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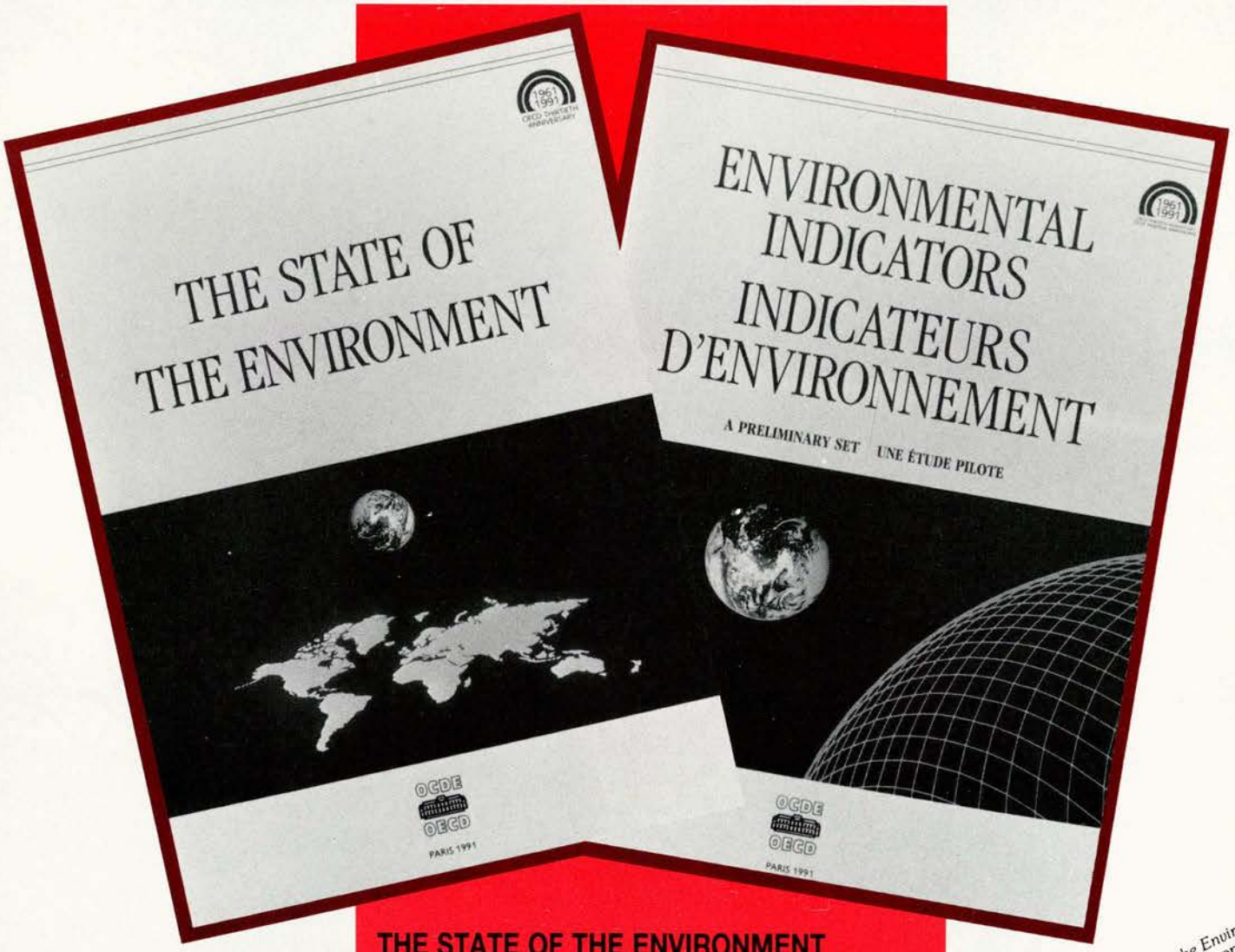

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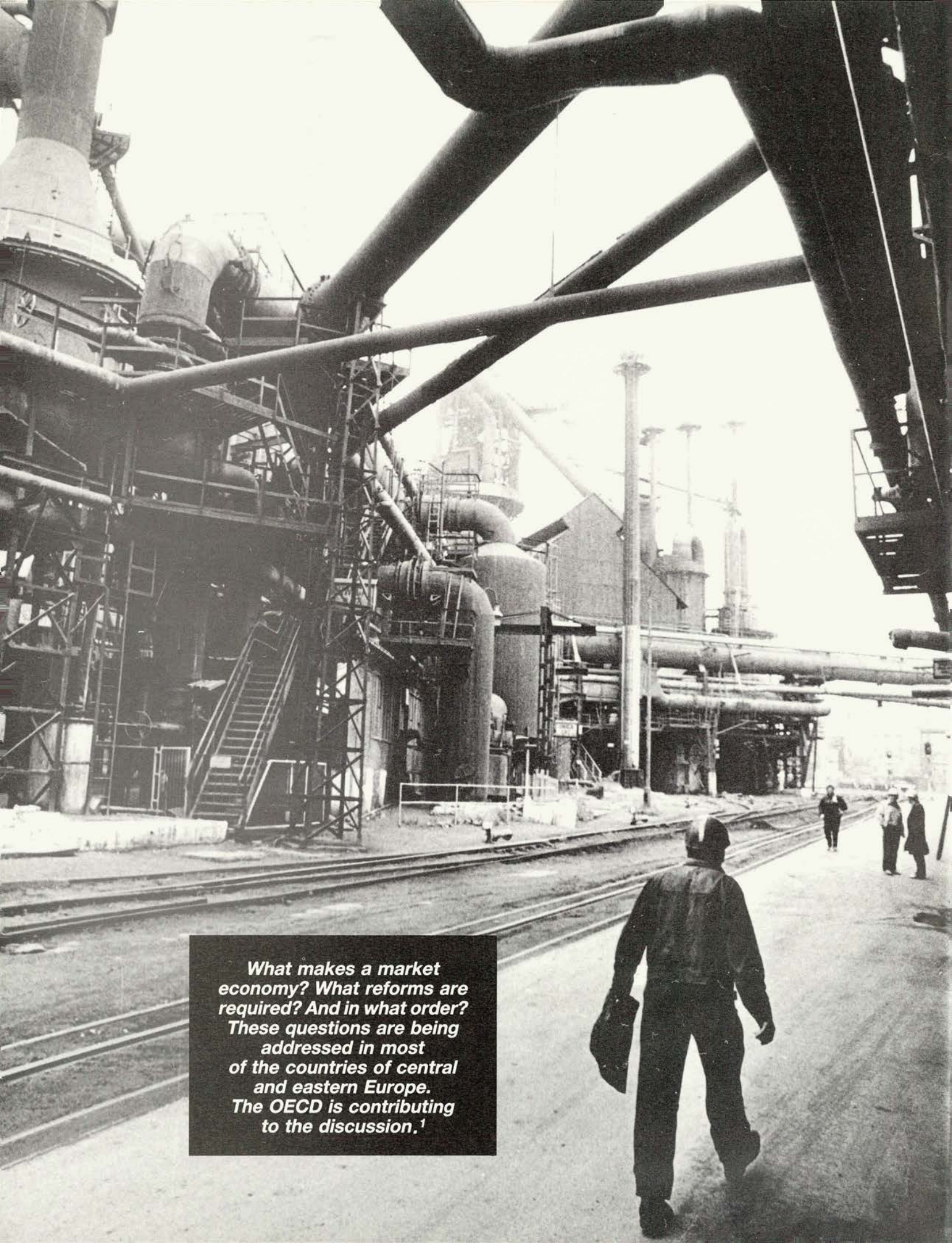
Sipa-Press

The successful introduction of markets in eastern and central Europe requires a huge range of reforms in both macro- and micro-economic policy: monetary stabilisation, fiscal discipline, realistic exchange rates, property rights, privatisation, mobile capital and labour, and much more.



What makes a market economy? What reforms are required? And in what order? These questions are being addressed in most of the countries of central and eastern Europe. The OECD is contributing to the discussion.[1]

The Transition to a Market Economy in Central and Eastern Europe

Paul Marer

All the economies of central and eastern Europe that are currently in transition from a command to a market-based system are experiencing a rapid deterioration in economic performance and standards of living. In some countries the situation has reached crisis proportions and is expected to get worse this year. The deterioration has three main causes whose relative importance varies from country to country.

The Legacies of Centralism

First, there are the accumulated legacies of several decades of command economy. These include:

- a structure of production dominated by heavy industries, an unusually high energy and material intensity of production, distorted factor and product prices, an old and often obsolescent capital stock, and skills unsuited to the requirements of a modern, competitive economy. Transition means exposing these hitherto sheltered economies to market forces. That in turn means having to depreciate or discard an enormous amount of unsuitable production and capacity, leading to decline in output and painful losses of privileges, jobs and incomes
- a neglected infrastructure (whose increasingly frequent breakdowns are causing severe problems)
- environmental pollution that is much worse than in the western part of Europe and can no longer be neglected
- trade excessively oriented toward one another's uncompetitive markets
- in most countries, a large and growing volume of non-performing loans to enterprises are held by banks, whose ability to support the healthy sectors of the economy is thereby limited
- in Poland, Bulgaria and Hungary, large foreign debts, the servicing of which would require the transfer of 3–5% of GNP to the West at a time when these countries themselves require large net resource inflows to help rebuild their economies. Much of the money was borrowed by the previous regimes to keep their economies, including consumption, afloat in the face of deteriorating economic performance, and to avoid having to make fundamental systemic changes.

One symptom of these legacies is the macro-economic disequilibrium that is a feature of all these economies. It means increased open or suppressed inflation, shortages and interruptions to supply that are not being corrected.

A second cause of economic decline, at least in some earlier cases, like Poland and the USSR, was that partial reforms added new problems. Perhaps the most important was decentralising management before imposing financial discipline and accountability. Managers had neither sufficient pressure nor incentives to restructure production and to increase supply.

In some countries partial reforms led to the authorities losing control over the money supply, as central planning was dismantled or fell apart before the institutions and behaviour patterns of a viable market system had been created. This cart-before-horse policy has had a pronounced adverse effect on the inherited macro-economic imbalances. Hoarding and thus shortages multiplied, supplies and markets were disrupted, and money rapidly lost its value. Here the Soviet Union faces the most severe problems. Poland had to revert to shock therapy to try to keep runaway inflation in check.

External Shocks

The third main source of the economic plunge is that the first two causes have recently been compounded by large new external economic shocks. The first of these shocks is trade-related. The deepening crisis in the Soviet Union, their largest trading partner, means disruptions

Paul Marer is Professor of International Business at Indiana University. He was the Rapporteur at the OECD/World Bank Conference on the Transition to a Market Economy in Central and Eastern Europe held in Paris on 28–30 November 1990. He was helped in this task by the Rapporteurs of the eight Workshops during the Conference: Val Koromzay, Kenneth Messere, Peter Scherer and Jean-Pierre Tuveri (OECD); Alan Gelb, Julian Schweitzer and Ulrich Thumm (The World Bank); Amnon Golan (The World Bank/Economic Development Institute). Farid Dhanji (The World Bank) and Jean-Pierre Tuveri assisted in the preparation of the final text.

1. **The Transition to a Market Economy in Central and Eastern Europe**, OECD Publications, Paris, forthcoming 1991.

D. Stewart-Smith/R.E.A.

Le Segretain/SIPA

Throughout central and eastern Europe expectations about improved living standards are high, fuelled by decades of deprivation and stimulated by the powerful example of the West.

for the other central and eastern European countries in the supply of energy, raw materials and other essential imports. To the extent that such goods are available, they now have to be paid for in convertible currency. Moreover, several countries have accumulated surpluses with the USSR which they cannot readily convert into the kinds of goods or currencies they require.

Given the difficulty for these countries of reorienting their trade to the world market, and improving quality, the decline in trade is severely disruptive, with multiplier effects. Trade with the eastern part of Germany has also been disrupted as suppliers from the western part are replacing earlier sources from the CMEA[2] countries. In 1990, however, some countries, notably Hungary and Poland, proved able to increase rapidly their exports to the West.

As of 1 January 1991 all of intra-CMEA trade has been conducted at current world market prices and settled in dollars or other convertible currencies. By and large, the central and eastern European countries import raw materials and energy from the Soviet Union and export manufactures, often of inferior quality. The move to world prices will have large adverse impacts on their current-account balances, although this change in the system of trade is essential.

2. In 1990 the members of the Council for Mutual Economic Assistance were the USSR, Bulgaria, the Czech and Slovak Federal Republic, the German Democratic Republic (until re-unification), Hungary, Poland, Romania, Cuba, Mongolia and Vietnam.

For these countries, having to reorient much of their trade to the West comes at a time when world energy prices are very uncertain. This increases the pressure to restructure their energy-intensive economies. How rapidly the countries can adapt to this urgent task may be an important factor conditioning the success of transition. In addition, the Gulf crisis has more severe economic implications for these countries than for the Western European countries because they depend much more on energy imports and because Iraq and Kuwait were important trading partners.

