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# REPORT FROM THE COMMISSION TO THE COUNCIL AND THE EUROPEAN PARLIAMENT

on the implementation of macro-financial assistance to third countries

a

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# I. OVERVIEW

## 1. Introduction

Initially conceived for intra-Community balance of payments support, macro-financial assistance from the Community has been extended since 1990 to third countries, mainly those of Central and Eastern Europe, with a view to supporting their political and economic reform efforts.

The first Community macro-financial operation in favour of a third country goes back to February 1990, where the Council, on a proposal by the Commission, decided to grant Hungary a five-year ECU 870 million loan in support of the country's efforts to overcome structural adjustment difficulties.

In 1991, in view of the political impetus given by the European Council at its December 1990 meeting, the Commission presented to the Council a series of Community initiatives in favour of Central and Eastern European countries (CEECs) similar to the one decided for Hungary. The Council adopted four decisions in that respect granting 6 or 7 year financial assistance of ECU 375 million to Czechoslovakia, ECU 290 million to Bulgaria, ECU 375 million to Romania and a further ECU 180 million to Hungary.

All these initiatives were taken in the context of overall G-24 coordinated financing packages. Overall the requests totalled some ECU 2.4 billion in 1991, around 50% of which was committed by the Community.

The macro-financial assistance operations have been responding to the following principles; that were recently reconfirmed by the Council :

- Exceptional character : the assistance is exceptional in nature. All operations are undertaken on a strictly case by case basis. The operations are to be discontinued when the recipient country can fully rely on financing from the IFIs and private sources of capital.
- Political pre-conditions : the assistance is provided to third countries with which the Community maintains close political and economic links, taking into account their gegographical proximity, on the proviso that they fully respect effective democratic mechanisms.
- Complementarity : the basic prerequisite for the mobilization of the assistance is the existence of a significant residual external financial gap, over and above the resources provided by the IMF and other multilateral institutions and despite the implementation of strong economic stabilization and reform programmes.
- Conditionality: the loans are generally released in successive tranches, the disbursement of each of them being conditional upon the fulfillment of macroeconomic performance and structural adjustment criteria, normally based on the economic programmes of the beneficiary countries, as agreed in an arrangement with the IMF.

Community macro-financial assistance complements and supports other Community assistance instruments, including in particular technical assistance in favour of CEECs (PHARE), project financing (EIB), and EC agreements with CEECs (trade and cooperation agreements and Europe agreements). In fact, the possibility for the Community to provide, in exceptional circumstances, macro-financial assistance is referred to under the chapter of financial cooperation in the context of the Europe Agreements recently signed with the CEECs.

## 2. Implementation of the assistance packages for 1991 in favour of CEEC

As reported in the Commission's Communication to the Council and the European Parliament, dated 16 September 1992[1], the stabilization and reform programmes supported by the Community and G-24 balance of payments assistance presented common features. Hungary, Czechoslovakia, Bulgaria and Romania, although starting from different initial conditions, all embarked in 1991 upon comprehensive programmes of transformation from highly centralized planned systems to market oriented economies, while implementing policies to stabilize the financial situation. The attempt to adapt their economic structures for integration into the world economy involved far-reaching reforms to move quickly to the desired market-based productive structure, including : liberalization of foreign trade; price liberalization and a substantial elimination of price subsidies; privatization and restructuring of state enterprises; unification of exchange rate and introduction of current account convertibility; and financial sector reform. With respect to the exchange rate, both Hungary and Czechoslovakia adopted a peg as a nominal anchor; Bulgaria and Romania, for lack of foreign exchange reserves, let the exchange rate float.

The programmes were implemented in the context of an external environment significantly harder than initially envisaged, notably with regard to the greater-than-expected decline in trade with the ex-CMEA countries, especially the USSR, and in a situation where structural reform had not yet generated an adequate supply response. In the circumstances, the decline in output turned out to be larger than expected and inflationary pressures persisted in most economies. Furthermore, in the case of Bulgaria and Romania, there was a shortfall in pledges from non-Community G-24 countries and delays in the disbursement of commitments.

Nevertheless, the countries benefiting from assistance from the Community and the G-24 determinedly implemented the programme measures, including price and trade liberalization, cautious financial and income policies, fiscal and financial reform and liberalization of the exchange regime. In addition, the authorities introduced a series of important structural measures, with the aim of fostering private economic activity, privatizing state assets and building the legal and institutional framework necessary for the efficient functioning of a market-based economy. In view of the performance achieved with regard to the quantified performance criteria and the structural adjustment criteria, the review of the conditionality attached to the Community loans was positively concluded in all countries and the assistance from the Community for 1991 was entirely disbursed.

While all the countries achieved significant results, there have been important differences in performance among them, reflecting in part the diversity in the initial conditions that the various countries faced at the start of the reform process. Consequently, the advancement of the process of return to external viability has varied considerably among the countries. In particular, Hungary and Czechoslovakia experienced rapid progress towards access to international capital markets, whereas, as anticipated, the mobilization of external private funding remained modest in the case of Bulgaria (burdened by an external debt overhang) and Romania, which relied heavily on credit from official sources to finance their external deficit in the short run.

Consequently, no additional exceptional financing was required for Hungary and Czechoslovakia in 1992, whereas additional macro-financial assistance from the EC and the G-24 was needed to sustain the stabilization and reform efforts in Bulgaria and Romania.

## 3. Other macro-financial assistance packages in 1991

Two other Community loan operations were decided by the Council in 1991 in favour of countries outside the region of Central and Eastern Europe. In the context of Community

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[1] Report on the Implementation of Medium-Term Financial Assistance to the Balances of Payments of Central and Eastern European Countries, COM(92)400 final.

support for Middle-Eastern and Mediterranean countries adversely affected by the Gulf conflict, the Council granted to Israel in July 1991 an ECU 160 million loan, which was made available in a single tranche and for a six-year period. The loan, that was accompanied by an interest-rate subsidy totaling ECU 27.5 million in charge of the general budget of the Community, was released in January 1992.

In September 1991, another medium-term loan of ECU 400 million was decided in favour of Algeria to help the country carry through the political and economic reforms under way. The Community assistance also played a major role in catalyzing an important voluntary refinancing arrangement between Algeria and its commercial bank creditors. The first tranche of the loan was released in January 1992. However, owing to a later relaxation of stabilization and reform efforts, the second tranche could not be disbursed.

## 4. Community macro-financial assistance in 1992-93

In late 1992, a second series of Community loan operations was decided by the Council for CEECs, comprising : a further ECU 110 million for Bulgaria; a further ECU 80 million in a single tranche for Romania; and a global amount of ECU 220 million in favour of the Baltic States (40 million for Estonia, 80 million for Latvia and 100 million for Lithuania to be disbursed in two tranches). Macro-financial support was also decided in favour for Albania (ECU 70 million, also in two tranches) but took the form of a grant in view of the low level of development of this country and its lack of creditworthiness.

All these initiatives were taken in the context of G-24 financing packages designed to complement the resources provided by the multilateral financial institutions. Overall, the requests for exceptional financial assistance from the G-24 totalled US$ 1185 million, of which the Community contributed approximately half.

Clearly, when these new assistance packages were launched the beneficiary countries were in different stages of the transition to market economies. Romania and Bulgaria had already begun to put in place some of the necessary legislative framework and to implement important structural reforms, including in the key areas of liberalization of foreign trade, introduction of convertibility, and price liberalization. Both countries, however, had been less successful in macroeconomic stabilization than other CEECs (owing largely to a more difficult starting position and a harsher external environment). In Albania and the Baltic States reform was still at earlier stages.

In both Romania and Bulgaria, the new economic programmes were designed to maintain the momentum of stabilization and reform. Along with the consolidation of the key achievements of 1991 - in particular, the liberalization of prices, trade and the exchange rate, and privatization, strict monetary and fiscal policies were essential means to reduce inflation and create the necessary preconditions for sustained growth and external viability.

In Romania, the government maintained prudent fiscal and monetary policies during most of 1992. All quantitative macro-economic performance criteria for end-June and end-September were observed, and the IMF could complete its review of the programme in November. Significant progress was made in the implementation of the structural reform measures : in particular, consumer prices were substantially further liberalized; and the phased elimination of consumer subsidies proceeded on schedule. In view of this progress and of the commitment by the authorities to remedy the slippages recorded in the area of the exchange rate and the privatization process, the Community loan was disbursed.

Despite this progress, macroeconomic developments in 1992 showed that the results of the economic programme were mixed. Economic activity continued to deteriorate sharply and following initial success in bringing down inflation, a surge in prices re-emerged by year-end that was fed by a relaxation of the monetary stance. Also, the overall balance-of-payments target for end-1992 was not reached, owing to delays in the disbursement of foreign assistance (commitments from the G-24 in particular only reached US$ 111 million, including ECU 80 million from the EC, against an identified financing gap of US$ 180 million), and to the inadequate exchange rate policy at the end of the year. As no decisive action was taken in 1993 to overcome the persistent difficulties in stabilizing the

economy, inflation continued unabated, the premium in the parallel market remained substantial, and official reserves were depleted by end-1993. Furthermore, the pace of reform in state enterprises remained slow.

Owing to policy shortcomings, Romania was not in a position to make the final purchase under the IMF stand-by arrangement before it expired at end-March 1993, and the negotiations on a new stand-by arrangement dragged on during most of 1993.

In Bulgaria, the authorities continued to implement tight macro-economic policies in the first half of 1992 that resulted in progress towards stabilization. They also developed the legal framework for enterprise restructuring and privatization, and proceeded with the reform of the financial sector.

However, from mid-1992, in a context of growing political and social tension, the authorities relaxed their policy stance. Performance of state enterprises deteriorated. Owing to spending overruns, the fiscal deficit widened. Inflation rose again to 5-6% per month by the end of 1992 and the arrangement with the IMF went off track. In 1993, policy performance remained weak, and efforts by the authorities to maintain the stability of the currency through central bank intervention resulted in a sharp drop of official reserves by the end of 1993. In the circumstances, negotiations with the IMF on a new arrangement could not be concluded and Community assistance remained undisbursed.

Despite irreversible progress in the process of transformation to a market-based economy in both Romania and Bulgaria, delays in the implementation of appropriate reforms have led to renewed price pressures. Also, progress towards external viability remained elusive through the end of 1993. Clearly, external trade has been depressed by the trade embargo on Serbia-Montenegro, and in the case of Bulgaria, by the lack of agreement with its commercial creditors on a reduction package for the debt contracted under the previous regime. The impact of the external factors has been compounded by inadequate demand management and overvalued exchange rates. These policy shortcomings, in turn, have precluded the mobilization of foreign official financial assistance.

The agreement in principle with the IMF in December 1993 on a new programme in both countries, and on a comprehensive debt reduction scheme with commercial creditors in the case of Bulgaria, should be a major step towards stabilization, reform and external viability. To that effect, further assistance from the EC/G-24 will have to be considered in 1994.

In Albania, the government embarked on a comprehensive economic reform programme in mid-1992, when the country was experiencing severe economic, social and administrative dislocation and facing fiscal and external imbalances much larger than in other countries in the region at the beginning of their transformation process. The immediate priority of the programme was to stabilize the economy and to initiate profound structural changes towards an open market economy.

By mid-1993, the first stage of economic stabilization and reform had been successfully achieved. The slide into hyperinflation had been reversed, the downward spiral of output halted and financial discipline on state enterprises was enforced. Price reform had advanced rapidly, and foreign trade was liberalized. Land privatization had resulted in a significant resumption of growth of agricultural production, allowing a rapid phasing-out of the massive food aid that the international community, with the EC as a principal donor, had been providing since 1991. Macro-financial assistance from the Community (ECU 70 million disbursed in two tranches in December 1992 and August 1993) and from other G-24 countries had been instrumental in strengthening the reserve position of the country and in allowing the authorities rapidly to stabilize a freely determined exchange rate. The stabilization gains remain fragile and tentative, however, and Albania will have to continue to rely heavily on foreign assistance in the short run. Exports cover only a fraction of import needs, and the external outlook remains clouded by Albania's large external debt.

The Albanian authorities have now shifted from a mainly short-term horizon, dictated by the state of crisis, towards a consistent medium-term approach, by adopting a comprehensive medium-term economic programme for 1993-96 that was presented to the

G-24 High Level meeting in November 1993. The G-24 recognized the need for further macro-financial assistance (complementary to the ESAF arrangement agreed in July 1993). In the context of this programme, Albania will seek an early normalization of relations with its commercial creditors.

It was against a background of major disruptions in the trade, payments, and monetary arrangements with the other countries of the former Soviet Union that the Baltic States embarked in mid-1992 upon comprehensive programmes of transformation to market-oriented economies. In the circumstances, the reintroduction of their own currencies at an early stage of the adjustment process, in order to insulate their economies from inflationary impulses from the other states of the former Soviet Union, constituted an important and original feature of the stabilization and economic reform programmes. These programmes also encompassed a rapid liberalization of prices and foreign trade to realign domestic prices with world prices, as well as strong fiscal and monetary stabilization policies, supported by incomes policies designed to adjust real wages to the severe terms of trade shocks that resulted from the move by Russia towards world market prices for oil and raw material exports. In support of these programmes, substantial financial assistance from the international community was mobilized. Assistance by the EC/G-24 reached 87.2 per cent of the identified financing gap.

The Baltic States have been successful in stabilizing their economies despite these severe initial conditions; the consistency of the policies pursued by successive governments has greatly contributed to this success. In Estonia, furthermore, the currency board arrangement, wich provided a strong anchor for the price system, helped gain strong confidence from the outset. Despite progress in reforms, restructuring of the banking sector has incurred substantial delays. In all three countries, the stabilization process was accompanied by large losses in output; however, by end-1993, the output decline had bottomed out. The first tranches of EC assistance were disbursed in 1993, and the second tranches are expected to be disbursed in early 1994, as reviews are completed. No further exceptional macro-financial assistance has been requested by the Baltic States.

## 5. Conclusions

Overall, the Community has committed so far some ECU 3.1 billion in macro-financial assistance to third countries (Table 1). This includes in particular the support to CEECs that since 1991 has been entirely provided in the context of the G-24 coordination process, where an overall amount of US$ 3.5 billion were mobilized, the non-EC donors providing roughly 40% of the assistance (Table 2). Among them, Japan has been, by far, the single most important contributor (some 20 percent of overall assistance), followed by the EFTA countries (17 per cent altogether). Clearly, the coordinated effort has permitted sizeable untied assistance to be mobilized which would probably not have been forthcoming in a purely bilateral context.

This exceptional assistance has been instrumental in the liberalization of foreign trade and the introduction of external convertibility in the recipient countries at an early stage of the transformation process. More generally, it has improved the mix between adjustment and financing and therefore helped stabilize the economy and maintain the momentum of reform. This quick-disbursing Community support was also effective in providing the implementation in the CEECs of the necessary legal framework and sectoral reforms, allowing for a better absorption of project-related Community assistance (PHARE, EIB) and private investment from EC member states. Overall, macro-financial assistance by the Community (and the G-24) has played a major role in supporting reform and thereby in strengthening the democratic process, as it is now clearly recognized. Where governments were unable to implement appropriate stabilization and reform policies, however, assistance was suspended until policy shortcomings were remedied, and cooperation could be re-established. (Macro-economic performance indicators and the status of economic reform are summarized in Tables 3 and 4.)

No additional funding from the Community (and the G-24) was required by Hungary and the Czech Republic (that regained access to international capital markets) and by the Baltic States (that recorded relatively strong external reserve positions). Nevertheless, the Community (and the G-24) have to respond this year to further requests from Bulgaria, Romania, Albania, and possibly other countries (the Slovak Republic, Algeria, etc.) to sustain their stabilization and reform efforts.

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The present report, submitted in accordance with Council decisions regarding macro-financial assistance from the Community to Hungary (90/83/EEC and 91/310/EEC), the Czech and Slovak Federal Republic (91/106/EEC), Bulgaria (91/311/EEC and 92/511/EEC), Romania (91/384/EEC and 92/551/EEC), Albania (92/482/EEC), the Baltic States (92/542/EEC), Israel (91/408/EEC) and Algeria (91/510/EEC) assesses the economic situation and prospects of each country and the progress of economic reforms with particular reference to the implementation of the conditions attached to the assistance.

TABLE 1
**COMMUNITY MACRO-FINANCIAL ASSISTANCE TO THIRD COUNTRIES**
**Status of effective disbursements as of 31.01.94**
**(in million of ecus)**

| Country | Maximum amount authorized (Council Decision) | Disbursed | Undisbursed |
|---|---|---|---|
| Hungary I (struct. adj loan) | 870 (22.2.90) | 610 (350 - April 1990) (260 - Febr. 1991) | 260 |
| Czech and Slovak Federal Republic (BOP loan) | 375 (25.2.91) | 375 (185 - August 1991) (190 - Febr. 1992) | - |
| Hungary II (BOP loan) | 180 (24.6.91) | 180 (100-August 1991) (80 -Jan. 1993) | |
| Bulgaria (BOP loan) | 290 (24.6.91) | 290 (150 - Aug. 1991) (140 - March 1992) | - |
| Romania (BOP loan) | 375 (22.7.91) | 375 (190 - Jan. 1992) (185 - April 1992) | - |
| Israel (struct. adj. soft loan) | 160 (22.7.91) | 160 (March 1992) | - |
| Algeria (BOP loan) | 400 (23.9.91) | 250 (Jan. 1992) | 150 |
| Albania (BOP grant) | 70 (28.9.92) | 70 (35 - Dec. 1992) (35 - Aug. 1993) | - |
| Bulgaria II (BOP loan) | 110 (19.10.92) | - | 110 |
| Baltics (BOP loans) of which : | 220 (23.11.92) | 110 | 110 |
| Estonia | 40 | 20 (March 1993) | 20 |
| Latvia | 80 | 40 " | 40 |
| Lithuania | 100 | 50 (July 1993) | 50 |
| Romania II (BOP loan) | 80 (27.11.92) | 80 (Feb. 1993) | - |
| Total | 3130 | 2500 | 630 |

Table 2: EC/G-24 macro-financial assistance to Central and Eastern Europe since 1991 (cumulative amounts)

| Country (Identified gaps) | ALBANIA (US$ 165 million) | | | | BALTIC STATES (US$ 600 million) | | | | BULGARIA (1) (US$ 800 million) | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Commitments | | | Disburs. | Commitments | | | Disburs. | Commitments | | | Disburs. |
| | Mln US$ | % of gap | % of commit. | Mln US$ | Mln US$ | % of gap | % of commit. | Mln US$ | Mln US$ | % of gap | % of commit. | Mln US$ |
| Community | 82.5 | 50.0 | 71.8 | 82.5 | 300.0 | 50.0 | 57.4 | 150.0 | 400.0 | 50.0 | 65.2 | 400.0 |
| EFTA | 12.4 | 7.5 | 10.8 | 4.2 | 123.1 | 20.5 | 23.5 | 31.5 | 95.0 | 11.9 | 15.5 | 32.0 |
| United States | | | | | | | | | 10.0 | 1.3 | 1.6 | 10.0 |
| Japan | 20.0 | 12.1 | 17.4 | | 100.0 | 16.7 | 19.1 | | 100.0 | 12.5 | 16.3 | |
| Others | | | | | | | | | 8.7 | 1.1 | 1.4 | |
| Total | 114.9 | 69.6 | 100.0 | 86.7 | 523.1 | 87.2 | 100.0 | 181.5 | 613.7 | 76.7 | 100.0 | 442.0 |

| Country (Identified gaps) | CSFR (US$ 1000 million) | | | | HUNGARY (US$ 500 million) | | | | ROMANIA (US$ 1180 million) | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Commitments | | | Disburs. | Commitments | | | Disburs. | Commitments | | | Disburs. |
| | Mln US$ | % of gap | % of commit. | Mln US$ | Mln US$ | % of gap | % of commit. | Mln US$ | Mln US$ | % of gap | % of commit. | Mln US$ |
| Community | 500.0 | 50.0 | 56.4 | 500.0 | 250.0 | 50.0 | 48.3 | 250.0 | 590.0 | 50.0 | 69.5 | 590.0 |
| EFTA | 146.0 | 14.6 | 16.5 | 146.0 | 95.0 | 19.0 | 18.3 | 95.0 | 136.4 | 11.6 | 16.1 | 136.4 |
| United States | 15.0 | 1.5 | 1.7 | 15.0 | 10.0 | 2.0 | 1.9 | 10.0 | | | | |
| Japan | 200.0 | 20.0 | 22.5 | 200.0 | 150.0 | 30.0 | 29.0 | 125.0 | 100.0 | 8.5 | 11.8 | 62.5 |
| Others | 26.0 | 2.6 | 2.9 | 1.0 | 12.8 | 2.6 | 2.5 | 12.8 | 22.0 | 1.9 | 2.6 | 22.0 |
| Total | 887 | 88.7 | 100.0 | 862.0 | 517.8 | 103.6 | 100.0 | 492.8 | 848.4 | 71.9 | 100.0 | 810.9 |

| Country (Identified gaps) | ALL (US$ 4240 million) | | | |
|---|---|---|---|---|
| | Commitments | | | Disburs. |
| | Mln US$ | % of gap | % of commit. | Mln US$ |
| Community | 2122.5 | 50.0 | 60.6 | 1972.5 |
| EFTA | 607.9 | 14.3 | 17.3 | 445.1 |
| United States | 35.0 | 0.8 | 1.0 | 35.0 |
| Japan | 670.0 | 15.8 | 19.1 | 387.5 |
| Others | 69.5 | 1.6 | 2.0 | 35.8 |
| Total | 3504.9 | 82.6 | 100.0 | 2875.9 |

(1) Commitments for the 1992/93 exercise are not taken into consideration since the operation has not been implemented.

Source: European Commission

Table 3: Selected economic indicators

| | 1991 | | 1992 | | 1993 | |
|---|---|---|---|---|---|---|
| | Programme (1) | Actual | Programme (1) | Actual | Programme (1) | Estimates |
| **GDP at constant prices** | | | (Percent change) | | | |
| Albania | – | -27.0 | -22.0 | -10.0 | 0.0 | 11.0 |
| Bulgaria | -11.0 | -12.0 | -4.0 | -5.4 | – | -4.0 |
| CSFR | -5.0 | -15.9 | -5.0 | -7.0 | | |
| Czech Republic | | | | | 2.0 | 0.5 |
| Slovak Republic | | | | | -9.0 | -7.0 |
| Hungary | -3.0 | -11.9 | 2.0 | -4.4 | 0.0 | -1.0 |
| Estonia | – | -11.8 | -28.0 | -23.0 | 1.0 | -5.0 |
| Latvia | – | -8.3 | -25.0 | -33.8 | ... | -10.0 |
| Lithuania | – | -13.4 | -25.1 | -37.7 | ... | -16.2 |
| Romania | 0.0 | -15.1 | -5.0 | -15.4 | – | 1.0 |
| Algeria | 4.5 | 0.2 | – | 2.8 | – | ... |
| **Consumer/retail price (end year)** | | | (Percent change) | | | |
| Albania | – | 104.0 | 345.0 | 237.0 | 32.0 | 31.0 |
| Bulgaria | 234.0 | 339.0 | 44.0 | 79.0 | – | 64.0 |
| CSFR | 30.0 | 52.0 | 12.0 | 12.7 | | |
| Czech Republic | | | | | 15.0 | 18.2 |
| Slovak Republic | | | | | 30.0 | 25.1 |
| Hungary | 31.0 | 32.2 | 17.0 | 21.6 | 19.2 | 21.1 |
| Estonia | – | 302.7 | ... | 953.5 | ... | 35.7 |
| Latvia | – | 262.5 | ... | 958.6 | ... | 31.3 |
| Lithuania | – | 382.7 | 1069.0 | 1162.5 | ... | 188.6 |
| Romania | 104.0 | 222.8 | 130.0 | 198.5 | – | 298.0 |
| Algeria | 35.0 | 22.8 | – | 32.0 | – | ... |
| **Fiscal balance - Cash** | | | (Percent of GDP) | | | |
| Albania | – | -43.7 | -28.2 | -21.8 | -16.7 | -15.5 |
| Bulgaria | 0.1 | -3.7 | -4.5 | -6.9 | – | -9.4 |
| CSFR | 0.8 | -2.0 | -2.9 | -3.6 | | |
| Czech Republic | | | | | -1.0 | 0.0 |
| Slovak Republic | | | | | -7.0 | -7.0 |
| Hungary | -1.5 | -4.4 | -0.5 | -7.4 | -7.0 | -7.0 |
| Estonia | – | 4.8 | 1.0 | 1.0 | 0.0 | 0.0 |
| Latvia | – | 6.4 | -1.8 | 0.0 | ... | -0.4 |
| Lithuania | – | 2.8 | 0.3 | 0.9 | ... | -0.1 |
| Romania | -1.5 | -2.6 | -2.0 | -5.6 | – | -2.0 |
| Algeria | 4.5 | 4.3 | – | -0.7 | – | ... |

.../...

