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Eastern Europe's Experience With the IMF

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An Intelligence Assessment

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Eastern Europe's Experience With the IMF [redacted]

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An Intelligence Assessment

This paper was prepared by [redacted] 25X1
[redacted] the Office of European Analysis. It was coordinated with the Office of Global Issues and the Office of Soviet Analysis. Comments and queries are welcome and may be directed to the Chief, East-West Regional Economics Branch, East European Division, Office of European Analysis, [redacted] 25X1

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Eastern Europe's Experience With the IMF

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Key Judgments

Information available as of 1 August 1985 was used in this report.

The International Monetary Fund (IMF) shepherded Yugoslavia, Romania, and Hungary through the worst of their debt crises in the early 1980s. The East European members rank among the leading borrowers from the Fund, and IMF credits gave these countries breathing room to improve payments performance. The IMF, however, has had difficulty adapting its policy guidance to Communist economic systems. Fund programs have not produced the adjustment needed for these countries to achieve sustained economic growth without payments problems. 25X1

The IMF's inability to attack the root causes of the payments problems predates the region's recent crisis. Staff assessments during the 1970s pointed out flaws in these economies that hurt trade performance. Yet the IMF programs designed to correct balance-of-payments difficulties focused largely on controlling monetary growth and investment and failed to prod the regimes to attack systemic weaknesses. 25X1

Since the failure of large standby programs given to Romania and Yugoslavia in 1981, IMF programs have tried to correct inefficiencies in resource allocation that, the Fund believes, are behind poor export competitiveness and sluggish growth. Expanded performance criteria have tried to give greater weight to market incentives—similar to Fund recommendations for market economies and most Third World debtors. East European policymakers, however, managed instead to produce trade surpluses by tightening controls on investment and consumption, foreign exchange allocation, and imports. Although such controls did correct payments deficits, we believe the associated distortions have frustrated the IMF's overriding goal of balanced, sustainable growth. 25X1

In our opinion, the changes needed to achieve the Fund's goal presume a basic economic reform that none of the regimes seems prepared to implement. The IMF faces the dilemma of either better adapting its policy prescriptions to the political and economic institutions in these countries or insisting that the regimes carry out systemic change so that market instruments will work. The latter option, however, violates the Fund's charter, which stipulates neutrality on the institutional arrangements of its members and the Fund's contention that the impetus for systemic change must come from the member. Moreover, the major reforms required could involve serious political risks for the leaderships of these countries.

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Although not demanding systemic reform, the IMF's recent programs have challenged political control of resource allocation and have tried to force the governments to put economic efficiency ahead of other priorities. The slight improvement in the three countries' financial positions in the last year has reduced the willingness of these regimes to accept tough Fund prescriptions:

- Romania not only terminated its standby program ahead of schedule in early 1984, but also denounced IMF meddling and reversed many of the changes made at the Fund's insistence.
- Mounting criticism of the IMF won Yugoslavia some easing of IMF conditions; Belgrade is pressing for termination of close IMF supervision after 1985.
- Even Hungary shied away from the thoroughgoing reforms that the Fund anticipated and chose to forgo a new standby arrangement this year. [redacted]

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The most complicated challenge facing the IMF in Eastern Europe is the prospective membership of Poland. While most groups in the regime appear eager for membership as a way to win new credits and a better credit rating, they seem unready to accept the Fund's conditions:

- The Fund almost certainly will push Poland to improve debt repayment capacity by curbing consumption, investment, and government spending to a much greater extent than Warsaw would like. The leadership's reluctance to acquiesce would stem in part from the almost certain opposition of much of the population to sweeping new austerity programs.

- Even most regime supporters of membership seem unwilling to consider basic changes. Regime opponents of the IMF fear diluting the centralism and greater discipline they believe is necessary for economic recovery.

- The USSR may also complicate IMF dealings with Warsaw. Despite misgivings about closer Polish involvement with the West, Moscow apparently approves Polish membership if borrowing from the IMF can reduce Soviet economic support to Warsaw without risking extensive economic reforms or political liberalization. Nonetheless, Moscow presumably has advised Warsaw on the guidelines for negotiations with the IMF and would intervene if developments seemed to threaten its interests in Poland. [redacted] 25X1

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Even if agreement is reached, Warsaw's resistance to austerity and basic reforms, as well as the IMF's problems in coming to grips with centrally planned economies, will probably result in a program that is inadequate—if not irrelevant—to Poland's needs. The Poles might try to avoid full implementation, leaving the IMF and Western governments to decide how tough they wanted to be in enforcing compliance. 25X1

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Introduction

The financial problems and economic malaise of Eastern Europe have prompted discussion—in both East and West—about whether the International Monetary Fund (IMF) can help the region correct its economic weaknesses. Improvements in the financial position of the East European member countries under IMF programs in 1983-84 suggest to some observers that the Fund can make a difference. Others, however, question the linkage between these gains and IMF policy guidance and doubt the Fund's ability to correct the region's basic economic problems. [redacted]

The IMF's effectiveness in dealing with East European economies assumes particular importance with the prospective entry of Poland into the Fund. Poland will prove a difficult challenge, given the magnitude of its problems and the differing expectations held in the West and Warsaw about the IMF's role. Western creditors and some Poles are looking to the Fund to enforce basic economic reforms—a role that the IMF may be ill equipped to perform. While Polish financial officials are counting on IMF credits, important segments of Polish opinion—ranging from former Solidarity leaders to regime hardliners—oppose IMF-mandated austerity. [redacted]

This paper will assess the IMF's performance in dealing with East European economic and financial problems. It begins with a brief look at initial problems between the Fund and the socialist states, and then examines the Fund's failure to forestall financial crises in Yugoslavia and Romania. The paper will next review the IMF's role in helping its East European members deal with their debt problems in 1982-84, with emphasis on whether tougher standby programs have produced lasting improvement. The discussion of future IMF–East European relations focuses particularly on the problems posed by Poland. [redacted]

Early Relations Between Eastern Europe and the IMF

The feasibility of East European countries joining the IMF has been debated since the establishment of the Fund in the 1940s. Western critics argued that government monopolization of foreign trade in centrally planned economies conflicts with the Fund's objectives of promoting the growth of world trade and eliminating payments restrictions. The East Europeans had reservations about joining an organization controlled by developed capitalist countries. They were concerned that the Fund would insist on policies that conflicted with their economic and political institutions. Moreover, the East European regimes were reluctant to provide economic data required by the Fund's Articles of Agreement. [redacted] 25X1 25X1

Despite these differences, Czechoslovakia, Poland, and Yugoslavia became founding members. Although an active participant in the organizational talks, the Soviet Union chose not to join. Problems soon arose with the Fund's two Soviet Bloc members: Poland withdrew in 1950, arguing that the Fund had become an instrument of US policy. The withdrawal apparently resulted from Warsaw's failure to supply economic data required for credits from the World Bank, the Fund's sister organization. Czechoslovakia withdrew in 1955 after the Fund declared it ineligible to draw credits. Prague had refused to supply information justifying sweeping monetary reforms initiated in 1953. [redacted] 25X1 25X1

The IMF, nonetheless, remained willing to accept the East Europeans and rejected accusations that it was overly supportive of market economic theories. The Fund contended that, while members are expected to achieve certain goals, it is strictly neutral on their institutional arrangements, with its policies paying "due regard to the domestic social and political objectives, the economic priorities, and the circumstances of members." The IMF argued that it could

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The Soviet Union and the IMF

Although the Soviet Union gave no formal reason for its refusal to join the IMF, the discussions at Bretton Woods highlighted several basic objections to Fund procedures:

- *Displeasure with the distribution of voting power.*
- *A desire to pay a lower gold subscription.*
- *The right to alter its trade and exchange rate practices independently of Fund approval.*
- *A refusal to release certain economic information, especially balance-of-payments statistics and gold reserves.*

Some of these issues eventually were resolved, but Moscow failed to proceed with membership when the time arose.

While these objections no doubt played a part, political motivations were probably at the heart of Moscow's rejection of Fund membership. Attendees at Bretton Woods were entitled to become founding members of the Fund no later than 31 December 1945, a date by which East-West relations were already chilling. The Soviets decided that the Fund was merely a front for the United States and its allies and would use its powers to promote Western policies.