As the external payment surpluses of Germany and Japan decline while worldwide demand for capital increases, a global shortage of capital may emerge. This does not bode well for the countries of central and eastern Europe, either in terms of attracting new foreign investment or easing the burden of servicing their outstanding debts.

What Policies for Economic Transition?

In spite of the move towards democracy, the political systems in the countries of central and eastern Europe are not well developed for managing these simultaneous economic crises. In countries with newly elected democratic governments, the authorities have to contend with the unrealistic expectation of their populations that throwing off the yoke of a command society would yield immediate economic improvements; in all transition economies there is lack of public understanding of the unavoidable costs of systemic changes.

Fledgling democracy entails the expression of political power by interest groups, all of whom are determined to protect their vested interests. More generally, there is a deep unwillingness of the populations to accept too much pain. These new governments have the most difficult task of building a social consensus behind

(continued on p. 8)

Bohemia has long had a tradition of high-quality glassware. But the quality of many other exported goods will have to be improved for the world market.

Sherbell/SABA-REA

THE OECD CENTRE FOR CO-OPERATION WITH EUROPEAN ECONOMIES IN TRANSITION

In 1989/90 the OECD was approached informally by the governments of several central and eastern European countries which were embarking on the transition from centrally planned to more market-oriented economies, and which were seeking advice on a wide range of possible economic reforms.

The OECD is well placed to offer such advice, or engage in dialogue, about the kinds of policies necessary for the transition to a market economy. It has over forty years of experience – including during its initial post-war phase as the OEEC[1] – in transforming intellectual insight into policy. Its expertise – not only through its Secretariat but also through the networks of government officials and experts who attend its numerous committees and working parties – covers a wide range of economic and social issues and represents a considerable variety of viewpoints. In order to respond to the central and eastern European countries and to mobilise OECD expertise on their behalf, the Council of the OECD created in March 1990 the Centre for Co-operation with European Economies in Transition.

The aim of the Centre, which works under the responsibility of the Secretary-General of the OECD, is to design and implement a coherent programme of activities that draws on the diverse multidisciplinary experience and intellectual resources of the OECD to help central and eastern European reformers address specific problems in the transition to a market economy. It also acts as a focal point for contacts with these countries, and co-ordinates its activities with those of other international organisations, principally the IMF, World Bank and the G-24 PHARE programme led by the Commission of the European Communities, in order to ensure the complementarity of these efforts.

The first principal task faced by Salvatore Zecchini, Assistant Secretary-General of the OECD and the Director of the Centre, was the development of a preliminary programme of activities to address the central issues involved in the transition to a market economy – competition, investment, taxation, banking and financial markets, as well as statistics to measure the performance of the economy. These initial activities for the most part took the form of broadly focused conferences, seminars and workshops – vehicules which could promote mutual information between the OECD and the reforming countries and cover a spectrum of issues from which to identify more specific concerns.

One of the first major events was a conference in September 1990 on the statistical systems of Central and Eastern Europe, which was co-sponsored by the UN Economic Commission for Europe. Most of the centrally planned economies had for very many years collected statistics, not on a national accounts basis, but on a purely physical basis ('the net material product basis'), which excludes the entire service-sector component of the economy. The reforming countries now want to move towards a comprehensive system of national accounts based on western concepts and definitions. The Conference focused on the requirements of users of statistics – government policy-makers, international organisations, businesses and households, research institutions – to see how the systems of reforming countries should be adapted both during the transition period and over the long run. It also examined the types of assistance that international organisations and national statistical offices can provide in order to rationalise these efforts, as well as fill any gaps.

Léo Jouan/OECD

The OECD/World Bank conference in November – unique in the range and depth of the topics it covered.

The centrepiece activity for 1990 was a Conference on the Transition to a Market Economy in Central and Eastern Europe held in November and organised in co-operation with the World Bank. This Conference was unique both in the range of issues covered and the depth in which they were treated. It attracted a large number of top-flight academics and other experts, together with high-level officials from the full range of central and eastern European countries and OECD member countries. The papers presented, on both macro- and micro-economic issues, covered, *inter alia*, privatisation and restructuring of the enterprise sector, currency convertibility, trade liberalisation, investment, fiscal reform, labour markets, social policy and the development of the financial sector.

In the second year of its operations the Centre will continue to take advantage of OECD expertise and offer advice and dialogue in such areas as labour markets and social policy, environment, agriculture, education, science and technology, industrial policy, public management and nuclear safety. With experience, and as the central and eastern European countries themselves have a clearer idea of their own requirements, assistance will become progressively more focused. For example, one particularly effective kind of activity has been in response to requests from reforming countries for comments on draft legislation in competition, investment, taxation or insurance. The Centre brings together policy experts drawn from the OECD committees, national administrations, the academic world and the private sector, as well as other multilateral institutions, to sit down with reformers to discuss the ins and outs of each clause of their proposed laws. And the fact that in these discussions the OECD experts sometimes vigorously disagree with one another gives the reforming countries a full, varied perspective on the kinds of considerations they have to take into account.

A recent initiative is the 'Partners in Transition' programme, designed to help countries who have moved farthest on the path to a market economy – Hungary, Poland and the Czech and Slovak Federal Republic in the first instance – in a particularly in-depth, tailor-made, concrete manner. Discussions are now underway with these countries to establish what sort of programme would be the most effective. It is likely to include a country economic survey along the lines of the OECD's regular annual series of Economic Surveys of its member countries.

1. The Organisation for European Economic Co-operation was founded in 1948; it was replaced by the OECD in 1961.

Le Segretain

It is Hungary (left) and Poland (below) that are the furthest ahead in introducing systemic changes; the Czech and Slovak Federal Republic (right) had, until recently, adopted a gradual approach.

the necessity of reform and for accepting the high short-term costs involved. This underlying lack of a well-founded consensus endangers the positions of many reform-minded governments and may threaten the longevity and sustainability of reform. To ease this problem, several participants at the OECD/World Bank Conference recommended the establishment of tripartite (government-business-labour) councils, as well as improved public communications, openness and candour on the tasks and the difficulties.

At the same time, it is important to point out that many of the men and women who are now running these governments were dramatically and quickly thrust into their positions without having had time to prepare for the immense tasks ahead, and without the benefit of experience to guide them in the transition.

In the USSR, there is the additional problem of most states, and even some of the smaller political entities, wanting to go their own way, politically and economically. There are strong centripetal pressures also in the Czech and Slovak Federal Republic.

Some of the conference participants raised the possibility that certain governments may soon have the unenviable choice of facing being swept aside or having to resort to force to maintain power – and perhaps also law and order.

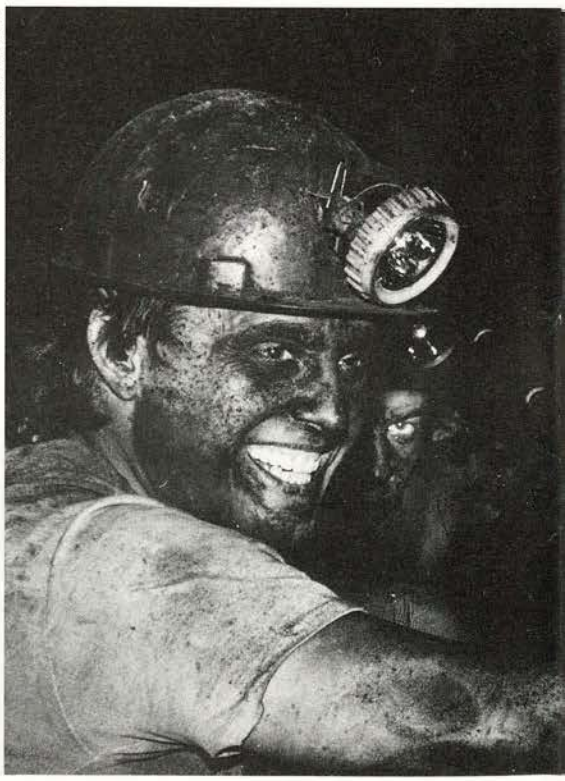
One reason the political difficulties are so enormous is that the costs of transition – a decrease in 'detrimental' output (i.e., production that could survive only because it was not subject to the test of market demand) and in living standards, open inflation (replacing suppressed inflation), and open unemployment – are immediate, visible and painful, but the benefits of reform will appear only in the future. They are also less easily identifiable and are uncertain, since they depend on the transition programme being successful. This is why the general aspiration in all these countries for moving toward a market-oriented economic system goes hand-in-hand with staunch resistance to each of the specific painful steps that are required to get there.

Although these countries face many common problems, there are significant differences among them. For example, Hungary and Poland are the furthest ahead in introducing fundamental systemic changes. Bulgaria and Romania have started to adopt appropriate programmes. The Czech and Slovak Federal Republic had until very recently adopted a gradual approach. It is in the Soviet Union that agreement on a reform programme has been the most difficult to secure.

What Makes a Market Economy?

The creation of well-functioning market economies in central and eastern Europe will require, *inter alia:*

- monetary stabilisation to curb inflationary pressures generated by price liberalisation, the reduction of subsidies, and the external shocks on the one hand, and to deal with the complex institutional and political problems of effective control over credit on the other
- improved fiscal discipline, elimination of large budget deficits, reduction of the size of government in the economy, and creation of a modern tax system that improves resource allocation and provides incentives to work, to save, and to invest
- a quick move to a realistic exchange rate and currency convertibility, at least for most current-account transactions; establishing liberal trade regimes and liberal foreign investment regulations is especially important
- clearly defined and enforced property rights and business contracts, which requires the introduction of a new legal system
- a retreat by the state from comprehensive public ownership; this means that the majority of firms must be autonomous, which requires speedy and wide-ranging privatisation and the promotion of new business by eliminating barriers to entry and exit
- the operation of enterprises which, in the meantime, remain state-owned must be improved by exercising financial discipline and by restructuring enterprises which are potentially profitable; the state will have to continue to play a role in exercising its ownership function, especially in connection with restructuring and privatisation



D. Stewart-Smith/R.E.A.

F. Horvath/SABA-REA

• competition, which calls for programmes of industrial and agricultural deconcentration and the opening up of the economy to the rest of the world for trade and foreign investment
• a social safety net that is affordable and does not take away the incentives to seek work and to perform well
• an income and wealth distribution that is not egalitarian but is seen as fair, one aspect of which is a restoration of public morality and business ethics
• fostering and encouraging the mobility of capital and labour
• the establishment of a predictable business environment, not least in credit, public administration, taxes, the trade regime, and the exchange rate
• temporary technical, financial, and moral assistance from the West.

Which Steps First?

Many speakers at the OECD/World Bank conference stressed the close interdependence among all these essential components. On sequencing – the order in which the various reforms should be tackled – there was broad agreement that stabilisation policies could not be separated from structural reform. Both should be started simultaneously. Although most structural reforms, once initiated, would clearly take a long time to be completed, this should not detract from the pursuit of prudent fiscal and monetary policies.

It was also agreed that one of the most difficult issues to address is the mode of privatisation. Some advocate the free distribution of at least a part of the state's assets, on the grounds that:
• households have insufficient purchasing power
• much of the private money is not in the most deserving hands
• it would generate broad political support for privatisation
• it would accomplish the task quickly.
Others prefer only real sale and only to real owners, on the grounds that only this way will the functions of ownership be exercised effectively. In any event, all agreed that the speed and mode of privatisation will differ for small business (like shops and most services) and for the huge conglomerates.

Lessons from Post-war Western Europe?

Are the post-war experiences of the OECD countries relevant for designing and implementing transition programmes? The consensus of the conference seemed to be 'Yes, but only in a limited way'. Obviously 'yes', because the institutional arrangements and policies of successful market economies do indicate the general nature of the targets toward which the transition economies must be orienting. Especially important here are the laws and institutions of the European Community, since much effort has gone into identifying what is common, workable, and important. Their relevance for the transition economies is enhanced by the fact that these countries want to become associated with and in some cases eventually join the EC.

The qualifications to the 'yes' refer mainly to the path and difficulty of transition. First, the OECD countries after World War II for the most part faced the problem of re-establishing old institutions, behaviours and systems. The transition economies have much weaker foundations of entrepreneurship, market mechanisms, and democratic institutions. Even in the countries where such foundations were stronger, generations have grown up under a fundamentally different kind of economic, social and political system.

Second, the domestic political environments are also fundamentally different. The populations of the OECD countries emerged from World War II with low or modest near-term expectations, but with confidence in their longer-term future. In the transition economies expectations about improved living standards are high, fuelled by decades of deprivation and stimulated by the powerful examples of high living standards in Western countries, about which information is being obtained through tourism and television programmes. And if the comparison is made with the successful newly industrialised countries in South-East Asia, a major difference is that they built their market mechanisms and competitive international strengths under authoritarian and interventionist governments, with the populations and the labour force co-operating and acquiescing in economic direction. Therefore, in many instances, perhaps it is the experiences of some of the less developed countries in making macro-, structural- and sectoral adjustments that could be usefully applied to the emerging market economies of central and eastern Europe.

