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The IMF-Supported Programs of Poland and Russia, 1990-1994: Principles, Errors, and Results[1]

The paper discusses four IMF-supported adjustment programs in Poland, 1990-1995, and two in Russia, 1992-1994, in terms of the underlying theory, policy objectives, assumptions, policies, errors, and results. The paper suggests that the role of the IMF and the World Bank has been helpful and significant but, compared to the influence of domestic factors and local reformers, relatively modest. Transition-related features of the programs are the focus of the analysis. The specific topics include the choice of nominal anchors, the speed of disinflation, the choice of performance criteria, and the role of foreign economic assistance. *J. Comp. Econom.* June 1995, 20(3), pp. 316—346. London School of Economics and Political Science, London, WC2A 2AE, United Kingdom. © 1995 Academic Press, Inc.

Journal of Economic Literature Classification Numbers: E63, E65, P41.

The primary objective of this paper is to discuss the IMF-supported adjustment programs of Poland and Russia in terms of the underlying theory, policy objectives, explicit and implicit assumptions, proposed policies, major errors in assumptions and policies, and actual results. Throughout this discussion, the intention is to identify the influence of systemic features and transition circumstances. The analysis suggests that the roles of the IMF and the World Bank have been helpful and significant but more modest than generally presumed.

Part I of the paper provides a discussion of the broad policy objectives, common and separate, of the authorities of Poland, Russia, and the two Bretton Woods institutions, the IMF and the World Bank. Part II outlines the theory underlying the standard IMF adjustment programs. Part III collects and discusses what, according to this author, have been the major errors in assumptions and policies. The aim is to identify the origins and the implications of those errors. Part IV provides an analysis of the actual adjustment programs. The major feature of this analysis is the discussion of aims and results of the various programs. Finally, Part V addresses the issue of the role of foreign financial assistance in transition economies.

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I. Broad Policy Objectives

The main economic actors whose policy objectives I consider in this paper are the local reformers in Poland and Russia, the IMF, and the World Bank. The local reformers include above all the successive finance ministers and presidents of the central banks who are the main negotiating partners for the two Bretton Woods institutions (BWIs) and, often, actual policymakers. They and their aides and advisors are also the key policy designers. The governments, including the President in Russia, and the parliaments are the key institutional partners and formal policy makers. The immediate analytical problem, especially evident with respect to Russia, is the wide variation in views among reformers at any time and the considerable changes in their views over time. Some changes of objectives have also occurred on the part of the IMF and the World Bank. Nevertheless, at a very broad level, both local reformers and these two institutions have important policy objectives that have been common and stable. In terms of specific issues, there have also been distinct differences between the objectives of the IMF and the World Bank, and between these two institutions and the local reformers. Because I wish to comment on reform programs in terms of success and failure, and such an evaluation depends critically on the objectives of the program designers, the nature of these objectives is important.

1. Differences in Policy Objectives

At the level of broad and long-term objectives, the approaches of local reformers and the Bretton Woods institutions have been similar. These are expressed well by the first Polish letter of intent: ‘ ‘the sustained growth of output and living standards and the strengthening of our external position over the medium term ... are the ultimate goals of our efforts” (December 22, 1989, p. 1). The proposed strategy to achieve these goals had the familiar three, generally accepted, components: extensive and rapid liberalization of prices and trade, macroeconomic discipline, and market-oriented structural and institutional reforms, particularly privatization. Safety nets and external assistance were additional, supportive features. Most reformers, especially in Poland but probably also in Russia, would even agree with the IMF that ‘ ‘it has taken us far too long to shake off two dangerous misconceptions of the 1970s: first, that monetary stability and growth are at odds with one another; and second, that external financing – borrowing – is the best path to growth’’ (Camdessus, July 11, 1990). To meet popular criticisms, the Director of the IMF also explained that ‘ ‘we are striving to improve the design of our programs to ensure a better blend of adjustment, growth and equity,. . . we encourage governments to avoid raising taxes on the basic staples . . . and to protect critical social expenditures” (p. 4).

However, the traditional and central concern of the IMF has been neither economic growth as such nor equity but macroeconomic stability in the short and medium term. Its main role is that of the major global regulator of economic policy, acting on behalf of the common interests of all member states, particularly of the G-7 group, to assist in maintaining a proper international economic order. Its services are called

upon when that order is endangered, and Fund programs are designed specifically to assist in removing danger and restoring order. Hence, the core policy concerns of such programs are the restoration and sustainability related to external and internal macroeconomic equilibria. The policy objectives and the performance criteria are related to these concerns. The recipients of the IMF funds are typically central banks, not governments or enterprises, because the primary purpose of such loans is to strengthen the external position of a country during the adjustment period.

While the IMF is concerned mainly with creating the right macroeconomic conditions for growth, the World Bank is a development agency concerned with the promotion and financing of economic growth itself (Table 1). To fulfill this role, the World Bank aims to create the right economy-wide micro-economic conditions for growth, largely by promoting the liberalization of prices and trade, the removal of subsidies and excessive import tariffs, market competition, and privatization.

Table 1. Poland: credit lines of the world bank and their utilization until 31 January 1994

Name	Receiving in-stitu-tions	Approval date	Sum in million $US	Utilization in million $US				Cumulative utilization 1.01.1990–31.01.1994	
				1990	1991	1992	1993	In millions	In %
Ind. export develop.	NBP	6.II.90	260	10.1	17.7	12.0	20.4	60.2	23
Agricult. export develop.	NBP	6.II.90	100	14.9	9.1	32.4	15.0	71.4	71
Environmental management	G	24.V.90	18	0.5	0.4	6.5	3.0	10.5	58
Transport general	E	1.V.90	4.75		1.0	0.6	1.4	3.0	63
Transport railways	E	1.V.90	145		16.0	18.5	20.6	57.3	39
Energy resource develop.	G	5.VI.90	250		32.2	46.6	81.1	161.0	64
SAL	G	31.VII.90	300	28.4	270.9	0.7		300.0	100
Telecommunications	G	23.IV.90	120		24.3	23.2	1.8	49.2	41
Employment promotion	G	23.VI.91	100		2.0	3.1	0.1	5.2	5
Financial inst. develop.	G	11.VI.91	200			75.1	7.2	82.3	41
Privatization restruct.	G	11.VI.91	280		0.1	74.6	8.2	82.9	30
Agricultural develop.	G	11.VI.91	100			1.0	4.7	5.7	6
Heat supply restruct.	E	26.VI.91	285			47.5	25.3	73.2	14
Health	G	7.V.92	130						
Private enterprise develop.	E	7.VI.92	60						
Housing	G	25.VI.92	200				4.6	4.6	3
Roads	G	9.III.93	150						
EFSAL	G	4.V.93	450				27.7	100.0	33
ASAL	G	4.V.93	300				4.7	4.9	3
Forestry	G	29.VII.93	146						
TOTAL	Poland		3598.75					1071.3	30

Source. Poland's Ministry of Finance.
Note. NBP = National Bank of Poland, G = Government, E = Economy

The coordination of policies for transition economies between the two sister organizations, however, became somewhat of a problem. Institutional and other structural reforms are the core of the transformation, and they are neither macro nor microeconomic. In principle, these reforms were supposed to be the province of the World Bank, but the immediate problems in Poland, 1989-1990, and in Russia, 1992-1994, were those of stabilization. This initial primacy of macroeconomic issues gave the IMF the leading role in formulating conditions for all Western assistance, including

that of the World Bank. The policy interest of the IMF has consequently expanded over time to cover all economy-wide market-oriented structural reforms. Except on the occasion of negotiating the so-called Structural Adjustment Loan in Poland, in spring 1990, the role of the World Bank has been reduced to discussing sectoral adjustments and specific, government-supported investment projects.

