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ECONOMIC SITUATION AND ECONOMIC REFORM IN EASTERN EUROPE

Introduction

One result of the momentous political changes in Eastern Europe and the Soviet Union in recent years is that all countries in the region have now embarked on the fundamental transformation of their economic systems from central planning to a market economy. The economic services of the Commission have since 1989 sought to complement the Community's economic assistance efforts (through the PHARE programme and other actions) by conducting and commissioning relevant economic analysis. This has already led to several publications in the main European Economy series: No. 43, 'Economic transformation in Hungary and Poland', March 1990; No. 45, 'Stabilization, liberalization and devolution: assessment of the economic situation and reform process in the Soviet Union', December 1990; Special Edition No. 2, 'The path of reform in Central and Eastern Europe', 1991.

Now, for the first time, a short assessment of the economic situation and the progress of reform is published in Supplement A; it attempts to give a snapshot of the situation, focusing on recent developments (until end-July 1991) but placing them in the context of the process of systemic change which is now under way.

A caveat is in order here. The statistical apparatus of the countries in transition, based as it is on the requisites of the now-defunct planning system, is ill-suited for the type of comparative analysis that is usually presented in this series. Although efforts to improve the situation are being made in all countries concerned, even quite basic macroeconomic indicators are as yet either unavailable or compiled according to a methodology that differs substantially from what is used in the Community. The figures quoted below therefore need to be treated with great caution; in particular, they cannot be readily compared across countries.

Bulgaria

The deterioration in economic performance that occurred in 1990 has continued in 1991. Real GDP fell by more than 11 per cent in 1990 as a result of severe external shocks, structural constraints and domestic policy mistakes. The value of production for the first six months of 1991 fell by 22.6 per cent compared to the same period in 1990. The main causes were a shortage of raw materials and a loss of markets.

Retail prices went up by 84 % in 1990, with the highest price increases concentrated in September-December. Prices of foodstuffs, household items and furniture more than doubled with respect to 1989, while clothing and footwear increased by 76 %. The price of water and rents rose the least (11 %). Price liberalization in February led to sharp increases amounting to 230 % in February and March together. At the end of March prices were 280 % higher than at end-December, and 470 % above end-May 1990. However, the latest figures released show that inflation fell to virtually nil in April and May. The price of fuel was increased by between 70 % (electricity and coal) and 113 % (gas) on 3 June.

Unemployment is increasing. In December about 63,000 people were unemployed, and the number rose to 206,000 at end-May 1991. The projected level for the end of the year of 350,000 seems to be optimistic.

BULGARIA – Main economic indicators

	1989	1990	1991 Q1
GDP at constant prices ([a])	−0.3	−11.3	—
Industrial production ([a])	−2.6	−16.0	—
Agricultural production ([a])	−4.8	−6.0	—
Consumer price index ([a])	6.4	26.3	470.0
Unemployment rate, %	0.0	1.4	8.1
Trade balance, $ bn	−0.8	−1.0	−0.1
Current account, $ bn	−0.7	−0.8	—
Gross foreign debt, $ bn	9.2	10.0	11.0

([a]) Percentage change over (same period of) previous year.

Figures for the first six months of the year show that Bulgaria's trade deficit had fallen to zero. However, this positive tendency should be seen in the context of sharply reduced export and import volumes caused by the collapse of CMEA trade and reduced domestic production. In value terms exports fell by 56 per cent in the first half of the year while imports decreased by 63 per cent in the same period. The reduction in hard-currency exports has exacerbated the precarious external financial situation. On 17 April Bulgaria obtained an arrangement with the Paris Club, which recommended deferral and rescheduling of all debt servicing payments to official creditors, including arrears on short-term credits. Debt servicing on medium- and long-term debt has been rescheduled over a period of ten years with a grace period of six years. 1 January 1991 was set as the cut-off date. However, the greater part of the debt — about 80 % of the total — is owed to commercial banks, with which the government is seeking a long-term arrangement. The authorities hope to settle the commercial debt problem by exploring with the banks a range of options, including debt reduction, preferential interest rates, debt-equity swaps, as well as new financing.

At the end of September 1990 Bulgaria joined the IMF and the IBRD. In February 1991 the IMF approved a drawing under the compensatory and contingency financing facility to assist with the increased cost of oil imports. In March 1991, it approved a twelve-month stand-by arrangement for SDR 279 million.

A comprehensive stabilization programme was elaborated in collaboration with the IMF, which began to be implemented in February 1991. Measures undertaken so far include:

- a tax reform, together with a set of measures to curtail state expenditures, to reduce subsidies, and to limit the state budget deficit to 3.5 % of GDP;
- a massive liberalization of prices, with the overwhelming majority of prices determined freely, prices for four energy products administratively set, and those of 14 categories of goods subject to a special monitoring system;
- a restrictive incomes policy providing for an initial reduction of real wages followed by a freeze, with the consent of the trade unions;
- a set of measures to reduce the monetary overhang and to introduce a restrictive monetary policy;
- the introduction of a new exchange rate system providing for a single exchange rate determined on the basis of supply and demand. At the same time the foreign trade regime was significantly liberalized.

In March 1991 a new land law was adopted, which allows for land to be returned to the previous owners. New legislation on trade, foreign investment and privatization is still pending.

On 12 July the parliament approved a new constitution, paving the way for a general election on 29 September. The new constitution guarantees basic human rights, recognizes various forms of property ownership, including private and state, and defines the powers of the government and president. It also guarantees the validity of all international treaties and conventions approved by previous parliaments. Although the new constitution obtained more than the two-thirds parliamentary majority required, it also led to protests from opposition MPs, about twenty of whom went on hunger strike.

