capital market that could be expected from transferring the shares without payment would be restricted to the trade between local authorities. Individuals would be integrated only as they buy shares from the local authorities, which would take a long time to happen.

Second, even if regulations on holdings of local companies' shares are issued, the local authorities would have a strong temptation to use political power on their dealings on shares of companies in their territory.

Third, local Governments are not suited to make quick decisions on shares trading. On the contrary, transactions would most likely become subject to political and bureaucratic considerations. Moreover, it is quite probable that, even if some initial trading takes place, local authorities would very fast achieve their desired portfolio composition and would stop trading, locking the development of the capital market.

Fourth, there is no guarantee that the transferred wealth would be spent in a way that would benefit all the citizens of a locality equally or nearly so.

A.39. Some of these problems may be solved through ad-hoc regulations, such as forcing local authorities to liquidate their portfolios within a short time. This would force down the price of shares, to levels that would make them affordable to the population (possibly to levels close to zero). In this case, the local authorities would act only as intermediaries for Government auctions.

It is not clear that they have a comparative advantage for this role. Overall, it does not seem that giving the shares to local authorities would be a solution to the problem of quickly and fairly creating a capital market.

c. Distribution to Individuals

A.40. Another solution would be to allocate shares of all enterprises to each citizen, to each citizen registered to vote or to each family. The transfer of shares to individuals without payment has been tried successfully at least in two instances, although not in the scale proposed for Eastern European countries. In Canada, the Government of British Columbia privatized the British Columbia Resources Investment Corporation by offering 5 free shares of the enterprise (worth C$10 each) to each Canadian citizen or applicant residing in the province for at least one year. Those people could also buy up to 5,000 more shares each. In Chile, the two largest banks in the country were privatized by selling share packages to taxpayers under conditions that effectively reduced the price of the shares to zero.

i. Distributing Enterprises to All Individuals

A.41. Transferring shares to individuals may present two problems. One is that it could be too cumbersome. The transfers would involve complicated operations to identify the potential recipients, tracking them down and handing them the shares. However, Eastern European countries have mechanisms that could be used for the distribution, including the system to allocate rationing cards. Actually, the logistics of distributing the shares to the population would not be different to that used for each rationed commodity.

A.42. A more fundamental problem would be that the distributed claims on each individual enterprise would be very small in value, especially if the enterprises are broken down into smaller units before the privatization. Also, the number of enterprises of which individuals would get shares would be large,

making it difficult for them to make portfolio decisions (whether to keep them or sell or exchange them). In such circumstances, many people would most likely lose interest in the shares.

ii. Distributing Groups of Enterprises to Individuals

A.43. The second problem could be solved by dividing the enterprises into groups of similar value and then distributing the shares of the enterprises of each group to different groups of the population. That would increase the number of shares of each enterprise that each individual would receive while reducing the number of enterprises in his or her initial portfolio.

A.44. This solution could be implemented by district. Enterprises to be privatized would be divided into groups, the size of which would be proportional to the population of each of the districts in terms of the expected value of their assets. Thus, if the number of the enterprises to be privatized is on the order of, say, 120, and there are 50 districts, each head of family (or voter) would receive shares of 2 to 3 enterprises only. The value of each of these shares would be more substantial, enough to motivate them to think what to do with them. Such value could be increased if the number of enterprises to be privatized in the first phase is increased.

A.45. Yet another solution could be to distribute the shares of the enterprises to the population of the districts where they are located. This solution would present a problem of fairness only if all enterprises are privatized in this way. In such case, since the ratio of assets to population is not uniform throughout the districts, the inhabitants of some districts would receive more than others. However, if only a subset of enterprises are privatized in the first phase, this problem would not exist because the subset would be chosen in such a way that the value of the enterprises would be roughly the same across provinces.

A.46. Under this option, the regional concentration of ownership, which would be a problem if the shares are distributed to local Government institutions (because local Government institutions may try to manipulate the enterprises), would present no problems if the shares are given to individuals. On the contrary, it could be an advantage to foster trade because individuals would know better about the enterprises. Also, it is possible that the issues of fairness in the valuation of the enterprises (who receives shares of what enterprises) would be more easily accepted if enterprises are distributed geographically rather than based on other groupings.

A.47. The main problem with all the variants of this solution is that it requires a judgement on the value of the enterprises in order to establish the groups. However, the effects of this problem would be much less serious than in the case of selling the enterprises because the recipients of the shares would not spend cash in obtaining them.

iii. Distribution of Shares of Holding Companies

A.48. The Government also may distribute the shares of holding companies rather than those of individual enterprises. The privatized holding companies could be some of those proposed to manage socialized enterprises. Distributing their shares would make mutual funds out of them. These mutual funds would be able to sell and buy shares to any agent (including individuals) and their managers would be appointed by their shareholders (which, initially, would include the Government). People wanting to trade their shares in the mutual funds for shares in the enterprises would carry out their transactions in the newly created market.

A.49. This solution presents several advantages in addition to providing more incentives to the new shareholders to care about their investments. First, it would use the institutional setting built to manage the public sector enterprises. This would not only economize in terms of the creation of institutions

but would also facilitate future privatization decisions. Second, this solution would establish the basis not only for the development of individual trading in shares but also would establish a parallel track of institutional investors.

d. Selling the Enterprises to the Workers

A.50. Giving away the enterprises or stopping the financing to the socialized sector may be too drastic or impractical solutions. Another possibility would be to sell the enterprises to the workers, on credit. Such sale would have to be on an individual basis (that is, not to the Workers'Councils but to the individuals).[6] This possibility is quite attractive for at least two reasons. One is that it can be done quickly. Another reason is that, given the state of most enterprises (including the serious labor problems likely to emerge with any new owner), it could be impossible to have other people interested in investing their time, money and energy in restructuring them. Although this solution would be seen as unfair by the people not employed in industry, it could be fair dynamically, because all citizens would benefit from having better managed enterprises within a short period. If there is no other way to privatize quickly, this could be an optimal solution. How acceptable politically this argument would be, however, is open to question.

A.51. There would be several problems that would have to be solved to implement this solution. One is that, to have an effect, the distribution of shares would have to be done in a way that concentrates ownership and power in a relatively few people, most probably the managers. This would ensure the rapid introduction of the discipline required to reduce overstaffing and increase operational efficiency. Resistance could be reduced by giving equal shares to

6 I am grateful to John Nellis (World Bank), Jean Tirole (MIT) and Barry Bosworth (Brookings Institution) for provocative discussions of this possibility.

all workers. The cost would be that, with everyone holding a equal share, decisive action could be precluded, especially on reducing overstaffing. Workers are unlikely to sell their shares if that would put their jobs in jeopardy.