Third, differences in the international

Jean-Pierre Laffont/Sygma

The advent of competitive markets will require far-reaching programmes of deconcentration, in agriculture and industry alike.

economic environment are very important. The take-off years of the OECD and the newly industrialising economies coincided with an era of gradual reductions of barriers to the cross-border flows of trade, technology and investment. Although today's system of international commerce is probably as yet more open than it was in the 1950s, the transition economies are facing an environment of growing protectionism and the strengthening of trade blocks from which so far they are excluded.

Fourth, and not least, whereas the earlier take-offs occurred during a period of low volumes of international debt and a growing supply of increasingly mobile capital, the transition economies are facing a world saturated with foreign debt, a growing shortage of capital, and a rising real rate of interest, for which a partial responsibility rests with the policies of some of the OECD countries.

In sum, not only are the immediate problems facing the transition economies deep and becoming critical, but their transition is also likely to take longer, be much less smooth and politically much more difficult than it was for the OECD economies after the War or for the newly industrialising economies during the last generation.

What Should the West Do?

'Marshall plan or martial law' was the way one conference participant put the stark choice facing western governments and international economic organisations. Others predicted that the bleak prospects would lead discontented people to move *en masse* to the West to seek a better life for themselves and their children.

There was broad agreement that the West must do what it can to support social and political stability and the forces of constructive change in these economies, not only for obvious humanitarian and political reasons, but also in its self-interest.

Specifically, the West should be prepared to provide massive food, medicinal and other kinds of humanitarian assistance to countries or places where such help is urgently required, provided that their effective distribution to the needy can be assured. It should provide temporary, transitional assistance to help the countries absorb the drastic adverse impacts of multiple external shocks.

The West should also find ways to ease the very large burdens of servicing the huge inherited debts of these countries, as a minimum, to ensure that there is no large net transfer of resources from these economies to the industrial West during their most crucial and difficult early years of transition. It should assure that some new money will flow to the countries of central and eastern Europe, in part to give confidence to prospective foreign investors.

It is equally important that the West keep its markets open and reduce barriers to trade, technology and investment flows, to make it possible for the central and eastern European countries to jump-start their economies through export expansion.

These forms of help should be coupled with the provision of sustained, genuinely co-operative and internationally co-ordinated technical assistance and training in the design and implementation of the kinds of market-oriented economic and democratic political changes without which the transformation programmes cannot be effective.

□ □

But western assistance can be effective only if countries adopt comprehensive programmes of reform, creating conditions conducive to the engagement of the foreign private sector and the efficient use of western financial and technical assistance. Assistance should not delay adjustment or transition, but should facilitate it. Ultimately, responsibility for adopting programmes rests with the countries themselves. Western governments and multilateral institutions can and should play a larger role, but they cannot substitute for domestic commitment and willingness to reform. ■

Magnaux/Sipa Press

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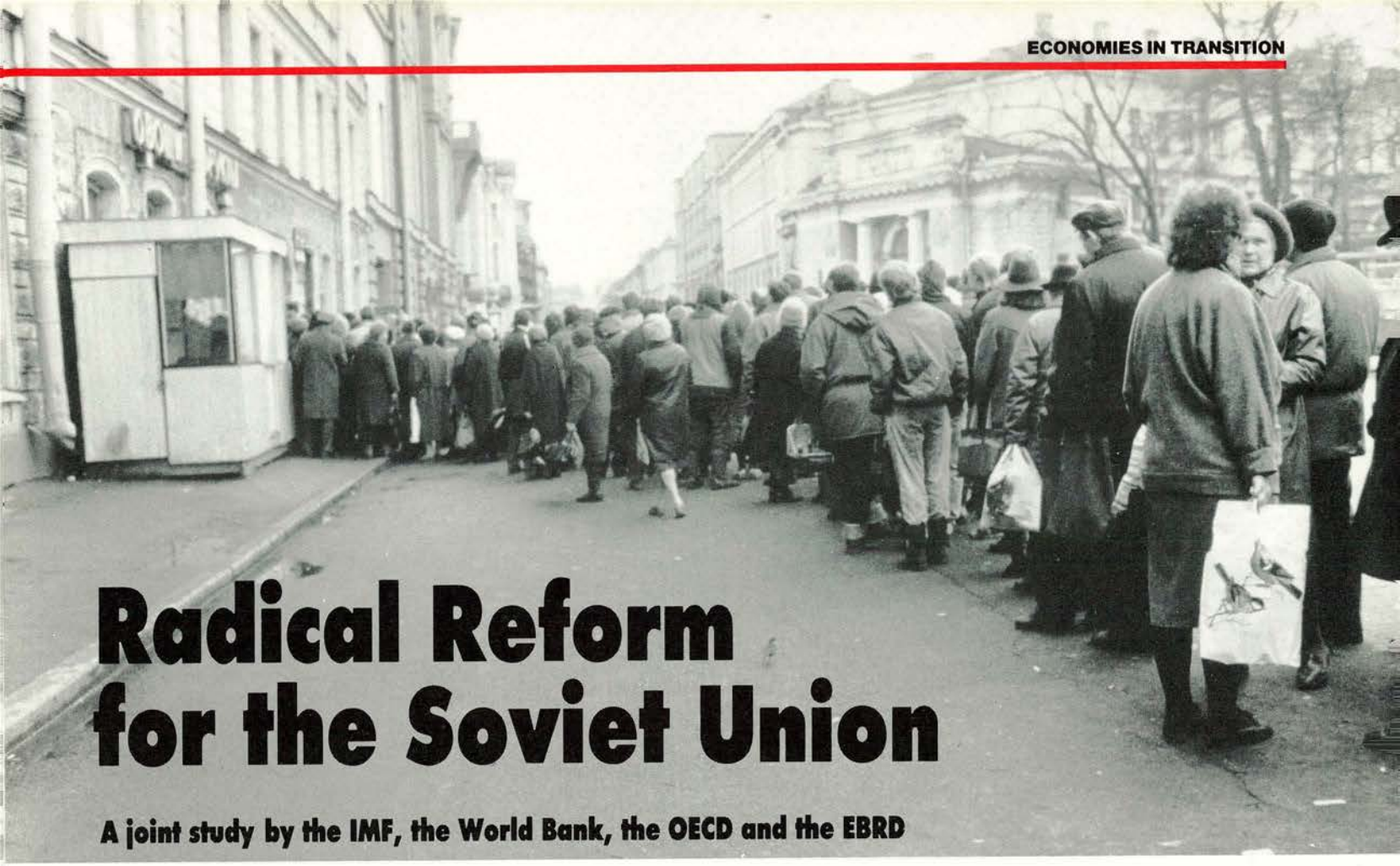

Radical Reform for the Soviet Union

A joint study by the IMF, the World Bank, the OECD and the EBRD

The joint study by the IMF, World Bank, OECD and EBRD reviews the recent evolution of Soviet economic performance and reform efforts. It then describes possible developments in 1991, based on an assessment of current Soviet policy intentions and offers various assumptions about how reforms might be implemented in the course of this year. It goes on to consider alternative approaches to reform and recommends action in a range of areas. Overall, the report advocates a more radical approach to reform than that which currently appears to be intended by the Soviet authorities. Finally, in the light of this analysis, it lays down the criteria for, and forms of, external assistance.[1]

The process of reform in the Soviet Union is far from straightforward, and it is surrounded by deep uncertainty. Yet its success is of vital importance, and not only for the country itself. Aware of what is at stake, of the difficulties involved, and since the USSR had expressed the wish that it do so, the international community decided to consider ways in which it could help the USSR to implement its reform process.

This was why, at the Houston Economic Summit in July 1990, the heads of state and government of the seven major industrial countries requested the International Monetary Fund, the World Bank, the Organisation for Economic Co-operation and Development and the President Designate of the European Bank for Reconstruction and Development to undertake a detailed study of the Soviet economy, to make recommendations for its reform, and to establish the conditions for Western economic assistance to support such a reform effectively. The study was carried out collectively and submitted, as planned, at the end of 1990.

The Beginnings of the Crisis

The Soviet Union saw its economic growth start to slow from the early 1970s. There were several reasons for this, but the fundamental ones were the malfunctions, low productivity and inefficient resource allocation inherent in the centrally planned economic system. These weaknesses became increasingly apparent as the stimulating effects of post-war reconstruction faded, and the growth strategy based primarily on increasing the quantity of labour and capital inputs ran into ever tighter limits. Technological progress was required to sustain productivity gains; but an economy such as that of the Soviet Union, protected from competition and burdened with all kinds of rigidities, was incapable of perceiving that change was necessary, and even less capable of effecting it.

In spite of slowing growth, macroeconomic balance was reasonably well-maintained into the 1980s, although imbalances in the Soviet economy began to

1. **The Economy of the USSR**, International Monetary Fund, World Bank, Organisation for Economic Co-operation and Development, European Bank for Reconstruction and Development, OECD, published in English by the World Bank, Washington DC, 1990, and in French, as *L'économie de l'URSS*, by OECD Publications, Paris, 1991.

Clapet/R.E.A.

From 1988–89 the relative autonomy granted to enterprises (here a Moscow factory with French equipment) under a 1987 law started to disrupt the planning system – without replacing it with another.

build up from 1988–89, when the effects of the 1986 oil counter-shock (which had cut export earnings) started to bite and when the relative autonomy granted to enterprises under the 1987 Law on State Enterprises started to disrupt the planning system. In the following two years the internal mechanisms of the planning system progressively broke down – but market signals and discipline were not put in their place. Investment fell, production was disrupted, budget deficits burgeoned and wage increases got out of control. As a result, the economy went into recession in 1990, and demand-pull inflation, masked by administratively fixed prices, led to increasing shortages.

The economic crisis has been amplified by a political and constitutional crisis that has raised the spectre of a break-up of the Soviet Union. A direct descendant of the tsarist empire, the Soviet Union is a patchwork of 120 ethnic groups. It is a federal union consisting of 15 Republics, themselves federative and very different from one another in size, population and other ways: the population of Russia numbers 148 million, that of Armenia only 3.3 million. Fanned by the wind of liberalisation blowing through the country, nationalist pressures grew until, by the end of 1990, all the republics were clamouring for sovereignty, even for independence. Protectionist barriers have sprung up between republics, regions, districts, even towns. Throughout the Soviet Union there has been an extraordinary increase in self-reliance.

This situation, as the study notes, means that two tasks will have to be addressed simultaneously, and in view of the attendant problems they are colossal: the stabilisation of a completely unbalanced economy, and far-reaching structural reform. But before a start can be made the division of powers between the Union and the Republics has to be clarified, quickly and effectively.

Increasing Difficulties in 1990

According to official estimates, Soviet net material product (NMP)[2] fell by 4% in 1990, although with the continued growth of the service sector the fall in GDP may not have exceeded 2%. At the same time, the wage bill rose by about 12% and household total income by an even larger percentage (Table 1). The authorities tried to tighten financial and fiscal policies. In particular, public investment was cut, enabling the fiscal deficit to be reduced to 8.3% of GDP compared with 9.5% in 1989 and 11% in 1988. While efforts were made to avoid financing the deficit by printing money, these were not successful because of the lack of response from the public to government bond issues. The result, coupled with growing credits to enterprises, was that money creation remained strong.

Table 1
USSR: INCOMES AND PRICES
annual growth, %

	1986	1987	1988	1989	1990[1]
Retail price index	2.0	1.3	0.6	2.0	4.8
Average monthly wage	2.9	3.7	8.3	9.4	10.0
Household money incomes	3.6	3.9	9.2	13.1	14.5
Household purchases of goods and services	2.8	3.1	7.2	9.5	13.7
Saving rate (percent of disposable income)	6.9	7.6	9.2	12.0	12.9

1. Estimates.
Source: Data provided by the Soviet authorities

Although the 'visible' increase in retail prices was only about 5% in 1990, underlying inflation (that is, taking account of unsatisfied demand) may have been about 12%. As prices remained fixed and the money supply grew rapidly, surplus savings (excess liquidity) of enterprises and households continued to expand, reaching some 250 billion rubles, some 30% of national income. This growing monetary overhang was the financial counterpart of increasing physical shortages. Last year real consumption grew further – by 3% – but, despite increased imports, the supply of certain consumer non-durables fell considerably.

Table 2
USSR: BALANCE OF PAYMENTS, 1986–90
billions of dollars

	1986	1987	1988	1989	1990[1]
Convertible currencies					
Trade balance[2]	4.1	8.3	4.8	0	-5.7
Current account[2]	2.3	6.7	1.6	-3.8	-10.7
Gold sales	4.0	3.5	3.8	3.7	3.6
Capital account	-5.7	-12.5	-6.1	-3.6	-7.2
Overall balance	0.6	-2.3	-0.7	-3.7	-14.3

1. Study projections.
2. Excluding gold.
Source: Data provided by the Soviet authorities and study estimates

One very disquieting development was that, because of a fall in production, oil export volumes fell by 20%. Furthermore, the USSR was unable to take full advantage of the rise in oil prices during the second half of the year because intra-CMEA energy prices are set annually.[3] As a result, in 1990 the convertible currency-current account deficit was nearly $11 billion (Table 2). The capital account also showed a deficit of $7 billion as a result of the cutback in international short-term loans. Taking into account the proceeds from gold sales ($3.6 billion), the deficit on the overall balance of payments was an

2. Net material product (NMP) differs from GNP in that it excludes depreciation and most service-sector outputs.

3. See note 2 on p. 6.

estimated $14.3 billion. It was financed by drawing heavily on foreign exchange reserves (which fell from $14.7 billion in 1989 to $5.1 billion in 1990, the equivalent of less than two months' imports) and negatively, as it were, by allowing arrears to foreign suppliers (nearly $5 billion) to build up. This explains why, despite the sharp move of the external accounts into deficit, the external debt fell slightly, to $52 billion (Table 3).