Czechoslovakia

Fundamental economic reform in Czechoslovakia started in earnest only in January 1991. The first year after the 'velvet revolution' was mainly devoted to a political restructuring of the country, and to discussion and preparation of the transition to a market economy. The uncertainty created by the abolition of the command system and by the lack of progress with reform had an adverse effect on economic performance. This was exacerbated by shortfalls in supplies of energy and raw materials from the Soviet Union and by sharply reduced export possibilities following the breakdown of the CMEA trading system.

CZECHOSLOVAKIA – Main economic indicators

	1989	1990	1991 Q1
Net Material Product constant prices ([a])	3.1	2.3	−1.7
Industrial production ([a])	1.0	−3.7	−9.2
Agricultural production ([a])	1.3	−3.9	—
Consumer price index ([a])	1.4	10.0	54.7
Unemployment rate, % of labour force	0.0	1.0	2.3
Trade balance, $ bn	0.2	−1.3	−0.4
Current account balance, $ bn	1.0	−0.4	—
Gross foreign debt, $ bn	7.9	8.1	8.3

([a]) Percentage change over (same period of) previous year.

The tensions between the Czech and Slovak republics which came out into the open after the end of communist rule needed to be addressed before full-scale economic reform could be contemplated. Although the devolution issue is very far from having taken on the violent and destructive character it has in the Soviet Union and Yugoslavia, it has slowed down economic reform and continues to dominate policy debates. In particular Slovakia, the smaller and less developed of the two republics, has during the past year repeatedly resisted economic reform measures at the federal level; it contends that it is less able to cope with rapid industrial restructuring — for instance, much of the country's armaments manufacturers and heavy industry are in Slovakia. The Czech republic, although stressing its independence in many areas, appears to be less opposed to assigning significant economic policy responsibilities to the federation.

Some progress towards a mutually acceptable division of powers was made in early 1991. In particular, it was agreed how tax revenue (which is entirely federal) was to be distributed: 40 % to the federal authorities, 35 % to the Czech republic, and 25 % to the Slovak republic. The major blocks of expenditure for which the republics are responsible are infrastructure, education, justice and health. Defence is entirely a federal responsibility, and social expenditure is divided between the federal and republic levels.

Czechoslovakia's economic performance deteriorated markedly during 1990, even though a collapse of the order observed in Bulgaria or Romania was avoided. Industrial production fell by 3.7 %, and consumer price inflation rose from very low levels to 10 %. Unemployment was still low but rising rapidly. The trade and current account balances moved from surplus into deficit in 1990 as the Soviet Union reduced its oil deliveries by 30 %; this oil, which was very cheap by international standards, had to be replaced from other sources at a much higher price and at higher transport costs. Under the CMEA trading system Czechoslovakia used to obtain Soviet energy and raw materials at prices significantly below world market levels.

A comprehensive package of measures went into effect in January 1991 which combined wide-ranging liberalization with strict macroeconomic control:

- Prices for 86 % of retail sales were freed, with controls remaining in place for rents, public utilities, energy and some foodstuffs. This led to a higher-than-expected initial jump in the consumer price level: 25.8 % in the first month, 7.1 % in February and 4.7 % in March. It tapered off to 2 % in April and May, but an increase in retail energy prices in May will have added another 5 % to the price level.
- At the end of December 1990, the exchange rate was unified at Kčs 28 per $ (i.e., devaluation of 14 % for commercial and non-commercial transactions, and revaluation of 12 % for tourism). At the same time, 'internal convertibility' was introduced, which provides unlimited access to foreign exchange for trading purposes. The government's commitment to defending the new rate — which has so far been quite successful — makes the exchange rate the reform programme's 'nominal anchor'.
- By way of a 'real anchor', a wages and incomes policy was agreed with the trade unions and enterprises which contains a formula for partial indexation intended to limit the fall in real wages to about 10 % in 1991; in fact, the decline was closer to 20 % at the end of May.
- A temporary 20 % import surcharge on food and consumer goods was introduced in January 1991; it was lowered to 15 % from June.
- Monetary and fiscal policies are very restrictive. By mid-year, the consolidated surplus was even substantially higher than originally planned (Kčs 8 billion, or nearly 1 % of GDP, for the year as a whole), essentially because of the much higher rise in prices and thus in profits tax receipts. To avoid excessively contractionary effects, substantial additional spending was therefore approved in early July 1991. The paradoxical coincidence of falling sales and output with higher-than-expected price rises, rising profits and a budget surplus indicates that price increases have often been excessive and enterprise behaviour is still quite monopolistic.

Industrial output has suffered more than anticipated; it fell by 15 % during the first five months of 1991, compared with the same period of last year. The authorities claim that the main cause for this is not linked to domestic economic reform, but to the collapse of trade with the Soviet Union. In theory, since 1 January 1991 intra-CMEA trade has had to be conducted at world market prices and settled in convertible currency; in practice, the transition is being effected somewhat more gradually, with trade continuing in part on a clearing basis, at least for the current year. Nevertheless, export volume has fallen substantially (-35 % for the first quarter), and import prices have risen steeply.

A sharp distinction has been made between 'small' and 'large' privatization. Small privatization started at the end of January and is to be completed by mid-year. For large privatization, highly complex legislation was adopted only on 26 February and provides for a voucher scheme to distribute ownership among the population, as well as for auctions where foreigners can participate. The first privatizations under the new rules are being prepared, but the process is likely to be slow.

