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Policy, Research, and External Affairs

WORKING PAPERS

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Long Term Prospects in Eastern Europe

The Role of External Finance in an Era of Change

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and
Fernando Saldanha

What should the governments of Eastern Europe and the public and private institutions in the West do to promote the successful movement to a market economy?

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This paper — a product of the Debt and International Finance Division, International Economics Department — is part of a larger effort in PRE to examine the effects of external finance and external debt on the process of reforms in Eastern Europe. Copies are available free from the World Bank, 1818 H Street N , Washington, DC 20433. Please contact Sheilah King-Watson, room S8-040, extension 33730 (42 pages).

Private investors have an important role to play in the ongoing process of reform in Eastern Europe. So external creditworthiness is crucial to a successful transition. Large government borrowing crowds out the formation of private contracts between international investors and domestic entrepreneurs and firms. Given the overall credit ceiling in international lending, the public sector needs to curtail its external borrowing to leave room for the private sector.

This also implies that public debt reduction may be especially desirable in the highly indebted countries of Eastern Europe. Rather than flood the public sector with new loans, international organizations should attempt to improve domestic creditworthiness by supporting debt reduction and borrowing restraints during the transition period. Such a strategy would also force governments to finance their deficits internally, thereby increasing accountability.

Debt for equity swaps represent an attractive vehicle for debt reduction in the highly indebted countries of Eastern Europe. Such schemes, when tied to the privatization effort, are not inflationary — unlike the case of the public debt for private equity schemes of Latin America. They simply represent a swap of public liabilities, and they create value to the extent that foreign private investment leads to positive externalities. The challenge will be to create swap mechanisms that will allow the Eastern Europe countries to retain a large share of those gains.

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The recent political changes in Eastern Europe (EE) aim at the creation of political and economic institutions in the style of the West. With amazing rapidity East Germany has been re-unified with West Germany, and the post-communist politicians of Poland, Czechoslovakia, and Hungary have dropped any support for a "third way" and seem intent on moving to a fully fledged market economy. The Soviet Union has initially moved in the same direction but now seems to be backing off on the way to reform. At the same time, the old system based on central planning is crumbling for lack of proper incentive schemes to allocate scarce resources to their most efficient use. It is hoped that a reliance on market signals, together with financial discipline and the integration of the productive structures into the international system will allow for a renewal of economic development and growth. But important uncertainties persist; in particular, the scope, timing and form of privatizations programs are still the subject of heated debates; and the potential role of the Western public and private sectors remains poorly defined.

During the transition period, EE governments will have to ensure that macroeconomic conditions as well as microeconomic incentive systems allow and encourage adjustment. Large sectors of economic activity need to close down, and new sectors with comparative advantages allowed to emerge. Labor must be retrained and must reallocate to new jobs. Savings must be collected and institutions created to direct scarce investment resources efficiently. The public sector must shrink and redirect its attention only to activities where markets cannot be expected to function properly. Important factors that contribute to this transformation are: social stability, price stability, credibility of the reform process and of the new hard budget constraints, open trade and international technological transfers, especially in the managerial sphere.

It is uncertain whether EE countries catch up rapidly or slowly with

the rest of Europe. But various ingredients that have been revealed to be important for growth in other countries are present in EE--high levels of schooling, low income inequality, and the proximity of large and unexploited markets in the EC. But entrepreneurship is hampered by ill defined property rights and a lack of a market tradition. During the transition period, pressures on resources will increase dramatically, as the supply side takes time before it responds to new relative prices. The burden of the past will extract its toll. And the dismantling of the CMEA trading system will hit these countries hard.

New international borrowing--from private and official sources--can reduce resource scarcity for the countries that are creditworthy. But for the non-creditworthy countries, private loans will not be forthcoming unless some debt is forgiven and the reform process is deepened. As a result, the formation of private contracts between domestic and foreign investors will remain inhibited (the debt overhang effect). We also argue that large official loans from the West--while helpful in the short run--run counter to the reform process. They tend to favor sectors that fall outside the market sphere; when directed to the domestic private sector, they tend to be allocated in an inefficient way; they can reduce the incentives to reforms; and they increase the debt overhang, reducing further the ability of the emerging private sector to directly contract with foreign counterparts.

So how should the West use its economic resources to promote a successful transition to a market economy in EE? While the precise answer will certainly vary from country to country, the overall goals should be the promotion of a private sector under price stability. Ideally, the public external debts should be low enough to allow the emerging private sector to be able to enter into credible contracts with international investors and banks. This implies that the official sector in the West must maintain delicate balances between new loans to the public sectors and debt reduction. For the

highly indebted countries that have lost access to voluntary finance, we argue that official debt reduction is more productive that new loans. As a result, a large share of foreign assistance should be directed at reducing--rather than increasing--public sectors indebtedness, especially in Poland, Hungary and Yugoslavia. However, debt reduction should not be upfronted, but instead, it should remain conditional on advances in the reform programs. Besides debt reduction, we also discuss mechanisms that can be used to increase the efficiency of existing international financial contracts, and in particular, debt to equity swap mechanisms.

The paper is structured in four sections. In section I, we review the recent economic history of EE. In section II, we argue that growth will not pick up unless property rights are clarified. In section III, we discuss issues related to the privatization drive and we examine the potential role of foreign investors. In section IV, we develop the case for external debt reduction and transformation for Poland, Hungary, and Yugoslavia and analyze possible mechanisms to achieve these goals.

I. Political Liberalization and Economic Performance: Lessons From History.

The current crisis of EE economies is best understood in a historical perspective. We see the developments in these countries as a sequence of stages which follow logically one from another. These stages, which are described and analyzed in detail below, are:

Stage 1. Forced industrialization under central planning.

Stage 2. Financing of centrally planned investments by monetization and foreign borrowing.

Stage 3. Open inflation.

Stage 4. Stabilization attempts with no supply response.

Each country went or is going through these four stages at its own pace. Poland and Yugoslavia came out of stage 3 into stage 4 in 1990.[1] Bulgaria is

[1]The case of Poland is reviewed in Lipton and Sachs (1990).

moving from stage 2 into stage 3, but may be soon in stage 4. Czechoslovakia may never have entered stage 2 and may skip stages 3 and 4 by privatizing its industry in a short period of time. Hungary is difficult to classify. It cannot borrow abroad, and its inflation rate is increasing.

Underlying the events there was a long term trend towards political liberalization. This trend can be taken as exogenous for the purposes of this paper. In retrospect, it appears that political liberalization had an adverse impact on economic performance. The essence of the problem is that while in capitalism success is rewarded and in stalinism failure is punished, in democratic socialism individuals have the same pay-offs regardless of their efforts or the outcomes of these efforts. Egalitarianism and restrictions on ownership prevent individuals from being rewarded for their efforts. In a liberal political environment where minimum standards of living are guaranteed by the state failure is also not punished. Thus, democratic socialism is in theory a "no carrot, no stick" economic system. The interplay between the inefficiencies of socialism and the prevailing egalitarian ideology had important consequences in the macroeconomic sphere. The need to equalize incomes and to minimize unemployment forced governments to subsidize inefficient and loss-making enterprises. Due to these subsidies these countries ran large consolidated public sector deficits which eventually led to macroeconomic instability.

Stage 1: Forced industrialization under central planning.

After the Second World War, the policy of centrally planned massive industrialization was exported from the Soviet Union to all EE countries. High investment/GDP ratios were typical. The repressive political environment allowed for compression of real wages, so that domestic savings were high enough to finance these high investment levels. This was a period of macroeconomic stability and rapid growth, but standards of living were low.

Stage 2: Financing with monetization and foreign borrowing.

After Stalin's death there was a gradual increase in political freedom, prompted in part by fears of explosions like that of Hungary in 1956. Although the Czechoslovak's experiment with "socialism with a human face" was crushed, and Khrushchev was eventually ousted, the general tendency towards increased political liberalization was unmistakable by the late 1960's.