Faced with the rapidly deteriorating macro-economic situation, the President of the USSR persuaded the Supreme Soviet (Federal Parliament), after much discussion, to adopt broad 'guidelines for the stabilisation of the economy and transition to a market economy'. But these guidelines indicate only the ultimate goal; they contain neither detailed plan of reform nor timetable for the transition. This is primarily because a considerable amount of economic freedom is envisaged for the republics in the new union treaty due to be signed between the centre and the republics.

For this reason and others, the measures adopted are difficult to interpret. Moreover, the programme, which is based on unrealistic budget forecasts, is not accompanied by any suggestion of how to implement it. The joint study argues that the guidelines reflect a rather 'gradualist' approach to the transition to a market economy: first, because a large share of output will continue to be produced, at least initially, to state orders; and second, because price reform will proceed cautiously.

Table 3
USSR: EXTERNAL DEBT AND RESERVES
billions of dollars

	1985	1986	1987	1988	1989	1990[1]
External debt[2]	28.9	31.4	39.2	43.0	54.0	52.2[a]
of which: Short-term	6.9	7.4	8.6	11.2	17.7	10.0[a]
External debt service[3]	n.a.	7.8	8.8	8.2	9.4	13.4
(% of goods and services)[4]	n.a.	27.7[b]	26.5[b]	23.1[b]	24.2[b]	33.0[b]
Foreign exchange reserves[5]	12.9	14.7	14.1	15.3	14.7	5.1

n.a. not available.
1. Study projections.
2. External debt contracted or guaranteed by the Vneshekonombank.
3. Total debt service on debt contracted or guaranteed by the Vneshekonombank, excluding repayments of short-term debt.
4. In convertible currencies.
5. BIS data excluding end-1990 which are staff projections.
a. June 1990.
b. Estimates.
Source: Data provided by the Soviet authorities, the Bank for International Settlements (BIS) and study projections


Frédérique Hibon/Sygma

The process of privatisation will be a long one, except perhaps in the retail trade and service sectors and for small industrial businesses.

Another area in which change will be hesitant is that of private property rights and the privatisation of state property. The process will be a long one, except perhaps in the retail trade and service sectors and for small industrial businesses. It also seems that the liberalisation of foreign trade and the weakening of the monopoly positions of the state will be slow.

No Improvement in 1991

Since it is unclear what economic policy measures will be implemented in the next few months, the prospects for the Soviet economy in 1991 are of necessity uncertain, particularly as the debate between the federal authorities and the republics on the direction and implementation of reform is by no means over. So, adopting an intermediate assumption, the study makes some forecasts for 1991. They are based on the following assumptions:

- a political agreement on the division of powers between the centre and the republics will be rapidly concluded, ensuring a single economic space, with a single currency and free trade between the republics
- on the supply side, traditional inter-enterprise links will be re-established, and state orders will continue to account for a large share of production
- wholesale prices will increase by 50–60%, and agricultural procurement prices by about 30%
- the directives set out in the draft federal budget for 1991 will be followed.

As regards the budget, the study projects that the deficit will be twice (59 billion rubles) the figure envisaged in the presidential guidelines for 1991. That is because the price policy as planned will automatically double, in nominal terms, the subsidies for consumer products. But this projection assumes that several planned measures are indeed implemented: that many items of capital expenditure for restructuring are shifted to off-budget financing (in particular to stabilisation funds); that the payroll tax is increased from 12 to 37% to finance pension expenditure, and that a tax on the excess stocks of enterprises is introduced. Very steep

Since the privatisation of the larger state enterprises will be a lengthy and complicated process, rapid 'commercialisation' – financial autonomy, with responsibility for management and strategy – would be the best way of placing them in a competitive environment.

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increases in expenditure on research and development, health and education are also planned.

Consequently, the study foresees that the budget will result in a very large increase in the tax burden on enterprises and a net transfer to households. Furthermore, it must also be taken into account that some tax revenue seems to be overestimated (such as that from profits tax) while expenditures, such as those on interest payments or unemployment benefits, seem underestimated. In short, the 1991 budget is likely to boost demand without stimulating supply. For these reasons, the study considers that the rate of growth of the money supply is likely to accelerate both because of the additional public financing requirements and the increased demand for bank credits from enterprises, since they will have to pay higher taxes and, it is proposed, their bank deposits will be frozen.

Absorption of the monetary overhang would thus be in doubt, particularly as for the moment there is no clearly defined incomes policy that would make it possible to secure wage moderation. In these conditions, despite the uncertainty inherent in such forecasts, it is considered that the rate of inflation will exceed 40%, and to the extent that the increase in input costs are passed on only partially to retail prices, net material product could fall again – by 5% or more.

An improvement in the current-account balance in convertible currencies is unlikely. The study estimates that the current deficit with the convertible-currency area will be between $10.1 and $14.7 billion ($10.7 billion in 1990) and that the servicing of the external debt will require $12 billion. As some $17 billion of western financing is already secured, the financing gap in convertible currency will amount to between $5.6 and $10.2 billion. However, the USSR is likely to run a surplus on current account with the former CMEA countries. To the extent that this surplus will be settled in hard currencies, the financing gap might be closed in this way. Generally, the study considers that the current policies will be unable to stabilise the Soviet economy in 1991. More seriously, it takes the view that the issues involved in the transition to a market economy have not been set out clearly. That is why it advocates a radical approach to reform.

The Principles of Radical Reform

The transformation of the Soviet economy is likely to be a complex process, and to take many years to complete. First of all, crucial, and essentially political, decisions will have to be taken. How can property be privatised while the concept of ownership has not been clearly defined, and property rights have not been fully guaranteed? How can tax reform be embarked upon until the taxing authority and expenditure responsibilities of the various tiers of government have been defined clearly? A new union treaty and a consensus between the various strata of government on the main principles of the reform is thus urgently required.

In setting out the principles of radical reform, the study shows that the policies currently being implemented approximate to them only very roughly. Macro-economic stabilisation, for example, requires a reduction in the budget deficit to a size that can be sustained without recourse to inflationary money creation, and a restrictive monetary policy to impose a hard budget constraint on enterprises. A rise in interest rates is also required to keep in check the inflationary consequences of price liberalisation.

Prices have to be freed: markets cannot develop if prices cannot respond to changes in domestic and external supply and demand. The exchange rate must therefore be brought into line with its

market-clearing value. Unless the ruble has a real exchange value, administratively imposed increases in producer prices are unlikely to have the desired incentive effect. Macro-economic stabilisation and price decontrol cannot be disassociated from each other. How can the economy be stabilised when subsidies amount to 10% of GDP? Conversely, inflation could not be contained if prices were decontrolled in an unbalanced environment.

Likewise, price decontrol becomes meaningless if enterprises are not free to adjust prices. So they must have financial autonomy, with owners and managers taking full responsibility for management and strategy (commercialisation). Private ownership of assets is obviously the surest way of achieving this goal, since it makes managers take responsibility for the costs of their decisions, as well as allowing them to reap the benefits of them. But given that the privatisation of the larger state enterprises will be a slow and complex process, rapid 'commercialisation' would be the best way of placing them in a competitive environment. To break down monopolies, the system of state orders and branch ministries will also have to be dismantled.

As a restructuring on this scale will involve the dislocation of entire sectors of the economy, an effective social safety net will have to be put in place, and the necessary budgetary resources will have to be made available to pay for it. Financial stabilisation is also required to implement an incomes policy and a temporary policy of selective support for enterprises that suddenly have to cope with price decontrol and exposure to foreign competition. Lastly, a market economy cannot get off the ground if investors do not have confidence in the country's legal environment (property rights, banking regulations, competition law, labour legislation); transport and communications infrastructure, too, will have to be upgraded.

This statement of the basic prequisites for a transition to a market economy shows the extent to which reform issues are interrelated. It thus seems difficult to address each issue separately; the sheer scale of the changes required in each sector means that reforms must be carried out

simultaneously in all of them. That is why the study advocates explicitly the 'radical' approach to reform rather than the 'conservative' (gradual) approach.

In the conservative approach – which the current policies of the Soviet leadership seem to embody – reform starts with some tightening of fiscal policy and an adjustment of prices, most of which, however, continue to be administratively controlled. Structural reforms are introduced slowly and prices are liberalised over a period of two or three years. In contrast, the radical approach would start with a vigorous macro-economic stabilisation programme to bring the budget deficit rapidly down to 2–3% of GDP, accompanied by immediate decontrol of most prices and a start to the privatisation of small enterprises.

The likely consequences of the radical programme would be that prices would rise much more, and much more rapidly, than they would in the conservative approach. Output would fall sharply as uncompetitive firms were driven out of business, and unemployment would rise. But if some international financial assistance were available, aggregate consumption might be maintained, since investment would fall and inventories would be run down. The study recognises, nonetheless, that the prospect of such an upheaval in prices and production is daunting.

The key question is whether hesitancy of the kind implied by the conservative approach could mitigate the initial loss of output and still permit the transition to a functioning market economy with sustained growth. The report concludes that the conservative approach would almost certainly fail on both counts. There are two possibilities: first, stabilisation is partially successful within a continuing framework of administratively set prices – but in this case the elimination of unproductive enterprises and the shedding of surplus labour would be delayed, and productivity would not improve. Inflation would rise and output would continue to fall, in the process discrediting the goal of a market economy. Alternatively, the authorities fail to implement sufficiently rigorous fiscal and monetary policies – which is likely, given the lack of price signals – and macroeconomic imbalances grow, shortages increase and black-market prices rise. In short, the best outcome that could be expected from the conservative approach would be that the benefits and costs of restructuring cancel one another out.

The radical approach, obviously, is not without its dangers. The study cites three: dramatic social consequences for the most vulnerable sections of the population; a wage-inflation spiral accompanied by large monopoly profits; dangerous pressure on enterprises without enough time for them to adjust. The study therefore recommends that measures be introduced to ease the way for the transition. First, support targeted at the more disadvantaged groups of the population, and the maintenance of administratively controlled prices in public services and housing. Second, very vigorous macroeconomic stabilisation to accompany price liberalisation and measures to promote competition. Third, a controlled – rather than immediate – increase to world prices of a few key industrial inputs via temporary export taxes, and selective financial and technical government aid to potentially competitive enterprises while they are in the process of being restructured.

What International Assistance?

The conclusion of the study is unambiguous: 'The specific measures that have been adopted do not yet constitute the coherent and comprehensive programme which, in our view, is necessary if the transition is to be successful'. But this does not mean that the international community should sit back and do nothing while preparations for reform are being made. Technical assistance on the legal, statistical, accounting, tax, banking and monetary questions could stiffen Soviet resolve to implement reform. Labour market, management and marketing specialists could also be supplied. This assistance should come primarily from the private sector, with public initiatives limited to filling the gaps.

To deal with the immediate problem of shortages, food aid could be envisaged, provided that it were targeted and distributed under supervision. Assistance to a few carefully selected industrial projects could help to improve the situation in some sectors (energy, environment, telecommunications). Public and private investment in transport infrastructure and in the retail trade and distribution sectors could also be envisaged immediately. These sectors will play a key role in the transition to a market economy, and should be privatised fairly quickly.