Table 3 : Selected economic indicators (continued)

| | 1991 | | 1992 | | 1993 | |
|---|---|---|---|---|---|---|
| | Programme (1) | Actual | Programme (1) | Actual | Programme (1) | Estimates |
| **Broad money** | | | (Percent change) | | | |
| Albania | – | 104.0 | 122.0 | 153.0 | 47.0 | ... |
| Bulgaria | ... | 122.0 | 38.5 | 43.5 | – | 51.0 |
| CSFR | 5.9 | 26.9 | 12.0 | 17.5 | | |
| Czech Republic | | | | | 17.5 | 17.7 |
| Slovak Republic | | | | | 19.0 | ... |
| Hungary | 22.9 | 29.4 | ... | 27.4 | 19.8 | ... |
| Estonia | – | ... | ... | 68.0 | ... | 21.0 |
| Latvia | – | 153.1 | 123.0 | 169.9 | ... | 76.1 |
| Lithuania | – | 133.2 | 270.6 | 351.3 | ... | 114.0 |
| Romania | 15.0 | 101.2 | 88.0 | 74.8 | – | 108.0 |
| Algeria | 11.7 | 21.3 | – | 23.6 | – | ... |
| **Current account (convertible)** | | | (in billion US$) | | | |
| Albania | – | -0.20 | -0.50 | -0.40 | -0.40 | -0.40 |
| Bulgaria | -2.00 | 0.30 | -1.40 | -0.40 | – | -1.00 |
| CSFR | -2.50 | 0.33 | -0.60 | 0.23 | | |
| Czech Republic | | | | | 0.70 | 0.60 |
| Slovak Republic | | | | | -0.30 | ... |
| Hungary | -1.20 | 0.25 | -0.65 | 0.26 | -1.55 | -2.70 |
| Estonia | – | ... | -0.18 | -0.01 | 0.00 | -0.07 |
| Latvia | – | ... | -0.09 | 0.05 | -0.24 | 0.04 |
| Lithuania | – | ... | -0.16 | 0.09 | -0.48 | -0.25 |
| Romania | -1.70 | -1.30 | -1.30 | -1.50 | – | -1.30 |
| Algeria | -0.31 | 2.56 | – | 1.20 | – | ... |
| **Official foreign exchange reserves (level)** | | | (in billion US$) | | | |
| Albania | – | 0.01 | 0.03 | 0.03 | 0.07 | 0.15 |
| Bulgaria | 0.50 | 0.40 | 1.00 | 0.90 | – | 0.70 |
| CSFR | 1.70 | 3.20 | 2.20 | 1.30 | | |
| Czech Republic | | | | | 2.20 | 3.80 |
| Slovak Republic | | | | | 0.30 | 0.40 |
| Hungary | 1.90 | 4.00 | 2.20 | 4.40 | 6.00 | ... |
| Estonia | – | ... | 0.14 | 0.20 | 0.16 | 0.34 |
| Latvia | – | ... | 0.15 | 0.16 | 0.23 | 0.52 |
| Lithuania | – | ... | 0.04 | 0.14 | 0.15 | 0.28 |
| Romania | 1.00 | 0.20 | 0.70 | 0.10 | – | 0.05 |
| Algeria | 1.53 | 1.61 | – | 1.70 | – | ... |

(1) Programme targets as set in : August 92 for Albania, March 91 and April 92 for Bulgaria, January 91 for CSFR, March 93 for the Czech Republic, July 93 for the Slovak Republic, February 91 and September 93 for Hungary, September 92 for Estonia and Latvia, October 92 for Lithuania, April 91 and May 92 for Romania and May 91 for Algeria.

Sources: National authorities

# TABLE 4

## STATUS OF ECONOMIC REFORM

### 1. ALBANIA

| | | |
|---|---|---|
| 1. | Price liberalization | Most wholesale and retail prices freed in 1992-93, with the exception of prices for wheat, bread, sugar beet and a number of non-food items produced under monopolistic conditions, for which major adjustments were mace in mid-1993. |
| 2. | Trade liberalization | Major liberalization in 1992-93. No quantitative restrictions on imports; import duties ranging 0-40%. Limited export restrictions. |
| 3. | Exchange regime | Free float since July 1992. Current account convertibility. Large external debt arrears to commercial banks to be negotiated. |
| 4. | Foreign direct investment | Liberal regime, recently streamlined to limit approval requirements |
| 5. | Monetary policy | Use of bank-by-bank credit ceilings. Administrative guidance to ensure that interest rates remain positive in real terms. |
| 6. | Public finances | Ongoing efforts to broaden tax base: personal incomes tax introduced in 1993; property tax scheduled for implementation in 1994 and VAT in 1995-96. Regarding expenditure: major reduction in price subsidies in 1992-93; allowance made for investment in line with PIP in budget for 1994. |
| 7. | Privatization and enterprise restructuring | 80% of land area privatized with distribution of titles to be completed by end 1994. Small privatization in trade and services completed. Law on restitution passed in April 1993. Industrial enterprises : privatization of small and medium-size enterprise in late 1993 through decentralized auction; newly-created Enterprise Restructuring Agency to supervize 30 major problem enterprises. However, financial discipline reestablished in early 1993 through strict monetary policy and abolition of the system of receivable orders. |
| 8. | Financial sector reform | Two-tier banking system. Three existing state-owned banks still to be restructured, and their non-performing loans replaced by government bonds. |

| TABLE 4 (Continued) | |
|---|---|
| **2. BULGARIA** | |
| 1. Price liberalization | Most prices freed in 1991. Close to 90% of retail turnover under free prices. Subsidies on some energy prices gradually reduced, but prices remain below cost. |
| 2. Trade liberalization | Imports liberalized in 1991. Import tariffs and remaining quantitative restrictions on exports low by international standards. Trade agreement with the EC and the EFTA. |
| 3. Exchange regime | Since 1991, unified floating exchange rate and internal current account convertibility (with few restrictions). Massive Central Bank interventions in late 1993 to limit exchange rate depreciation. Large interest arrears on foreign debt. Debt and debt service reduction agreement with commercial bank creditors expected to be finalized in mid-1994. |
| 4. Foreign direct investment | Liberal foreign investment regime allowing direct investment (law adopted early 1992). Free repatriation of profits and proceeds of liquidation of investment by non-residents. But has been limited by delays in reaching DDSR agreement with banks. |
| 5. Monetary policy | Bank-specific credit ceilings remain the main instrument for conducting monetary policy, but increasing reliance on indirect instruments and reserve money targeting. Limited open market operations introduced in 1993. Development of a market for government securities. For 1994, specific credit ceilings on the largest loss-making enterprises are contemplated. |
| 6. Public finances | Laws on VAT, excise tax, tax administration and budget procedure adopted in 1993. VAT to enter in force in April 1994. |
| 7. Privatization and enterprise restructuring | Restitution of land and small urban property to be completed in 1994. Most enterprises transformed into joint-stock companies, with the State as unique share-holder. Further restructuring and privatization of industry on hold in 1992-93, allowing therefore hidden privatization and decapitalization of the state sector. Bankruptcy legislation still lacking. Financial discipline weak. The authorities are contemplating acceleration of privatization through a new programme for market privatization in 1994 and a voucher-based mass privatization scheme for 1995. Private sector accounts for 20-25% of GDP. |
| 8. Financial sector reform | Two-tier banking system. Banking supervision: prudential regulations adopted mid-93; on-site inspections to be held in 1994. Bank consolidation started in 1991 close to complete. Partial clean up operation of commercial banks' balance sheets in 1992-93. Law on non-performing pre-1991 loans to enterprises (issuance of government bonds against bad debts) adopted in December 1993. Stock exchange introduced. |

TABLE 4 (Continued)

3. THE CZECH REPUBLIC

| | | |
|---|---|---|
| 1. | Price liberalization | Virtually all prices free, following extensive liberalization in 1991 and follow up action in subsequent years. Only few products still subject to some form of price regulation. |
| 2. | Trade liberalization | Imports iberalized, except for a few remaining quantitative restrictions on agricultural products, textiles, steel and coal. All imports subject to an ad valorem import tariff of about 6%. Limited number of products still require export licenses. Trade agreements with the EC, the EFTA and the Visegrad countries. Customs union with Slovakia since dissolution of CSFR. |
| 3. | Exchange regime | Current account convertibility almost completed in early 1991; remaining restrictions to be removed in 1994, with phased liberalization of capital outflows. Exchange rate pegged to a basket of two currencies (the US dollar and the D-Mark). Since February 1993, transactions with the Slovak Republic conducted through a clearing system at a different exchange rate. |
| 4. | Foreign direct investment | No limits on equity participation in enterprises by non-residents, except in the case of a few sensitive or defence-related sectors. Free repatriation of profits and proceeds from the liquidation of investments. |
| 5. | Monetary policy | Czech National Bank (CNB) created in January 1, 1993; operates independently from government. Czech crown introduced in February 1993. Since October 1992, monetary policy conducted through indirect instruments. Banks' lending and deposit rates have been gradually freed. |
| 6. | Public finances | VAT reformed, excise tax system, and personal income tax introduced in January 1993. Profit tax share substantially reduced. |
| 7. | Privatization and enterprise restructuring | First wave of large-scale privatization completed in Spring 1993. Second wave to be completed by end-1994, by which time about 90% of the assets of the economy will be in private hands. Bankruptcy legislation since April 1993 but very few companies have filed for bankruptcy. |
| 8. | Financial sector reform | Two-tier banking system established in January 1990. Major financial institutions partially privatized under first wave of large-scale privatization. Since 1991, several measures to strengthen banks' balance-sheets. Prague Stock Exchange in operation since April 1993. A bond market and a significant market for Treasury and CNB bills emerging. |

(3)

**TABLE 4 (Continued)**

**4. THE SLOVAK REPUBLIC**

| | | |
|---|---|---|
| 1. | Price liberalization | 96% of total turnover based on free prices, with regulation still in force only in the areas of transportation, heating and rental. |
| 2. | Trade liberalization | Imports liberalized except for a few sensitive items subject to import licences. 6% average tariff. Export licensing remains for a limited number of products. Free trade agreements with the EC, the EFTA countries and the Visegrad countries. Customs union with Czech Republic since dissolution of the CSFR. |
| 3. | Exchange regime | Current account convertibility almost completed in early 1991. Temporary restrictions on current account convertibility reintroduced to stem loss of reserves. Exchange rate pegged to a basket of 5 Western currencies. Since February 1993, transactions with Czech Republic conducted through a clearing system at a different exchange rate. |
| 4. | Foreign direct investment | No limits on equity participation in enterprises by non-residents, except in the case of a few sensitive or defence-related sectors. Free repatriation of profits and proceeds from the liquidation of investment. |
| 5. | Monetary policy | Slovak National Bank established in January 1993 operates independently from government. Slovak crown introduced in February 1993. Monetary policy relying on credit ceilings. |
| 6. | Public finances | VAT reformed, excise tax system and personal income tax introduced in January 1993. Profit tax share substantially reduced. |
| 7. | Privatization and enterprise restructuring | First wave of large scale privatization completed by Spring 1993. Second wave, under preparation, will emphasize traditional privatization methods (direct sales, tenders, etc.). With completion, 80% of state enterprises privatized. A bankruptcy law since June 1993 but very few companies have filed for bankruptcy. |
| 8. | Financial sector reform | Two-tier banking system established in January 1990. Major financial institutions privatized under first wave of large-scale privatization. But state-owned Savings Bank with controling stake in the biggest commercial bank (VUB). Since 1991, several measures to strengthen banks' balance-sheets. Bratislava Stock Exchange in operation since 1993 but financial markets remain underdeveloped. |

## TABLE 4 (Continued)

### 5. HUNGARY

| | | |
|---|---|---|
| 1. | Price liberalization | Nearly all price controls and subsidies eliminated |
| 2. | Trade liberalization | About 93% of non-agricultural imports liberalized. Several industrial products subject to import licensing. Imports of consumer goods under a universal quota system. Free trade agreements with the EC, the EFTA and the Visegrad countries. |
| 3. | Exchange regime | Current account convertibility, except for certain services and transfers. Crawling-peg system against US dollar and D-Mark. |
| 4. | Foreign direct investment | No limits on equity participation in enterprises by non-residents, except in the case of a few sensitive or defence-related sectors. Free repatriation of profits and proceeds of liquidation of investment by non-residents. |
| 5. | Monetary policy | Monetary policy through indirect instruments. |
| 6. | Public finances | Taxation gradually shifting away from corporate taxation towards personal income and consumption. VAT introduced in 1988. Large cuts in State subsidies from 13% of GDP in 1988 to less than 5% in 1993. |
| 7. | Privatization and enterprise restructuring | About 20% of the business property held by the state in 1990 privatized. Private sector accounting for some 45% of GDP end 1993. Tough bankruptcy law into effect since January 1992. |
| 8. | Financial sector reform | Two-tier banking system introduced in 1986. Interest rates progressively freed. Several operations to recapitalize and clean up banks' portfolios. State holds controlling stakes in major banks but the Banking Law requires a reduction of state ownership in all banks to 25% by 1997. Budapest Stock Exchange opened in June 1990. |

## TABLE 4 (Continued)

### 6. ESTONIA

| | | |
|---|---|---|
| 1. | Price liberalization | Major price liberalization in 1991. By end 1992, virtual completion of price liberalization, including in energy sector. |
| 2. | Trade liberalization | In early 1992, abolition of most import tariffs (except few luxury goods), and of most remaining quotas and licensing requirements except for oil shale, clay, quartz. Import subject to a 0.5% administrative fee plus 18% VAT. Few exports tariffs (art works, rape seed oil, metals). Free trade agreement with Baltic States and Nordic countries. |
| 3. | Exchange regime | Current account convertibility. In June 1992 departure from rouble zone. Since 1992, Estonian Kroon pegged to the D-Mark under a currency board system. |
| 4. | Foreign direct investment | Free repatriation of profits and proceeds of liquidation of investment by non-residents. |
| 5. | Monetary policy | Central bank responsible for operation of currency board (Issue Department) and, in exceptional cases, for emergency lending to banking system (Banking Department, responsible for managing reserves in excess of currency board cover). Bank does not interfere with the setting of interest rates by commercial banks. |
| 6. | Public finances | In 1991, personal income tax and VAT introduced, turnover tax replaced by corporate income tax; social security, natural resource and specific excise taxes introduced. |
| 7. | Privatization and enterprise restructuring | Well advanced in small-scale privatization (more than 50% privatized by mid-1993); slower progress on large-scale privatization. Establishment of Estonian Privatization Agency in 1992 to organize the privatization process. |
| 8. | Financial sector reform | Two-tier banking system. Increased pressure on state enterprises to restructure through hard budget constraints and selective application of the bankruptcy law. Reduction of number of commercial banks from 40 to 24 through increase in minimum capital requirement following a banking crisis in Winter 92/93. Stock exchange introduced. |

## TABLE 4 (Continued)

### 7. LATVIA

| | | |
|---|---|---|
| 1. | Price liberalization | Major price liberalization in 1991 and 1992 including for energy products. Maximum profit margins abolished. By end-1992, price liberalization essentially completed, excluding utility prices and rents. |
| 2. | Trade liberalization | All export quotas and licensing and most export tariffs abolished in 1992. No licensing requirements for imports, but various import tariffs. Free trade agreements with Baltic States and Nordic countries. |
| 3. | Exchange regime | Exchange rate unified and current and capital account convertibility introduced. In July 1992 departure from rouble zone. Exchange rate of lats stabilized under managed floating system |
| 4. | Foreign direct investment | Free repatriation of profits and proceeds of liquidation of investment by non-residents. |
| 5. | Monetary policy | Independent central bank. Credit policy through indirect instruments. |
| 6. | Public finances | New tax system since January 1991. VAT introduced in February 1992. In 1993 replacement of progressive income tax by flat rate tax (25%) plus a 10% surcharge on annual income. |
| 7. | Privatization and enterprise restructuring | Substantial progress on small-scale privatization, but barely any progress on large-scale privatization. Problems still to be solved : restitution issues and establishment of a centralized and coherent privatization strategy. State enterprises not up for immediate privatization transformed into stock companies. Slow progress on liquidation. |
| 8. | Financial sector reform | Two-tier banking system. 49 former branches of the Bank of Latvia either merged into a core bank (21 now forming the Universal Bank to be restructured and privatized later) or privatized, except for one which was liquidated. Capital adequacy ratio increased in January 1994. Stock exchange introduced. |

| TABLE 4 (Continued) | | |
|---|---|---|
| | **8. LITHUANIA** | |
| 1. | Price liberalization | Major price liberalization in 1991, 1992 and 1993, including for most energy products. Level of subsidization reduced for natural gas (household use), heating, transport and hot water ; plans to abolish subsidization completely in Fall 1994. |
| 2. | Trade liberalization | Export quotas and licensing removed partially in the course of 1992 and completely in June 1993. All import controls and licenses removed. New system provides for import tariff rates between 5 and 15% on majority of goods. |
| 3. | Exchange regime | Exchange rate unified and current and capital account convertibility. Left rouble zone in Fall 1992. Exchange rate of litas stabilized vis-à-vis a basket of Western currencies. |
| 4. | Foreign direct investment | Free repatriation of profits and proceeds of liquidation of investment by non-residents. |
| 5. | Monetary policy | Largely independent central bank. Credit policy through indirect instruments. |
| 6. | Public finances | Reform of tax system which now includes personal income and profit taxes, property tax, natural resource tax, individual excise taxes, as well as general sales tax. |
| 7. | Privatization and enterprise restructuring | Substantial progress on small and large-scale privatization through auction, public share subscription and voucher system. By January 1994, 2/3 of all companies eligible for privatization (1/3 of state capital) privatized. Little progress on land privatization. Autonomous operation of state enterprises promotes efficiency. |
| 8. | Financial sector reform | Two-tier banking system. Creation of two-tier banking system in 1992 with State Commercial Bank taking over all commercial functions of Bank of Lithuania. No further progress on reforming the banking sector dominated by three State Banks is expected in 1994. Stock exchange introduced.. |

**TABLE 4 (Continued)**

**9. ROMANIA**

| | | |
|---|---|---|
| 1. | Price liberalization | Liberalisation of most prices completed in May 1993. Energy prices remain controled but adjusted regularly for changes in international prices. Public utilities and some basic staple food prices still controled and subsidised. |
| 2. | Trade liberalization | Fully liberalised. A limited number of import/export quota/bans is still in force, either for health reasons or for subsidised goods. Trade agreement with the EC and the EFTA. |
| 3. | Exchange regime | Mutiple exchange rate practice. Official exchange rate established at Central Bank foreign currency auctions which are not market clearing. Foreign exchange available to individuals through private exchange bureaus at a free market rate, substantially above the official rate. Major overhaul of the exchange rate regime is expected in early 1994. |
| 4. | Foreign direct investment | Free legal environment for equity participation and profits repatriation by non-residents. Lack of progress with respect to privatisation has limited the volume of investment inflows. Land ownership by foreign nationals not allowed yet. |
| 5. | Monetary policy | Attempts to tighten monetary policy by an increase in refinancing rates; but strongly negative real interest rates stimulate flight into foreign currency holdings. Weak financial discipline of state companies. |
| 6. | Public finances | Major reforms including succesful introduction of single rate VAT, abolition of nearly all consumer subsidies and incorporation of extra-budgetary funds into a consolidated budget. New profit tax law. Overhaul of the income tax system is expected by end 1994. |
| 7. | Privatization and enterprise restructuring | Substantial progress with privatisation of small-scale enterprises through management-employee buy-outs. Progress with medium- and large scale enterprises privatisation through the State Ownership Fund remains far below targets. About 80% of arable land has been privatised by distribution to farmers. Registration of land titles is on-going. Private sector about a quarter of GDP mid-1993. |
| 8. | Financial sector reform | Two-tier banking system. Several foreign banks already operational. Clearing of interbank payments and transfers remains very slow. Privatisation of former state-owned banks expected to start in 1995 only. |

## II. HUNGARY

### 1. Introduction

In the autumn of 1989 Hungary was at a critical turn of its recent economic and political history. A comprehensive set of measures to promote structural reform and adopt a market economy model were being implemented and the country was preparing to hold the first free elections of the post-war period (eventually held in April 1990). On the macroeconomic front, however, the situation was extremely difficult. A sharp deterioration of the domestic and external economic and financial situation in the first half of 1989 had led to the suspension of IMF support in the summer of that year. The emergence of an unsustainable current account deficit (which would reach almost US$ 1500 mio for the whole of 1989) and a heavy foreign debt burden threatened the consolidation of the economic and political reforms.

In this context, the Hungarian authorities requested supplementary medium-term financial assistance to the European Community to help the country meet its growing debt service burden, rebuild its foreign exchange reserves and introduce current account convertibility. In response, the Council agreed on 22 February 1990 (Decision 90/83/EEC) to grant an ECU 870 million medium-term loan to help Hungary overcome the difficulties of the structural adjustment of its economy.

The 1990 loan was to be disbursed in three tranches, the first of which (of ECU 350 million) being conditional on the conclusion of a stand-by agreement between Hungary and the IMF and the other two on the fulfillment of the macroeconomic and structural performance criteria listed in the Memorandum of Understanding subsequently signed between the Commission and the Hungarian authorities. The first tranche was effectively disbursed in April 1990 and, following a successful review by the Commission of progress in economic stabilization and reform (including the compliance with the Memorandum's performance criteria), the second tranche (of ECU 260 million) was released in February 1991.

Changes in the international environment, and in particular the collapse of the Council of Mutual Economic Assistance trading and payments system, made it clear at the beginning of 1991 that Hungary, like other Central and European countries, would be facing a much more difficult external position than was initially forecasted. While the IMF granted in 1991, at the Hungarian authorities' request, an Extended Financing Facility (EFF) and access to the Compensatory and Contingency Facility under the "oil window", the Fund's assistance was not expected to be sufficient to cover all the exceptional balance of payments financing needs for 1991. Accordingly, Hungary requested complementary financial assistance from the Community and the Group of Twenty-Four (G-24). This led the Council to adopt on 24 June 1991, on a Commission proposal, a new Decision (91/310/EEC) providing further financial assistance to Hungary of ECU 180 million, with the understanding that a similar amount would be provided by the other members of the G-24. The objectives of this new initiative were to ensure a sustainable balance of payments situation and to strengthen Hungary's reserve position.

The 1991 loan was to be disbursed in two installments. The release of the first installment (of ECU 100 million), which was conditional upon the Hungarian government reaching agreement with the IMF on a three-year EFF, took place in August 1991. The release of the second tranche (of ECU 80 million) was agreed in mid-1992, following the Commission's review of Hungary's economic situation and the fulfillment of the performance criteria listed in the 1991 loan's Memorandum of Understanding but, for technical reasons, the assistance was actually disbursed in January 1993. The Commission agreed with the Hungarian authorities to consider at a later stage the disbursement of the third tranche of the 1990 loan. This tranche, amounting to ECU 260 million, has not been disbursed to date.

As noted in the previous report, Community macro-financial assistance to Hungary has undoubtedly played an important role in helping the country overcome the difficult economic and political situation it faced at the beginning of its current process of reforms. The delicate balance of payments situation that prevailed in 1989 threatened to increase to

unacceptable levels the costs in terms of lost output and unemployment associated with the macroeconomic stabilization an structural transformation of the economy. This risked, in turn, weakening the support of the Hungarian population for the economic and political reforms. EC macro-financial assistance was successful both in easing Hungary's balance of payments constraint and in helping the country restore its access to the international private capital markets.

The following sections review economic developments in Hungary in 1992 and 1993.

## 2. Recent Macroeconomic Developments

### 2.1. Output and unemployment

The four-year reform programme adopted by the Hungarian government in early 1991 had projected a modest 3% decline of GDP in 1991, followed by a 1 to 3% increase in 1992, accelerating in 1993. In the event, real GDP fell by 11.9% in 1991, by a further 4.4% in 1992, and is estimated to have declined by 1% in 1993 despite an encouraging recovery of industrial production in the second half of the year.

The weaker than expected behaviour of total output in 1992 and 1993 is partly explained by the collapse of agricultural production. Between December 1991 and December 1993 agricultural output is estimated to have fallen by about 30% reflecting a severe drought, cut-backs in investment and export subsidies and problems and delays in the privatization and structural transformation of formerly state-owned farms.

Industrial production declined a further 9.8% in 1992 but has been experiencing a distinct recovery since last summer. Thus, industrial output was in the period January-November 1993 4.3% higher than in the same period of 1992 and was growing in November 1993 at a year-on-year rate of 7%.

Unemployment growth slowed down in 1991, with the registered unemployment rate increasing from 8.5% at end-1991 to 12.3% at end-1992. After reaching a peak in March 1993, the number of registered unemployment has been steadily declining, standing at 632.000 by the end of 1993, or 12.1% of the labour force. While this trend partly reflects the decreasing number of people receiving unemployment benefit, it may also reflect the fact that much of the labour shedding associated with the restructuring and liquidation of enterprises has already taken place.

### 2.2 Inflation

In the first half of 1992, substantial progress was made in reducing inflation, partly thanks to the "strong-forint" policy pursued by the authorities. Year-on-year inflation fell to 20% in July 1992 from 32.2% at end-1991. However, in the second half of 1992 monthly inflation accelerated again, reflecting a large drought-related surge in seasonal food prices and anticipatory buying in advance of the January of 1993 VAT reform. In 1993, increases in the VAT and excise taxes aimed at controlling the budget deficit, combined again with above-average price increases, have caused inflation pressures to remain high. Thus, at the end of December 1993, year-on-year inflation stood at 21.1%, about the same level as in December 1992 (21.6%). Consistent with the real appreciation of the forint, however, producer prices are increasing half as fast as consumer prices.

### 2.3. Fiscal policy

In 1992, the deficit of the consolidated state budget widened sharply (from 4.4% of GDP in 1991 to 7.4% of GDP), leading in mid-1992 to the interruption of the EFF agreed with the IMF in 1991. Despite the corrective measures taken last summer, which included, as indicated before, an increase in indirect taxes, the deficit is estimated to have reached 7% of GDP in 1993. Such measures were part of the conditions agreed with the IMF to obtain last September a 15-month stand-by credit. The authorities' commitments with the IMF also include other corrective fiscal measures to be implemented in 1994. However,

reflecting upward revisions in debt service due to higher than expected interest rates, the 1994 budget that was approved by the Parliament in December 1993 foresees a consolidated budget deficit Ft 81 bn higher than the Ft 249 bn target initially agreed with the IMF.

The difficulties that Hungary has encountered in reining in its budget deficit are basically due to the sharper than expected contraction in economic activity (which has both weakened revenues and increased unemployment compensation), difficulties to tax the emerging private enterprises and incomes, and several one-time events often linked to the reform efforts. Among the one-time events, the most important are the loss of revenues from taxation of oil imports following the shift of CMEA prices to world market levels, the suspension of tax and social security payments by firms filing for bankruptcy proceedings as a result of the adoption of the Accounting and Bankruptcy Laws, and the costs associated with the clean-up of banks' balance-sheets (including the sharp fall of profit taxes from financial institutions as banks accelerated their provisioning to comply with the new capital adequacy requirements). Another factor increasing pressures on the budget has been the rapidly rising public debt interest payments due to the larger-than-programmed deficits.

While some of the fiscal problems faced by Hungary will gradually disappear as the economy and the tax base recover, other problems will remain. This is obviously the case of the erosion of the traditional state-enterprise tax base and the pressures to extend social security benefits.