Since September 1989, the Polish authorities have taken the view that the two institutions' long-term objectives coincide with the ultimate interests of Polish reforms so much that the success of those reforms could become for them an important policy objective in itself.[1]

A special problem for Poland was its large foreign debt. A very important and distinctive aim of the Polish reformers was therefore to enlist the international authority of the BWIs in supporting the case for a deep reduction of Poland's foreign debt, which was seen as a precondition of long-term external viability and growth. The eventual reduction of Poland's debt by about US$20 billion has been by far the dominant form of external financial assistance. The intermediary role of the BWIs, and especially of the IMF, in obtaining the reduction has been significant.

The first common objective of the governments of Poland and Russia was to gain the IMF's support in order to obtain international credibility for their proposed reforms. The second common objective was that of the central reform groups, based largely in the finance ministries and the central banks. It was to enlist the professional authority of the BWIs in supporting their policies within the government, above all, and to some extent also in the parliament and the country in general, in order to obtain internal credibility for the reforms. For this purpose, it was useful for the groups to stress, even exaggerate, to domestic audiences the importance of external assistance and the influence of the BWIs among Western governments, banks, and private investors. The third common objective was to secure new credits (Table 2). Finally, the missions of the BWIs represented international think tanks of highly professional experts who have been providing Polish and Russian reformers with systematic analysis of the two economies, helping them to identify major economic problems and to formulate specific policy responses. The fourth common objective was therefore to secure and benefit from the BWIs', and particularly the IMF's, know-how.

2. Policy Arguments and Controversies

Policy controversies in Poland between the BWIs and reformers concerned important issues such as energy pricing; the role of expectations in formulating the exchange-rate policy in 1990 (see footnote 9); the level of interest rates in early 1990; the methods for the financial restructuring of banks and enterprises in 1991/1992 (Kawalec *et al.*, 1994b); the form of wage policy in 1990; the choice of nominal anchors in 1991-1993 (see Section 2 of Part II); the speed of state-led commercialization and privatization, in particular the mass corporatization program in 1990/1991 and the mass privatization program in 1990-1994; the ideal level of subsidies; and the level of tariff protection.

[1] As in other countries, in Poland and Russia there were, of course, policymakers and legislators who were deeply suspicious of the BWIs' intentions.

However, most of the disagreements were either relatively minor or on relatively minor issues, and they were usually resolved by the BWIs accepting the Polish view.[1] Of overriding importance has been the agreement, initially much stronger in Poland than in Russia, that quick policy actions are required to liberalize prices and foreign trade, to impose a restrictive macroeconomic policy to discipline enterprises and stabilize liberalized prices, and to establish a process for fast privatization. Following the Polish experience, the common ground in Russia also included the acceptance of the view that a large fall in output might be an unavoidable consequence of the accumulation of inherited structural problems and a necessarily rapid pace of system transformation following the sudden collapse of the old political system.

Perhaps the most controversial issue has been the initially great emphasis placed by the IMF on a very rapid reduction of the inflation rate during transition. The IMF's view on that matter has been changing somewhat, but the initial position was that low inflation, while not sufficient, is nearly necessary to effect a transformation to a market economy successfully. A low-inflation environment was taken by the IMF to be a monthly inflation rate of less than 1%. It was deemed essential that this rate be achieved within one year of the stabilization effort. This particular policy aim was adopted by Poland for the end of 1990, and later for 1991. This initial view is the main reason that despite the large amount of progress in liberalization and privatization reforms in Russia, the IMF was most reluctant to support the reforms financially in 1992-1993. In hindsight, it is fairly clear that inflation need not be low for a system transformation to be successful.

The IMF is an institutional guardian of low inflation, and its credibility worldwide depends on how well that role is discharged. It may therefore have developed an institutional bias toward attributing excessive resource costs to high inflation and refusing to accept that, in conditions of extraordinary falls in output, which are a specifically transitional feature, welfare benefits arising from income redistribution from rich to poor, among both households and enterprises through the inflation tax may be sizeable and socially important. But it is an exaggeration to maintain, as Fortes (1994b) does, that "[t]he main trap ... was in the over-emphasis on macroeconomic policy itself." Fortes goes on to argue that it was wrong for the non-Fund agencies, e.g., G7, G24, the EC, and the World Bank, to make aid ' 'conditional on agreement to a stabilization programme with the Fund and thereby to put its priorities at the top of policy-makers' agendas" (p. 1184). Even if one accepts this assessment, as I am inclined to do with reference to the IMF advice for Poland in the years 1989-1991, macroeconomic stabilization is still an important aim to achieve fairly quickly. The destructive impact of high inflation is particularly high when inflation is caused by large subsidized credits to enterprises. A loose macroeconomic

[1] The IMF's technical expertise was still important in providing a critical consistency analysis of the Polish programs, particularly the stabilization program for 1990. The macroeconomic assumptions underlying the state budgets, the budgets themselves, and the policies to implement the programs were, with few exceptions, of Polish origin. Therefore the credit and blame for the results of the programs should go largely to Polish reformers rather than Fund experts. By and large the same applies with respect to Russia.

policy then interferes with needed structural adjustment, as was the case in Russia in 1992-1994.[1]

Table 2. Poland: credit lines from institutions other than the world bank, until 31 dec. 1993

Credit given	Credit taken	Credit	Equity capital	Utilization (%)
EBRD[a]	Private sector	264.0	75.5	7
IFCD	Private sector	158.1	32.6	7
EIB[b]	Economy	303.0	-	45
EBRD[a]	Government	165.5	-	1
IMF[c]	NBP			
(i) Standby 20.11.90- 14.11.91		545 (about $710)		60
(ii) EFF IV.91-V.93		1828.6 (about $2500)		16
(iii) Standby III.93-IV.94		475 (about $600)		80
G-24	Government	1000 (stabilization fund)		100

Source. Poland's Ministry of Finance, "Information concerning the utilization of foreign credits," mimeo, 23 February 1994.
[a] Million US dollars.
[b] Million ECU.
[c] Million SDR.

Still, in transition economies, relative prices need to undergo exceptionally large changes, and these are easier to accommodate when the inflation rate is fairly high, or at least moderate, for a while (Balcerowicz and Gelb, 1994). There may, therefore, be a case, in transition economies, for a more gradual disinflation path than the one the IMF so strongly insisted upon initially, a path of the type actually followed by Poland or one somewhat steeper: 3000% in 1989, the last five months of the year, on an annual basis; 249% in 1990; 60% in 1991; 44% in 1992; 38% in 1993; 30% in 1994; and about 25% expected in 1995, measured by within-year changes of the consumer price index. This view has recently been given support by several economists (Bruno, 1993; Dornbusch and Fischer, 1993; and Layard, 1994). Initial proposals for instant stabilization of liberalized prices also overlooked that, in the course of transition, a serious budget deficit problem tends to develop for good, transition-related reasons: a smaller tax base as economic activity shrinks, initially inappropriate tax systems, poor tax administration, and the growth of a shadow economy. In market-based economies, the cases of successful gradual disinflation from very high inflation rates have been rare, but Poland in 1989 and Russia in 1991-1994 did not belong to the category of true hyperinflation cases. The Polish and Russian experience suggests that the reasonable aim of stabilization policy should be to ensure that the annual inflation rate falls to some 20 to 40% in the medium term, during a period of falling output, and to below 10% during the recovery period. In 1994, Poland adopted the latter objective for 1997, primarily in order to reduce interest rates and stimulate investment but also to facilitate negotiations concerning Poland joining the European Union. For Poland to actually join the Union it will have to achieve a further reduction of inflation, probably to about 3% per year.

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[1] When inflation is not fully anticipated, which may have been the case in Russia in 1992, subsidies to enterprises financed by central bank credit creation tend to raise real purchasing power and therefore help to sustain old output (Kierzkowski *et al*., 1994, p. 33).

II. The Conceptualization Of Policies And Performance Criteria

The standard IMF program has five interconnected components: fiscal, monetary, external balance, incomes, and structural and institutional changes. It sets principal policy aims and formulates policies in all five areas to achieve its aims. Given initial conditions and some behavioral and other assumptions, it also formulates performance criteria for the purpose of monitoring the program's implementation.