A.52. Another issue is how to value the capital of the enterprise. This could be solved by auctioning the enterprises, having as one bidder the workers. The complication is that the workers can force the price to be zero by threatening unruly behavior if they do not get the enterprise. Although they can use this threat in any circumstance, it would be less probable that they would use it if the shares are valued through an alternative mechanism.

A.53. One possibility would be to defer the valuation, establishing incentives for the workers to increase the value of the shares. This may prove to be difficult, because the workers have a strong incentive to decapitalize the enterprise: the more they extract capital from the enterprise before the valuation, the less they have to pay for the capital existing today.

C. A PRIVATIZATION SCHEME MIXING TRANSFERS WITH SALES

A.54. Not all privatizations need to be carried out through transfers without payment. Once the capital market had been created, the Government would be able to sell enterprises. Governments could aim at a mixed solution, comprising both the transfer of ownership without payment in an initial phase and the sale of shares in a subsequent one. Under this mixed scheme, the Government would privatize companies in sets. The first several sets would be privatized combining both transfers without payment and selling, while the second series of sets would comprise only sales. The main objective of the first phase would be to prepare for a fast privatization by creating a relatively deep capital market where the

price of shares could be established. Once this is achieved, the Government may proceed to sell shares. Of course, for this process to materialize it is necessary to have in place an institutional setting for capital markets transactions.[7]

A.55. To create the capital market, the Government would distribute 80% of the shares of the first few sets of enterprises to the population and would retain the remaining 20% to keep control of their management. That 20% would be sold to a controlling interest (domestic or foreign) after trading on the distributed shares had determined their prices. Since this sale would convey control, the Government may charge a premium on that price (the alternative for the entrepreneurs seeking control would be to buy more than 20% from the population, which would be more costly). Subsequently, the Government may privatize the rest of the enterprises through selling only.

a. The Stages of Privatization

A.56. If the Government decides to pursue the mixed strategy, there would be five stages in the process of privatization. In the first stage, the Government would create the necessary infrastructure for trade in shares and other instruments and would regain control of the socialized enterprises. In this stage, the Government would also break down the enterprises into smaller units.

A.57. In the second stage, the Government would chose the enterprises or holding companies to be included in the first batch of privatization. Then, it would distribute 80% of the shares of the first batch of enterprises to be privatized.

A.58. The third stage would involve trading of the shares among the recipients of the shares and with other agents, including citizens, banks, insurance companies, pension funds, and other enterprises. Trading would be subject to three restrictions.

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7 This is a very important requisite for the success of privatization. It goes beyond the scope of this paper, however.

First, foreign investors would be initially excluded. This is because, given the small amount of liquid savings available and the poor macroeconomic condition of the countries, it is likely that the market would initially undervalue the existing capital stock. This restriction may not be necessary if the process is gradual, and only a small fraction of the total capital stock is transferred at a time.

Second, banks would not be allowed to become holding companies. That is, there would be a limit on the proportion of its assets that a bank could invest in shares for two reasons. One is that their financial power could allow them to purchase the greater part of the existing capital stock, thus suffocating the newly born capital market. The other is that ownership linkages between banks and potential borrowers should not be allowed. Similar restrictions would apply to insurance companies and pension funds. Insurance companies and pension funds must concentrate in low-risk investments.

Third, enterprises without clearly defined owners would not be permitted to purchase stocks. Otherwise the problem of undefined ownership would be just moved one step back. Single-person companies would be able to buy stocks. So would joint-ventures and limited-liability companies if all of its investors would also classify.

In the fourth stage foreign investors would be allowed to purchase shares, and the Treasury would sell the remaining 20% of equity. Since this block of capital may guarantee the control of the enterprise, it may be sold at a premium.

A.59. After this process is carried out with a substantial portion of the socialized assets, a capital market would have been established. The Government may wish to repeat the process with other sets of companies to give more depth

to the market. Afterwards, it could sell all other enterprises targeted for privatization using several methods, some of which are discussed in Section F of this Chapter.

A.60. It is important to note that, although the initial distribution of shares can be carried out while heavy distortions are still in place, the distortions would distort the prices of shares once trading starts. The subsequent removal of those distortions would most likely lead to wide fluctuations in the stock prices. Eliminating distortions should be given priority in the initial stages of privatization, aiming at ensuring that trade in shares takes place at prices that reflect the economic realities of enterprises rather than artificial advantages and disadvantages imbedded in a distorted environment.

D. SUMMARY

A.61. In summary, privatization seems to be unavoidable if true decentralization of economic decisions is to be achieved. Privatization through selling enterprises would take decades to create the critical mass needed to have a functional market. The alternative is aiming at a fast privatization through transferring the ownership of enterprises without payment. There are many options to do it, some of which have been sketched in this Annex.

A.62. The creation of a financial capital market and the simultaneous liberalization of the economy should be major objectives in the first stages of privatization. Once a capital market emerges, and the prices quoted in it are reasonably realistic (that is, they are not conditioned by substantial distortions in the environment where the enterprises operate), the range of options open to the Government would increase exponentially. Experience in other countries shows

that successful privatization requires a very flexible approach in tailoring privatization mechanisms to the specific nature and circumstances of the subject enterprises.[8]

8 For an excellent analysis of privatization perience in 83 countries see Charles Vuylsteke, Helen A. Nankani, Rebecca Candoy-Sekse and Anne Ruiz Palmer, "Techniques of Privatization of State-Owned Enterprises", World Bank Technical Paper Number 88-90, The World Bank, Washington DC, 1988.

ISSUES IN THE INTRODUCTION OF MARKET FORCES IN EASTERN EUROPEAN SOCIALIST ECONOMIES

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ANNEX II

BANK RESTRUCTURING AND REFORM ISSUES

I. BACKGROUND

B.1. The implications of the reasoning of Chapter II of the main text for the financial system are straightforward. Financial institutions could play only a peripheral role in the allocation of resources among uses in an economy where investment is a fixed proportion of profits, profits are arbitrarily determined and factors lack mobility because of the essential features of the system. Moreover, if those restrictions are removed but no true factor markets are created, the financial system would be even more irrelevant, because the economy would most likely move into a chaotic situation, with large disinvestments and severe political problems caused by unemployment and large differences in the wages paid for the same activity.

B.2. However, if ownership and public enterprise management reforms are introduced to transform these economies into true markets, a full fledged financial system would have to be developed. The three reforming countries have started a process to create such financial systems. The models adopted to create the

system have been different in Yugoslavia, on the one hand, and in Poland and Huhgary on the other. This Annex reviews some of the most important issues they now face in this task.