Some other major reform measures are also progressing only slowly. Major legal changes are still needed, such as a bankruptcy law, resolution of contract disputes, and anti-trust law. The introduction of a VAT-type turnover tax is foreseen for 1993.

Hungary

The Hungarian economy has embarked on a major effort of stabilization and medium-term adjustment, designed to transform Hungary into a competitive market economy. For the time being, however, economic stabilization and the reform effort have contributed to a decline in economic activity. Recession has been accelerated by the breakdown of the CMEA trading system.

Results for 1990 and the first five months of 1991 point to a severe contraction of economic activity, although it is not completely clear to what extent official statistics are able to take into account the increasing rate of expansion of private activity. Real GDP declined by 5 % with respect to the previous year and industrial production by more than 10 %, as a result of the collapse of demand within the CMEA and the depressed condition of the domestic market.

HUNGARY – Main economic indicators

	1989	1990	1991 QI
GDP at constant prices (a)	−2.8	−5.0	−4.3
Industrial production (a)	−0.5	−10.5	−12.3
Agricultural production (a)	1.2	−4.0	2.8
Consumer price index (a)	17.0	28.9	34.2
Unemployment rate, %	0.0	0.2	0.3
Trade balance, $ bn	1.0	0.3	0.5
Current account, $ bn	−1.4	0.1	0.2
Gross foreign debt, $ bn	20.6	21.8	—

(a) Percentage change over (same period of) previous year.

Tight fiscal policy led to a reduction in the state budget deficit, reported at Ft 1.4 bn (i.e. less than 1 % of GDP) for 1990. Despite a restrictive monetary policy, inflation increased during 1990: the consumer price index rose by 30 % on a yearly basis.

The performance of the economy in the first months of 1991 has been mixed. Industrial production continues to decline and unemployment is increasing at a faster rate. However, inflation is lower than forecast.

Industrial production declined by 15 % in volume terms in the first five months of 1991 compared with the same period last year. The number of registered unemployed increased to 185,500 by the end of May, corresponding to 3.9 % of the work-force. Actual unemployment has been increasing, especially in those sectors more dependent on exports to the Soviet Union. However, the informal sector of the economy and the dynamic development of small enterprises have been able to absorb part of the shock. Unemployment forecasts for the end of 1991 vary between 260,000 and 400,000.

Monthly price increases have slowed continuously from January, when consumer prices increased by 7.5 % with respect to the previous month. In March the increase was 3.5 %, and in April 2.4 %. For the year to May the annual consumer price increase was 34.8 %. However, price inflation is expected to resume somewhat in the second part of the year, especially since subsidies on energy supplies to households were withdrawn from 1 June.

In spite of unfavourable external shocks, the performance of the external sector was positive in 1990. A surplus of $127 million was recorded in convertible currency trade, which implies a dramatic improvement with respect to 1989, when a deficit of $1.4 billion was recorded. This result was achieved despite an unexpected shortfall in Soviet oil deliveries and higher oil prices on the world market in the last quarter of 1990. Moreover, the collapse of CMEA trade led to a loss of nearly one-third of traditional exports.

This positive performance spilled over into the first quarter of 1991 but the latest figures issued by the Ministry of International Economic Relations show a $950m deficit in Hungarian convertible trade for the first five months of the year. National Bank of Hungary (NBH) statistics for the same period put the deficit at only $151m. The discrepancy is due to the different basis on which the figures are calculated. Whereas the Ministry arrives at its figures on the basis of goods crossing borders, the NBH uses a system of payments actually registered. The Hungarian government and the IMF have recently concurred on a forecast for the trade deficit for the year of approximately $800m. However, economists at the NBH are optimistic that an even lower figure could be achieved because of a partial recovery in trade with the Soviet Union, a lower than expected oil price and a lower overall demand for oil.

The programme of structural reform proceeds, especially for privatization. The State Property Agency (SPA) has launched several programmes that should lead to the privatization of over 50 % of state enterprises by 1994. However, the rejection of the Compensation Bill by the Constitutional Court, after its approval by the National Assembly, may slow down somewhat the privatization process. The Finance Ministry has put forward new proposals designed to increase the efficiency of the privatization process, involving a higher degree of decentralization and a more restricted role for the SPA.

In the meantime the Hungarian government has drawn up a list of 19 key enterprises that are to remain in complete or majority state ownership. The list includes the energy and telecommunications network, the post office, Malev airline, state television, the aluminium sector, the railways, and the biggest saving banks.

Poland

The declining trends which were strongly evident in the Polish economy during 1989 were exacerbated by the radical stabilization measures introduced on 1 January 1990. The stabilization programme provided for: price liberalization and an end to most subsidies; a devaluation of the zloty and the introduction of convertibility for current transactions; strict control of wage rises above stipulated levels; a significant reduction in real wages; a reduction in the state budget deficit to 1 per cent of GDP.

The stabilization programme helped to reduce significantly hyperinflation from a monthly rate of 78.9 % in January 1990 to 1.8 % in August. During the second half of 1990 inflation stabilized at around the 5 % level (month-on-month) and was 250 % for the whole year (December-to-December). Prices rose steeply in January 1991 (12.7 %), an event attributed to one-off utility price rises, but have since declined gradually to a monthly level of about 2.5 % (32.6 % for the first five months of the year or 67.8 % year-on-year to May 1991). The government has revised its initial forecast for inflation this year from 36 % to 55 % but even this target might be substantially exceeded. The slowing of inflation has prompted the National Bank to lower the key interest rate from 72 % in January to 50 % in July. During the past few months the government has been facing mounting pressures from trade unions for a relaxation of strict wage controls in the state sector and from farmers for minimum guaranteed agricultural prices and protection against EC imports. As a result, higher tariffs on food imports were introduced in May.