Political liberalization had two main effects on the economic sphere. First, it became increasingly difficult to contain the aspirations of the population for better living conditions. Second, as discipline started deteriorating, and corruption blossomed, economic efficiency decreased. The multiple attempts at increasing efficiency by decentralization were ineffective, and probably counter-productive.

The adverse effects of the political liberalization made it virtually impossible to finance investment from voluntary domestic savings. However, although investment rates decreased, they remained very high when compared to those of Western economies. The nomenklatura continued to control the economy, and its preference for empire building and large projects is well documented. The increased consumption had therefore to be financed from abroad or through money creation. During this stage the EE socialist economies ran large current account deficits. In this way they could, to some extent, avoid monetizing their public sector deficits. With the exceptions of Yugoslavia, which moved to self-management in the 50's, and of Hungary which initiated reforms in 1968, the allocation of resources continued to be centrally determined. Price controls remained in place, so money creation was not reflected in high inflation rates. Rather, these countries developed the syndrome known as "money overhang:" an abnormally high money/GDP ratio.

Stage 3: Open inflation.

Sooner or later foreign creditors would have to limit the flow of

resources to the inefficient and bankrupt EE socialist countries. As this happened, monetary creation accelerated, and it was impossible to maintain price controls. Inflation rates skyrocketed in Poland and Yugoslavia, and increased to double digit levels in Hungary. Bulgaria is now entering this stage. While political events had an important impact on the economic sphere in the earlier stages, the inflationary explosion of Stage 3 had a feedback effect on the political sphere: the government's authority was eroded by the evident failure of the economic system. The central planning mechanism was gradually dismounted, and replaced mostly by self-management.[2] As a consequence, the economic performance further deteriorated.

Political and economic liberalization had other adverse impacts. In some countries the scope for private entrepreneurship was expanded, and exterior signs of wealth went unrepressed. Citizens were also allowed to open bank accounts denominated in foreign exchange. As has been pointed out by Manuel Hinds (1990), these developments further perverted the incentive structures of EE economies. In the old times there was little incentive to divert resources from the State, since a high level of consumption was not allowed and the implicit interest rates on the available financial instruments were negative. Under a more liberal environment an individual can consume, save in US dollars or German marks, or even invest in his/her own business. The incentives to appropriate public resources were therefore multiplied. The punishments for these crimes were simultaneously virtually abolished. The outcome was a noticeable increase in illegal and semi-legal activity.

Stage 4: Stabilization attempts with no supply response.

On January 1st 1990, both Poland and Yugoslavia embarked into tough stabilization programs. These plans were very similar: the basic elements were: a) fixed exchange rates and wage controls, which would function as

[2]For a study of Yugoslav self management, see Saldanha (in this volume).

nominal anchors, b) full price liberalization, c) tight monetary and fiscal policies. In both cases, the inflation rate in January was extremely high, due to the sudden price liberalization. In the subsequent months inflation dropped gradually and by mid-year the inflation rate had dropped dramatically. In December the Polish and Yugoslav inflation rates were about 6% and 3% on a monthly basis. Output contracted sharply without a parallel decrease in employment, and, as a consequence, the real wage was drastically reduced. Exports soared, as domestic demand contracted, and producers would rather export than sell to domestic buyers since the latter frequently defaulted on payments.

After more than one year has elapsed from the date of implementation of the Polish and Yugoslav plans, the perspectives for Poland and Yugoslavia look grim. The reaction to the stabilization programs was a general shrinkage. Industrial output dropeed by 20% in Poland and 10% in Yugoslavia.Self-managed enterprises would rather cut wages than "fire" its members, hence there was no parallel increase in unemployment.[3] Since the capital stock is "socially" owned, it could not be traded and rationally rearranged by entrepreneurs. The two economies remained ossified, and did not undergo deep structural changes.

One important difference between the two programs is that Poland started the year with a highly undervalued currency, while in Yugoslavia the dinar was probably not too much out of line with its market value in January 1st. Since the exchange rates of the two countries remained fixed, the real exchange rate appreciated considerably since then. In Poland this was not much of a problem: the undervaluation of the zloty was partially corrected. On the other hand, the Yugoslav dinar eventually became extremely overvalued. This forced the Yugoslav government to devalue the dinar by 28% on Janury 1st.,

[3]The unemployment rate in Yugoslavia remained around 10 percent. In Poland, the official rate increased from 1 percent to 7.5 percent. The statistics are however misleading in this case due to the new possibility of earning unemployment benefits.

1991. The expectation is that the inflation rate will, as a consequence, jump to about 12% per month.

The export performance of both countries was good. Faced with declining domestic demand and with difficulties of collecting from domestic clients, producers in both countries turned to foreign markets. Given the favorable exchange rate, Polish firms made huge profits in the first months of 1990. Since the dinar was overvalued, Yugoslav firms exported at a loss. The alternative would be to stop production and lay off workers. This might have been the optimal policy of a capitalist. For workers, it was better to continue the firm's operation, eat up the firm's capital, and keep receiving wages. The firm's capital that was and is consumed in the process consisted of the depreciation funds and foreign currency reserves that had been accumulated abroad.

Poland also benefited from superior wage restraint in the initial months of the plan. Due to the partial wage indexation scheme, real wages fell by more than 30% in the first quarter, and only recently have started climbing back to their previous levels. It should be noted however that shortages have been eliminated. In Yugoslavia wages started increasing from the beginning of the program, as the republics did not comply with the wage restraint measures imposed by the federal government.

The number of bankruptcies in Poland during 1990 was insignificant: only six were reported. Several factors contributed to enhance the profitability of Polish firms. The undervalued exchange rate was favorable to exporters, and energy, the only economically significant imported input, was subsidized. In contrast, there were hundreds of bankruptcies in Yugoslavia, where the exchange rate was overvalued and restrictions on wage raises were not respected. Only a handful of these enterprises were actually liquidated, and most remain operating. Small enterprises in difficulties turned to the local authorities for help, and received subsidies. Medium and large

enterprises were bailed out by the republican governments. In both cases deals that amounted to debt forgiveness were struck with suppliers.

The private sector now enjoys greater freedoms in Poland and Yugoslavia, but its activities remain marginal. Private sector investments are concentrated in trade, agriculture and services, and are usually small scale efforts. Several factors have adversely affected private sector development. The situation of general economic distress, and the possibility of a political regression are not favorable to investment. Private sector enterprises have to compete with public enterprises for inputs, and face discrimination from public sector suppliers. A similar situation obtains with regards to credit, with one aggravating feature. Many banks have become hostages of their clients in the public sector, and cannot stop lending to them under penalty of bankruptcy. Credit to private enterprises is therefore crowded out.

It is worthwhile comparing macroeconomic developments in EE and Latin America. In both regions large consolidated public sector deficits led to high inflation. However, these deficits had very different causes. In Latin American countries most productive activity is conducted by the private sector, which is relatively efficient. The deficits were due to problems specific to the public sector, in particular to overbloated civil services, and to inefficient public enterprises that sometimes overpaid their staffs, and had to be subsidized. These problems were, so to say, localized. In contrast, inefficiency is pervasive to the whole economic structure in EE. Moreover, inefficiency is not restricted to the enterprise level: the whole allocation of resources is irrational, as investment decisions are made by bureaucrats who are subject to perverse incentive schemes, ignore economic principles, and do not have access to market signals.[4]

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[4]Kimme and Crane (1984) measure the gap between potential and actual output due to productive inefficiencies at 35 percent for the seventies.

The Inherent Instability of Market Socialism.

It has been frequently argued that two ingredients have been missing in the reforming EE economies: financial discipline and competition. With these two ingredients, goes the argument, efficiency would increase and the demands of population for better standards of living could be satisfied without the need to run trade or budget deficits. Our point of view is that this argument overlooks the fundamental differences that exist between capitalist and socialist economies.