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The study recommends that the international community should not provide further assistance to the USSR until a coherent reform programme has been introduced and the relations between the centre and the republics have been stabilised. That private foreign investors will wait and see how the situation develops before investing goes without saying. It is particularly important that this criterion be applied to balance-of-payments assistance programmes (credits for purchases of consumer products, ruble stabilisation fund). The report states quite clearly: without such a reform, additional assistance of this type would be of little value. ■

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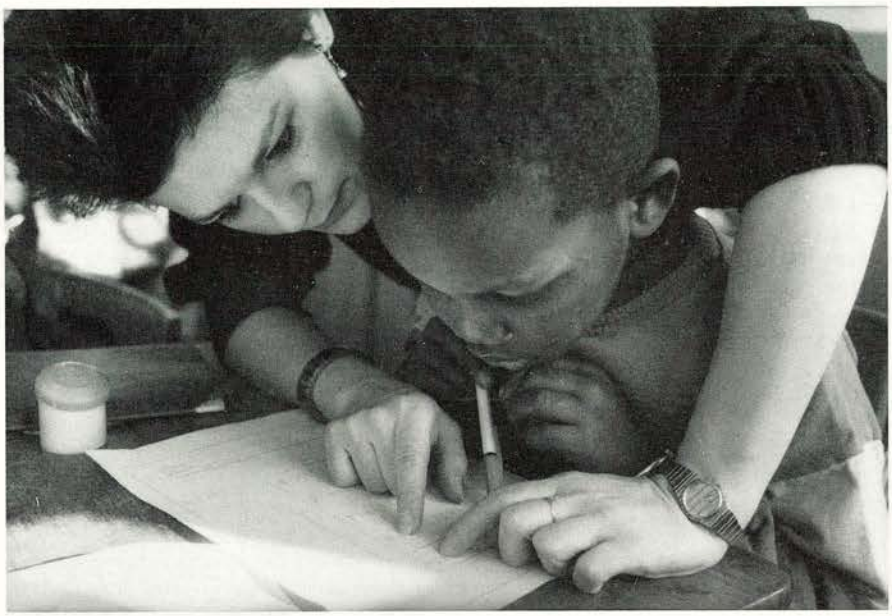
Educating Teachers

Alan Wagner

Teachers remain at the heart of almost all efforts to improve schooling, although their own education has not always been given the same attention. Developments in recent years within and outside schools have combined to give a new emphasis to proposals for reform.[1]



Lily Franey/Rapho

With mounting concern about the quality of education provided to children, the education of teachers, both in theory and in practice, has been the object of scrutiny and change. Perhaps the most important of the developments that have given rise to a new agenda for teacher training are derived from a shift to a 'school-centred' provision of education and an emphasis on learning strategies which directly engage each pupil. The strategies depend on support in the school itself, drawing on an approach to teaching and learning that involves the entire school: the development of language skills in every subject, or the introduction of microcomputers; the use of team teaching, teacher aides, and volunteers in the classroom; and the involvement of parents and local communities in the education of children.[2]

As a result, teachers have to have a good grounding not only in their subject matter but also in the new approaches to teaching and classroom management. In addition, they have to possess skills related to the social development and care of children. They must also be capable administrators and managers now that the school is increasingly responsible for the establishment of goals and priorities, the details of the curriculum, the selection and placement of personnel, the allocation of the budget and the evaluation of student performance – functions previously assigned to different staff in the school or to different tiers in the system.

These developments are directly related to the contents and organisation of teacher education. One consequence is simply the number, breadth and depth of the items on the agenda. A second may be that teachers will assume a more central role in the design of initial training as well as of their own continuing in-service education.

Although recent trends differ according to country, tradition and circumstance, three broad changes can be discerned: higher standards; new efforts to rationalise and control training; and an increased role for the school. The introduction of 'alternate routes' to certification, moreover, represent a significant departure from conventional approaches to the training of teachers.

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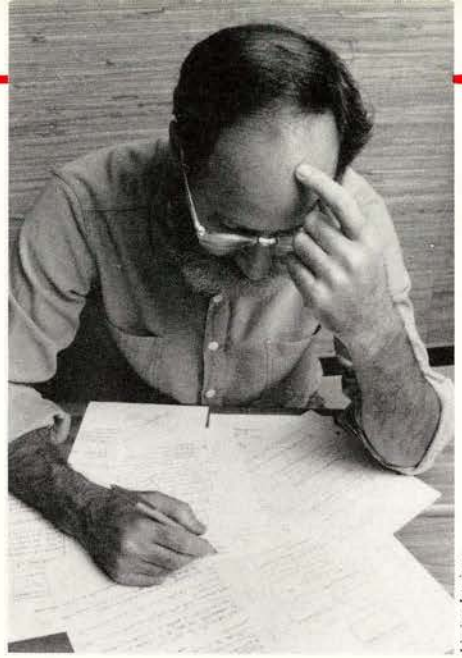
The Move to Higher Standards

Programmes for teacher education have clearly moved to improve the quality of graduates from initial training. In a number of countries, criteria for candidate selection have been tightened, training programmes lengthened and subject-matter requirements increased. In the Netherlands, for example, admissions requirements for candidates for training in primary education were increased in 1989

1. **The Training of Teachers**, available free of charge from the Centre for Educational Research and Innovation at the OECD.

2. **The Teacher Today**, OECD Publications, Paris, 1990; see also Kathleen Kelley-Lainé, 'The Environment at School', **The OECD Observer**, No. 165, August/September 1990.



Limier-Jerrican

The teacher now has to undertake many tasks that – unlike the correction of exam papers – are not directly related to teaching.

(mathematics is specifically required). Candidates seeking teaching credentials after completion of regular degree programmes now must pass an admissions board assessing the suitability of candidates for a one-year compulsory course of professional training.

In the United States, most states now require some form of specialised testing and/or minimum academic performance for entry into training or teaching. And there has been interest in extending initial teacher training to five or six years. Greece has recently imposed the condition of a full higher-education degree for entry into primary teaching. And among other countries emphasis on professional teaching skills in initial teacher-training courses has increased in Sweden, Ireland, Japan, Belgium and Spain.

These changes may be characterised as 'more of the same', and in many respects they constitute appropriate responses to heightened expectations of teachers in the classroom. But how efficient is simply extending initial teacher training, which is already lengthy and expensive? The question is being raised more and more often. Some observers suggest, moreover, that training in professional education subjects is better handled through an intensified provision of traditional in-service education. That would allow teachers to apply the principles and theory they have learned to their own work. Yet, in many OECD countries, the pattern of part-time work and periods outside teaching, linked to the relatively flat career structure in teaching, complicate efforts to introduce such an approach. With part-time teachers, the time necessary for in-depth in-service education often simply isn't available. And after some time away from the classroom, teachers returning to it have to re-acquire more basic class management skills.

Under these circumstances, one strategy is to undertake more comprehensive changes in career structures, aligned with the new responsibilities shouldered by teachers and supported by strong, continuous in-service. Such changes are currently under consideration in Australia and the United States. In their absence, the most promising approach connects initial teacher training more closely to practice and orients in-service training to bringing about improvements in the effectiveness of the school.

Rationalising Training

A second trend has been an increase in the efforts of education authorities to influence more directly the contents and provision of both initial teacher training and in-service education. The Council for the Accreditation of Teacher Education (CATE) in the United Kingdom (England and Wales), the most recent manifestation of this approach, is distinguished by the detail of its requirements and the systematic nature of its programme review. Following guidelines set down by the Secretary of State CATE now keeps its criteria for assessing courses under review; programmes of initial teacher training are not accredited if they do not meet those guidelines. Local committees – comprising representatives of training institutions and of local education authorities (LEAs), teachers, academics who are not involved in teacher training, and local businessmen – are charged with the detailed review of initial courses.

Another method of ensuring co-ordination and control is to require providers of teacher training to 'compete' for funds and students. Providers who do not meet the criteria set down for funding will be unable to continue to train students through lack of resources. In Denmark all initial teacher training institutes have been invited to provide in-service education for teachers (INSET); formerly, the Royal Danish Institute for Education Studies was solely responsible. In Sweden, LEAs receive funds to support the in-service training of teachers. They identify the requirements, select the teachers who will participate and choose the programmes from among those offered by colleges and universities. Under the new Local Education Authority Training Grant Scheme in the United Kingdom (again, England and Wales), a local authority must first submit its plans for INSET for approval by the central government. Differential rates of support give extra weight to in-service training aimed at national objectives (65% of the cost) as opposed to locally identified requirements (50%).

In general, these approaches appropriately place responsibilities for teacher training closer to the school and to teachers. Yet controls and incentives set by government leave teacher education susceptible to unstable and shifting priorities.

Focussing on the School

The third broad trend has been an increased role for the school and practising teachers in the provision of training. In initial training (pre-service), trainees are now generally spending more time gaining practical experience. In Japan, for example, the two to four weeks of practice teaching have been increased by one week to permit further experience with student counselling and parent involvement. In Finland, the Committee on the Development of Teacher Education has emphasised the importance of integrating practical training into professional education studies. Increased attention is also being given to the induction of newly trained teachers – as in Australia, where the Schools Council has recommended a comprehensive review of current practices with the view of developing an understanding of what contributes to effective induction.

In some countries, practising teachers have assumed larger roles in pre-service programmes, ranging from traditional roles of supervising trainees to reviewing the curricula of teacher education and selection of candidates, as is now the case in the United Kingdom (once more, England and Wales only). Teacher trainers in the United Kingdom are now required to update regularly their own experience of teaching in schools. For in-service education, the shift is toward 'school-focussed' programmes, both because of cost and effectiveness.

The trend to locate a larger share of the

Decout/R.E.A.

Theory or practice? There is as yet no resolution to the long-standing debate on the correct balance in the training of teachers.

training in schools responds to a perceived weakness in teacher-education programmes. But there are concerns about the apparent lack of capacity within the school to develop and carry out appropriate and effective training. Efforts to design and implement such school-based training will become even more complicated, as changes in the organisation of schools blur established distinctions among school staff, and lead to a teaching force that is more differentiated in tasks and responsibilities.

Alternative Routes

Provision for alternative selection and alternative training (shorter in duration and combining work with part-time training), while found in only a few countries, represents a radical departure from conventional approaches to the training of teachers. The 'alternative route' programmes are seen as necessary because candidates entering such programmes bring with them different types of expertise and because the programmes appeal to potential recruits in certain geographic areas and who are specialists in subjects where teachers are required who otherwise would not enter the profession.

In rural northern Norway, for example, candidates – most of whom possess regular entrance qualifications – are recruited to teaching through a combination of eight weeks of part-time teacher education (spread over the school year) and part-time supervised teaching in their local school. In the United Kingdom (England and Wales), recent college graduates without teacher training can enroll, while still teaching in schools, in an integrated, two-year postgraduate certificate in education (PGCE) training course developed in collaboration with a teacher-training institution and the school. These candidates are known as 'Articled Teachers'. A separate programme, the 'Licensed Teacher' scheme, is designed to enable talented individuals who have either been trained abroad as teachers or who possess other skills to take a course of training developed by the school and suited to their own requirements. Similar types of alternative routes to teaching (and, in most cases, to teacher certification) exist in the United States.

In part because the programmes are new, the number of teachers entering classrooms through alternative routes is small. Nonetheless, the prospect of alternative routes raises challenges about the adequacy of teachers prepared in this way. A natural suspicion is that diversity in programmes means diversity in standards, when what is desirable is something like a single standard that guarantees quality preparation.

Other means are available to meet the demand for teachers, in general or within identified shortage areas. One approach has been to lower standards to generate supply by, for example, accepting teachers who are unqualified or whose qualifications are inferior to those required. Class size can be increased. Another option is further to differentiate roles within the profession (for instance, master teachers or 'advanced skills' teachers, teacher assistants) and then elaborate training requirements around each role.

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The practical effects of all of this on existing teacher training programmes remain to be worked out. There is as yet no resolution to the long-standing debates about the balance between theory and practice in teacher education, and the related discussion of the merits of locating such training in universities (which offers the benefits of professional status and scientific rigour), as opposed to specialised institutes (which stress the important link between theory and practice).

Rather, recent developments have brought to the surface questions about the nature and aims of teaching and learning, the roles of the teacher and the relation of the school to society. The evolution of teacher education is now seen to be closely linked to changes in the demands on schools, in the organisation of schooling and in career patterns in teaching.

More is now known about the best arrangements for effective teaching and learning in a period when there is continuing competition for qualified manpower and constraints on public resources. As a result, there are growing indications that teacher-training programmes will have to incorporate new approaches that enable current and prospective teachers with diverse backgrounds – in age, experience, training and ability – to acquire and update their knowledge and skills.

At the same time, arrangements for teacher training will have to be made more attractive for potential entrants and current teachers, both in the time and financial resources they must commit to training as well as in the relevance of the training for immediate use and for career development (within and outside of teaching). Finally, the training of teachers will have to take into account a new relationship between the profession and the state, one in which responsibilities for education are shared more fully than has been the case in the past. In all of these respects, the deeper involvement of teachers in training and the use of alternative forms of training may indicate the future directions for teacher education. ■

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Brian Lynch/Irish Tourist Board

John Lowe

Ireland and its Teachers

Education in Ireland is currently the focus of concern among some educationalists, not least because of spending cuts and what they perceive as too strong an emphasis in recent years on promoting the links between education and the economy. Although this concern may serve to prevent any unwanted distortion of the perpetual aims of education, the present balance between strictly educational interests and economic or manpower priorities is satisfactory. Ireland has had no choice but to develop its industrial capacity at speed, which has necessitated a drive to expand and enhance the quality of vocational and technical education. But this expansion has been accompanied by a parallel drive to widen access to post-compulsory general education.

The pursuit of cost-effectiveness in the financing and management of education reflects the contemporary pressure throughout OECD countries to keep public expenditures that had grown out of hand during the expansionist '60s and '70s within tenable bounds. Ireland, indeed, had been facing a particularly acute problem of excessive expenditure.