POLAND – Main economic indicators

	1989	1990	1991 Q1
Net Material Product constant prices ([a])	0.2	−13.0	—
Industrial production ([a])	−2.9	−23.0	−9.3
Agricultural production ([a])	2.0	—	—
Consumer price index ([a])	640.0	250.0	88.2
Unemployment rate, % of labour force	0.1	6.1	8.4
Trade balance, $ bn	0.2	2.2	−0.3
Current account balance, $ bn	−1.8	0.7	—
Gross foreign debt, $ bn	43.3	46.5	48.5

([a]) Percentage change over (same period of) previous year.

Stabilization has resulted in significantly lower levels of economic activity. GDP declined by 12 % in 1990 (+0.2 % in 1989). Industrial production in the state sector fell by 23 %, although the overall effect was mitigated by an 8.5 % rise in private sector output. Gross agricultural production, however, increased by 2.5 % over 1989. During the first five months of 1991 industrial output fell by a further 8.6 % compared to December 1990. The pronounced decline in economic activity resulted in a growing deficit for the state budget ($1.03bn or 4.2 % of the GDP by April), which was mostly due to lower tax revenues from the corporate sector. Unemployment rose from negligible levels at the start of 1990 to 1.5 million in June 1991 (8.5 % of the work force) and could reach two million at the end of 1991.

In 1990 Poland achieved a hard-currency trade surplus of $2.2bn, despite having to buy more oil at higher world market prices because of a 35 % reduction in Soviet deliveries. Export receipts rose by 43 % on the previous year to $10.9bn as enterprises turned to the external sector to compensate for the fall in domestic demand, while import expenditures rose by 18 % to $8.6 bn. Net official reserves rose by more than $2.1bn.

Trade prospects appear markedly worse for 1991 as a result of higher energy prices, the shift to hard-currency settlement of trade with other East European countries, the loss of markets in the former East Germany and the collapse of exports to the USSR (-60 % for first quarter of 1991 compared with the same period in 1990). Total imports for January-April 1991 jumped by 124.1 % on a year earlier while exports rose by 31.4 %. In response to growing pressures from exporters and in an effort to promote an export-led recovery of output levels, the government devalued the zloty by 14.4 % on 17 May 1991, following 16 months of exchange-rate stability, and announced that in future the value of the zloty would be fixed against a basket of convertible currencies.

Poland had been unable to service fully its external debt of $48.5bn (February 1991), since 1981. This situation has recently been alleviated by a debt reduction from the Paris Club of creditor governments, which account for about three-quarters of the country's total debt. The agreement, which will reduce the net present value of the debt by fifty per cent, is formally dependent on the implementation of an IMF-approved three-year economic programme. However, Poland has failed to meet the IMF performance criteria relating to its budget deficit, rate of inflation and foreign reserve level for June 1991. Polish authorities have indicated their intention to request a considerable easing of IMF terms at the first semi-annual review, scheduled for August 1991. The Polish government has been carrying out parallel negotiations on the $10.6 bn owed to private banks, plus $1.2 bn of overdue interest. These talks have been deadlocked on the banks' insistence that Poland pays $250m of its interest arrears before any discussions on restructuring the principal of the country's bank debt begin.

The experience of the past few months suggests that macroeconomic stabilization is only the first stage of systemic economic reform. Popular support for the stabilization programme has weakened because of the protracted recession and the sharp decline of real wages. Profound structural adjustments still need to be implemented in the months to come, including large-scale privatization and legislation which will provide Poland with the basic institutions of a free market economy. This task has been rendered considerably more difficult by the lack of a stable government majority in the Sejm (Parliament), which is still largely dominated by the communists and their allies. Parliamentary elections are scheduled to take place in October 1991.

The privatization programme, which got off to a rather slow start in 1990, has been accelerated this year. A large number of small and medium-sized enterprises have already been privatized through a system of quick sales by auction. The government aims to transfer to the private sector about half of Poland's 8,000 enterprises during the next three years. A number of methods are being used to achieve this goal, including outright sales of state-owned enterprises, public offers of shares on the open market and privatization through liquidation (changing the legal status of an enterprise in order to sell it). However, the most ambitious scheme involves the privatization of 400 state-owned firms, accounting for a quarter of the country's industrial sales and 12 per cent of total employment. The government intends that 60 % of the shares in the commercialized companies will be distributed free to all adult citizens, 30 % will be held by the State Treasury and 10 % given to the employees. Special investment groups will be set up in order to restructure and manage the companies on behalf of the shareholders. The market value of the shares will only be determined in 1993, following the publication of the companies' first-year results.

The privatization process is complicated by the absence of a sound commercial banking system. A two-tier banking system has been created, and the liberal licensing policy has resulted in the creation of about sixty new private banks, half of which are privately owned while the rest belong to state enterprises. Nonetheless, the foreign exchange market is still tightly controlled by the National Bank; the money market is embryonic; and there is only rudimentary experience in credit analysis and accounting. The government is anxious to speed up banking sector reform and to put an end to the existing system of inter-enterprise credits so that banks can if necessary force uncompetitive firms to go bankrupt.

Finally, a thorough reform of the country's public finances is under way. The taxation system is being overhauled, with efforts to increase tax revenues from the rapidly expanding private sector in order to make up for falling revenues from unprofitable state enterprises (15 % less than planned in the first quarter of 1991). A law introducing personal income tax has been passed by Parliament, while value added tax is scheduled to be introduced in early 1992. The budgetary procedure will also need to be streamlined so as to improve controls on government spending. However, the necessary legislation has yet to be enacted and the administrative structure which would manage the new system is not in place.