The usual argument for socialism is based on its greater equity: the income and wealth distributions are compressed in comparison with capitalism. If our point of view is correct, there is a trade off between equity and efficiency, in the sense that a price in terms of efficiency has to be paid for socialism's advantages in terms of equity. While equity may be desirable, ultimately, what is to be achieved is a high standard of living for the population of the EE countries. If the losses from having a certain level of economic equality are too large, then it may be worthwhile to allow for greater inequality. One can hope that the most disadvantaged will also benefit from it, but the change may be worthwhile even if this does not turn out to be the case.

In any economy where the survival of large numbers of enterprises has been since long ensured by subsidies, the imposition of financial discipline is bound to generate much disruption. Many enterprises would have to close, and unemployment would increase dramatically. Faced with economic prices and a liberalized environment entrepreneurs would then reorganize economic activity, creating wealth and employment. The process would be painful, but beneficial in the long run, and the period of hardship would be short. In contrast, in a market socialist economy there would be no supply response. The short run adverse effects of financial discipline would not disappear. One can imagine that, as governments become aware of this lack of supply response they will

naturally relax the discipline that they were so eager to impose before.

Why is it that market socialist economies are bound to respond perversely to an environment that would stimulate growth for a capitalist economy? The problem lies at the level of microeconomic incentives. There are two main problems: ownership dilution and the non-negotiability of streams of rents.

a. Ownership Dilution

Socialist enterprises are, in a way, "owned" by society as a whole. A higher level of efficiency of the enterprise sector would be reflected in higher standards of living for the population as a whole. This linkage between efficiency and welfare only exists at the aggregate level. Variations in the efficiency level of a particular enterprise have very little effect on the welfare of most individuals. The exceptions are the workers and managers of the enterprise. But these individuals may also benefit if the enterprise adopts courses of action that are not optimal from the point of view of value and efficiency. Managers want to build empires, so they will have enterprises overinvest. They may also favor some suppliers or clients over others in exchange for side payments. Workers want to earn high wages. So labor competes with capital for the revenues of enterprises. In the absence of large shareholders that have strong incentives to counteract the pressure for higher wages the enterprise may be decapitalized: funds that could be used for maintenance, replacement, or investment are paid up as wages.

b. Imperfect Appropriability of rents

A share of a capitalist enterprise gives to its owner the right to receive future streams of payments (dividends) that correspond to rents on capital. In capitalist economies individuals freely trade such streams, but they are, by definition, forbidden to do so in market socialism. At the same time, individuals do collect rent payments in market socialism. Workers in capital intensive or monopolistic firms receive higher "wages" than others.

Conceptually, this means that their "wages" can be divided into two parts, one being the wage proper, and the other rents on capital or monopoly power. However, this second portion cannot be traded. This severely distorts incentives, because the workers are finite-lived. That is, they will try to shift the time patterns of the streams of rent payments generated by their enterprises towards the period of their tenure. The way to do this is to underspend in maintenance, replacement, and investment, and to pay themselves high wages. There is some conflict of interests between young workers, who may expect to remain with the firm for an extended period of time, and older workers, who expect to retire soon, but in any case the incentives are to underinvest and let the capital stock deteriorate.

The non-negotiability of future streams of rents has other adverse effects on incentives. Incumbent workers will be hesitant to admit new workers in their enterprises, as this would lead to the dilution of their rents. As a result, labor mobility is severely reduced. For the same reason, workers choose highly capital intensive technologies.

Having their rent payments attached to their paychecks also increases uncertainty for workers. In case their enterprises fail they lose both their jobs and their "investments." In such circumstances workers will fiercely resist plant closures and lay-offs. The unwillingness of workers to accept closures and lay-offs is increased by their inability to appropriate the scrap value of their enterprises. A capitalist will compare that scrap value with the net present value of the stream of future dividends he expects to receive from a plant, and close down in case the former greater than the latter. Workers will compare the future wages they expect to receive with their best alternative, which may be unemployment compensation, a chance of finding another job, or nothing at all. Only rarely will the second alternative be the most attractive.

II. The Transition to a Market Economy.

The experience of EE countries suggests that democratic forms of socialism are even less efficient than the old central planning system, which was no paragon of efficiency itself. Hence, it is unlikely that economic efficiency can be significantly increased in these countries without a radical transformation of ownership relations. For the EE countries to attain the level of efficiency of the developed capitalist countries, they must first establish private property as the cornerstone over which a whole network of new economic relations will be built.

Stabilization and Adjustment.

In the previous section it was argued that the problems of macroeconomic instability faced by the EE socialist economies have as its fundamental cause the productive inefficiency of these economies. As a result, the EE countries will only achieve macroeconomic stability after they have gone through a massive privatization process. This has important consequences for the choice of reform sequencing.

It is often argued in policy circles that macroeconomic stabilization should precede structural reform.[5] But if social ownership of the means of production is the ultimate cause of macroeconomic instability, then stabilization can only come after or together with privatization. It is true that some of the external features of macroeconomic stability can be temporarily mimicked by imposing strict credit and fiscal controls. This was actually done in Poland and Yugoslavia in 1990. However, the stability thus attained is fictitious and precarious.

Attempts at establishing competition and imposing financial discipline are bound to fail in those countries where the stock of capital has no owners. The structure of incentives precludes the efficiency gains that could be achieved by imposing discipline in a capitalist economy. The lack of a supply

[5]For a discussion, see Fisher and Gelb (1990).

response to disciplinary measures creates unsustainable situations: market socialism is inherently an unstable economic system.

One can make an analogy with previous misguided attempts to stabilize Latin American economies through the imposition of price controls. In both cases the underlying causes of instability were not eliminated, but strong disciplinary measures created a semblance of stability. The Latin American programs failed as it became impossible to continue enforcing discipline. The EE programs will most likely suffer a similar fate.

Successful stabilization is only possible with successful privatization, and conversely. This means that privatization/stabilization programs will have to be implemented in a relatively short period of time. The target for each country should be to have at least 50 percent of the economy privately owned five years from now. This realization is more important than the specification of an "optimal sequencing," and has important implications for the choice of privatization method.[6]

The Importance of Politics.

Granted that rapid privatization is necessary in EE, it is true that the obstacles are formidable. The old bureaucracies still have considerable control over the productive and administrative structures, and privatization would take away many of their privileges. Many privatized enterprises would reduce employment and resist wage increases, others would be closed down. Hence, large numbers of workers would face temporary reductions in their incomes immediately after a massive privatization program. These groups could oppose privatization.

It is important to distinguish between the bureaucracy and the workers with regards to their motivations to resist privatization. Bureaucrats, as a

[6]The debate on the optimal speed of reforms is far from conclusive. See for eg. Dornbush (1990), Williamson (1990) and van Wijnbergen (1990) for a review of the issues involved.

group, necessarily have less power and control over an economy based on private ownership of the means of production. Although the most intelligent, entrepreneurial, and competent of them may benefit from privatization, most bureaucrats are just average individuals who would descend socially, although not necessarily economically, in a more meritocratic society. Bureaucrats are thus essentially in opposition to privatization. Also, it could be very difficult to "bribe" them out of this attitude, as any large transfers to this group would cause a public outcry.

Privatization will certainly benefit workers in the long run. They do not enjoy significant perks, privileges, or the joys of exercising power. It is the fear of the hardships of transition that leads them to cling to the old system. The way to overcome this fear is to give to workers a guarantee that they will have a minimum income during the transition period. This can be accomplished through the establishment of a social safety net. Ensuring a minimum income for the unemployed is costly. Workers are likely to lobby against reform unless they expect the safety net to function properly, an unlikely event unless governments are perceived to be rich enough.

Pre-conditions for Efficient Private Sector Development.

