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REPORT ON THE IMPLEMENTATION OF MEDIUM-TERM FINANCIAL ASSISTANCE TO THE BALANCES OF PAYMENTS OF CENTRAL AND EASTERN EUROPEAN COUNTRIES

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I. OVERVIEW

1. Background and objectives of the Community and G-24 balance of payments assistance for Central and Eastern European Countries

Following the political changes in the Central and Eastern European countries (CEEC), the economic summit held in Paris in July 1989 gave impetus to concerted action in favour of these countries and the EC Commission was entrusted with the task of coordination. This initiative was supported by twenty-four industrial countries and all the relevant financial institutions.

During late 1989 and 1990 it became increasingly clear to the Commission, the Twenty-Four and the International Financial Community that the needs of the Central and Eastern European Countries exceeded the level of assistance that was already being provided for economic restructuring and other specific purposes. For all these countries, albeit to different degrees, the external payments situation was beginning to constitute a serious constraint on the process of transformation. Additional external financing would be needed to support investment, to make import of capital equipment for modernisation possible and to provide for a minimum level of domestic consumption. Substantial support would also be required to raise the level of international reserves of those countries that were committed to unifying exchange markets and make their currencies convertible for current account transactions at an early stage of the reform process.

In addition to the needs directly linked to the transition efforts, evidence mounted during 1990 that the external environment in which the CEEC were expected to implement their reform programmes was undergoing a dramatic alteration with the demise of the intra-CMEA trade and settlements system and the consequences of the Gulf crisis.

Against this background, analyses produced by the Commission services for the G-24 during the second half of 1990 pointed to the prospects of exceptionally large financing needs in 1991. Even allowing for a substantial degree of adjustment and full recourse to the multilateral financial institutions it was clear that there was a risk of significant residual financing gaps, which, if left uncovered, would need to be closed either through the accumulation of arrears, or through intensified adjustment and additional import compression. A further option might have been to delay those reforms that would be likely to have an adverse impact on the balance of payments in the short run, notably trade liberalisation and currency convertibility. Any of these solutions were regarded as undesirable since they would compromise the success of the reform effort and delay the integration of these economies into the world economy.

From the outset, the Community and the G-24 governments adopted the position that the multilateral financial institutions, and especially the IMF and the World Bank, should play the central role in providing financial assistance for the countries of Central and Eastern Europe, in the context of comprehensive adjustment and reform programmes. However, since these institutions could not cover alone the entire financing requirements, and since there were indications that commercial banks and other private investors were reluctant to provide substantial amounts of financing at an early stage of the transformation process, broad participation by official creditors had to be ensured in order to fill the remaining financing gap.

As a result, the Commission, as coordinator of the Twenty-Four, has presented in close cooperation with the IMF four proposals for G-24 financing packages in favour of Hungary, Czechoslovakia, Bulgaria and Romania, designed to complement the resources provided by the multilateral financial institutions. The participation of the European Community in the different packages has been based on the principle that the Community would contribute approximately half of the required additional financing with the expectation that the other G-24 member countries would, together, commit an equivalent amount.

2. General features of the initiative

The medium-term financial assistance initiative has been implemented by the Community and the G-24 on a case-by-case basis subject to some commonly agreed guidelines.

- Complementarity: the assistance is additional to resources from the IMF and other multilateral institutions that are being mobilised to strengthen the reserve position and improve the balance of payments situation of the CEEC.

- Exceptional character: the assistance is expected to be transitional, with the aim that it can be progressively discontinued.

- The basic prerequisite for this complementary assistance is considered to be the existence of a significant residual financing gap despite the implementation of a strong economic programme of stabilisation and comprehensive reforms supported by the IMF and other multilateral financial institutions.

- The coordinated assistance includes grants, official guarantees or medium-term loans provided these are untied. Untied parallel financing of World Bank structural adjustment loans is also deemed to qualify for inclusion to this initiative. The interest rate of the loans normally reflects the cost of borrowing on the capital markets of the contributing countries.

- When the loans are to be disbursed in more than one tranche, macroeconomic performance criteria are attached to the loans based on the conditionality agreed with the IMF. Structural adjustment criteria may also be included with a view to helping safeguard the momentum of the economic reform process over the medium term.

3. Implementation of the initiative

The financial assistance initiative has for 1991 resulted in support packages for Czechoslovakia, Hungary, Bulgaria and Romania. Overall, these four countries requested exceptional financial assistance from the G-24 totalling US$ 3.3 billion (ecu 2.44 billion). Following the European Parliament's favourable opinion on all four relating Commission proposals, the Council approved the contributions by the European Community for Czechoslovakia (Decision 9/106/EEC of 25 February 1991), Hungary (Decision 91/310/EEC of 24 June 1991), Bulgaria (Decision 91/311/EEC of 24 June 1991) and Romania (Decision 91/384/EEC of 22 July 1991) in the form of medium-term loans, in the amounts of up to ecu 375 million, ecu 180 million, ecu 290 million and ecu 375 million, a total of ecu 1.22 billion respectively, representing roughly 50 percent of the total exceptional financial assistance requested[1]. In each case, the Community loans were made available in two instalments. The disbursement of the first instalment was conditional upon the conclusion of an arrangement with the Fund[2]; the disbursement of the second instalment was subject to the fulfilment of conditions set out in a Memorandum of Understanding agreed by the EC Commission and the authorities of each country after consultation of the Monetary Committee. These conditions included quantified macro-economic performance criteria identical to those in the arrangements with the IMF, and structural adjustment criteria designed to evaluate progress with respect to the implementation of structural policies.

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 from different initial conditions, all embarked in 1991 upon comprehensive programmes of transformation from highly centralized planned systems to market oriented economies, while stabilizing the financial situation. The attempt to reform and adapt the economic structure 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 (Table 1). 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 interbank market determine the exchange rate.

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. These difficulties were aggravated in the case of Bulgaria and Romania by a shortfall in pledges from non-Community G-24 countries and delays in the disbursement of commitments. In the circumstances, the decline in output turned out to be larger than expected and inflationary pressures persisted in most economies (Table 2).

However, the countries benefitting from assistance from the Community and the G-24 determinedly implemented the programme measures, including price and trade liberalization, cautious financial and income policies,

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1) In 1990, the Council had already granted a medium-term balance of payments loan to Hungary in the amount of ecu 870 million (Decision 90/83/EEC of 22 February 1990), without contributions from G-24 members.

2) In the case of Bulgaria, owing to the critical external debt situation of the country, the disbursement of the first instalment was also conditional upon the conclusion of a rescheduling agreement on official debt with Bulgaria's Paris Club creditors, the conclusion of a deferral of the commercial debt servicing payments with Bulgaria's commercial bank creditors, and progress towards concluding a long-term rescheduling agreement for this debt.

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 liberalizing 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 have achieved impressive results, there has been significant differences in performance among them, some of which originating from the considerable 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.

In Hungary, which had already made considerable strides in the reform and opening-up of its economy before the political liberalization of 1989-1990, the Community and G-24 assistance (which followed the decision on a previous Community loan in 1990) was primarily designed to help maintain external creditworthiness. The pledging of the 1991 package was completed without difficulties.

The achievements of the Hungarian economy in 1991 have been impressive. External borrowing from private sources reached some US$ 1.5 billion, thereby illustrating the return of confidence by financial markets. Furthermore, the country consolidated its positive external performance by running a surplus in convertible currency trade, which resulted from a successful shift of trade towards the West. Consequently, no additional exceptional financing is required for 1992.

For Czechoslovakia, the early assurances for a complementary financial support package permitted the government to embark in January 1991 on an ambitious reform programme, based on a rapid liberalization of prices and of foreign trade. The foreign financial assistance was primarily to be used to strengthen the reserve position of the country, and allowed the government to introduce current account convertibility for the crown and to peg the currency to a basket of five foreign currencies.

The combination of substantial external support with successful domestic and monetary policies resulted in a considerable strengthening of the foreign currency holdings of Czechoslvakia, implying that for 1992 no additional exceptional financing will be required.

The assistance effort has however been more complicated in the case of Bulgaria and Romania. For Bulgaria, total pledges for assistance to fill a financing gap of US$ 800 million fell short by some US$ 200 million. In addition, G-24 countries who participated in the initiative faced difficulties in concluding their bilateral agreements with the Bulgarian authorities. As a result, only minor amounts have been disbursed outside the amounts committed by the Community.

It is nevertheless clear that also in the case of Bulgaria the commitments from the international community were instrumental in allowing the country to introduce partial convertibility of its currency as part of a comprehensive reform programme. In addition the international support effort enabled the country to initiate the discussions on an agreement with its bank creditors. However, owing to the fragile external position of the country, a continued financial backing by the international community will also be needed in 1992.

The case of Romania is a particular one. Because of domestic political developments, the country was faced with the problem of gaining international political credibility. Nevertheless, the authorities remained committed to far-reaching economic reforms which required substantial external support. As in the case of Bulgaria, pledges to fill the US$ 1 billion gap as identified by the IMF fell short by some US$ 250 million, which resulted in some delays in the unification of the exchange rate.

The country which continues to be deprived from sufficient private financing will need additional financial assistance in 1992 in support of its reforms.

4. Conclusions

The implementation of the medium-term financial assistance initiative in 1991 suggests that the Community and G-24 balance of payments assistance has been instrumental in improving the mix between adjustment and financing in the CEEC and in maintaining the momentum of economic reforms. Contraction of domestic activity and, hence, employment in these countries would have been significantly larger in the absence of this initiative. In this regard, it is important to underline that the coordinated effort has permitted to mobilize more assistance than would have been likely to be forthcoming in a purely bilateral context.

Overall, and this is clearly recognized throughout the region, there is no doubt that the Community and the G-24 have played a major role in supporting the economic reform process and thereby in strengthening the democratic forces in Central and Eastern Europe.

For Hungary and Czechoslovakia, the initiative has proven to be fully successful as these countries do not require in 1992 additional funding from the Community and the G-24. Nevertheless, the Community and G-24 have to respond this year to further requests from Bulgaria, Romania and possibily other CEEC (Albania, the Baltics etc.) to sustain their stabilisation and reform efforts.

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The present report, submitted in accordance with Council decisions 90/83/EEC, 91/106/EEC, 91/310/EEC, 91/311/EEC and 91/384/EEC, regarding medium-term financial assistance from the Community to Hungary, the Czech and Slovak Federal Republic, Bulgaria and Romania, assesses the evolution of the economic situation of each country in 1991, the progress of economic reforms with particular reference to the implementation of the conditions attached to the loans, and the prospects for 1992.

TABLE 1 : STATUS OF ECONOMIC REFORM

	HUNGARY	CZECHOSLOVAKIA
Privatization	Government committed to reduce state owned property to less than 50% of total assets in the competitive sector of economy by 1993.	Small enterprise privatization to be completed in 1992. Large : voucher system initiated. First round to be completed in Summer
Liberalization of prices	Around 90% of total consumer prices were liberalized at end-1991	Total turnover based on free prices estimated at 94%
Exchange rate regime	Exchange rates unified and current account convertibility (at enterprise and trade organizations level) de facto introduced. Further enhancements expected in 1992. At present forint is pegged to a simplified currency basket based on equal shares of ecus and dollars	Unification of exchange rates and introduction of current account convertibility end 1991. Pegging of crown to basket of 5 major currencies
Monetary Policy	Independent central bank; main policy objectives include keeping inflation under control and achieving a balance of payments equilibrium. Credit policy through interest rate	Independent central bank; tight credit policy through credit ceilings and interest rate policy to prevent inflationary spiral
Trade regime	Some 90% of imports liberalized with the exception of a restricted negative list (sensitive and strategic commodities). Average custom tariff level lowered from 16 to 13%	Imports liberalized; temporary import surcharge on consumer goods reduced from 20% to 10% in January 1992
Foreign investment	No limits on equity participation in enterprises by non-residents. Free repatriation of profits and proceeds of liquidation of investment by non-residents.	No limits on equity participation in enterprises by non-residents. Free repatriation of profits and proceeds of liquidation of investment by non-residents.