Romania

Romania is in the midst of a deep recession. The shortages of food and other basic commodities, which were endemic under the previous regime, have been reduced but not eliminated. In April 1991 industrial production was 19.7 % lower than a year earlier, and public investment was 28.6 % down. The price level more than doubled in six months. Exports have collapsed and a convertible currency current account deficit of $0.5 billion was recorded for the first quarter of 1991; there is little room for a further deterioration since Romania's access to foreign credit is virtually zero.

ROMANIA – Main economic indicators

	1989	1990	1991 QI
Gross Domestic Product, constant prices ([a])	−5.8	−7.9	—
Industrial production ([a])	−5.3	−17.5	−15
Agricultural production ([a])	−5.9	5.0	—
Consumer price index ([b])	—	—	80.4
Unemployment rate, % of labour force	—	—	—
Trade balance, $ bn	2.1	−3.1	−0.6
Current account balance, $ bn	2.5	−3.1	−0.5
Gross foreign debt, $ bn	0.6	2.3	—

([a]) Percentage change over (same period of) previous year.
([b]) Percentage increase since October 1990 (start of series).

The conditions under which Romania embarked on economic reform were particularly difficult. The country had no net foreign debt, but this was achieved at a substantial human and economic cost. In recent years imports were kept very low; during the past decade virtually no western machinery was imported. Exports (most notably of agricultural goods) were stimulated, but they were made possible by repressed consumption at home.

A deliberate policy was followed of holding down services and high technology in favour of heavy industry and manual labour. Moreover, significant resources were squandered on prestige projects. As a result, Romania's industrial infrastructure is among the most backward in Europe, and its work-force is particularly demoralized and badly trained.

Initially, economic reform was slower than elsewhere in Central and Eastern Europe, in part because the government's limited popular support made it hesitate to take painful measures. On the contrary, during the first part of 1990, the authorities announced several measures designed more to alleviate the hardships imposed by the old regime than to stabilize the economy. The working week was reduced by 17 %, more resources were channelled into consumption to the detriment of investment and exports, and some prices were lowered. As a result, output fell by 15 %, while national income declined 10-11 %, and investment by as much as 35 %. The fact that food exports were halted and imports sharply raised to improve domestic supply, together with the disruptions in the domestic economy, led to a drop in exports of 42 % in 1990 and a 50 % increase in imports. The 1989 trade surplus in convertible currencies of $2.6 billion was thus replaced by a $1.7 billion deficit for 1990.

Romania has traditionally been less dependent on cheap Soviet raw materials and energy than other CMEA countries, so the switch in its trade regime with the USSR towards world market prices and convertible currencies is having only a moderately negative impact. The Gulf situation and the consequent oil supply problems, on the other hand, have caused serious dislocations in the country's important petrochemical industry. Furthermore, Iraq is a significant debtor to Romania ($1.7 billion) and had undertaken to repay part of its debt in supplies of oil. Together with the sharp worsening of the trade balance, these effects have virtually wiped out the foreign exchange reserves.

During October 1990 Prime Minister Roman obtained from parliament the authority to implement much more radical economic reform by decree. The first batch of reform measures was introduced on 1 November; others followed in April 1991:

- a partial price liberalization in November, with major exemptions for basic goods, rents etc., which led to an initial 23.4 % increase in the retail price index; the announcement of further increases in January led to vociferous public protests and to delays; under IMF pressure a second round of increases was implemented on 1 April. By the end of April, consumer prices had risen by 128 % compared to October;

- a 67 % devaluation on 1 November, to a rate of 35 Lei/$, followed by another devaluation to 60 Lei/$ in early April, and the announcement of a further devaluation in August; inter-bank currency auctions held since mid-February have yielded rates of about 200 Lei/$, close to the black market rate;
- partial compensation for the inflationary effects of the two previous measures through direct transfers to workers and pensioners. Real wages declined by 24 % from October to April;
- Restrictive budgetary policy; during the first quarter of 1991 a surplus of 31 billion Lei was recorded (2 % of GDP).
- In early April, Parliament adopted a fairly liberal law on foreign direct investment. It allows for wholly foreign-owned companies in all sectors of the economy, and grants significant tax and import duty relief to investors; profits may be repatriated in hard currency up to an amount of 8 to 15 % of the capital invested, depending on the sector of activity.

Other planned reform measures include:

- privatization of 50 % of state assets within three years, preceded by transformation of state enterprises into autonomous companies;
- a modernization of the tax system, including the introduction of VAT.

Soviet Union

The collapse of the Soviet economy is accelerating. The breakdown of the state procurement system, without a concomitant development of a market economy, has increased shortages and weakened economic performance.

The steady worsening in economic performance of the last five years accelerated in 1990. For the first time, official statistics showed a decline in GNP (by 2 %) and in national income (by 4 %). Real Net Material Product fell during each quarter of last year, and economic performance in the first half of 1991 indicates a further marked deterioration in the economy. GNP declined by 10 % with respect to the corresponding period of last year, Net Material Product by 12 %. A sharp reduction of industrial production (-6 %) and agricultural production (-11 %) was coupled with a strong decline in investment (-6 %), and productivity of labour (-11 %).

SOVIET UNION – Main economic indicators

	1989	1990	1991 Q1
Gross Domestic Product, current prices [a]	3.0	−2.0	−10.0
Industrial production [a]	1.7	−1.2	−6.0
Agricultural production [a]	1.3	−2.3	−11.0
Consumer price index [a]	2.0	5.0	23.8
Convertible trade balance, $ bn	−0.2	3.3	
Convertible current account balance, $ bn	−0.2	1.4	
Gross foreign debt, $ bn	54.1	56.1	

[a] Percentage change over (same period of) previous year.