Assuming that the political difficulties are overcome, the pre-conditions for private sector development must also be present. A new legal and regulatory environment must be established. Accounting rules must be in conformity with western standards. Private enterprises must interface with a healthy financial system, charging positive real interest rates. The fiscal burden must be moderate. The economy must be open, and the exchange rate must remain competitive. Enterprises must be free to set prices, but the inflation rate must remain low since the information content of prices is crucial for entry and exit decisions. But some inflation might be needed in the initial phase of the reforms in order to eliminate the monetary overhang and adjust relative prices.

A very important component of the privatization/stabilization plan is the reform of the financial system. The role to be played by the financial system in the ocess is a dual one. Banks must allocate financial resources to efficient enterprises, and they must impose financial discipline to prevent and stop inefficiency. However, the current state of banks' portfolios may prevent the banks from performing either of these functions. In some countries there are also ownership links between banks and enterprises: this problem is particularly serious in Yugoslavia, where many enterprises own banks.

Many banks in EE countries have problem portfolios. Credits to inefficient enterprises have been systematically rolled over or forgiven, so that a large part of the banks' assets is fictitious. This was unavoidable. In most socialist countries there are almost unsurmountable legal and administrative obstacles to the attachment of borrowers assets, and bankruptcy is frequently explicitly or implicitly forbidden. Even if those obstacles are discounted, a bank that would refuse to roll over the debts of its borrowers would drive them and itself into bankruptcy, a most undesirable outcome from the point of view of the bank's management. As banks lost the freedom to refuse rolling over bad debts they also became incapable of allocating resources properly. That is, the most inefficient enterprises are "crowding out" the most efficient (or least inefficient) ones.

The portfolios of banks must therefore be cleaned up from bad loans, and the ownership linkages between banks and enterprises must be cut, if the financial systems of EE countries are to perform their functions efficiently.

How to Privatize ?

There is an ongoing debate on the issue of the method of privatization that suits better the EE socialist countries.[7] Most people agree that small enterprises should be sold for the highest bid. With regards to large and

[7]For a survey, see Dhanji and Milanovic (1990), Sadanha and Milanovic (1990), and Borensztein and Kumar (1990).

medium enterprises opinions are more divided. There are two main positions: those who advocate privatization through free share distribution, and those who prefer sales. Each method has its advantages and disadvantages.

Share distribution is equitable, does not require enterprise valuation, and can be implemented in a short period of time. Most proposals along this line assign an important role to financial intermediaries that would hold the shares of enterprises and would initially be owned by the population. What would be distributed would be shares in these trusts or vouchers that could be traded for such shares. The main disadvantage of share distribution is that the state collects no revenues. Also, ownership would be diluted among millions of ultimate owners (the unit trusts being just intermediaries). This means that at least initially there would be no large shareholders that would monitor managerial behavior.

Privatization through sales has been successfully implemented in countries like the United Kingdom, Canada, Chile, Mexico, and Tunisia. In some cases the net revenues accrued to the State were considerable (U.K.), while in others they were small (Tunisia). In most cases the privatized enterprises were acquired by large or medium-sized corporations. Canada was an exception: there some enterprises were sold to large numbers of small investors. From the point of view of economic efficiency the first alternative is the preferred one, since large shareholders have the incentive to monitor managerial performance.

One disadvantage of privatization through sales is its slowness. In the United Kingdom about a dozen enterprises were privatized in ten years, despite the Thatcher government's dogged determination. The main stumbling blocks were related to concerns about fairness and income distribution. There is strong opposition to selling the state assets cheap. Hence careful enterprise valuation is needed, which is time consuming. In EE this problem is more serious since the only groups that have the resources to buy enterprises

in EE are foreigners and the nomenklatura. If foreigners are excluded from the process for political reasons, the nomenklatura would not have the resources to buy the enterprises at fair prices.

Another important issue in EE relates to the financing of privatization. Existing private wealth is low compared to the present value of state assets. As a result, the state will have to sell assets on credit. This would however lead to large debt to equity ratios, reducing the incentives of firms to behave in an efficient manner (see below). The debate goes on. Whatever the method preferred, it is crucial that most assets now owned by the State be passed on to the private sector in the next decade.

III. Private Sector Efficiency and Foreign Finance

The initial conditions of the privatization/adjustment drive are mixed. The EE economies have several characteristics that can foster growth, especially the relative high level of education of their population, the proximity to the European market, an industrial tradition, and low level of wages. On the negative side, entrepreneurship is hampered by ill defined property rights, the scarcity of private wealth, scarce liquidity, and a poor command of modern accounting, managerial and technological skills. The burden of accumulated foreign debt and the recent external shocks are likely to be destabilizing at the macroeconomic level. The overhang of official debt is an impediment to new international borrowings by the emerging private sector.

In this section, we first describe the burden of the past. We then discuss the microeconomic conditions for private sector development and the factors that are likely to inhibit the formation of private contracts with foreign firms.

Macroeconomic Imbalances

The public liabilities of EE countries are large. First, the servicing of the accumulated external debt requires public funds. Second, a safety net needs to be established and the environment cleaned, further increasing the

demand for public finance. Third, investments in public goods--communication systems, roads, new institutions--are necessary for a resumption of growth. Fourth, the dismantling of the CMEA trade system and the recent rise in oil prices adds additional pressures. On the revenue side, tax revenues are expected to remain low until a supply response materializes.

In the absence of debt relief and the provision of new external finance, public sector deficits may have to be financed by money creation, domestic debt, and taxes. Monetization of the deficits is likely to lead to high inflation, thus weakening the signalling content of prices and generating capital flight. Increasing public indebtedness leads to a rise of real interest rates and crowds out private investment. In addition, the implied expectations of higher future taxes distort private behavior and reduces productive efficiency. Finally, raising taxes will not raise much revenue before the supply response materializes. In addition, a high tax rate distorts incentives and reduces productive efficiency.

External debts

The overall convertible currencies debts of the EE countries (excluding East Germany) are estimated to be about $155 billion in 1990. The Soviet Union and Poland account by themselves of 60 percent of this total. By international standards, the absolute level of EE debt is relatively small (Mexico and Brazil together have roughly the same amount of debt), and thus have attracted less attention in the international community. There are vast differences between the six countries in terms of creditworthiness, financing sources and debt burdens. Three countries, Bulgaria, Hungary and Poland are highly indebted by world standards; two other countries, Romania and Czechoslovakia have very little foreign debts. And one country, Yugoslavia is moderately indebted. The secondary market prices of those debts illustrate well their relative creditworthiness: Hungarian debt trades in the nineties, indicating the market belief in its creditworthiness despite large debt

ratios. Yugoslavia's debt trades in the mid-fifties, followed by Bulgaria and Poland (15-20). (see appendix 1 for details).

Expected Shocks

Resource constraints are compounded by the large costs imposed by the dismantling of the CMEA trade system. Estimates are available for Poland, Hungary and Yugoslavia.

o The dismantling of the CMEA trade system will impose a terms of trade shock due the reliance of EE countries on exports of manufactured goods to, and import of raw material from the Soviet Union. The total cost is estimated for these countries at about $5 billion for the period 1990-92.

o The recent oil shock due to the Gulf crisis will also take its toll for three reasons: first, EE countries rely on oil imports (but oil prices have declined soon after the beginning of the crisis); second, several of them have extended large credits to the Middle East and to Iraq, and those claims are unlikely to be serviced as long as the Gulf crisis is not resolved; third, workers remittances from nationals working in Iraq are likely to dry up. In all, they are likely to lose about $6.5 billion.