### 2.4. Monetary policy

From late 1991 through mid-1993, the National Bank of Hungary (NBH) allowed banks' liquidity to build up so as to put downward pressure on market interest rates, and reduced on several occasions its official interest rates. This policy, however, met with only partial success as banks, fearful of lending to insolvent companies and needing to increase provisions against bad loans in their portfolios, cut lending rates much more slowly than deposit rates. As a result, spreads between lending and deposit rates widened substantially and, with producer prices rising much more slowly than consumer prices, this led to the coexistence of very high real interest rates for loans to enterprises (which hampered private investment) and negative real interest rates for depositors (which undermined incentives for private saving). In contrast with commercial lending rates, yields on treasury bills were pushed down rapidly as banks sought safe investments for their excess liquidity.

At the beginning of last summer it became clear that interest rates on deposits and government paper had been allowed to decline too much. The high public borrowing requirements, the weakening of private savings and doubts about the authorities' commitment to a "strong forint policy" were beginning to put upward pressure on short-term interest rates. In that context, the NBH decided to raise its intervention rates last July and again last September.

### 2.5. Balance of payments and exchange rate policy

Since the third quarter of 1992, the Hungarian current account has suffered a sharp deterioration and is expected to show a deficit of about US$ 2.7 bn (7.5% of GDP) in 1993 (against a US$ 261 mio surplus in 1992). This rapid worsening of Hungary's current account is basically explained by four factors. First, domestic demand is experiencing a recovery at a time when Hungary's main Western export markets are suffering from recession or very weak growth. Second, agricultural production and exports have collapsed as a result of recent droughts and the disorganization caused by the privatization or transformation of state-owned farms and cooperatives. Third, exports have also been negatively affected by the observance of the UN embargo against Serbia and Montenegro. And fourth, Hungary has suffered an important loss of external competitiveness in recent years, as reflected in a cumulative appreciation of the forint's real exchange rate or around 35% (measured with consumer prices) since the beginning of 1990.

The real appreciation of the forint is the main cost of the "strong-currency policy" followed by the authorities until recently to bring down inflation. Such a policy basically meant that the forint was regularly devalued within a "crawling-peg system" but in amounts insufficient to fully compensate Hungary's inflation differential with its main trading partners. The poor performance of exports since the third quarter of 1992 has led the authorities to increase since early 1993 the frequency and magnitude of the forint devaluations in order to produce some real depreciation of the currency. With inflation remaining above 20%, however, the impact of this shift in policy on the real exchange rate has so far been very limited.

While exports are expected to grow substantially in 1994, as agricultural production and, to a lesser extent, foreign demand recover, this will be partly offset by the increase in imports as domestic demand accelerates. Furthermore, the recovery of exports itself could be limited by the weak competitive position of the outward-processing sector, persistent structural difficulties in the agricultural sector and the loss of export base associated with the bankruptcy of a large number of traditional export companies. In this context, the current account deficit is expected to shrink only moderately in 1994 (to about 6% of GDP).

Despite the very high current account deficit, official foreign exchange reserves expanded from US$ 4.4 bn at end-1992 to US$ 5.7 bn at the end of October 1993. This was made possible by the following two reasons. First, with an estimated US$ 1.3 bn net inflow of foreign direct investment (FID) in 1993, Hungary continues to be the main beneficiary of FDI flowing into Central and Eastern Europe. Second, Hungary enjoys an easy access to the international capital markets, which has allowed the NBH to successfully place international bonds in 1993 in the amount of about US$ 4 bn.

The negative side of the aggressive international borrowing programme of the NBH has been a rapid growth of foreign debt in 1993. Total convertible debt, which had decreased by US$ 0.9 bn in 1992, is estimated to have risen from US$ 21.5 bn at end-1992 to US$ 24.9 bn at end-1993. The debt/GDP ratio has also deteriorated slightly, reaching an estimated 66.3% at the end of last year. There has been, however, a significant improvement in the structure of the debt, with the proportion of medium and-long term debt increasing from 89.8 to 92.8%.

Total debt service amounted to 4.3 bn, practically the same level as in 1992. However, with exports estimated to have fallen by about 20% in 1993, the debt service ratio has considerably worsened, increasing from 43.9 to 48.1%. Principal repayments are expected to amount to around US$ 2.5 bn this year, down from US$ 2.8 bn in 1993, but they are projected to rise sharply in 1995 and 1996 to, respectively, US$ 3.4 bn and US$ 3.9 bn. With the current account deficit expected to remain at relatively high levels in those years, this "bunching" of amortizations could put considerable pressure on Hungary's balance of payments.

## 3. Review of the structural reform programme

Important steps have been taken in recent years in all the main areas of structural reform in order to transform the Hungarian economy into a market economy. These have basically included : 1) tax and other public sector reforms; 2) the removal of most subsidies and price controls; 3) the almost complete liberalization of trade and other current international transactions; 4) privatization and the strengthening of governance of firms remaining under state control; 5) the introduction of new accounting and bankruptcy laws; and 6) a series of measures to reform the banking system. Since 1992 efforts have been concentrated in these last three areas of reform. Also significant has been the signature of several trade and association agreements with the EC, the EFTA countries and Hungary's Central European neighbours. Recent actions in these four fields are described in what follows.

### 3.1. Privatization and the strengthening of governance in state enterprises

Privatization started in Hungary in 1988 with the adoption of the 1988 Company Act and the 1988 Foreign Investment Act. Since then, privatization has been carried out through a

number of different programmes and vehicles. Changes of approach have been frequent but in general privatization has relied heavily on foreign capital and has emphasized sales to "real owners", that is, those who would take an active role in managing the privatized enterprises. The important role assigned to foreign investors is explained by the initial desire to maximize foreign exchange revenues at a time of balance of payments difficulties, the limited financial wealth of domestic investors and the need to bring Western technology, and marketing and managerial expertise to Hungarian firms. As for the emphasis on sales to "real owners", it has avoided the negative implications for the proper restructuring of the enterprises that may result from the excessive dispersion of ownership created by mass-privatization schemes.

One limitation of the Hungarian approach to privatization (as opposed to, for example, the Czech and Slovak "voucher-based" schemes) it that it has resulted in a slow pace of privatization for big state-enterprises. Thus, while almost all retail establishments under the control of the State Property Agency have now been privatized, the government estimates that only about 20% of the total business property held by the state in 1990 has been privatized. The growth of the Hungarian private sector in recent years is, thus, explained more by the creation of new, previously inexistent firms than by the transfer to private hands of state property. The combination of both factors has increased to about 45% the share of GDP generated by the Hungarian private sector in 1993 (from 15% in 1990).

In order to both avoid a possible loss of steam of the privatization process and increase the participation of domestic investors, the Hungarian authorities have taken several initiatives. These have included compensation for past expropriations with warrants that can be used to purchase state property, preferential credit arrangements to facilitate purchase of state assets by domestic investors and "leasing" arrangements to enable Hungarian managers to buy their companies. Also, the government has introduced a new programme for small domestic investors to acquire with deferred payment shares in privatized enterprises.

Concerning the strategy for residual state ownership, the government announced in August 1992 a list of 150 business organizations in which the state will retain at least part-ownership. In October of that year the "State Asset Management Company" (AVRT) was created to manage and restructure if necessary those companies, and to sell the specified share not to be retained by the state.

### 3.2. Accounting and bankruptcy laws

Following several unsuccessful bankruptcy laws, a drastic bankruptcy legislation came into force in January 1992 which forced any company with payments in default for more than 90 days to file for bankruptcy or liquidation procedures. The result was quite dramatic. According to the OECD, in 1992 about one in every six companies applied for bankruptcy or liquidation, representing about 17% of employment and 25% of exports.

To reduce the harshness of the January 1992 law, the Parliament has recently approved some amendments, including the substitution of the mandatory self-initiation of bankruptcy procedures by the initiation by creditors. The amended law, is hoped, will allow illiquid but potentially viable companies to escape lengthy proceedings and will make it more likely that creditors will arrive at more constructive solutions.

### 3.3. Banking reforms

In 1986 Hungary became the first country in Central and Eastern Europe to establish a two-tier banking system separating central bank from commercial bank activities. Since then, the permitted operations of commercial and savings banks have been gradually enlarged, interest rates have been progressively freed and the National Bank's and Foreign Trade Bank's monopoly on foreign exchange operations has been loosened. Furthermore, since 1986 the state has on several occasions injected capital into the banking system to improve the solvency of state-owned institutions and a new Banking Law was passed in December 1991 subjecting financial institutions to prudential regulations modeled on the Community financial Directives and the Basle Committee capital adequacy regulations. Supervision has also been strengthened through the establishment of a special supervisory agency in charge

of overseeing banks' compliance with prudential regulations and, in case of a capital or liquidity shortfall, designing bank restructuring programmes. Finally, a National Deposit Insurance Fund was created last July.

All these steps have not been, however, sufficient to solve the problem of bad loans in the banks' portfolios which, like in other Central and East European countries, limits the effectiveness of banks' financial intermediation. Efforts to recapitalize banks were increased at the end of 1992 with the adoption of a "loan consolidation scheme", whereby government bonds were swapped for 50 and 80% of the face value of non-performing loans outstanding in, respectively, 1991 and 1992. A new bank consolidation operation was launched in December 1993. Such operation, which is to be supported by a US$ 150-200 mio Financial and Enterprise Sector Adjustment Loan from the World Bank, aims at recapitalizing the banks through the acquisition by the state (in return for 20-year government bonds) of new shares in 8 major Hungarian banks. In contrast with the 1992 bank consolidation operation, this new scheme leaves to banks most of the responsibility in forcing the reorganization or otherwise liquidation of the debtor enterprises.

### 3.4. The new regional trade agreements

The trade protocol of the Association Agreement between Hungary and the Community became effective on 1 March, 1992 and the "Visegrad agreements" with Poland, the Czech Republic and the Slovak Republic entered into effect on 1 March, 1993. A similar trade agreement with the EFTA countries came into effect in October 1993. All these agreements aim at a gradual lowering of import barriers with the final objective of establishing a free trade zone (except for agriculture) within a maximum period of ten years. While the Visegrad agreements are symmetrical, those concluded with the Community and the EFTA are asymmetrical, that is, the Community and EFTA countries will reduce trade barriers first, with Hungary only reciprocating at a later stage. With the ratification of the Association Agreement by EC Member States having been completed, the Agreement came fully into force in February 1, 1994.

## 4. Assessment and prospects

Since the presentation of the 1992 Report, progress has continued to be made in the area of structural transformation, particularly in the fields of banking reform and bankruptcy legislation. On the macroeconomic front, there has been a considerable deterioration as far as the fiscal and current account situation is concerned, with the IMF interrupting, as noted, the 1991 EFF in mid-1992 due to non-compliance with the fiscal targets. However, the new economic policy programme agreed between the Hungarian authorities and the IMF in the first half of 1993, and supported by the September 1993 stand-by arrangement, involves a serious effort of budget consolidation. Furthermore, the authorities are contributing to macroeconomic stabilization through the conduct of a very prudent monetary policy. Finally, a strong inflow of FDI and a relatively high degree of access to the international capital markets has allowed Hungary to finance without problems its growing current account deficit, making it unnecessary for the G-24 to complement the IMF stand-by with further macro-financial assistance.

No doubt Hungary still faces difficult challenges ahead. It will have to take tough measures to reduce the public deficit without loosing popular support for the reforms. It will also have to bring down its current account deficit and foreign debt burden to less uncomfortable levels. Finally, the Hungarian government will have to persevere in its structural measures to avoid a loss of momentum in the transformation programme. The authorities are taking the right steps in these directions and the country's main political forces seem committed to carrying forward the transition process. This, as well as the fairly high degree of consensus among the population in favour of the reforms, should ensure that progress continues to be made in the years to come.

# III. THE CZECH REPUBLIC AND THE SLOVAK REPUBLIC

## 1. Introduction

In February 1991 the EC Council (Council Decision 91/106/EEC) granted an ECU 375 million loan to the former Czech and Slovak Federal Republic (hereafter CSFR). This was done in the context of an initiative by the Group of Twenty-Four (G-24) to provide financial assistance supplementing that offered by the IMF and the World Bank. The objective of the loan was to ensure a sustainable balance of payments situation, strengthen international reserves and facilitate the introduction of currency convertibility. Together with a broadly equivalent contribution from the non-Community members of the G-24, the loan was supposed to cover the CSFR's balance of payments "financing gap" for 1991, estimated at US$ 1 billion.

The loan was to be disbursed in two tranches. The release of the first tranche was made conditional upon the CSFR government reaching agreement with the IMF on a stand-by arrangement based on a comprehensive economic policy programme. With the IMF Board having approved a 14-month stand-by credit in January 1991, the first tranche (of ECU 185 million) was effectively disbursed in August of that year. The disbursement of the second tranche was subject to a successful review by the European Commission, in consultation with the Monetary Committee, of progress in the field of economic stabilization and structural reforms, including the observance of a number of quantitative performance criteria agreed by the two parties. After a positive review, the second tranche (of ECU 190 million) was released in February 1992.

Regarding the assistance granted by the non-Community members of the G-24, US$ 384 million were committed, mostly in the form of medium-term loans to the CSFR. Of this amount, US$ 362 million were effectively disbursed.

In what follows, we review the situation after the full disbursement of the 1991 loan. Section 2 gives a brief description of economic performance and policies in the CSFR in 1992, the year before the break-up of the federation. Section 3 then discusses the issue of the division of the EC loan between the two republics that succeeded the CSFR on 1 January 1993. Section 4 analyzes the main economic repercussions of the dissolution of the federation and Section 5 spells out, for the Czech Republic and for the Slovak Republic separately, the main economic trends and policy measures of 1993. Finally, section 6 makes an overall assessment of the situation and prospects in the two countries.

## 2. Economic developments in the CSFR in 1992

Real GDP in the whole of the former CSFR fell again by an estimated 7% in 1992, after decreasing by 15.9% in the previous year. However, over the year the decline of output was partially halted and in the second half of the year some sectors began to show signs of recovery. Despite the decline in output, registered unemployment fell steadily during 1992 in both republics. For the whole of the CSFR, the unemployment rate fell from 6.6% at the end of 1991 to 5.1% at the end of 1992. Nevertheless, regional differences in the labour market remained pronounced: whereas, at the end of 1992 the unemployment rate stood at only 2.6% in the Czech lands, in Slovakia the rate was 10.4%.

Supported by the continued implementation by the authorities of the CSFR of tight monetary and fiscal policies, average inflation slowed down to 12.7% in December 1992, after having reached 52% in December 1991 in the wake of the liberalization of prices. However, consumer price inflation picked up somewhat in the latter half of 1992, partly as a result of an acceleration of wage growth. In an attempt to compensate for the massive (25%) decline in real wages that took place in 1991, average wages rose by 17%, implying a real increase of about 8%.

Having been almost in balance in 1990, the general government deficit in the CSFR swung into a deficit of 2% of GDP in 1991 and of 3.6% of GDP in 1992. This deterioration of the fiscal accounts is basically explained by the loss of revenue associated with the decline of

economic activity and the erosion of the traditional state-enterprise tax base, as well as by the negative budgetary impact of several structural reforms. However, in comparison to the experience of other Central and Eastern European Countries in transition to a market economy, the deterioration of the fiscal situation in the former CSFR was very moderate and was in fact consistent with a tight underlying fiscal stance.

The monetary programme adopted by the authorities for 1992 targeted a price inflation of 12% during the year, which was consistent with a modest real increase of credit to enterprises and households. Despite the complications for monetary management introduced by the uncertainties associated with the impending dissolution of the federation, the objectives of the programme were broadly met, with inflation growing in 1992 by 12.7% and broad money by 17.5%. Such uncertainties, however, resulted in quite divergent monetary trends in the Czech lands and Slovakia, with broad money growing at around 23% in the former and around 4.5% in the latter. There was also significant changes, in the stance of monetary policy in the course of the year. Until August, the strong balance of payments position and the success in reducing inflation led the authorities to ease monetary conditions in an attempt to support economic activity. But from September onwards monetary conditions were tightened again as inflation showed some signs of accelerating and as fears about the repercussions of the split of the federation provoked an intense capital flight from both republics (as well as from Slovakia to the Czech lands). Thus, banks' reserve requirements were raised and auction refinancing credit rates climbed from 14% to 20% by the end of December.

From the beginning of 1991 to the dissolution of the federation, exchange rate policy was characterized by the use of the exchange rate as a nominal anchor of the reform process. This was reflected in the almost complete stability of the nominal exchange rate of the crown, which remained in effect fixed against a basket of five Western currencies. With consumer prices increasing by 54% in 1991 as a result of that year's liberalization of prices and removal of subsidies, and with the inflation differential vis-à-vis the CSFR's main trading partners remaining positive in 1992, the stability of the nominal exchange rate translated into a substantial real appreciation. By the end of 1992, the CSFR had lost practically all the competitive edge gained through the 50% nominal devaluation engineered in 1990.

Like monetary policy, the CSFR's balance of payments experienced very different trends in the first and second halfs of 1992. With exports to the West growing strongly despite the recession in European markets, and imports below expectations, the current account posted a US$ 0.7 billion surplus in the first half of the year. Furthermore, at US$ 2.1 billion, official hard-currency reserves at mid-year exceeded by US$ 1 billion the projections incorporated in the stand-by programme agreed with the IMF in April. By contrast, in the second half of the year uncertainties surrounding the division of the federation affected very negatively inflows of foreign direct investment (FDI), provoked, as noted, a capital flight and induced an increase in imports on concerns about future external relations between the two republics. Imports also accelerated at the end of the year due to the expectations of the introduction of the VAT in January 1993. All this resulted in a sharp reduction in official reserves to US$ 1.3 billion by year-end. For the whole of 1992, the convertible current account surplus fell from US$ 357 million in 1991 to US$ 330 million.

Although the dissolution of the CSFR tended to dominate the political debate since the summer of 1992 and diverted some attention from structural reforms, progress in several areas continued to be made. Thus, the bidding rounds of the first wave of large-scale "voucher-privatization", involving 1.500 companies with a book value of about 50% of GDP, were completed in December of 1992. Under the voucher scheme, citizens 18 years or older were invited to purchase a booklet of vouchers worth 1000 points for a fee equivalent to one week's average wage. Individuals could use these points to bid for shares in companies being privatized or entrust them for management to the Investment Privatization Funds (IPFs), about 400 of which emerged spontaneously. In the event, about 70% of the distributed points were handed over to the IPFs.

Following the 1991 "big bang", some further deregulation of prices took place in 1992. Further progress was also made in the institutional and regulatory framework for the capital markets with the adoption of a Securities Act and a basic law to regulate the IPFs, and

preparations to set up stock exchanges in both Prague and Bratislava (which would be eventually opened in 1993). The authorities of both republics also worked intensively last year in the design of a comprehensive tax reform which entered into force in January 1993 and included the introduction of a VAT and a complete overhaul of direct taxation. Concerning the banking sector, bank regulation and supervision was strengthened by the adoption in February 1992 of new banking laws establishing capital adequacy regulations in line with BIS standards, as well as limits on large credit exposures and foreign exchange positions. The main elements of these banking regulations have been broadly maintained by the new independent republics after the dissolution of the CSFR. Additional measures to improve the portfolio and capital position of banks were also taken by the federal authorities in 1992.

In the area of foreign trade, the provisions on trade of the Association Agreement concluded with the Community in December 1991 became effective in March 1992 on the basis of an interim agreement. The Association Agreement, which was replaced in October 1993 by separate Agreements with each of the successor republics, aims at establishing a free trade area between the Community and the former CSFR in ten years. Regarding industrial goods, many of the remaining EC tariffs and quantitative restrictions were eliminated immediately after the agreement entered into force. For some sensitive industrial products and for most agricultural products, however, a less ambitious or more gradual liberalization was agreed. In March of 1992, the CSFR signed another trade agreement with the EFTA countries and in December of 1992 concluded the so-called "Visegrad Agreement" with Hungary and Poland, which aims at the gradual introduction of a free trade area among those neighbouring countries by the year 2000 at the latest. Like in the case of the European Agreement, the agreements with the EFTA and the other Visegrad countries have been replaced in 1993 by separate agreements for each successor republic.

### 3. Division of the 1991 EC Loan

In view of the institutional changes which led to the partitioning of the Czech and Slovak Federal Republic into two separate states, the Commission took the initiative to propose to the authorities of the CSFR and of the two successor republics in December 1992, and again in January 1993, that the loan be continued on the understanding that the two new republics would be jointly and severally liable towards the Community for the full amount.

The authorities of both republics, however, declined on several occasions to accept the proposal made by the Commission and requested that the Community consider the possibility of individual liability of the Czech and the Slovak Republics, according to a 2:1 ratio, consistent with their separation agreement. In justifying their position, the new republics emphasized the fact that individual responsibility is one of the most important aspects of sovereignty, and that economic autonomy was a crucial factor in the separation of the Czech and Slovak Republics. They also argued that some other important official creditors had already accepted separate liability of the successor states.

After consultation of the Monetary Committee, the Commission agreed to go along the Czech and Slovak request and adopted in August 1993 a proposal for a Council decision designed to establish the principle of the split of the 1991 EC loan to the CSFR according to the 2:1 ratio, with each successor Republic being individually liable for only its allocated part of the loan. Accordingly, the Czech Republic and the Slovak Republic will be responsible for, respectively, two thirds and one third of the total payments of principal, interest and fees associated with the EC loan. After consultation of the Parliament, the proposal was formally approved by the Council on January 24, 1994. It empowers the Commission to agree with the national authorities of the two republics on the necessary adjustments to the original Loan Agreement.

Finally, it must be noted that since the partition of the federation the authorities of both republics have been discharging fully and timely the interest payments associated with the 1991 loan.

## 4. Economic implications of the dissolution of the CSFR

Following the general elections of June 1992, the governments of the two republics decided to dissolve the federation by the end of the year. They then proceeded to agree on the division of federal assets and liabilities. Fixed properties would be divided according to the territorial principle and most other assets and liabilities according to a 2:1 ratio that reflected the relative population shares of the two republics.

In order to avoid excessive disruptions in economic relations between the two republics after the separation, the respective governments also agreed to set up a customs and monetary union between the two countries starting on 1 January, 1993. The customs union guaranteed the free movement of goods and services between the two republics, prohibited the use of tariff and non-tariff barriers within the territory of the former CSFR, and stipulated identical custom policies vis-à-vis third countries. Capital and labour would also be allowed to circulate freely between the two countries. As for the monetary union, it was envisaged to last at least six months but could be dissolved earlier under certain conditions, including a sharp decline in international reserves or bank deposits in any of the two republics.

Nevertheless, uncertainty about the consequences of the break-up of the federation and speculation about the future of the monetary union (which was seen as a transitory agreement) soon gave rise to a strong capital flight out of both republics and out of Slovakia and into the Czech lands (on expectations of a devaluation of the Slovak crown against the Czech crown). This produced large losses of foreign exchange reserves in both republics and provoked the collapse of the monetary union at the beginning of February, that is, only a month after it was set up.

The introduction of new currencies, initially through the attachment to the notes of different stamps in each republic, proceeded smoothly. The conversion against the old Czechoslovak currency was effected at par for both the Czech crown and the Slovak crown. In order to minimize possible disruptions of trade after the split of the currencies, the authorities of both countries introduced a bilateral settlement system for inter-republican transactions. Payments between the Czech Republic and the Slovak Republic are now centralized through two clearing accounts. Payments arising from post-8 February transactions are settled through an account denominated in "clearing ECUs", with balances being settled in hard-currency at the end of the month and only to the extent that they exceed ECU 130 million. While, in principle, one clearing ECU is equivalent to one ECU, the exchange rate of both national currencies in terms of the clearing ECU are allowed to deviate by $\pm$ 5% from their exchange rates against the actual ECU. Inter-republican payments arising from pre-8 February transactions are settled through a different clearing account denominated in the so-called "Czechoslovak Accounting Crown". Balances in this second clearing account are regularly settled either in hard-currency or by transferring them to the ECU-based account.

Despite the establishment of the bilateral clearing system and the maintenance of the customs union, inter-republican trade fell sharply (by about 45%) in the first quarter of 1993. Although bilateral trade turnover has recovered somewhat since then, inter-republican trade is estimated to have declined by around 20% in 1993 as a whole.

The split of the federation and the subsequent demise of the monetary union between two republics has had a much more adverse impact on Slovakia than on the Czech Republic. First, the dissolution of the CSFR has put an end to the very considerable fiscal transfers that Slovakia used to receive from the Czech Republic through the federal budget. This, in turn, has unmasked an important Slovak current account deficit vis-à-vis the Czech Republic. Second, with the separation, Slovakia has also lost much of the federal government's solid reputation for orthodox macro-economic policies and market-oriented reforms, a reputation that has in effect been inherited by the Czech Republic. Third, with most federal institutions being located in the Czech Republic and many of the better qualified professionals remaining in the newly-created Czech institutions, Slovakia's economic policy has been impaired by the lack of proper institutions and human capital.

To the comparatively worse repercussions of the division of the CSFR on the Slovak Republic must be added the less favourable economic situation that already prevailed in Slovakia before the division. At the end of 1992 Slovakia had not only an average rate of unemployment four times higher than that of the Czech Republic but also a weaker industrial structure and a greater share of the defense and heavy industries that had most suffered from the collapse of the CMEA traditional markets.

## 5. Economic developments in 1993

### 5.1. The Czech Republic

Real GDP in the Czech Republic is estimated to have grown moderately in 1993 (between 0 and 1%), the first positive rate since real output began declining in 1990. Real GDP (seasonally adjusted), has been growing since the second quarter of 1993, spurred both by the recovery of consumption and investment and by a surprisingly strong performance of convertible exports.

With banks and other creditors continuing to refuse to apply effectively the April 1993 bankruptcy law, the unemployment rate has remained at very low levels (3.5% at end-1993, only moderately up from the 2.6% rate prevailing a year before).