	BULGARIA	ROMANIA
Privatization	Small privatization to be initiated shortly. Large conglomerates to be dismantled and converted in joint stock companies. Privatization law passed. Implementation expected to start in 1992	Small privatization through breaking up of viable assets of large firms and auctioning. Large privatization: pilot project initiated in 92
Liberalization of prices	Close to 90% of prices were freed in 1991	Broad liberalization of prices. List of 15 products still controlled
Exchange rate regime	Unification of exchange rates; free floating of exchange rate through interbank market. No restrictions on most current account transactions.	Unification of exchange rates in November 1991. Current account convertibility with managed float.
Monetary policy	Tight monetary policy by independent Central Bank to counter inflationary pressures; positive real interest rates	Strict control of monetary policy by independent central bank, but undesired money creation through interenterprise arrears
Trade regime	Imports liberalized. Export liberalization through elimination of taxes and reduction of list of restrictions (licenses and export bans)	No quantitative import restrictions. Export quotas for limited list of products
Foreign investment	Liberal foreign investment law allowing direct investment. Free repatriation of profits and proceeds of liquidation of investment by non-residents.	No limits on equity participation in enterprises by non-residents. Free repatriation of profits and proceeds of liquidation of investment by non-residents.

Table 2 : Central and Eastern European countries :
Selected Economic Indicators

	1989 Actual	1990 Actual	1991 Programme	1991 Latest estimates
GDP at constant prices	(Percent changes)			
Bulgaria	0	-12	-11	-23
Czech and Slovak Republic	...	0	-5	-16
Hungary	0	-4	-4	-10
Romania	-6	-7	0	-13
Consumer/retail prices (end year)				
Bulgaria	10	64	234	339
Czech and Slovak Republic	2	18	30	54
Hungary	19	33	31	32
Romania	...	...	104	223
Fiscal balance - Cash	(Percent of GDP)			
Bulgaria	-1.4	-9.2	0.1	-3.7
Czech and Slovak Republic	-2.4	-0.1	0.8	-2.0
Hungary	-0.8	-0.1	-1.5	-4.1
Romania	8.4	0.1	-1.5	-2.6
Broad Money	(Percent change)			
Bulgaria	11	12	24	25
Czech and Slovak Republic	4	1	6	27
Hungary	14	29	23	29
Romania	6	17	15	94
Current account (convertible)	(in billions of US dollars)			
Bulgaria	-1.3	-1.2	-2.9	-0.9
Czech and Slovak Republic	0.4	-1.1	-2.5	0.2
Hungary	-1.4	0.1	-1.2	0.3
Romania	2.9	-1.7	-1.7	-1.4
Official Foreign Exchange Reserves (level)				
Bulgaria	1.0	0.1	0.5	0.4
Czech and Slovak Republic	1.1	0.5	1.7	1.4
Hungary	1.7	1.1	1.9	4.0
Romania	1.9	0.5	1.0	0.2

Sources : National authorities

II. HUNGARY

1. Introduction

In the autumn of 1989 Hungary reached a critical turn in its recent history. Although for several years the country had been gradually implementing market-oriented reforms with the support of the IMF and the World Bank, in 1989 domestic and external economic performance started to deteriorate sharply, a large current account deficit appeared, which further strained the already precarious external financial position of the country.

At the Paris Summit in July 1989, the major industrial countries decided to implement a special initiative, to be coordinated by the EC Commission, to assist Hungary and Poland. The Hungarian authorities subsequently asked the European Community to provide supplementary medium-term financial assistance aimed at helping the country to meet its growing debt servicing burden, strengthen its reserve position, introduce current account convertibility, and support the overall balance of payments. As a result of this request and on a proposal by the Commission, the Council agreed in February 1990 (Decision 90/83/EEC on 22.2.1990) to grant Hungary a medium-term balance of payments loan of ECU 870 million.

The loan was to be disbursed in three tranches, the first tranche of ecu 350 million being conditional upon the conclusion of a stand-by agreement between Hungary and the IMF. The amounts and the timing of the following tranches were to be decided later. Following the adoption of the IMF stand-by arrangement in March 1990 and the subsequent signature of a Memorandum of Understanding between the EC Commission and the Hungarian authorities, which described the terms and conditions attached to the Community loan, the first tranche of the loan (ECU 350 million) was disbursed in early April 1990.

A review of progress in economic stabilization and reform, as well as the monitoring of a number of performance criteria agreed with the Hungarian authorities and laid down in the Memorandum, was carried out at the end of 1990. This led to a Council decision in February 1991 for the disbursement of a second tranche of the loan (ECU 260 million).

In early 1991 Hungary requested and obtained further assistance from the IMF in the form of an Extended Financing Facility (EFF) and access, under the "oil window", to the Fund's Compensatory and Contingency Financing Facility.

However, the Fund's assistance was not expected to be sufficient to cover all the exceptional financing needs for 1991. Accordingly, Hungary requested complementary financial assistance from the Community and the Group of Twenty-Four. The need for such supplementary assistance was assessed by the Commission services in close cooperation with the IMF staff and was estimated at some US$ 500 million.

In June 1991, the Council of Ministers approved a further Community financial assistance to Hungary of ecu 180 million (approximately 50% of the total uncovered requirements of the country for 1991). (Decision 91/310/EEC on 24.6.1991). The first tranche (ECU 100 million) of this new loan was disbursed in early August on the basis of a second Memorandum of Understanding agreed between the Commission and the Hungarian authorities in July 1991. The Commission also coordinated the contributions of the non-Community G-24 members.

In late 1991 the Hungarian authorities requested the Commission to consider the disbursement of the remaining tranches of the EC loans to Hungary. Following a review of Hungary's economic situation and fulfilment of performance criteria the second tranche (ECU 80 million) of the second loan is being disbursed. Owing to a better than expected performance of the country's balance of payments, it was agreed with the Hungarian authorities that the release of the third tranche of the 1990 loan would be considered at a later stage, possibly in 1993.

The loans have been particularly successful in achieving their objectives to support Hungary at a difficult financial juncture to undertake fundamental reforms towards establishing an open market economy. In 1991, financial market confidence has been restored, the external position of the country has been consolidated and the reform process has advanced substantially.

2. General economic developments in 1991

The Hungarian economy in 1991 was faced with a number of shocks, including the collapse of the Soviet economy, a severe depression affecting Hungary's former CMEA partners, the transition from rouble to dollar settlements in CMEA trade, the general scarcity of convertible currency in the region as well as unstable international energy prices.

Despite these extremely difficult circumstances, the Hungarian economy was able to continue to adjust in 1991 as well as to proceed with economic and administrative reform. In some areas results were more favourable than originally forecasted, especially with respect to the country's external situation.

2.1 Output and demand

GDP is estimated to have declined by 10.2% in 1991, about 6 percentage points more than expected. This figure, however, does not take full account of the dynamic development of the small private sector, which is estimated to be growing by 20 to 40% annually. Output in the industrial sector declined by 19.1% in 1991. The collapse in CMEA trade and the contraction in domestic consumption and investment were the main factors behind this worse-than-expected economic performance. Those primarily affected were large, state-run enterprises, which were more dependent on exports to the Soviet Union.

Production in the agricultural sector fell by 3% in 1991. This was largely due to the reorganization of production, operations and ownership structure which is currently under way.

Private consumption continued to contract in 1991 (-9.5%) as a direct consequence of the erosion of real incomes (-9.8%). Gross fixed investment fell by 5.5% in 1991 over the previous year (at constant prices). Despite the government's determination to keep inflation under control, the consumer price index rose by 35% in 1991 (29% in 1990). The main reasons for faster inflation were a new round of subsidy reductions introduced in 1991, energy price rises and a higer-than-expected budget deficit.

Unemployment grew rapidly in 1991, the number of unemployed reaching 406,000 or 8.5% of the labour force at year-end (80,000 or 1.7% at the end of 1990). The rising unemployment was a direct consequence of the structural changes taking place in the economy, particularly in the industrial sector. On the positive side, it should be noted that new employment opportunities have been created in those dynamic sectors where private initiative is more prevalent, such as services, construction and small-scale industry.

2.2 Budget

The budget deficit has expanded rapidly and was estimated at more than 4% of GDP for 1991, overshooting the initial target by one percentage point of GDP, mainly as a result of higher than expected falls in revenue. The collapse of the CMEA market and the decline in domestic demand led to lower-than-expected revenues from import levies and duties, VAT and personal income tax. Spending, on the other hand, was kept within the budgetary limits. Considerable savings were achieved through the reduction of government subsidies for consumer goods, investment and housing.

2.3 Trade balance, current account, international reserves and external borrowing

During 1990 and 1991 Hungary achieved a significant reorientation of its foreign trade from CMEA (and the USSR in particular) to Western markets. This reflected the government's policy of encouraging enterprises to restrict their trade relations with former CMEA partners, and the ability of Hungarian exporters to penetrate EC markets, in particular. At present some 70% of total Hungarian exports go to industrialized countries, while exports to former CMEA countries represent a mere 19% of the total.

As a result of this trend, in 1991 Hungary was able to consolidate its positive external performance despite the fact that the collapse of East European markets and the shift to hard currency accounting caused an estimated terms-of-trade loss of around US$2 bn. In 1991, the country's trade balance (in convertible currencies) showed a surplus of US$ 189 million (compared with a surplus of US$ 248 million in 1990) and the current account (in convertible currencies) a surplus of US$ 267 million, reflecting a levelling off of interest payments on the external debt and a substantial surplus on the tourism account. The current account surplus in convertible currencies in 1991 was considerably higher than the US$ 128 million surplus recorded in 1990 and the US$ 1.2 bn deficit originally forecast for 1991.

It is worth noting that the non-convertible balance of payments also recorded a surplus, though declining, both in the trade balance (US$ 175 million) and in the current account (US$ 144 million). Transactions in roubles were phased out in the second half of 1991.

International reserves in foreign currencies expanded from US$ 1.1 bn in 1990 to 4 bn at end-1991, equivalent to 4 months' exports. As of end-1991, gross external debt stood at around US$ 22.7 bn, subject to fluctuations arising from movements in the dollar. The maturity structure of the external debt continued to improve during 1991: the share of medium- and long-term debt in the total increased to 91% (86.2% in 1990). This process, associated with the expansion of exports, allowed for a significant reduction of the country's debt service ratio to around 30% in 1991. Interest payments amounted to US$ 1.3 bn, and amortization of principal to US$ 2.5 bn. The country is firmly committed to service promptly its external debt obligations; it continues to maintain normal relations with Western commercial banks and its creditworthiness on international financial markets, already satisfactory, is improving.

Figures concerning the medium- and long-term external borrowing programme implemented in 1991 suggest that the target of US$ 1.6 bn for total external borrowing on the international capital markets and from banks was attained by the end of the year, though for some operations the assessment of Hungary's financial risk by the markets entailed costs that were higher than expected.

In 1991, official sources provided Hungary with further loans worth around US$ 2 bn (US$ 1 bn disbursed in the course of 1990). The main sources of official funds were the IMF, EC and G-24 for macroeconomic assistance, the World Bank for project lending and structural adjustment purposes and Japan's Ex-Im Bank.

Finally, foreign direct investment also developed promisingly in 1991, reaching US$ 2.5 bn, of which total capital inflows amounted to US$ 1.45 bn.

2.4 Monetary, credit and exchange rate policies

In 1991 Hungary continued to implement a restrictive monetary and credit policy, which focused in particular on stabilizing the domestic currency and controlling inflationary pressures. This was in line with the agreements reached between Hungary and the IMF in March 1990 for a 12-month stand-by arrangement and in February 1991 for a three-year Extended Financing Facility. This policy was implemented by the National Bank of Hungary, which made effective use of traditional instruments of monetary and liquidity control. Demand for money in 1991 remained however somewhat high, as a result of the rising budget deficit and the growing financial needs of loss-making public enterprises for restructuring and investment.

Moreover, some preferential lending continued to be extended, particularly to state enterprises to strengthen their production and export capabilities. Unhealthy financial relations between banks and enterprises still represent a major source of concern for the government, as they reflect an unsatisfactory degree of financial discipline.