Moscow's basic view of the Fund has probably not changed much in the intervening years. Indeed, the Fund's recent tougher approach on lending conditions has probably reinforced Soviet misgivings. Soviet propaganda regularly denounces the Fund as a tool used by Western banks and governments to exploit debt-troubled developing countries. During the past year Soviet media have criticized sharply the role of "international financial institutions" in seeking to solve Eastern Europe's debt crisis. 25X1

Why, then, do the Soviets tolerate Hungarian and, prospectively, Polish membership? As early as the mid-1970s, Hungary and Poland began exploring IMF membership, but—unlike the Romanians—these regimes did not ignore Moscow's opposition. The USSR finally gave the green light in 1981 25X1 *probably because it perceived the region's growing financial difficulties and did not want to shoulder the burden. Moscow presumably could swallow its objections as long as the West was willing to pump several billion dollars into the region and the regimes did not consent to extensive changes in policy. Moscow probably realizes by now that IMF membership does not threaten Communist rule. Romania's 12-year membership has in no way diluted Ceausescu's near Stalinist control of the economy. Hungary's reform movement—while probably abetted by Fund guid-* 25X1 *ance—was initiated well before it joined the Fund and has not weakened the party's control.* 25X1

better promote international monetary cooperation and world financial stability by allowing all countries to become members.

A Hands-Off Policy

The conditions attached to IMF loans to Yugoslavia during the 1960s and 1970s and to Romania, which joined the Fund in 1972, did not address the root causes of external imbalance. Most of the borrowings were reserve and first credit tranche drawings that impose minimal conditions on economic policy (see table 1 in appendix). Belgrade and Bucharest also borrowed from the compensatory financing and oil financing facilities. These borrowings entailed limited conditions because they were to cover supposedly 25X1 temporary financial gaps caused by developments beyond government control—OPEC oil price hikes, Western recession, poor weather, and even earthquakes. Where the IMF saw the need for adjustment of the domestic economy, it focused almost exclusively on measures aimed at restraining investment and imports. Little attention was given to changing the mechanisms by which resources are allocated within these economies. 25X1

IMF Adjustment Programs

IMF adjustment programs for Eastern Europe have followed the format typical for any Fund member. The IMF sets conditions for the use of its credits to help ensure that the country overcomes its balance-of-payments problems within a reasonable period of time and can sustain financial equilibrium without continued reliance on the Fund. At least until recently, the Fund focused almost entirely on fiscal, monetary, and exchange rate measures aimed at balancing domestic demand with available resources.

The starting point for the development of an adjustment program is an estimate of how large an improvement in a country's current account is required and over what period of time. This estimate depends on an assessment of the likely inflow of foreign capital. Once the Fund has established a current account target, it considers the level of domestic demand that can be sustained while bringing about the necessary improvement in foreign trade performance. Domestic expenditures must be reduced in order to lower demand for imports and to free up more production for export. A Fund adjustment program aims to cut purchasing power primarily by:

- *Controls on wages to lower real household income and consumption.*
- *Controls on aggregate credit to lower investment.*
- *Increases in taxes and reduction in government spending both to reduce government demand directly and to reduce government pressure on credit markets.*
- *Decreases in the rate of growth of the money supply to control inflation.*

These expenditure-reducing policies are usually accompanied by substantial devaluation of the domestic currency to encourage exports and discourage imports.

The Fund has begun to pay somewhat greater attention to "supply-side" policies in recent years because its traditional demand-oriented approach seemed to have an excessively depressive effect on economic growth. Fund programs have focused increasingly on measures to improve resource allocation and productivity, especially by encouraging greater reliance on price mechanisms. The IMF has tried to promote greater efficiency by recommending liberalization of trade and payments practices and by pressing for the elimination of subsidies and controls on prices. 25X1

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The Fund's policy advice is contained in the program negotiated with the country seeking access to Fund lending. The first section of the program contains the so-called performance criteria. These criteria always include commitments that prohibit the borrower from:

- *Imposing or intensifying restrictions on payments.*
- *Introducing or modifying multiple currency practices.*
- *Concluding bilateral payments agreements that are inconsistent with the Fund's articles.*
- *Imposing or intensifying import restrictions.*

In addition, the programs contain "quantitative" performance criteria that typically set targets for:

- *Domestic lending by the banking system.*
- *Gross convertible currency reserves.*
- *Short-term foreign debt.*
- *Trade or current account balances.*

These targets have to be met—either on a quarterly, semiannual, or annual basis—in order for the member to maintain access to IMF credits. 25X1

The second section of the program contains the letter of intent drawn up by the borrowing country, usually with the advice of Fund staffers. The letter reiterates the quantitative targets to be met over the duration of the program and outlines the policies the country plans to adopt to achieve the targets. These policy understandings may involve fiscal reform, investment reform, price liberalization, and incomes policies. 25X1 *Unlike the quantitative performance targets, however, compliance with policy understandings is generally not binding on the borrower.* 25X1

Yugoslavia's borrowing put Belgrade among the top users of IMF credits during the 1960s and early 1970s (see table 2 in appendix). Fund lending—particularly several small standby loans—helped reassure Western bankers when payments imbalances arose, in part as a result of the implementation of major decentralizing reforms. Belgrade's financial problems, however, were seen as only temporary disequilibriums that could be corrected by controls on domestic demand.

The IMF began to give more attention in the late 1970s to institutional weaknesses as a cause of Yugoslavia's growing payments deficits. The Fund's recommendations, however, continued to focus on limiting the expansion of credit, which the IMF saw as the basic cause of Yugoslavia's excessively high rate of investment and worsening inflation. The programs did not address the systemic causes of balance-of-payments problems:

- The highly decentralized political and economic system that allowed regional authorities to pursue policies of autarkic development resulting in irrational and redundant investment, subsidization of inefficient enterprises, and protection of local monopolies.

- The lack of a capital market to ensure efficient allocation of investment and foreign exchange.

- Limited control by central authorities over government spending and taxation.

- The wage-price spiral embedded in the worker self-management system.

Since the Fund would not question a member's political and economic institutions, staff assessments at this time did little more than urge better policy coordination between Belgrade and the republics. Moreover, the IMF's leverage on Yugoslav economic policy was limited because the growth of Western official and commercial lending had reduced Belgrade's need for Fund loans in the late 1970s.

Romania is an even clearer example of the IMF's failure to attack the root causes of payments problems. Bucharest joined the Fund largely to demonstrate its independence from Moscow. Romania also was interested in the financial benefits to support its growing trade with the West, although it drew few credits in the first years of membership (see table 3 in appendix). Two standby credits drawn in 1975 and 1977 were second tranche loans not subject to tough conditions. The performance criteria focused merely on domestic credit and external payment indicators. 25X1

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As the first Soviet Bloc member since the 1950s, Romania received kid-glove treatment. The Fund allowed Bucharest to skip much of the data submission required of members and did not even insist on the statistics typically demanded when a country applies for IMF credits. The standby programs did nothing to correct the regime's overly ambitious industrialization program, which was making the country increasingly dependent on imported materials and energy, weakening agriculture, and undermining trade performance. 25X1

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The IMF and the Debt Crisis

The IMF assumed greater importance in Eastern Europe with the onset of financial crisis in the early 1980s. Poland's slide toward insolvency, as well as deteriorating East-West relations, prompted Western bankers to take an increasingly hard look at East European creditworthiness. The rapid buildup of debt by Yugoslavia and Romania in the late 1970s put these countries in a particularly poor light. The bankers responded with an increasingly rapid withdrawal of credit. 25X1

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The IMF tried to offset the loss of bank lending in hopes of giving Yugoslavia and Romania time to improve their trade performance and regain the confidence of Western bankers. Yugoslavia was granted 25X1 one-year standby loans in 1979 and 1980 and a compensatory financing credit in 1980. Romania also received a compensatory financing loan in 1979. Both Belgrade and Bucharest adopted austerity programs, including sharp reductions in imports, but they could not improve their trade and current account balances enough to counter the loss of capital inflows—even with the IMF credits. As the financial position of both countries deteriorated, the Fund moved to larger and longer term programs. In early 1981 Yugoslavia and Romania were granted three-year standby facilities (see table 4 in appendix).

Although these credits were upper tranche drawings, the IMF did not impose significantly tougher performance criteria. The Fund continued to focus mainly on controlling monetary growth through limits on domestic credit and foreign borrowing, as well as on targets for the trade balance, current account balance, and international reserves.

