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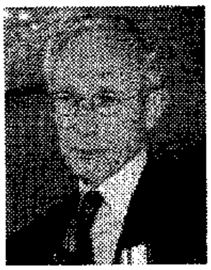
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The Lessons of Reform — Ten Years On

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Sofia, Bulgaria, May 25, 2000

1. Introduction

It is a great pleasure to be here today, to visit Sofia for the first time and to have the opportunity to discuss with you — students and others who have been living through the process of transition — some of the lessons we have drawn from studying 10 years of reform in the transition economies, and the extent to which they apply to Bulgaria.[1]

And what better place to talk about the journey from central planning to an open market economy than here, with students, at what from 1951 to 1990 was the Karl Marx Institute, and then became the University for National and World Economy? One of my senior colleagues at the IMF — Mark Allen — enjoyed studying here in the early 1970s and remembers using the library on the third floor of the old university building. There was a sign warning the students that they could use the elevator to go up, but that to save power they had to take the stairs coming down. I'm not sure how the elevators got down to the bottom to start going up again.

The basic lesson from a study of the transition economies is an optimistic one. Experience in the transition economies strongly suggests that if Bulgaria continues down the path of reform on which you embarked so courageously three years ago, these efforts will ultimately be rewarded. In country after country, determined stabilization and structural reforms have by now successfully laid a foundation for economic recovery and durable increases in living standards.

Of course, you don't need me to tell you that the path of reform and restructuring is an often difficult and uncomfortable one to travel. This week's record unemployment figures — and the suffering that joblessness means for many Bulgarians today — testify to that fact. But economic growth, with exports playing a leading role, is picking up and with a continuation of the right policies, the rewards of reform will become increasingly widely spread.

Having said this, let me add one word of warning: Bulgaria's own experience in 1996 and 1997 shows how easily reform can slip. This is an unfortunate lesson of economic policy in general, not only policy in transition economies — that the fruits of years of hard work can be lost in a short time if policy makers relax prematurely or turn to populist policies. Bulgaria's experience shows how dire the economic and social consequences can be. I sincerely hope the same mistake will not be made again.

Let me begin by describing the relationship between reform and performance in the transition economies as a group — and in Bulgaria in particular. I will then say something about what this experience suggests needs to be done to ensure that Bulgaria can build on its recent achievements and emulate the performance of the most successful reformers.

2. Macroeconomic Performance After Transition

When transition to the market began with Poland's economic reform program in 1989[2], no-one expected the process to be painless. It was understood that output and employment would decline initially as macroeconomic conditions were stabilized and as structural reform shifted resources from unproductive to productive uses.

But the adjustment turned out to be much more severe than people had predicted. Take the 25 transition economies in central and eastern Europe, the Baltics, Russia and the other countries of the former Soviet Union. Output in these countries fell more than 40 per cent on average before it reached its trough. In each case the largest fall in output was typically recorded in the year that transition got under way. And growth typically resumed two years after a stabilization program had been put in place.

By 1998 some 20 of the 25 transition economies had started to grow again. But the depth of the initial fall in output — and the strength of the subsequent recovery — varied widely from country to country. The transition experience is of course of immense human importance. But it also faces economists with a very unusual circumstance, in which 25 economies set off on more or less the same path at roughly the same time, with sufficient variations in policies and performance for us to study econometrically the determinants of the different outcomes.

In studying the determinants of economic performance, we are fortunate to be able to draw on indices developed at the EBRD, under the leadership of Nicholas Stern (who will shortly take up the position of Chief Economist of the World Bank), of the extent of structural reforms implemented in the different economies. We use the inflation rate as a basic indicator of the extent of macroeconomic stabilization.

The results are clear: growth is affected by several initial conditions affecting the economy, including for instance how long it had been in the Soviet bloc, and its dependence on previous trade patterns — *but* the basic strategy advocated by market-oriented proponents of reform a decade ago was correct. That is, that both stabilization and structural reforms — particularly price liberalization and small-scale privatization of state enterprises — contribute to growth. It is also clear that the faster the reforms take place, and the more consistently they are pursued, the quicker the economy will pull out of the inevitable recession and the more rapid growth will be.

These results of course raise another question — what is it that determines the extent to which a country embraces transition and is effective in undertaking the needed economic reforms? In some cases countries may fail to pursue the right policies because they lack the necessary technical expertize. But more often the answers are likely to lie elsewhere, in the political realm, in a lack of effective political or societal support, and in problems of governance.

Bulgaria's experience is unusual in that it experienced a "double-dip" growth path. Output had already been falling for two years when transition got under way in 1991 — and it continued to fall until 1993. Growth then resumed in 1994 and 1995, following substantial adjustments in wages and the fiscal position. This was consistent with the typical pattern elsewhere: economic revival coming two years or so after stabilization.

However, in the case of Bulgaria, the recovery was unfortunately not maintained, in large part because reform had not extended to what were severe governance problems in the banking and corporate sectors. Fiscal policies were eased in 1996, while monetary policy was loosened to help refinance insolvent banks. In short, the good work of the stabilization was thrown away. A succession of bank runs and growing speculation that neither the government nor the banks would be able to meet their foreign exchange obligations prompted a full-blown crisis. The consequences are familiar to you all. GDP fell by 17 per cent over the following two years, more than reversing the brief recovery.

Since then, as all the world knows, Bulgaria has returned to the path of reform, and has made substantial progress. The currency board arrangement put in place in mid-1997 has achieved macroeconomic stabilization, underpinned by a prudent fiscal policy. Inflation has been brought under control, interest rates are low and stable, fiscal reserves are ample, and the commercial banks have plenty of liquidity. It is particularly reassuring to see that the currency board enjoys support from across the political spectrum.