During 1991, short- and long-term refinancing rates were used with more flexibility. The NBH basic refinancing rate (rediscount) was raised to 22% (+10% on the previous year) and then stabilized at that level in 1991. The automatic refinancing of commercial banks by the NBH was reduced to 10% of the total capital of the main commercial banks, the NBH target being to abolish it completely from the beginning of 1992. The lower obligatory reserve requirements introduced for commercial banks in 1990 were extended in 1991 to cover foreign currency deposits as well. Following the progressive slowing down of monthly inflation in 1991 the government and commercial banks began to lower interest rates.

In 1991, the National Bank of Hungary adopted an active exchange rate policy. The forint was devalued by 15% in January 1991 essentially to preserve the country's external position. A further devaluation of 5.8% in November 1991 was intended to offset part of the appreciation of the real exchange rate which had occurred during the previous months as a result of inflation. In December it was decided to peg the forint to a simplified currency basket based on equal shares of the ecu and the dollar.

3. Status of reform process

In 1991 the government continued the process of transforming the economy into a "social market economy" in the framework of a three-year "Economic Programme of National Renewal" issued in September 1990. The programme, supported by the IMF, focuses on the need to carry out macroeconomic stabilization and anti-inflationary policies and at the same time to implement social and labour market measures designed to protect those segments of the population most affected by the transformation process.

The reorientation of foreign trade towards western markets has been reinforced by the signature of a Europe Agreement. Hungary's access to Western high technology has been facilitated by the COCOM directive approved in 1991, which reduced the number of items on the prohibition and licence list from 120 to 10.

Proposals for a free trade area with neighbouring countries have been launched in the framework of the Visegrad Accord with Poland and Czechoslovakia. Barter and other forms of trade arrangements are pursued particularly with the Baltic states and the republics of the former USSR. In this respect, the country's main strategic aim is to reduce its heavy dependence on energy imports from one source and to develop new markets for Hungarian products. It appears that the Hungarian economy could be badly hurt by the war in Yugoslavia and the consequences of the UN trade embargo on Serbia, though the possible effects are difficult to quantify at this stage.

The most salient events in 1991 were:

3.1 <u>Legislation</u>

Concessions Act: It relates to concessions on state property. These are not transferable and can be granted for a specified period of 5 to 35 years. Foreigners enjoy the same rights as residents.

Accounting Act: It conforms with the international norms.

Law on Compensation: It refers to private property nationalized after June 1949. The total cost of the programme for the government is expected to amount to Ft 70-90 bn. The law will assist the privatization process by removing all uncertainties related to final ownership and property rights.

Act on the Central Bank: It limits the extension of credit to finance the national budget deficit and defines the tasks of the Central Bank (the main difference with Western practice is the stricter control on foreign exchange transactions). The Act allows the government to appoint its representative on the Board of Directors of the NBH.

Law on Financial Institutions: The Law mainly addresses the ownership of financial institutions. Shareholders other than financial institutions may not own more than 25% of commercial banks' and other financial institutions' equity. Foreign investors may own up to 10% without prior approval. The law also defines the legal status and powers of the State Banking Inspectorate and establishes the Deposit Protection Fund, which limits the responsibility of the State Budget for deposit insurance.

Law on Investment Companies: The law is designed to attract financial investors and to speed up the privatization process, particularly in the industrial sector.

Law on Bankruptcy: It provides for rigorous treatment of insolvency and bankruptcy. The Hungarian government considers this law as the basis for re-establishing normal inter-enterprise payments in the coming months.

3.2 Trade Liberalization

Encouraging progress was also made in 1991 in trade liberalization. The Hungarian government ended its monopoly on foreign trade, and a number of new entities became active in foreign trade.

Some 90% of imports have been liberalized, so that at present almost all imports and exports are exempt from any licensing, with the exception of a negative list for some sensitive and strategic commodities. The average customs tariff level has also been lowered from 16% to 13%.

Also in 1991 antidumping legislation was introduced, as well as new rules against market disruption. A harmonized custom classification system (following EC directives) is being introduced in stages.

3.3 Price liberalization

Following the adoption in November 1990 of a new Pricing Act and the subsequent abolition of the Price Commission, a new round of price liberalization was effected on 1 January 1991. As a result of these measures, in 1991 only about 10% of consumer prices remained subject to official price fixing.

3.4 Banking reform and security market development

Since the establishment of a two-tier banking system in 1987, 37 new commercial banks have been granted permission to operate in Hungary. A bill on the new role of the National Bank of Hungary as an autonomous body accountable only to the Parliament was approved at the end of 1991.

In 1991, the security market was further developed, though the number of companies registered at the Budapest stock exchange remains small (around 30) and the value of transactions is still modest.

3.5 Joint Ventures

As of end-1991 the number of newly established joint ventures in Hungary was around 10,000, compared with 5,693 at end-1990. In 1991 foreign cash inflows were about US$ 1.4 bn.

Following the adoption of new joint venture legislation which permits Western undertakings to establish fully owned companies in Hungary, some 1,268 companies were funded exclusively with foreign capital in 1991. More than half of the joint ventures already operating are in the commercial sector. Industrial ventures represent slightly less than 20% of the total.

It appears that some 60% of total foreign investment in Eastern Europe has been directed to Hungary.

3.6 Privatization

The privatization process started in Hungary in 1989, but progress so far has been slow. The government set up the State Property Agency (SPA) in March 1990 in order to implement the privatization programme, manage state assets while they were being privatized and ensure a satisfactory degree of transparency in the process. Its aim is to put half of state property into private hands by 1994. Up to now, however, the strong growth of the private sector has been due less to the privatization of state-owned companies than to the rapid expansion of new enterprises, aided by sizeable infusions of foreign capital.

The main reasons behind the delays in the privatization process are the growing management problems within the SPA, the difficulty in distinguishing between asset valuation and market value when drawing up inventories at enterprise level, and the limitations placed by a restrictive credit policy on setting up preferential credit facilities in support of those businesses to be privatized. Furthermore, while sales of state-owned consumer goods companies to Western multinationals have been quite successful, the privatization of less financially attractive manufacturing enterprises is proceeding slowly.

3.7 Foreign direct investment

Additional legislative and regulatory measures, such as foreign investment protection rules, profit repatriation, foreign investment liquidation, etc., are now being introduced in the framework of the Association Agreement signed with the EC in December 1991.

4. Review of performance criteria attached to the EC loans

Two Memoranda of Understanding were signed between the EC Commission and Hungary, one in March 1990 and one in July 1991, describing terms and conditions attached to the EC loans. Both Memoranda, which were agreed after consultation with the Monetary Committee, foresaw the periodical monitoring of an agreed set of performance criteria as well as major structural economic and sectoral indicators. Those criteria generally included the quantitative criteria stipulated in the IMF arrangements (mainly ceilings on money supply and bank credits to the state budget as well as targets on budget deficit and external reserves and liabilities) as well as objectives for the current account and the international reserves, price and import liberalization, reduction of state-owned property, adoption of appropriate legislative measures and the continuing effort to mobilize external financing from private sources.

The results achieved by the Hungarian authorities at the end of 1991 with respect to the performance criteria were broadly in compliance with the commitments undertaken in the Memoranda. Performance with respect to the structural adjustment indicators can also be considered broadly satisfactory. A relatively rapid process of transformation of state owned enterprises into joint stock or limited liability companies was implemented in 1991, but privatization is progressing more slowly than initially planned. Figures referring to the number of newly established joint ventures and small and medium-sized enterprises show a positive trend.

Finally, information on bankruptcy and liquidation procedures started in 1991 or completed during 1991 illustrates progress on the microeconomic transformation process.

5. Developments in 1992

The decline in output continued during the first months of 1992, industrial production fell a seasonally adjusted 17.3% in April 1992 compared to a year earlier. Monthly price increases have continued to decelerate; by May 1992 the year-on-year consumer price increase was 22.6%. The number of unemployed has continued to rise, reaching 523,000 or 9.7% of the workforce in May. However, the Hungarian economy's most significant problem remains its growing budget deficit, which exceeded Ft 69 bn by the end of May. Revenue was 8.2% less than expected while expenditure was 2.4% less. A budget deficit of Ft 160-180 bn is now forecast for the full year, requiring the adoption of a supplementary budget.

Hungary will finance the 1992 deficit with state bonds and treasury bills, as well as with special bonds issued by the National Bank which will be used to regulate the money supply. Spending on social programmes is scheduled to grow by 23% in 1992, the budget's single biggest area of growth, in order to alleviate problems created by rising unemployment and deteriorating living standards. The amount spent on subsidies is forecast to decrease in 1992 to Ft 139 bn, against Ft 171 bn in 1991. On the revenue side, most tax and duty payments are expected to rise by less than the inflation of 20-22% predicted by the government, with the exception of personal income tax and consumer tax, which are scheduled to rise by 28% and 26% respectively.

On the external side, during the first four months of 1992 Hungary's trade showed a further remarkable expansion, in particular to industrialized countries. Exports increased by some 23% over the same period of last year, while imports grew by 4%, reflecting a still sluggish demand for imported goods by local enterprises and households. As a result of this favorable trend, according to NBH figures, at the end of the first four months of 1992 Hungary recorded a better-than-expected trade surplus (US$ 612 million) and a sizeable current account surplus (US$ 485 million).

No further decline in Hungarian trade with former CMEA partners and the former USSR is expected to occur in 1992. At present all trade-related transactions between Hungary and this zone are settled in hard currency or on a counter-trade basis.

By the end of May 1992 international reserves in foreign currencies had increased to US$ 5 bn, thus covering some 5.5 months' imports.

During the first quarter foreign direct investment inflows amounted to an estimated US$ 300 million, reflecting the positive Western perception of Hungary's investment risk and promising profit prospects, despite the adoption at the end of 1991 of more restrictive rules on taxation of foreign investment and the abolition or reduction of some allowances already granted to foreign joint ventures. Depending on the evolution of the balance of payments in the coming months, the external financing requirement for 1992 could reach US$ 2-2.5 bn. In 1992 Hungary expects continuing official external financial assistance mainly from the IMF and the World Bank, totalling US$ 1.4 bn. Furthermore, the authorities intend to implement a borrowing programme with a view to raising some US$ 1-1.3 bn on the international capital markets. During the first quarter, approximately 65% of this programme was already accomplished on the German, Japanese and Austrian markets. Some further bank-to-bank credit lines are also expected to be negotiated by the NBH during the current year.

In April 1992 international rating agencies have upgraded Hungary's financial risk. As of end-April 1992, the country's gross foreign debt in convertible currencies had stabilized at around US$ 22 bn,with a debt service ratio of around 30%. Its price on the secondary debt market has been stabilized at around 88-90 cents to the dollar.

III. CZECH AND SLOVAK FEDERAL REPUBLIC

1. Introduction

In 1991, at the Commission's suggestion, US$ 1 billion in financial assistance was granted to the Czech and Slovak Federal Republic (hereafter CSFR or Czechoslovakia), in the context of the initiative by the G-24 Group, and in addition to the financing provided by the IMF and the World Bank. Accordingly, the Council adopted a decision (Council Decision 91/106/EEC of 25.2.1991) granting financial assistance of ecu 375 million to Czechoslovakia. The loan agreement, signed on 29 May 1991, was designed to assist the country in its economic reform process and to allow for a successful introduction of currency convertibility; it was matched by an equivalent financial contribution from the other member countries of the G-24 Group. In mid-1991, the Commission disbursed ecu 185 million, corresponding to the first of the two loan tranches. The release of the second tranche was subject to a successful review of progress in the field of economic stabilisation and reform, including the observance of a number of performance criteria agreed by the two parties. After a positive review, the second tranche of ecu 190 million was disbursed in February 1992.

Early assurances of additional financial support from Western countries permitted the government to embark on an ambitious reform programme. The foreign financial assistance was used primarily to strengthen the reserve position of the country, and allowed the government to introduce current account convertibility for the crown (koruna) and to peg the currency to a basket of foreign currencies. As a result, substantial external support combined with successful domestic fiscal and monetary policies have resulted in a considerable strengthening of the foreign currency holdings of the CSFR, implying that for 1992 no additional exceptional financing should be required.