A. THE CASE OF YUGOSLAVIA

B.3. In Yugoslavia, banks have been truly decentralized for decades. They are owned by enterprises (called the founding members). Their role is to be financial agencies for their founding members, creating a conflict of interests that has led banks to run large losses for the sake of their owners. They will allocate resources to them even if the funds could be invested more profitably with other customers. Banks' credit activities are discretionary only when undertaken with funds mobilized from households or with non-earmarked credits from the National Bank of Yugoslavia (NBY) that are not in demand from their founding members. In practice, operations meeting these requirements represent a very small portion of the credit transactions of Yugoslav banks.

B.4. Linkages between banks and debtor firms have been identified as a major source of portfolio problems in several countries suffering from financial crises similar to that of Yugoslavia because they encourage the concentration of bank credit on related companies and weaken the criteria used to approve loans to these companies. In Yugoslavia, however, the subservience of banks to their owner-borrowers goes beyond other comparable cases. In the 1970s, for example, banks borrowed in foreign currencies and lent in dinars to their founding members, creating the stage for their current huge devaluation losses. Even in the early 1980s, when the disastrous consequences that this practice had for financial institutions, banks kept on doing it until it was prohibited by the monetary authorities. Until very recently, they had been lending to their borrowers at interest rates that were lower than their cost of funds. Even now, since banks

show profits in their accounts because the authorities allow them to defer their losses, they are distributing dividends to the very same owner-borrowers that are not repaying their debts.

B.5. Recently, the Government has issued a series of measures aimed at curbing the power of the founding members to transfer profits from their banks to their enterprises. However, these measures have been mainly administrative regulations, such as limiting the amount of credit that a bank can give to a particular enterprise, including independent persons in the Board of Directors and instructing managers to be independent from the owners when making business decisions. Since the founding members keep the ownership rights and can dismiss managers, the measures are very weak.

B.6. Furthermore, the Government measures have been directed to achieve a rather unusual objective: delinking ownership from management. If this objective is achieved, the founding members would continue to own the banks but they would not run them. That is, the banking system would run under a system that has been already applied to enterprises with disastrous results. Delinking ownership from management in enterprises under the self-managed system was, in fact, one of the other major factors contributing to the current crisis. There is no reason to believe that it will work better in banks than in enterprises. The new measures seem to be an attempt to build a complicated system in order to keep the current ownership scheme in place.

B. POLAND AND HUNGARY

B.7. Until very recently, as a reflection of its subsidiary role, the banking system of most Eastern European countries comprised only five institutions: (a) the National Bank, whic played the role of a the central bank while also being the largest commercial bank in the country; (b) the agricultural bank, typically the central institution of the cooperative banks, a network of small local banks that mobilize resources from the population and lends to specified

activities, mostly agricultural; (c) a savings bank to work with the population; and in some cases, (d) a bank specialized in obtaining resources abroad to transfer them to the National Bank and to socialized enterprises. Competition did not exist. Banks were specialized in specific activities and there were very few and unimportant overlaps. Interest rates and employees wages were set by the Council of Banks, a central body that regulated the system.

B.8. Under central planning, the banking system is an extension of the Treasury. Financial resources follow the allocation of real resources, providing little more than a unit of account. In order to isolate the flows related to production from the more volatile flows of the population, the Government keeps two separate "monetary circuits." Savings banks operate only with the population and the small number of small private enterprises, while the rest of the banking system operates only with the socialized sector (state enterprises and cooperatives). Transfers of resources between the two circuits are not allowed.[1]

B.9. Under the Financial Reform of the late 1980s, the Governments of Poland and Hungary decided to specialize their National Banks in central banking and to split their deposits and commercial loans into a number of commercial banks and one housing savings bank. These institutions were created as universal banks. That is, each of them can engage in any banking activity, operating with both the private and the socialized sectors and lending to enterprises or individuals in any activity in any region of the country. The existing banks were granted the same freedom, so that, under the spirit of the Law, all banking institutions in Poland and Hungary can compete on a level playing field.

B.10. The Governments of Poland and Hungary kept the ownership of banks while decentralizing management, under a model that resembles that used in the

1 In Hungary, they are still formally prohibited by a provision deemed to be temporary.

enterprises. The control of banks, however, has not been given to workers but to managers, who are appointed by the Government or the Central Bank and are accountable to the Government for the profits and losses of their institutions.[2]

B.11. While these provisions of the Law are quite conducive to make of the banking system an efficient intermediary of resources, banks are still not free to mobilize and allocate resources in accordance with market signals. There are several obstacles that preclude the attainment of the objectives of the Law.

II. THE ROLE OF BANKS

B.12. In socialist economies, banks have traditionally been expected to have a social role that is opposed to their economic objectives. That is, banks have been expected to sacrifice their profitability in order to provide cheap credit to their customers. This is as true in Yugoslavia as in Poland and Hungary. As part of this concept of banking, the banking system has had the obligation to finance each and every enterprise in the socialized sector, regardless of the profitability of doing so.

B.13. This conception of banking breaks down the mechanism of transmission of market signals. In order to allocate resources efficiently in a market economy, the only social and economic objective of banks should be to optimize their profits. To achieve this goal, they identify profitable opportunities to lend and mobilize resources to finance them. The country's savings, then, are attracted to finance the most productive undertakings.

B.14. When a bank makes losses, it effectively converts savings that could be useful for productive investments into losses that reduce the standard of living of the population. This behavior makes a disservice to society. When profitable, a bank ensures that the investments it finances are productive enough to yield a profit to the borrowers and to the bank itself. Profits can then be

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2 In Hungary, the Government has kept 50.5% of the ownership of banks. The rest is widely distributed among enterprises and other bodies.

reinvested to promote more growth or could be taxed to pursue other social objectives. The increased economic activity results in a substantial social benefit.

III. THE OWNERSHIP AND MANAGEMENT OF BANKS

B.15. The ownership of banks presents problems similar to those of the ownership of enterprises in the real sector. Bank managers carry a great responsibility because they play a central role in the allocation of resources. Currently, the banking system is still functioning as an extension of the National Banks in Poland and Hungary. It is not functioning as an independent system, and cannot function as such as a result of the problems described in the following Sections. Because of this, the need to design a system to mimic as much as possible market incentives for managers has not been felt as urgent. However, as the constraints on the financial system are lifted, this will become a pressing problem.