The programs quickly proved inadequate to avert financial crisis. The Fund had overestimated both the amount of likely bank lending to both countries and the improvement in current account performance the IMF programs would produce. In Romania's case, bankers were not reassured by the Fund's standby program and continued to withdraw short-term credit lines. By late 1981, Romania was trapped in a serious liquidity crisis and found unpaid obligations mounting. With arrears a violation of the IMF charter, the Fund suspended drawings under the standby only a few months into the program.

The Fund realized that its efforts would not restore Romania's financial health. Bucharest's relations with foreign creditors had sunk so low that bankers were unlikely to resume normal lending soon. The IMF persuaded Bucharest that rescheduling was the only solution—a difficult task given the regime's fear of being labeled a "second Poland." The IMF's advice and expertise proved invaluable in concluding agreements with Western banks and governments, especially given the inexperienced and incompetent Romanian negotiators.

Yugoslavia's standby program proved nearly as unsatisfactory as Romania's. Continuing current account deficits and missed payments by some Yugoslav banks in early 1982 led to a precipitous decline in Western bank lending. At the Fund's prodding, Belgrade attempted to recentralize control over foreign exchange to manage its dwindling reserves, but by the end of the year Yugoslavia's reserves had fallen to less than a month's worth of imports, and arrears were building. 25X1

In response to Belgrade's alarming financial position, the IMF pressed Western governments and banks to adopt a financial rescue plan. The Fund's role in 25X1
assembling the package and providing its seal of approval was critical in gaining both Yugoslav acceptance of tougher performance criteria in 1983 and a commitment by creditors to reschedule maturing loans and extend new credits. 25X1

The debt crisis helped push Hungary to join the IMF. Budapest applied to the Fund in late 1981, when its 25X1
payments position was weakening due to poor export performance and rising interest payments on its debt. By the time of its entry in May 1982, Budapest had survived—with help from Western central banks and the Bank for International Settlements (BIS)—the worst of a severe liquidity crisis brought on by the sudden withdrawal of over $1 billion in short-term credits by Western, CEMA, and OPEC banks. 25X1

Hungary immediately sought IMF assistance because the BIS loan required the adoption of an IMF standby program, and because Fund support was essential to restoring Budapest's standing with commercial banks. 25X1
Hungary drew its reserve tranche and received a compensatory financing credit as well as a 13-month standby arrangement in December 1982 (see table 5 in appendix). 25X1

New Program Conditions

The East European debt crisis took the Fund by surprise because it failed to anticipate the loss of confidence in the region by bankers, following Poland's financial collapse. Reschedulings for Romania and Yugoslavia coming on the heels of large, 25X1 multiyear standby arrangements left the Fund open to criticism. Bankers—who to some extent made the Fund a scapegoat for their own mistakes—denounced "soft" IMF programs for Eastern Europe, arguing that the Fund's policies reflected glaring misunderstandings of the region's economic systems. [redacted]

The Fund reacted to the failure of its Romanian and Yugoslav programs by taking a closer look at planned economies, and it developed some new thoughts on adjustment and conditionality:

- The Fund concluded that performance criteria focusing on fiscal policies pay few dividends in East European adjustment programs. These regimes do not use deficit financing, and tax policies play little role in the control of consumption or investment. Nonetheless, the Fund recognized the need to reduce central budget subsidies to both consumers and enterprises in order to rationalize prices and force greater financial discipline.

- The Fund continued to believe that monetary policy can promote adjustment by controlling credit expansion and the tendency of socialist economies to invest at extremely high rates.

- The Fund acknowledged, however, that reliance on monetary policy alone cannot correct problems of inefficient resource allocation in these economies. While controls on domestic credit and foreign borrowing can reduce the overall amount of investment, they do not ensure that economically efficient projects are protected at the expense of undesirable ones. The lack of rational pricing for capital, foreign exchange, labor, and goods means that the established pattern of resource allocation will persist even with reduced inputs. With no movement toward greater efficiency, constraints on demand to improve the balance of payments simply lower output. [redacted]

Standby programs over the past two to three years have begun to reflect the Fund's judgment that performance criteria must address microeconomic distortions as well as demand restraint. The more recent East European programs have called for:

- Reducing price subsidies and lifting price controls.
- Raising artificially low interest rates.
- Adjusting exchange rates to balance the supply and demand for foreign exchange and to enhance export competitiveness.
- Reducing trade restrictions that protect domestic industries from import competition and prevent the sale of exportable goods to foreign markets. 25X1
- Increasing wage differentials to reflect productivity and enterprise profitability. [redacted] 25X1

The Fund also has begun to press for tougher financial discipline on enterprises through reductions in price, credit, and budget subsidies and enforcement of bankruptcy laws. As long as enterprises can continually operate at a loss and default on obligations to domestic creditors, rational prices will not promote improved resource allocation. [redacted] 25X1

The shift in focus of IMF programs has coincided with growing tensions between the Fund and the debtor countries. To some extent, the gradual improvement in the financial positions of these countries since 1982 has reduced their tolerance of Fund guidance. But the reasons for complaints about IMF meddling are more deep seated. The Fund's growing interest in correcting systemic weaknesses threatens the power of political leaderships to control allocation of resources and gives primacy to economic efficiency over the traditional sociopolitical concerns of East European governments. [redacted] 25X1

Yugoslavia

The IMF's new approach to Eastern Europe is most evident in its programs for Yugoslavia. The Fund toughened its stance in the final year of the 1981-83 standby agreement. In addition to controlling domestic demand through tighter limits on credit and government spending, the performance criteria called for monthly devaluations of the dinar and price hikes in transportation, housing, and energy. The large cutback in domestic demand and import rationing produced a significant gain in trade and current account performance, but output declined (see figure 1). Some of this downturn was unavoidable, but it also reflected the inflexibility and ineffectiveness of

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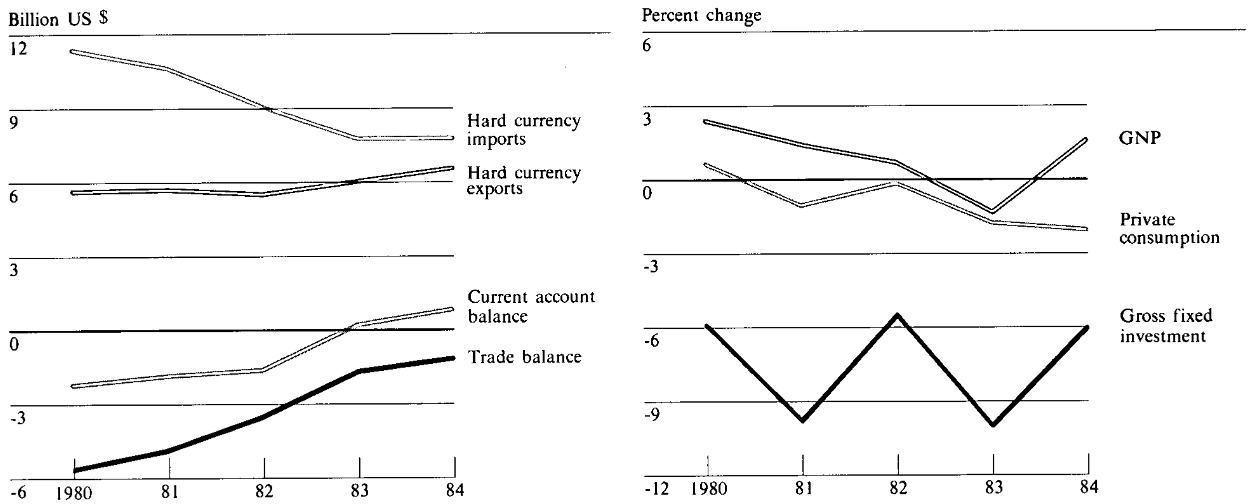
Figure 1
Yugoslavia: Economic Indicators, 1980-84



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mechanisms for resource allocation, particularly for moving capital and foreign exchange to export sectors. [redacted]

Because of the shortcomings in 1983 performance, the 1984 standby program moved harder against distortions in the Yugoslav economy. Performance criteria were expanded to include:

- A lifting of the general price freeze with at least 55 percent of producer prices to be market determined and higher prices for those items still under federal control.
- Monthly adjustments in nominal exchange rates to achieve effective real devaluation between the dinar and the currencies of Yugoslavia's main Western trading partners.
- Quarterly increases in interest rates to achieve positive real interest rates by April 1985.
- Limits on wage hikes, with harsher terms applying to workers in unprofitable enterprises.
- Limits on support payments to insolvent enterprises.