1. The Macroeconomic Consistency Conditions

Using standard notation, a demand-driven macroeconomic model may be written in the form of ten equations,

$$Y = C(Y_d, M/p) + I(\Pi/p, r) + G + X(p_q) - p_q Q(p_q, Y), \quad (1)$$

where $p_q = ep^*/p$, the ratio of foreign to domestic prices, e is the exchange rate, r is the interest rate, Π is profits, F_d is disposable income, I is investment, X is exports, and Q is imports, all in real terms;

$$Y_d = Y_d(Y, T/\mathrm{p}, r) \quad (2)$$
$$T = T(pY, \mathrm{IT}, \text{tax rates}) - \text{transfers} \quad (3)$$
$$\Pi = pY - wL(Y) \quad (4)$$
$$M_d = V(r, i^e)pY \quad (5)$$
$$M_s = eR + \int(pG - T)dt + K(r), \quad (6)$$

where T is net government revenue, w is the wage rate, L is employment, R is the stock of net international reserves, K is the stock of bank credit to the nonfinancial sector of the economy, and i^e is the expected inflation rate; and

$$M_d = M \quad (7)$$
$$X - p_q Q + NCF = \Delta R \quad (8)$$
$$p = p(w, e, r) \quad (9)$$
$$w = w(p - 1, p^e, u, \ldots), \quad \text{or} \quad pMP_L = w, \quad \text{or } w = \overline{w}, \quad (10)$$

where NCF is the net capital flow, p^e is the expected price level, w is the unemployment rate, and MP_L is the marginal product of labor.

The ten endogenous variables in this model are Y, Y_d, Π, T, M_d, M_s, p, w, r, and either e, under the floating exchange rate regime, or R, if the exchange rate is exogenously fixed. In the system above, the variables influenced strongly by expectations, p^e and i^e, are regarded as given parameters.

In terms of our four macro components of the program, the relevant variables are:

fiscal: the budget deficit, $BD = pG - T$
monetary: r
external: e and R
incomes: w.

The quantity of money is endogenously determined:

$$M = eR + \int BDdt + K(r).$$

In order to stabilize quickly, the wage rate, w, is sometimes fixed or subjected to an incomes policy. In this case, under the fixed exchange regime, w and e are exogenously given and all the other variables of the model are functions of the two variables. In particular, given G, the rates w and e would determine the price level as well as the interest rate, the budget deficit, NIR (net international reserves), and the demand for credit, K, and for money, M.

2. The Question of Nominal Anchors

The preferred IMF approach in 1989-1991 was to have both e and w serve as nominal anchors of a stabilization program, as was the case in Poland in 1990. Therefore, the IMF felt at a loss in Russia in late 1991 when neither of the two variables could serve as an anchor. Given the virtual nonexistence of international reserves in Russia at the start of the transition in 1992, a floating exchange rate policy was accepted by the IMF as inevitable and superior to a fixed exchange rate combined with rationing of the foreign exchange by central authorities.

The budget deficit outcome is conditional on meeting the revenue target, T, and choosing the level of government spending, G. In transition economies, and especially in periods of high inflation, both taxes and government spending undergo large changes and it is they, rather than the exchange rate or the level of international reserves, that are under direct government influence. In such circumstances, the evolution of BD, bank credit to enterprises and households, and possibly of w decides the level of prices and the rate of inflation. In this case, the policy instruments remaining under the formal control of the Central Bank, such as the money supply, the nominal exchange rate, and the nominal interest rate, are decided to a large extent by developments that are outside of the Central Bank's control.

The argument in favor of using a fixed nominal exchange rate as the policy instrument for bringing the rate of inflation down rests mainly on the proposition that once the authorities are publicly and strongly committed to the policy, they would judge it politically less costly to make the required adjustments to fiscal policy, with an aim of reducing bank credit to the government, or to interest rate policy, in order to reduce credit to enterprises and households, rather than to devalue the exchange rate.

It is safe to adopt policies based on this proposition only when reformers enjoy considerable freedom of action, as they did in Poland at the end of 1989 and the beginning of 1990. In most transition economies and most of the time the political conditions are volatile and the freedom to act is limited. This author therefore promoted the doctrine that exchange rate policy in Poland should be subordinated to the needs of securing and maintaining external equilibrium, while fiscal, monetary, and incomes policies should address the inflation problem. The implication of this separation principle has been that the real exchange rate should be set at a competitive

level, though not excessively competitive, and should be stable. This has indeed been the policy in Poland since late 1991 (see also footnotes 5 and 9). The stability of the real exchange rate was achieved through the very transparent instrument of daily devaluations at a preannounced rate linked to anticipated inflation, with the exchange rate being corrected further when necessary by additional small and infrequent devaluations linked to past inflation. The policy has been adopted and maintained despite considerable and, given its primary responsibility for external equilibrium, somewhat unexpected misgivings by the IMF, which wished it to play a more active role in reducing inflation.

Portes (1994b) notes that, with respect to the exchange rate policy, "the trap was not early convertibility or fixed nominal exchange rates where these were implemented, but rather over-devaluation" (p. 1184). However, a large upfront devaluation in Poland and other countries brought about important benefits that Portes and other critics of the exchange rate policy actually adopted tend to overlook or undervalue: it protected domestic producers from excessive imports in the vital initial stage of transformation, and it stimulated exports at a time when domestic demand fell sharply and international reserves were low. A significant overdevaluation does have a major drawback in that it opens up a gap between world prices and domestic prices for tradeables. The consequence is that external competition can not help arrest a rapid increase in domestic prices in the period following devaluation, despite the fact that the nominal exchange rate remains constant (Williamson, 1991; Gomulka, 1993). For the exchange rate to be a truly effective nominal anchor, the magnitude of its undervaluation should not be excessive. If it is, there is either no solid anchor in place or that role is played by the money supply. In Poland, the money supply was a solid anchor only in the first quarter of 1990, while the exchange rate played the role of anchoring the price structure strongly only in early 1991. From that perspective, the upfront devaluation in Poland was clearly excessive, and it was even more excessive in Czechoslovakia and the former Soviet Union. However, the anchoring role is, in the initial phase of transition, less important than the benefits of a low real exchange rate mentioned earlier (see also footnote 5).

Portes also states that "there was insufficient clarity regarding the exchange-rate regime." In fact, it was assumed already in the autumn of 1989, though not stated in official documents, that a form of crawl might have to, and probably would, follow the peg once the real exchange rate appreciated to an appropriate long-run level.

When the central authorities set the interest rate at a level too low to bring the market for credit into equilibrium, which is often the case in transition economies, credit to enterprises is subject to an administrative limit imposed by the central bank. In this case, this credit limit, in addition to direct or indirect central bank financing of the budget deficit, is the second main nominal variable influencing prices and is in this sense a sort of nominal anchor. This has been the case in Poland in 1990-1991 and Russia throughout 1992-1994, where, however, both anchors were highly flexible.

3. Hazards in the Choice of Macroeconomic and Other Assumptions

The starting point for a macroeconomic program designer is usually the price path, specified in terms of the monthly inflation rate, in the course of the period covered by the Fund-supported program. Achieving the targeted price path is typically a principal short-term policy aim of the program. If it is a stabilization program, that price path would show a strong disinflation. Already at this stage of program design, the problem is to estimate correctly the unavoidable cost-push impact on prices of intended policy actions. This impact is largest at the start of transition and, as I discussed earlier, this is also the time when the choice of disinflation path represents the greatest hazard.

The second major step in designing a program involves the use of the Fisher equation to determine the quarterly changes in the quantity of money that are consistent with the targeted price path, Eq. (5) above. At this stage, assumptions have to be made about the level of real GDP and the velocity of money circulation. Again, in a period of systemic transformation, the risk is that the assumptions adopted are seriously wrong, as in Poland in 1990 and 1991 and in Russia in 1992.