B.16. The market provides a natural set for incentives for managers through the linkage between ownership and management that prevails in private banks. It is through this linkage that the interests of capital are represented in the bank, ultimately enforced by the right of owners to appoint and fire managers and to intervene in the management of the bank through the board of directors or other means. The linkage between ownership and management provides a symmetrical structure of incentives that encourages, and ultimately enforces, responsible behavior. If the owners make mistakes, they pay for them by losing the capital they invested in the bank. If the owners make the right decisions, they get the associated profits.

B.17. Creating a system of incentives for managers that would make them play the role that owners play in a market economy is as difficult as that described for enterprises in Annex I and the main text. The problems of setting them free while tying their compensation to current profits are even larger than

in industrial enterprises. In banks, focus on short-term profits results in strong pressure to lend, which leads to hasty lending decisions. After a while, such practice deteriorates the institution's loan portfolio and could even lead to bankruptcy.

B.18. Furthermore, bank managers are subject to corrupting temptations. For example, even if his official earnings are tied to the banks' profits, potential borrowers may offer kickbacks worth more than the managers' share of profits in order to get preferential treatment in detriment of the bank. Such behavior is primarily deterred by the vigilant eye of the owner.

B.19. Thus, in order to establish the right set of incentives for managers, Eastern European countries should privatize their banking systems, or most of them. Currently, however, there are many problems that turn privatization impractical. The solution of those problems would most likely take several years. Those problems include the lack of an appropriate structure of prudential regulation and of effective means of monetary control, as well as the profitability problems associated with the currently poor condition of the banks' portfolios. Also, the banking system's portfolios are likely to deteriorate further as a result of the shifts in relative prices caused by the needed economic structural reforms. Although highly desirable, privatization should be postponed until these problems are solved. Therefore, Government ownership will have to be the main form of banks' ownership in the immediate future. Within this environment, the Governments may try the scheme proposed in Annex I and the main text for incentives to enterprise managers: giving bonuses based on long-term performance.

B.20. An important problem that should be solved immediately, however, is that of the ownership lonkages. In Yugoslavia, this is a pressing problem. In Hungary, where the participation of enterprises in the ownership of banks is more limited, the linkages already affect decisions. In Poland, the current Banking Law allows for ownership linkages between banks and borrowers. In both

Poland and Hungary, banks are receiving proposals to establish joint ventures with enterprises working in the real sector. This is very dangerous, as it also is allowing enterprises to create banks. When borrowers control banks, bankers lose their independence and credit decisions are taken to solve the liquidity problems of the borrower, to conceal its bankruptcy when it becomes insolvent, and, in the case of enterprises founding banks, to maximize the profits of the enterprises rather than those of the bank. Experience in other countries shows that allowing ownership linkages between borrowers and banks easily leads to the bankruptcy of the banking system. Those practices should be forbidden.

IV. OBSTACLES TO COMPETITION

B.21. The banks are operating within an environment in which they will hardly be able to compete against each other. The major issues in this respect are the basic account and the pressures to discriminate among banks in terms of regulations and operational rules.

A. THE BASIC ACCOUNT

B.22. One of the main features of socialist banking systems is the "basic account". This account is a remnant of the central planning system. It was used to track the use of funds. Firms can open only one basic account through which they had to carry out all their normal transactions, and can get most kinds of credit only from the bank where they have their basic account. A firm can open other accounts or get credits from other banks but only for restricted uses, in special circumstances and, in most cases, with the permission of either the bank managing the basic account or the National Bank. Conversely, banks cannot stop giving service to enterprises having their basic account with them.

B.23. By forcing enterprises to work primarily with an specific bank, and forcing banks to keep on operating with specific enterprises, the basic account system reduces the possibility of competition between banks to a point that would

render useless the whole reform. Moreover, it would be an obstacle to the necessary diversification of the banks' portfolio alluded to before. It should be repelled.

B. THE STRUCTURE OF ASSETS AND LIABILITIES

B.24. The structure of loan portfolios and liabilities that the National Banks legated to commercial banks makes it very difficult for banks to compete. Several of the banks have their asset portfolios concentrated in long-term loans granted to a handful of enterprises at very low fixed interest rates. There are cases in which most of the portfolio is with one single enterprise or conglomerate. Banks in these circumstances are hardly able to generate resources to compete for new credits and would have to wait for decades to diversify their portfolios. The structure of liabilities also varies widely from bank to bank. In Poland, for example, whereas Bank Slaski's deposits represent 3% of their liabilities, Bank Krakow's represent 50%. The need for credit from NBP is much higher in the former than in the latter.

C. PRESSURES FOR DISCRIMINATION

B.25. As a result of these problems, there are strong pressures to create differences in legal reserve requirements, refinancing limits, taxes and other regulations to compensate for the wide differences in the structure of the liabilities of different banks. Efficient competition, however, would become impossible if some banks are able to obtain privileges not open to their competitors. In such an environment, banks would succeed not because they are efficient but because of their success in obtaining such privileges. This destroys the morale and motivation of managers and staff and perverts the role of the banking system.

B.26. Solving the problem of asset structure requires a thorough restructuring of the banking system (see Section K). The IMF Central Banking Department suggested a practical solution for the liabilities issue in Poland. Namely,

that the banks' present liabilities to the Central Bank be transformed into securities with maturities matching those of the loans financed with them. The Central Bank should make it clear that it will collect at maturity, without possibility of rolling over. This would establish a strong incentive for all banks to mobilize resources to compensate for the loss of the Central Bank financing. Also, it would allow to establish equal refinancing and legal reserve requirements for all banks because refinancing would apply only to new operations.

B.27. There are other issues, however, where pressures for discriminatory practices exist. The Government should resist those pressures and find pragmatical but fair solutions to solve those issues.

V. THE LACK OF ADEQUATE PRUDENTIAL REGULATION AND SUPERVISION

B.28. Regulation of bank operations is still partial and supervision is almost inexistent. Given the fact that banks manage the funds of the public, it is important that their freedom be tempered with rules that discourage their taking excessive risks and punish immoral behavior. Such rules should be properly enforced through supervision. The Bank has produced detailed recommendations on this issue to the three reforming countries.

VI. THE LACK OF APPROPRIATE INSTRUMENTS OF MONETARY CONTROL

B.29. As the economy becomes increasingly monetized, the need for appropriate instruments of monetary control is becoming urgent. Currently, the rate of inflation is too high and increasing. The best instruments of monetary control are those that do not interfere with the allocation of resources between competing uses. They are based on direct control of reserve money creation and indirect control of the banking system's multiplier and interest rates.