The New Corporate Finance and the Role of Foreign Investors

The modern corporation is a web of contracts between shareholders, management, debtholders, staff, and society at large, and its level of productive efficiency is heavily dependent on the way in which potential conflicts of interest between these various groups are dealt with.[8]

A classical example of a conflict of interest is that between shareholders and creditors with regards to the undertaking of risky projects. Shareholders of highly leveraged firms will only be rewarded in the good state of nature--those states where the return on investment exceeds the fixed obligations of the firm. This creates incentives for the shareholders to play

[8]For a good review of the finance litterature on agency problems within firms, see Barnea, Haugen and Senbet (1985).

go-for-broke strategies and to invest in risky projects, possibly with negative net present value ("moral hazards", in the terminology of modern corporate financial theory). In bad states, the return to shareholders would be zero anyway, so higher risk allows for some return in the lucky states. Shareholders of highly leveraged firms have also incentives to distribute large dividends and invest below the economically efficient level because it is the debtholders--and not themselves-- that are the most likely beneficiaries of the investment returns. As a result of the moral hazard created by large indebtedness, rational lenders will require large interest rates to lend, reducing the scope for efficient investment.

Another important agency problem is adverse selection, i.e the impossibility to discriminate between good and poor investment projects. A good project is one with high probability of large returns and low probability of low returns. One would hope and expect that market forces would direct investments to the good projects, and lead to a rejection of the bad ones. However, even quite bad projects have a positive expected gain for entrepreneurs under 100% leveraging since they do not stand to lose anything if large returns do not materialize, but can expect gains if luck strikes. To illustrate, suppose that entrepreneurs do not have any personal funds and that lending rates are fixed. Then entrepreneurs with good and bad projects will be equally at the doorsteps of banks asking for loans. If the banks are unable to distinguish between good and bad projects, the financial system would simply not work.

If the entrepreneurs have some wealth to invest in their projects, moral hazard and adverse selection problems are alleviated. By investing his own funds, the entrepreneur signals his belief in the value of the project since he stands to lose funds in the event of failure. Aware of this, the lender is likely to revise his prior distribution of total returns for the project so as to assign higher probabilities to high returns and full

repayment.

There are also important conflicts of interest between shareholders and management. The latter have firm-specific human capital, and therefore tend to be more risk averse than shareholders that can diversify their holdings. Managers also have a tendency to build empires (maximize size, not value), and may shirk and give themselves perks. The separation of ownership and control that prevails in large corporations can thus be a source of inefficiencies. Shareholders have incentives to monitor managers, but there are costs involved. For small shareholders the optimal amount of information gathering will be smaller. A small shareholder that is dissatisfied with management policies typically "votes with his feet," i.e., sells his stock instead of attempting to change management or its policies by participating in the General Assembly. Large shareholders in contrast will spend much time and money on monitoring management. Small shareholders therefore act as free riders, leaving to large shareholders the monitoring task. The existence of large shareholders also facilitates the functioning of the takeover market, which further disciplines management and increases the efficiency of the corporate form of governance.

The weaknesses of the corporate form discussed above are especially relevant in the EE countries. First, the lack of experience of economic agents with conflict resolution skills reduces the effectiveness of contracts as a means to reduce conflicts of interests. Second, the scarcity of private wealth makes it hard for the financial system to allocate funds efficiently. Third, the even distribution of wealth precludes large ownership stakes by any individual, exacerbating managerial inefficiencies.

There are also potential conflicts of interest between society and corporate owners. The optimal amount of risk a firm chooses to take (for example, the risk of oil spills) is unrelated to the optimal amount of risk a society is willing to face. Firms, because of limited liability, care only so

much since the cost of cleaning up the mess they might leave behind will have to be borne by all taxpayers, while they can expropriate all the benefits of their investment in case of good luck. Similarly, insured thrift institution take too many risks, and so do firms that expect to be bailed out in case of failure. All this raises difficult questions about optimal regulation that are still quite poorly understood.

What Role for Foreign Firms?

From the above discussions, it appears clearly that the role of foreign firms in the transition period is likely to be crucial. Their involvement can reduce microeconomic inefficiencies and macroeconomic imbalances. Foreign involvement with the emerging private sector will also reinforce the political lobbies favorable to change.

The liquidity needs of the EE countries are large. And so are their need for wealthy investors and large shareholders that have the right incentives to transfer the technological, contracting and managerial expertise that is available in the West into countries where private initiative has been outlawed for four decades or more. But while foreign capital ownership creates efficiency gains, it also involves another layer of potential conflicts with domestic shareholders and bondholders, and with society at large. Because domestic entrepreneurs are likely to be liquidity constrained and less diversified than foreign investors, their own valuation of domestic assets will fall below foreign investors' valuation. A public outcry will certainly oppose what would be perceived as fire-sales of public assets to foreigners. The issue that arises then is how the EE countries can sell assets to foreign investors at prices that are closer to the foreign (and higher) valuation of the expected cash-flows.

In the present circumstances, foreign investors are unlikely to invest before the uncertainty concerning the definition of their property rights is resolved. These concerns are being debated now by most parliaments in these

countries, but the outcome remains uncertain. An important issue concerns the rights to convert domestic earnings into foreign exchange in order to repatriate them. Large uncertainties loom there due to the overhang of official debts that inflict some of those countries. True, most of the outstanding debt is public and owned to public entities that have been faithfully recapitalizing all interest bills coming due in the context of the Paris club. The problem here is that the relative seniority of public and private debtors is not--and cannot--be well defined. The official sector can decide to adopt a more aggressive posture in the future. As a result, massive new private lending is unlikely to occur as long as the public debt overhang has not been resolved, especially in Poland, Bulgaria, and to a lesser extent, in Yugoslavia and Hungary. For the foreign investor to be confident about sovereign risk, official creditors would have to commit not to extract too many resources for the indefinite future. Debt reduction seems to be the only credible commitment mechanism.

IV. Policy Implications

Overall, the EE countries will grow in the long run if they are able to maintain price flexibility and some price stability in the short term while privatizing quickly. The chances of a good outcome are difficult to predict and depend mostly on the behavior of actors in the concerned countries. We examine below how the behavior of the international community affects the likely outcome.

The discussion above suggests that a relatively rapid privatization program is needed, and that this is actually the least painful alternative for the EE countries. There is an ongoing debate about privatization in the EE countries, and there is wide divergence about the speed and scope of the privatization effort. The balance of the political forces may tip one way or another. Those who advocate a slow, relatively painless privatization process, argue that rapid privatization would disrupt the economic mechanism. We argued

that the opposite is actually true. It is social ownership of the means of production in all its forms that has severely impaired economic efficiency. Moreover, the coexistence of social and private ownership has perverse effects on incentives. A slow process in which private ownership would gradually replace social ownership would therefore lead to hyperinflation and snowballing indebtedness (Hinds, 1990). These adverse developments are currently taking place in EE, in the absence of strong privatization programs. The arguments of the partisans of quick privatization need not be repeated (see Borenztein and Kumar, 1990). What emerges however is that massive privatization is unlikely to occur without strong support from the international community and the IFIs.

One corollary of the above reasoning is that the current indecisiveness of EE governments should not be an argument for a wait-and-see attitude from the part of the international financial institutions (IFIs). This is because it is precisely the intervention of the IFIs and the international community through conditionality and guarantees of financial support that could tip the political scales to the side of the pro-privatization parties. But the importance of strong conditionality must be stressed. Foreign financing without the proper conditionality could backfire and actually delay the privatization/stabilization process. There are two reasons for this. First, the social pressures for reform could be reduced, as the population could be appeased by the availability of cheap imported goods. Second, the expected gains to bureaucrats from remaining in control would increase, as they would have at their disposal larger sums of money.

The Case for Debt Reduction

As in the case of corporate debt, high external country debt creates moral hazard. Domestic incentives to reform are reduced since a large share of the efficiency improvement is expected to benefit the creditors rather than the reforming economy (Sachs [1990], Krugman [1990]). These debt overhang

considerations are especially important for the highly indebted EE economies because the immediate cost of reforms cannot be smoothed entirely through international borrowing. In the presence of a large public debt, the private sector will expect large future taxes, reducing incentives to accumulate assets. Moreover, as long as a debt overhang exists, the emerging private sector is unable to contract credibly with foreign investors. For those reasons, the most productive use of Western governments' aid in the highly indebted EE countries would be to reduce the public debt overhang. The goal of debt reduction would be to facilitate the redeployment of productive assets and liabilities from the public to private hands. The point is that a reduction in the stock of public debt would be a more efficient form of aid as compared to new money because it would reduce rather than increase the debt overhang and thus leave more room for the uncoordinated formation of private contracts.