The third step is to divide the available money increase between credit to the government, credit to the nonfinancial sector of the economy, and a change in the NIR, Eq. (6). The money increase thus represents a budget constraint. In order to decide on the uses of new money, it is essential to know the size of the budget deficit that would have occurred under the existing legislation, the likely net inflow of foreign capital, and the size of the so-called directed credit to economic units. During systemic transformation, major revenue and expenditure reforms take place, the level of economic activity changes rapidly, and fiscal discipline is difficult to maintain. Assumptions underlying the government budget are consequently often wrong by wide margins, as in Poland in 1990-1991 and in Russia in 1992-1994.

The fourth step is the consideration of detailed policy measures that appear to be needed to bridge the gaps between the targets implied by the three-way division made at the third stage of the permissible money increase and the likely outcomes in the absence of such measures. By the nature of things, these measures are focused on public finances.

To achieve consistency, the analytical framework cannot be a linear sequence of steps as outlined above but must be of a general equilibrium type. In particular, the original assumption concerning the targeted inflation path may be altered in view of the necessary policy measures implied by the analysis at stage four, and this may lead to the next round of program design.

4. The Inherent Tension between Strict Quantitative Criteria and Loose Quantitative Analysis

The choice of performance criteria by the B WIs reflects the strongly macro-economic and short-term orientation of the IMF and the microeconomic and medium-term orientation of the World Bank. The IMF criteria are typically few, quantitative,

and quarterly. The interesting feature of these programs is that the inflation rate is a policy objective rather than a binding target. This is in recognition of the fact that policymakers do not control inflation directly, and their indirect control is imprecise (IMF, 1986, p. 16). The key criteria are as follows:

(a) the upper limit for the cumulative change in net credit of the banking system to the general government;

(b) the upper limit for the cumulative deficit of the general government;

(c) the upper limit for the cumulative change in the net domestic assets of the banking system; and

(d) the lower limit for the cumulative change in NIR in convertible currencies of the banking system.

There may also be a limit for changes in average wages or wage funds in the socialized sector, and a limit on the contracting or guaranteeing of new external debt.

These criteria are not different in conception from those of the standard IMF program; they are, in fact, the same. This underscores my earlier point that, despite substantial interest in, and intensive policy discussions about, systemic transformation reforms, the inflation rate and the external position, and not these reforms as such, remain effectively the central focus of IMF programs for transition economies. The only significant concession for transition concerns the quality of programs as reflected in the reduced tightness of criteria. Of the three types of programs, the Extended Fund Facility, the Stand-By Agreement, and the Systemic Transformation Facility, the first is the most demanding and the last is the least demanding. Fund programs for economies in transition are usually of the latter two categories. The credibility of the IMF requires that it treats the agreed quantitative targets seriously. While waivers may be granted, the programs are usually suspended if limits are breached by significant margins.

III. Major Errors in Assumptions and Policies

Part IV of the paper discusses actual programs and their outcomes. However, it will be useful to collect and discuss briefly in this section the major errors in assumptions and policies. It will be evident that these errors are related mainly to the exceptional complexity of the transformation process, the influence that difficult to predict political developments have on economic policies, the presence of large uncertainties, and the limited experience of the program designers at the start of the process. In these circumstances the forecasting errors were virtually inevitable and these in turn influenced policies. Some errors (4, 7, and 9 listed below), however, were in policy design and implementation. Despite those errors, the Polish stand-by program for 1990 was successful on its own terms, but errors contributed to the failure of the Fund-supported program for Poland in 1991 and for Russia in 1992/93. The third Polish program, for 1993, was almost error-free and exceptionally successful. An important difference between Poland and Russia was that Polish programs were negotiated by authorities with the political will to implement them. Most programs for Russia, especially in the years 1992-1993, were proposed and accepted by the Russian authorities without adequate commitment to implement them.

Poland

Error 1. Assumptions concerning GDP growth:
–3.5% in 1990 against the actual –11.4%, and
+3.5% in 1991 against the actual –7.4%.

The so-called actual numbers above are, in fact, the official estimates of measured changes in GDP. The actual GDP declines were significantly lower than officially stated (Zienkowski, 1992). Nevertheless, these forecasting errors were probably large, especially for 1991, when the size of the collapse of the CMEA and the impact of that collapse and of the dollarization of trade on the former CMEA area were grossly underestimated. In the program for 1990, little attention was given to the other two phenomena that deepen the fall of output: the destocking of inventories and high savings of households. While these assumptions on GDP growth were made by the Polish Finance Ministry, they were accepted by the IMF.

Error 2. The assumptions concerning corrective inflation in the consumer price index, following price corrections and price liberalization, compared to the average prices of December 1989: 45% against the actual 79.6% in January 1990, and 75% in Ql, 1990 against the actual 133%.

The IMF team produced estimates, dated December 5, 1989, that predicted the following monthly inflation rates: 42.6% in January, 16.6% in February, and 4.9% in March, 1990. This prediction formed the basis for the choice of the disinflation path in the course of 1990 and the choice of the exchange rate in the Polish stabilization program for 1990. In view of the fact that both choices were very important and both have subsequently attracted strong criticism, it may be useful to give more details of the underlying analysis. The estimates of the IMF team were based on the following assumptions:

The Ql, 1990 price effect of excess liquidity was to be 20%, the excess being absorbed by coal and other energy price increases, 12% in January, 5.4% in February, and 1.7% in March.

The coal price increase would be 500% and the gas increase 200% in January; these were approximately the actual increases.

The January wage increase would be equal to inflation minus the impact of exchange rate adjustment. Wage levels would remain fixed in February-April and then would be indexed on inflation of the same month with the 70% coefficient from May. This assumption was approximately correct, except for January, when the wage increase was much lower (see footnote 9).

The new exchange rate would be 9706 zloty to the dollar, the result of adding up the December unification level of 5888, export incentives due to be removed, 430, the effect of January inflation, 2505, and a 10% safety margin of 882 zloty. The actual rate chosen was 9500.

The wage increase was assumed to be 26.5% in January, but its contribution to inflation would be only 4.3%, and then 2.1% in February and 0.7% in March.

The cumulative Ql, 1990 price impact of devaluation was thought to be 24%, 14.4% in January, 6.3% in February, and 2% in March.

At the request of the Polish authorities, I discussed these projections with the IMF's team on December 6, 1989. My notes show that I proposed corrections, including the price impact of wage increases that were three times higher, energy price increases that were twice as high, no impact of the stock excess demand, which I assumed to be already nonexistent, but an impact of the flow excess demand of 10% in January, which implied the following inflation rates: 70% in January, 30% in February, and 10% in March. The actual rates were 79% in January, 24% in February, and 4.7% in March. My projection for Ql, 1990, was therefore close to the actual outcome, 143% against the actual 133%. The actual wage increases were lower than assumed by both sides in these discussions, while neither side took full account of the cost-push impact of sharp increases in interest rates and depreciation rates or the December 1989 devaluations. It is quite clear that both sets of estimates were little more than educated guesses, but the IMF showed a strong tendency to come up with low estimates for corrective inflation.