The decline in industrial production is particularly significant in branches like coal mining (-11 %), steel (-12 %) and oil (-9 %). This sharp decline can be ascribed to labour unrest, as well as to a complete disruption of links among enterprises. Living conditions have deteriorated further, with shortages of virtually all types of consumer goods and a flourishing black market.

The 1990 budget deficit was officially reported at R58.1 billion (i.e., less than 6 % of GNP, and down R20 billion on 1989), but this is probably a substantial understatement. It appears that the budgetary situation in 1991 is much worse. First, many Republics have ceased to transfer to the central authorities taxes they used to collect on behalf of the Union. Second, subsidies on consumer prices had to be increased sharply because wholesale prices were raised in January to improve production incentives but retail prices were left unchanged during the first quarter. For the first five months of the year, the Union budget, i.e., the revenue and expenditure at the level of the federal government, showed a deficit of R39 billion, which is already higher than the R27 billion deficit officially projected for the year as a whole.

Open inflation is on the increase. Compared to the same months of 1990, wholesale price increases were 65 % in January, 85 % in February, 96 % in March, and 112 % in April. Retail prices, despite being under administrative control until 1 April, increased by 23.8 % in the first quarter of the year. An inflation rate of 200 % is reported for the first half of 1991. The partial price liberalization went into effect on 2 April under conditions of persisting shortage and repressed demand, which might well create conditions for hyperinflation.

To mitigate the effects of the recent official price increases, an income indexation mechanism has been introduced. Wage-earners will in principle receive a once-and-for-all compensation for 85 % of the price increases; a similar mechanism exists for pensioners. Still, the price rises imply an additional reduction in the standard of living of the portion of the population that depends on fixed incomes. Further changes in the indexation mechanism are under way.

The main benefit from the price increases should be a reduction in the budget deficit: since incomes are not fully indexed, the decline in consumer price subsidies should more than offset the increase in income transfers. There is substantial ground for pessimism on this score, however. Already last year wages increased much faster than planned, as enterprises took more and more liberties with central wage policy guidelines. Moreover, any budgetary gains at the Union level could easily be wiped out by the loss of central control over the Republic budgets. If this were to occur, and in view of the ineffectiveness of monetary policy, the recent one-off price increases could well be followed by a period of hyperinflation.

The external situation of the Soviet Union deteriorated dramatically in 1990. At mid-year a substantial deficit in trade with the West developed, but the central authorities managed to regain control over imports, and redirected much of their energy exports to the hard-currency area. Consequently, the trade deficit of R10 billion for 1990 is the result of a huge deficit in non-convertible trade, essentially with the former CMEA partners (R12 billion), only partially offset by a reported surplus in convertible currencies (R2 billion). In the first half of 1991 exports declined by 23 %, and imports by 48 %, mainly as a result of the collapse of CMEA trade. A trade surplus of R4.9 bn was recorded.

The reluctance of western banks to extend credit because of the political unrest and the worsening economic situation was reinforced during the last part of 1990. Virtually none of the Soviet Union's short-term credits are being rolled over. The problem of arrears in the repayment of trade credits, which was temporarily reduced by western government loans and credit guarantees in the last months of 1990, has resurfaced; arrears are now reported to amount to $5 billion. In the absence of access to private external credit, and with exports sharply down because of domestic supply disruptions, imports are severely constrained. The ensuing decrease in imported inputs will further aggravate the economic crisis.

Prompted by the prospect of President Gorbachev's meeting with the G-7 leaders on 17 July, a number of agreements were reached and laws were passed in early July.

First, 10 of the 15 Republics (all except the Baltic Republics, Georgia and Moldavia) signed the anti-crisis programme based upon the proposal prepared by Prime Minister Pavlov. Its main provisions were:

- attempts to overcome the food crisis and stabilize the consumer market;
- measures aimed at scaling down public expenditure, bringing the budget deficit under control;
- the creation of an intergovernmental (Union/Republics) commission to draft proposals on the coordination of economic legislation, and on the sharing out of internal and external debt;

- the introduction of tax incentives, VAT, curbing of subsidies to loss-making enterprises;
- a gradual price liberalization;
- privatization; specific Union and Republic programmes had yet to be drawn up but were intended to come into force during the third quarter of 1991;
- the introduction of internal convertibility for the rouble by 1992.

Second, a number of laws intended to speed up the transition to a market system were approved, both by the Supreme Soviet and by some Republic parliaments, though many details remained unclear:

- a Union-wide framework law on foreign investment, devolving considerable regulatory power to the Republics; the Russian Federation approved its own law granting unimpeded transfer of profits;
- a privatization law;
- an anti-trust law;
- a law regulating financial markets;
- several laws (Union-wide and Republic) lowering profits tax; in this context an unhealthy tax competition seemed to be developeding.

On the whole, however, there was no clear indication of progress towards a true economic reform, and the measures that had been taken and proposed lacked coherence. Following the G7 summit in London, the USSR applied for membership of the IMF and the World Bank.

Yugoslavia

During the late 1980s, Yugoslavia's most acute economic problem was hyperinflation (2,500 % in 1989). In mid-December 1989, the government introduced a package of drastic stabilization measures: the exchange rate of the Dinar was fixed vis-à-vis the DM; full current-account convertibility was introduced; wages were frozen from November 1989 to June 1990; prices for some 20-23 % of goods and services were frozen; the instruments at the disposal of the central bank to implement a restrictive monetary policy were substantially strengthened; the budgets of the various levels of government were in future to be financed by tax revenue.