The growth of education has shadowed that of the economy. From the birth of national independence in 1922 up to 1960 it was both static and short of adequate resources. In compulsory schools many of the classes were too large and the curriculum too narrow: 22% of teachers were reputed to be untrained in 1957–58. The upper secondary sector was small and fee-paying, catering largely for the children of better-off parents. Higher education was elitist. The public was not inquisitive about what happened inside the system, though always deeply respectful of it. The overriding priority of the state was to promote the national language; it displayed no interest in educational reform.

Ireland sets much store by the quality of its 'human resources'. Public documents contain frequent references to the necessity of having a well-qualified workforce in this age of high technology and rapid economic change. So no one questions the importance of education and training for the vitality of the economy, employment, and the entire process of national development.[1]

The economic expansion that began in the 1960s was a watershed for education. The public began to show increasing concern. The state came to assume an interventionist role. The notion of investment in education for national growth and development took firm root.[2] The social demand for education increased apace. Money was found to build new schools and colleges, and thousands of new teachers were appointed. The system expanded up to the mid-1980s when the policy of economic austerity called a halt: some expansion still continued in programmes oriented towards the labour market.

In spite of the rapid pace of its economic development in recent years, Ireland has preserved a distinctive cultural identity, and traditional values and mores to a degree not found in many other industrialised countries. The Catholic church continues to play an important role in all aspects of life.

Yet the effects of modernisation have

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been considerable. Society has become more pluralist; there is increasing dissent; individual aspirations compete with collective regulation; there is growing cultural diversity; there is heightened sensitivity about social equity and women's rights; there is much family break-down, even though divorce is not allowed; a rising crime rate and drug abuse trouble the inner cities; there is structural unemployment.

As a result of all this, schools and teachers are being hard pressed to play their part in conserving all that is best in the Irish heritage – its family and neighbourhood unity, lively arts, a powerful oral as well as literary tradition, and distinctive rural life – while simultaneously adapting the curriculum and their relations with pupils and parents to contemporary realities.

The Quality of Teachers

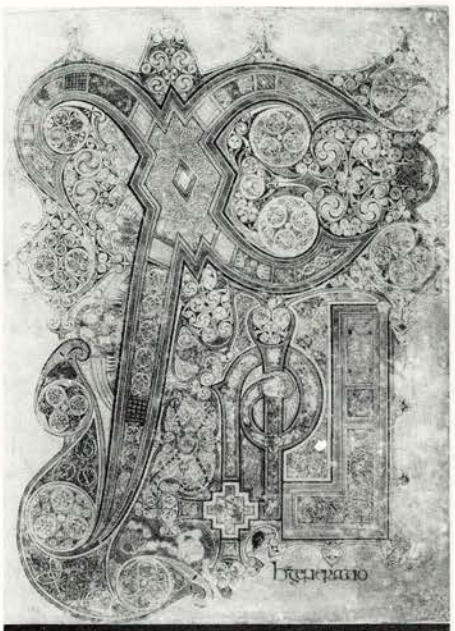
Although schools and teachers are under pressure to change, they have so far been spared the kind of scathing criticism to which those in several other OECD countries have been exposed during the past decade or so. Visitors are informed that education has forever been held in high esteem by the Irish people. Nearly everyone speaks of the excellent quality of the teaching force and the respected status of teachers in their communities.

Recruits to the colleges of education responsible for the training of primary school teachers have been of outstanding academic ability. Year after year, the colleges received far more applications than there were places available, and those selected for admission obtained marks in their final examinations that would have comfortably guaranteed them a university place.

The overall quality of the secondary teacher intake was variable over time according to its size but was never less than satisfactory, even though a teaching career may not have been the first choice of many candidates. It is undoubtedly of sound academic quality at the present time when the competition for places in most subjects is intense.

Practising teachers have few reservations about their own competence and secure standing in society. Moreover, they enjoy satisfactory conditions of service in what will soon be an entirely graduate profession. Their salaries are relatively high compared with other professions in Ireland and with the low remuneration of teachers in some other OECD countries. Since 1969 there has been a common basic salary scale for all regardless of the education level at which they teach. They have a short working year by international reckoning. Their autonomy in the classroom is legendary. And, unlike in certain other countries, their relations with the employing authorities are generally cordial.

Ireland faces rapid social and cultural change, and unless there is a major shift in the supply policy of the national education authorities few new teachers with fresh ideas will be appointed. So can the quality of the teaching force as a whole be maintained over the years ahead?



The Board of Trinity College Dublin

The Board of Trinity College Dublin

The eighth-century Book of Kells, housed in the Library of University College, Dublin, is testimony to Ireland's long scholastic tradition.

How Many Teachers?

Traditionally, Ireland has had one of the very highest birth-rates among OECD countries. This, combined with rapidly increasing post-compulsory enrolments from the early 1960s, a fall in the pupil/teacher ratio and the appointment of specialist teachers, ensured that the demand for teachers kept increasing, especially in secondary schools.

Since 1980 the birth-rate has fallen and the annual increase in the numbers staying on after compulsory schooling has flattened out. The available calculations of future trends show that there will be a pronounced decline in enrolments in primary schools between 1989/90 and 2000/2001 of the order of 22% and a significant decline in secondary schools (mostly lower secondary) of around 11%.

Simultaneously, the government's tight economic policy has entailed for education a general squeeze on resources and a temporary raising of the pupil/teacher ratio in primary schools. The outcome has been a sharp decline in the demand for additional teachers and the emergence of a critical rate of unemployment or under-employment among newly qualified teachers. The consequences for the training establishments have been traumatic.

The danger, which is faced by many other

1. **Review of National Policies for Education: Ireland**, OECD Publications, Paris, forthcoming 1991.

2. **Investment in Education: Ireland**, Government Publications, Dublin, 1966.

OECD countries, is that teaching will become an immobile profession as only a trickle of new entrants find their way into it. The majority of practising teachers in Ireland are under 45 years of age (72% in secondary education). Only relatively few will be retiring annually over the next twenty years or so. As a result, opportunities for career improvement and changes of post will dry up unless special incentives are created.

Teaching will become a 'greying' occupation. Professional knowledge and skills may become rusty. The traditional dedication of teachers may become hard to sustain. More and more of them may burn out, especially given the new social pressures and problems. In short, the regular infusion of healthy new blood into the teaching force is essential in order to prevent its arteries from hardening.

The danger can be averted, by recognising that there is now a teacher surplus not only because the demand for teachers has been checked by the high pupil/teacher ratio but also by deferring school improvements that have been under consideration for some time. It would thus be beneficial to lower the pupil/teacher ratio in overcrowded classrooms on pedagogical as much as equity grounds , to institute a six-year secondary cycle for all students, to lengthen the school year, to appoint many more teachers of special subjects such as modern languages, to strengthen school management structures, and to put in place a comprehensive system of induction and in-service training. More immediately, it is urgent that more specialised instruction be provided for disadvantaged students. Making all these improvements would necessarily take time but would certainly create a substantial demand for new teachers.

The Future of Training

The question of whether a short- or long-term view of teacher supply determines recruitment policy is crucial for the future size, vitality and very survival of the teacher-training institutions. These underwent rapid expansion from the early 1960s, complementing, more or less, the increase in school enrolments, especially in secondary schools. From the early '80s they began to contract in order to reconcile as far as possible the size of their intakes with the number of teaching posts available. During the last few years their enrolments have been in free fall, especially in the colleges of education. In 1986, the Minister of Education felt obliged to take the decisive step of closing one of the three big colleges. Now the national authorities must decide whether to maintain the status quo, to close down still more institutions or else to effect institutional mergers and consolidate teaching and physical resources.

Similar options now face several OECD countries and have already faced others. The wisest choice would appear to be merger and consolidation. Since in Ireland all initial training courses now lead to the award of a degree validated by a university, and the students of some colleges of education already have access to university courses and their general facilities, there exists already close collaboration between the two types of institution.

This could be formalised by merging each of the colleges with a university department of education so as to constitute a school or faculty of education. Such a measure has been adopted recently in Italy and Spain, and in Ireland it could have important advantages. For example, it could reinforce those practical aspects of training and help disseminate those pedagogical values that have been traditionally associated with the highly regarded colleges of education. It could also strengthen the national capacity for educational research and development.

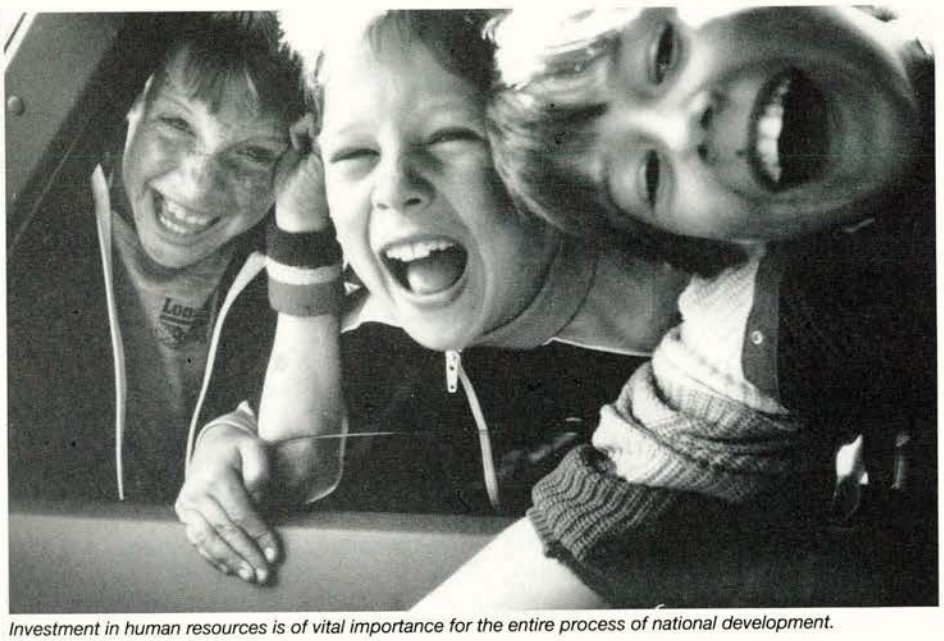
A Teaching Career?

The most valuable return from increased investment in the education and training of teachers will come from the careful planning and construction of a nation-wide induction and in-service system using the concept of a teaching career as the foundation. The emphasis on 'teaching' highlights the necessity of ensuring that Ireland's excellent teachers stay in the classroom and gain satisfaction from doing so. At the same time, in-service training is required for principals and other persons concerned with the education service.

There is no dearth of potential expertise for induction and in-service purposes within the system, whether in the univer-

P. Tuttyl/Irish Tourist Board

Ireland's teachers (here at the Dublin Language Centre) have few reservations about their own competence and secure standing in society.



Silvia Thompson/OECD

Investment in human resources is of vital importance for the entire process of national development.

sities and colleges, the national inspectorate, the professional associations and unions and the schools themselves; nor is there any lack of willingness or enthusiasm to apply it. Ireland has the human capability to build up an outstanding in-service education and training system for all its teachers. The main difficulty is the lack of appropriate structures and resources.

The provision of In-Service Education and Training (INSET) is under-developed in Ireland. Improving it on a significant scale will require considerable resources and widespread consultation and discussion. Furthermore, instead of regarding organised professional development as an optional, voluntary and *ad hoc* experience, all educators and the community at large will have to perceive it as normal.

Although co-ordinated national planning and resourcing are essential, the delivery of INSET should involve an array of providers and interest groups. The colleges and universities already participate in all phases of teacher education and could undertake additional responsibilities if financially enabled to do so. The provision of advanced diploma courses in special educational fields and courses leading to post-graduate degrees could be strengthened, and consideration could be given to financial assistance for teachers who attend them. The existing network of teachers' centres could be expanded and reinforced to provide accessible facilities for courses, meetings and practical projects both locally and regionally. The professional associations and unions have an important part to play, as also do such bodies as the associations of school managers and parents.

The next ten to 15 years of falling enrolments and curricular reforms will pose formidable challenges for school managers and governing boards. Since parental choice will be widely exercised, it would appear inevitable that schools will be competing for students and that they will have to adopt techniques for advertising the quality of the instruction and physical facilities that they are able to offer. Schools will also be expected to assume full accountability for their actions. All those concerned with government and management will therefore require relevant training through nationally, regionally and locally based courses.

No less important will be the rapid promotion of courses on parent education under the sponsorship of the Department of Education and organised either by concerned groups such as the National Parents Council or by teacher-training institutions or teachers' centres. If the national authorities believe that community members – including parents – should actively participate in determining school policies without being the prisoners of professional groups in the educational field, they should adopt a positive training policy expressly designed to cater for their requirements.

There has been widespread debate in several OECD countries on whether a national council is required for the education and training of teachers, reporting to the Minister of Education and representing a wide range of educational interests apart from those of teachers. In Ireland most educationalists welcome the idea. It is hard to see how initial training, induction, and in-service training can be strengthened and harmonised in the absence of an effective form of centralised machinery.