B.30. In Eastern Europe, these instruments are not yet developed and monetary control has to be exerted through instruments, such as credit ceilings, that restrict the allocational freedom of the banking system. This situation will not change in the immediate future because some of the parameters on which

indirect monetary control is based are not known. For example, the multiplier of the banking system is not known. Furthermore, it is bound to change as a result of the introduction of check payments and, hopefully, as a result of declining inflation. Therefore, the constraints imposed by the inefficiency of the monetary control mechanisms are likely to stay in place for some time. The Government, however, should try to minimize the negative impact of those instruments on the allocation of resources.

VII. MANAGED INTEREST RATES AND DIRECTED CREDIT

A. INTEREST RATE CEILINGS

B.31. In Poland, banks cannot attract deposits at the highly negative interest rates now in place. Instead, the incentives are for the population to save in unproductive assets, such as foreign currency notes and durable consumption goods. Such unproductive assets carry yields much higher than deposits in the banking system. Weak demand for financial assets denominated in zlotys is translated into high demand for goods and services, which fuel inflation, and for foreign currency, which keeps away from useful purposes the large stock of foreign currency now held by the population outside the banking system.

B.32. Negative real interest rates have also become a major source of excess demand, inflation and misallocation of resources in Poland. They convey large real subsidies to borrowers, which are being financed through imposing a high inflation tax on holders of assets denominated in local currency. This creates a vicious circle, because the higher the inflation rate, the higher the subsidies and, the higher the subsidies, the higher has to get the inflation rate to finance them.

B.33. Negative real interest rates also affect the profitability of banks. Since banks' assets are denominated in nominal terms, their real value is eroded if the rate of interest charged on them is lower than the rate of inflation.

When this happens, the real volume of their operations contracts in real terms and they become too small for their operating costs, which do not fall because they follow the general trend of inflation. They start making losses.[3]

B.34. Negative real interest rates have also devastating effects on the efficiency of investment. They discourage the efficient allocation of investment by introducing rationing, thus creating two markets with opposite signals, both of them distorted. In the formal market, subsidized lending interest rates reduce artificially the cost of capital and lead to the adoption of unduly capital-intensive techniques, excessive inventory levels, low rates of capacity utilization and waste. As a result of this inefficiency, capital intensity becomes excessive in the formal market and the volume of investment required to obtain an expansion in production is increased. In the informal market, excessively high real interest rates discourage the formation of capital and the adoption of techniques inappropriate for the country's factor endowment. As a result, the choice of techniques is distorted, in opposite directions, in both the formal and informal markets.[4] Overall, subsidized credit increases the volume of financial savings required for growth while reducing the availability of those savings.

B.35. Furthermore, since negative real interest rates make it impossible for banks to mobilize resources, they encourage banks' dependence on the Central

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3 To maintain profitability it is necessary not only to charge positive real interest rates but, also, the ratio of profits to equity capital has to exceed the rate of inflation. Otherwise, the bank suffers a capital loss.

4 In Poland, the informal credit market seems to be very small, not because the financial market is not fragmented but, because private agents have had no possibility of owning capital goods. With the development of the private sector, such informal market will emerge if the subsidization and fragmentation of the official market is not eliminated.

Bank, a clearly uncompetitive behavior. Furthermore, such dependence would contradict the basic objective of the financial reform, the creation of an autonomous banking system.

B.36. The financial reform will start to have an impact on the economy only after free money and capital markets are in place, which requires free interest rates. Therefore, measures to increase real interest rates to positive levels should be implemented as soon as possible.[5]

B. DIRECTED CREDIT AND MARKET FRAGMENTATION

B.37. Although in theory banks are free to allocate resources in accordance with market signals, in practice they are not. Mobility of resources is precluded by the various schemes that force banks to direct portions of their credit to specific activities. There is little that banks can do to change the allocation of resources because funds available for agriculture cannot be used for housing or manufacturing, and viceversa. Most credit in socialist countries is granted under these schemes. It is clear that the financial system will not be able to carry out its responsibilities as long as directed credit remains as pervasive as it is now.

B.38. Directed credit lines specify the interest rates that banks can charge on them, which differ from line to line. This results in a damageful distortion, because the cost of capital differs artificially for enterprises in different activities. Thus, demand for credit from different sectors cannot be compared with each other because it reflects not their comparative ability to make capital productive at a uniform cost, but the fact that some of them can get the funds cheaper than the others. Currently, in Poland, the rate of inflation is so high relative to all interest rates that the differences between different credits have become minor in comparison with the high subsidization that all of them

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5 The problems involved in raising real interest rates are discussed in the main text.

carry. This situation, however, is unsustainable, and interest rates will have to be increased to positive real levels. When doing that, it is important that the Government makes sure that the rate of interest is equalized throughout the financial market.

C. THE PROVISION OF LONG-TERM FINANCING

B.39. One of the objectives of directed credit in Eastern Europe is the provision of long-term credit. This is a negative but common practice in developing countries. It is usually assumed that market forces in developing economies cannot provide long-term financing because there is no supply of long-term financial savings. It is true that long-term instruments are not popular in many developing countries. However, this is mostly the result of high and variable rates of inflation and interest rate controls, which render those instruments too risky to bear, especially when they carry fixed rates of interest. A very large portion of savings are long-term in nature and are invested in long-term real assets. There is no reason to expect that, given a fair yield, people who are now investing in real assets would not be willing to invest in financial instruments which have much more liquidity and more convenient to hold.

B.40. Therefore, the problem is how to mobilize financial resources out of the flow of savings. In addition to allowing interest rates to reflect the opportunity cost of savings, the government could promote such mobilization by creating new instruments that make term transformation safe and by releasing the huge potential of pension, insurance and social security funds.

B.41. Rather than subsidizing credits, the Government should focus on providing liquidity to equity and long-term lending instruments. There is no institution in the whole world that can mobilize deposits matching the maturity of 15- to 20-year loans. However, such loans are common throughout the developed world, financing all kinds of investments, including housing. This is done

through the use of instruments that allow for low-risk term intermediation, mainly floating rate bonds and deposits as well as secondary markets for mortgages (see next Sub-section on housing financing). While those instruments perform better in stable monetary environments, they can also be attractive in inflationary environments, provided, of course, that interest rates are set in the market and that inflation rates are within controllable limits.

B.42. The government subsidization of long-term credits is not just an inefficient way of providing long-term funds but is also one of the main obstacles to develop a long-term credit market because it discourages the mobilization of market resources to fund term lending. Subsidization of other credits also has a negative impact because they increase the cost of non-subsidized credits, in many cases to levels that are too high relative to the profitability of real capital. The higher the share of subsidized interest rates in total credit, the higher will be the interest rate in the free portion of the market.