The initial results were positive. Price stability was achieved in April and maintained until June. However, prices began rising again during the autumn, mostly because of wage rises granted by the republics in contravention of federal economic policy guidelines and because of lack of adequate central monetary control. For 1990 as a whole, consumer prices rose by 120.4 per cent (December-to-December). The stabilization measures, along with the external shocks resulting from the Gulf conflict, pushed the economy into recession, with industrial output falling by 10.6 % and GNP by 7.5 % in 1990. Widespread enterprise closures edged unemployment up to over 17 % in December 1990, and there was a significant drop in living standards.

YUGOSLAVIA – Main economic indicators

	1989	1990	1991 Jan.-May
Real GSP ([a])	0.7	−7.6	—
Industrial production ([a])	−1.0	−10.6	−17.6
Agricultural production ([a])	4.5	−7.0	—
Consumer price index ([a])	1256.0	588.0	77.6 (b)
Unemployment rate, % of labour force	10.7	12.8	—
Trade balance, $ bn	−1.5	−4.7	−0.6
Current account balance, $ bn	2.4	−2.4	—
Gross foreign debt, $ bn	17.1	17.8	15.9

([a]) Percentage change over (same period of) previous year.
([b]) Prices rose by 95.5% on a year-on-year basis (June 1990-June-1991).

The fixing of the exchange rate and the introduction of current-account convertibility, combined with the relaxation of import controls, resulted in a rapid growth of imports and a $4.6 bn trade deficit for 1990. The current account also recorded a deficit, following three consecutive years of surpluses and despite sizeable revenues from tourism and migrants' remittances. In response to complaints that the overvalued dinar was hurting exports, a new rate (9YD = 1DM) was set on 1 January 1991 and convertibility was severely circumscribed. However, on 20 April 1991 a further devaluation of the dinar was announced, by 31 % (13YD = 1DM). Foreign exchange reserves, having reached a record $9.6bn in October 1990, declined to $4.6bn in June 1991.

Initial results for 1991 show a continuation of the negative trends evident in 1990. Industrial production dropped by 17.6 % during the first five months of 1991 on a year earlier. Exports fell by 4.9 % in the first five months, compared with the same period in 1990, while imports rose by 1.2 % resulting in a trade deficit of $988 mn. Inflation for January-June 1991 was 53 % (95.5 % for June 1990-June 1991), and Prime Minister Markovic's forecast of a 70-80 % inflation rate for the 12 months to December will clearly not be attained. Finally the tourist industry, which earned $2.7bn in 1990 (5 % of GNP) expects a collapse in revenues this year (-60 % in the first four months of 1991), and there has been a drop in remittances from Yugoslavs working abroad.

The political turmoil in Yugoslavia entails serious economic consequences: trade between the republics has been curtailed and the single Yugoslav market is being put in question. At the same time, some republics have stopped payment of tax and customs revenues to the federal budget, exceeded planned public spending levels, granted excessive wage rises and illegally printed and issued banknotes.

Disagreement among the republics, principally over the level of military spending, delayed the adoption of this year's federal budget. In early July the federal government finally adopted an emergency budget and a series of drastic policy measures aimed at preventing economic collapse. These include:

- In the 1991 federal budget spending has been slashed from the planned YD 163 bn ($ 6.9 bn) to YD 100 bn ($ 4.25 bn). It will be financed by custom revenues and by the national bank and will be used exclusively to finance the state administration and the federal army.

- The imposition of a tight monetary policy, to be implemented through a credit squeeze on the country's commercial banks. Credits will only be available for housing and for projects aimed at stimulating the growth of the private sector.

- There will be no financing or subsidies for bankrupt state enterprises.

The federal government also aims to secure at least $ 3 bn of external financing in order to meet the country's international obligations. However, the adoption of an emergency budget for 1991 will not unblock a $1 bn stand-by credit from the IMF, which would in turn facilitate additional loans totalling $2.3 bn from other western financial institutions, unless the political crisis is resolved. The country's total debt was $17.8bn at the end of 1990. The price of Yugoslav debt on the secondary market has declined from 60 cents on the dollar in 1990 to under 40 cents in 1991. Because of the political turmoil, the United States has suspended its economic aid and has pledged to withdraw its support for loans and credits to Yugoslavia by international financial institutions. The European Community has also suspended assistance.

1 August 1991

Principal economic policy measures — July/August 1991

Community (EUR 12)

8.7 ECOFIN COUNCIL: The Council carried out the multilateral surveillance exercise envisaged under the convergence decision of March 1990: Member States have been asked, where necessary, to submit medium-term convergence strategies before the end of October 1991.

23.7 COMMUNITY REGIONAL POLICY: Three development programmes have been approved by the Commission for the adaptation and diversification of rural zones in France and Spain.

25.7 1992 draft Community budget approved by the Council.

Belgium (B)

2.8 At the end of the 'budget conclave', an overall agreement is reached on the budget for 1992. The agreement envisages central government net borrowing of BFR 405,4 billion, i.e. 5,5% of GNP, which implies a BFR 50,6 billion deficit for the Communities and Regions. In order to attain this target the government will make savings of BFR 82,5 billion. A large proportion comes from the Ministry of Finance itself: BFR 21,2 billion from modernizing the management of central government debt; BFR 6,5 billion from the accelerated collection of unpaid taxes and the advance collection of a fraction of the withholding tax on earned income; BFR 6,7 billion within the department itself, i.e. mostly an increase in non-tax revenue. In addition, the government is planning to save BFR 16 billion in the social security sector. The balance of BFR 32 billion represents savings to be made by all ministerial departments.