Unless Western governments want to keep pumping money in EE for the indefinite future, they must seek to create conditions under which foreign capital can truly contribute to growth and prosperity. Rather than flood the new governments with funds that would encourage the continuation of old spending habits, it would therefore be important for foreign donors to give sparingly to the public sector, and to attach conditionality on new loans to encourage privatizations, the formation of a modern social net and the financing of basic infrastructure. Macroeconomic conditionality can also directly help governments resist domestic pressures to spend funds for unproductive purposes. Official finance to the public sector should not be so large as to place the new governments in a situation where they would have to yield to the social pressures to save failing enterprises or oppose the shrinking of some industries. Large official assistance to the EE public sectors would be counterproductive. It would not only reduce the incentives to reform (the overhang effect), but also unleash expectations that soft budget

constraints will continue to dominate economic discipline.

Although resources are needed in both the public and emerging private sectors, it is more profitable to direct a large share of new finance to the private sector. One reason is that the EE public sector are not in a good position to intermediate between foreign funds and domestic private needs. In effect, large official loans to the public sectors run against the movement of history: it would be ironic to provide incentives for renewed growth in the public sector in the name of supporting a reform agenda whose main intention is to reduce public intervention in the economy.[9]

The public sectors of the EE countries will need finance to support the political process as there is a risk of emergence of populist regimes if the social front is not stabilized during the reform period. The productive restructuring that is needed will no doubt increase short term unemployment, and a social safety net is necessary to reduce the associated pain, encourage workers mobility, and set the needed training programs. Moreover, selected investments in infrastructure to complement private investment is a crucial element of any strategy to revive growth. The point is that foreign aid in the form of debt relief is likely to be the best form of aid. Debt reduction will reduce the public financing needs. And if the private sector can freely borrow abroad for productive purposes, governments in EE will be able to finance their own operations domestically. Since domestic borrowings will crowd out domestic private investment, it can be expected that domestic lobbies would rise to limit the extent of future government spending.

How far to Creditworthiness ?

One question that arises when trying to foresee the medium to long term evolution of the the EE countries is how far they stand today from creditworthiness, and the extent of export growth and/or debt relief that is required in order to regain international creditworthiness. For this purpose,

[9]For a discussion, see Brainard, 1989.

we use the debt value function estimated by Claessens, Diwan, Froot and Krugman (1990). This function relates secondary market debt prices to the debt to exports ratio (more generally, the extent of creditworthiness also depends on the degree of openness, on the general performance of the economy, on the existence of arrears, etc..).

Typically, countries whose debt claims trade in the eighties have access to voluntary loans from the international markets. We estimate below the predicted debt prices for each country: with no debt relief or export growth; with debt relief (half of the debt cancelled); with export growth (exports double). Finally, we estimate the extent of debt reduction that is necessary to regain voluntary access when exports double. The results are reported in the table below:

	X/GNP	D/X	Debt prices				
			(1)	(2)	(3)	(4)	(5)
Bulgaria	38	230	45	20	76	80	none
Hungary	36	284	48	80	80	80	none
Poland	23	500	15	22	51	52	45 percent
Romania	22	103	98	--	--	--	none
Czechoslovakia	16	104	80	--	--	--	none
USSR	7	132	80	80	--	--	none
Yugoslavia	30	105	79	55	--	--	none

(1) predicted using the model; (2) actual price; (3) predicted with 1/2 of debt forgiven; (4) predicted with doubling exports; (5) debt forgiveness needed if exports double.

The results indicate that--given the actual level of their Debt-to-Export ratios--the debts of Bulgaria and Yugoslavia are overpriced by our model relative to their actual prices while the debt of Hungary is underpriced relative to its market value. The predicted price for Polish debt is slightly above, but close to its observed market value. Various interpretations are possible. Both Bulgaria and Poland are running arrears on their commercial debts, which reduces their creditwothiness further than predicted by the

model. Bulgaria has not just started stabilizing its economy, and as a result, its future creditworthiness is extremely uncertain. Yugoslavia is somewhat a special case as uncertainties about its future as a state abound. What is more surprising is the observed high value of Hungarian debt. Perhaps because it has never rescheduled its debt, the market seems to discount its very high debt ratios.

Our model predicts that Bulgaria regains creditworthiness if its debt is reduced by half, or if its exports double. But more needs to be done for Poland: if exports double, Poland still needs to have its debts reduced by 45 percent in order to regain creditworohtiness. The other countries are--according to our simulations--marginally creditworthy.

The Case for Debt Transformation: Debt to Equity Programs

Even if debt reduction is achieved for the highly indebted countries of EE, the remaining debt is unlikely to allow for free access to foreign capital markets until domestic growth picks up. Efficiency gains can be created by changing the nature of the external liability contracts. In particular, foreigners have larger incentives to play a useful role in the productive sphere when they hold equity stakes rather than debt. When foreign equity is unlikely to flow in because of the debt overhang, it becomes profitable to attempt to swap part of the existing debts into more "productive" equity contracts.

A debt to equity (DE) swap transaction can be viewed as two transactions that have been packaged together: first, a country subsidizes foreign direct investment (to the extent that part of the discount on debt is retained by the foreign investor); and second, the proceeds from the investment is used by the government to buyback its foreign debt at market price.

A major criticism of DE swaps is that, in general, there are no good reasons to use the proceeds of direct foreign investment to retire debt.

Indeed, other uses of the proceed can increase welfare by more. This criticism applies when government debt is retired for domestic money that is then used to purchase private equity. When public equity is instead purchased, the transaction in effect swaps one public liability (debt) for another (equity). On a net basis, the government does not have to reduce expenditures to finance the transaction.

Another criticism of DE swaps is that debt reduction involves a transfer of resources to the creditors (Bulow and Rogoff, 1988). This is due to the fact that the equilibrium market price of buybacks reflects the expected improvement in creditworthiness that follows debt reduction. Thus, debt prices go up before the actual exchange takes place. This is reinforced when swaps create efficiency gains. However, when the swap program is agreed on as part of an overall debt deal, this criticism does not apply as the debtor can get concessions in return (Diwan and Kletzer, 1990).

DE swaps are then profitable to the debtor if two conditions are satisfied: the swap must create efficiency gains; and the debtor must retain part of those gains. There is no doubt that the first condition is satisfied in EE. Auctions of domestic equity rights take care of the second concern only partially, because all creditors gain when the debtor's creditworthiness improves. It is thus important that the programs be part of an overall concerted debt agreement in which the remaining creditors offer concessions in return for the improvement of the value of their claims.

Burden Sharing and Menu Considerations

Since only private debts are traded on an organized secondary market, it would be profitable for the indebted EE countries to structure overall debt deals in such a way as to reduce official debt and transform commercial debt into equity. Burden sharing between the official and commercial creditors can be achieved by requiring that the private creditors that choose not to exit provide new loans (as in the recent Mexico deal for example). That commercial

creditors would mainly advance new money does not indicate that no burden sharing is accomplished. New loans that are traded at a discount immediately after they are provided include an important element of concessionality.

If a reduction of public debt owed to public creditors is achieved, there would also be much less of a need for private debt reduction. Two issues must be addressed. First, those debts have been contracted by the public sector. A successful transition should involve the transfer of these debts to the emerging private sector, and their transformation into more efficient contracts. Second, official debt reduction will increase the value of existing private debt, raising other issues of burden sharing.