□ □

In the Irish education system the role of teachers is of truly critical importance, not least because the authorities, compared with other OECD countries, have chosen to devote a very high percentage of educational expenditure to teacher salaries, arguably by economising severely on other resources. If essential reforms are to be implemented there will have to be changes in the behaviour of already trained teachers, a large majority of whom were educated and professionally trained before the electronic revolution. This will entail a substantial financial outlay on in-service training and better resources within schools in order to enhance teacher effectiveness. At the same time, it will be essential to ensure that there is a steady flow of new recruits into the teaching profession. ■

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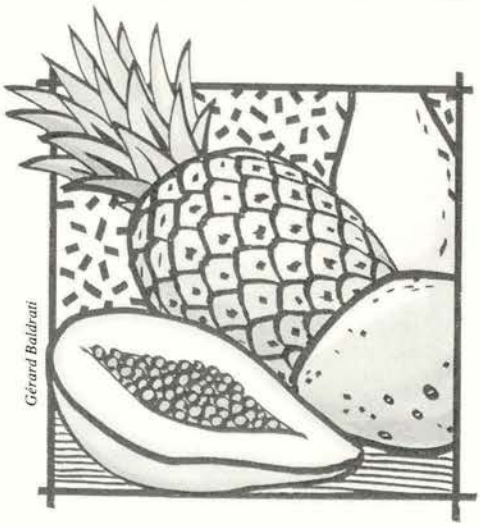
From Commodity Dependency to Development

Bernhard Fischer

Real commodity prices were, in general, relatively high in the 1970s. That helped engender hopes that commodity terms of trade could be maintained by a system of international agreements underpinned by a central stabilisation fund. But they fell sharply in the early 1980s, contributing to the economic distress of many developing countries and forming an important factor in the emergence of the debt problem, since much of the borrowing and lending in the 1970s was based on the then prevailing commodity prices and outlook.

Less than three decades ago, most developing countries were still exporting primary commodities. The steady growth in the share of developing countries in world exports of manufactures since 1983 is almost entirely accounted for by the four


Gérard Baldrati

Asian newly industrialising economies (Korea, Taiwan, Singapore and Hong Kong). Only a few countries such as Brazil, Malaysia, Thailand and Indonesia, among others, could diversify and increase their commodity exports and raise the domestic value added through improvements in quality and marketing.[1]

The increased uncertainty in the world economy has had a considerable impact on developing countries. Those that are heavily dependent on the production and export of non-energy commodities are the most exposed of all.

These countries also have been able to adjust to the changing structure of the transport and distribution industries in the advanced world (air freight, national and even international supermarket chains, and so on) which have created both new requirements and new opportunities, especially in fresh produce. Yet there remains a large number of poor exporting countries who still correspond to the classic picture of a highly commodity-dependent country.

Degrees of Commodity Dependence

For virtually all developing countries – except the fast-growing exporters of manufactures – primary production is still the single most important contributor to GDP. For the majority of these countries the share of primary production is more than 30%. If mineral fuels are excluded, at least 89 developing countries depend for more than 50% of their export earnings on commodity exports. In many cases, moreover, this dependence relates principally to one or two commodity products. Declining earnings from commodities are usually associated with negative import growth rates, declining investment and negative real per capita income growth rates.

There seems to be a correlation between dependence on commodity export and low income. No other region in the world depends on commmodity exports as much as sub-Saharan Africa. Burkina Faso and Mali, for example, rely on cotton for over 50% of their export receipts. Burundi, Ethiopia, Ghana, Kenya and the Ivory Coast get over 50% of their export

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Table 1
COMMODITY PRICES UNTIL 2000[1]
1979–81 = 100

	Past and Projected Prices Indices[2]				
	1970	*1980*	*1985*	*1995*	*2000*
Commodities (excluding energy)	111	105	81	62	63
Agriculture	103	104	81	58	59
Food	103	104	83	56	58
Beverages	96	99	95	53	61
Cereals	109	101	74	49	51
Fats and oils	121	96	76	58	49
Non-food	101	106	75	65	63
Timber	60	110	80	99	101
Metals and Minerals	143	105	80	65	66

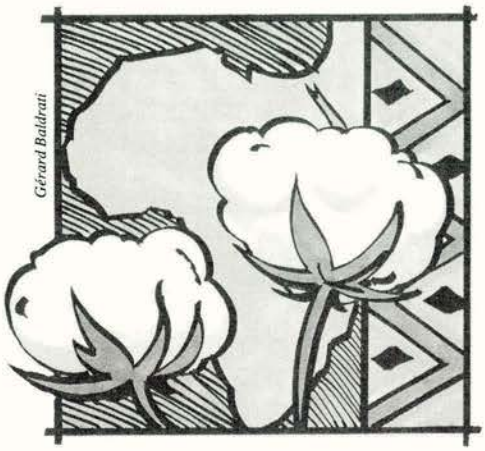
1. Short-term forecasts of commodity movements vary widely between forecasting institutions, partly reflecting the variety of factors influencing prices. Forecasts by the World Bank up to the year 1995 suggest a general decline in the prices of the major categories. Beyond 1995, beverages will be the only group that is projected to experience significant gains in real prices. But these projections are sensitive to assumptions on economic growth, inflation and government policies affecting the commodity markets, and have not proved to be reliable in the past.

2. In constant US dollars, deflated by the World Bank manufacturing unit value index.

Source: *Quarterly Review of Commodity Markets*, World Bank, Washington DC, September 1989

revenues from tropical beverages. Malawi, Mauritania and Somalia derive similar proportions from food products. Niger and Zambia heavily depend on the exports of metals and minerals. These countries in general show very little diversification within the primary commodities exported.

But primary commodities are not of equal importance for all such countries. The considerable difference in the openness of these economies results in a large variation of commodity export earnings relative to GDP: from over 55% in the case of Mauritania to as low as 4% for Somalia, over a 1985–87 average. But for most of these countries the revenues from exports of primary commodities form a large part of their foreign exchange earnings. Since many of them have severe problems servicing their debt, and practically no access to the international capital markets,



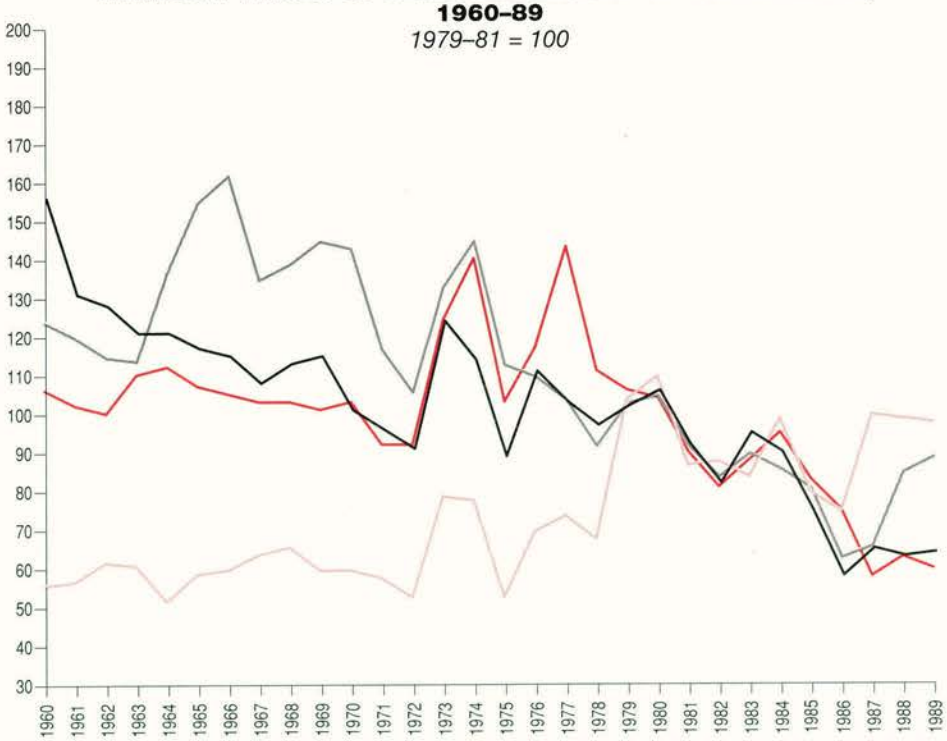
only foreign aid is left to pay for the capital goods, food and other products they have to import.

Over the past decade the major trend in international commodity prices has been one of decline, marked by a considerable degree of volatility compared to manufactured prices.[2] But the declining trend in the barter terms of trade of primary commodities does not reflect productivity gains and increases in the export volumes. Indeed, the income terms of trade (defined as the value of exports divided by the price of imports) indicate steady increases in economic gains from trade for quite a number of developing countries, even over the last decade.

Figure 1

TRENDS IN PRICES OF SELECTED GROUPS OF COMMODITIES,[1] 1960–89

1979–81 = 100



1. In constant US dollars, deflated by manufacturing unit value index.

Source: *Quarterly Review of Commodity Markets*, World Bank, Washington DC, September 1989

Why the Decline in Prices?

The long-term decline of commodity prices is mainly the outcome of falling long-term production costs as a result of new technologies and intensified competition in the world economy, including the competition generated by more advanced developing-country exporters. The high volatility of prices is partly a result of rigidities in supply caused by the very nature of the commodities, like dependence on weather conditions or long gestation periods of investments. A coffee tree, for example, has to grow for five years before a crop can be harvested. These supply rigidities are very often reinforced by inappropriate domestic policies which insulate domestic production decisions from international price movements.[3]

On the demand side, low income elasticities of demand for most commodities, resource-saving technological progress, ready availability of cheap substitutes, low population growth and the shift towards a service society have slowed down demand from industrial countries for most commodities. Demand for coffee, for example, is nearly saturated in terms of per capita consumption; artificial substitutes for sugar have taken increasing shares of

1. See André Barsony, 'Co-operation with the Dynamic Asian Economies', **The OECD Observer**, No. 168, February/March 1991.

2. Estimates of the extent of price movements tend to vary depending on the base period, choice of the deflator, country and product coverage. In addition, large variations exist between individual commodities and sub-periods.

3. See Christian Morrisson, 'More Trade, Less Poverty' **The OECD Observer**, No. 162, February/March 1990.

the markets; and demand for raw materials like cotton or copper are sensitive to growth of industrial output. Demand from developing countries has been constrained by the relatively slow growth in the 1980s of the countries with debt problems, by a higher degree of protectionism and by the low incomes of the bulk of the population.

What Impact on Development?

The economic performance of the commodity-dependent developing countries as a group has been dismal over the last decade. Average annual growth of real GDP per capita was only 0.2% between 1965 and 1987, considerably worse than the average of all developing countries (2.7%).[4] Although the economic and social situation is highly diverse, some characteristics are common to most of these countries: per capita income is generally below the average of developing countries; domestic markets are relatively small and fragmented; agricultural production is dominant and the share of manufacturing low; domestic savings fall short of investment, a substantial part of which is financed by development aid; and the poor economic profile is reflected, naturally enough, in low living standards.

Structural trends on both the supply and demand sides continue to point to relatively low prices for many commodities. These trends could favour the developing countries that are either net importers of commodities or that benefit as commodity producers from improvements in productivity that bring continuing reductions in cost. But the likely continuation of the decline in prices has renewed concerns for prospects of the poorer countries – most of them in Sub-Saharan Africa.