The much lower IMF-projected inflation rates were seen by the Polish side as probably unrealistic, but they were accepted nevertheless as a built-in safety margin of the program. The point was that some expenditures of the government budget and money supply targets of the Central Bank would have to be increased if the projected inflation rate were also increased. The actual fiscal and monetary policies were consequently, in the first half of 1990, much tighter than in the program, and so helped to increase exports and achieve the targeted disinflation path, though probably at some cost in the form of reduced output (IMF, 1990b; Gomulka, 199lb).[1]

[1] On December 7, 1989, the IMF team produced the so-called Alternative 2 projection, in which the impact of price liberalization, including energy price rises, was increased from 20% to 40% in Ql, 1990. The impact of wage rises was also increased somewhat, hi this scenario, prices would rise 53% in January, 21% in February, and 6.6% in March, giving a total increase, in Ql, of 97% and an exchange rate of 10,385 zl to the US$. That alternative was eventually dropped as too pessimistic. The Polish program was later often criticized for adopting an excessive devaluation of the zloty. The Polish Ministry of Finance, on the strong advice of the Ministry for External Trade and with the support of the Central Bank, assumed initially that the new exchange rate would be 10,500 zl. and that it would be fixed until April 1990 and then progressively increased to 14,500 zl. by the end of 1990. In a note to Leszek Balcerowicz, dated December 4, 1989, Michael Bruno, at that time Governor of the Bank of Israel on a visit to Poland, suggested that there may be no need to devalue, or there may be a need for only a small correction, at the launching of the stabilization program. The suggestion would imply a rate of about 6500-7000 zloty per US dollar. The note influenced the correction of the Polish original intention and the choice of 9500 zl as the rate, which happened to be also the IMF's original suggestion: their Alternative 1. Bruno's suggested rate would probably have been sustainable for much of 1990, and may possibly have been a superior choice, although the actual choice was in my view justified by the urgent need to increase international reserves and to provide a safety margin for the program. In December 1989 about 2/3 of broadly defined money was in the form of dollar deposits and the macroeconomic credibility of the authorities was poor. In these circumstances dollar reserves and the safety margin were far more important considerations than the inflationary or even recessionary impact of a potentially excessive devaluation; the latter was stressed much, but without evidence or estimates, by several critics of the chosen exchange rate (Kolodko, 1992; Lutkowski, 1994; Portes, 1994b; and Rosati, 1994). For further discussion, see Sections 11,2 and IV,1.

Error 3. The misinterpretation of the reasons for large taxable statistical profits in 1989 and 1990, the consequent large underestimation of holding gains during that period, and a large overestimation of taxable profits in 1991.

These matters are discussed best in Schaffer (1993). The presence of holding gains was known in principle, but the absence of good data on inventories prevented the Polish/IMF program designers from coming up with a credible estimate of any gains or their impact on profits and budget revenue. In the absence of such estimates, a popular hypothesis in 1990, later abandoned, was that very high profit margins and sharper-than-assumed output falls reflected the monopolized market structure.[1]

Error 4. The reforms of the pension system in 1990-1991 which led to an explosion of social transfers in 1991-1994.

It was overlooked that a backward-looking indexation rule, linking current changes in transfers to past changes in wages, would result in a sharp increase in the ratio of benefits to wages with the progress of stabilization. Also, the criteria for early retirement and disability pensions are too liberal, and this resulted in a sharp increase in the number of pensioners (Gomulka, 1993; Barbone, 1994).

Errors 3 and 4 were large enough to set the stage for the fiscal crisis in 1991-1992, the collapse of the EFF programme in the middle of 1991, and severe fiscal problems in 1992-1994.

Error 5. The targets for state-driven privatization were initially excessively optimistic.

However, an explosive growth of the original private sector has largely neutralized the negative impact of that particular error on the assumed growth of the private sector (Rostowski, 1993; Gomułka and Jasiński, 1994).

Error 6. The Extended Fund Facility (EFF) program for 1991-1993 assumed a hugely optimistic growth rate of 15% per year for the level of investment activity.

In 1990 the perception was that the recovery in output would be led by investment and net exports (Gomulka, 1990; Republic of Poland, 1991). It was overlooked that after large falls in output and real incomes, recovery is likely to be consumption led. The Polish government programs for each year of the period 1991-1993 continued to call for a redistribution of expenditure from private consumption to investment and net exports, but the actual developments had each year moved in the opposite direction. This changed only in 1994, when the classical model of recovery and growth began to apply.

[1] This view was particularly popular at the IMF as well as among the domestic critics of the government program. According to Camdessus (1991), "The decision to free prices (at a stage in the reform process when large state enterprises had not yet been either privatised or split up into competitive units) may have allowed some state enterprises to exercise the monopoly power they already had." This statement is probably correct but Camdessus goes on to claim that "[t]his may explain why prices rose more than expected in 1990, despite tight monetary policy," which appears to regard the monopolized market structure as the principal reason for the error.

Errors 7 & 8. The exchange rate was kept fixed for several months longer than needed and import tariffs were increased in August 1991, instead of at the beginning of 1991 as initially planned.

These two policies may not have been errors in the long term since they promoted competition and structural changes. Nevertheless, in 1991, they must have accentuated the fall in output and contributed to the budget deficit.

Russia

Most errors in Russia were in implementation rather than in design. The Russian IMF team from late 1991 on included several experienced members of the earlier Polish IMF teams, but the IMF's impact on policy implementation in Russia, especially in the years 1992-1993, was clearly less substantial than in Poland. This changed in late 1993 and in 1994.

Error 1. An initial error of the Gaidar Plan was again a vast underestimation of corrective inflation in January, 1992, which was assumed to be 100% against the actual 245%.

The assumption was influenced by the advice of the IMF team, which itself was influenced by the analysis of Mario Blejer (1991, p. 5). The analysis appeared to be careful, with many caveats, but it concluded that "the initial rise in the price level needed to restore *stock* balance to the money market should not exceed 70-75 percent." The IMF team suggested that the increase would be 50%. An internal estimate by the Russian Economics Ministry, based on unit cost analysis, was of an increase of about 200%. This appeared vastly excessive and was rejected in a written directive to the Budget Group of the Finance Ministry by Gaidar himself. The error was not fatal by any means, but it was large enough to undermine significantly the credibility of the first Gaidar budget for Ql, 1992.

Error 2. The IMF's initial support for a common currency and a monetary union spanning most of the FSU was a policy mistake that betrayed a technocratic bias and political naivete or insensitivity.

The proposal was intended to limit the inflation rate by providing "a set of rules for a coordinated monetary policy" (Hernandez-Cata, 1994). An additional outcome of the proposal, if adopted, would have been a lower trade shock and a lower fall in output. However, the proposal could not be accepted by Russia without its central bank controlling fully the credit expansion by the non-Russian members of the ruble zone, and such control would be at variance with the aspirations for independence of most of those members (Odling-Smee, 1992). The prolonged existence of the ruble zone did probably limit the trade shock, but it also contributed to the budgetary problems of Russia.[1]

[1] On July 1, 1992 Russia discontinued the automatic extension of CBR credit to other central banks of the FSU. This accelerated the introduction of separate currencies. The CBR's withdrawal of the pre-1993 ruble notes in July 1993 and the elimination of subsidies from the Russian Government to other republics in the second half of 1993 led to the end of the ruble area.

Error 3. As mentioned earlier, strong emphasis by the IMF, bordering on single-minded concern, was placed initially on inflation and macroeconomic policies, while little recognition in the terms of the formal performance criteria, as opposed to policy interest, was given to key transformation-related reforms in liberalization, institutional change, and privatization.

Even the major improvement in the external position of the country was not recognized early enough or properly. The IMF's 1993 Systemic Transformation Facility of US$4 billion was a financial innovation intended essentially to redress the imbalance.[1]

IV. Programs and Outcomes

This section discusses briefly six IMF-supported programs, four for Poland and two for Russia, in order to identify their distinct features and purposes.

1. The Polish Stand-By Program for 1990: A Conditional Success?

This program, which was extremely important for both Poland and the IMF, had a number of unusual features (Republic of Poland, 1989). They were directly linked to the launching of a radical reform in crisis circumstances and the absence of any similar experiences for policy designers. The main paradoxical feature of the program was that many of its important assumptions and policy aims were missed by wide margins, yet all of its six performance criteria were comfortably met during most of 1990, allowing Poland to draw three tranches of the total support granted out of the four available. Compared to the initial assumptions, the output fall was much larger, yet the fiscal out-turn of the general government, including extrabudgetary funds, was much better, resulting in a 3.1% GDP surplus instead of 0.6% GDP deficit; the surplus was particularly large and clearly excessive, about 8% of GDP, in the first half of 1990. The exchange rate had held throughout the period yet consumer prices increased by 250% rather than the assumed 94%, and despite the large appreciation of the zloty, the trade surplus was much higher than assumed (Table 3). All these developments have good ex post explanations but were wholly surprising for the program designers, both Polish and IMF. Another surprise was that two major concerns of the designers proved to be misplaced. These were the rules for indexing the wage norm in the first six months of the program, particularly in the first month, and whether a public and binding commitment could be made by the Polish authorities to defend the exchange rate at a fixed level for a specific period of time, e.g., 3, 6, or a full 12 months.[2] For the IMF, a satisfactory agreement about these two matters was seen

[1] Supporting the G-7 proposal for an exceptional program of assistance to Russia, the World Bank has an Accelerated Program of lending which also amounts to US$ 4 billion. The Bank's Rehabilitation Loan of US$ 0.6 billion, approved in 1992, belongs in the same category.