2. Economic reform in 1991

2.1 Initial conditions in Czechoslovakia

Czechoslovakia embarked on the transition to a market economy in late 1990/early 1991 under better macroeconomic conditions than other countries in transition. Thanks to a conservative fiscal and monetary policy over the past decade, inflation had never emerged as a serious problem, the monetary overhang was relatively small, hard-currency debt was less than 15 % of GDP, and net government debt was negligible.

Czechoslovakia was disadvantaged, however, compared to e.g. Poland and Hungary, with regard to the structure of the economy and the legal framework and basic institutions: concentration in industry was much higher, the private sector was very small, and exports were heavily biased towards East European countries and towards heavy industrial goods and armaments. Furthermore, frictions between the different levels of government and the need to deal with growing tensions between the Czech and Slovak republics, and the Slovaks' aspirations for more independence put additional burdens upon the reform process.

The first steps to reform the economic and institutional structure were taken in 1990, when the commercial and non-commercial exchange rates for the crown were unified, the crown was devalued, a two-tier banking system was created, and a mixed system of centralized and decentralized prices was introduced.

However, fundamental economic reforms started in earnest only in 1991. More than a year later, remarkable successes in macroeconomic management have been achieved, with prices stable, and the government and external accounts close to balance. But output has fallen sharply, and structural reform is proving to be slow and difficult.

A "Scenario of the Economic Reform" adopted by the Federal Assembly in September 1990 outlined the key elements of transformation policy. Corner stones of this programme were the complete liberalization of prices and external trade, large-scale privatization and a rigorous macroeconomic stabilization policy.

2.2 Price liberalization, incomes policy and supply-side policy

In January 1991, prices were freed and most subsidies for consumer goods were abolished. A General Agreement, concluded by the Government, employers and trade unions, established a cap on wage increases during 1991 consistent with a decline in real wages of 10 percent, following a decline of about the same magnitude during 1990. Although prices rose by 40% in the first quarter, a price-wage-price spiral was avoided. Significant subsidies for housing and transport were, however, maintained.

2.3 Fiscal policy

Fiscal policy was designed to achieve a substantial disengagement of the state from the economy and to help stabilize the economy in a turbulent period following trade and prize liberalization and the terms of trade shock. With respect to the microeconomic perspective of fiscal policy, measures were taken to boost investment by reducing profit-tax rates by 10 - 20 per cent. Also, the vast number of turnover-tax rates was reduced to four, subsidies were abolished and privatization begun. From the macroeconomic perspective, fiscal policy aimed at an overall budget surplus of 1% of GDP while the ratio of revenue to GDP was supposed to fall by about 10 percentage points. Consequently, a small budget surplus could only be achieved with the help of considerable expenditure restraint.

2.4 Privatization

Important elements in the strategy to disengage the state from the economy were the privatization programmes approved by parliament. While small privatization started immediately in 1991, privatization of large state enterprises was intended to be achieved mainly with the help of a voucher system in the course of 1992. Overall, privatization seems to be well under way. Small-scale privatization got off to a quick start; and large-scale privatization seems to be on track.

2.5 Monetary policy

Monetary policy, like fiscal policy, was designed to be restrictive so as to bolster the exchange rate anchor and help stabilize prices. A tight credit policy was intended to ensure that the initial price jump did not trigger a process of protracted inflation. Credit policy has consisted mostly of direct ceilings on commercial banks. While such ceilings create inefficiencies and distortions, the rudimentary nature of financial markets made it impossible to rely on reserve money management and other indirect instruments. The State Bank, however, has already introduced a number of measures to move towards a system of reserve money management, and intends to take further steps in this direction, so as to allow for the implementation of monetary policy through market-based instruments. In addition, new banking laws are to be introduced, which should promote the independence of the State Bank and foster the development of a competitive banking system (including the participation of foreign banks). At the same time the State Bank has kept close control of interest rates through three main instruments: the discount rate, a maximum lending rate, and moral suasion in the area of deposit rates. After being raised to 10% in early 1991 (from 5% in 1990), the discount rate was slightly lowered in September to 9.5%.

2.6 Trade and exchange rate policy

The CSFR's trade regime has been considerably liberalized: imports and exports may now be undertaken by any registered enterprise or private entrepreneur; import licenses are required only for a small number of so-called strategic items, whereas all commercial imports are subject to an import tariff, ranging from 0 to 35%. The temporary import surcharge on consumer goods (reduced to 10% since 1 January 1992) is expected to expire on 1 January 1993; it was originally introduced to avoid import surges that may jeopardize the balance of payments position.

Following a devaluation at the end of 1990, the crown was made convertible for current account transactions. The commercial and tourist exchange rates were unified at the same time, at a rate of Kcs28 = US$1. Since then, the crown has been pegged to a basket of five currencies, which has resulted in a relatively stable rate against the dollar of between 28 and 30 Kcs. As the authorities have been successful in keeping inflation under control, there is little pressure to devalue the crown. In fact, owing to inflation differentials, the crown has actually depreciated in real terms vis-à-vis the Polish zloty and the Hungarian forint. In March 1992, the real effective exchange rate of the crown against the dollar was 7% below its January 1990 level.

3. General economic developments in 1991

3.1 Production

Czechoslovakian output suffered a serious setback in 1991 as a result of several factors, not all linked to the domestic reform process. On the external side, the fall in exports to former CMEA countries reduced total demand for Czechoslovakian products while the switch of CMEA trade to a convertible currency base implied a significant deterioration in the terms of trade. On the internal side, the pace of the reallocation of resources (rapid decline in output in existing branches and a slow and hesitant start in building new structures), as a result of the move to a market system and the change in relative prices, contributed to a negative output shock. Also, restrictive monetary and fiscal policy in the aftermath of the (unexpectedly high) price surge in early 1991 contributed to the overall contraction of supply. Finally, domestic demand, especially investment expenditure, was driven down by large uncertainty concerning future institutional issues, the structure of relative prices and the consequences of privatization.

All in all, real GDP declined by 16% in 1991, and both in the Czech republic and in Slovakia the decline in industrial production reached more than 20%, and construction output shrank by about one third. According to official statistics, collective consumption stagnated, but personal consumption slumped by one third, and net investment even became negative as from the third quarter.

3.2 Labour market

Naturally, the labour market was negatively affected by the major slump in output, and employment declined by about 14%. Unemployment, which virtually did not exist in early 1990, reached more than 500,000 by the end of 1991, and the unemployment rate climbed to about 7%. Labour-shedding differed very significantly between regions. While enterprises in the Czech republic tried to avoid major lay-offs by allowing labour productivity to decline by 20 to 30%, more rigorous employment adjustment in Slovakia limited the decline in productivity to 10 to 15% but led to soaring unemployment. Furthermore, job creation in the growing private sector (by end-1991 about 1.2 million out of a total labour force of 8.7 million were employed in this sector, some of them in second jobs) was mainly taking place in the Czech republic. Consequently, despite similar falls in industrial and construction output, unemployment rates in Slovakia (12%) were about three times higher than in the Czech republic (4%) in late 1991.

3.3 Inflation and wages

Following price liberalization in January 1991, prices at the producer and retail level jumped on average by about 45%. The magnitude of the price jump exceeded the working assumptions used to formulate economic policies and led to a sharper than agreed decline in real wages and to a tighter than intended fiscal and monetary policy stance. However, the increase was relatively small compared with the increases in other East European countries. Furthermore, the first surge in prices worked itself out in the first months of the year and inflation was rapidly brought under control, so that average annual inflation was limited to somewhat above 50%.

Nominal wages grew on average by about 16%, indicating a sharp decline in real wages. Inter-sectoral wage differentiation started to emerge: wages in the service sector, where prospects were rosy, increased by about 40% (insurance sector) to 60% (banking sector), while they almost stagnated in the agricultural sector. Pensions were raised by about 30%.

3.4 Public finances

The fiscal stance in early 1991 was substantially tighter than envisaged, reflecting on the revenue side a temporary surge in profit tax receipts (owing mainly to capital gains on inventories) and on the expenditure side limitations designed to support the anti-inflationary stance. Thus government wages and transfers to private households were increased with a significant lag following the larger than expected price jump. Furthermore, subsidies and capital transfers were postponed, and the budget showed a surplus of more than 2% of GDP in the first six months of the year.

In the second half of the year, fiscal policy became somewhat more relaxed, partly as a result of less buoyant revenue growth, partly because of automatic stabilizers working and also because of discretionary actions of the government. The last mainly comprised a reduction in VAT rates, increases in the allocations for health and education and once-off compensations to enterprises negatively affected by the effects of the embargo on Iraq. For the year as a whole, the deficit of all levels of government was crown 18.5 billion, about 2% of GDP.

3.5 Internal monetary aspects

As price increases were much larger during the first part of 1991 than had been anticipated, real credit contraction was correspondingly greater. As a consequence, monetary policy was eased somewhat during the second part of the year, to reduce its deflationary impact. The supply of credit appears to have been constrained by a number of factors: the inefficiency of credit ceilings, as margins not used by one bank could not be used by other banks; the State Bank and, in turn, commercial banks built significant safety margins into their ceilings; moreover, the banks were reluctant to lend in the highly uncertain environment, in view of the changing prospects facing enterprises and the banks' own inexperience in credit risk assessment. Czechoslovak commercial banks began to restrict new credit to state-owned enterprises and insisted on repayment of large portions of outstanding debt ahead of schedule. Unable to obtain bank loans, many enterprises resorted to supplier's credit, so causing an expansion of inter-enterprise credit, which complicated the task of monetary policy.

The announced strengthening of the bankruptcy laws may precipitate a wave of closures throughout the economy. But as the flow of financial resources to non-viable state monopolies is curtailed, credit to the emerging private business sector and joint ventures with foreign investors should rise. While the tight stance of credit policy, especially in early 1991, helped avoid the onset of an inflationary spiral and of pressures in foreign exchange markets, it may have added to the weakness of aggregate demand and the contraction in output.

3.6 External aspects

A number of factors have affected the trade flows between the CSFR and its main trade partners in 1991: the switch to convertible currency trade at world market prices among the CMEA countries, economic recession in the CSFR itself and in its eastern neighbours, and a redirection of trade towards developed market economies, in particular the Community market.

In 1991 the value of exports declined by 6%, while imports fell by a more substantial 22%. Trade growth with Western Europe was not strong enough to compensate fully for the collapse of CMEA trade. Exports to developed countries actually increased by 14% in 1991. Much of this increase stemmed from the good performance in the EC market: in 1991 the Community accounted for some 41% of CSFR's total exports compared with 24% in 1988. By contrast, in 1991 exports to the former CMEA bloc dropped by about a quarter. The collapse of exports to the former

Soviet Union in particular has deepened the domestic recession, especially in Slovakia, with its heavy concentration of arms factories and other production geared mostly to the former Soviet market.

Lower imports reflected both the recession, and the shift away from the energy-intensive, polluting industries. As to the origin of the CSFR's imports in 1991, a third came from the Community, another third from the former CMEA countries, and the rest of the world supplied the rest. With imports dropping faster than exports, the CSFR's trade balance recorded a crown 25 billion surplus in 1991. This led to a switch in the current account balance from deficit to surplus: at the end of 1991, the convertible-currency current account surplus exceeded US$ 300 million, instead of the US$ 2.5 billion deficit originally projected. Such a surplus has the effect of reducing the need for foreign borrowing, making easier the management of foreign debt. At the end of 1991 the Central Bank's convertible-currency reserves amounted to US$ 1.4 billion.

As part of the reform process, foreign trade has been substantially liberalised. As a result, the number of firms or individuals involved in foreign trade has boomed. As of January 1992, the import surcharge was reduced from 15% to 10%, while at the same time customs tariffs were restructured, with the average tariff increasing by 20%. At present after tax hard-currency profits, or a foreign investor's capital share in the case of divestment or liquidation, can be repatriated.