B.43. Interest rate liberalization and unification of financial markets are the most important measure that the Government can take to provide liquidity to long-term instruments. However, there are other measures that it can take to promote such liquidity, mainly establishing the right environment for the growth of contractual savings as well as enacting and enforcing regulations geared at giving transparency to the capital markets and at punishing bad practices. The Government can also contribute to the creation of a critical mass of capital market transactions by financing its needs through bonds sold to the public at market interest rates.

B.44. Contractual savings institutions--such as pension funds, social security schemes and life insurance companies--are natural providers of long-term funds. Such institutions can provide term financing in the shape of equity and loans, and of all the intermediate instruments that combine some features of each of these.

B.45. Contractual savings institutions in Eastern Europe, however, suffer from several problems that constrain their growth as the main actors in a nascent capital market. The Pension Funds work under a pay-as-you-go principle, which eliminates their role as mobilizer of long-term funds. The life insurance companies are forced to invest all or a substantial portion of their reserves in low-yielding government paper that is used to finance the Government. As a result, they cannot offer attractive savings plans to their potential customers, and then experience low, or zero, growth in real terms.

B.46. Solving the problems of contractual savings institutions, enabling them to mobilize resources in free competition and investing the proceeds judiciously would have a stronger developmental impact than providing direct financing to enterprises. As in the case of floating rate deposits and bonds, contractual savings instruments work better in stable than in inflationary monetary environments, but they can develop instruments ensuring that the returns on their saving plans are competitive with other market instruments.

D. HOUSING FINANCING

B.47. The lack of an adequate provision of housing is a long standing problem in the socialist economies. In addition to causing obvious social problems, the lack of housing contributes to the rigidity that affects the mobility of factors in the country. The workers' inability to find new housing prevents workers from looking for jobs in locations different from where they live. It equally restricts the companies' ability to transfer executives accross cities. This could prove to be an important obstacle for the restructuring of the economy and for the efficiency of its subsequent operation.

B.48. There are several factors contributing to the deficiency in housing supply. Some of them are related to distorted relative prices in the housing industry. Chronic shortages of building materials, one of the most frequently binding restrictions in several countries, are evidence of inefficient pricing

of inputs. Other problems are related to regulations. One of them is that, in several countries, it is illegal to build or buy dwellings for rent. This restriction was recently removed in Poland, but banks can only provide short-term loans to finance rental buildings. As a result, a source of substantial investment in the sector has been closed and, since rentals were not available, it was practically impossible to move temporarily to other locations.

B.49. Also, quite fundamentally, there is a problem of ownership. In several countries, most housing is provided through enterprises, who build the units and allocate them to their employees. Although there are other sources of housing (cooperatives and state housing, for example), it is extremely difficult to get apartments outside enterprises, so that obtaining ownership is almost impossible. In Yugoslavia, for example, where people can own housing units, they have to give first priority to enterprises when selling them. As a result, the market is quite restricted. Furthermore, in some countries, like Poland, people obtaining housing from cooperative and state organizations do not own the units either. They obtain housing loans to acquire the right to live in an apartment. However, they cannot be expelled, even if they do not pay their dues, unless another, equivalent unit is given to them.

B.50. The scarcity is partly caused by the high subsidization of housing finance. For example, in Poland, nominal interest rates on housing loans are 3% for collective and 6% for individual housing. With high inflation rates, such interest rates dissipate a large portion of the savings used in building dwelling units, so that only a small slice of those can be used to build new units. In some countries, the monthly payments of tenants in state and cooperative housing do not even cover the maintenance costs, which are paid by the Government.

As a result, the total amount financed is constrained by the Government's ability to subsidize the operations.[6] Although this problem is more acute in countries with high rates of inflation, it is common to all socialist countries.

B.51. The housing problems are unlikely to be solved unless a full-fledged housing market is established. This would require establishing at least clear ownership rights, rights of eviction, equal treatment of rental and condominium buildings in the financial system, opening the construction industry to private competition and eliminating the privileges of enterprises in providing housing.[7]

B.52. Establishing a market for housing does not necessarily mean that the state should stop the subsidization of housing. Subsidies could still be provided, but in a more efficient way, without distorting the financial system and the relative prices of the housing industry. A mechanism that has worked quite efficiently in Chile is to subsidize low-income, first-home buyers with a lump sum. The beneficiaries can use this sum to buy any house in the free market (old or new), financed at market interest rates. Financing is provided by any bank, which in turn sells the mortgage in the secondary market. Thus, the distortions caused by the subsidy are minimized and long-term resources are mobilized from the public to finance construction.

B.53. Establishing such a system would require deciding on the amounts of the subsidies and on the regime of interest rates to be used in housing finance. Since inflation would be a permanent threat to socialist countries throughout their transition toward a market organization, the best regime would be to index the mortgages to an indicator of inflation.

B.54. The problems in financing housing are related not only to the low interest rates charged but, mainly, to the fact that they are stated in nominal terms and the interest rates are fixed. Charging higher interest rates would

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6 Also, the quality of maintenance is very poor.

7 This is essential to provide mobility of labor.

increase the share of housing payments to levels that would be unaffordable for the average family. But, of course, the fact that interest rates are fixed means that, in an inflationary environment, real repayments decrease very rapidly, increasing the subsidization and reducing the share of housing payments in family income. Figure B.1 shows the behavior of the interest rates regime currently used in Poland to finance housing. It is clear how the amount of subsidization increases and the share of payments in family income decreases with the rate of inflation using data for Poznan in 1988. The housing unit is a basic flat of 50 square meters.