Both of these concerns are best addressed in the context of the menu approach to debt restructuring. The Brady umbrella involving menu driven deals for commercial debts, with an active support by the international community, can be very useful in EE.[10] However, it also presents some clear dangers. Burden sharing should not be taken to imply that commercial debt reduction is needed when official debt reduction is being considered, but rather that banks should be encouraged to provide new money to the private sector. The banks that are already exposed to EE are also those that are the most likely to provide new money when the conditions would improve. Thus, there is a strong case for attempting to nurture the evolving credit relation rather than to severe it by negotiating debt reductions. New money should not necessarily

[10] The main features of the Brady Initiative are the following. Debtor countries should maintain growth-oriented adjustment programs and take measures to encourage repatriation of flight capital. The IMF and World Bank would provide funding for debt and debt-service reduction through debt buybacks, exchanges of old debt at a discount for new (partly) collateralized bonds, and exchanges of old debt for new bonds at par value, with reduced interest rates. Over a three-year period, the Fund and the Bank are expected to provide up to $20-25 billion. Japan is envisaged to provide about $10 billion over the next several years as additional financing. In principle, commercial banks would provide debt reduction and new money, and support the accelerated reduction of debt and debt service. Creditor governments would continue to reschedule their loans through the Paris Club and to maintain export credit cover for countries with sound reform programs. Tax, accounting, and regulatory impediments to debt reduction would be eliminated.

flow in terms of new debt: it would be best to allow the new sectors to directly negotiate with foreign investors the type of contract that fits both their needs best.

The potential contributions of those banks and of their western clients to the development of the economic base in EE is likely to be a crucial ingredient of the reform program. It can thus be argued that it would be more valuable for EE countries to offer concessions to commercial banks in order to encourage them to retain--and even deepen--their stakes in domestic ventures. In this view, EE countries would not seek large commercial debt reductions, but would rather attempt to lure commercial banks to transform their debts into instruments that would generate more incentives for direct involvement by the creditors in the managerial decisions of specific firms. One such strategy would be to develop creative debt/equity mechanisms that would be politically acceptable in EE. Good mechanisms are those that offer rewards to the banks that are conditional on an improvement in the management of the firms they invest in.

How to organize official debt reduction? The difficulties of a public sector debt reduction initiative should not be underestimated. Different creditor governments face different institutional constraints in writing off loans by their respective Exim Banks, Central Banks and various involved ministries. As with private debt, unilateral actions are unlikely due to the public nature of the credit relationship. After all, public debt is also subject to the creditworthiness test: the less debt there is, the larger the probability of repayment. As with the Baker plan, the need for fair burden sharing together with the constraint of a unified policy followed by all has stalled the possibility of any solution other than repeated reschedulings.

Differences between the various public creditors involved militate for a menu type debt reduction arrangement. With differences between creditors, burden sharing can best be imposed by devising a menu of options creditors can

freely choose from. This type of approach has been successfully implemented for sub-Saharan African countries within the Toronto agreement. In this agreement creditors were given the choice between exiting and contributing new money. Such an arrangement could also be worked out for EE. Two main difficulties would however need to be resolved: the definition of acceptable debts, and the issue about the treatment of inter-CMEA debts. Once these hurdles are resolved, a menu can produce gains as some creditors would seek to exit, either because they are overexposed, or because of liquidity constraints. Other creditors and the multilateral institution will want to lend, a process that would be reinforced by the overall reduction in outstanding debt. The result of the exercise would be to reduce overall public debt to make room for the development of more sophisticated private contracts.

Ideally, the remaining official debt claims should be privatized on the creditor side of the relation as well so they can be transformed into more efficient contracts. The international official sector-Exim banks, ministries, central banks--have little incentives and technological knowhow to pass on to their debtors. In contrast, private lenders not only have incentives to see their debtors prosper, but they also have the means to teach them how to do it. It may be possible to privatize official loans in the donor countries. For example, the menu offered to official creditors can include rights to swap debt into local equity. In turn, these rights can be sold by the official sector to private investors.

Concluding Remarks: Sequencing Considerations

We have argued that privatization of state assets is a crucial component of reforms in EE and that the following initiatives are beneficial to the reform process and in particular, would support its privatization component: (i) official debt relief; (ii) Brady deal for commercial debts stressing new money rather than debt reductions; (iii) debt contract transformation stressing debt to equity swaps.

Sequencing issues arise. In particular, debt for equity swaps should follow privatizations in order to allow the new firms to directly contract with their foreign counterparts. Official debt relief should be conditional on the speed of the prizatization process. A Brady type deal should preceed D/E swap transactions so that the debtor country can extract equivalent concessions from its commercial creditors. Finally, Paris and London club deals should be simultaneous enough to manage a fair burden sharing.[11]

These considerations imply that ideally the sequencing of the moves by the foreign official and commercial sectors would be as follows:

(i) The Paris club meets and offers rescheduling and debt relief contingent on a privatization program. The deal offers a menu of options, including the pledging of debts into a special fund that would offer debt relief as privatization proceeds.

(ii) At the same time (or soon afterwards), the commercial banks negotiate a menu driven deal that seeks relatively more new money than debt reductions, and that includes an auction driven debt to equity program.

(iii) As firms get privatized, the public sector retains some claim on the new firms. These claims can be in the form of short term debt (two to three years).[12] This reduces further the drain on public finances, and provides the new owners with incentives to either recapitalize the firm with their own capital, or more likely, to look for a fitting foreign associate.

(iv) As debt to equity swaps proceed, foreign investors acquire domestic IOUs that can be used to buy a share in newly privatized firms. Foreign investors negotiate directly with the private entities, and their stakes are capitalized with the IOUs they hold on the government. In turn, these IOUs are used by the new firms to extinguish their debts to the government.

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[11] For a discussion centered on the case of Poland, see Nuti (1990).

[12] In case of default, the firm comes back under state control and is privatized again.

Appendix: External Debt in EE

Bulgaria

The external debt situation in Bulgaria is precarious. Its total external debt in convertible currencies has risen to 9 billion at the end of 1989, over 3 times convertible exports. The country's debt increased steadily during the eighties: external liabilities doubled between 1973 and 1985, and doubled again between 85 and 89, partly because of exchange rate movements. The combination of increasing debt and decreasing hard currencies export boosted the debt to export ratio from 119 in 1985 to 430 in 1989.

Bulgaria's debt is heavily concentrated: about 83 percent of total obligations are due to commercial bank creditors. The GOB announced on March 1990 that it was suspending all amortization payments, and on June 1990, it requested a 90 days moratorium on all payments due to the London Club. Short term credits virtually dried up and the country no longer has access to the international financial markets. While the Bulgarian commercial Banks continue to meet their debt service obligations, they have suffered a contamination effect and have seen a hardening of terms and conditions.

In the recent past, growing trade deficits resulted from convertible currencies payments against non-convertible currencies exports. But Bulgaria's current payment difficulties were recently exacerbated by a severe bunching of maturities in 1990 and 1991. Convertible export dropped sharply partly because of the impossibility to acquire imported inputs. In 1989, the convertible CA deficit amounted to $1.1 billion, and debt service payments absorbed 77 percent of convertible currencies exports.

Bulgaria's liquidity problems have been compounded by a substantial amount of non-performing loans (about 12 billion in total trade credits), a large part of which are concentrated in the Middle East.

Czechoslovakia

Czechoslovakia has very small external debts. Czechoslovakia's debt is

mostly short term debt credits. Its debt problems are of an other nature: it has been obliged to accumulate as much as 5 billion of claims as a result of its exports to non-socialist economies, half of which may be uncollectible.

Hungary

Hungary's debt stocks have steadily risen in the eighties while economic activity has stagnated. By 1989, Hungary had about 21 billion of external convertible currency debt, representing about 78 percent of GDP and 2.8 times exports (up from 40 and .9 respectively in 1980). Of this 72 percent are owed to private sources (about 9 bil to commercial banks, 6 bil in bonds).