The currency board both required and gave impetus to structural reform.

Take a few examples:

- During 1999 alone 1,225 privatization deals were completed, including major sales in the steel, airline, oil refining and fertilizer production sectors.
- The financial sector has been strengthened, with bank privatizations, reform of foreign exchange regulations and improvement of bank supervision.
- State enterprises have been subjected to greater financial discipline, with restrictions on wage increases and the worst performers forced to restructure.
- Prices and the trade regime have been substantially liberalized, while important steps have been taken to make the market for land work better.
- Restructuring of the energy sector has begun in earnest, with an independent regulator set up, under the new energy law, and restructuring of the natural gas and electricity monopolies initiated with a view to eventual privatization of appropriate parts of these enterprises.

In the face of these real policy improvements, it is understandably frustrating that the benefits are not being felt more tangibly by the person on the street. Cumulative economic growth of 6 per cent over the last two years has reversed only a small part of the preceding decline, while unemployment has risen by more than a third over the last year to a record high of 19 per cent. Some weakness was to be expected during the most intense period of privatization and restructuring, a phase other countries had completed earlier. But this was compounded by adverse shocks, including falling export demand from countries affected by the emerging market financial crises of 1997 and 1998, and the blocking of transit routes to western Europe during the Kosovo conflict in 1999.

As these shocks have subsided, so output and exports have picked up. This year it is reasonable to expect export growth in double figures and economic growth at a decade-high of 4 per cent. In the longer term, provided it stays on the path of reform, there is no reason why Bulgaria should not enjoy the sorts of recoveries that the earlier reformers in central and eastern Europe have enjoyed. These countries — the Czech Republic, Hungary, Poland, the Slovak Republic and Slovenia — have now reversed all or a large part of falls in output that they endured in the early years of transition and stabilization.

3. What Needs To be Done

If Bulgaria is to follow their example, then macroeconomic discipline will have to be maintained up to and beyond next year's elections. The Ministry of Finance is to be congratulated on setting tight expenditure limits and controlling spending, but in some areas lack of reform is leading to arrears. Arrears and non-payment can be particularly insidious in undermining reforms, as has been seen for instance in Russia and several other countries. Thus it is urgent to tackle the problem of arrears.

If the government does find itself with room for fiscal manoeuvre, then there may be some scope to increase social assistance for the unemployed, accelerate public investment or raise public sector wages. But this will have to be done cautiously, maintaining a strong fiscal position, as the mistakes made in 1996 in Bulgaria and similar mistakes made elsewhere serve to remind us.

In addition to maintaining sound macroeconomic policies, sustained and more rapid growth requires that the momentum of structural reforms also be maintained. Only then can an enabling environment be created for private-sector growth. This in turn is the key to cutting unemployment and alleviating poverty. Structural reform and sustained growth will also be essential if Bulgaria is to achieve its ambition of joining the European Union in the next few years, and to begin to catch up to west European living standards.

Action is needed in several areas:

- First, privatization needs to be completed quickly, but in a transparent fashion. As I mentioned earlier, the pace of privatization was impressive during 1999. But it was marred by a large number of insider deals which have prompted allegations of corruption. To promote efficient restructuring after privatization, the government should also put effective bankruptcy procedures in place and relax the employment and investment requirements in privatization contracts.

- Second, more needs to be done to improve governance and the climate for business. Surveys have identified red tape, corruption and administrative inefficiencies as important obstacles to doing business here. A high-level working group has already made valuable suggestions which need to be acted upon. Legal uncertainty also needs to be minimized, contracts enforced more effectively, and accounting standards implemented stringently.

- Third, the authorities need to press ahead with reform of the crucial energy sector. The decision taken in March to freeze electricity prices sends an unfortunate signal about the government's commitment in this area. It casts doubt on the government's promise to unify electricity prices for households and industry, it puts pressure on the budget and it may deter foreign investors interested in the privatization of the state electricity company.

- Fourth, wage discipline and flexible labor markets need to be encouraged to preserve competitiveness and bring unemployment down. This implies a need for continued wage discipline in state enterprises, plus amendments to the Labor Code to make hiring, firing and working hours more flexible.

4. Conclusion

This is certainly an ambitious agenda. But it is one that Bulgaria has shown itself more than capable of achieving. Policy reforms have now been on course for some time, reflected in ongoing access to the IMF's financial support, despite the need for some waivers. In addition Bulgaria has been at the forefront of the transparency initiatives being sponsored by the Fund: the government, before we even inquired, decided to publish its three-year program on the Internet in English and Bulgarian, and by volunteering for a report on observance of international standards and codes — which delivered a generally positive assessment — and agreeing to the publication of the IMF staff report on the country's economic prospects and policies. Steps like these demonstrate to the world your seriousness about reform.

Even so, for now the transition process may feel as though it is all effort and no reward. But other countries have been through the same adjustment pains and emerged stronger and better off in the end. The frustrations are all the greater here because the process began relatively late, was interrupted by the crises of the mid-1990s that led to the high inflation and the currency board, and was then interrupted again by the emerging market crisis and the Kosovo conflict. But that is all the more reason to stick to the reform path now and not to suffer another setback.

All Bulgarians stand to benefit from that reform in the end as they undertake the policies that will put them firmly into the Europe from which they were kept apart for so long.

1 I will be drawing in this presentation on a paper written with my IMF colleague, Ratna Sahay, "The Transition Economies After Ten Years", IMF Working Paper, WP/00/30, February 2000.

2 While reform efforts began earlier in Hungary and other countries, it was only in 1989 with the end of the Soviet bloc that economic programs aimed at making the transition from state to market were explicitly undertaken in Eastern Europe.