Czechoslovakia's gross external debt is currently just over US$ 9 billion, of which US$ 4.6 billion is owed to commercial banks. Assuming that the economic reforms stay on track, the CSFR should have no major difficulty in borrowing in the international markets. In 1991, Czechoslovakia received US$ 1.8 billion credits (under various forms) from the IMF, and the World Bank pledged a US$ 450 million loan. In January 1992 the IMF approved a drawing by the CSFR under the Compensatory and Contingency Financing Facility (CCFF) equivalent to about US$ 147 million to counter soaring oil import costs, whereas in April 1992 it granted an annual stand-by credit of US$ 322 million in support of the Government's economic and financial programme; in June the World Bank approved a US$ 246 million loan to modernize existing power-generating facilities and to aid in pollution control. Apart from the various types of credits from both the IMF and the World Bank, Czechoslovakia has been able to raise commercial loans and issue government-backed bonds in the international capital markets.

In addition to foreign borrowing, the CSFR's finances benefited from inflows of foreign exchange from direct foreign investment, which in 1991 totalled about US$ 600 million. In the light of the growing interest in the area and the favourable investment laws, the role of foreign investors in the CSFR's economy is expected to grow in coming years.

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

The memorandum of understanding between the Community and the CSFR, agreed after consultation of the Monetary Committee, provided for a regular 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 and included the following elements: quarterly limits on overall credit and on credit to the government, quarterly minima for international reserves, and limits 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 liberalisation, the privatization of enterprises and the continuing effort to mobilise private funding of overall financial needs. The successful review of progress in economic stabilization and reform, including the observance of performance criteria, was a condition to the release of the second tranche of the loan.

The review of IMF conditionality, completed in two reviews in June and November 1991, concluded that the quantitative performance criteria were met and the reform programme was considered as being on track, so that no adjustments to the programme were required. The structural performance criteria were also largely met. Total turnover based on free prices was estimated at 94-95%, compared to the original 92% target. Trade liberalisation was well advanced: the list of products subject to export licensing was reduced, and further reduction are expected in the near future; the import surcharge was reduced from 20 to 10%, and is expected to expire at the end of 1992. The programme for the privatisation of large scale enterprises was also well advanced. The State Bank was able to raise a significant amount of financial resources in the international capital markets. A bankruptcy law entered into force in October 1991, while laws for the establishment of a stock exchange, and the functioning of the banking system, investment companies and mutual funds were submitted to the Parliament. The authorities continued to permit the free repatriation of profits and the proceeds of liquidation of investment made by nonresidents in Czechoslovakia, while bilateral investment protection agreements were signed with ten EC Member States.

With all criteria attached to the Community loan broadly met, the second tranche of the medium-term loan was disbursed in February 1992.

5. Developments in 1992 and short-term outlook

In mid-1992, there is some evidence that the economic decline is about to taper off, with production in traditional sectors stabilizing and output and employment growth in new sectors gaining momentum. Inflation seems now to be under control, public finances show no alarming developments, interest rates have come down somewhat, and the exchange rate remains stable. Furthermore, the trade balance is in surplus and the gross hard-currency debt is no longer rising.

In the first quarter of 1992 there was a significant recovery in Czechoslovakia's trade. Exports increased by 13% and imports by 8% compared to the same period in 1991. The re-direction of trade away from the former CMEA bloc continued, and it now accounts for less than one fifth of total CSFR exports. The economic authorities intend to maintain a fixed exchange rate for the crown, so as to constrain domestic prices and wages within reasonable bounds.

However, major structural adjustment is still to come, and will probably have significant negative repercussions on the labour market and for enterprises' balance sheets. Although registered unemployment rates edged down in early 1992 (partly as a result of changed registration methods), large-scale labour shedding seems unavoidable to improve the competitiveness and profitability of enterprises as the alternative (a further significant decline in real wages) is politically not feasible. Major (budgetary) risks are also hidden in the enterprises' accounts, as liabilities are accumulating and debt servicing may endanger the necessary modernization of the capital stock.

Although the CSFR has been able to meet part of its financial needs in the international financial markets, in the past few months the CSFR's authorities have expressed concern about the recent rise of interest rates on commercial credits, well above their traditional levels. In fact, the high cost of borrowing has discouraged them from seeking larger loans.

The economic success story of Czechoslovak reforms, resulting from favourable macroeconomic starting conditions, comprehensive and rapid economic policy reform and good macroeconomic demand management is however increasingly overshadowed by political developments. Since 1990, growing tensions between the Czech republic and Slovakia have slowed down the reform process. Since early 1992 reform-related legislation has come to a standstill and is unlikely to resume before the future of the Czech and Slovak Federal Republic is settled.

IV. BULGARIA

1. Introduction

At the end of 1989, after the removal from power of Todor Zhivkov, the reform process in Bulgaria, which had started timidly in 1986-1987, accelerated. However, not until the end of 1990 did it move into an operational phase.

By that time, the economic situation worsened considerably. Real GDP fell by some 11% in 1990 (following a decline already in 1989); inflationary pressures, which had been building up in the economy over several years, began to manifest themselves in acute shortages of food and basic consumer goods and price increases (open inflation exceeded 64% in 1990, up from 10% in 1989). The extremely precarious financial situation of the country (at the end of 1990, external reserves were down to US$ 125 million, or just one week of imports), resulting in part from the discontinuation of private financing which followed the moratorium on foreign debt servicing[1)], left little room for manoeuvre. It was clear that fundamental changes could not be delayed any longer.

In December, an independent Prime Minister was appointed; in early January 1991, a transitional coalition government was formed. This government was given a mandate to speed up the reform process and to conclude an agreement with the International Monetary Fund (Bulgaria joined the IMF in September 1990). It was also mandated to set a date for new local and parliamentary elections.

The government's economic programme adopted in the beginning of 1991 was seeking to address the needs for economic stabilization and a rapid transition to a market economy. The three main objectives of the programme (stabilize the economy by curtailing excess demand, restore external balances and credibility, and introduce market mechanisms through necessary structural adjustments) were to be achieved by the implementation of a comprehensive set of liberalization, stabilization and structural policies. The domestic reforms were to be supported by the exchange system and trade reform leading to early current account convertibility with a floating exchange rate.

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1) Although Bulgaria had started to borrow substantial amounts in the West already in the 1960s - mainly to finance imports of equipment goods needed to fulfil export commitments to the CMEA - its net external debt in hard currency remained moderate until the end of the 1970s. The debt even declined during the first half of the 1980s, as the country made a deliberate effort to curtail imports and re-exported cheap Soviet oil to the world market. From then on, however, gross foreign debt increased sharply, from US$ 3.2 billion in 1985 to US$ 9.2 billion in 1989. The main explanations are increased imports of consumer goods, in an attempt to offset inadequate domestic production, and credits to developing countries (such as Libya and Iraq) to which substantial machinery exports were made but not paid for. By early 1990, in a context of rapid economic disintegration both inside the country and within the CMEA as a whole, the debt burden became unbearable. The high level of debt and the bunching of repayment obligations forced the country to declare a unilateral moratorium in 1990, first on principal repayments and a few months later on all debt servicing.

The reform was to be implemented in an extremely difficult external environment. Bulgaria was practically excluded from international capital markets and had to face the collapse of CMEA trade, on which Bulgaria was more heavily dependent than any other country (in 1990, the USSR alone still absorbed 57% of total Bulgarian exports, or 19% of GDP). Moreover, Bulgaria tended to pay prices below world market levels for its energy and raw material imports from the USSR, while its exports of manufactured goods to the Soviet Union were overpriced by international standards. The collapse of Soviet import demand, and the transition to world market prices for remaining transactions, implied a double adverse shock, probably of more than a quarter of GDP for the 1989-1991 period. To this should be added the loss which Bulgaria incurred from the international embargoes against Iraq and Libya (outstanding but non-performing claims on Iraq, for instance, are well in excess of US$ 1 billion).

The total financing needs of the Bulgarian economy for 1991 consistent with the stabilization targets were estimated to be close to US$ 3.8 billion. This amount included the financing of current expenditure, the repayment obligations on the foreign debt, the settlement of arrears and the build-up of a minimum level of international reserves. The financing of the programme was to be assured exclusively through debt rescheduling and deferral as well as through new official credits. The debt relief was assumed to provide US$ 2.2 billion; approximately half of the remaining US$ 1.6 billion was to be covered by the Bretton Woods institutions. The IMF was to conclude with Bulgaria a SDR 279 million (some US$ 390 million) twelve-month stand-by arrangement with an attached contingency mechanism for oil and gas prices; additional resources could be drawn under the oil element of the Compensatory and Contingency Financing Facility. The World Bank was to make available a Structural Adjustment Loan of US$ 250 million. To close the residual financing gap of approximately US$ 0.8 billion, Bulgaria made a request to the Community and the Group of twenty-four for complementary balance-of-payments assistance.

The Community assistance to Bulgaria of ecu 290 million (approximately US$ 400 million, or half the estimated financing gap) was decided in June 1991. It was made available in two tranches (of respectively ecu 150 and 140 million). The disbursement of each tranche was subject to a number of conditions some of which were specific to Bulgaria. In particular, the government's programme was to be implemented in the context of the negotiations with public and private creditors on the country's foreign debt. The need to achieve substantial progress in these negotiations was reflected in the conditions attached to the loan.

The first tranche was made conditional, in addition to a conclusion of a stand-by arrangement with the IMF, upon a debt rescheduling agreement with the Paris Club and a deferral of debt servicing payments to commercial banks together with progress towards the conclusion of a long-term debt restructuring agreement. A debt rescheduling agreement with the Paris Club was reached in April. The debt restructuring negotiations with the commercial banks were less conclusive but the assurances received in June from both the Bulgarian authorities and the commercial banks' advisory committee that the parties were committed to make substantial progress towards such an agreement before the end of 1991 were strong enough to allow for the release of the first tranche of the loan which took place in August 1991. The second tranche was conditional upon the fulfilment of standard economic conditions attached to the Community loans and a positive assessment of progress made with respect to achieving a long-term debt restructuring agreement with the private creditors. The Commission's decision to disburse the loan took place in March 1992 after consultation of the Monetary Committee and was based on indications of progress towards such an agreement provided by both sides.

The pledges provided by the other member countries of the G-24 amounted only to some US$ 214 million thus leaving the assistance package short by nearly US$ 200 million. Almost all the contributions were in the form of untied loans, to be disbursed in one or two tranches, subject to compliance with conditions attached to the IMF stand-by arrangement or the World Bank SAL. Only a small contribution from the United States was effectively disbursed in 1991. The delays in the disbursement of the other contributions (by the EFTA countries and Japan), were mainly due to procedural constraints of the Bulgarian administration itself. In addition to the lower-than-requested commitments and the much longer-than-expected delays in mobilizing the G-24 assistance, delays have also occurred in the disbursement of the World Bank SAL: the first tranche of the loan (US$ 150 million) was only put in place in February 1992.

2. Macroeconomic policies and performance in 1991

2.1 Stabilization programme for 1991

The macro-economic policy developed by the authorities was designed to create conditions for a reversal of the decline of the economy (unavoidable in view of the size of the imbalances to be corrected) already before the end of 1991. Overall, the programme aimed at limiting the fall of GDP to some 11% and at reducing the monthly inflation to 1-2% by the end of the year, after the initial price jump following the comprehensive price reform in February.

The stabilization policy implemented by the government in 1991 was based on two nominal anchors: a tight monetary policy which, through credit ceilings imposed on the banks and sharply increased interest rates, controlled broad money growth; a tight tax-based incomes policy, which foresaw a steep decline in real wages, negotiated with the trade unions. In addition, fiscal policy was aimed at simultaneously reducing the share of public spending in GDP and cutting the budget deficit. Weak international reserves and uncertainties in the external financing did not allow a fixed exchange rate system to be introduced and maintained with credibility.

The economic results during the first year of reform have been substantially worse than anticipated. Real GDP fell by 22.9% although this figure probably overestimates the actual decline in output by taking insufficiently account of small private-sector activity, in particular in retail trade and services. Retail prices jumped by 277% during the first quarter reflecting greater than anticipated depreciation of the exchange rate. Prices have since then continued to increase at a 4-5% monthly rate, or at an annual rate of some 70%.