Yugoslavia's success in restoring economic growth in 1984 and increasing its current account surplus through export growth led the IMF to conclude that this program had finally put Belgrade's adjustment effort on the right track. [redacted] 25X1 25X1

The Fund's decision to target distortions in the Yugoslav economy provoked a deterioration in relations with Belgrade. As long as adjustment programs had centered on monetary policy, the Fund's prescriptions were consistent with Yugoslavia's traditional use of credit controls to regain balance. But once the Fund began pushing for greater use of market forces, it was challenging the decisionmaking prerogatives of Yugoslav politicians and the regime's priorities. [redacted] 25X1

The debate between Belgrade and the Fund has centered on the impact of the recent criteria on inflation, enterprise solvency, and output. Yugoslav critics contend that freeing prices, devaluing the dinar, and raising interest rates are responsible for Yugoslavia's inflationary spiral. Increases in the consumer price index have risen from 30 percent in 1982 to more than 70 percent in early 1985. The Fund's view is that the costs of a temporary acceleration in inflation due to the program's conditions are more than offset by the long-run benefits from improved resource allocation and better incentives for export. The high inflation rate reflects impediments caused by fragmented markets that limit the economy's responsiveness to changing prices. The IMF acknowledges that a solution to these basic problems must address sensitive social and political issues, but insists that structural changes must be made if the economy is to regain growth with external balance and ease inflationary pressures. Gains in exports and improved trade balances have been small comfort, however, to Yugoslav politicians who are more concerned about growing dissatisfaction at home over their failure to reduce inflation and protect household incomes. [redacted]

Yugoslav critics of the IMF have argued that reducing the subsidies to enterprises provided by negative real interest rates would weaken the already precarious solvency of many enterprises. This would produce substantial losses in output and employment and widen economic disparities between the relatively prosperous North and the poorly developed South. [redacted]

The Fund countered that the costs in lost output from reduced investment would be minimized if interest rates allocated capital to projects offering the highest return. Administrative controls on credit can reduce investment to promote stabilization, but regional powers can still protect pet projects and squander resources on inefficient ventures. By trying to use interest rates to ration credit and enforce financial discipline on enterprises, the IMF has challenged Yugoslavia's priority system for investment decisions and threatened to suppress the use of political criteria in allocating resources among competing projects and regions. [redacted]

Belgrade's objections paid off in some easing and simplifying of performance criteria in the 1985-86 program. Even though the intent of the new program, [redacted] is to deal more with supply problems than demand restraint, the performance criteria have returned largely to fixing macroeconomic targets rather than influencing microeconomic decisions. For the most part, the current criteria resemble those of earlier programs, which emphasized limits on public-sector expenditures, monetary growth, and foreign borrowing. Even these criteria have been loosened to allow for some growth in investment, which the Fund believes is necessary to upgrade the aging capital stock. Criteria in the 1984 program on price liberalization, subsidies, and wage hikes in unprofitable enterprises have become less binding policy understandings; only the achievement of positive real interest rates has remained a specific target. Apart from Yugoslav demands for a simpler program, the easing of conditions reflects the Fund's judgment that Yugoslav policies have begun to shift resources toward more efficient uses—and particularly toward export sectors. Specific criteria are no longer needed, provided Belgrade keeps to the policy understandings. Nonetheless, the IMF has made it clear that it will monitor closely Yugoslavia's compliance. [redacted]

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Romania

The IMF began pressing the Romanians harder than before for policy changes when it reinstituted the suspended 1981 standby arrangement in late 1982. The Fund demanded price increases and exchange rate adjustments, including increased energy prices, the gradual merging of the commercial and noncommercial exchange rates, and the pegging of the leu to a basket of Western currencies. In the letter of intent Bucharest also stated that it would conduct four detailed studies on further changes in prices and exchange rates, and on future policies regarding interest rates and investment policy. [redacted]

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Romania achieved an impressive improvement in its hard currency current account in 1982-83, but the gain was based on a sharp curtailment of imports which depressed economic growth (see figure 2). Concerned over this trend, the Fund pressed Bucharest for additional policy action: further devaluations, increases in interest rates to ensure the selection of

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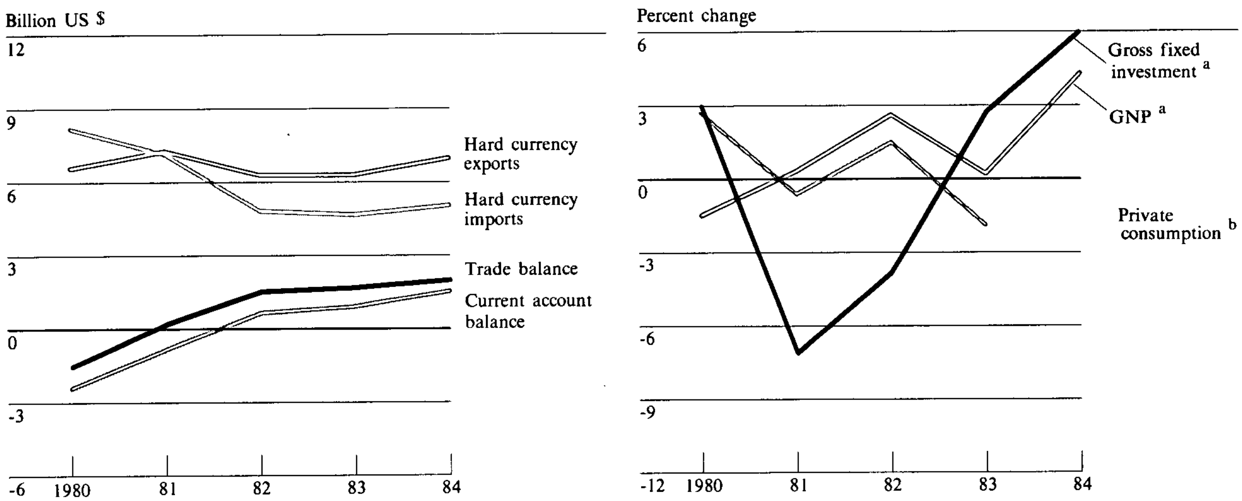
Figure 2
Romania: Economic Indicators, 1980-84



[a] Because of the large distortion in official indexes, we have less confidence in the estimates for Romania than for the other countries.
[b] Romania has ceased publication of data needed for the calculation of consumption after 1983.

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efficient investment projects, and increases in crude oil prices to reduce domestic consumption and to stimulate production.

The Ceausescu regime, however, balked at the IMF guidance and refused to conduct the studies stipulated in the letter of intent. Bucharest had grown weary of IMF involvement in economic decision making and, with its external position improving, felt that compliance with more demands was unjustified. The Fund, with Bucharest's agreement, canceled the last year of the standby arrangement in early 1984.

Romania's estrangement from the Fund deepened following termination of the program. The regime reversed earlier actions on devaluation and reduction of multiple exchange rates. In the Fund's view, these decisions—coupled with Bucharest's continued tight controls over imports and exports—have undone the regime's earlier small steps toward balanced adjustment. In his speech to the Romanian Party Congress, Ceausescu denounced the IMF and called on the Fund to cease imposing political and economic conditions as the basis for its lending. 25X1

Hungary

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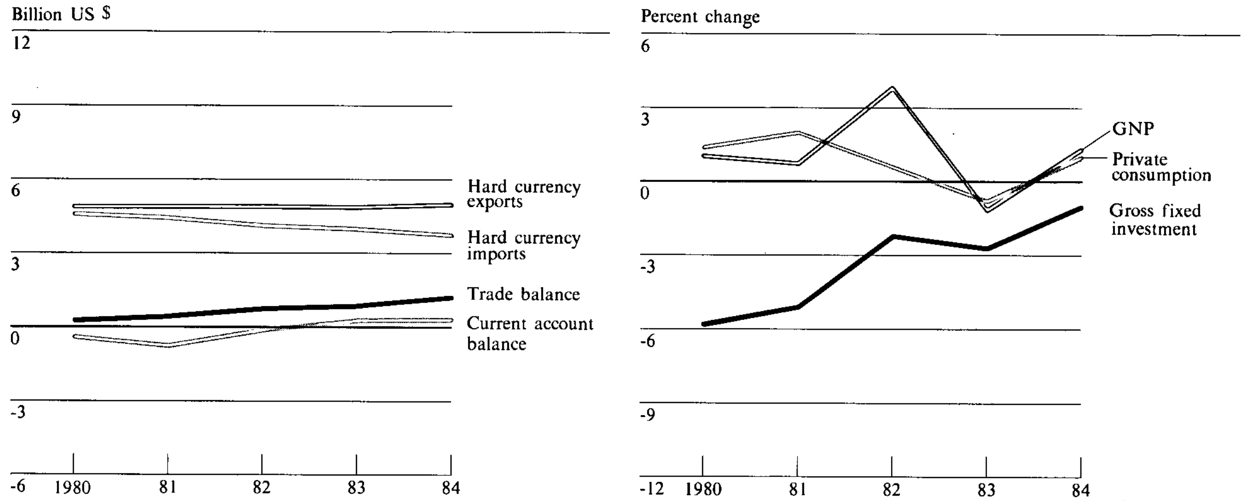
The IMF's dealings with Hungary have been more placid than those with Yugoslavia and Romania, but the Fund has taken an increasingly critical stance on Budapest's efforts to correct systemic problems. During the honeymoon phase, the Fund accepted almost uncritically the regime's adjustment policies and reform program. But the IMF began to look harder at Budapest's management once it became clear that the 25X1 stabilization efforts were falling short of the mark and the reform proposals promised more than they delivered. 25X1