Following a severe liquidity crisis in 1981-82, Hungary has been able to improve its debt profile by gradually substituting MLT to short term debt. While Hungary never rescheduled its debt and managed to retain market access, current account imbalances and fluctuations in exchange rates in the past three years have led to a rapid growth of debt. But Hungary's external financial position has become precarious again in 1990 in spite of a strong improvement in its convertible CA that can partially attributed to the ongoing stabilization plan. A substantial withdrawal of short interbank deposits (about 500 million) following the Bulgaria moratorium, and an unexpected repayment to the IMF (200 million) have caused a sharp drop in reserves. But in support of its stabilization program, Hungary recently received about 5 billion in commitments from western official sources.

Hungary's external situation will be difficult in the next years unless the stabilization program is quickly followed by a decisive structural adjustment effort. Amortizations coming due are about 2 billion a year at a time where commercial financing seems to be drying out given the low level of anticipated growth prospects.

Poland

Current debt in Poland is about 43 billion or about .7 GNP, and 4.5 times convertible export. Poland has not serviced its Paris Cub debt since

1981. It has accumulated arrears on its commercial debt for about one year, and has started discussions with its commercial creditors about a debt reduction package, possibly along the lines of the Brady approach.

Poland debts are mostly medium and long term and are mostly owed to official sources: more than two thirds of Poland's convertible currency debt is owed to the Paris Club; 20 percent is owed to commercial banks, of which 90 percent is MLT under the 1988 restructuring agreement Poland has not had to service any of its Paris Club debt in the eighties as all payments due were rescheduled. While the effective burden of debt is expected to remain low, its debt overhang prevents the flow of any significant private capital.

The last rescheduling agreement with the Paris club in 1990 involved a rescheduling of all arrears as of the end of 1989 and all debt service due between Jan 1990 and March 1991. [3.4 billion of accumulated arrears, plus all obligations coming due in 1990 and in the first quarter of 1991--about $6 billion--have been rescheduled for 14 years with an eight years grace period.] At the same time, it was decided to set up a working group to explore long term solutions to the Polish debt problem.

Poland is at a crossroads. The new Solidarity-led government has put forth a program design to first stabilize and then transform the economy into a market system. A particular feature of the program is the availability of substantial foreign official assistance. Official transfers are expected to be about 1 billion in 1990, in addition to the transfers implied by the Paris club reschedulings. Moreover, Poland has been able to secure over 10 billion dollars of new commitments from official western sources.

But Poland needs private capital to rebuild its economy at a time of large and increasing debt service obligations. Actual debt service obligations after 1991 remain very high, of the order of 6-7 billion a year, 75 percent of convertible exports. As a result, Poland's creditworthiness is poor, and the country is unable to raise money in private international capital markets, or

to attract significant amounts of DFI. This is reflected in the price of its debt on the secondary market: in July 1990, the price of MLT debt stood at 15 cents, and the price of short term debt (that is still serviced) at 35 cents. Without a satisfactory settlement of its debt problem, voluntary private capital inflows will remain marginal.

Romania

Romania has very small external debts. The Romanian economy has been stagnating for several years as a result of an economic strategy that stressed repayment of foreign debt at all costs.

The Soviet Union

It is estimated that Soviet debt in convertible currencies amounted in 1989 to about $56 billion, roughly 124 percent of exports of goods and services. The Soviet Union has large international reserves (about $15 billion), and it is a major lender with nominal claims estimated at around $132 billion. However, the overall quality of those claims remains unknown, as a large share of them is due by countries experiencing debt repayment difficulties.

Until 1988, the Soviet Union was perceived by external creditors as a good credit. In the early years of perestroika, this reputation enabled the SU to attract massive credits from major Western banks ($9 billion in 1988, and $6.5 billion in 1989). But by late 1989, debt service rose to an estimated $8.3 billion, representing about 21 percent of exports and pessimism has replaced the earlier euphoria. The perceived risks of lending to the Union grew considerably, due to the deterioration of the trade deficit ($6.2 billion in 1989 and growing rapidly), the booming state deficit (now in excess of 10 percent of GDP), and to the risks of a major split in the Union.

Payment arrears have recently increased to about $3 billion (by August 1990), but are expected to be reduced to $.5 billion by year-end. Short term debt has increased, and is now estimated at about 40 percent of total debt,

with the remainder about equally split between commercial and official sources. President Gorbachev recently hinted that the SU would attempt to refinance a large share of its short term debt with longer terms loans.

In spite of those difficulties, the issue of debt rescheduling is not considered seriously at the moment. The external debt situation remains far from critical, and it is conceivable that the Soviet Union would be able to attract significant inflows in the future. But it is difficult to predict with any degree of confidence whether and when the reform program will materialize and take hold, and when will the decline in economic performance will be stopped and reversed.

Yugoslavia

Yugoslavia's external debt is relatively small [21 billion, 36 percent of GNP, .9 times exports], and is about equally divided between commercial and official sources. However, its economic performance has been weak, partly because of heavy debt service obligations and it has rescheduled its external debt several times in the eighties. In addition the CA surplus was achieved through a combination of devaluations and compression of imports, leading to adverse consequences on investment and growth, and severe imbalances in the economy that ultimately emerged as hyperinflation in the late 1980s.

In 1988, Yugoslavia rescheduled its debt with both the Paris (all principal payments rescheduled until June 1990) and the London (all the 7 billion outstanding, no principal payments until 1994) clubs. As a result, the debt burden has eased: in 1989, total debts service amounted to 25 percent of GNP before rescheduling. And recently, Yugoslavia has accumulated large reserves and its current account is in surplus. But external finance is not likely to flow as long as political uncertainties persist. And the lack of foreign finance represents the major element of risk in the reform program: without inflows, the government will be unable to finance the gap in public expenditures without posing serious threats to price stability.

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Table 1
Convertible External Debt in EE: 1989
(billion of US dollars and percent)

	TED	TD/GNP	TD/X	--percent of total-- Tot. Off.	MLT Priv.	STD/1
Bulgaria	16.2	148	430	18	37	45
Poland	43.3	80	500	75	18	2
Hungary	21.1	78	284	12	72	16
Yugoslavia	21.3	36	91	40	54	6
Czec.	8.0	16	97	14	50	36
Romania	0.5	0	3	0	0	100
Soviet Union	44.5	n.a	132	30	29	41

1/ excluding IMF credit which is included in official credit.
Sources: World Debt Tables, 1990-91 and IIF Reports.

Table 2
Net Flows of MLT Debt in EE: 1980-1990
(billion of US dollars)

	1980	1982	1984	1986	1987	1988	1989	1990
Bulgaria	n.a	n.a	1.3	0.8	0.4	2.4	1.5	0.4
Poland	3.0	1.3	0.2	0.7	-0.5	-0.3	-0.4	
Hungary	0.7	0.2	1.0	1.0	1.1	1.4	1.2	
Yugoslavia	2.2	0.1	-0.1	-0.9	-0.8	-0.8	-1.5	
Czechoslovakia	n.a	n.a	-1.0	-0.1	0.4	0.6	0.7	0.7
Romania	2.0	0.8	-1.1	-0.7	-1.5	-3.3	-1.6	
Soviet Union	n.a	n.a	2.6	-1.2	-1.3	6.8	6.5	4.2
Total			2.9	-0.4	-2.1	6.7	6.6	

Sources: World Debt Tables, 1990-91 and IIF Reports.

Table 3
External Debt Rescheduling in EE

	Paris Club	London Club	Present Status
Bulgaria			Arrears to com. & off. creditors
Poland	81, 85, 86, 87, 90	82, 83, 84, 86 87, 88	Arrears to com. creditors
Hungary	none	none	
Yugoslavia	84, 85, 86, 88	83, 84, 85, 88	
Czechoslovakia	none	none	
Romania	82, 83	82, 83, 86, 87	

Sources: World Debt Tables, 1990-91.

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