[2] Under the terms of the incomes policy operating in 1990, most enterprises paid a large penalty if the average wage or the total wage costs exceeded the enterprise-specific wage norm. The effectiveness of the policy in bringing inflation down depended crucially on the choice of the coefficient

as crucial for the success of the entire program. Discussions of these issues, especially the exchange rate policy, were therefore both intense and time consuming. In any event, the much tighter than planned actual fiscal and monetary policies, largely the automatic result of Errors 2 and 3, and a deeper than expected fall in output, rendered the two issues irrelevant for the critical first half of 1990.

In retrospect, given the novelty of the systemic circumstances and the initial crisis conditions, the program served its role of a clear and broadly consistent declaration of intentions remarkably well with respect to the transition policies. The built-in safeguards and errors of the program resulted in a stop-go sequence of policies that proved more pronounced than desirable, but this feature was secondary compared to the large achievements (IMF, 1991; Gomułka, 1991, 1992, 1993a; Rosati, 1993). Some critics of the actual policies conducted in 1990, notably Kołodko (1993), stress excessive overshooting in the first half of 1990. However, some overshooting should be an important feature of any good stabilization program. Poland's overshooting in the first few months of 1990 was probably excessive. This was recognized by the end of April 1990 when the reasons for a large overfulfillment of all the performance criteria for Ql, 1990, were discussed by Balcerowicz and his top advisers on the Polish side and the IMF. A correction of the policies was subsequently made for the second half of 1990.[1] Industrial output in the second half of 1990 was about 15% higher than in the first half, but part of the increase was due to seasonal factors. Pointing to the large welfare costs of the first Polish program therefore seems wrong, especially in

linking changes of wage norms to inflation. The lower the coefficient, the lower would be the scope for compensating workers for past inflation, and therefore also a faster rate of disinflation. Two broad options were considered by the government. The initial option assumed the coefficient to be close to 1 in the first month of the stabilization program and 0.7 thereafter. The subsequently preferred option assumed the coefficient to be close to 0.5 in the first month (0.3 was in fact chosen) and 0.2 in the next three months, followed by 0.6 thereafter. The IMF was prepared to accept at most 0.5 for the first few months of the program. The Polish second proposal was therefore wholly acceptable to them and became part of the program.

Although the setting up of a $1 billion stabilization fund by the G-24 was proposed already in September 1989, both the Polish Government and the IMF were uncertain that it would actually be set up. It was set up only at the end of January 1990 from contributions by 10 countries. Nevertheless the IMF was insisting very strongly during the October-to-December 1989 negotiations that, in order to break the inflationary expectations of the population, the exchange rate should be fixed for a period of at least 3 and possibly up to 12 months, and a public commitment to defend the rate should be made by the Polish authorities. The Polish side argued that a mere public announcement by the government carries little weight in Poland, and that the fate of the exchange rate will be decided instead by the actual fiscal, monetary, and incomes policies. Despite large uncertainties, the intended policies seemed strong enough and the initial devaluation seemed large enough for the Polish negotiators to accept, as a policy aim, the preservation of the fixed exchange rate for (at least) the first three months.

[1] The pressure for correction came mainly from within the Government and the Central Bank. Among top advisers, only this author argued for a controlled relaxation. In the event, relaxation proved stronger than desirable, partly because of the impact of the presidential election in December 1990 on wages. This forced the authorities to tighten monetary policy sharply at the end of 1990 and the beginning of 1991, which in turn may have accentuated somewhat the recessionary impact of the CMEA collapse in the first half of 1991. The IMF was not consulted about these policy changes.

view of the still larger output falls that occurred in the postcommunist countries that adopted a much more gradual approach in their macroeconomic policies, including Hungary and most of the FSU.

2. The Polish EFF Program for 1991—1993: A Failure That Served a Purpose?

This three-year program was meant to be a successful follow-up of the first stand-by (Republic of Poland, 1991). However, the Errors 2, 3, and 4 discussed in Part I, Section 3 led to its suspension only a few months after approval on April 18, 1991.[1]

Table 3. Poland: selected economic indicators, 1988-94 (percentage change unless otherwise indicated)[a]

	1988	1989	1990	1991	1992	1993	1994
Domestic indicators (in real terms)							
Gross domestic product (SNA basis)	4.1	0.2	-11.6	-7.6	2.6	3.8	5.0
Consumption (SNA basis)	2.6	6.1	-11.7	3.3	3.5	4.6	3.1
Gross fixed investment	6.1	-2.1	-10.6	-4.5	2.8	2.9	6.0
Consumer prices (period average)	60.2	251.1	585.8	70.3	43.0	35.3	32.2
Consumer prices (12 months increase)	72.9	639.7	249.3	60.4	44.4	37.6	29.5
Average monthly wages (period average)							
nominal	81.9	291.8	398.0	70.6	39.2	33.6	36.3
Fiscal indicators (in percent of GDP)							
State Budget revenue	35.6	30.8	33.3	25.7	27.0	29.6	29.7
State budget expenditure[b]	37.0	36.9	32.7	32.7	33.9	32.9	32.4
State budget balance[b]	-1.4	-6.1	0.7	-7.0	-6.9	-3.4	-2.7
General government balance[b]	-	-7.4	3.1	-6.5	-6.7	-2.9	-2.5
Monetary indicators (end of period)							
Net domestic assets[c]	127.3	192.3	38.4	142.0	35.6	21.7	22.5
Money and quasi-money	133.0	236.0	121.9	47.4	57.5	36.0	37.6
External indicators in convertible currencies (in terms of U.S. dollars)							
Exports[d,e]	17.6	4.5	43.4	17.5	9.7	-2.9	25.0
Imports[d,e]	23.1	16.3	17.9	46.9	6.1	17.7	11.0
Trade balance							
In billions of dollars	0.9	0.2	2.2	0.1	0.5	-2.3	-0.8’
In percentage of GDP[f]	1.4	0.4	3.6	0.1	0.6	-2.7	-0.9
Current account							
In billions of dollars	-0.6	-1.8	0.7	-2.2	-0.3	-2.3	-0.9
In percent of DGP	-0.8	-2.7	1.1	-2.9	-0.3	-2.7	-1.0
External debt (end of period)[g]							
In billions of US dollars	39.1	40.2	48.9	48.3	47.6	48.7	46.2
Ratio to exports of goods and nonfactor							
services in convertible currencies		4.8	4.0	3.3	3.1	3.2	2.4
External debt services ratio[h]							
Due	85.0	61.6	56.3	71.5	20.0	21.5	14.0
Paid	20.0	16.0	6.9	6.6	9.9	11.2	—

Sources: Central Statistical Office, *Rocznik Statystyczny*, data provided by the authorities, and Fund estimates.

[a] In the five main areas of the socialized sector through 1990; thereafter in the six main areas of the economy.

[b] On a commitment basis, except external interest, which is on a cash basis.

[1] Poland had already breached the criteria for June 1991. The negotiations of new criteria for the second half of 1991 and 1992 were not successful. However, the financial assistance by the World Bank was not halted. Moreover, Poland did not need the IMF's money during those two years. The IMF's tough stand in 1991 enhanced its credibility and helped to negotiate and implement sensible policies for 1993.