The overriding priority in the IMF's first program for Hungary was to help Budapest overcome its liquidity crisis. The focus was on controlling demand to achieve a large improvement in the current account rather

Figure 3
Hungary: Economic Indicators, 1980-84



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than on correcting underlying economic weaknesses. The Fund endorsed the regime's stabilization program, which has been implemented since 1978, with specific performance criteria aimed only at controlling the growth of the money supply and foreign debt. Budapest pledged to place stricter controls on real incomes and investment, higher interest rates, and a more active exchange rate policy. Rather than establish specific criteria, the IMF merely monitored performance against Budapest's own targets for reduction of expenditures. The regime stated that it would pursue its program of economic reform. The Fund welcomed this intention—but apparently had no input into the specific measures—and merely noted that Budapest should eventually deal with such distortions as import controls and subsidies.

The 1983 program proved only a limited success (see figure 3). The improvement in hard currency trade and current account performance was less than anticipated largely because investment and consumption did not decline as much as planned. Because of the program's shortfall and the large debt repayments facing Hungary, the Fund insisted on somewhat tougher conditions in the 1984 program. The performance criteria expanded controls over credit—in particular, lending to support state investments—and over enterprise use of retained earnings. While the thrust of the program remained demand restraint, the Fund stressed that Budapest had to do more to increase supply in order to restore economic growth. The Fund applauded Budapest's commitment in the letter of intent to reduce wage controls, increase wage differentiation, free more prices, and cut subsidies; nonetheless, the Fund urged the Hungarians to move beyond these policy understandings in the areas of wage determination, market-determined prices, and banking reforms.

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Budapest's financial and economic health improved in 1984. Economic growth resumed, and Budapest at least maintained its current account surplus. Western lender confidence revived sufficiently to produce a sizable inflow of loans and an increase in foreign exchange reserves. The Fund declared that Hungary was well enough off to forgo further support upon completion of the 1984 program.

The IMF's explanation for not extending further standby assistance masks friction with Budapest over the stabilization and reform effort. With the worst of the financial crisis over, the IMF contended that further cuts in investment and income in the socialist sector were no longer appropriate. The Fund noted that the longer run problems from reduced investment could be lessened by ensuring that scarce capital is not wasted on inefficient projects. The appraisal criticized the lack of rational pricing and of financial responsibility of enterprises, which frustrated efforts to improve efficiency. Sustaining the improved financial position and growth required new policy instruments to manage demand, as well as a stronger role for market forces to promote efficiency and productivity. The IMF urged the Hungarians to:

- Expand enterprise authority over the determination of wages and prices.
- Intensify competition by reducing subsidies to loss-making firms, eliminating most controls on imports, and expanding the foreign trade rights of enterprises.
- Introduce tax reforms which would provide better control over rapid increases in consumption resulting from the buoyant growth of income in the private sector.
- Improve incentives by widening wage differentials.
- Pursue a more flexible exchange rate policy.

While Budapest addressed some of these issues in the reform program for 1985-90 approved by the Party Central Committee in April 1984, the IMF's guidance went beyond what the regime was willing to implement.

The Hungarians asked for IMF financial support for 1985 and beyond to facilitate implementation of its reform program. The Fund was sympathetic to the need for standby assistance should adoption of new reforms produce temporary disequilibrium in the economy and external finances. The IMF, however, faulted the Hungarian proposals for the slow pace of implementation and excessive exceptions and loopholes that watered down the thrust of the reforms. The Fund complained that the package of measures planned for 1985 had been scaled back from earlier discussions, and, as a result, there would be little impetus toward greater efficiency, exports, and output. 25X1
Moreover, the Fund was unhappy with Budapest's protection of consumption at the expense of investment in its adjustment policies. The IMF called upon the Hungarians to place tighter controls on the growth of income in the booming private sector and to adopt a more thorough program of reform, or do without IMF credits. Buoyed by its strengthened financial position, Budapest chose to do without the IMF's support. 25X1

Has the Fund Made a Difference?

The financial positions of Yugoslavia, Hungary, and Romania improved under IMF programs, in some cases far more dramatically than even the Fund had anticipated. Each of the countries moved its current account balance from deficit to surplus. Romania and Yugoslavia negotiated debt refinancing arrangements, while Hungary restored its creditworthiness sufficiently to resume large-scale borrowing from Western banks. While important in repairing creditor-debtor relations, the IMF's guidance does not seem to have done much to ensure that these gains will be long lived. 25X1

The IMF's major contribution to Eastern Europe has been arranging reschedulings and new credit packages. Direct lending by the IMF and World Bank plus new credits extended by commercial banks at the IMF's insistence totaled nearly \$6 billion in 1982-84. The three East European countries rank among the leading users of IMF credits although only Yugoslavia has used more than half its credit limit with the 25X1
Fund (see table 6 in appendix). These loans covered over half of the borrowing requirements for Yugoslavia and Romania. Although IMF and World Bank credits covered a smaller share of Hungary's financing requirements in 1982-84, Budapest could not have raised the nearly \$2 billion in Western bank loans needed to avoid rescheduling without the Fund's seal

Eastern Europe and the World Bank

The World Bank is a multilateral lending institution whose long-term credits are to promote economic development. While IMF lending and programs traditionally have focused on correcting short- to medium-term payments problems, the World Bank has concentrated on lending to specific projects that are designed to augment long-term capital inflows. Over the years, however, the distinction between the World Bank and the IMF has blurred. While the Fund's goals have led it to delve increasingly into matters of microeconomic efficiency—such as investment priorities and pricing policies—the World Bank has realized that it must deal with long-term balance-of-payments problems that threaten economic development. Thus, the Bank's mission has begun to overlap with the Fund's to the point that the Bank now extends "structural adjustment loans," or credits specifically designed to help countries with balance-of-payments difficulties. 25X1

The three East European members of the World Bank have made extensive use of its lending programs:

- ***Yugoslavia** has drawn on World Bank credits more than the other two, and indeed has been one of the largest users among the Bank's 144 members. It has received 83 loans worth nearly $4 billion during its 30 years of membership. At present, the Bank's outstanding commitments to Yugoslavia account for over 4 percent of the Bank's loans, placing Belgrade among the top 10 borrowers. While the vast majority of the loans have been project loans for agriculture and export industries, Belgrade was awarded a structural adjustment loan for $275 million in 1983. Conditions for this loan included tightening investment allocations, especially in energy, and undertaking jointly with the IMF a study on improving foreign exchange allocation. In addition, Yugoslavia has made some use of credits provided by the International Finance Corporation (IFC), an arm of the World Bank whose purpose is to promote development of the private sector. Loans worth almost $360 million have been offered to 18 different projects since Belgrade joined this organization in 1970.*

- ***Romania** has received 33 project loans worth about $2.2 billion since it joined in 1972. The projects have covered transportation, agriculture, energy, and export industries. Use of the Bank's resources tapered off after 1982 as Bucharest sought to reduce its hard currency debt. Romania, however, has now decided to seek new borrowing from the Bank and recently submitted several project proposals.*