Following a 8.5% price jump in January 1993 associated with the introduction in that month of the VAT, inflation came down rapidly to about 0.5% per month in March-July. Inflation, however, accelerated again between August and October as a result of unusually large food price increases and ended the year at 18.2%, above an initial target of 14-16% and the 12.7% rate recorded in December 1992. The main threat to inflation continues to be the rapid growth of wages. Although wage increases moderated somewhat after the reintroduction by the Czech authorities on July 1, 1993 of a tax on excessive wage increases, they have remained very high. Thus, in the third quarter of 1993 nominal wages in enterprises with 25 or more employees were 26% higher than in the same quarter of 1992.

Speculation against the currency, unfavourable wage and price developments and the need to drain the excess bank liquidity that resulted from the conversion of cash holdings and bank deposits ahead of the currency split, led the Czech National Bank to tighten monetary policy in the first months of the year. However, since the end of April 1993, as trends in currency in circulation began to reverse, foreign exchange reserves increased and inflation started to show a positive behaviour, monetary policy has been gradually eased. Regarding fiscal policy, the state budget recorded in 1993 a Kc 1.1 bn surplus, representing 0.1% of GDP. Together with an unexpectedly strong financial position of the local authorities, this has resulted in a general government deficit close to zero, against the 1% of GDP deficit target that had been agreed with the IMF.

The Czech current account (excluding transfers to Slovak citizens of shares in enterprises privatized in the first wave of voucher-privatization) is tentatively estimated to have posted in 1993 a surplus of some US$ 600 million, or about 1.9% of GDP. This is a surprisingly good result given the acceleration of domestic demand and imports and the weakness of the Czech Republic's main export markets. In contrast with the sharp drops in exports suffered by other Central European countries, Czech exports (excluding exports to Slovakia) performed strongly, growing by 13% in real terms in the first 10 months of 1993.

Although the net inflow of foreign direct investment slowed down in 1993 to US$ 450 mio (from US$ 983 mio in 1992), the Czech Republic has been experiencing a surge in other capital inflows since the third quarter of 1993. Thus, net portfolio investment (to a large extent in the form of equity purchases) reached in 1993 about US$ 700 mio and Czech enterprises borrowed abroad US$ 750 mio (basically in the form of bank credits). Furthermore, the Czech National Bank successfully placed several international bond issues last year. This relatively high degree of access of the Czech Republic to the international capital markets has been reinforced by the upgrading of Moody's rating (from the Ba1 previously assigned to the CSFR to Baa3) and by the assignment by Standard and Poor's of a comparable BBB rating. This makes the Czech Republic the only Eastern European

country to have been issued an "investment grade" mark by the lending international rating agencies.

The combination of a healthy current account position and a strong capital inflow has put upward pressure on the nominal exchange rate and has resulted in a rapid growth of official foreign exchange reserves, which stood at US$ 3.8 bn at end-1993, compared to US$ 0.7 bn at end-1992. In order to stem the upward pressure on the exchange rate, the Czech National Bank is planning to make the crown fully convertible for current account transactions and to liberalize in a phased manner controls on capital outflows.

Despite recent speculation on a possible revaluation of the Czech crown, the currency has remained stable against the reference basket of Western currencies used to peg its value. As of May 1993, the number of currencies in the basket was reduced from 5 to 2 (the US$ and the Deutsche Mark). This has strengthened considerably the link of the crown to the German currency. The persistence of a significant price and wage inflation differential between the Czech Republic and its main trading partners has continued to appreciate the real exchange rate, which stands now at a level similar to that which prevailed before the 1990 devaluations.

The IMF approved a 12-month, SDR 177 mio stand-by credit to the Czech Republic in March 1993. Granted in the wake of the speculation and sharp decline in reserves that accompanied the dissolution of the CSFR, the credit aimed at providing an early boost to reserves and helping the Czech authorities reestablish international confidence in its policies. With the external situation improving rapidly in the course of 1993, the Czech authorities only made the first purchase under the stand-by arrangement (SDR 70 mio) and repurchased this amount ahead of schedule in September 1993.

The Czech Republic has continued to make progress on the structural side. With last spring's distribution of enterprise shares, the first wave of large-scale privatization was completed. Moreover, a second wave of large-scale privatization is already underway. As was the case in the first wave, almost one third of the assets, with an estimated book value of Kc 145 billion will be sold through the voucher method. The distribution of vouchers began in October 1993 and the first bidding round is expected to start in April of this year. The second wave should be completed by end-1994, by which time about 90% of the assets of the economy will be in private hands.

The implementation of bankruptcy legislation was originally planned for October of 1992 but was delayed for fear that an excessive number of bankruptcies could boost unemployment, thwart the recovery of the economy and clog-up the court system. In April of 1993, the bankruptcy law finally came into effect, following an amendment that allows three months for creditors to attempt to reach an agreement before a bankruptcy procedure is initiated by the court. Contrary to expectations, however, the number of companies filing for bankruptcy procedures since the law came into effect has been relatively small.

Regarding the reform and development of the financial system, the Prague Stock Exchange started operating in April 1993 and the banking laws inherited from the CSFR have been slightly modified to strengthen banking supervision. In addition, part of the privatization proceeds have been earmarked by the National Property Fund to purchase bad loans in the banks' portfolios at a discount.

### 5.2. The Slovak Republic

Slovak real GDP is estimated to have declined by 5-7% in 1993, implying the fourth consecutive year of recession. Unemployment, for its part, has kept climbing, reaching 14.4% of the labour force at end-1993, up from 10.4% at end-1992.

The prolongation of the Slovak recession is largely explained by the negative effects the dissolution of the CSFR has had on Slovakia. The split of the CSFR not only has disrupted trade with the Czech Republic, but has also obliged the Slovak authorities to pursue restrictive macro-economic policies. Monetary policy had to be overly tight in the first half of 1993 in order to defend the country's foreign exchange reserves amid persistent

speculation about a devaluation of the Slovak crown. While the monetary stance was gradually eased after the July devaluation, the reemergence of pressures on the exchange rate at the end of 1993 obliged the National Bank of Slovakia (NBS) to raise the discount rate from 9.5% to 12% on December 21. On the fiscal front, the authorities have made a significant effort to control the budget deficit after the termination of the fiscal transfers from the Czech lands. In particular, the government adopted in the summer of 1993 a tough package of fiscal measures (including an increase in the VAT) aimed at cutting the deficit by 2.5% of GDP in the second half of the year. Although the general government is estimated to have run a deficit of about 7% of GDP last year, this would mean a substantial correction from an estimated budget deficit before Czech transfers of 14% of GDP in 1992.

The increases in indirect taxation and the 10% devaluation of the Slovak crown in July 1993 have resulted in an increase in CPI inflation from 12.7% at end-1992 to 25.1% at end-1993.

The loss of the fiscal transfers from the Czech Republic was expected to unmask a large deficit in the Slovak current account. In the event, however, the sharp compression of domestic demand and imports and the devaluation of the Slovak crown have avoided the emergence of a too serious current account deficit. Thus, excluding transfers from the Czech Republic associated with the distribution of voucher-shares to Slovak citizens, NBS data show a total current account of US$ 289 mio (or 2.9% of GDP) in the first 10 months of 1993.

Slovakia is, however, having problems to finance even this smaller-than-expected current account deficit. First, at an estimated US$ 100 mio in 1993, net foreign direct investment continues to be of little significance. Second, Slovakia lacks good access to the international capital markets. Slovak borrowers have placed only two international bonds since the break-up of the CSFR[2] and in both cases paying quite high spreads over Libor. Third, speculation about a devaluation of the Slovak crown has resulted both in the first half of 1993 and since the end of that year in a significant outflow of short-term capital.

To help ease its balance of payments constraint, the IMF granted to Slovakia an SDR 64,35 mio (US$ 89 mio) Systemic Transformation Facility (STF) loan in July 1993. The IMF is also about to reach agreement with the Slovak authorities on an economic policy progamme that could be supported in the coming months by a stand-by arrangement and, possibly, a second purchase from the STF. In addition, the World Bank approved in November 1993 a US$ 80 mio Economic Recovery Loan. It can also be expected that further macro-financial assistance from the G-24 will eventually be requested to supplement the IMF and World Bank loans.

The weakness of Slovakia's balance of payments has been reflected in a very vulnerable foreign exchange reserve position. Capital flight in early 1993 practically depleted official hard-currency reserves, which (excluding gold and SDR holdings) fell from approximately US$ 350 mio at end-1992 to US$ 119 mio at end-February 1993. This led the authorities to restrict current account convertibility. Thus, in late January banks were obliged to increase their overall short position in foreign currency to 35% of their capital before they could buy foreign exchange from the NBS, and in February minimum financing requirements for imports were introduced. Between May and September official foreign exchange reserves recovered gradually, reaching US$ 513 mio at end-September. Much of the increase, however, reflected the STF purchase and the international bond issued by the NBS in September. Furthermore, since the second half of October the NBS has again been losing reserves. In spite of this, the authorities decided to remove the restrictions on convertibility introduced in early 1992. Official foreign exchange reserves stood at US$ 415 mio (or about three weeks of imports) at the end of 1993.

Regarding exchange rate policy, the currency continues to be pegged to a basket of five Western currencies. The Slovak crown was devalued by 10% against convertible currencies

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[2] A US$ 240 mio bond issued by the SNB in September 1993 and a US$ 21 mio bond issued by Calex, a state-owned manufacturing company, in January 1994.

last July. This was done in the context of the adjustment programme agreed with the IMF and supported by the STF purchase. Furthermore, the Slovak crown was devalued by 5% against the clearing ECU in early December 1993. Given the almost simultaneous 3% revaluation of the Czech crown against the clearing ECU, this means that, since the split of the currencies and with respect to inter-republican transactions, the Slovak crown has been devalued by about 18% against the Czech crown.

Concerning structural measures, with the first wave of large-scale privatization completed last spring, the Slovak government is now preparing a second wave including some 650 enterprises. In contrast to the first wave (and the second Czech wave), however, the Slovak government intends to rely primarily on traditional privatization methods, such as direct sales to investors, "management buy-outs" and tenders. Coupon privatization will still be used but in a much smaller scale than before. The aim of this shift to more conventional methods is both to increase badly-needed state and foreign exchange revenues and to make sure that enterprises are transferred to capable owners.

A bankruptcy law finally entered into effect in June 1993, following (like in the Czech case) an amendment under which a board of creditors will have three months to work out a rehabilitation plan. The Slovak government has also initiated an operation to net out part of the inter-enterprise arrears. At a first stage, the operation was concluded on a voluntary basis but, in order to achieve a further reduction of inter-enterprise arrears, the government has recently decided to make enterprise registration of claims obligatory.

Finally, regarding financial sector reform, Slovakia is preparing some amendments to the banking laws and regulations inherited from the former CSFR and is elaborating a strategy to strengthen the balance-sheets of the major Slovak banks, probably with the support of the IBRD and the PHARE programme.

## 6. Assessment and prospects

As noted in the 1992 Report, by helping to close the estimated balance of payments "financing-gap" at a crucial moment in the country's transition towards a market-economy, EC macro-financial assistance to the former CSFR has contributed to the success of the CSFR's stabilization and reform programmes. Without the G-24/EC balance of payments support, the cost of the transformation process in terms of output lost and unemployment would have been significantly higher and, perhaps, unacceptable to the population. G-24/EC macro-financial assistance eased the CSFR external constraint both directly and by helping the country to gain access to the international private capital markets.

Since the presentation of the previous Report, progress has continued to be made in both republics in the major areas of structural reform. On the macro-economic front, the Czech Republic has continued to implement sound and orthodox fiscal and monetary policies. As a result, inflation has been brought back under control following last January's VAT-induced price-jump, and official reserves have been rebuilt to very comfortable levels. Also, the projected current account deficit will be amply financed by expected inflows of foreign direct investment and other private capital inflows.

The Slovak Republic faces, as noted, a more difficult macro-economic situation. First, the loss of large fiscal transfers from the Czech Republic has resulted in an important budget deficit and, although a serious current account deficit will probably be avoided, the Slovak recession has proved to be deeper and longer than was initially expected. Second, the recent devaluation of the Slovak crown and a new increase in indirect taxes has complicated the fight against inflation. Third, official reserves remain at a very low level and Slovakia has limited access to the international capital markets. However, recent measures like the tough emergency fiscal package adopted by the Slovak government last summer, and the rigorous monetary policy implemented since the beginning of 1993 confirm the high priority that the Slovak authorities continue to attach to the stabilization of the economy.

The dissolution of the federation has had negative repercussions on both the Czech and the Slovak economy, compounding for the latter the difficulties of the transition process. But both countries seem committed to the structural reform programmes and are taking the

right steps to ensure that the reforms continue to be backed by a stable macro-economic framework.

# IV. BULGARIA

## 1. Introduction

The radical economic reform process in Bulgaria started in early 1991 when the country's first non-communist government embarked on an ambitious stabilization and reform programme under which tight macro-economic policies were put in place and several important structural reforms were undertaken. In support of the programme, the IMF concluded with the authorities a twelve-month Stand-by arrangement in March 1991 providing for up to some US$ 390 million, with an attached contingency mechanism for oil and gas prices, under which approximately US$ 80 million was drawn. The World Bank was to make available a Structural Adjustment Loan (SAL) of US$ 250 million. The Group of Twenty-Four pledged complementary financial assistance of some US$ 600 million, including a Community loan of ECU 290 million (disbursed in two tranches, in August 1991 and March 1992).

As noted in the previous report, the results of the policies implemented in 1991 were satisfactory : price distortions were decisively addressed; trade and exchange systems were liberalized; and some important institutional and legislative changes were introduced. Several key structural reforms, in particular land reform and enterprise restructuring and privatization, proceeded, though more slowly than planned owing mainly to political uncertainties.

The programme for 1992-1993 was designed to achieve further progress towards a viable external financial position to secure a stable domestic financial framework with low inflation and increased financing of the non-government sector, and finally to reduce the fall in output mainly through the continuation of the structural transformation of the economy. The programme was in particular intended to make a decisive start on the long delayed ownership reform.

The financing needs associated with the programme were estimated at US$ 2.6 billion, down from US$ 3.8 billion a year earlier. They were assumed to be met, like in 1991, through debt rescheduling (with the Paris Club of official creditors) and roll-overs (with the commercial banks), and through official assistance from the International Financial Institutions and the Group of Twenty-Four. In particular, the programme was supported by a new twelve-month Stand-by arrangement with the IMF (concluded in April 1992) under which Bulgaria would be able to purchase up to some US$ 215 million, and the second tranche of the World Bank 1991 SAL (US$ 100 million). The G-24 was requested to provide new complementary financing of US$ 240 million. In the context of the 1992-93 assistance package, the Community decided to grant Bulgaria a new loan of ECU 110 million (Council decision 92/511/EEC of 19 October 1992) which represented approximately 50% of the residual financing gap. However, the IMF supported programme went off-track and the Community loan has not been disbursed.

## 2. Macro-economic developments and policies in 1992-1993

In the first half of 1992, the Bulgarian authorities continued to implement tight macro-economic policies, and achieved further progress towards stabilization. In mid-1992, though, the government came under strong criticism from the opposition, the trade unions and the industrialists for mishandling the economic reform and in particular for neglecting to address decisively the needs of the enterprise sector (by the end of 1992, half of Bulgaria's state and municipal enterprises were operating at a loss) and for proceeding too slowly with privatization. As political opposition to the stabilization programme was growing, macro-economic management weakened in the second part of the year and most programme targets for fiscal, monetary and incomes policies were missed. As a result, Bulgaria was not in a position to draw the last tranche under the SBA (some US$ 43 million).

In late October 1992, the centre-right Union of Democratic Forces government had eventually to step down. A new, non-party, government, backed by a heterogeneous coalition of the Socialist Party, the Movement for Rights and Freedom and a fraction of the UDF, came

to power on 30 December 1992. From the outset, this government placed an emphasis on structural reforms, in particular on privatization. At the same time, it was not prepared to take unpopular economic policy measures. The new authorities did not implement strict fiscal policies, and therefore failed to conclude in 1993 the discussions with the IMF on a new financing arrangement. The World Bank, on its part, withheld the disbursement of the second tranche of the 1991 SAL.

## 2.1. Macro-economic policies

The fiscal policy intended to be implemented in 1992 was aimed to limit budget financing and credit to state enterprises to make financial resources available for the growing private sector. In particular, the budget deficit was intended to be limited to 4.5% of GDP.

From July 1992, government spending increased beyond targets due to wage, social assistance and defence spending overruns. The adjustment of energy prices, that would have broadened the energy sector profits tax base, failed to materialize. Meanwhile, the financial performance of the state sector continued to deteriorate, bringing about a structural decline in tax revenues. For the year as a whole, the fiscal deficit was thus close to 7% of GDP. In 1993, fiscal policies remained lax; the budget deficit increased further, approaching 11% of GDP.

Monetary policy reflected the fiscal stance. In the first half of 1992, the monetary authorities respected the targets for money creation that had been agreed with the IMF. Growth of domestic credit to government was contained to 6% in the first six months, against an increase in the general price level of almost 40%. In the second half of the year, it almost doubled; the resulting increase in the general government's monetary financing by more than 110% far exceeded the targets of the economic programme. Credit expansion to government crowded out the private sector.

Restrictive incomes policy had been one of the essential components of the government's stabilization programme since February 1991. Its relaxation in July 1992 when the government raised minimum wages and wages of state employees was one of the main causes for inflation in the second part of the year. Average real wages rose by about 12% in 1992. In 1993 (on 1 April), wages of public sector employees were increased by 44% and a new wage indexation system which reflected nearly 100% of price increases and thus perpetuated inflation.

## 2.2. Economic results

GDP fell by about 6% in 1992 (after a drop of some 12% in 1991). Industrial production declined by around 11%, as compared to 18.6% the previous year. The services sector declined much less (around 3%) and began to show signs of recovery, thanks to private sector activity, especially in retail trade. Agricultural production declined by about 7%. For 1993, GDP decline is estimated at 3 to 4%.

As a result of depressed activity and labour shedding in the state sector, unemployment rose during 1992 and early 1993, from 10% to 16%, the highest level in all of Eastern Europe. It has remained stable at around this level since. Private sector employment, however, recorded a dramatic rise. It is estimated that by the end of 1992 the private sector accounted for some 14% of total employment. "Side income" (various forms of income from the private sector) is estimated by the authorities to have greatly risen and to have become the second largest source of household income by end 1992. These trends continued in 1993.

The monthly inflation rate fell to 2% in July 1992, but rose again to 5-6% by the end of the year. The annual inflation rate was 91% in 1992. In 1993, the year-on-year inflation rate decreased to 73% (end-year inflation in 1992 and 1993 was 79% and 64% respectively).

After the initial sharp devaluation following the exchange system reform in February 1991, the lev gradually depreciated from around 18 per dollar in April 1991 to 27 per dollar by August 1993This nominal depreciation of the Bulgarian currency represents in fact a strong

real appreciation. In the last months of 1993, however, the national currency came under strong pressure and the exchange rate depreciation accelerated. By the end of 1993, the exchange rate of the lev was about 32 per dollar.

2.3. External Developments

The structural shift in foreign trade from the former CMEA countries to the Western industrialized countries continued in 1992 from the previous year. Exports in convertible currencies rose by 30% (reflecting a competitive exchange rate, low labour costs and a more liberal trade regime), while those to former CMEA countries halved in 1992. According to national statistics, trade with the EC increased particularly rapidly, with both exports and imports doubling. EC trade is expected to receive a further boost through the recent Interim Agreement, which came into force on 31 December 1993.

The trade account was balanced in 1992, but it is likely to have recorded a significant deficit in 1993, estimated at US$ 0.5 billion. This is due not only to reduced external competitiveness, following wage increases and real appreciation of the lev, but also to recession in the EC export markets and to UN trade sanctions against rump Yugoslavia (Serbia and Montenegro). The sanctions, imposed in May 1992 and made more severe in April 1993, not only bar exports to Serbia and Montenegro, but also disrupt trade with Western Europe by blocking transport links. The Bulgarian authorities allege that they cost the country US$ 240 million a month between lost exports and increased transport costs. Latest IMF estimates of the effect of the sanctions on Bulgaria's current account point to a loss of up to US$ 400 million in 1992 and US$ 700 million in 1993.

Smaller than expected official capital inflows have been more than offset by private inflows, mainly related to export receipts and repatriation of capital due to high returns on leva denominated domestic financial assets. The Bulgarian National Bank could thus increase its international reserves to close to US$ 1 billion, equivalent to over three months of merchandise imports. By the end of 1993, the reserves were much lower (some US$ 700 million) due in particular to the interventions of the BNB in support of the national currency on the foreign exchange market. Foreign direct investment remained, however, extremely low (some US$ 40 million in 1992 and US$ 20 million in the first half of 1993), despite a particularly liberal law passed in January 1992 allowing foreign investment in virtually all sectors of the economy.

In order to secure deferral and rescheduling of external debt servicing obligations on official debt, in December 1992 Bulgaria reached an agreement with the Paris Club of official creditors. This agreement that covered maturities falling due until April 1993 was the second agreement of this type (the first one was concluded in April 1991). A new official debt rescheduling will need to be negotiated as soon as Bulgaria has reached an arrangement with the IMF.

In parallel Bulgaria was negotiating a comprehensive restructuring of its private debt (the bulk of the debt is owed to some 300 commercial banks). In November 1993, after three years of ups and downs in these negotiations, the authorities and the banks' advisory committee virtually agreed on the parameters of a comprehensive debt and debt-service reduction scheme (an agreement in principle on the main orientations of the scheme had already been reached in November 1992). According to the agreement, Bulgaria's commercial debt (approximately US$ 7.3 billion, in principal) will be substantially reduced through a mix of debt cash buy-backs and long-term securities (discount bonds at 50% of face value and front-loaded interest reduction bonds). The agreement foresees separate treatment of interest arrears (some $2 billion), through buy-backs, cash payments and long-term bonds. The deal, however, will have a high cost for Bulgaria: up to US$ 900 million up front, which is more than all of the Central Bank's international reserves, and US$ 280 million per year in terms of debt servicing in the first years of restructuring (substantially more than Bulgaria had been paying since the last months of 1992 when it started making a portion of current interest payments as a goodwill gesture; such payments were, however, discontinued later to be resumed only in December 1993).

## 3. The structural reform process in 1992-1993

### 3.1. Liberalization

After the extensive price liberalization at the onset of the reform programme, controls had remained at the end of 1991 only for prices of energy and agriculture products. In the course of 1992 and 1993, despite repeated nominal increases, most energy prices (electricity, heating and coal) were still below cost. Only the prices of petroleum products are virtually liberalized, since they are adjusted monthly on the basis of a formula that links them to world prices. The number of agricultural products subject to price restriction was reduced in May 1992. It is estimated that some 85 to 90% of all retail turnover takes place under free prices.

In the area of foreign trade liberalization, the tariff system was modified in July 1992 with a new, simplified set of tariffs being introduced. Under the new system, the maximum tariff is 40% and the (unweighted) average tariff 18%. By comparison, Czechoslovakia, Hungary and Poland all had average unweighted tariffs between 9 and 14% in 1992. The average weighted tariff in Bulgaria in 1992 was 10.6%. Restrictions on exports, for the most part removed at the beginning of 1991, remained low by international standards despite the re-introduction of quantitative restrictions on a small number of products in July 1992 and January 1993, as in particular licensing requirements for a number of agricultural goods were replaced by export taxes.

### 3.2. Enterprise restructuring and privatization

The structural reform programme, that was launched at the beginning of 1991, recorded significant progress in the first half of 1992 when a number of important measures was adopted. Between December 1991 and February 1992 legislation was enacted allowing the restitution of shops and small businesses to the former owners. The law on privatization of agricultural land was finally revised in April 1992 and by the end of 1993 about 40% of agricultural lands was restituted. Following the implementation of the 1991 Company Act, two thousand large state-owned industrial enterprises were transformed into commercial companies with the state as single shareholder by November 1992. In April 1992, a comprehensive law was passed on the privatization of both small and large state owned enterprises, and in September a programme to privatize 1600 companies was announced.

Although these measures were implemented at a lower pace than initially envisaged (mainly due to lack of political consensus), by end-1992 a new, dynamic sector of small retail and service enterprises emerged, especially in the cities: by that time, 46% of property had been returned to its original owners. Overall, it is estimated that the private sector contributed 50% of the total retail and wholesale trade in 1992, and between 15 and 30% of total value added in the Bulgarian economy.

### 3.3. Financial sector reform

Financial sector reform continued in 1992 with the adoption of a Law on Banks and Credit Activity. The legal framework for the creation of a modern banking system is now in place, including an independent central bank and a private banking sector. In September 1992, the Bulgarian National Bank also introduced new payment and clearing arrangements. A second stock exchange was created in early 1992, dealing with small but rising amounts of shares. By mid-1993, the two stock exchanges together traded several million leva per week.

Despite these achievements, many critical problems of the financial sector remained largely unresolved, and the banking system is still in dire need of modernization and recapitalization. Bank assets comprise many non-performing loans to enterprises; partial clean-up operations of bad debts that have taken place in the past and are to be implemented in 1994 (following the adoption of a law on pre-1991 debts) are still insufficient to restore the commercial banks' balances. The state enterprise sector is weak and debt-ridden (inter-enterprise debt may account for about one-quarter of the value of industrial production).

Budget constraints on enterprises remain too soft, partly because no effective bankruptcy provisions exist yet. This lack of adequate bankruptcy legislation and banking supervision (prudential regulations were only adopted by the second half of 1993) allows unprofitable enterprises to absorb a large share of domestic savings, thus reducing the scope for investment and development of private enterprise. Some progress has been made with the restructuring of the banking system, but the consolidation of the existing commercial banks into a small number of viable units was still not completed. A process of gradual recapitalization of the banks progressed only slowly, owing to its budgetary cost.

### 3.4. Institutional strengthening of public finances

In the second half of 1993, with the adoption by parliament of new tax laws (on VAT, income tax and profit tax), the new taxation system whose foundations had been put in place as early as in 1991 was virtually completed. Together with the laws on budget procedure and on tax administration, the adoption of new laws are viewed as an important step towards institutional strengthening of public finance.