The stabilization policies successfully implemented in 1991 have clearly contributed to the much stronger than expected recession. However, by far the most important reason for the contraction of output has been the collapse of trade with the CMEA (and especially the USSR). The collapse of Bulgaria's traditional foreign markets and the decline in domestic output led to a sharp decrease in exports. This forced a very rigorous contraction of imports, which in turn exacerbated the domestic contraction. These trends were further aggravated by acute shortfalls in external financing, as a large proportion of official assistance committed to Bulgaria was not effectively paid out; overall, of US$ 1.6 billion initially expected only US$ 0.7 billion materialized.

2.2 Output and demand

The decline in real GDP reflects primarily the decline in industrial activity (27.5%); output in agriculture and services is estimated to have dropped by respectively 13% and 21%. The bulk of the decline in industrial production is accounted for by the five largest industrial subsectors most dependent on trade within CMEA: chemical and petrochemical industry, electrical and electronical engineering, ferrous metallurgy, machine building and metal processing and agro-industry. Most of the decline occurred in the first half of the year; some resumption of activity was registered in the last quarter of 1991 (with, in particular, a cautious recovery of the output of some export-oriented industries, namely machine building and textiles), but it proved to be temporary.

The decline in agricultural production reflects both domestic and external factors. Livestock declined due in particular to shortages of imported feed grain (this resulted in a temporary increase of meat supply). A relatively poor performance of crop production (with a notable exception of vegetables subsector) reflects slow implementation of land reform and an unfavourable purchase price structure resulting from a still highly monopolistic food processing industry. The decline in services reflects primarily the contraction of the banking sector and transportation.

On the demand side, investment is estimated to have been reduced by two thirds in real terms. This reflects the effects of domestic uncertainty, restrictive monetary policy and shortfalls of external financing. Consumption declined much less - by some 8%, owing exclusively to the decrease in public consumption (by almost half) while on the other hand, private consumption seems to have increased slightly, despite a substantial drop in real wages. Monthly business surveys suggest that weakness of domestic (and foreign) demand, and no more input shortages, became by mid-1991 the predominant factor behind output decline.

2.3 Wages and labour market

Wages and the labour market have largely borne the cost of adjustment. Real wages fell very sharply (by 42%, compared to a target of 35%) during 1991. The drop had been much stronger in the first months of the year when restrictive incomes policy had prevented real wages catching up larger than expected retail price rise. Public sector labour shedding has been very substantial at around 900,000 jobs (over 20% of the labour force), both in the state administration and in the state enterprise sector. Unemployment rose from negligible levels at the start of 1991 to 419,000 (10.2% of the labour force) in December 1991. The difference suggests that there has been a substantial increase in small private-sector activity, although statistical problems prevent a precise assessment of this effect.

2.4 Fiscal policy

In the fiscal area, the government's objectives were only partly achieved in 1991. On the expenditure side, subsidies were slashed from 14.9% of GDP in 1990 to 4.0%. The budget was, however, caught in a "debt trap": the full cost of interest due on internal and external debt amounted to 17.5% of GDP in 1991. Only by not servicing external debts could the cash deficit be limited to 3.7% of GDP (against a target of 0.1%; on an accrual basis it was 14.9%). A real effort was made, nonetheless, as is shown by the primary budget balance (which excludes interest charges), which improved from -3.5% of GDP in 1990 to +2.7% in 1991. On the revenue side, the budget faced unanticipated shortfalls, mainly in the first half of 1991 (following the weak activity); this led in particular to emergence of interest and expenditure arrears (the situation improved somewhat later). The financing of the budget deficit was mainly assured through credit from the banking system. In addition, treasury bills amounting to leva 0.8 billion were issued to non-banks (including subscription by the state insurance company).

2.5 Monetary policy

Monetary policy has been particularly restrictive in the first half of 1991 when policy restraint led to large real declines in monetary and credit flows. In the second half of the year, in view of reduction in inflation and signs of a liquidity crunch in the real economy, credit policy was eased to support an anticipated recovery. Overall, with the exception of credit to general government, credit and monetary aggregates remained under control in 1991 and nominal monetary targets were met (with broad money to GDP ratio declining from 111% at the end of 1990 to 75% at the end of 1991).

Interest rates were substantially increased in the beginning of 1991: the basic rate of the National Bank was adjusted from 4.5% to 45%. Subsequently, it was raised to 54%, which implied effective lending rates of commercial banks of some 70%, or real rates close to zero. On the other hand, real deposit rates were still negative owing to high intermediation costs. In the second half of 1991, new indirect instruments of monetary control were introduced, and the Lombard rate has de facto replaced the basic refinancing rate as the leading interest rate.

2.6 External developments

Foreign trade in 1991 was reduced dramatically reflecting weaker domestic economy and the collapse of Bulgaria's traditional trading partners, as well as deteriorating terms of trade and external financing shortfalls. Overall, export volumes dropped by an estimated 40% and import compression was even larger (47%). The decline was substantially more pronounced with the former CMEA (61% and 67% for exports and imports respectively). Trade with non-CMEA countries declined much less: imports were down by 27%, and exports by just 8.5%. Overall figures hide some recovery registered with the non-CMEA area in the second half of the year. Along with the decline in volumes, a significant structural shift in the trade towards industrialized economies was recorded in 1991.

As for transactions in hard currencies, export volumes in 1991 decreased by about 35% and import volumes by 62% thus resulting in a balanced trade, although at very low levels. Exports and imports amounted to US$ 3.7-3.8 billion, against targeted levels of US$ 6.6 billion and US$ 8.0 billion respectively. As a result, the deficit of the current account for 1991 was limited to US$ 0.9 billion. The much stronger than expected import compression allowed the targets in terms of build-up of international reserves to be met: these were increased at the end of 1991 to some US$ 0.7 billion (or close to two months of convertible currency imports), with official reserves rising to US$ 0.4 billion.

3. The strategy and the achievements of the liberalization and structural reform programme

From the beginning of the implementation of the reform programme, the government has proceeded with extensive liberalization measures in the fields of price formation, foreign trade and exchange regulations. In addition, the programme included an ambitious set of structural reforms: social protection, specification of an energy policy, financial sector reform, enterprise restructuring and privatization, agrarian reform.

These have proceeded more slowly than planned in 1991. After the first batch of measures adopted during the first half of the year, the absence of a broad political agreement within the government, and the prospect of presidential and parliamentary elections in October 1991 and January 1992, caused a prolonged pause in the reform process from the summer onwards; only in late 1991 and early 1992, under a new government excluding the ex-communists, did the process start again.

3.1 Liberalization

The price liberalization was successfully implemented in the beginning of the year. Most prices were freed at one stroke, in order to eliminate the increasingly pervasive shortages and the very substantial overhang of unwanted savings. However, prices for four energy products and public utilities were administratively set (but periodically increased to limit the budgetary cost of subsidies), and those of 14 categories of goods remained subject to a special monitoring system. Overall, entirely free and monitored retail prices are now estimated to represent some 90% of total retail turnover.

The foreign trade regime was also significantly liberalized, non-tariff barriers being removed except for a limited list of products which remained subject to export bans. In July, export restrictions were further reduced.

A new exchange rate system was put in place in February, providing for a single exchange rate which was left to float on the inter-bank market. Following the initial overshooting, the exchange rate stabilized at some 15 leva per dollar. Subsequently, the Bulgarian currency gradually depreciated to a rate of 20-23 leva par dollar. The nominal exchange rate was significantly more depreciated than envisaged in the beginning of 1991 (7-10 leva), reflecting weaknesses of the economy and a still low level of credibility of the reforms, at least regarding the external policies. The unification of the exchange regime was accompanied by the removal of restrictions on most current-account transactions, including invisible payments and transfers. Although this was never officially declared, the lev became convertible to all intents and purposes for current-account commercial transactions by residents.

3.2 Enterprise restructuring and privatization

A start was made with the demonopolization of large firms and their transformation into commercial companies. A land act was adopted which aimed at a restitution of agricultural land to individual farmers. It was however so hemmed in with restrictions that it remained inoperational. Large sections of a commercial code were adopted. Nevertheless, existing bankruptcy and liquidation procedures have not been enforced (a separate bankruptcy law does not exist yet), and budget constraints on enterprises remained too soft in practice. Small privatization began but was suspended in mid-year as legislative authority lapsed.

In the financial sphere, progress was made with the restructuring of the banking system and the enactment of modern banking legislation. A large proportion of bank assets consists however of bad loans to enterprises. This has a number of pernicious effects. It limits severely the banks' scope to finance the emerging private sector, since most of their resources are absorbed by the forced rolling over of non-performing loans to large state enterprises. It also prevents the banks from initiating enterprise bankruptcies (since writing off bad loans is impossible in view of the banks' own weak asset structure), thus hindering the process of restructuring of the enterprise sector. The government has started a process of gradual recapitalization of the banks, by replacing bad debts with government bonds, but this is hampered by its budgetary cost.

4. Review of performance criteria attached to the EC loan

The Memorandum of Understanding signed by the EC Commission and the Bulgarian authorities after consultation of the Monetary Committee, set up the quantified performance criteria and the structural adjustment criteria attached to the Community loan. The quantified criteria were identical to those in the stand-by arrangement with the IMF. They included quarterly limits on net credit of the banking system to the general government and to the economy overall, quarterly floors for the increase of the international reserves of the National Bank, limits on contracting or guaranteeing medium- and long-term external debt as well as on the stock of short-term debt of the public sector. The structural adjustment criteria were designed to evaluate progress made by Bulgaria with respect to the implementation of structural policies, with particular emphasis on the liberalization of prices, the reduction of trade and exchange restrictions, the establishment of a legal framework for private property rights and the privatization of enterprises. The successful review of progress in economic stabilization and reform, including the observance of performance criteria, was a condition to the release of the second tranche of the loan.

The review of conditionality took place in December 1991 (by which time the IMF had completed three reviews of the economic developments and policies, and of the financing of the programme). It was concluded that the quantitative performance criteria were either met or waived by the IMF, and that the structural performance criteria were broadly met (despite delays with regard to privatization).

Price liberalization has been almost completed, with the only exception of some energy items still subject to controls. A law on competition has been adopted which established a legislative framework to promote competition and to control abuses in the field of monopolistic price setting. With regard to foreign trade regime, quantitative restrictions on exports has been reduced. Free repatriation of profits and of the proceeds of liquidation of investment made by non-residents are legally permitted within the framework of the foreign investment law; investment protection agreement negotiations have advanced with a number of EC countries. The exchange system reform has been broadened with further restrictions on invisible payments and transfers being removed. Considerable progress has been achieved in enterprise demonopolization and restructuring. The legislative framework for the privatization is being completed and amended versions of several laws adopted in the beginning of 1991 are being prepared in order to speed up the implementation of the privatization process and improve its efficiency.

5. Developments in 1992

There has been little significant change in the trend of economic developments during the first months of 1992. Although the statistical basis is too weak to ascertain this with any precision, the output decline continued but is likely to have slowed down. Unemployment continued to increase; it stood at 12.5% in May. The underlying trend of inflation remained at 4-5% per month; it was substantially stronger in May (12%), reflecting further increases in utility prices. Inflationary expectations remain high, and it is likely that the official target of a 2% monthly rate by end-1992 will not be met. Exports to the West appear to have recovered during the first quarter, but trade with the ex-Soviet states has collapsed further.

No significant improvement in these trends can be expected unless structural reform gets under way. In this area, the most recent developments are encouraging. The first months of 1992 have seen the adoption of a number of major pieces of legislation which open the way for the start of effective implementation.

Between December 1991 and February 1992 laws were passed allowing the restitution of shops and small businesses to former owners, and implementation has begun. Especially in the cities, this has already led to the emergence of a new, dynamic sector of small retail and service enterprises. For large industrial enterprises, a privatization law was adopted in April after considerable political controversy. It does not provide for free distribution of shares, although employees will get preferential terms. Privatization of agricultural land has proved equally difficult politically; the 1991 land act was finally revised in April 1992, which should ease the process. In 1992, agricultural output will still decline as a result of uncertainties over land title, but a positive supply response may be hoped for in 1993. In January 1992, a new and more liberal foreign investment law was passed (replacing the one adopted in mid-1991).