- ***Hungary** has already received seven project loans worth $689 million since joining in July 1982. Moreover, Budapest has taken advantage of the Bank's promotion of cofinancing loans to obtain additional commercial bank financing for the projects. Syndications for these projects have brought in $1.3 billion, of which the World Bank has kicked in an additional $118 million. In 1985 Hungary joined the IFC and the International Development Association (IDA), a World bank affiliate that provides very-long-term, low-cost project loans to the poorest developing countries. Hungary is looking to the IFC to provide funding—potentially through joint ventures with Western commercial banks—to its private enterprise sector, particularly in agriculture. Budapest is interested in using the IDA as a vehicle to bid on projects in the Third World.* 25X1 of approval. This financing enabled the three countries to avoid default and offered them breathing room to achieve external balance without crippling austerity—an opportunity Romania chose to ignore. [redacted]

Even though IMF programs have given more scope to market forces in Yugoslavia and Hungary, East European policymakers continue to allocate resources largely through administrative measures. The East Europeans responded to the need for trade surpluses after 1981 by tightening direct controls on investment and consumption, foreign exchange allocation, and the level of imports. Hungary, Yugoslavia, and Romania negotiated programs with the Fund in order to obtain credits, but the truly effective measures were those that the regimes would have employed without the Fund. The Fund's policy measures were neither necessary nor sufficient to produce adjustment within these economies. Moreover, the Fund does not seem to have made much headway in correcting the inefficiencies and distortions of these systems. [redacted]

Yugoslavia
The IMF apparently believes that its policy guidance has produced the most change in Yugoslavia. The improvement in hard currency trade and current account balances coupled with revival of economic growth in 1984 convinced the IMF that its program had helped Yugoslavia achieve a "watershed." In the IMF's view, its recommendations have started to promote greater efficiency and to shift resources to export sectors. [redacted]

These gains, however, do not seem deeply rooted. The major improvement has been a more realistic exchange rate that has helped boost Yugoslav exports. It is unclear, however, whether growth in export industries reflects a movement of resources in response to prices or administrative allocation of needed imports to this sector. The interaction of supply and demand is determining a greater share of prices, and movements in interest rates and exchange rates are more fully reflected in prices. Nonetheless, the persistent problem of inflation indicates that excessively fragmented and protected markets are still preventing goods, capital, labor, and foreign exchange from moving to their most efficient uses. Moreover, the regime's bias toward repressing inflation rather than dealing with the underlying causes—as seen in the partial reimposition of controls in early 1985—continues to limit the effectiveness of prices in allocating resources. [redacted] 25X1

Yugoslavia has not made much progress in moving capital and labor out of inefficient uses into more productive sectors. The IMF's effort to restrict wage hikes in money-losing firms in order to encourage workers to move elsewhere has been undercut by numerous loopholes and exceptions. The effort to impose tighter financial discipline on enterprises by reductions in subsidies and tougher application of bankruptcy laws has been similarly weakened. Proposed legislation on banking and foreign exchange gives little reason to expect the establishment of efficient, integrated capital markets. In the absence of such markets, the authorities will continue to rely on direct intervention and subsidies to allocate investment resources and foreign exchange. Without more progress in removing the impediments to the movement of inputs, the recent policy changes could be short lived and the progress with adjustment reversed. [redacted]

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Romania
The policies advocated by the IMF were totally irrelevant to economic decision making in Romania. Romanian enterprises have little power over pricing, their financial position, and investment, which means that changes in real variables must come through modifications in the central plan. There is little evidence that plan provisions were adapted to the IMF-mandated increases in domestic and export prices. Through controls on profits and selective tax relief for enterprises, Bucharest largely neutralized the impact that the devaluations, increases in interest rates, and hikes in energy prices could have had on incentives for production, exports, and the efficient use of inputs. The fiscal and monetary targets set by the Fund had little effect on economic activity since the financial plan was drawn up in conjunction with the economic plan and was designed to accomodate rather than influence the targets for production, investment, and consumption. [redacted] 25X1

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Bucharest improved its hard currency trade and current account performance by imposing draconian cuts in imports and diverting much domestic production—particularly of food and energy—to exports. This has cut living standards drastically and apparently damaged the economy's growth potential.

Hungary

Budapest's failure to meet the minimal performance criteria and policy understandings negotiated with the Fund is strong evidence that the 1983-84 programs did little to improve the efficiency and competitiveness of the Hungarian economy. Control over investment was achieved largely through licenses and credit allocation rather than interest rates. As a result, cutbacks have been general rather than selective, slowing completion of all projects rather than eliminating the least efficient. To control consumption, the regime has imposed tight constraints on wages in the socialist sector in preference to reductions in consumer subsidies and control over incomes in the private sector. These policies seem to have distorted the allocation of labor and to have caused losses in productivity. Hungary's disappointing export performance—despite repeated devaluations of the forint—suggests that the response of enterprises to changing prices remains weak.

The Problem of Reform

The limited impact of the Fund's market-oriented prescriptions reveals the fundamental dilemma facing the IMF in Eastern Europe. The IMF must either adapt its advice to the economic institutions in these countries or insist that the countries carry out systemic change so that market instruments will work. While administrative controls can be effective in meeting the Fund's primary requirement of correcting payments deficits, the associated inefficiencies can frustrate the goal of sustainable growth. The changes needed to deal with this problem, however, are long term and affect the basic organization of these systems and how they function. They go beyond the scope of IMF adjustment programs and conflict with its commitment to work within the member's institutions.

The Fund, nonetheless, has tended to develop a symbiotic relationship with supporters of reform within the economic leaderships of Hungary and Yugoslavia. The Fund, for its part, appeals to domestic reform prosposals as a source of legitimacy for its policy recommendations, while maintaining the official position that it did not tell the government what to do, but rather accepted a program proposed by the government. The advocates of reform within the regimes, for their part, appeal to the need to meet the Fund's conditions in their effort to push forward desired reforms. In Hungary, the Fund has worked closely with reformist elements within the National Bank of Hungary, and its staff assessments have urged government adoption of this group's program. In Yugoslavia, the Fund has linked its recommendations to the Kraigher Commission report—adopted by the Yugoslav government in late 1983—which came down strongly for reforms establishing national capital and foreign exchange markets, market-determined prices, and a reduction in ad hoc political intervention in economic decision making.

The Fund, however, has been frustrated in its efforts to get the regimes to move fast and effectively in correcting systemic flaws. The regimes may accept Fund guidance to deal with an immediate financial crisis, but the major reforms needed to correct systemic problems could involve serious political risks for the leaderships in these countries. Decisions on basic reform are made in the political arena where the influence of the IMF and its regime allies appears limited.

The Fund thus confronts the task of better adapting its policy recommendations to the mechanisms by which economic decisions are made.

adjustment programs must look more closely at plan objectives, particularly at variables affecting investment, output, and, ultimately, foreign trade results. Nonetheless, staff assessments of the East European

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economies still show a strong bias toward the use of market forces in resource allocation.

Waning Influence

The IMF's influence in Eastern Europe seemingly has waned over the past year with termination of the Romanian and Hungarian standby arrangements. The possibility of Yugoslavia replacing its standby with a less rigorous monitoring arrangement next year suggests further diminution of the Fund's role. This trend, however, could be quickly reversed. The external payments performance of both Romania and Hungary has been poorer than anticipated so far in 1985, and either or both regimes may request new standby arrangements. Even if Belgrade succeeds in ending standby supervision, the creditors probably would be quick to demand renewed IMF guidance if Yugoslavia's payments position weakened.

Yugoslavia

In its negotiations for a multiyear rescheduling agreement with Western banks, Belgrade has demanded enhanced Article IV consultations in place of a standby agreement after April 1986.[1] The regime sees this as a way to respond to domestic criticism of IMF-mandated austerity and to reduce the Fund's leverage to demand changes in the economic system. Belgrade has argued that its improving economic and financial performance entitles it to the same, less rigorous Fund oversight granted Mexico in its multiyear bank rescheduling agreement.