## 4. Community macro-financial assistance in 1992-1993 and prospects

The ECU 110 million Community loan was to be disbursed in two tranches, the disbursement of each tranche being subject to a number of specific conditions. In particular, in view of significant delays in implementing the 1991 G-24 assistance package (often due to inefficiencies on the Bulgarian side) and the uncertainty over the outcome of the negotiations on the restructuring of the country's foreign debt, two specific conditions were attached to the release of the first tranche of the loan: (i) the Bulgarian authorities had taken the necessary steps to allow the release of the amounts committed by the non-Community G-24 members in the context of the 1991 support package, and (ii) an agreement in principle had been concluded between Bulgaria and its commercial bank creditors on a set of guidelines regarding a future debt restructuring deal. The second tranche was to be disbursed when decisive progress had been made towards a comprehensive medium-term commercial debt restructuring, and subject to a positive assessment by the Commission of progress in the field of economic stabilization and reform, on the basis of precise criteria that were to be specified in a Memorandum of Understanding.

By the end of 1992, Bulgaria had completed the negotiations on the assistance with most members of the G-24 that had made commitments in 1992; it had also reached an understanding with the commercial creditors on the parameters of a future debt restructuring package. The implementation of the Community assistance was, however, delayed as the 1992 stand-by arrangement with the IMF went off track and the authorities started negotiating a new financing programme with the Fund. For the same reason, no other G-24 assistance has been disbursed so far under the 1992-93 complementary package.

The situation did not change during most of 1993 as the discussions on a new IMF-supported programme could not be concluded. However, at the very end of 1993, two important developments took place that basically restored conditions for the resumption of Community and G-24 assistance to Bulgaria. An agreement on the restructuring of the commercial debt was reached that regularizes Bulgaria's position as a debtor and clarifies its medium-term financing needs; and a new stand-by arrangement with the Fund was agreed in principle.

# V. ROMANIA

## 1. Introduction

In July 1991, the Council of Ministers decided to grant Romania a first medium-term financial assistance of ECU 370 million in the context of an initiative by the G-24 aimed at providing a total of US$ 1 billion in assistance. This initiative supported a comprehensive reform programme aimed at stabilizing the economic situation and initiating the process of transformation from a highly centralized planned system to a market-oriented economy in the aftermath of the long period of political turmoil that had followed the collapse of the Ceauscescu regime. The financial assistance from the EC/G-24 was complementary to an IMF stand-by arrangement.

As reported in the previous report , despite progress in liberalizing the economy, the main stabilization objectives of the authorities' macroeconomic adjustment programme for 1991 could not be achieved. Output declined substantially (by some 13 percent). Inflation accelerated late in the year and reached some 20 percent per month in January 1992, reflecting both the sharp depreciation following the unification of the exchange rate in November and the accommodating credit policy resulting from the rapid build-up of inter-enterprise payments arrears. External reserves were depleted. The shortfall in non-Community pledges and the resulting delays in the disbursement of external assistance was in part responsible for these slippages, especially with regard to the international reserve objective.

Drawing on the experience of 1991, the Romanian authorities designed a new programme for 1992, that aimed to re-establish macroeconomic stability while developing the reform process. With regard to stabilization policy objectives, the authorities intended to slow the decline in real economic activity (to 5 percent), to lower the rate of inflation sharply (to 1.5 percent per month by year end); and to increase international reserves (to 1.7 months of imports by year end). To achieve these objectives, the authorities intended to pursue strict fiscal and monetary policies, a tight incomes policy and a flexible exchange rate. Structural reform measures included further price liberalization, privatization and financial discipline through restructuring state enterprises.

To support the Romanian economic programme, on 27 November 1992, the Council of Ministers decided to grant to Romania a further medium-term loan in the amount of ECU 80 million to assist the country in its economic reform process and to strengthen the reserve position of the central bank[3]. The assistance was made available in the context of an initiative by the Group of Twenty-Four aimed at providing a total of US$ 180 million in assistance complementary to that provided by the IMF under a stand-by arrangement approved in late May 1992.

The Community loan was disbursed in one tranche in February 1993, following a positive assessment of progress in the field of economic stabilization and reform.

## 2. Macro-economic performance in 1992

The government maintained prudent fiscal and monetary policies and exercised wage restraint during most of 1992. Measures in all key areas showed the strong commitment of the government to the stabilization programme : the phased elimination of consumer subsidies began with an initial 25 percent reduction in May and continued with a further 25 percent reduction in September; the refinancing rate of the National Bank of Romania was increased to 80 percent in May in an effort to ensure that interest rate is positive in real terms; and the exchange rate liberalization started on June 2, following the elimination of the 100 percent surrender requirement a month earlier.

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[3] Decision 92/551/EEC, OJ n° L 353 of 3.12.92, p. 30

In the fiscal area, in response to the significant erosion of the tax base during the year, nominal tax rates were raised and expenditures in the state budget and major social funds were restricted. Thus the consolidated deficit of these entities amounted to only 1 percent of GDP, well within the programme target.

Macroeconomic developments in 1992, however, indicate that the result of the economic programme of the Government was mixed. The authorities had some success in bringing down inflation, but economic activity continued to be weak. Inflation came down dramatically to about 3 percent a month in July and August 1992, but following a new round of adjustments in the prices of subsidized consumer goods in September, it hovered around 10 percent a month by the end of the year. In 1992, aggregate output fell by some 15 percent. The decline was especially marked in the industrial sector, where output fell by some 23 percent. Unemployment increased from 3 percent to 9 percent of the labour force. Private sector activity, however, increased rapidly, reflecting in large part the privatization of agriculture, and, to some extent, the incipient development of private activity in the service sector. By the year-end, it already accounted for some 28 percent of recorded GDP.

The balance of payments was on track during the first semester of 1992. In the third quarter, the external current account improved significantly, registering a surplus of US$ 100 million as export performance remained strong while imports declined sharply. In the final quarter of 1992, however, the current account deficit worsened sharply, and for the year as a whole, it amounted to some 8 percent of GDP.

Official balance of payments support from the Community and other G-24 countries was expected to reach US$ 917 million in 1992, including the carry-over of the disbursement of US$ 737 million corresponding to the entire balance of payments assistance relating to 1991. Most of the assistance relating to the 1991 exercise was disbursed in 1992. With regard to the balance-of-payments assistance package for 1992, corresponding to the identified financing gap of US$ 180 million, commitments only reached US$ 111 million (including ECU 80 million for the EC) and no disbursement was made in 1992. Consequently, the balance-of-payments target for the entire 1992 was not reached.

### 3. Structural reform in 1992

Significant progress was made in the implementation of the structural reform measures : prices were substantially liberalized, subsidies reduced, foreign trade was liberalized, an agency in charge of the privatization process was established, certificates of ownership were distributed, state enterprise arrears reduced and a foreign investment legislation introduced.

In certain areas of reform, however, some slippages were recorded. The exchange rate was pegged to the dollar in the last quarter of 1992 at an unsustainable level in view of the prevailing inflation rate, resulting in the re-emergence of a parallel exchange market where the national currency sold at a discount of 20-25 percent. Importers' requests for foreign exchange were not fully met, and following the elimination of surrender requirements for exporters in June 1992 exporters built up their deposits in foreign currencies. The privatization process recorded delays, affecting both the quick privatization programme for small subunits and the pilot privatization programme for large enterprises. Delays were also recorded in the passage of adequate legislation regarding bankruptcy.

### 4. Review of performance criteria attached to the EC financial assistance

The Memorandum of Understanding between the Commission and Romania provided for an evaluation of progress made with respect to stabilization policies and structural adjustment policies. The quantified performance criteria were identical to those contained in the IMF stand-by arrangement approved in May 1992. The structural adjustment criteria were designed to evaluate progress made in the major fields of reform.

The review of performance criteria was effected in December 1992. At that time, the IMF had completed its mid-term review. All quantitative macro-economic performance criteria for end-June and end-September were observed and the disbursement by the IMF of the

first three tranches of the stand-by credit had been effected. Net credit to the government had declined in the first nine months of 1992, as the fiscal position had moved into surplus in the third quarter. Net domestic assets had remained well below the programme ceiling. International reserves through September had increased in line with the programme through September despite delays in disbursements form official sources, owing to a significant improvement in the current account.

The structural performance criteria included in the Memorandum of Understanding were reviewed by the Commission staff in cooperation with the authorities. The findings on these criteria, which are summarized below, suggested that these conditions were also broadly met. Based on this assessment, the Community loan was disbursed in February 1993.

4.1. Prices and subsidies

On May 1 and September 1, 1992, the government had increased the price of the consumer products still subject to control, cutting by 50 percent the subsidies on these items. The government intended to eliminate the remaining subsidies in the first semester of 1993. With regard to energy prices, the government had maintained parity with world market prices for crude oil, electricity, coal and lignite, and it had increased the price of natural gas by 10 percent per quarter in real terms.

4.2. Foreign trade

All export quotas as well as licensing requirements for imports and exports had been eliminated, except for goods still subject to price control and subsidies, and few strategic items.

4.3. Privatization

The Private Ownership Funds and the State Ownership Funds had been established, and were developing their internal organization. The National Agency for Privatization had distributed Certificates of Ownership representing 28 percent of the bank value of the commercial companies (corresponding to 92 percent of the Certificates to be distributed).

Out of 3000 units selected for early small privatizations, 1,214 had been sold by mid-November, whereas the structural adjustment criteria called for the completion of the bulk of these privatizations by year end. In this area, where some delays had been experienced, the government committed itself to expediate the privatization process.

With regard to the thirty companies selected for early pilot privatization, 8 were privatized and 18 other prepared for privatization, of which 6 were in advanced phases of negotiations.

4.4. Enterprise financial discipline

With regard to enterprise financial discipline, a new law to enforce enterprises financial discipline (Law 76) was enacted on July 16, 1992, followed by Government Decision n° 701/1992 on the same purpose. The law established procedures by which creditors can sue debtors for overdue payments, and the actions they can take, like seizure of monetary and real assets, forced restructuring and liquidation, against defaulting enterprises. As a result of these measures, the state enterprises arrears declined form 25% of state enterprises turnover in June to 15% in October. Furthermore, to reduce tax arrears, the government has raised the penalty rate on overdue tax payments to above the level of market interest rate.

4.5. Investment

With regard to investment, the Law providing for free repatriation of profits for foreign investors had been passed.

## 5. Developments in 1993 and prospects

Macroeconomic developments in 1993 indicate that progress towards stabilization continued to be elusive. Inflation continued unabated with prices rising by approximately 300 percent over the year. The official exchange rate depreciated sharply in nominal terms (from lei 430 per dollar in December 1992 to lei 1280 per dollar by end-1993); and the spread between the official rate and that of the parallel market remained substantial (in the order of 50 percent by year-end), while official reserves were depleted. However, the decline in economic activity seems to have bottomed out in 1993.

The authorities brought to its final stage the process of price liberalization and elimination of consumer subsidies. They eliminated some consumer price controls and substantially adjusted the remaining ones on May 1, 1993, while eliminating the corresponding subsidies. Moreover, controls on allowable commissions and markups were eliminated on July 1, 1993. Also, VAT was introduced on May 1, with a single rate of 18 percent, to replace the turnover tax.

Despite those important and difficult measures, other actions in key areas that are necessary to overcome the experienced persistent difficulties in stabilizing the economy, had not yet been taken by December 1993. In particular, the pace of reform in state enterprises has remained inadequate, allowing to undermine macroeconomic policies and the credibility of the government's stabilization efforts. Also, the exchange rate regime needs to be liberalized, not to discourage much needed export-oriented investment.

Owing to these policy shortcomings, Romania was not in a position to make the final purchase under the IMF stand-by arrangement before it expired in end-March 1993, and the negotiations on a new stand-by arrrangement with the IMF that started early in 1993 dragged on during most of 1993. The G-24, at the Country Coordinating Meeting for Romania held in May 1993, impressed on the Romanian authorities the need to implement forcefully stabilization and reform measures; the G-24 recognized that this will be a particularly difficult task and that further assistance from the international community will be critical in the successful implementation of the measures. They however cautioned that new complementary macro-financial assistance by the G-24 will be considered in light of the commitment to reform by the Romanian government and in view of the outcome of the consultations underway between Romania and the Bretton Woods institutions.

In December 1993, the authorities finally reached a new agreement in principle with the IMF, that should be, in principle, a major step towards stabilization and structural reform of Romania's economy. In this context, they requested further complementary financing from the EC/G-24 that will have to be considered in the beginning of 1994.

# VI. ALBANIA

## 1. Introduction

In mid-1992, against a background of severe economic, social and administrative dislocation, and facing fiscal and external imbalances much larger than in other countries in the region, the government of Albania, backed by the strong political mandate in the elections in March, committed itself to the daunting task of implementing a comprehensive economic reform: The immediate priority of the Albanian authorities was to stabilize the economy and to initiate profound structural changes towards an open market economy.

The government's programme was supported by the international financial institutions and the G-24. A twelve-month stand-by arrangement with the IMF covered the period mid-1992 to mid-1993. In view of the need to restore official reserves and of the large commercial arrears that impeded access to private creditors, the programme was critically dependent on complementary external support from the G-24. At the High-Level meeting held in Tirana in July 1992, the G-24 responded positively to the Albanian request for complementary macro-financial assistance in the form of grants or highly concessional loans to fill the residual balance-of-payments gap of US$ 165 million. In the context of the G-24 initiative, the Community decided, on 28 September 1992, to grant Albania financial assistance of a maximum amount of ECU 70 million in the form of a grant, to be disbursed in two installments (Council Decision 92/482/EEC). Overall, the assistance committed by the G-24 under the 1992-93 programme has amounted to some 70 percent of the original gap, despite the fact that the assistance initially committed by some countries was eventually disbursed in the form of tied aid (which does not fall within the G-24 macro-financial assistance scheme).

The Community grant was disbursed in two tranches. A first trance of ECU 35 million was disbursed in December 1992; and, following a positive assessment of the economic situation and progress in the reform process in Albania, and a favourable opinion of the Monetary Committee, the disbursement of the second tranche was effected in August 1993.

Macro-financial assistance from the Community and other G-24 countries has been instrumental in permitting the government of Albania to implement its ambitious economic programme. The foreign financial assistance was used primarily to strengthen the reserve position of the country, and allowed the authorities to rapidly liberalize the exchange market and to introduce a freely determined exchange rate within a unified exchange market.

The first stage of economic stabilization and reform having been successfully achieved, the Albanian authorities have now shifted from a mainly short-term horizon, dictated by the crisis prevailing at the beginning of 1992, toward a consistent medium-term approach. To that effect, they have adopted a comprehensive medium-term economic programme for 1993-96. This programme was presented to the G-24 High-Level meeting held in Brussels in November 1993. At that meeting, the G-24 recognized that Albania continues to face a very difficult external financial situation and that it will continue to need macro-financial assistance from the G-24, in the order of US$ 72 million, for the period mid-1993 - mid-94, complementary to the ESAF arrangement agreed with the IMF in July. In that context, the Commission will, in due course, propose further financial assistance to Albania.

## 2. Macro-economic performance in 1992-1993

In view of the great difficulties and risks under which Albania embarked in its programme in mid 1992, achievements on the macroeconomic front have been considerable. The slide into hyperinflation has been reversed, and the downward spiral of output has been corrected. By 1993, government domestic financing requirement dropped (to 11 percent of GDP from 41 percent of GDP in the first half of 1992), while credit expansion was reduced sharply, well within the credit ceilings, and redirected in favour of the incipient private sector. Credit to non-performing public enterprises and state farms has been substantially curtailed since the beginning of 1993. In sharp contrast to the situation prevailing up to the

end of 1992, state enterprise financial discipline has been enforced in 1993, and the sharp rise in inter-enterprise arrears which threatened the stabilization effort has been arrested, as the system of receivable orders has been abolished and the banks have been instructed not to accept any payment order not backed by sufficient funds. As a result of the tight budgetary and monetary policies, inflation was curbed (to a monthly rate of 2 percent in 1993). Reflecting the strong domestic effort as well as large external support, foreign reserves were built up as planned (amounting to some $ 80 million equivalent to 1 1/2 months of imports at end-June 1993, and US$ 146 million by the year end) and the (floating) exchange rate remained fundamentally stable, hovering around leks 95-105 per US dollar. The fall in production has bottomed out since the end of 1992 (GDP is estimated to have grown by 11 percent in 1993), albeit from a very low base, thanks to the good performance of the private sector (in agriculture, services and construction), whereas state-sector industrial output has continued to drop in 1993 owing to the imposition of financial discipline.

The stabilization gains of recent months remain, however, fragile and tentative and Albania will have to continue to rely heavily on foreign assistance in the short run. Exports ($ 70 million in 1992; $ 105 million in 1993) cover only a fraction of import needs ($524 million in 1992; $ 585 million in 1993). Furthermore, the external outlook remains clouded by Albania's large external debt, mainly with commercial banks ($ 834 million at end 1993, including accumulated arrears of $ 621 million), and Albania's very limited capacity to pay. Whether Albania is able to attain external viability in the medium term will depend critically on an early normalization of relations with commercial banks as well as with bilateral official creditors.

### 3. Structural reform

While making significant gains in macro-economic stabilization, Albania initiated in mid-1992 profound structural changes towards a market economy. Critical measures under its programme for 1992-93 included major reforms of the price and exchange regimes, liberalization of trade and foreign investment, and the start of other structural changes focusing on agriculture, state enterprises and the financial sector. During this period, progress was made in imposing financial discipline on state-owned enterprises and privatizing agriculture and small scale services and industry. However, reforms have proceeded at a slower pace in the fields of privatization of medium and large sized industrial enterprises and foreign direct investment. A new momentum of structural reforms has been built up in the wake of the preparation of the comprehensive medium-term economic programme for 1993-96 formulated in the Policy Framework Paper.

Price reform has advanced rapidly during the past year and the budgetary cost of subsidies has therefore been contained. All wholesale and retail prices have been freed, with the exception of wheat, bread, sugar beet and a number of non-food items produced under monopolistic conditions (energy, rents, medicines, telecommunications, urban transport etc). A new series of price rises was implemented in mid-1993, which included the doubling of the prices of wheat, flour and bread, a sensitive issue due to the importance of bread in the local diet and the dependence of the country on wheat imports. This constitutes a major additional step towards completing price reform in Albania, and should help stimulate the recovery of domestic wheat production, as well as promote the import, distribution and processing of wheat by the private sector. In an effort to cushion the social impact of this measure the government has designed a large compensation scheme, in the understanding that it will be phased out in the course of 1994. Other price rises initiated in mid-1993 include the twofold to threefold increase of public housing rents and household energy.

Foreign trade has been liberalized, with export licensing only applying to products still subject to price controls and to a limited list of strategic products, or in order to prevent diversion of food assistance. The exchange rate is determined freely within a unified exchange market, the efficiency and depth of which has been improved by the licensing of foreign exchange dealers and exchange bureaus.

In agriculture, a key sector of the economy which accounts for half of the value added and employs around 60 per cent of the population, the upheaval associated with the dissolution of the former cooperative farms resulted in at least a 35% drop in output during the 1990-91 season. Albania, formerly a net exporter of food became a recipient of food aid. The international community, with the EC as the principal donor, furnished 400,000 tons of food aid in 1991-92 and 450,000 tons in 1992-93. The privatization of agricultural land resulted in a 18% rise of output in 1992 and a further substantial increase in 1993 (14%). Yet, despite the rapid growth of output, further shipments of food aid to Albania might be necessary, albeit in reduced quantities.

About 80% of the land area has been privatized to date. Nearly all former co-operative farms, constituting about 75% of arable land, have been successfully privatized. This has resulted in the creation of over 315,000 private farms. State farms, which occupy the remaining 25% of the land and are mostly situated in the fertile lands of the coastal plains, are being privatized through leasing arrangements, or through the distribution of ownership rights to workers. The distribution of titles should be completed by the end of 1994. However, this strategy has led to the division of arable land into small, uneconomic plots, averaging 1 1/2 ha, and the majority of farmers operate on a subsistence basis. In an effort to facilitate the consolidation of the small holdings, the government is pushing for the rapid conclusion of the distribution of private ownership titles. The government plans to complete the legal framework concerning agricultural property, with rights to sell, lease and mortgage the land, thus leading to the creation of a land market.

The reform of the public enterprise sector poses one of the greatest challenges to Albania's economic programme. Clearly, large sections of industry are no longer viable and most enterprises will find it difficult to operate now that budgetary support has been depleted and they are forced to operate on commercial terms, as the capital stock is obsolete, the domestic market is small and impoverished and there is no tradition and experience of export-oriented production and marketing. Furthermore, the administrative capacity to carry out a large scale restructuring is limited.

At first, in 1992, reform was mostly confined to the privatization through direct sales to employees of the small units operating in the handicraft, transport and services sectors. The authorities had difficulties to maintain financial discipline on the remaining public enterprise sectors. The sharp increase of inter-enterprise arrears in 1992 undermined the survival of enterprises and posed a major threat to the stabilization policy. Since the beginning of 1993, however, the government has stopped the flow of new arrears by issuing appropriate instructions involving both enterprises and banks.

Privatization in the enterprise sector also has been delayed by the difficulty to establish a restitution policy. The passage of a law on the restitution or compensation for urban properties to previous owners on 15 April 1993, and a law for the compensation to former owners of agricultural land on 22 April 1993, followed by the administrative arrangements to implement these laws (including the setting of firm deadlines for the presentation of claims), have paved the way for the rapid implementation of a privatization strategy, to complement those operated in 1992.

The government is currently developing a multi-track approach that involves rapid privatization of small- and medium-sized industrial enterprises as well as longer-term procedures for large, more problematic enterprises.

The government is proceeding with the estimated 1200-1500 small and medium-size enterprises (up to 300 employees) quickly, without allowing fiscal revenue considerations to slow the process significantly. To that effect, the Council of Ministers has issued a decree on 1 June, that provided for the privatization of those enterprises through auction. These auctions will be effected with a decentralized procedure at the level of the district by local councils. Some 300 enterprises have already been identified for this immediate privatization.

With regard to the 300 larger enterprises, the government is finalizing a strategy inVolving rapid privatization or liquidation for most enterprises. A small group of "strategic" firms will be sold by tender. Budgetary support will be minimized, focussing mainly on about 30

"problem" enterprises. To deal with those, the government has established, with the support of the World Bank, an Enterprise Restructuring Agency (ERA) placed under the authority of the Council of Ministers. The ERA is to formulate targets regarding privatization, liquidation or restructuring for all enterprises under its control in order to bring these enterprises into operating balance within 1-2 years. A fixed budgetary envelope is available to finance these reforms.

Control over the remaining state-owned enterprises will be established through the creation of a financial monitoring system and the appointment of outside directors. A tight budget constraint will be maintained for all enterprises, with bank credit available only on commercial terms and safeguards against the accumulation of arrears.

With regard to the financial sector, a two-tier banking system was created in Albania in early 1992, when the central and commercial banking activities were separated and respectively transferred to the new Bank of Albania and to four state-owned commercial banks. The resulting commercial banking sector is characterized by a high degree of monopolistic segmentation and is burdened by the existence of a large portfolio of non-performing loans.

The government is in the process of dealing with the problem of non-performing loans by replacing net enterprise debts to banks by government bonds. Further restructuring of the banking system is envisaged.

The legal framework of a market economy is currently being put into place. The Parliament has approved a Company Law, a Banking Law, a Central Banking Law, a Bankruptcy Law, an Accounting Law, as well as labour legislation. The first part of the revised Commercial Code has been adopted while a new Anti-Trust law and a Civil Code still have to be completed.

In view of the very weak enterprise sector and the extremely limited outside contacts that Albania had before 1991, it has a particular need for foreign investment. Yet the existing legislation did not provide sufficient guarantees to ensure foreign participation in the privatization process while the law on land ownership does not allow foreigners to own land in Albania (though they may lease it for 99 years). Amendments to the 1992 Foreign Investment Law, which will eliminate separate authorization requirements for foreign investment and will allow foreigners to participate in privatization of state assets, were passed in late 1993.

## 4. Review of performance criteria attached to the EC financial assistance

The memorandum of Understanding between the Commission and Albania, signed on 10 December 1992, provided for an evaluation of progress made with respect to stabilization and structural adjustment policies. The quantified performance criteria were identical to those contained in the IMF stand-by arrangement and included the following elements : quarterly limits on overall credit and on credit to the government, quarterly minima for international reserves, and limits on external payments arrears and on the contracting of new external debt by the public sector.

The structural adjustment criteria were designed to evaluate progress made in the field of price, trade and exchange liberalization, the establishment of a legal framework for private activity and the privatization of enterprises. The successful review of progress in economic stabilization and reform, including the compliance with performance criteria, was a condition for the release of the second tranche of the grant.

The review of IMF conditionality, completed in March 1993, concluded that the quantitative performance criteria were met and the reform programme remained on track, so that no adjustments to the programme were required. In the face of the shortfall in external assistance, it means that domestic policy restraint by Albania was stricter than envisaged in the programme to preserve the targeted external position. The structural performance criteria were also largely met. Price reform advanced rapidly. Foreign trade was liberalized and the exchange rate has been determined freely within a unified exchange

market. Major elements of the legal framework of a market economy have been put in place. Privatization of agriculture and of small enterprises in the services sector progressed rapidly.

With all criteria attached to the Community loan broadly met, the second tranche of the Community grant was disbursed in August 1993.

## 5. Assessment and prospects

The Government of Albania now aims to sustain the momentum of stabilization process, promote growth and progress toward external viability. To that end, it has formulated a comprehensive medium-term economic strategy for 1993-96 and designed a detailed programme for the first year under this framework (mid-1993 to mid-1994).

The principal macro-economic objectives of the programme for 1993/94 are : a real growth of 3-4 percent; a reduction of the 12-month rate of inflation to 33 percent by mid-1994; and a further strengthening of the external position, including a build-up of official reserves to 3 months of imports by mid-1994. The adjustment strategy will remain centered on tight demand policies, supported by adequate external support and an early solution of the arrears problem.

In order to reduce macro-economic imbalances, fiscal adjustment remains a central element of the programme, together with the continuation of tight monetary and state-sector incomes policies. In view of the expected decline of food aid counterpart revenues and the need to attend to a number of critical expenditure needs (including investment and structural reforms) that can no longer be deferred, the commitment to reduce the domestic financing of the budget to 7 percent of GDP will constitute a major challenge. In support of the Albanian programme, the IMF approved in July 1993 an arrangement under the Enhanced Structural Adjustment Facility (ESAF), and the authorities have requested complementary assistance from the EC/G-24 of $ 72 million for the first year of the programme.