The foreign trade regime was further restructured in July 1992: the tariff schedule was simplified (import duties now range between 5 and 40%, against 0 to 150% previously); the 15% import surcharge was abolished and export restrictions have been reduced.

Negotiations with Bulgaria's commercial bank creditors, which had been stalled for a long time, have resumed; in April, the government proposed a comprehensive, one-off debt and debt service reduction scheme of the Brady type. At present, the talks on the proposal including straightforward debt forgiveness, interest reduction, debt buybacks and debt-equity swaps are continuing. A rapid and successful conclusion of these negotiations, and the lifting of Bulgaria's complete financial isolation would be a major step forward on the road to recovery.

In March 1992, Bulgaria addressed to the Commission a request for complementary Community and G-24 balance of payments assistance for 1992 worth US$ 240 million. The assistance is being requested to support the government's economic programme for 1992 backed by a new twelve-month stand-by arrangement approved by the IMF in April under which Bulgaria will be able to purchase up to SDR 155 million (some US$ 218 million). The Community is currently considering providing a two-tranche medium-term loan of ecu 110 million.

The Bulgarian authorities are placing the 1992 programme in a longer-term perspective. The government's medium-term objectives include progress towards a viable balance of payments, the resumption of private capital flows, the setting of a domestic financial framework to secure low inflation and provide for increasing financing of the non-government sector, and finally the continuation of the structural reform. The authorities are in the process of elaborating a medium-term programme which they expect to finalize during 1992. On the basis of such a programme Bulgaria has requested an extended arrangement with the IMF.

6. Assessment and prospects

The Community assistance to Bulgaria has been instrumental in ensuring substantial success in the country's efforts to stabilize and reform its economy. The move away from central planning and towards market democracy appears to be irreversible and a number of positive results have been achieved during 1991 and early 1992. Shortages have been eliminated and prices now clear markets, even if at levels which many can ill afford. The price shock following liberalization has absorbed the substantial monetary overhang and hyperinflation has been avoided, although the danger has not been entirely averted. Much of the legislative and institutional framework of a modern market economy is now in place and social peace has been maintained, even if the political consensus has at times been less than optimal. Finally, the external financial situation of the country has also improved; international reserves have increased substantially and current account convertibility is basically achieved.

Yet the most difficult part of the transition process is still ahead. Domestically, the scope for structural reform created by the new legislative framework will need to be effectively used. Rapid and effective implementation of the measures decided upon in principle now appears to be the major challenge facing the Bulgarian authorities. Only thus will a supply response from the emerging private sector be of sufficient magnitude to offset the inevitable losses from a restructuring of the state sector. Failure in this respect will undoubtedly lead to a further protracted phase of output decline, and will increase the risk of hyperinflation considerably. This in turn would undermine public support for reform and endanger social cohesion.

Macroeconomic stability is very fragile. A resumption of growth will need to be export-led, since there is no room for domestic fiscal or monetary stimuli. This requires that market access for Bulgarian exports, especially in Western Europe, be adequate. In this respect, the association agreement between the Community and Bulgaria currently being negotiated could play an important role.

Large-scale foreign assistance from official sources will remain necessary for some time to come since, even assuming that a generous debt reduction package will be agreed with the banks, it is not realistic to count on sufficient spontaneous inflows of private capital in the next few years.

V. ROMANIA

1. Introduction

After a long period of political turmoil following the collapse of the Ceauscescu regime in December 1989, the Romanian authorities embarked in 1991 upon 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. However, the starting conditions for this process were unfavourable. The previous regime's overriding concern of repaying the foreign debt through a policy of import compression had left the country with an obsolete capital stock and huge pent-up demand for consumer goods. As a result, major imbalances had started to appear as the command system was abolished and resources were redirected towards meeting the consumption needs of the population.

The Romanian government began to introduce a number of economic reforms in late 1990. In November 1990, a partial price liberalization and the adjustment of controlled prices brought prices of most imported inputs broadly in line with world market prices at the current exchange rate. Furthermore, a separation of the central and commercial banking functions of the National Bank of Romania constituted a first step towards the creation of a market-based financial system while at the same time enhancing the authorities' ability to enforce monetary control.

For 1991 the government designed a comprehensive programme aimed at restructuring the economy while eliminating or reducing major economic imbalances. The programme's stabilization objectives for 1991 were to contain the decline in output, to stabilize the price level and to rebuild the level of foreign reserves through tight fiscal and monetary policy, wage restraint and an appropriate exchange rate policy. The structural reforms included liberalization of foreign trade, price liberalization, privatization and restructuring of state enterprises, and financial sector reform.

To support the economic reform and adjustment programme, the authorities requested assistance from the IMF in the form of a stand-by arrangement in an amount equivalent to SDR 380.5 million (about US$ 518 million), as well as drawings under the oil-import element of the Compensatory and Contingency Financing Facility of SDR 209.4 (about US$ 285 million), which were approved by the Executive Board of the IMF on 11 April 1991 and 15 March 1991, respectively.

In addition, the authorities requested complementary financial assistance from the Community and the Group of Twenty-Four to close the remaining financing gap, which was estimated at some US$ 1 billion. First indications from non-EC G-24 members regarding their participation in the overall effort to assist Romania were mixed. In particular, the United States indicated that it would not participate because of doubts about the depth and permanence of the political changes that had taken place.

In the circumstances, the European Council on 4 April 1991, agreed in principle to grant Romania a medium-term balance of payments loan for a maximum amount of ecu 375 million (equivalent to US$ 500 million), provided that a comparable amount was committed by non-EC G-24 and third countries, and that the issue of the depth and permanence of Romania's political reform efforts was clarified. The loan was to be disbursed in two tranches, the first tranche being subject to approval of the agreement by the IMF Executive Board, the second (to be disbursed in the fourth quarter of the year) subject to compliance with a number of performance criteria set out in the Memorandum of Understanding agreed between the Commission and Romania after consultation of the Monetary Committee.

The shortfall in non-Community pledges resulted in considerable delays in the finalization and in the disbursement of the assistance. The formal decision was adopted by the Council on 22 July 1991 (Decision 91/384/EEC) more than two months after the European Parliament delivered a favourable opinion on 16 May 1991. The conditions for the disbursement of the first tranche of ecu 190 million were in place in early August, when the need for matching commitments by other members of the G-24 was met (amounting to US$ 227 million). However, a lengthy budgetary process further delayed the disbursement of the first tranche. Against this background, a bridging loan from the BIS, equivalent to the first tranche of the Community loan, was extended in September 1991. In December 1991, the Council agreed on the release in due time of the second instalment of the loan despite insufficient commitment from non-Community members of the G-24. Eventually, the first tranche was disbursed at the end of January 1992, and, following the positive assessment in early 1992 of the fulfilment of the conditions attached to the agreement, the disbursement of the second instalment (ecu 185 million) was effected in April 1992. As of mid-1992, commitments by other members of the G-24 in support of the Romanian programme for 1991 amounted to US$ 237 million and disbursements totalled US$ 115 million.

The delays in mobilizing the necessary external financing from the Group of 24 further aggravated the difficulties for the implementation of the adjustment and reform programme that had already resulted from an external environment that was significantly harsher than initially envisaged, notably in regard to the greater-than-expected decline in trade with the ex-CMEA countries, especially the USSR. In the circumstances, the objectives of the 1991 programme with regard to growth, inflation and international reserves could not be achieved.

Despite these shortcomings, the Romanian authorities did implement the programme measures, including price and trade liberalization, cautious financial and income policies, fiscal and financial sector reforms and liberalization of the exchange system. In addition, the authorities introduced a series of important structural measures, with the aim of liberalizing private economic activity, privatizing state assets and building the legal and institutional framework necessary for the efficient functioning of a market-based economy. Even the political unrest in September only slightly delayed the unification of the official exchange rate, until November 1991.

The present report describes the evolution of the economic situation of Romania in 1991 and early 1992 with particular reference to the implementation of the conditions attached to the loan, including the disbursement of the second tranche in April 1992.

2. Macroeconomic Developments and Performance in 1991

The authorities' macroeconomic adjustment programme for 1991 aimed at limiting the fall in real GDP, stabilizing the price level after the elimination of price controls and moving towards a viable balance of payments situation, including an adequate build-up of external reserves. The authorities made significant progress in stabilizing the economy during most of the year, but the objectives for the whole year could not be achieved -- particularly with regard to inflation and international reserves -- because of the difficult external environment and the shortfall in external financing, and because of the relaxation of the hitherto tight monetary policy at the end of the year.

The original programme assumed zero real GDP growth. However, continuing external problems (including the effects of the collapse in CMEA trade and the shortfall in external financing) and the effects of the disorganization of the economic system led to a decline in GDP, now estimated at 13 percent in 1991.

As regards inflation, the original programme targeted the end-of-year rate of inflation at 15 per cent per annum (about 1 per cent a month). However, monthly inflation accelerated to about 10 per cent late in the year, and in January 1992 reached nearly 20 per cent, reflecting the sharp depreciation following the unification of the exchange rate and an accommodating credit policy.

Exports and imports were significantly less than originally projected. Exceptional financing from the Community and the G-24 amounted to only US$ 250 million compared with a planned US$ 1 billion. In addition, other capital inflows fell short of planned amounts. The decline in reserves of the banking system exceeded US$ 800 million during the year, compared with a planned decline of US$ 600 million.

2.1 <u>Output and demand</u>

Real GDP fell by 13% in 1991, following a 7.5% decline in 1990. The collapse in CMEA trade, the disruption of economic links with the Middle East because of the Gulf War, the obsolescent capital stock and energy shortages contributed to a 20.6% decrease in industrial production. Production fell in all sub-sectors of industry, with the biggest losses recorded in energy-intensive industries (chemicals, metallurgy, etc.).

Agricultural production declined by 0.6% in 1991, following a 2% decline in the previous year. Shortages in fuel, equipment and spare parts have prevented substantial increases in output and productivity.

Consumption declined by about 16% in 1991 as a direct consequence of the erosion of average real wages (-4.2%). Gross fixed investment fell by almost 31% in real terms, as a result of the sharp cutbacks in public sector investment. Investment by the private sector showed negligible growth in 1991 to reach 4.5% of total investment.

2.2 <u>Monetary policy</u>

The expansion of domestic credit from the banking system was kept under strict control through September 1991 (net domestic assets increased by less than 20 per cent relative to end-1990 broad money). However, weak financial discipline led to a rapid build-up of inter-enterprise payments arrears. Starting in October 1991, the National Bank of Romania began to allow an expansion of credit to enterprises to resolve the problem of inter-enterprise arrears, and in December, a law was enacted by Parliament, referred to as "the global compensation", calling for an additional expansion of bank credit to clear these arrears. The net amount of credit extended under the scheme was equivalent to about 12 per cent of GDP. Accordingly, the credit objective for end-December was exceeded by a wide margin.

2.3 Fiscal policy

The fiscal stance turned out to be tighter than planned. Some difficulties arose in tax collection during the last quarter of 1991, because of blockages in the payments system. The estimated outcome for 1991 was a deficit for the general government budget of about 2 ½ per cent of GDP on a cash basis, roughly in line with the planned deficit. However, after the global compensation operation was completed in January 1992, all outstanding tax arrears from the previous year were cleared. After this adjustment, the deficit amounted to only 0.8 per cent of GDP. The unemployment fund and other extra-budgetary funds recorded substantial surpluses.