[c] In relation to broad money at the end of the previous year.
[d] Balance of payment basis.
[e] Including transactions with former CMEA area for 1991 and 1992.
[f] Gross domestic product in zloty terms is converted into US dollars at the commercial exchange rate.
[g] Including arrears in the Fund.
[h] In percent of exports of goods and nonfactor services in convertible currencies, including the Fund.
[i] If unrecorded trade is included, the trade balance in 1994 was probably positive.

In early 1991, the flaws in the program were already apparent, but there was no time to renegotiate it because, on March 18, 1991, the Paris Club offered Poland an immediate 30% debt reduction, conditional only on its having a Fund-supported economic program. The condition was met on April 18, 1991, and the reduction was granted on April 19, 1991. The EFF therefore served an important purpose.

3. The Polish Stand-By for 1993: A Model of Success?

Errors 2, 3, and 4 mentioned above led not only to the suspension of the EFF program, they also produced a threat to the progress of stabilization in the form of a large budget deficit. Despite corrective measures, the deficit of the general government reached 6% of GDP in 1991 and 7% in 1992 (Table 4). The deficits were financed to a large extent by monetary expansion and, by 1992, became the main source of inflation. In the meantime, the Paris Club accepted that Poland would qualify for a further 20% reduction of the official debt if it ran a successful Fund-supported program in 1993. Reaching an implementable agreement with the Fund therefore became essential. This was made easier by the more flexible position displayed by the IMF in 1992. Influenced probably by the course of events in Hungary and elsewhere in eastern and central Europe, the IMF increased its tolerance level for the budget deficit and the inflation rate. Moreover, to ease the deficit problem, the organization offered to support the Polish case for an import surcharge. However, a package of strong fiscal measures, amounting to about 5% of GDP of new tax revenues and expenditure cuts, was proposed by Polish authorities, not the IMF. The package reflected the outcome of an internal policy debate within the government and the country about the potential net costs and risks associated with a large budget deficit.[1] To increase the chance of success, the program for 1993 was based on conservative fiscal assumptions (Republic of Poland, 1992). Its success was also aided by an economic recovery that was stronger than assumed. In any event, all performance criteria were met comfortably and in a manner that should help the progress of recovery and stabilization in the postprogram years.

[1] A first draft of the package was written by this author in August 1992. The package was then, with some modifications, adopted by the Board of the Finance Ministry and incorporated into the Budget for 1993. It was approved by the Government in December 1992 and by the Parliament in February 1993. The critical role in pushing the package through was played by Jerzy Osiatynski, the Finance Minister. For details of the package, consult Republic of Poland (1992) or Gomulka (1994a).

Table 4. Poland: consolidated revenue and expenditure of the general government[a] (in % of GDP)

	1989	1990	1991	1992	1993	1994	1995
Total revenue	41.4	43.0	42.3	43.8	47.6	46.5	47.7
Tax revenue	35.5	37.2	35.3	36.4	39.1	39.5	39.4
Personal income tax	3.4	3.0	2.9	7.1	9.0	9.5	9.7
Social security contributions	9.1	9.0	9.8	9.7	9.4	10.0	9.8
Profit tax	9.7	14.0	7.3	4.4	4.2	3.3	3.1
Popiwek	1.8	1.5	3.4	1.5	0.6	0.2	—
Turnover, VAT, excises	8.8	6.3	7.6	9.0	11.4	11.5	13.0
Import duties	—	0.6	2.1	2.3	2.8	2.3	2.0
Nontax revenue							
Dividend	1.7	2.2	1.6	0.7	0.4	0.3	0.5
Central bank transfer			0.8	0.9	0.9	1.1	1.3
Capital revenue	—	—	0.2	0.4	0.8	0.9	1.2
General government total expenditure[b]	48.9	39.8	48.9	50.4	50.5	49.0	50.7
Current expenditure	38.9	33.2	45.3	47.0	47.3	45.9	47.7
Subsidies to enterprises			5.1	3.2	2.3	2.0	1.8
Transfers to households[c]			17.4	19.9	20.6	21.3	22.4
Interest payments	—	0.4	1.6	3.2	3.4	4.0	5.3
Other current expenditure[d]	—	—	21.3	20.6	21.0	18.5	18.2
Overall balance	-7.5	3.1	-6.7	-6.6	-2.9	-2.5	-3.1
Financing	5.4	-2.8	6.7	6.6	2.9	2.5	3.1
Domestic	5.6	-2.7	5.2	7.1	3.0	2.9	3.4
Banking system	5.2	-2.8	5.1	6.6	2.3	2.1	2.8
Nonbank	-0.4	—	0.1	0.5	0.7	0.8	0.7
Foreign	-0.3	-0.7	-0.1	-0.2	-0.4	-0.5	-0.4
Increase in arrears, net[e]	2.0	-0.3	1.6	-0.6	0.3	0.1	—
Other	0.1	0.6	—	0.4	—	—	—

Sources: Polish authorities and Spring 1995 Fund staff estimates. Data for 1994 are preliminary, for 1995, from budget projection.
[a] Comprising the state budget, extrabudgetary operations, and local government operations.
[b] On a commitment basis except for external interest payments, which are on a cash basis.
[c] About three quarters of these transfers are pensions.
[d] Included in other current noninterest expenditures for 1989.
[e] Expenditure arrears to the bank and nonbank public that were not converted into treasury bills.

4. The Polish Stand-By for 1994-1995: A Macroeconomic Success but a Structural Failure?

The fourth Polish/IMF agreement was for an 18-month program to run from July 1994 to December 1995 (Republic of Poland, 1994). It was also linked to a debt-reduction agreement, but this time with private banks represented by the London Club. To implement it, on 27 October, 1994, Poland needed $1.9 billion, of which $0.9 billion was provided by the IMF and $0.4 billion by the World Bank.

The program itself was innovative in that it placed strong emphasis on several structural and systemic reforms. Two such reforms were considered particularly important: implementation of the long-delayed mass privatization program for 444 large enterprises and a politically sensitive change of the pension indexation rule, linking periodic adjustments to a consumer price index rather than to wage developments. Positive government decisions on both reforms were given the status of "specific benchmarks against which progress in implementing the stand-by arrangement would be assessed at the time of the first review" (Republic of Poland, 1994).

Although the Polish Government accepted the arrangement, the implementation of the two politically sensitive reforms was held up in 1994.[1] This put the credibility of both the Government's ' 'Strategy for Poland'' and the IMF's qualitative conditions to the test. The noncompliance with these conditions on time was overlooked, the IMF falling back once again on the usual five quantitative criteria, which were all met in 1994, and on public assurances by the government that the two reforms would eventually be implemented.

5. The Russian Experience: A Macroeconomic Failure but a Transformation Success?

There has been much confusion about what kind of strategy Russia has followed and much discussion about policies that the country should follow— less shock and more therapy? or more shock and more therapy? Was the strategy excessively gradual? With respect to macroeconomic policies, why have they been so inflationary? Were they irrational?

From the perspective of a student of systemic transformation, there is much evidence in favor of the view that Russia in its own chaotic manner has followed a very radical reform, as documented in IMF (1994d). The main components of that reform have apparently been implemented. A fast liberalization of most prices, at least at the federal level, has permitted the replacement of central planning by market coordination. The liberalization of the foreign exchange market and internal convertibility of the ruble improved the mobility of resources and the quality of prices. A considerable foreign trade liberalization has led to large shifts in the geographical and product composition of trade. The size of the initially overblown defense sector has been much reduced. A large progress in privatization and other systemic, structural, and institutional changes have also taken place. A deep fall in industrial output, by some 50%, may be taken as indirect evidence of the substantial volume of painful reforms that have been implemented, although a longer and deeper recession than that experienced in Poland is also related to a much smaller private sector at the start of transition (Goldman, 1994). Moreover, the floating exchange rate policy led to an extremely deep real devaluation, and this in turn has produced a fairly strong improvement in the external position of the country.