# VII. THE BALTIC STATES

## 1. Introduction

Following the Soviet annexation of Estonia, Latvia and Lithuania in 1940, their economies underwent a rapid industrialization as a result of massive capital formation and labour movements (both from agriculture into industry and from other parts of the Soviet Union into Estonia, Latvia and Lithuania). They nevertheless kept a strong competitive position in agricultural production and provided other (former) Soviet republics with meat, dairy and fish products, which had been formerly exported to the West. Given their higher economic efficiency stemming from a skilled work force and a comparatively well-developed infrastructure, the countries' per capita income was significantly above the Union average. However, it was increasingly felt that the Soviet central planning system restricted the potential of the economies. In November 1989, Estonia Latvia and Lithuania succeeded in obtaining the adoption of the Law on Economic Independence by the Supreme Soviet of the USSR, which opened the way for the initiation of economic reforms in a number of areas, including price and wage determination, fiscal policy, and financial sector policies. By the time the Baltic States formally regained their independence from the (former) Soviet Union, in August 1991, they had already made the first steps to reform their economies and disentangle them from the highly integrated Soviet economic structure, which had provided over 90% of their imports, through their re-orientation towards Western markets. When in 1992 the three countries had to pay imports from Russia at world market prices, compared to the earlier heavily subsidized rates, they suffered a severe terms of trade shock.

After the Baltic States had become members of the International Monetary Fund (IMF) in Spring 1991, they finalized, in close cooperation with the IMF their stabilization and reform programmes, covering the period from mid-1992 to mid-1993. In support of these programmes, the authorities of the three countries requested complementary macro-financial assistance from the EC/G-24 to cover the residual financial gaps estimated at US$ 105 million for Estonia, US$ 210 million for Latvia and US$ 285 million for Lithuania. Following positive indications made by a number of G-24 countries towards the participation in the support scheme, the IMF Board approved the Latvian stand-by arrangement on 14 September 1992, the Estonian arrangement on 16 September 1992 and the Lithuanian arrangement on 21 October 1992.

In November 1992, the EC Council decided (Council Decision 92/542/EC of 23.11.1992) to provide the Baltic States with a loan of up to 220 mecu (40 mecu for Estonia, 80 mecu for Latvia and 100 mecu for Lithuania), which corresponded to roughly half of the balance of payments gaps estimated by the IMF, in order to address the general balance of payments needs of these countries; this contribution was nearly matched by financial assistance from the EFTA countries and Japan. The EC loan agreements and memoranda of understanding were signed with Estonia and Latvia on 8 January 1993 and with Lithuania on 1 March 1993. The Commission disbursed the first tranches of the loans to Estonia and Latvia on 31 March 1993 and to Lithuania on 27 July 1993. The release of the second tranches was made conditional on a successful review of progress in the area of economic stabilization and reform, including the observance of a number of performance criteria agreed by the respective parties. Following a positive review and the conclusion of a supplementary agreement regarding the absorption of the assistance in October, the Commission is expected to disburse the second tranche to Estonia in Spring 1994. Following similar reviews and subject to analogous agreements, the disbursements of the remaining tranches for Latvia and Lithuania are expected for the same period.

## 2. Estonia

### 2.1. Economic reforms from mid-1992 to mid-1993

#### 2.1.1. Background

In the course of 1990 and 1991, the prices of a number of goods were either liberalized or administratively raised and subsidies on energy, telecommunications and transport were reduced. After the adoption of the Law on Enterprises in 1989, the number of Estonian companies with less than 100 employees increased from 34 to over 20,000 at the end of 1991. Following the passage of the Law on Privatization of State-Owned Trade and Service Facilities in 1991, the privatization of smaller enterprises progressed substantially. Reform of large-scale enterprises had a slow start. Following initial financial sector reforms undertaken by the Soviet authorities in 1988 with the objective to establish a two-tier banking system, the nationalization of the Estonian financial system began. In 1990, the Estonian authorities recreated the Bank of Estonia, but it was not until 1 January 1992 that the regional branch of the Gosbank could be liquidated and incorporated into the Bank of Estonia. By early 1992, there were 40 licensed commercial banks, in addition to four state-owned banks. After Estonia gained independence from the (former) Soviet Union, trade with this area, and in particular with Russia, collapsed. In order to stem this development, Estonia concluded a number of bilateral agreements with former Soviet republics hoping to secure the resumption of imports, in particular of energy from Russia. This was only partly successful. Trade with Western countries grew rapidly, albeit from a low level. This was made possible by Estonia's fairly liberal trade regime. Since early 1991, the Estonian Government has adjusted the budget process and the tax system to the needs of a market economy.

Following a deterioration of the Estonian economy in the 1980s in line with the gradual breakdown of the Soviet planning system, output dropped sharply in 1991 (-11%, after -4% in 1990) due to trade disruption with other Soviet republics. Unemployment remained very low during this time (less than 1%). Given the liquidity overhang, price liberalization led to high inflation.

#### 2.1.2. Objectives and features of the Government's reform programme starting mid-1992

The two main objectives of the Government's economic programme for mid-1992 to mid-1993 were macroeconomic stabilization and structural reform. With regard to stabilization, the main features were the completion of price liberalization, restrictive fiscal policies, monetary discipline under the currency board system, strict incomes policy and further liberalization of the exchange and trade system. With respect to structural reform, the programme comprised an acceleration of the privatization process, completion of the restitution process, financial sector reform, improvement of the social safety net, restructuring or closure of nonviable enterprises and banks and the establishment of a legal framework in support of a market economy. The programme targeted a fall in output of 15% for the programme period and a deceleration of the annual rate of inflation to 6% by the end of the programme period.

#### 2.1.3. Price liberalization

By mid-1992 most price controls had been dismantled, leaving only some prices under regulation which were charged by certain state-owned enterprises considered to be of special importance; goods and services produced in the private sector were not subject to any controls. Further progress was made in the second half of 1992. The Government removed the authority of municipalities to regulate the prices of state enterprises operating in their locality. In addition, a number of items including bread, flour, grains and sugar were removed from price control. Finally, the adjustment of energy prices to world market levels was continued with further increases in the prices of natural gas and fuel oil. By the end of 1992, the price liberalization process had been essentially completed.

2.1.4. Enterprise reform

Privatization of small firms has continued to progress. By mid-1993, the share of small enterprises privatized had exceeded 50%. Privatization of medium- and large scale entreprises, however, has turned out to be more difficult than envisaged. Problems included disagreements regarding the privatization mechanisms and unresolved restitution issues. (The Government is committed to restitute or compensate all owners of property in Estonia prior to 1940, or their descendants). One obstacle to progress in privatization was finally removed when the Government set the final deadline of 1 April 1993 for the receipts of any restitution claims. In August 1992, the Government passed a comprehensive bill that established mechanisms for the sale of enterprises worth more than EEK 600,000. At the same time, the Estonian Privatization Office (EPO) was established to organize the privatization process. From the initial list of 38 enterprises offered for sale in late 1992, 25 were privatized. By mid-1993, another 52 enterprises had been offered for privatization. The proceeds of the sales are allocated between a compensation fund for restitution claims, the state budget and the Bank of Estonia. The authorities have also made efforts to improve the performance of those enterprises remaining under state control. Pressure to restructure resulted from hard budget constraints which were in part maintained by applying the Bankruptcy law passed in September 1992.

2.1.5. Financial sector and currency reform

The Bank of Estonia, which had been reintroduced in 1990, is responsible for monetary policy, managing the payments system and for banking supervision. Until mid-1992, it also undertook some commercial activities inherited from the merger with the former branches of Gosbank and the Vnesheconombank.

Since its independence from the (former) Soviet Union in August 1991, Estonia was faced with a shortage of cash roubles, which had been traditionally supplied by Gosbank in Moscow. This led to the disruption of certain kinds of payments and the limitation of access to bank deposits by the public. The Estonian authorities implemented a currency reform on 20 June 1992 which put an end to Estonia's membership in the rouble zone (it was the first republic to leave it). The reform included the reintroduction of the Estonian kroon (EEK) as national currency under a currency board system providing 100% reserve backing for all money issued. The exchange rate of the kroon was legally fixed at 8 EEK = 1 DM. The kroon was rapidly accepted as the only legal tender and international reserves held at the Bank of Estonia increased following the reform.

In the period immediately after the currency reform, strains in the banking system became evident. They were generally characterized by delays in clients' access to deposits with commercial banks, ranging from a few days to several weeks. As these were symptoms of liquidity problems, in particular with three large banks, it was decided in early 1993 to recapitalize and merge two of them and take the merged bank under Government control, and to liquidate the third one. This helped restore normalcy to the banking system. At the same time, the Bank raised the minimum capital requirement from EEK 500,000 to EEK 6 million, which contributed to the decline of the number of commercial banks licensed in Estonia from 40 to 24 by mid-1993.

2.1.6. External sector policies

By March 1992, Estonia had abolished nearly all import tariffs that had existed under the Soviet system, leaving Estonian trade entirely tariff free except for a few items (import tariffs on alcohol, tobacco, furs, automobiles; export tariffs on art works, rapeseed oil and metals) and a 0.5% administrative fee on imports. Since November 1992, imports have been also subject to a 18% VAT. In parallel with the general removal of tariffs, the remaining quotas and licensing requirements for imports had also been abolished to a large extent. On 1 January 1993, the list of goods was further shortened (eliminating e.g. alcohol, tobacco, grain, hide, ferrous and non-ferrous metals) so that it covered only oil shale, clay and quartz. In February 1993, the Government took trade of non-ferrous metals under its direct control (state monopoly) in order to eliminate illegal re-exports. As a whole, Estonia's trade and foreign investment regime can be considered as liberal.

Except for the trade agreement concluded with Russia in February 1992, which foresaw trade volumes guaranteed by both Governments, agreements concluded with most other former Soviet republics between December 1991 and July 1992 foresaw direct trading between enterprises. In general, the agreements did not fulfil their objective in overcoming the severe trade disruptions with former trading partners, in particular Russia. In contrast, trade agreements with Finland, Sweden and Norway (free trade except for agriculture) and with the EC certainly contributed to a dynamic development of trade with this area.

Since the currency reform, the Bank of Estonia guarantees the convertibility of the kroon for valid currency account transactions in unlimited quantities and at 8 EEK per 1 DM. Foreign currency accounts of resident individuals and enterprises with domestic banks were allowed to be kept after the currency reform, but balances could not be increased. In January 1993, the Foreign Currency Law was approved according to which the Bank of Estonia could issue licences to enterprises involved in exports or imports to keep a working capital in accounts opened abroad. As a general rule there was a requirement to surrender 100% of export proceeds to any commercial banks in Estonia. Capital account transactions must receive approval of the Bank of Estonia. However, this does not apply to the repatriation of capital by foreign investors.

## 2.2. Macro-economic developments

### 2.2.1. Production and employment

From mid-1992 to mid-1993, Estonia's GDP declined by an estimated 18%. This reflects in particular the terms of trade shock suffered by Estonia following Russia's move to world market prices for energy products since early 1992 and general trade disruptions with the (former) Soviet Union. In addition, it signals the breakdown of the production of certain goods that are no longer competitive after being exposed to international competition. Finally, agricultural production suffered from the drought of Summer 1992. By mid-1993, the economic situation had broadly stabilized, and there were first indications that industrial production was increasing.

Compared to the sharp output decline experienced in Estonia between 1990 and 1992, unemployment remained low until mid-1992. However, during the following 12-month period it rose to some 4% of the labour force. In addition, there is increasing evidence of temporary lay-offs, unpaid leave and a reduction in working days.

### 2.2.2. Inflation and wage developments

In mid-1992, the year-on-year increase in consumer prices had reached 1080%. This was above all the consequence of the liberalization of prices and the rise of import prices. These factors continued to play a role until the end of 1992, but during the first half of 1993 inflation dropped sharply to reach 2-3% a month by mid-1993. Apart from the virtual completion of price liberalization, this successful move towards stabilization is due to the tight monetary policy implied by the currency board system and the firm incomes policy implemented by the Government since September 1992. Wage increases were broadly in line with price developments during the programme period, following a decline of real wages by about 45% in the first half of 1992.

### 2.2.3. Public finances

Whereas Estonia was not permitted under the Soviet system to borrow in order to finance deficits, such a rule did not apply after independence. Nevertheless, the Government tightly controlled expenditures and improved its revenues through a number of tax revisions after independence that the general budget was in surplus in 1991 and, owing to emergency measures, also in the first half of 1992. This fiscal stance was broadly maintained in the course of the following 12-month period with the support of revenue enhancing tax measures accompanying the currency reform, the removal of subsidies and a reduction in tax arrears linked to the implementation of the Bankruptcy Law. In the second half of 1992, the budget surplus stood at 1.5% of GDP and in the first half of 1993 at 1% of GDP. However, if the Government use of foreign loans in the first half of 1993 is taken into

account, the Government general borrowing requirement stood at 2.2% of GDP during this period. These loans were used to finance critical imports and to lend funds to the non-Government sector in order to support investment in energy and infrastructure.

2.2.4. Internal monetary conditions

Before Estonia left the rouble zone in June 1992, its scope for independent monetary policy was strictly limited. Because of the adoption of the currency board system, this is still broadly the case after the monetary reform, but now Estonia is effectively insulated from the effects of Russian monetary policy. The link to the D-Mark and the currency board system have strengthened the confidence in the kroon.

Credit policy, which had already been tight in the first half of 1992, tightened further following the monetary reform. Despite an inflow of foreign exchange, the banks increasingly refrained from extending credits as they became aware of the risks involved when the authorities lowered or stopped altogether the subsidization of ailing enterprises and given that real estate or other assets could not be legally accepted as collateral. As a consequence, loans were extended almost exclusively on a short-term basis, generally for trade deals.

The real money stock continued to fall in the second half of 1992, and it was not until the second quarter of 1993 that broad money rebounded both in nominal and, to a lesser extent, in real terms. The composition of broad money changed dramatically after mid-1992, as the awareness about the risk of banks increased with the development of the banking crisis. As a consequence, the share of currency holdings rose from 7.4% in mid-1992 to 26.5% by year-end.

Interest rates, which were in the rage of 80-100% for loans (20-40% for deposits) in mid-1992, rose after the currency reform, and with the intensification of the banking crisis. But once the crisis was resolved, rates fell to 25-30% in mid-1993. Since this development was accompanied by a rapid deceleration of inflation, real interest rates which had previously been negative became positive during this period.

2.2.5. External developments

For the period 1 July 1992 - 30 June 1993, the Estonian current account showed a surplus of US$ 61 mio (4.3% of GDP) compared to the deficit of US$ 213 mio previously forecasted by the IMF. This was to a large extent due to a better than expected performance of exports and non-factor services. The expansion of imports may also have been limited to some extent by delays in the disbursement of foreign loans.

After the collapse of trade with the former Soviet Union in the first half of 1992, trade volumes with this area remained low (42% of 1990 import levels, 34% of 1990 export levels). At the same time, trade with Western countries expanded dynamically so that exports to the West constituted nearly two thirds of Estonian exports in the first half of 1993, compared to less than 10% before Estonia's independence from the Soviet Union. This reorientation of trade is the natural consequence of Estonia's exposure to international competition.

Estonia's external debt stood at about 6.5% of GDP or some US$ 86 mio in mid-1993. Thanks to its liberal foreign investment policy and the credibility of its currency regime, Estonia benefited from foreign direct investment of US$ 102 mio between mid-1992 and mid-1993, which is substantially higher than expected. By mid-1993, the Bank of Estonia's gross international reserve holdings stood at US$ 275 mio (which equals 4.3 months of imports), compared to US$ 62 mio a year earlier. Net international reserves increased by US$ 224 mio, which is substantially higher than expected under the original IMF programme (US$ 91 mio).

2.3. Review of the performance criteria attached to the EC loan

The Memorandum of Understanding agreed between the Commission and Estonia, after consultation of the Monetary Committee, provided for a regular evaluation of progress made with respect to stabilization and structural adjustment policies. The quantified macro-economic performance criteria were identical to those contained in the IMF stand-by arrangement and the structural adjustment criteria were designed to evaluate progress made in the area of enterprise reform, including privatization, banking sector reform, foreign trade and foreign direct investment. A favourable review of progress in economic stabilization and reform, including the observance of performance criteria was a condition for the release the second tranche of the loan.

The reviews of IMF conditionality concluded that the stabilization programme was successfully implemented and that the performance criteria were met to the satisfaction of the IMF Board. An EC mission to Estonia in September 1993 concluded that the structural adjustment criteria attached to the EC loan were also broadly met: small scale privatization continued to progress; obstacles related to restitution were removed and new initiatives were taken and further measures are foreseen to speed up the privatization process; the generally liberal trade and foreign investment policy has been maintained and investment protection agreements have been concluded with EC members or will be concluded soon; efforts were made to restructure the banking sector and thereby to address the banking crisis. In a Supplemental Memorandum of Understanding concluded between Estonia and the Commission, the Estonian authorities agreed that they will pay special attention to the banking system, continue its restructuring and improve its capacity to perform normal credit operations and thus also channel appropriately to the domestic economy external macro-financial assistance. In order to limit the Government's intervention in the allocation process, it was also agreed that in principle the full amount of the second tranche of the EC balance of payments assistance would be channelled through the banking system. With all criteria attached to the Community loan broadly met and the Supplemental Memorandum of Understanding signed, the second tranche of the EC medium-term loan is expected to be disbursed in Spring 1994.

2.4. Recent developments and prospects

In the second half of 1993, the decline in output seems to have stopped and industrial production has begun to recover. Unemployment continued to rise only slowly, as enterprises were reluctant to implement redundancies because this would force them to pay up to eight months' severance pay. Inflation, which was reduced dramatically during the first half of 1993 to a monthly rate of 2-3%, did not continue to fall in the second half of the year. With the pick up of the economy, import growth seems to have strengthened further so that it is not likely that the current account has remained in surplus in the second half of 1993.

Estonia has been receiving external financial assistance during the second half of 1993 and in 1994, including from the G-24 countries (the remaining US$ 56 mio not yet disbursed by mid-1993) and the World Bank. In September, it purchased the remaining three tranches (some US$ 20 mio) under the first IMF stand-by arrangement. Estonia concluded a second arrangement with the IMF covering the period mid-1993 to end-1994 (a combination of stand-by and systemic transformation facility). This will give the country access to purchases from the Fund in the order of US$ 40 mio over that 18-month period. This arrangement supports the authorities' comprehensive programme that aims at continuing the transformation of the Estonian economy while maintaining macroeconomic stability. Emphasis will be put on increasing investment in infrastructure, implementing structural policies aimed at strengthening the financial and entreprise sectors, and improving the effectiveness of markets, in particular the labour market. At the same time, the authorities will aim at maintaining fiscal prudence and the currency board.

## 3. Latvia

### 3.1. Economic reform from mid-1992 to mid-1993

#### 3.1.1. Background

In 1991, the Latvian authorities initiated comprehensive price reforms which involved administrative price adjustments combined with the liberalization of an increasing share of commodities in the consumer basket. Associated with these reforms was a reduction in subsidies from 13.7% of GDP in 1990 to 1.3% in 1991. The Latvian authorities also introduced a number of measures to nationalize and reform the financial system. The Bank of Latvia took over the activities of the previously nationalized Gosbank and four other state-owned banks (Industrial, Agriculture and Social Banks, which had been created under the Soviet reforms of early 1988 and the Foreign Trade Bank). This left the Bank of Latvia not only with central bank activities, but also with commercial activities and assets amounting to 65% of total assets of the banking system. In addition, thirty commercial banks were created between 1988 and early 1992, although some of them were relatively small. In June 1992, Parliament adopted legislation that allowed the Bank of Latvia to separate its commercial banking functions by end-1992. There were also first efforts with respect to enterprise reform and in particular privatization. A Law on Privatization of Small Municipal Enterprises was enacted in November 1991 and amended in 1992. The Latvian programme for ownership comprises three stages: municipalization, denationalization (or restitution), and privatization. By mid-1992, the first stage was largely completed, but progress with the other two stages was hampered by unresolved problems concerning citizenship, restitution and the lack of a coherent legal and institutional framework. Nevertheless, the private sector grew quite rapidly, in particular in the area of trade and services, as new small enterprises were established or privatized by municipalities.

#### 3.1.2. Objectives and features of the Government's reform programme starting mid-1992

The two objectives of the Government's economic programme for mid-1992 to mid-1993 were macroeconomic stabilization and structural reform. The main elements of the programme were the continued liberalization of prices and of the foreign exchange and trade system, as well as a number of systemic changes, including an acceleration of the privatization process. The measures were to be supported by restrictive fiscal, monetary, and incomes policies, which were considered crucial for creating a stable environment for the successful departure from the rouble zone and subsequent replacement of the interim currency. The programme targeted an output decline of some 18% and a monthly inflation rate of 1 1/2% by June 1993.

#### 3.1.3. Price reform

In July 1992, the Latvian authorities progressed further with price liberalization. The restrictions on profit margins for processors of agricultural products were removed and guaranteed minimum prices for agricultural products (except for grain) were abolished. At the same time, price restrictions were lifted for fuel oil, liquid gas and coal for industrial purposes (but maintained for household supply), as well as for international tourism and non-rail cargo transport. As a consequence of these measures, the weight of regulated goods and services prices in the consumer price index dropped below 8%. In October 1992, prices for alcohol were also liberalized. By end-1992, the price liberalization process was virtually completed. Included in the small number of items remaining subject to price control were utility prices and rents, which were adjusted upwards in Fall 1992 as a reaction to the large increase in the costs of imported energy.

#### 3.1.4. Enterprise reform

From mid-1992 to mid-1993, Latvia made substantial progress in small-scale privatization for which the municipalities were responsible. However, large-scale privatization barely advanced during this period despite the fact that some 700 enterprises had been identified for privatization in 1993. Apart from unresolved restitution problems (in particular, long

deadlines for claims and unclear compensation alternatives), the process was hampered by the lack of a centralized and coherent privatization strategy and institutional set-up. In particular, line ministries were responsible for submitting privatization proposals that would entail a loss of control on these enterprises. The enterprises which were not likely to be privatized in the near future were transformed into joint stock companies. Only one enterprise had been liquidated by late 1993, which seems to be due to the complexity of the bankruptcy law of November 1991 on the one hand and to the fear to destroy a large number of enterprises interrelated by interenterprise debts on the other hand.

3.1.5. Financial sector and currency reform

On 20 July 1992, the Latvian authorities decided to replace the remaining Russian roubles in circulation by Latvian roubles, following the partial introduction of Latvian roubles in May 1992 when a severe shortage of cash roubles developed.The reform in July was speeded up by the inflow of roubles related to Estonia's departure from the rouble zone in June, and it was the starting point of a new, tight monetary policy. However, it is only with the introduction of the lats started in Summer 1993 that a permanent currency (the lats) was introduced.

Following the adoption of the Law on the Bank of Latvia in May 1992, the Bank of Latvia issued instructions which made its commercial branches subject to all the stipulations applying to commercial banks under the Law on Banks and granted them a high degree of operational independence. At the beginning of 1993, a Privatization Commission appointed by the Parliament took over the 49 branches from the Bank of Latvia. Subsequently, 21 were consolidated into a core bank (Universal Bank) which will be rehabilitated and privatized, and all other branches were privatized, except for one which was liquidated. The Bank of Latvia also decided to increase the capital adequacy requirement from the current 25,000 lats to 100,000 lats (about US$ 165,000) from January 1994 with a view to strengthening the banking sector. Furthermore, steps have been taken to strengthen banking supervision. In particular, new regulatory standards and formats of accounts complying with EC directives have been established. The liquidation of the first two banks was not realized until Fall 1993.

3.1.6 External sector policies

Latvia has a fairly liberal trade system. In June 1992, all export quotas and licensing were abolished and replaced by a system of export taxes. The Government also decided to abolish the export duties on most products with effect from 1 September 1993. There are no licensing requirements for imports. But new import duties have been levied since mid-1992 on selected consumption goods. The Tariff Council established in May 1992 by the Government to periodically review tariffs and trade taxes has decided in a number of cases to increase specific import tariffs in order to protect local producers, in particular in agriculture. This has greatly complicated the Latvian import tariff structure. However, an Interim Customs Tariff Law submitted to Parliament is expected to partly correct the situation. The proposal does not only foresee a substantial reduction of previously increased particular tariffs, but also the introduction of (moderate) tariffs for raw materials, including energy.

Latvia's foreign investment law allows free repatriation of capital and transfer of shares in the event of liquidation. Residents and enterprises are allowed to hold foreign currencies in cash, in domestic bank accounts or abroad. Enterprises can conduct their exchange transactions either through their banks or with private exchange dealers. Neither the Government nor the Bank of Latvia interfere in the allocation of foreign exchange. The Bank of Latvia ensures the smooth functioning of the foreign exchange market.

3.2. Macro-economic developments

3.2.1 Production and employment

Latvia's economic activity suffered greatly from the terms of trade shock it faced in early 1992 as a result of Russia's decision to liberalize its prices and to bill its exports to Latvia

in hard currency and at (near) market prices. The output decline was further compounded by trade disruptions with the former Soviet Union, resulting in a GDP decline of 34% in 1992 (following a fall of 8% in 1991). But in the first half of 1993, the output contraction decelerated. Latvia's official unemployment rate increased to some 5% of the labour force in mid-1993, and increasing numbers of employees accepted a reduction in working time or salary.

3.2.2. Inflation and wage developments

After the near completion of price liberalization at the end of 1992, inflation also decelerated rapidly. By mid-1993, the year-on-year consumer price increase had been reduced to 152% from 959% observed at the end of 1992. By that time, the monthly inflation rate had declined to about 1/2%. This dramatic decline was made possible by the tight monetary policy conducted by the Bank of Latvia since the currency reform of July 1992, complemented by a broadly balanced general government budget and a tax-based incomes policy.