Commercial bank creditors and the Yugoslavs have reached general agreement on the form of such monitoring: the IMF would conduct two—instead of one—Article IV consultations annually, assessing performance and—possibly—prospects. The banks and the Yugoslavs also reached agreement on "trigger" criteria that would precipitate consultations with the banks on economic policy if performance fell short of the targets. While the IMF is willing to do the consultations, it is wary of becoming a tool of the private creditors and insisted that it would not agree to any trigger mechanisms that would require the Yugoslavs and the Fund to hold policy consultations. 25X1

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The agreement in principle between Belgrade and the banks does not ensure that the Yugoslavs have a way out from IMF supervision. The Paris Club of official creditors merely indicated that it will consider the appropriate nature of future IMF surveillance at the time of rescheduling 1986 debt. Since many Western governments believe that Belgrade has done little to correct its fundamental problems, the Paris Club may continue to insist on explicit policy conditions in a standby arrangement. If this were the case, the Fund probably would demand more reductions in administrative controls over capital and foreign exchange in favor of integrated markets, greater use of wage incentives, and the liquidation of bankrupt enterprises. Belgrade would try hard to soften the IMF's conditions but probably would agree in the end to a new program. 25X1

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Romania

Worsening financial problems could build pressure on the Romanians to reinstitute a standby arrangement. Poor hard currency trade performance in 1985 has led to late payments to suppliers and to an emergency short-term loan from a few major bank creditors. Bucharest's ability to cover the large payments due on its rescheduling agreements late this year seems increasingly uncertain, and a group of banks are trying to syndicate a medium-term credit to bolster the country's cash reserves. The banks have not yet insisted on a new IMF program, but if Bucharest's situation deteriorates to the point of needing a rescheduling, private and official creditors presumably would press for renewed IMF supervision. 25X1

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A new round of negotiations with the Fund would prove difficult. President Ceausescu would find returning for help particularly galling, given his sharp

[1] Annual Article IV consultations are meetings with IMF staff that primarily oversee exchange rate issues, but that more recently have examined broader economic and financial problems. They do not involve policy guidance.

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criticism of the IMF. The Fund presumably would demand that Bucharest first comply with the criteria of the program terminated in 1984. The criticism in the 1984 staff evaluation lays the basis for future conditions. The report indicates that the Fund would:

- Require further devaluations of the leu.
- Mandate additional price hikes, especially for energy.
- No longer tolerate incomplete, inconsistent, or untimely economic information.
- Seek the elimination of many restrictive trade and payments practices.

But, even under pressure from creditors, Bucharest might refuse to conclude a new agreement with the Fund and would continue its costly effort to close financial gaps with its own strapped resources. [redacted]

Hungary

Budapest has hinted that it may reapproach the Fund for a standby program and credits because of disappointing hard currency trade performance this year. Hungary has had success in raising loans from commercial banks; however, Budapest may fear that the decline in its payments surplus will tarnish its creditworthiness unless it resubmits to IMF supervision. In contrast to Romania, Hungary remains on good terms with the IMF and has left the door open for resuming a standby relationship if conditions warranted. [redacted]

Even so, dealings between the IMF and Budapest would probably entail more friction than in 1982-84. The Fund almost certainly would require more restraint on consumption than the Hungarians have allowed in their current plan. This could prove a sore point for Budapest, which seems increasingly uneasy about social tensions associated with even the modest austerity imposed up to now. Moreover, the Fund would press for faster movement on price and wage deregulation, subsidy reduction, and wage differentiation than Budapest seems prepared to accept. While the IMF would insist on stricter conditions and more attention to correcting problems with supply, the Fund would probably be willing to make compromises to strike a deal with Budapest. The IMF seems eager to support Hungary because it sees Budapest as the most promising example of a planned economy implementing systemic change. [redacted] 25X1

Poland: The Looming Challenge

The prospective membership of Poland will prove a major headache for the IMF. Warsaw's application to rejoin the Fund—submitted in November 1981—was held in abeyance as one of the Western sanctions imposed after the December 1981 declaration of martial law. Preparations for Poland's entry resumed in early 1985, following withdrawal of the US objection to Warsaw's membership. The IMF board, however, probably will not take a final vote until early 1986. While the regime appears eager for member- 25X1
ship in order to obtain new credits and an improved credit rating, Polish leaders seem to have a poor understanding of the requirements of membership. Consequently, negotiations on standby arrangements will be long and difficult. [redacted] 25X1

The US [redacted] Embassies in Warsaw see 25X1
Polish support for IMF membership crossing party, government, and church lines. There are major differences, however, in the way these groups perceive the advantages of membership. The largest group of supporters within the regime is that which sees membership as the means to improved standing with 25X1
Western banks and access to low-interest, long-term credits. The objective of this group—centered in the Finance Ministry—is to squeeze more money out of the West. A smaller group within the regime hopes that membership will be a catalyst for effective reform and sees the Fund as the scapegoat on which hard economic measures can be blamed. Finally, those outside the regime favoring the IMF believe that membership can help sustain economic links with the West and act as a counterweight to Soviet efforts to tie Poland more closely to CEMA. [redacted] 25X1

By contrast, a small but vocal opposition to membership has brought together some strange bedfellows. On the one hand, some former Solidarity leaders oppose any step that might ease the economic pressures that they hope will eventually force the Jaruzelski regime to resume a dialogue with the banned labor union. This group also believes that workers would shoulder most of the burden of IMF adjustment through reduced subsidization of food and other consumer goods. Joining in opposition to membership are regime hardliners who believe an IMF agreement will enable creditors to squeeze Poland for more debt repayment and will dilute the centralism and greater discipline they believe necessary for economic recovery. Sources of the US Embassy in Warsaw indicated that the hardliners pressed for a reassessment of Poland's strategy for dealing with creditors and the IMF earlier this year, but the pro-IMF faction apparently retained the upper hand. Warsaw went ahead with conclusion of a rescheduling agreement with Western government creditors in July in hopes of smoothing the path to Fund membership.

The USSR seems to be taking a wait-and-see attitude about Warsaw's dealings with the IMF. Despite repeated criticism of the Fund in Soviet media, Moscow has remained quiet about the Polish bid for readmission. The Soviets undoubtedly are wary about Warsaw's developing closer contacts with the West, but they apparently do not see the IMF as a serious threat to their efforts to integrate Poland more closely into CEMA. More important, Moscow probably is counting on IMF lending to help reduce the cost of Soviet economic support to Warsaw. Senior Soviet officials have probably advised Warsaw on the guidelines for negotiations with the IMF, and Moscow has kept its options open by avoiding a public position on membership. The Soviets undoubtedly would step in if they saw a need to influence Polish-IMF decisions, but they seem unlikely to veto membership unless new events in Poland threaten vital Soviet interests.

Credits and Conditionality

Poland presumably would seek to draw funds as soon as possible after entry into the Fund. Although precise amounts depend on the quota—which we estimate will be about $900 million—Warsaw probably could draw about $450 million with little difficulty (see table 7 in appendix). This would include $225 million from the reserve tranche (Warsaw's own money) and $225 million from the first credit tranche, neither of which requires strict conditions. Warsaw also may seek a credit from the Fund's compensatory financing facility, although it may be unable to demonstrate much export shortfall according to IMF procedures. We estimate that Warsaw's drawings from this facility are unlikey to exceed $100 million. These credit tranche drawings and compensatory credits would increase Warsaw's payment capacity by roughly 25 percent. 25X1

Polish financial officials apparently are counting on more IMF and World Bank money. Warsaw's projection of $3 billion from the IMF during the first three years of membership evidently assumes the establishment of a standby arrangement. In addition, Warsaw hopes to obtain about $1.5 billion from the World 25X1 Bank in its first two years of membership, an overly optimistic projection. 25X1

Before releasing more than the first $450 million or so, the IMF will require Warsaw to implement the comprehensive stabilization program that the regime so far has avoided. The IMF will demand slower growth in consumption, investment, and government expenditures in order to shift resources to the external sector. Recommendations are likely to include reducing budget subsidies, hiking interest rates and prices, and tying wage increases to productivity gains. In the foreign sector, the Fund is likely to urge simpler trade and foreign exchange systems. 25X1

Many obstacles may well prevent the conclusion of a standby arrangement. Unlike its position in Yugoslavia and Hungary, in Poland the IMF does not seem to have many allies within the economic leadership 25X1 willing to push for major changes. Some Polish officials—particularly in the Ministry of Finance—have argued that reform measures adopted in 1982 would 25X1 go far toward meeting IMF demands. In our view, these reforms do little to ensure achievement of strict performance criteria. The Fund probably will examine much more critically than Warsaw anticipates the discrepancy in Polish reforms between theory and practice. Although a few officials would like to use the Fund as a scapegoat for imposing tough austerity measures, the regime probably would not accede to IMF proposals if it felt social tensions would increase. Since lifting martial law, Warsaw has backed off from imposing austerity on consumers and has caved in to industrial ministries wanting to accelerate investment. Warsaw's interest in a borrowing arrangement probably would slacken if, as seems likely, Western creditors insisted that IMF funds be used to pay debt service rather than to buy more imports. Moreover, the USSR will be watching closely and would press Warsaw to reject measures that might risk political instability or excessive economic decentralization. 25X1