FIGURE B.1

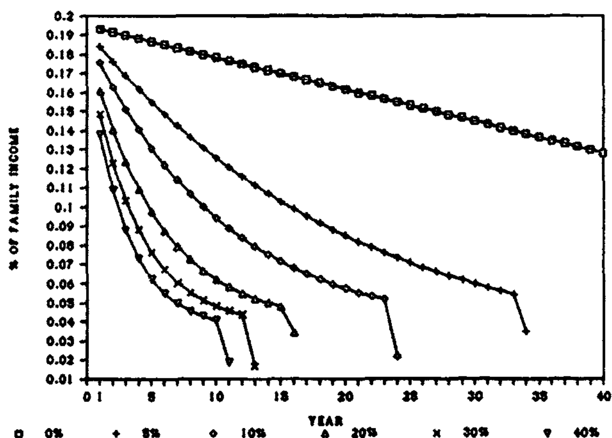
SUBSIDIES AND PAYMENTS AS A

PERCENT OF FAMILY INCOME AT DIFFERENT RATES

OF INFLATION IN POZNAN, 1988

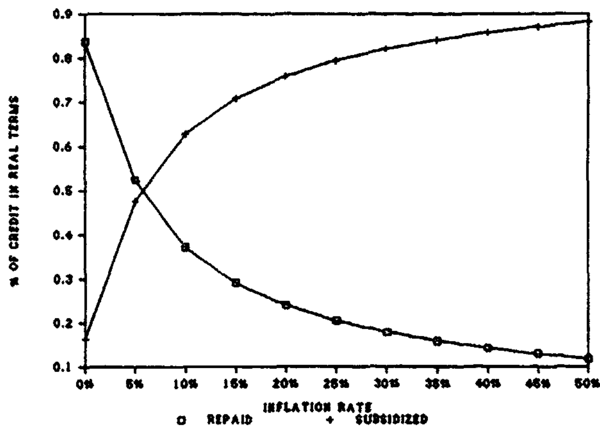
PERCENT OF FAMILY INCOME

CURRENT METHOD



REAL REPAYMENTS AND SUBSIDIES

CURRENT METHOD

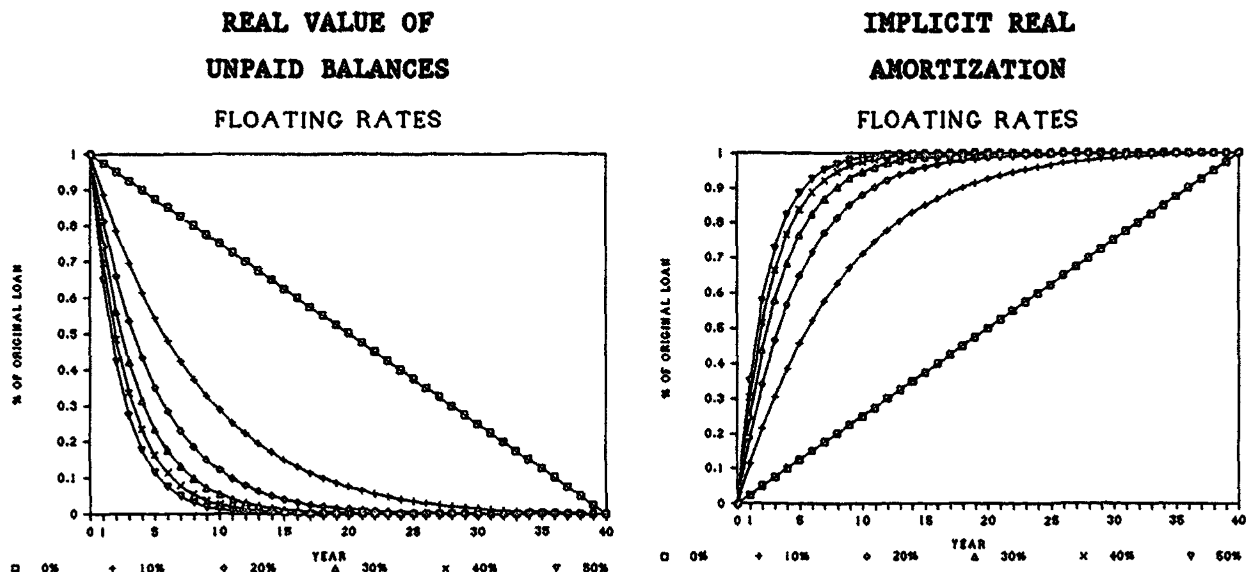


B.55. Floating nominal interest rates, however, would be impracticable at the high inflation rates currently prevailing in Poland, Yugoslavia and even Hungary. At high inflation rates, floating nominal rates result in extremely high installments at the beginning of repayments and extremely low installments at the end of them. This is so because floating rates increase the rate of real amortization of loans over the scheduled one when inflation is present. Floating nominal rates cause this effect because they go up to compensate savers for the losses that inflation cause in the total stock of debt oustanding. Since the debt oustanding is defined in nominal terms, its purchasing power declines in real terms in proportion to inflation. Thus, the only way to protect the real value of the savers original investment is to pay them immediately for the loss of purchasing power of the whole unrepaid stock. So, in each installment, the borrower has to pay in cash not just the scheduled amortization plus interests on the unrepaid stock, but also a compensation for the loss of purchasing power of the whole unrepaid balance. This is reflected in the nominal interest rate.

B.56. The impact of accelerated real amortization on a 40-year, 3% interest rate loan is shown in Figure B.2. The schedule is set so that 2.5% of the nominal value of the loan would be amortized each year (equal nominal amortization method). The graph to the left shows the real value of the unpaid balances. At zero inflation rate, they coincide with the nominal payments. As inflation goes up, however, the real value of the unpaid balances drop. Such drop is compensated by the implicit amortization carried out through interest payments. As a result, the real amortization of the initial years goes up rapidly, as shown in the graph to the right (which is the complement of the one to the left). Thus, at 50% inflation rates, most of the amortization would have been completed in the first five years, even if people would have to keep on paying up to the fortieth year.

FIGURE B.2

ACCELERATION OF REAL AMORTIZATION CAUSED BY INFLATION ON FLOATING INTEREST RATE LOANS AT DIFFERENT INFLATION RATES



B.57. Because of the acceleration of real amortization, the floating rate scheme results in initial housing installments that are too high to be affordable by the average Polish citizen. At 50% inflation, the initial installment reaches almost 100% of family income.

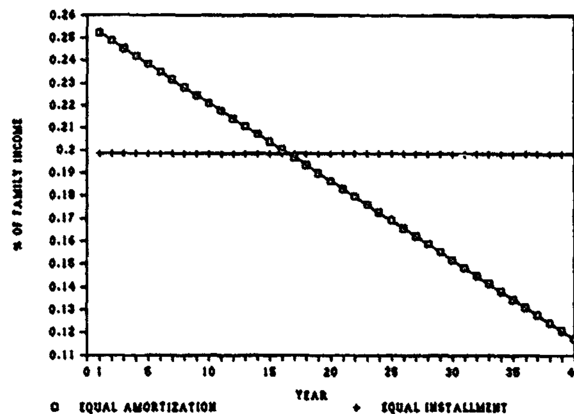
B.58. Because of these problems, it seems that the best solution would be to index the loans and to use equal combined payments of interest and amortization. Figure B.3 shows the share of family income that would be paid by an average family in Poznan for a basic 50 square meters flat with a 7% real interest rate. The graph was calculated assuming that the buyer does not receive any subsidy. Of course, housing input prices are so distorted that, in a free market, the results could diverge substantially. Nevertheless, the graph shows that financing

a basic flat is well within the reach of an average family (in western countries, 20-25% of family income is considered an acceptable share by financial institutions).