Wage increases continued to fall short of inflation in the second half of 1992. In the budgetary state sector this was achieved by the Government's decision in June 1992 to keep the minimum wage unchanged at LVR 1500, based on which all salaries were calculated, and a monthly taxable flat allowance of LVR 400 was granted. This allowance was increased in October and November to compensate for price increases. For non-budgetary state enterprises, the authorities adopted a tax-based incomes policy under which excessive wage increases were taxed at high and steeply progressive rates. With this policy, which lasted until mid-1993, real wages in the first half of 1993 were 8.5% lower than a year earlier (following 14% and 16% declines in 1991 and 1992, respectively).

3.2.3. Public finances

The Latvian Government managed to control budget expenditures and improve revenues so that the general government deficit for 1992 was kept below 1% (including the Government's net lending activity in the order of 0.8% of GDP) and a small surplus was achieved in the first half of 1993. Apart from tight budget control, the good performance in 1993 must also be attributed to a better than expected performance in a number of areas: First, profit taxes were much higher than estimated, which seems to be related to the highly profitable re-export of (the often subsidized) goods originating from the former Soviet republics. In addition, VAT revenues benefited substantially from improvements in tax collection and the change of the accounting law from cash to accrual basis. Finally, expenditure for unemployment benefits remained much lower than expected because of the relatively slow rise in unemployment.

3.2.4. Internal monetary conditions

Following the departure from the rouble zone in July 1992, the Bank of Latvia pursued an independent monetary policy geared towards stabilizing the economy and reducing inflation. It conducted a very stringent credit policy, reducing its credit allocation to banks in real terms, partly to counteract a large inflow of roubles from neighbouring countries and partly to offset the monetary impact of the Government borrowing in hard currency from state enterprises which was sold to the Bank of Latvia for domestic currency and then used to assist the drought-affected agricultural sector. The refinancing rate of the Bank of Latvia was raised in several steps from an annual 15% to 120% in October 1992. However, real rates of interest for bank deposits reacted only slowly to these changes. The tight monetary stance of the Bank of Latvia led to an inflow of convertible currency which strengthened in the first half of 1993. The Bank of Latvia allowed the nominal and real exchange rate of the Latvian rouble (starting from March 1993, the lats) to appreciate significantly to partly reflect this higher demand for domestic currency, but it also accumulated a substantial amount of reserves to prevent a rise with potential damage to Latvia's external competitiveness. In order to stem a further currency inflow through downward pressure on market interest rates, the refinancing rate was gradually cut back again in 1993; whereas interest rates on deposits have continued to increase, those on credits have started to come down slowly.

3.2.5. External developments

The current account situation for the period 1 July 1992-30 June 1993 turned out substantially different from what had been originally expected. Instead of the planned deficit of nearly US$ 300 mio, the current account was in surplus in the order of US$ 70 mio or some 4% of GDP. To some extent, there may still be a problem of underreporting of imports from former Soviet republics which are subsequently re-exported at high profits to Western countries. But this situation also reflects a better-than-expected balance in the services account (a surplus of about US$ 200 mio rather than some US$ 80 mio), which can be attributed to a good performance in the transport sector.

The reorientation of Latvian exports towards Western countries continued vigorously. Export volumes to the CIS and Baltics fell by 19% in 1992 and by 51% in the first half of 1993 compared to the corresponding period of the previous year. At the same time, exports to the other countries expanded by 107% and 13%, respectively, in volume terms. Since 1992, their share in Latvian export revenues is more than half. On the other hand, the decline of non-energy imports from the CIS and the Baltics (55% in 1992) decelerated substantially in the first half of 1993 to a 5% decline. There was also a slight deceleration of the contraction of non-energy imports from other countries (a 35% decline in 1992, followed by a 24% reduction in the first half of 1993).

At the end of 1992, Latvia's external debt stood at 4% of GDP or some US$ 55 mio. Between mid-1992 and mid-1993, Latvia benefited from direct foreign investment in the order to US$ 50 mio. A crucial factor promoting this foreign investment activity has been the liberal foreign investment law which allows the repatriation of capital and transfer of shares in the event of liquidation. On the other hand, unresolved problems surrounding restitution and property rights, as well as the impossibility for foreigners to acquire land in Latvia have prevented a more dynamic development. From mid-1992 to mid-1993, gross convertible reserve holdings of the central bank increased from some US$ 100 mio to nearly US$ 300 mio which covers more than three months of imports. This reserve increase of some US$ 200 mio compares to an initial IMF target of a US$ 50 mio increase for this period.

3.3. Review of the performance criteria attached to the EC loan

The Memorandum of Understanding agreed between the Commission and Latvia, after consultation of the Monetary Committee, provided for a regular evaluation of progress made with respect to stabilization and structural adjustment policies undertaken. The quantified macro-economic performance criteria contained in the Memorandum follow those of the IMF stand-by arrangement and the structural adjustment criteria included in the Memorandum of Understanding were designed to evaluate the progress made in the area of privatization and enterprise restructuring, banking sector reform, foreign exchange and trade regime as well as foreign direct investment. A condition to release the second tranche of the loan is the successful review of progress in economic stabilization and reform, including the observance of performance criteria.

The reviews of IMF conditionality concluded that the stabilization and reform programme was successfully implemented and that all performance criteria were met, to the satisfaction of the IMF Board. An EC mission to Latvia in November 1993 assessed the compliance with the structural adjustment criteria attached to the EC loan. It concluded that most criteria were met. Banking sector reform had progressed well, and supervision was strengthened. Latvia maintained the liberal trade, foreign exchange and investment regimes; it was expected that those investment protection agreements that had not yet been concluded with the EC would be concluded soon. In the area of privatization, progress was less forthcoming. Small-scale privatization advanced further, but large-scale privatization was hampered by the lack of a comprehensive body of legislation and of a centralized approach to privatization, as well as unresolved problems surrounding restitution and property rights. A Supplemental Memorandum of Understanding was agreed between the Latvian authorities and the Commission, according to which the disbursement of the second tranche would be linked to further progress in a number of these issues. Furthermore, in order to limit the Government's intervention in the allocation process, it is

stipulated that in principle the full amount of the second tranche of the EC balance of payments assistance would be channeled through the banking system and that the extension of a Government guarantee on these loans would be strictly controlled. It is expected that the signature of the Supplemental Memorandum of Understanding and the disbursement of the second tranche of the EC medium-term loan will take place in Spring 1994.

### 3.4. Recent developments and prospects

The decline in output appears to have stopped in the second half of 1993, and it is expected that GDP will grow in 1994. Unemployment continued to rise slowly to reach nearly 6% in December 1993, as the budget constraints enterprises are facing were continuously hardening. It is expected that progress in privatization will further increase the unemployment rate in the course of this year. Inflation, which was reduced dramatically during the first half of 1993, increased to some 2% a month in the second half of the year, but this is attributable to seasonal factors and tax increases and does not indicate a departure from strict monetary control. In October 1993 a supplementary budget was approved by Parliament that authorized increases in expenditures including for pensions and public sector wages. Despite a concurrent increase in taxes, the budget recorded a deficit in the fourth quarter of 1993 following a surplus during the first three quarters. With the pick up of the economic growth and of imports in the course of the second half of 1993, the current account surplus is likely to have disappeared by the end of the year.

External financial assistance received during the second half of 1993 and expected in 1994, includes loans from the G-24 countries (the remaining US$ 136 mio not yet disbursed by mid-1993), the World Bank and the IMF. The country has concluded a second arrangement with the IMF covering the period 1 October 1993 to 31 December 1994 (a combination of stand-by and systemic transformation facility) which should give Latvia access to additional purchases from the Fund for an amount of SDR 68 mio (some US$ 95 mio). This arrangement supports the authorities' comprehensive programme that aims at maintaining macroeconomic stability and reinforcing the transformation of the Latvian economy. The programme provides for the continuation of restrained fiscal and firm monetary policies, the rationalization of the trade regime and a speeding up of the structural reform efforts, particularly in the area of privatization.

## 4. Lithuania

### 4.1. Economic reform from mid-1992 to mid-1993

#### 4.1.1. Background

Following the adoption of the Law on Economic Independence in late 1989, Lithuania prepared the legal framework for the removal of price controls and in February 1991, the Lithuanian Government permitted that enterprises increase their prices without the approval of Moscow, subject to a "profitability norm". Price liberalization progressed in several stages, and by early 1992, the majority of prices were liberalized. From the very beginning of economic reform the Government has stressed the importance of developing a strong private sector to support the transition to a market economy. The privatization programme included a combination of vouchers and cash sales. Vouchers were distributed to all eligible citizens in April 1991 and sales began in September 1991. By mid-1992, nearly 80% of small businesses had been privatized through auctions. With regard to large scale privatization, 600 of the 1100 large enterprises earmarked in the first phase of privatization had been privatized by mid-1992; i.e., on average 70% of their ownership was private.

#### 4.1.2. Objectives and features of the Government's reform programme starting mid-1992

The two main objectives of the Government's economic programme for mid-1992 to mid-1993 were to stabilize the economy by adjusting quickly to the terms of trade shock and to advance with structural reform. Elements of the macroeconomic stabilization plan included the introduction of a new currency and departure from the rouble area, as well as

the maintenance of sound fiscal, monetary and incomes policies. Elements of the structural plan comprised progress in building up a social safety net, implementing an anti-monopoly policy, privatization, enterprise reforms and the development of a legal and institutional framework for commercial activity. The programme targeted a decline in GDP of some 22% for the programme year and a reduction of inflation to about 2% at the end of the first quarter of 1993.

4.1.3. Price liberalization

By Summer 1992, prices of most goods had already been liberalized. The main exceptions were energy products, rents, municipal and utility services, communications, alcohol and tobacco. Minimum support prices in agriculture had been removed and agricultural subsidies were limited in order to keep the budget under control. Energy prices were adjusted to the rise in import prices which accelerated in Fall 1992 when Russia stopped providing Lithuania with energy at preferential prices. After legislation defining unfair competition and monopoly practices came into force in November 1992, the Agency for Prices and Competition was established. It has the authority to examine prices charged by dominant enterprises (with market shares above 40%) and to freeze them for up to six months, but it does not have the authority to break up monopolies. In Spring 1993, profit margins were abolished and price controls on petrol, diesel, liquefied gas and coal were removed.

4.1.4. Privatization

The privatization process continued in the second half of 1992. By mid-December 1992, more than 1000 medium and large enterprises had been privatized through public share subscription, including almost 350 industrial plants. But following allegations of improprieties, the subscription was halted by Parliament and then resumed, whereas the auction of smaller enterprises was interrupted until the end of March 1993. The auction procedure was changed to permit the submission of closed registered bids and the transferability of vouchers. The new rules for privatizing medium- and large scale enterprises required that 50% of shares of an enterprise being privatized should be sold to employees (compared to the earlier 30%). Privatization of agricultural enterprises advanced well; in April 1993, a decree was issued to allow the privatization of otherwise unsaleable enterprises at a heavily discounted price. By mid-1993, nearly 90% of the capital of agricultural enterprises (up for privatisation) had been privatized. On the other hand, only little progress was made in the privatization of land. The restitution of agricultural land has been problematic because of the small size of parcels restituted and because of outstanding restitution claims that exceed the available agricultural land. The process of privatizing non-agricultural land has not yet begun.

4.1.5. Financial sector and monetary reform

In September 1992, the Bank of Lithuania was divided into two legally separate central and commercial banking activities. The new (Central) Bank of Lithuania was from then on responsible for monetary policy, the management of the payments system, and prudential control and regulation; until October 1992 it also had a monopoly on foreign exchange transactions which was subsequently abandoned. The new State Commercial Bank of Lithuania resumed all commercial functions of the former Bank of Lithuania inherited in 1990 and 1991 from the former Gosbank, the Industry and Construction Bank and the Social Bank. Its assets account for roughly one third of total assets in the commercial banking system. Apart from the commercial banks, there are also the Savings Bank, which collects the bulk of household deposits, and the Agriculture Bank whose large credit volume has been mainly directed towards collective and state farms and in some cases also towards financing of government subsidies to the agriculture sector. These two state banks are holding claims against Gosbank in Moscow, which makes their financial situation fragile.

After independence, when the Russian supply of banknotes fell short of the increasing demand caused by rapid inflation, the Lithuanian authorities decided to issue special coupons (Lithuanian Provisional Money (LPM) or talonas) to supplement the stock of

rouble notes starting from 1 May 1992. In response to rouble inflows, the authorities declared that from 1 October 1992, talonas would be the only legal tender and provided it at 1:1 against rouble holdings, which was the first step of the currency reform. On 17 June 1993, the Lithuanian national currency, the litas, was introduced and replaced the talonas over the following weeks. Prior to this second step the exchange rate of the talonas had been stabilized in order to ensure the success of the reform. The value of the litas is kept stable relative to a basket of major Western currencies.

#### 4.1.6. External Sector Policies

Lithuania has made efforts to implement a liberal environment for imports. By Fall 1992, there were neither controls nor licenses on imports from any region. On the other hand, there were still export quotas and licensing, although steps were taken in the course of 1992 to remove a number of them. In June 1993, the Lithuanian authorities adopted a new trade system which provides for the removal of quantitative restrictions on exports, while export taxes were temporarily introduced for some formerly restricted goods. However the export of most foodstuffs and some agricultural inputs remained prohibited until 1 October 1993. The new system also foresees tariff rates for the majority of goods between 5 and 15%, with many goods entering tariff-free and a few exceptions of higher tariffs (e.g., eggs, sugar, butter, oil and a number of manufactured goods at 20-30%, and alcohol, tobacco and precious metals up to 100%).

Following the replacement of the rouble by the talonas in October 1992, Lithuania has maintained a relatively liberal payments system, with a high degree of convertibility on current international transactions. All bona fide requests for making transfers and payments for imports of goods and services are satisfied. In early 1993, the Government decided to introduce a surrender requirement of 25% for export earnings of state enterprises in convertible currencies to the Bank of Lithuania. Commercial banks are permitted to borrow abroad and extend credits to non-residents and residents in foreign currencies. Resident firms may borrow foreign exchange either abroad or from Lithuanian commercial banks. Households and private enterprises can hold their savings in foreign currency bank deposits. There is no restriction on the transfer of funds held by individuals or enterprises in foreign exchange accounts into or out of Lithuania.

### 4.2. Macro-economic developments

#### 4.2.1. Production and employment

By mid-1992, the disintegration of Lithuania's economic relations with the (former) Soviet Union had contributed to sharp production declines. After the GDP contraction of 13% in 1991, the output decline accelerated in the course of 1992 as inputs were more difficult to obtain and, following the price liberalization in Russia, at significantly higher prices. In addition, agricultural output was negatively affected by a severe drought in Summer 1992. For the year as a whole, GDP is estimated to have declined by 38%. In the first half of 1993, industrial production levelled off and the output contraction decelerated, reducing the output decline for mid-1992 to mid-1993 to some 30%.

Until mid-1992, the output decline was barely reflected in official unemployment figures which stood below 1%. And over the following twelve months, the rate increased by less than 1/2 percentage point. However, hidden employment was estimated to be in the order of 7%, which is still relatively low in view of the severe output contraction seen in the past year.

#### 4.2.2. Inflation and wage developments

Given the liquidity overhang, Lithuania's liberalization of prices, coupled with higher import prices, led to a steep price increase. By mid-1992, the year over year consumer price inflation stood at 865%. Monthly inflation rates picked up towards the end of 1992 when a preferential agreement with Russia on oil supplies ran out and higher import prices were passed on to consumers. In addition, price developments in Winter 1992 may have also reflected expansionary monetary consequences of the currency reform of 1 October 1992

linked to the exchange at par of talonas for roubles held in correspondent accounts as agreed with Russia. In the course of the first half of 1993, monthly inflation decelerated significantly as a consequence of strong tightening of monetary policy in Spring and the continuation of fiscal discipline. By July 1993, the monthly inflation rate, which averaged 14% in the first half of the year, had decreased to 3%. Lithuania has maintained a tight incomes policy. In the second half of 1992, real wages dropped by more than half and have been kept stable in the course of the first half of 1993.

4.2.3. Public finances

The Lithuanian authorities have put great emphasis on fiscal discipline and have set the objective of balancing the general government budget during the period covered by the IMF arrangement (mid-1992 to mid-1993). Lithuania kept public expenditures under tight control during this period, which in fact resulted in a small surplus for the general government budget. The releases of funds to ministries were made conditional on actual Government receipts. This led to sharp reductions in the real wage and benefit for government employees. In 1993, revenues were strengthened through trade reforms and an increase in the general sales tax from 15 to 18%.

4.2.4. Internal monetary conditions

Until Lithuania's departure from the rouble area the scope for independent action in the monetary field was very limited. Monetary aggregates expanded rapidly during 1991 and 1992. However, given the rapid rise in prices during these two years and the limited availability of banknotes, real money balances declined sharply prior to the first introduction of the talonas in Spring 1992. After the full introduction of the talonas in Fall 1992, Lithuanian authorities pursued an independent monetary policy which led to an appreciation of the talonas exchange rate against the rouble. However, in the first four months of 1993, the talonas depreciated by 30% against the dollar, reflecting to some extent also expansionary monetary consequences of the currency reform, related to the 1:1 rouble/talonas exchange of funds accumulated in the correspondence accounts. Evidence for the lack of confidence in the talonas was also given by large open positions in foreign exchange taken by Lithuanian commercial banks.

Monetary policy was considerably tightened in Spring 1993. In early April, the Bank of Lithuania announced a near-tripling of reserve requirements for the following month and the introduction of auctions for central bank refinancing. These measures, combined with continued fiscal and wage discipline, produced a 25% appreciation of the exchange rate of the talonas against the dollar in May and June. This new policy stance prepared the introduction of the litas, Lithuania's national currency on 25 June 1993. After the Government replaced interest rate ceilings (annual lending rate of 25%) by minimum interest rates payable on deposits, to be applied at both state and commercial banks (20-26%), interest rates rose but remained negative in real terms. This is above all due to the fact that the State banks, which have the major market share, set relatively low rates compared to the commercial banks.

4.2.5. External developments

Following a surplus position in 1991 and the first half of 1992, Lithuania's current account recorded a deficit in the order of US$ 150 mio (some 6% of GDP) from mid-1992 to mid-1993. This is considerably lower than the original Fund estimates of a deficit of about US$ 500 mio, mostly owing to a drop in interrepublican trade and, to some extent, to delays in the disbursements of external financial assistance.

After a fall of 38% of export volumes in 1992 (caused by the 62% decline in inter-republican trade), export volumes broadly stabilized in the first half of 1993, compared to the first half of 1992 (a 22% decline in interrepublican trade against a 18% increase in other trade). Import volumes, which had dropped by 57% in 1992, continued to decline in the first half of 1993, but at a considerably lower rate (16%, spurred by a 30% contraction in imports from former Soviet republics). Clearly, this demonstrates that Lithuania's trade reorientation continued as the country was exposed to world market prices.

By mid-1993, Lithuania's external debt stood at some 8% of GDP or US$ 250 mio.

4.3. Review of the performance criteria attached to the EC loan

The Memorandum of Understanding agreed between the Commission and Lithuania, after consultation of the Monetary Committee, provide for a regular evaluation of the progress towards stabilization and structural adjustment. The quantified performance criteria included in the Memorandum of Understanding are identical to those contained in the 11-month IMF stand-by arrangement and the structural adjustment criteria, included in the Memorandum of Understanding were designed to evaluate the progress made in the area of price liberalization, enterprise reform, including in particular privatization, banking sector reform, foreign exchange, foreign trade and foreign direct investment. The successful review of progress in economic stabilization and reform, including the observance of performance criteria, is a condition to release the second tranche of the loan.

The reviews of IMF conditionality concluded that all performance criteria were met. An EC mission to Lithuania conducted in January 1994 concluded that the structural adjustment criteria attached to the EC loan were also met : the Government's role in price determination had been further reduced; banking supervision had been strengthened; privatization and restitution had progressed; liberal foreign exchange and trade regimes were maintained. There was however less progress in other areas including the restructuring and privatization of the banking system; the revision and implementation of bankruptcy legislation, the revision of central and commercial banking laws and the conclusion of double taxation agreements with Member States. A Supplemental Memorandum of Understanding has been negotiated and is expected to be concluded shortly, according to which the disbursement of the second tranche would be linked to further progress in a number of these isues. In addition, it stipulates a series of conditions that should allow the proper absorption of the second tranche through the banking system, including the intensified absorption of technical assistance. It is expected that the Supplemental Memorandum will be signed in Spring 1994, which should be followed by the disbursement of the second tranche shortly afterwards.

4.4. Recent developments and prospects

There are signs that the output stabilized in the second half of 1993. Unemployment remains relatively low in light of the lower production levels. Following its decline during the first half of 1993, inflation picked up again in the second half of the year to monthly rates of 4.5%. This is partly due to the fact that the central bank expanded monetary supply more than foreseen in order to avoid an appreciation of the litas as a consequence of capital inflows. The current account appears to have deteriorated further in the second half of 1993

In September 1993, Lithuania purchased the remaining tranche (some US$ 18 mio) under the first IMF stand-by arrangement. Lithuania has concluded a second arrangement with the IMF covering the period up to end-1994 (a combination of stand-by and systemic transformation facility). This will give the country access to purchases from the Fund in the order of US$107 mio over a 17-month period. This arrangement supports the authorities' comprehensive programme that aims at building on the stabilization and structural adjustment programme achieved. The main programme goals are to raise real growth to sustainable levels while reducing inflation by end-1994 to single digits at an annual rate. The programme will attempt to achieve this by maintaining macroeconomic balance and building confidence in economic policymaking, improving the supply response of the economy through continuing structural reform, directing foreign financing to the most productive uses, and, through these policies, attracting foreign investment.

# VIII. ALGERIA

## 1. Introduction

On June 28 and 29, the European Council agreed in principle to provide medium-term macro-financial assistance to this country in support of an ambitious macro-economic reform programme in the context of political libersalisation. Accordingly, on the basis of a Commission proposal and after a favourable opinion by the European Parliament, the Council decided in September 1993 to grant an ECU 400 million loan to Algeria, to be disbursed in two tranches (Decision 91/510/EEC of 23 September 1991).

The loan agreement and the corresponding Memorandum of Understanding specifying the macro-economic conditions for disbursement of the two tranches, were signed in Algiers on 5 December 1991.

The disbursement of the first tranche (of ECU 250 million) was subject to two conditions:

- The conclusion of an agreement on a Stand-By arrangement with the IMF and a structural adjustment loan with the World Bank;
- The conclusion of an agreement between Algeria and its commercial bank creditors on improving the country's future debt servicing and repayment profile through new loans and/or new refinancing agreements.

Algeria reached an agreement with the IMF in May 1991 for a Stand-By facility of SDR 300 million (US$ 430 million) and with the World Bank in June 1991 on a US$ 350 million Enterprise and Financial Sector Adjustment Loan (EFSAL).

In October 1991, the Bank of Algeria also reached an agreement with a consortium of commercial banks, led by the Credit Lyonnais, for a syndicated loan of US$ 1,454 million. This loan allowed an effective re-profiling of commercial debt over a longer period. Burden-sharing with private creditors was an essential component in this loan agreement. Other agreements, including the US$ 147 million loan by the Japanese EXIM Bank (April 1991) and an Italian government guaranteed inter bank loan facility of US$ 7.2 billion (May 1991) also contributed to an effective refinancing of Algerian foreign debt.

In the circumstances, the Commission considered that the conditions for the disbursement of the first tranche were satisfied and the funds were released in January 1992.

In accordance with the Memorandum of Understanding, the release of the second tranche was subject to two sets of conditions :

- The respect of the quantitative macro-economic performance criteria agreed in the context of the IMF programme;
- A positive assessment by the Commission of the progress accomplished in structural reform programmes, including : convertibility of the dinar, price and import liberalization, adoption of legislative measures on a Commercial Code, bankruptcy procedures, the establishment of a stock exchange and further liberalization of foreign direct investment. These conditions were consistent with the economic adjustment programmes agreed between the Algerian authorities and the IMF and the World Bank.

The lack of compliance with the macro-economic performance criteria as well as insufficient progress on structural reform have, so far, prevented the release of the second tranche.

Progress with respect to those economic programmes is assessed hereafter.

## 2. Economic developments in 1992-1993

The Algerian adjustment and reform programme, which started in 1991, was designed to foster growth through the implementation of liberalization measures, while reducing inflation by pursuing tight monetary and fiscal policies and achieving a viable external situation. The objective for 1991 was an increase by 4.5% of real GDP in 1991 (against a decline of 1.5% in 1990). Annual inflation was targeted at 35% and the budget was expected to gradually reach a surplus of 4.8% of GDP, mainly through increased revenue from the hydrocarbon sector which accounts for two thirds of all government revenue. On the external side, the government's medium-term objective was to maintain a significant current account surplus so as to make possible a reduction in the stock of Algeria's heavy external debt. An increased inflow of foreign financial resources and a reduction in the external debt service were also key elements in this respect.

The targets of this IMF-supported programme were met until the end of 1991, but it went off-track in early 1992. Socio-political tensions led to a softening of the incomes, fiscal and monetary policies and to an increase of credits to the public enterprises sector. These factors fueled inflation which remained high throughout 1992 and is expected to accelerate in 1993.

The steady appreciation of the real exchange rate throughout 1992, together with the high level of debt service payments, have created a tight situation in the exchange market and delayed the necessary move towards convertibility of the national currency. Furthermore, from late 1992 onwards, a gradual fall in hydrocarbon world market prices had a serious negative impact on the balance of payments and the public finance situation, since over 90% of Algeria's foreign earnings come from export of oil and gas, which also constitute the main source of revenue for the budget.

### 2.1. Domestic output and demand

Real GDP growth was modest in 1992 (some 2.8%) and the introduction of restrictive foreign exchange allocation procedures, in late 1992, are likely to increase the shortages of imported parts and supplies to the manufacturing and construction sectors and have a serious negative impact on GDP growth in 1993 with adverse implications for the labour market.

Growth in agriculture reached 4.8% in 1992, mainly because of good weather conditions but deteriorating conditions in 1993 may lead to a less favourable performance. Value-added in the hydrocarbon industry was growing steadily in 1992, despite a slight decrease in output from 108 million barrels in 1991 to 106.5 million barrels in 1992. For 1993, uncertainties concerning world market prices could also influence developments in this sector.