Even if an agreement is struck, the IMF probably will not make much headway in correcting Poland's economic problems, at least not very quickly. Warsaw's resistance to austerity and basic reforms as well as the IMF's problems in coming to grips with centrally planned economies may produce a program that is inadequate—if not irrelevant—to Poland's needs. Warsaw might agree to policies to draw funds, but fall short in adhering to the conditions. If performance criteria are not met, the IMF and Western governments will have to decide how tough they want to be in enforcing compliance. Even with acceptable compliance, the magnitude of Poland's economic and financial problems ensure a lengthy period of IMF supervision. 25X1

Appendix

Tables

Table 1
Eastern Europe: Commonly Used IMF Credit Facilities

Type of Credit	Share of Quota [a] (*percent*)	Conditions on Recipient
Reserve tranche	25	Demonstrate balance-of-payments need. Requests are almost never contested by the Fund.
First tranche	25	Demonstrate balance-of-payments need and show the Fund that reasonable efforts are being made to solve the problems.
Upper tranches	50 to 100	Demonstrate "substantial" justification of need and agree to conditions worked out with the Fund. Program duration is usually up to one year.
Standby	95 [b]	Demonstrate serious balance-of-payments needs over an extended period of time. These facilities are made available for up to three years subject to strict conditions worked out with the Fund, usually involving structural adjustments.
Compensatory financing facility	83	Demonstrate temporary export shortfall due to circumstances beyond the member's control.

[a] A member's quota is denominated in Special Drawing Rights (as of June 1985 SDR=$0.997) and is determined by "the member's economic characteristics relative to other members of comparable size."
[b] Current annual limit on drawings. Under special circumstances, the Fund can approve standby or extended arrangements in excess of the limits.

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Table 2
Yugoslavia: Use of Fund Credit

Million SDRs
(except where noted)

	Use of Fund Credit [a]	Reserve Tranche	Compensatory Financing Facility	Oil Facility [b]	Credit Tranche: Ordinary	Credit Tranche: SFF+EAR [c]	Quota	Share of Quota (*percent*)
Total cumulative drawings								
1948-78	768.2	65.2		340.7	362.3			
1979	1,036.4	125.7	138.5	340.7	431.5			
1980	1,374.9	125.7	277.0	340.7	506.9	124.8		
1981	1,928.9	125.7	277.0	340.7	787.6	398.0		
1982	2,482.9	125.7	277.0	340.7	810.9	928.7		
1983	3,037.0	125.7	277.0	340.7	810.9	1,482.7		
1984	3,369.6	178.3	277.0	340.7	950.9	1,622.7		
1985 [d]	3,489.6	178.3	277.0	340.7	1,010.9	1,682.7		
Net drawings [e]								
1978	182.5			182.5			277	65.9
1979	346.0		138.5	136.7	67.6		277	124.9
1980	596.1		277.0	83.0	108.1	124.8	416	143.3
1981	1,075.5		277.0	8.3	392.2	398.0	416	258.6
1982	1,590.4		242.4	3.8	415.5	928.7	416	382.3
1983	1,975.2		121.2		383.5	1,470.5	613	322.3
1984	1,985.9		17.3	0	406.3	1,562.3	613	324.0
1985 [d]	1,946.9		0	0	374.3	1,572.6	613	317.6

[a] Because of rounding, components may not add to total shown.
[b] Credits to members with oil-related balance-of-payments difficulties. Discontinued granting new credits in 1976.
[c] Supplementary Financing Facility and Extended Arrangement.
[d] As of 30 June.
[e] Reported as of end of the year. Equals total drawings minus repayments.

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Table 3
Romania: Use of Fund Credit

Million SDRs
(except where noted)

	Use of Fund Credit [a]	Reserve Tranche	Compensatory Financing Facility	Credit Tranche: Ordinary	Credit Tranche: EAR [b]	Quota	Share of Quota (*percent*)
Total cumulative drawings							
1972-78	396.6	47.5	142.5	206.6			
1979	437.9	47.5	183.8	206.6			
1980	559.1	47.5	305.8	206.6			
1981	904.9	83.8	474.5	293.4	53.2		
1982	1,226.1	95.0	474.5	434.3	222.3		
1983	1,449.0	134.0	474.5	517.9	322.6		
1984	1,632.7	134.0	474.5	563.0	461.2		
1985 [c]	1,632.7	134.0	474.5	563.0	461.2		
Net drawings [d]							
1978	255.6		142.5	111.6		245	104.7
1979	246.8		153.8	91.6		245	100.7
1980	257.4		215.0	41.0		368	69.9
1981	506.7		355.5	97.9	53.2	368	137.7
1982	781.6		321.7	237.6	222.3	368	212.4
1983	904.7		270.7	311.3	322.6	523	173.0
1984	955.7		157.4	337.1	461.2	523	182.6
1985 [c]	884.2		105.9	323.8	454.5	523	169.1

[a] Because of rounding, components may not add to total shown.
[b] Extended arrangement.
[c] As of 30 June.
[d] Reported as of the end of the year. Equals total drawings minus repurchases.

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Table 4
Eastern Europe:
IMF Standby Arrangements, 1979-85

	Amount (*million US $*)	Comments
Hungary		
December 1982–January 1984	532	
January 1984–January 1985	451	
Romania		
June 1981–June 1984	1,300	Suspended from November 1981 to December 1982 because of arrearages to creditors; canceled in January 1984 after disbursement of $880 million.
Yugoslavia		
May 1979–May 1980	89	
June 1980–June 1982	441	Replaced by larger program in January 1981 because of worsening payments problems.
January 1981–December 1983	1,857	
May 1984–April 1985	370	
May 1985–April 1986	300	

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Table 5
Hungary: Use of Fund Credit

	Use of Fund Credit [a]	Reserve Tranche	Compensatory Financing Facility	Credit Tranche: Ordinary	Credit Tranche: EAR [b]	Quota	Share of Quota (*percent*)
Total cumulative drawings							
1982	295.9	81.4	72.0	94.6	47.9		
1983	628.4	81.4	72.0	248.7	229.3		
1984	1,092.3	120.3	72.0	458.2	441.8		
1985 [c]	1,092.3	120.3	72.0	458.2	441.8		
Net drawings [d]							
1982	214.5		72.0	94.6	47.9	375	57.2
1983	547.0		72.0	245.7	229.3	531	103.1
1984	972.0		72.0	458.2	441.8	531	183.2
1985 [c]	972.0		72.0	458.2	441.8	531	183.2

[a] Because of rounding, components may not add to total shown.
[b] Extended arrangement.
[c] As of 30 June.
[d] Reported as of end of the year. Equals total drawings minus repurchases.

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Table 6
Leading Users of IMF Credit [a]

	Amount (*million US $*)	Share of Quota [b] (*percent*)
Brazil	4,192	287.5
India	3,903	177.3
Mexico	2,695	231.9
Yugoslavia	1,941	317.6
Argentina	1,627	146.6
Korea	1,496	324.3
Turkey	1,326	310.0
Pakistan	1,214	222.9
Morocco	1,067	349.0
Hungary	969	183.2
Thailand	936	242.9
Romania	881	169.1

[a] As of 30 June 1985.
[b] The limit on cumulative borrowings under standby and extended financing arrangements is currently 450 percent of quota (net of scheduled repayments and excluding borrowings under the compensatory financing facility, the buffer stock financing facility, and the oil facilities).

Table 7
Estimated IMF Assistance to Poland [a]

Type of Credit	Share of Quota (*percent*)	Amount (*million US $*)	Conditions for Poland
Total		**1,000**	
Reserve tranche	25	225	Demonstrate balance-of-payments need.
First credit tranche	25	225	Demonstrate balance-of-payments need and show the Fund that reasonable efforts are being made to solve the problems.
Compensatory financing facility [b]	11	100	Demonstrate a temporary export shortfall due to circumstances beyond the member's control.
Standby	50 [c]	450	Adhere to relatively strong IMF-mandated stabilization program.

[a] Estimated assistance within the first 12-18 months of joining; estimates based on assumed quota of $900 million. The exact quota is determined by "the member's economic characteristics relative to those of other members of comparable size."
[b] Although technically CFF drawings can be as high as 105 percent of the member's quota, we believe that Poland will have great difficulty qualifying for much more than 10 to 12 percent.
[c] The annual limit on drawings under standby arrangements can be as much as 95 percent of quota, but the IMF is unlikely to approve more than 50 percent of quota for Poland.

25X1

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