2.4 External trade

In 1991, Romanian exports suffered from the virtual collapse of trade with the USSR. The main cause was a sharp contraction in demand for Romanian products, through supply disruption, including labour problems, shortages of imported inputs, and financing constraints also affected a number of exporters. As a result, total exports dropped to US$ 3.8 billion in 1991, from US$ 10.1 billion in 1989 and 5.5 billion in 1990. With all trade in transferable roubles ending at the beginning of 1991, except for the fulfilment of contracts from earlier years, exports in convertible roubles, which accounted for the equivalent of US$ 2.4 billion in 1990, were severely reduced. Exports in convertible currencies were almost unchanged from the previous year, despite a substantial liberalization of exports (in 1990, exports of food had been prohibited in order to supply the domestic market).

Imports recorded a severe compression in 1991, dropping dramatically to US$ 4.9 billion from US$ 8.8 billion and US$ 8.1 billion in 1990 and 1989 respectively. Imports in transferable roubles and under bilateral payments agreements, which accounted for the equivalent of US $ 4.0 billion in 1990, disappeared with the end of trade in transferable roubles. Imports in convertible currencies, which had benefited in 1990 from the reversal of the former import compression policy and the introduction of policies focusing on improving the population's standard of living, fell slightly in 1991. Imports, particularly of crude oil and natural gas, were hit hard by the decline in economic activity, financing constraints, and the general disarray in trading in the region, especially with the USSR.

3. The strategy and the achievements of the structural reform programme

The Romanian authorities designed a reform strategy to transform the economy rapidly into a market-based system. To this end, the government developed and implemented a legal and institutional framework to establish the central role of private ownership and decision-making. In this new environment, the role of the government is expected to be reduced substantially, in contrast to the virtually absolute control it had exercised over the economy before 1990.

By the end of 1991 the reform programme had achieved significant progress. Most prices had been liberalized, with controls continuing to apply only to a small list of products. Quantitative restrictions on imports had been removed, and tariffs used to protect domestic industries were reduced to low levels. Wage determination had been freed, with the institution of collective bargaining, although, for stabilization purposes, the government reserved the option to restrict overall wage increases. The financial system had been deregulated and banks were free to operate within the normal supervisory and regulatory limits. Citizens had been given the right to establish businesses, to compete freely in the market, and to acquire, retain and dispose of property. Finally, the Government was proceeding to transfer state assets to the population.

The reforms have also met with some setbacks. First, the exchange system since the rates were unified in November 1991 has not been functioning as envisaged. The lack of foreign exchange reserves has created expectations of sharp depreciation of the interbank rate, with the attendant adverse impacts on the price level, wages, and capital flows. To protect the economy from extreme volatility, the government supported the exchange rate through administrative measures in early 1992, before it recognized that this exchange rate policy was not sustainable. Second, while the government deregulated all interest rates as part of the financial system reform in April 1991, interest rates subsequently showed little movement and remained highly negative in real terms, largely because the Savings Bank exploited its monopoly position as a deposit-taking institution. Third, enterprise restructuring has not been as rapid as hoped, and lax financial discipline on enterprises in 1991 led to the accumulation of large inter-enterprise arrears.

3.1 Price liberalization

At the end of 1990, the government began a gradual price liberalization programme. In three steps taken in November 1990, April 1991 and July 1991, the Government liberalized most prices. By the third quarter of 1991 the share of free prices in the total value of sales had risen to 83 per cent for consumer goods, 88 per cent for capital and intermediate goods, and 70 per cent for raw and basic materials. The price liberalization allowed previously repressed prices to increase sharply and removed most of the monetary overhang. However, the government continued to subsidize staple foods and electricity throughout 1991.

In November 1991 the price regulations were further modified following the exchange rate unification. The prices of energy products (except some energy items for household use) were raised immediately, so as to pass through the price effect of unification. However, to prevent monopoly producers of intermediate products from using their market power to raise prices excessively, the government established rules for the setting of prices, allowable commissions and mark-ups, and price ceilings for 35 basic raw materials.

3.2 Exchange rate unification

The exchange market was unified in November 1991, and the formerly pegged official rate (of lei 60 per US$) was abolished. This action left the exchange rate to be determined by market forces in the interbank foreign exchange market, which had been established in February 1991. The foreign exchange bureaux that had been authorized since August 1991 for physical persons' operations could also, as of end-1991, participate in the foreign exchange interbank market through their correspondent banks. The new system also required 100 per cent surrender of foreign-exchange receipts to the banking system. The unified rate was initially lei 180 per US$, and it fluctuated between 180-200 per US dollar through the end of 1991.

Partly as a consequence of delays in external financing, a severe foreign-exchange shortage developed in the first months of 1992. In an effort to limit price rises in the light of the forthcoming wage negotiations, the Central Bank maintained the exchange rate at an overvalued level, forcing banks to ration foreign exchange. In the circumstances of an overvalued exchange rate and negative real interest rates, many exporters refrained from surrendering export proceeds, while importers experienced delays in obtaining foreign exchange from the banking system. Meanwhile, the central bank abolished access by the foreign exchange bureaux to the interbank market, and placed limits on purchases of foreign exchange by individuals. This action led to the emergence of a wide spread between the bureau and interbank rates.

3.3 Liberalization of the exchange system and foreign trade

Imports and exports of goods were substantially liberalized from 1 January 1991, since when they have been subject to automatic licensing, with the exception of a short list of prohibited items, controlled items and those subject to temporary quotas (mostly to restrain exports of goods still subject to domestic price controls). At the same time a number of changes were introduced to the tariff code, with the aim of reducing distortions. Generalized exemptions for production inputs used by the public sector were revoked. The highest tariffs were cut significantly. A new tariff code, with lower and less dispersed rates, was published in November 1991 and went into effect in early 1992. The average tariff is about 12 per cent.

All restrictions on invisible payments and transfers, including limitations on travel allowances and on the repatriation of profit, dividends and income, have been eliminated. A new foreign direct investment law became effective in May 1991. In principle, there are no limits on foreign equity participation in a commercial company set up in Romania. Foreign investments can be made in all sectors of the economy (except if they infringe on regulations designed to protect the environment, or affect Romania's national security and defence interests), and investors are allowed to repatriate all profits in hard currency after the payment of taxes. As of mid-1992, applications for foreign investment registered with the Romanian Development Agency amounted to an equivalent of US$ 387 million.

3.4 Privatization

The government has designed a far-reaching programme of privatization. This programme involves transferring to the private sector through sales or leases, state-owned enterprises, equipment and housing, as well as land held by agricultural cooperatives. Some 6,000 state enterprises have been converted into commercial enterprises since September 1990. The remaining state enterprises (about 320), operating in sectors considered strategic and called "regies autonomes", will be converted into commercial enterprises later, except for natural monopolies, such as utilities.

In July 1991 Parliament adopted a wide-ranging privatization law which was to be implemented by the recently created National Privatization Agency. The main pillar of the privatization process is the establishment of a "voucher" scheme, whereby all adult Romanian citizens are to be given, free of charge, 30% of indirect interest in state-owned commercial companies. This 30% will be transferred to five Private Ownership Funds, managed by professionals, while the remaining 70% will be transferred to a State Ownership Fund. The latter will gradually divest its holdings in the future until all commercial companies have been completely privatized. In the meantime, commercial companies will be prepared for privatization by increasing their efficiency through modernization and restructuring.

In a separate scheme, 30 companies from different sectors of the economy are to be rapidly privatized as part of a pilot privatization project which will provide a blueprint for other companies in their sector.

Privatization of small plots of farmland is well under way: nearly all co-operatives have been transferred to private hands while state-owned land is to be transformed into joint-stock companies and the shares distributed to farmers. About 40 per cent of agricultural land is currently in private ownership. Former landowners are expected to receive priority in acquiring state-owned farmland.

Finally, by mid-1991 about 50% of the housing stock and, by early 1992, a third of retail trade, had been privatized.

3.5 Financial system reform

Fundamental changes in the financial system and institutions started in 1990, when the establishment of private banks was allowed and banks were formally given the freedom to negotiate with economic units. In December 1990, a two-tier banking system was created by separating the commercial and central banking operations of the National Bank of Romania. At end-1991, the banking sector consisted of nine institutions, with the Saving and Loan Bank enjoying a dominant position for deposit-taking.

Deposit and lending rates were deregulated in April 1991 as part of the financial reform. In spite of these reforms, deposit rates subsequently showed little movement. By the end of 1991 interest rates on demand and time deposits were in the range of 8-14 per cent.

Concern that large spreads might develop between lending and deposit rates because of limited competition, led the Central Bank to impose limits on these spreads, which were removed in late 1991. In order to increase the cost of funds for banks, the Central Bank raised its basic refinancing rate in several steps, to 28 per cent per annum in January 1992.

4. Review of performance criteria attached to the EC loan

The Memorandum of Understanding signed by the EC Commission and the Romanian authorities after consultation of the Monetary Committee set out the quantified performance criteria and the structural adjustment criteria attached to the Community medium-term loan. The quantified performance criteria were identical to those in the stand-by arrangement with the IMF and included quarterly limits on overall credit and on credit to the government, quarterly minima for international reserves, and limits on the contracting of new medium- and long-term external debt by the public sector. The structural adjustment criteria were designed to evaluate progress with respect to the implementation of structural policies, with particular emphasis on the liberalization of prices, the reduction of trade and exchange restrictions, the establishment of a legal framework for private property rights and the privatization of enterprises. The successful review of progress in economic stabilization and reform, including the observance of performance criteria, was a condition for the release of the second tranche of the loan.

The review which took place in January 1992 concluded that the quantitative performance criteria were either met (based on end-September data) or waived by the IMF[1], and that the structural performance criteria were also broadly met. Price liberalization had been broadly completed, with a limited list of essential products still subject to price control. With regard to the foreign trade regime, there were no quantitative restrictions on exports and the number of products subject to export quotas had been significantly reduced. With regard to investment, free repatriation of profits and of the proceeds of liquidation of investment made by non-residents was legally permitted and investment protection agreements had been signed with nine member countries of the Community. The exchange rate had been unified in November 1991. Appropriate legislative provisions had been adopted concerning privatization, land reform, foreign investment and commercial law. Substantial progress in the privatization of land and housing had been achieved, and a timetable for the privatization of the bulk of public enterprises had been established.

With all criteria attached to the Community loan broadly met, the second tranche of the medium-term loan was disbursed in April 1992.

5. Developments in 1992

Drawing on the experience of 1991, the Romanian authorities have designed a programme for 1992 which aims to re-establish macroeconomic stability while advancing the reform process. With regard to stabilization policy objectives, the authorities intend to slow the decline in real economic activity (to 5 per cent), to curb inflation sharply (to 1.5 per cent per month by year end); and to increase international reserves (to the equivalent of 1.7 months' imports by year end). To achieve these objectives, the authorities will pursue strict fiscal and monetary policies, a tight incomes policy and a

1) The Executive Board of the IMF had to waive the non-observance of the performance criteria on net international reserves to allow four purchases under the stand-by arrangement in April, August and November 1991.

flexible exchange rate. Structural reform measures include further price liberalization, privatization, and financial discipline through restructuring state enterprises.

The recent measures undertaken in all key areas show the strong commitment of the government to the stabilization programme: the phased elimination of consumer subsidies began with an initial 25 per cent reduction on 1 May; the refinancing rate of the National Bank of Romania was increased to 80 per cent on 25 May in an effort to ensure that interest rates are positive in real terms; and the exchange liberalization started on 2 June, following the elimination of the 100 per cent surrender requirement a month earlier. The budget surplus during the first five months of the year and the moderate increase in money supply (4 per cent in January-April), further point to the implementation of a tight fiscal and monetary policy.

In support of their economic programme, the Romanian authorities have requested further Community and G-24 assistance, which would complement the resources available under the arrangement with the IMF that was approved in late May 1992. The amount of complementary assistance requested for 1992 was limited to US$ 180 million, largely owing to last year's shortfall in pledges and delays in the disbursement of commitments.

The Commission, as coordinator of the G-24 financial assistance, has supported the Romanian request and initiated discussions with non-Community G-24 countries with a view to ensuring the mobilization of the overall amount. There has been a general recognition of the eligibility of Romania for complementary G-24 financial assistance, and most countries revealed a positive attitude towards participation in the support scheme. The Commission has proposed for Council decision that the Community would participate in the financial support package from G-24 to Romania for approximately half of the amount requested.