### 2.2. The budget

Fiscal policies were relaxed substantially in 1992. Government current expenditures rose by 50% in nominal terms, largely because of strong rises in the wage bill (22% in real terms) and social transfers (50% in real terms). Revenue rose by 25% only owing to the appreciation of the effective exchange rate and the resulting lack of buoyancy of hydrocarbon receipts, which account for about two thirds of all fiscal revenues.

In view of the slow-down in the public enterprises reform programme and of the appreciation of the effective exchange rate, prospects for improvement of the budgetary situation are bleak. Moreover, the appreciation of the Dinar and the resulting lack of increase of budgetary revenue from hydrocarbon exports (two thirds of all revenue) are seriously aggravating the overall treasury balance, which turned from a surplus of 4.3% in 1991 to a deficit of 0.6% in 1992 and is projected to reach a deficit of around 9% of GDP in 1993.

2.3 Trade balance, exchange rate developments and external debt

Exports have decreased from US$ 12.6 billion in 1991 to US$ 11.6 billion in 1992. They are not expected to increase in 1993, mainly due to a stagnation in the hydrocarbon exports. Imports increased from US$ 7.8 billion in 1991 to US$ 8.2 billion in 1992 and are projected to reach US$ 8.4 billion in 1993. As a result, the trade balance surplus deteriorated from 11% of GDP in 1991 to 8% in 1992 and is projected at 6% of GDP in 1993. A slow reduction in interest payments abroad from US$ 2.4 billion in 1991 to an estimated US$ 2.2 billion in 1993 should somewhat limit the negative impact on the current account, which is expected to deteriorate from a US$ 2.6 billion surplus in 1991 to a US$ 1.1 billion deficit in 1993.

Since the mid-80s, the authorities pursued a policy of gradual depreciation of the Dinar (more than 70% between 1985 and 1992) to reduce the gap between the official and parallel market rate and slowly achieve current account convertibility. In 1992, the government changed this policy and stabilisation of the nominal exchange rate became the new objective. This resulted in a 22% increase in the real effective exchange rate. This appreciation is likely to continue in 1993.

The external debt stock has been reduced slightly from a peak of US$ 27.2 billion in 1991 to US$ 26.2 billion end 1992 and is expected to decline further in 1993 to US$ 25.7 billion. Total external debt service will fall slowly from a peak of US$ 9.6 billion in 1991 (76% of exports) to around 9 billion in 1993. However, in terms of exports, the burden of debt servicing will somewhat increase from 76% of exports in 1991 to an estimated 80% in 1993, whereafter it is expected to decline again.

The parallel market rate stood at approximately 6O Dinar per US dollar in June 1993, compared to an official rate of 22.5 Dinar per US dollar, which is clearly not a market clearing rate. The spread between official and parallel market rates has widened, increasing from 1:2 end 1991 to almost 1:2.7 at present.

2.4. Money and credit

Monetary policy remained accommodating during the first half of 1991 and became more stringent from July onwards only. However, given the dimensions of the increase in credit in the first half, overall results for 1991 still show an increase by 20.9% of the broad money stock, somewhat above the programme target of 18.8%. But the increase in credit was entirely allocated to households and enterprises (+21.1%) while credit to the government was squeezed (-2.1%).

Monetary policy further relaxed in 1992. Domestic credit increased by 26.1% of the broad money stock. Again, most of the increase went to households and enterprises (23.3%) but credit to the government was also allowed to grow slightly (2.8%) to finance part of the widening budget deficit. For 1993, credit growth is expected to remain around this level.

Real interest rates remained negative throughout 1991 and 1992, which constitutes a serious disincentive to savings. Inflation ran over 32% in 1992 while interest rates on savings' deposits remained at 8% and on 1-year treasury bonds at 10%.

## 3. Status of the reform process

Economic reform has taken place against a difficult political background. Following protests in October 1988, a new multi- party constitution was adopted in 1989. The Islamic FIS swept to victory in local and municipal elections in June 1990 and in the first round of national legislative elections in December 1991. The second round, scheduled for January 1992 was suspended and president Chadli resigned. He was replaced by a "Haut Conseil d'Etat", presided by M. Boudiaf. A period of violent confrontation with the FIS started, leading to the dissolution of the FIS and the assassination of Boudiaf in June 1992. He was succeeded by A. Kafi and a new government was formed by Prime Minister B. Abdesselam who pursued a policy of economic austerity and military confrontation with the FIS. Lack

of progress in solving the political and socio-economic problems resulted in the replacement of Abdesselam with a new Prime Minister, R. Malek, in August 1993.

The Abdesselam government produced a "Work Programme" in September 1992 which reiterated the commitment to economic reforms and a more liberal market-based economy. However, it also emphasized that the social and political situation required strong government intervention and austerity policies which could not be left to the market. Economic reforms would be continued once the internal political problems and the external debt crisis would be overcome, after a 3-5 years period.

After a series of substantial wage increases in the public sector, which had a negative impact on the budget and on inflation, a "Social Pact" was concluded in 1992 between the government and the labour unions, based on job security in return for a wage freeze and restrained price increases.

Economic reforms, particularly imports and currency liberalization introduced under president Chadli, have been slowed down. Emphasis has been put on economic austerity with priority utilisation of convertible currency for servicing of external debts, without rescheduling. Further depreciation of the dinar has been excluded.

Import controls have been put in place in October 1992, which are likely to slow down economic growth and deepen the recession because of shortages of imported inputs. Foreign currency is allocated to banks for transactions not exceeding US$ 100,000. Transactions exceeding this amount or "strategic" imports are decided on a case-by-case basis by an ad-hoc Inter-ministerial Committee. The new rationing system classifies imports in four categories:

a) "strategic" imports (goods related to hydrocarbon production, essential consumer goods like cereals, agricultural inputs, medicines, etc.) for which official foreign currency reserves are available and subject to a decision by an Inter-ministerial ad-hoc Committee;

b) imports to enhance production and investment activities for which foreign currency allocations are decided by the Inter-ministerial ad-hoc Committee if they exceed US$ 100,000, by commercial banks for amounts below this limit;

c) "authorized" imports for which no official foreign exchange cash or credit) is made available but which can be financed on private foreign exchange accounts;

d) "luxury" goods for which imports are "suspended" and for which neither official nor private foreign exchange can be used; barter deals are forbidden too.

In June 1993 the government proposed to partially liberalize the exchange rate with the introduction of a two-tier exchange rate mechanism: an official (fixed) rate for the exports of oil products, debt servicing and the imports of essential goods, and a (floating) free market rate for all other transactions (other exports, transfers by immigrants, transactions on residents' foreign currency accounts).

With regard to reforms in the financial and enterprise sector, the government presented an Economic and Financial Structural Adjustment programme that was supported by a World Bank loan (EFSAL). The programme aimed at improving the efficiency of the banking system (new prudential ratios, opening the domestic market to foreign banks) as well as a reform of the public enterprises sector. The government has granted or is about to grant financial autonomy to 363 public enterprises but their (partial) privatization and financial restructuration has slowed down since early 1992. For the 22 remaining non-autonomous public enterprises, audits and financial restructuring plans are in preparation.

A reform programme for the crucial housing sector has been introduced in 1993, focusing on increased private sector participation in the construction of dwellings, removal of rent caps, a reorganization of the housing credit system, replacing general interest rate subsidies by a targeted housing assistance programme, reform of public construction enterprises and public sector construction materials suppliers.

In the framework of the IVth Protocol on technical and financial cooperation between the Community and Algeria, the Commission has made available in July 1993 a 70 mECU grant as a contribution to this reform programme. This grant will finance a sectoral imports programme of construction materials to finish the construction of about 100,000 housing units. Counterpart funds from the import programme will be used to finance the construction and rehabilitation of housing units. This programme was developed in close collaboration with the World Bank, which has also instructed a housing sector loan with a construction material import programme (March 1993).

## 4. A review of macro-ecocomic performance and structural reform criteria

The Memorandum of Understanding between the Community and Algeria specified two sets of conditions for the release of the second tranche (150 mECU). The first set refered to the quantitative criteria in the Stand-By arrangement between Algeria and the IMF and ensured compatibility between this arrangement and the Community's Balance of Payments Support. The second set refered to a number of specific economic reform measures to be implemented by the government.

### 4.1. Performance criteria agreed with the IMF

On 3 June 1991, Algeria reached an agreement with the IMF on a 10-month Stand-By facility for an amount of SDR 300 million. The first tranche was immediately disbursed. This facility was accompanied by an external contingency mechanism of SDR 210 million under the Contingency and Compensatory Financing Facility (CCFF). The performance criteria and indicative targets in this programme included quantitative targets on changes in net domestic assets, treasury debt reduction, credit to public enterprises, external borrowing and international reserves.

The first review of performance criteria was concluded in November 1991, based on performance through September 1991, and led to the release of the second tranche. In fact, performance criteria were met until December 1991, taking into account the additional measures taken by the government at the end of fiscal year 1991. Total purchases amounted to 225 mSDR by the end of 1991.

From early 1992 onwards the programme got off-track. Monetary and budgetary performance criteria were not met. The second review, due in March 1992, was never completed and the final purchase was never made. No new programme has been agreed upon since.

### 4.2. Structural reform criteria

Five economic reform measures have been targeted in the Memorandum of Understanding concerning the Community loan: current account convertibility of the Dinar, liberalization of prices, liberalization of imports, legislative measures and protection of foreign direct investments.

Progress in price liberalisation has been encouraging, with a gradual move from fixed prices to controlled margins for most consumer goods and the total liberalisation of prices of farm products. By June 1993, the prices of only three basic foods remain subsidised. Prices of public utilities, transport and fuel still need to increase further to reflect economic costs.

Some progress has been made with respect to the legislative measures foreseen in the Memorandum of Understanding. The government has introduced an Investment Code and a Commercial Code which will substantially improve the legal environment for private and public enterprises and will also protect and liberalize foreign direct investments. Both these Codes are operational now. The regulatory environment for the establishment of foreign banks in Algeria has also been liberalised.

Major problems remain however with respect to the move towards current account convertibility of the Dinar and liberalisation of imports. In September 1992 the government backtracked on earlier exchange rate liberalisation policies by introducing a stringent foreign exchange rationing system combined with rigid import controls. This halted the process of gradual depreciation of the Dinar, started in 1985, and actually led to an appreciation of the real effective exchange rate, thereby reducing the competitiveness of the Algerian economy and creating internal price distortions. The announced introduction of a two-tier foreign exchange market in 1993 constitutes a positive step in the right direction but further progress appears necessary.

### 5. Assessment and prospects

The government has made some progress in the implementation of structural reform measures over the last two years. Prices of most goods have been liberalized in principle, although some forms of administrative control apparently remain. Legislative measures have also been taken to improve the legal environment for commercial enterprises and foreign investments.

Major problems remain with regard to the introduction of full current account convertibility of the Dinar and the liberalization of imports. The fixed exchange rate policy has led to a considerable appreciation of the Dinar and a growing budgetary deficit which keeps the economy under inflationary pressure. A more flexible two-tier exchange market system might by considered as a "second best" solution for a short transitory period towards full convertibility. The combination of a slow-down in the reform process and a restrictive imports policy have brought real economic growth to a virtual standstill while inflationary pressure has not been stabilized.

Because of the discontinuation of the macro-economic stabilisation programme agreed with the IMF and lack of progress in key economic reforms, conditions for the release of the second tranche (ECU 150 million) of the Community loan have not been met.

Faced with a particularly difficult political and economic environment Algeria has recently resumed discussions with the IMF on a new programme to be supported by a stand-by arrangement. Key policy measures associated with the new programme would include : the liberalization of the exchange rate regime and foreign trade; tight fiscal and monetary policy; public enterprise reform and domestic price liberalization. Owing in particular to the recent decrease in energy prices, it is expected that Algeria will have to meet considerable external financing needs in 1994/95 and that without substantial official assistance from abroad the new programme under discussion with the IMF could not be implemented.

The Community has recently indicated in this respect that the macro-financial cooperation with Algeria initiated by the first tranche of the 1991 balance of payments loan will be pursued, including if appropriate through new initiatives, on the basis of the conclusions of the discussions underway with the IMF.

# IX. ISRAEL

## 1. Introduction

On 22 July 1991, the European Council, taking into consideration the adverse economic consequences of the Gulf conflict, on the basis of a Commission proposal and after a favourable opinion by the European Parliament, decided to grant an ECU 160 million loan, accompagnied by a ECU 27.5 million interest rate subsidy, to the State of Israel and a ECU 60 million grant to the Palestinian population of the Occupied Territories, and authorized the Commission to negociate the terms and conditions with the beneficiairies (Decision 91/408/EEC of 22 July 1991)[4].

The loan agreement between the Community and Israel and the attached Memorandum of Understanding were signed on 16 December 1991. The terms and conditions set out in the Memorandum of Understanding were the following:

i) The loan will be disbursed in a single tranche following the modalities set out in the loan agreement;

ii) The interest subsidy will be disbursed in successive instalments in accordance with the provisions in the loan agreement;

iii) The funds are made available for the purpose of financing the essential imports needs of the population of Israel;

iv) The Israeli government will submit to the Commission, no later than one year following the disbursement of the aid, a report on the utilisation of the funds.

The loan, with a maximum duration of seven years, was released in January 1992. At the same time, the amount of the interest rate subsidy was put into an account at the Bank for International Settlements for payment to the Bank of Israel in succesive tranches on dates when interest payments are due. In accordance with paragraph 2(iv) of the Memorandum of Understanding, the Government of Israel informed the Commission on 26 October 1992 that the funds had been used entirely for the purchase of imported fuel.

In the Memorandum of Understanding, the Community took note of the Israeli government's firm intentions to ensure a sustainable external financial situation, contain the budget deficit, proceed with the liberalisation of the economy and ensure the appropriate conditions for a steady development of foreign direct investment in Israel.

Economic policies and developments in the Israeli economy are assessed hereafter.

## 2. Recent economic developments

Since 1989, the Israeli economy was subjected to two major economic shocks. First, the Gulf War caused a slump in the export and tourism industries and thereby increased the trade balance deficit. The adverse consequence of the Gulf War on the external balance led to the approval of the ECU 160 million Community loan as well as the approval of an SDR 266 million Compensatory and Contingency Financing Facility by the IMF in March 1992.

Second, a massive wave of new immigrants, mainly from the Former Soviet Union, increased the population by around 10%. This required substantial absorption efforts both in the housing sector and in the labour market. The authorities' strategy has been to

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[4] The utilisation of the ECU 60 million grant to the Palestinian population of the Occupied Territories has been discussed in a separate report.

provide the immigrants with subsistance grants, housing and education but to abstain from direct intervention in the labour market, which could be counterproductive in the long run. Emphasis was put on improving the business environment, which would lay the basis for a gradual absorption of the immigrants into the labour market.

2.1. Domestic output, prices and employment

The rate of growth of real GDP gradually increased over the period 1990-1992, from 5.4% in 1990, to 5.9% in 1991 and 6.5% in 1992. The inflow of immigrants contributed substantially to this demand-driven growth performance. Overall private consumption demand increased by 12.4% in 1991 and spending on residential housing increased by 76% in the same year. From 1992 onwards, a decrease in the number of immigrant arrivals, from a monthly average of over 20.000 in 1990-91 to around 7.000 in 1992, and the resulting build-up of a stock of unsold housing units (20.000 end 1992), slowed down construction activity (+4.5%). But strong export performance (+12.7%), after the Gulf War slump, took over as the main driving force behind economic growth. In March 1993, the closure of the borders with the Occupied Territories led to a slow-down in economic activity. But this trend is likely to be reversed after the signature of the peace agreement with the Palestinians.

In spite of this strong economic performance and a 4% annual average increase in employment over the past three years, the rapid growth in the labour force resulted in an overall increase in the unemployment rate from 8.9% in 1989 to 11.2% in 1992. New jobs were mainly concentrated in the construction industry and nearly two thirds of these jobs were taken up by immigrants. As a result, the unemployment rate among immigrants declined from 38 % in 1991 to 28% by end 1992. In the first half of 1993, the unemployment rate continued to drop against the background of the closure of the borders of the Occupied Territories which led to a partial substitution of Palestinian workers with Israelis.

The substantial increase in the labour force resulted in a nominal wage increase below inflation levels. In 1991, real wages decreased by 3.2% while labour productivity increased by 2.5%. In 1992, this tendency was somewhat reversed with a real wage increase by 0.9%, merely reflecting the fact that certain wage contracts had been negotiated on the basis of a higher expected rate of inflation, and a reduction in productivity by 1.5%.

Consumer price inflation varied between 18 and 20% p.a. over the period 1989-91. In 1992, it slowed down to 9.4%, the lowest level for the past decade. A reduction in the budget deficit, a more flexible labour market with lower real wages and a fall in housing prices, have contributed to this achievement. In the first half of 1993, inflation accelerated to around 12% in annual terms, mostly due to a rebound in housing prices after the fall in the second half of 1992. But a slow-down occured again in mid-1993.

Fiscal policy

Whereas overall government revenue and expenditures amounted to around 70% of GNP in 1985, these ratios were reduced to 53.7% for revenues and 58% for expenditures by 1992. Taxation policy shifted away from direct toward indirect taxes (VAT rate increase from 16 to 18%). In 1992, a reduction in top marginal income tax rates (from 60 to 48%, subsequently increased to 50% in August 1993)) and corporate taxe rates (from 61 to 41%) was introduced.

On the expenditure side, defense spending was reduced from 12.75% of GNP in 1985 to 8.75% in 1992. Defense imports, mainly financed by foreign grants, also fell from 6 to 2.75% of GNP over the same period. On the other hand, social services spending, including transfers to immigrants, increased from 10 to 15% of GNP between 1985 and 1992.

Since 1990, budgetary policy has been fundamentally affected by the objective of absorbing the wave of immigration, through subsistence grants, providing for housing needs and a variety of employment and investment incentives.

The initial cash grant for arriving immigrants, completed with health insurance and unemployment benefits, altogether amounted to an average US$ 10.000 per year per immigrant. Wage subsidies for immigrants up to one third of the salary and up to two years were introduced in July 1991. Some 30.000 employees have so far participated in this programme.

From the acceleration of immigration in 1990 up to mid-1992, the authorities' housing strategy was based on the belief that the housing market would react too slowly and needed additional incentives. Public spending on immigrant housing was channeled through direct construction, guaranteed sales of houses build by private constructors and mortgage subsidies. In order to avoid a worsening budget deficit, these housing sector incentives have been financed by a significant reduction in the proportion of public spending on defense, a temporary 5% income tax surcharge (cancelled in August 1993) and an increase in the VAT rate. In the second half of 1992, following a slow-down in immigration, the newly elected government scaled down spending on housing by the cancelation of 12.000 planned housing units and an elimination of the housing sales guarantee for private contractors.

Public infrastructure expenditure has stabilised at a very low 2% of GNP in recent years, thereby contributing to road congestion which presently constitutes a serious bottleneck to economic growth. A 30% increase in infrastructure investments is planned under the 1993 budget.

In spite of the increased social expenditure due to immigrant arrivals, the overall budget deficit declined from 4.25% of GNP in 1991 to 2.75% in 1992.

Outstanding public debt has declined from 154 to 129% of GNP between 1987 and 1992 but remains very high. Interest payments represented 8% of GNP and 14% of government expenditure in 1992.

### 2.3. Trade balance and external debt

In the wake of the Gulf War, exports stagnated around US$ 12.2 billion in 1990 and 1991. Imports, on the other hand, continued to grow, fueled by demand stemming from the inflow of immigrants. As a result, the trade balance deteriorated from a US$ 2.8 billion deficit in 1990 to a US$ 4.8 billion deficit in 1991. In 1992, the trade balance deteriorated further to a US$ 5.4 billion deficit. It is expected to stay around that level for 1993.

The services balance improved substantially following a post-war rebound in tourism, from a US$ 2.5 billion deficit in 1991 to a US$ 1.8 billion deficit in 1992. By contrast, intergovernmental transfers fell back to pre-war levels around US$ 3 billion, after a US$ 3.8 billion peak in 1991.

Owing to a significant increase in both private and public unrequited transfers, from US$ 5.3 billion in 1990 to US$ 6.7 billion in 1991 and 6.9 billion in 1992, the current account remained roughly balanced.

Since the Gulf War, direct investments and other long-term capital have registered a net outflow. The overall balance remained marginally positive due to short-term capital movements. Only in 1992 did a US$ 1.2 billion (1.8% of GDP) deficit occur for the first time since 1988, provoked mainly by an outflow of short-term capital (US$ 1.7 billion).

The credit guarantees, obtained from the US government at the end of 1992 (US$ 10 billion over 5 years or US$ 2 billion per year), will enable the authorities to promote productive investments in the domestic economy while building up reserves.

Total external debt stood at US$ 23.5 billion at end 1992. The gross external debt service ratio improved substantially, from 36.8% of total exports in 1990 to 29.2% in 1992. Net external debt service also fell from 29.1 to 22.3% over the same period.

2.4. Exchange rate, money and credit

Until 1991, Israel maintained a relatively fixed exchange rate pegged to a currency basket and floating within a band around a midpoint rate, with periodic realignments to compensate for the loss of competitiveness stemming from high domestic inflation. In December 1991, a more flexible "diagonal band" exchange rate system was introduced, whereby the midpoint was devalued daily vis à vis a currency basket and at a pre-announced rate, while the exchange rate floated freely within a band around this moving midpoint. This avoided speculative attacks on the national currency, the Shekel, in anticipation of devaluations while competitiveness was assured by setting a pre-announced devaluation rate consistent with the expected domestic inflation rate.

For 1992, the crawl pace of depreciation was fixed at 9%, consistent with an expected inflation rate of 14%. Inflation turned out to be lower than expected (9.4%), which resulted in a real depreciation of the Shekel by 6%. For 1993, the crawl pace was set at 8%, against an expected inflation rate not exceeding 10%. In July 1993, the expected annual inflation rate was reviewed downwards to 8% and the crawl pace was slowed down to 6%.

In the early parts of 1991, interest rates were kept low to stimulate investment. Following an unexpected 3% devaluation in March 1991, which was perceived by the market as a change in exchange rate policy, interest rates had to increase to dispel this view. As capital inflows continued during 1992, domestic interest rate lowered again, against a background of decelerating inflation and economic growth. Moreover, pressure by the Bank of Israel on commercial banks to reduce the borrowing-lending spread, as well as increased competition on financial markets, further reduced lending interest rates. By mid-1993, a temporary increase in interest rates occured against the background of a slight rebound in inflation. Real interest rates remained positive throughout the period 1991-93.

Until the mid-80s, the credit market used to be dominated by the government need to finance persistent large budget deficits. The reduction of this deficit, together with a deregulation of financial markets, increased the share and stimulated growth of unregulated credit to the private sector. Short-term bank credit increased by roughly 27% in both 1991 and 1992.

### 3. Status of the reform process

The Israeli authorities have stressed the crucial role of structural reforms, aimed at improving competitiveness and efficiency, in their strategy to promote investments and accelerate economic growth.

At the start of the reform process, the state owned around 85 business companies, with an estimated net worth of US$ 17 billion representing over 25% of GDP, strategically involved in the banking, communications, construction, energy, transport and defense industries. In 1991 and 1992, the government planned to sell 20 companies but effectively sold only 7 totaling only US$ 250 million in government revenue. The need for structural reform prior to privatisation, legal problems and vested interests, all provided obstacles to the success of the privatisation programme. For 1993, a revenue of US$ 400 million is budgeted under the privatisation programme, which is too small compared to the net worth of state enterprises to be considered a substantial reform of the economy. However, in August 1993, the Treasury announced an acceleration of the privatisation programme, with emphasis on the banking sector.

Public sector wages have remained virtually constant in real terms over the past three years, while private sector wages have declined by 7% in real terms over the same period. A public sector wage negociation was conducted in 1992 which aimed at reflecting productivity differences in the wage structure and breaking the link between public enterprises and public service wages. Although the private sector labour market has been able to absorb a large part of immigrant labour, increased flexibility could enhance its absorption capacity. Reforms in the minimum wage law and in shift-work regulations and

authorisation of private employment bureaus are required but no substantive reforms have been proposed yet.

The authorities concluded free trade agreements with the United States, the European Community (currently under review) and the EFTA countries, and have implemented a programme to liberalise trade with "third" countries. All quantitative import restriction have been replaced with an equivalent tariff. Tariffs are scheduled to be reduced to a maximum of 8-12% over 5-7 years. Taxes on imported tourist services and on travel abroad have been abolished. A 2% import duty surcharge and a 2% export subsidy, which constituted trade restrictions under GATT rules, have been abandoned in July 1993. Consequently, the Israeli economy has, for the first time in its history, a single exchange rate for all transactions.

Exchange restrictions have been liberalised with the objective of establishing full current account convertibility. Israel accepted the obligations under Article VIII of the IMF Articles of Agreement on 21 September 1993.

### 4. Assessment

Since the introduction of the structural reform programme in the mid-80s, the Israeli economy has been substantially liberalised, notably the financial and foreign trade sectors. While the results of the privatisation programme have, so far, remained below expectations, the state's share in the economy has been reduced. The decrease in the government budget deficit, together with a monetary and exchange rate policy aimed at nominal stabilisation, have considerably lowered inflationary pressure.

On top of these structural changes, the authorities have managed succesfully to cope with the economic consequences of the Gulf War and the massive inflow of immigrants. Prudent budgetary policies, aimed at satisfying immigrants' subsistence needs, combined with temporary tax measures, have prevented a worsening budget deficit.

The rather slow privatisation process, combined with persistent high public debt-to-GNP ratios, continue to weigh on the public deficit and leave little room for a highly desirable increase in public investment in basic infrastructure which could, in turn, be a driving force behind continued economic growth in the next few years.

The Community balance of payments loan has contributed to a stabilisation of Israel's external financial situation in the wake of the Gulf War and permitted the continuation of a prudent monetary policy which has finally resulted, in September 1993, in the achievement of full current account convertibility and the acceptance of the obligations under Article VIII of the IMF Articles of Agreement by the Israeli authorities.