Russia's reforms have been gradual, elusive, and controversial, mainly with respect to inflation (Hernandez-Cata, 1994). The country's inflation crisis has been due almost entirely to the monetization of large budget deficits and even larger subsidized credits to enterprises (Easterly and Cunha, 1993). In this respect, the sharp differences in public spending between Poland and Russia in 1992 are worth noting: much higher spending in Russia on defense, 6% versus 2%; producer and import subsidies, 10% versus 3.2%; subsidies to the former republics of the FSU, 5% versus 0%; but

[1] The mass privatization reform became politically sensitive once it assumed a leading role for foreign management groups. That role had been proposed already in 1990 (Frydman and Rapaczyński, 1990) and accepted by the Polish Parliament in 1993, subject to modifications. It was possible for the Prime Minister to delay the implementation of the reform on, effectively, national security grounds.

much lower spending on social transfers, particularly pensions, 8% versus 20%.[1] The large subsidies to enterprises have also slowed down the pace of restructuring. It is clear that the authorities in Russia and most of the FSU have retained the main prereform concerns: production by enterprises, foreign policy, and defense, while Polish authorities have developed concerns, arguably excessive, about consumption by individuals, particularly pensioners.

The distinctive feature of the Gaidar stabilization plan was that neither the wage rate nor the exchange rate would serve as a nominal anchor.[2] This feature had already caused concern for the IMF by the end of 1991. However, a strict monetary policy probably could have controlled nominal wage increases. Real wages fell sharply in 1992, as required by the stabilization objectives. The problem was the failure of the government to eliminate the need for the domestic bank financing of the budget deficit of 6% of GDP in 1992 (IMF 1993, Table 5) and an excessive flow of much-subsidized credit to enterprises and former republics of the FSU by the authorities.

The first Fund-supported program for Russia, in June 1992, was of a standby type.[3] It expired on January 4 1993. During that period, the inflation rate was supposed to decline to below 5% a month. Instead, it increased from about 10% a month in the second quarter of 1992 to about 25% a month in the fourth quarter of 1992 and remained at that high level for much of 1993. In terms of this particular indicator of performance, so central for the IMF, the program was a failure.[4] The second program was of the STF type. It started in June 1993 and is still continuing. Again, the chief aim of the program in 1993, reducing the monthly rate of inflation to single-digit levels by the end of 1993, was not reached. However, in 1994, Russia is showing an unexpected determination to bring the rate of inflation down.

V. Foreign Assistance in a Broader Perspective

In his address to the Group of Thirty at its Spring 1993 planning meeting in Vienna, Mr. Klaus, the Prime Minister of the Czech Republic, summarized his experiences as a reformer in the form of "Ten Commandments" for what he calls profound, fundamental, structural reforms. One of the Commandments asserts that the role of foreign aid in these reforms is marginal. This also happens to be my view with respect to most transition countries of the region. The reason is self-evident. Using purchasing power parities, per capita GDP in the FSU and central Europe was, just

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[1] The estimates of subsidies and social transfers in Russia are highly imprecise but are hoped to indicate the orders of magnitude involved.

[2] The original document which Gaidar presented to President Yeltsin in early November 1991, on the basis of which he was appointed to lead the Russian reform effort, had "stabilization plan" in its title. However, the body of the document was concerned mainly with liberalization, privatization, and institutional reforms, and not at all with detailed stabilization policies.

[3] Russia formally rejoined the BWIs in June 1992.

[4] Russia applied to G-24 for a $6 billion stabilization fund in December 1991. The Fund was potentially available in the years 1991-94 but it was not activated because "the appropriate conditions were not in place" (IMF, 1994e p. 78).

before the reforms, some US$5,000 and, therefore, the total GDP of all the transition countries was about 2000 billion US dollars. The average fall of measured GDP during the contraction phase of transition has been about 40% or $800 billion in flow terms. Even if the actual fall was much smaller, say $400 billion, the investment needed to restructure the region's capital stock so that at least the prereform level of GDP is regained must be several times the lost output, that is, some $1000 billion. The combined resources of international financial institutions are clearly too small by comparison to make a sizeable contribution to such an investment effort. The resources can, in any case, be provided only on a commercial basis, rather than as development aid, and are therefore subject to strict conditions that transition economies cannot easily meet. In the initial period of transition, there is, in addition, a low capacity to use large foreign capital effectively.

The argument above flies against the widespread perception of the large role that foreign assistance does or should play.[1] That perception may be based in part on a fairly large actual role of the international financial institutions, particularly the IMF, in providing the expertise and policy guidance for economic stabilization and institutional development, and on confusion concerning the motivations guiding the cooperation between transition countries and multinational institutions. An extreme view could be held, and it has been expressed at times, that the West has been attempting to impose specific reforms and policies that reflect its own values and interests rather than the needs of the reforming countries. Consequently, vast Western assistance has been provided, or should be offered, to transition countries as an incentive, or indeed as a form of compensation, to encourage the countries to adopt the capitalist system and specific policies. One of the reasons for the reluctance of Western governments to offer sizeable foreign assistance to transition countries may have been the concern not to lend credence to such a view.

Some economists have based their arguments in favor of foreign assistance on the apparent bankruptcy of the state in transition countries, dangerous for international security, on a drastic downgrading of the size of transition economies, and on a correspondingly vast exaggeration of the potential economic impact of such assistance (Sachs, 1993, 1994; for a different view, see Dąbrowski, 1995). Extreme devaluations of local currencies have, for some periods, reduced wages in most transition economies to some 20 US dollars a month and the region's GDP to about $200 billion. By this account, Russia's GDP in 1992 was a mere $100 billion, or about the size of West German annual assistance to the former GDR. It would therefore appear possible to stabilize the Russian economy by providing a relatively small amount of external aid, some $10 billion a year, to the government budget and the enterprise sector. However, such a stabilization plan would soon fail, as the inevitable rapid appreciation of the exchange rate, following stabilization, would reduce quickly the ruble value of the aid, opening up the budget deficit gap again.

[1] The IMF and the G-7 group were using quite effectively the method of ill-specified promises of substantial aid. The promises were costless for the western taxpayers but often served to help local reformers in persuading the governments and the parliaments concerned to adopt reforms.

VI. Concluding Remarks

The impact of foreign assistance can be substantial, even vital, only on a few occasions, especially when it is in the form of grants and debt reductions linked to performance. Most postcommunist economies are simply too large and their transitions to capitalism too costly for foreign assistance to have more than a marginal impact. Some of these economies are already heavily indebted, and this gives them little room for contracting new debt. A far more important foreign impact may come from the inflow of Western private investment and know-how. However, internal reform efforts rather than external financial assistance are needed for this inflow to take place.

International financial organizations, especially the BWIs, have been helpful for Russia and Poland by providing local reformers with modern analysis and expert policy advice. They were also most helpful in pressing Western creditors for a sizeable reduction of the Polish debt and a fast removal of trade barriers to West European markets. However, the sequence of reforms, their content, and the speed of transition have been decided largely by the initial circumstances, the new long-term goals of the countries concerned, and the various internal political and institutional factors during transition, rather than by the advice of the two institutions.

The major problem in the design of IMF programs for both countries has been the nearly exclusive choice of standard, purely macroeconomic and stabilization-related performance criteria. The key transformation reforms were recognized from the start, in the Polish program for 1990, as central for the success of long-term economic strategy, including the achievement of macroeconomic stability, but while these reforms were discussed with officials and incorporated in the program documents, they were not covered by formal performance criteria. This paper suggests that this was probably a mistake.

However, in the later IMF-supported programs, the initially strong emphasis on rapid stabilization has been reduced, and progress with structural reforms has been given more weight in the evaluation of performance. The difference between Poland and Russia has been mainly in the conduct of macroeconomic policy and not in the core of transformation reforms. Errors in forecasting, analysis, and policies have been made, some of them quite major, but in the crisis circumstances of the two countries, the main body of reforms, especially in Poland, has probably been about right.

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