15.8 The National Bank raises its discount rate from 7,80% to 8%, in response to similar decisions in particular by the Bundesbank and the Nederlandsche Bank.

Denmark (DK)

None.

Germany (D)

15.8 The Bundesbank raises its discount rate from 6,5% to 7,5% and its Lombard rate from 9% to 9,25%.

Greece (GR)

2.7 and 30.7 Further measures aimed at the deregulation and liberalization of credit extension to the private sector and at the abolition of specific credit regulations and controls and the reinforcing of the supervisory role of the Bank of Greece.

16.7 The ministerial Committee on Prices and Revenues adjusts the retail prices of oil products as follows:
— leaded petrol from DRS 140/lt to DRS 125/lt,
— unleaded petrol from DRS 130/lt to DRS 125/lt,
— diesel from DRS 67/lt to DRS 89/lt.
The increase in the price of diesel is a step in gradually adjusting the excise duty prevailing in Greece to the minimum level decided recently by the Council in the context of the harmonisation of indirect taxes.

15.7 New issue of Treasury bonds linked to ECU with a duration of two, three and four years and an interest rate of 10,10%, 10,25% and 10,40% p.a. respectively. New issue of Treasury bonds linked to USD with a duration of two, three and four years and an interest rate of 8,0% and 9,0% p.a. respectively.

9.8 The Bank of Greece decides that the banks are obliged to publicly announce their base interest rates, commissions and fees as well as taxes and levies for all banking operations.

22.8 By Ministerial decision a set of criteria and procedures were set based on which the tax authorities will carry out extensive controls among self-employed, craftsmen, shopkeepers, liberal professions and farmers.

29.8 The parliament votes a bill on rent regulation with respect to property rent for professional use.

Spain (E)

5.7 In order to keep the increase in the public deficit for 1991 within the limits laid down, the government cuts the expenditure planned in the central government budget for 1991 by PTA 341 billion (0,6% of GDP).

18.7 The Treasury increases the interest rate on 12-month Treasury bills (Letras del Tesoro) by 0,3 points to 12%.

1.8 Further 0,3 point increase in the interest rate on 12-month Treasury bills, taking it to 12,34%.

23.8 The Bank of Spain cuts the official intervention rate by 0,15 points to 12,6%.

29.8 The Treasury increases the interest rates on three, five and ten year Treasury bonds by some 0,4 points to 11,72%, 11,68% and 12,67% respectively.

France

24.7 The government approves a package of measures to assist the textile and clothing industry which include extending the tax credit available for research to the costs involved in creating collections, a greater drive to redevelop textile regions and recourse to short-time working combined with State aid at rates close to the authorized ceiling.

23.7 The government increases the allocation for Codevi (industrial development account loans to small businesses SMEs) from FF 16 billion to FF 25 billion with effect from 1 August. At the same time the Codevi ceiling is raised from FF 10 000 to FF 25 000, banks cut the top rate for such loans from 9,25% to 8,75% and the maximum turnover threshold for firms eligible for financing out of Codevi resources is raised from FF 100 million to FF 500 million. According to the authorities, these measures are part of a more comprehensive plan for measures to support small businesses to be announced in September.

20.7 The government increases Paris transport charges by 5,8% with effect from 1 August. This rise is 2,5% higher than the official inflation forecast and is in line with the public authorities' intention to bring public transport prices in the Ile de France, which are subsidized far more heavily than in the main provincial towns, gradually nearer to their true cost.

Ireland (IRL)

19.7 In the light of half-year exchequer returns indicating a substantial overshoot in the target for net borrowing, the Government announces a package of additional measures designed to achieve savings of IRL 100 million this year. The savings are being found in current expenditure, mainly on health, education and social welfare and are expected to limit the borrowing overshoot to IRL 100 million.

23.7 Central bank reduces official short term rate by half a point to 10¾%.

Italy (I)

7.7 Parliament gives its final approval to the reform of the Wage Supplementation Fund. According to the new provisions, the scheme will be applicable to industrial firms with a maximum of 15 employees and will have a maximum duration of 2 years (with a possible extension of two further years). Collective dismissal ('mobility') procedures have also been modified: workers dismissed will be entitled to the same treatment provided for by the Wage Supplementation Fund for a maximum of three years.

Luxembourg (L)

5.8 The government presents the outlines of its draft budget for 1992 which will be tabled in Parliament on 18 September. The government envisages a GDP volume growth rate of 3,8% and an inflation rate of 3,3%. Gross overall revenue is estimated at LFR 116,4 billion, a 6,7% increase on the budget for 1991. Gross expenditure is projected to be LFR 114,9 billion, up 6,4%. The budget will therefore close with a surplus of LFR 1,5 billion.

Netherlands (NL)

2.7 Parliament gives its agreement to a government proposal to increase the excise duties on fuel from 6 July. The price of leaded petrol will go up by 31 cents, unleaded petrol by 22 cents and gasoil by 8 cents.

15.8 The Nederlandsche Bank raises its discount rate from 7,75% to 8% and its secured loans rate from 8,50% to 8,75%. This increase is in line with those made by other central banks, in particular the Bundesbank and the Belgian National Bank.

Portugal (P)

5.7 The Bank of Portugal announces that non-resident investors will not be allowed to purchase floating-rate bonds quoted on the stock exchange before the end of the year.

United Kingdom (UK)

12.7 The Bank of England acts to cut bank base rates by a half-percentage point to 11%. Building societies and banks subsequently announce that their mortgage interest rates would also drop by ½% to around 12%.

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