FIGURE B.3

SHARE OF HOUSING INSTALLMENTS ON

FAMILY INCOMES UNDER A FULLY INDEXED SYSTEM



B.59. Indexation works better if combined with the secondary market of mortgages proposed in previous paragraphs. The secondary market allows all banks to participate in housing financing. Also, very importantly, it avoids problems of disintermediation that could arise if housing is financed with indexed short-term deposits issued by savings banks. In such a case, differences in real yields could arise if the real interest rate fluctuates in the normal deposits, leading to shifts of deposits from banks to savings banks, or viceversa. This problem would be minimized if all banks issue the two kinds of deposits, but still could cause mismatching of assets and liabilities in the financial

institutions. If, however, mortgages are sold in the secondary market, fluctuations in the real interest rate would affect only the price of the mortagage securities, in the same way that they affect the price of all securities.[8]

VIII. PORTFOLIO PROBLEMS

A. PORTFOLIO CONCENTRATION

B.60. Banks become prisoners of customers borrowing large proportions of their portfolios. Their own risks becomes too narrowly concentrated on the success or failure of those borrowers. As a result, they lose their freedom to make decisions aimed at optimizing the present value of their net worth. Recognizing this, proposed new banking laws include provisions to limit the exposure of banks to single enterprises to, say, 15% of the sum of their equity capital and deposits. However, the new banks were created with highly concentrated portfolios, a result of both their regional character and the pre-eminence of large enterprises in the industrial structure of socialist countries. Single enterprises take more than 25% of the total portfolio of several banks.

B.61. Such concentration is quite risky and the new laws are right in making it illegal. However, since the current exposure is, in most cases, over 10 times the equity capital, all banks were hopelessly in default the same day the regulation was issued. However, since a substantial restructuring of the enterprises is needed, which would affect seriously their creditors, it would be more efficient not to deconcentrate credit before such restructuring is carried out. With the current concentration, the restructuring of one enterprise would most likely affect only one bank, which makes it much easier to control the impact of the restructurings on the banking system. Deconcentration would become easier if undertaken as part of the restructuring of banks or shortly thereafter.

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8 For a discussion of the transitional problems found in introducing a new housing finance system see Roberto Rocha, Housing Finance and Financial Integration in Hungary, EMTTF mimeo, March 1990.

Loans could be swapped among banks, something that cannot be done presently because the face value of many loans does not correspond to their financial value, either because they are of doubtful collection or because they carry too low interest rates.

B. PORTFOLIO QUALITY AND CAPITAL ADEQUACY

B.62. The ability of the financial system to intermediate resources efficiently is also hindered by the large share of substandard assets in the portfolio of the banking system. These assets include loans granted at extremely low interest rates and loans of doubtful collection.

a. Uncollectible Loans

B.63. Large proportions of uncollectible loans introduces rigidities that preclude the flow of resources from inefficient to efficient activities. This perverse allocation is made possible by the changes that financial distress introduces in the normal behavior of economic agents. Faced with immediate bankruptcy, both bankers and their debtors give priority to their survival over other, longer-term objectives, including profitability. Debtors borrow at interest rates higher than the long-term profitability of their real assets, even if they have no clear idea of how they are going to repay their debts. Bankers refinance bad debtors because failing to do so would force them to increase their write-offs. Furthermore, bankers lend almost exclusively to bad debtors because, to remain liquid, they raise deposit interest rates to levels that the more solvent borrowers are not willing to pay. This effect is reinforced in Eastern European countries by the concentration of the portfolio of banks in a few borrowers.

B.64. The transfer of resources to loss-making firms has devastating effects on the allocation of resources. Loss-making firms are maintained in operation, wasting resources that could be employed in increasing production of exportable

goods or saved to reduce the rate of growth of domestic demand and macroeconomic instability. Furthermore, firms unable to sell their goods produce for inventories that will be hard to sell.

B.65. Although there are no figures available, the share of bad loans in the portfolio of the banking system in the reforming countries is likely to be large and bound to increase. The value of capital goods used to produce the activities that became unprofitable as a result of the reform will go down and their marginal productivity will not be enough to service the debts burdening them. This would most likely result in a further deterioration of the banking system's portfolio.

b. Low-Yielding Loans

B.66. A similar problem is posed by the large share of loans granted at extremely low interest rates in the banking system's portfolio. These loans are a drain of resources, which, for some banks at least, will result in substantial equity losses.

B.67. In Poland, for instance, 35% of the portfolio of Wielkopolsky Bank is in long-term loans at fixed interest rates averaging 7.5% per annum. At the current inflation rates, the losses caused by this portfolio are staggering. They would also be very large even in the current Hungarian environment. Assuming a long-term average inflation rate of 15%, the minimum rate that could be charged would be on the order of 30% (assuming a real deposit rate of 3%, 10% legal reserve requirements, administrative costs amounting to 6% and a net margin of 2%). The present value of a 20-year loan yielding 7.5% when other assets yield 30% is 32.5% of its nominal value. Assuming that the rest of the portfolio of Wielkopolsky Bank is healthy, this bank started its life with losses equivalent to 67.5% of 35% of its portfolio. That is equal to 23.6% of its portfolio, between 16 and 24 times its equity.

B.68. This problem is not circumscribed to the newly created banks. Previously existing banks have substantial substandard assets as well. This problem is particularly acute in housing financing in the three reforming countries. In Hungary, financial liberalization has been hindered substantially by this problem. The possibility of immediate bankruptcy of the savings bank has delayed interest rates increases and has prompted the Government to a series of temporary measures that keep in place the artificial separation of the financial system into enterprises and population circuits.

IX. LACK OF ENFORCEMENT OF BANKRUPTCY LAWS

B.69. Mobility of resources implies both the creation of new activities and the demise of existing inefficient ones. The growth of efficient activities is severely constrained by the continued existence of loss-making enterprises, which crowd out the efficient ones from factor and other input markets. In the banking system, this results in banks finding their resources in inefficient activities without possibility of collection. Once a borrower has become insolvent, banks or other creditors should be able to enforce their collection by sending the borrower to bankruptcy. If this is done quickly enough, banks would recover all or most of their loans to the failing enterprise, and they would be able to relend those funds to other enterprises. If it takes longer, the losses to banks would increase. If bankruptcy is not enforced at all, the banks would lose all the funds loaned to the loss-makers.