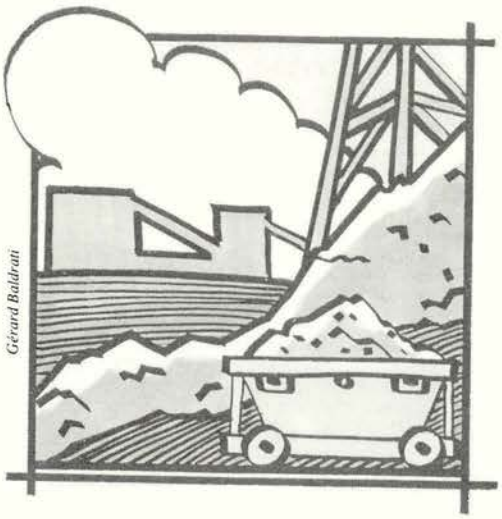
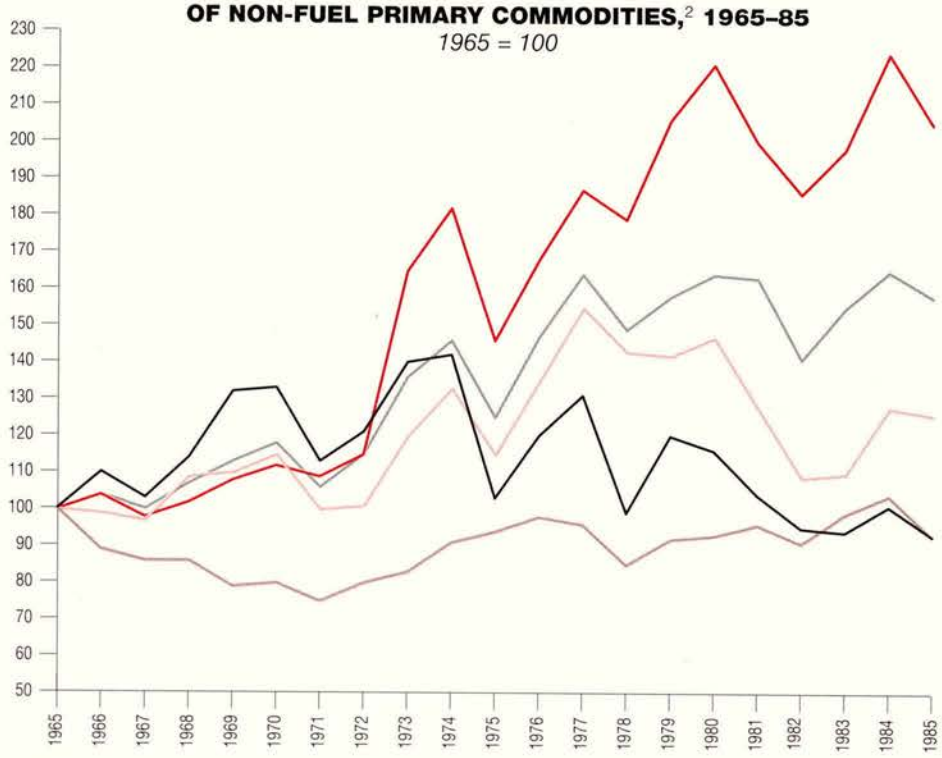

Gérard Baldrati

Figure 2
INCOME TERMS OF TRADE[1] OF NON-FUEL PRIMARY COMMODITIES,[2] 1965–85
1965 = 100



1. The value of exports divided by the price of imports.
2. Export revenues deflated by import unit values of manufactures.
Source: *Price Prospects for Major Primary Commodities*, World Bank, Washington DC, 1986

Past Failures

External and internal conditions alike have influenced the diversity of the development performance of these countries. The declining and volatile terms of trade have been aggravated by their increasing inability to adjust their economic policies to changes in the external environment and mounting external debt. International initiatives – commodity agreements, compensatory financing, preferences granted under the Lomé Convention or the Generalised Scheme of Preferences – have provided them with trade-linked aid but have also tended to freeze their production structure in favour of the supported products.

Agricultural policies in OECD countries as well as macro-economic and agricultural policies implemented in commodity-producing countries have discriminated against agricultural producers and exports in the developing countries. In the developed countries, subsidies for agricultural production and export have contributed to increased world supply and lower prices, particularly for temperate agricultural products. Protectionism in both groups of countries has reduced demand and contributed to the volatility of prices. And in the developing countries, macro and agricultural policies have been biased against agriculture. Incentives to produce in agriculture are distorted because of overvalued exchange rates, fixed-pricing policies, marketing monopolies, unfavourable prices relative to industrial output, and so on. These have led to monocultures, supply rigidities and low productivity, especially in the poorer commodity producing countries.

In addition to those conflicting policy signals, adjustment has been hampered by market segmentation, insufficient linkages among sectors, the high unit cost of labour, inefficient public enterprises, mounting budget deficits, and a rapid deterioration of public management in general. Other fundamental problems include high and even accelerating population growth rates, political instability sometimes manifested in political violence and

4. The country sample includes low-income and lower-middle income countries where more than 60% of merchandise exports in 1987 consist of non-oil primary commodities.

border conflicts, segmentation of societies along tribal lines, the 'personal' rule of parasitic elites and the emergence of a non-productive state class living on politically derived rents.[5]

Most of the commodity-dependent developing countries do not have a strong enterprise sector. A fundamental response to their difficulties must therefore centre on the basic development of human resources, the building of institutions and infrastructure, and the fostering of market-based enterprise economies.[6] Continued support from multilateral and bilateral aid donors in financing structural adjustment and policy reform efforts will be essential to help these countries in diversifying their economies and integrating them into the world trading system.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For the poorer countries, the principle of comparative advantage may justify official development assistance of well-prepared commodity projects that contribute to diversification, processing, improvement of marketing and distribution. But this support requires careful evaluation of the market prospects of the commodities concerned: a cost-benefit analysis of alternative uses of this kind of assistance; consideration (in the case of large investments) of the impact on other poor countries producing the same range of commodities and future price prospects; and careful assessment of managerial and institutional capacity, social and distributional effects and environmental impact.

Table 2
THIRTY YEARS OF PRICE TRENDS FOR SELECTED COMMODITIES
average annual rate of change, %[1]

	1962–80	*1980–89*[2]
Agriculture		
Sugar	4.3	–22.1
Groundnuts	1.4	–10.1
Coconut oil	–0.9	–7.7
Groundnut oil	1.7	–7.3
Tea	–3.3	–3.7
Cocoa	5.7	–2.7
Coffee	2.9	–1.6
Rubber	–1.5	–6.9
Cotton	0.6	–6.9
Hides and skins	0.9	–2.2
Tropical timber	1.3	–1.7
Minerals, ores and metals		
Tin	3.5	–13.4
Copper	–2.4	–5.1
Iron Ore	–1.4	–3.9

1. Constant 1980 dollars.
2. Prices for 1989 are for the first seven months.

Source: *UNCTAD Commodity Yearbook 1989*, United Nations, New York, 1989

International commodity agreements have, on balance, proven to be either unsuccessful or a relatively costly way of reaching their principal targets. Moreover, most of the poorer countries have played only a marginal role in these agreements because of their relatively small share in production. Apart from efforts to improve the transparency of commodity markets, including better information on future conditions of demand and supply, there is little real hope of improving development prospects through increased international co-operation to manage commodity markets.

Since the prospects for success for most of the least developed countries that depend on commodity exports are very poor, schemes to stabilise their incomes continue to offer a useful means of softening the impact of adjustment for those among them with limited potential to diversify their production. But these schemes have to be properly integrated with structural adjustment programmes, both to reduce substantially the risk of awarding a premium to uncompetitive structures and to ease the transition to other production lines with better export potential or with unsatisfied demand on local or regional markets such as food, agricultural inputs or building materials.

□ □

Improving the external economic environment and providing access to all markets is an essential part of the support of the industrial countries for those that are dependent on commodities. Lowering the degree of agricultural protection in OECD countries could be a market-oriented step towards increased self-sufficiency in food in some of the commodity-dependent developing countries. Undistorted prices in the world market would even lead to food exports and an increasing export diversification.

The removal of tariff escalation (which produces higher tariff rates on processed products than on the raw material) could attract export-oriented investment in the processing of commodities in developing countries. Tariff escalation biases trade flows towards raw materials, inhibiting first- and second-stage processing of products for which developing countries are the primary supplier of raw materials.

Finally, for non-traditional products such as textiles, clothing and footwear, the dismantling of protectionist instruments embodied in preferential trading arrangements could encourage efforts in these countries to establish internationally competitive lines of production and encourage export optimism among potential investors. ■

5. See Anne de Lattre, 'The Small Business in the Sahel', **The OECD Observer**, No. 163, April/May 1990.

6. See Cory Highland, 'Development through Enterprise', **The OECD Observer**, No. 162, February/March 1990.

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Green Labels for Consumers

Rudman

Jim Salzman

'Green consumers', exercising choice in the market, can contribute to the protection of the environment. Labelling products that have less of an adverse impact on the environment can help guide that choice.[1]

The 1990s have already been identified by journalists and politicians alike as 'the decade of the environment'. The title is apt: the environment today is threatened in a wide variety of ways, from global greenhouse warming to urban smog, from stratospheric ozone depletion to local contamination of drinking water. Public concern over the state of the environment has reached an unprecedented degree of intensity. Considerations of environmental protection are increasingly influencing everyday activities.

This influence has been felt in the political sphere, resulting in, for example, the Montreal Protocol to Control Substances that Deplete the Ozone Layer, as well as in the marketplace. Regardless of where one might shop in the OECD countries today, it seems likely the consumer will see products proudly proclaiming their environmental attributes. Whether they are 'CFC-

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free', 'biodegradable', or simply 'nature friendly', many products are taking on a green tinge. The force behind this massive shift in marketing appeal is, appropriately enough, the rise of the 'green consumer'. Consumers increasingly want to contribute to protecting the environment, and

are willing to use their everyday purchases as a tool of environmental protection. A study in the United States found that while 'green' products constituted only 0.5% of all new products introduced in 1985, that figure had risen to 9.2% in the first half of 1990 (an increase of almost 19 times).

Recent polls throughout the OECD area have clearly demonstrated consumers' willingness to pay a premium for goods that are environmentally more benign. In a nationwide poll in Canada, for example, 80% of the people polled stated that they were willing to pay up to 10% more for environmentally less harmful products. In short, looking green pays. And the competitive pressure on companies at least to appear environmentally friendly is intense.

Guiding Consumer Choice

Clearly, not all of these products are 'green', in the sense that they are environmentally preferable to other products available on the market. But while a consumer can judge for himself the validity of manufacturers' claims for, say, longer-lasting batteries or brighter washing powders, he may find it difficult to assess the validity of a statement on the environmental impact of a given product. And, besieged by a barrage of environmental claims, some true, some misleading, some downright false, what is an environmentally concerned yet confused consumer to do? The answer thus far has been to rely on informed third parties for guidance. One instance is *The Green Consumer's Guide*, a British paperback, published in September 1988, which topped the bestseller list for nine months and has sold over 300,000 copies.[2] It is being introduced in ten foreign editions. The green shopping guide of the Swedish Society for the Conservation of Nature has been bought by one out of every 23 Swedish households.[3]

Similarly, in their search for effective tools to protect the environment, a number of governments have turned to 'environmental labelling' programmes as a means of better informing consumers and thus allowing their choices to guide the market toward protection. These programmes involve the voluntary granting, by a private or public body, of labels to products which are judged to be more environmentally friendly than the goods against which they are competing.

The theory behind such labelling is based on the assumption that, within a given class of products, not all will place the same burden on the environment. In other words, there will be disparities in the impacts of various products if one assesses the environmental costs of producing, using and disposing of them. If the relatively more benign products, that is, those that are less 'costly', can be identified, the award of a label will provide the consumer with a basis of choice beyond price, performance and other attributes.

It is hoped that providing an environmental seal of approval will inform consumer choice, lead to increased purchases of the labelled products, and provide a competitive incentive for all the products in that class to raise their quality from an environmental point of view. The label can also serve to raise both consumer and corporate consciousness about the impact of the goods they purchase and produce.

BLUE ANGELS IN GERMANY

Germany issued its first environmental labels in 1978, ten years before any other country. Using the 'Blue Angel' logo of the United Nations Environmental Programme, the German label has been issued to over 3,500 products in 64 different product categories. Mirroring the rise in public concern, the number of labels has increased by more than six times from 1984 to 1990. The labelling decisions are made by a jury of sixteen people, with representatives from a variety of interests, including consumer and environmental organisations, industry, local government and the media. The programme is administered by a non-profit certification institute (RAL), while the government provides funding and technical expertise. The programme receives approximately 200 suggestions for new product categories every year. A 1989 poll showed that almost 80% of the public recognises the environmental label.

Who Awards the Labels?

Environmental labelling plans now circle the globe. Germany instituted its programme in 1978 (box); Canada and Japan began in 1989. Norway, Sweden, Finland, France, Portugal, Austria, and New Zealand hope to start issuing labels in 1991 and, by the end of 1992, it is possible that no fewer than 22 of the 24 OECD countries could have products with environmental labels on their market shelves. The Commission of the European Communities recently announced its own proposal for a Community-wide environmental labelling programme.

In all of these programmes, a committee determines, or suggests to a government ministry, which product categories should be eligible for labelling. The scope of the product category is defined, and the requirements a product must meet to qualify for a label are established with the aid of expert working groups. Manufacturers may voluntarily submit products for consideration and, if successful, sign a contract for

1. **Environmental Labelling**, OECD Publications, Paris, forthcoming 1991.

2. John Elkington, Julia Hailes and Joel Makower, *The Green Consumer: A Guide for the Environmentally Aware*, Penguin Books, London.

3. B. Thunberg and F. Holm, *Handla Miljövänligt*, Naturskyddföreningen, Stockholm, 1989.

a period of years and pay a fee for use of the label. While the extent of government involvement varies from country to country, the decision-making or advisory bodies of all these programmes have broad representation, with members from consumer, environmental and industry groups.

In truth, precious few products improve the environment. So the labelling programmes must seek to identify those products in a category which are relatively less harmful to the environment than others. This can be done only if the labels are based on an overall assessment of a product's environmental effects. The determination of relative environmental friendliness of a product first requires an assessment of its total environmental impact – which is extraordinarily difficult to calculate. And unfortunately, there is no generally accepted technique to measure environmental impact, much less in a timely and inexpensive fashion.

Throughout its life cycle, from manufacture to disposal, a given product affects the environment in different ways and to different degrees. A meaningful environmental assessment must thus include the sum of these environmental impacts, through the entire life cycle of the product, on air, water and soil. In practice, no labelling programme attempts to do this. Of necessity, they all examine the product life cycle but then focus on a few particularly important environmental aspects (such as the heavy metal content of a battery). Thus, although environmental labels are more comprehensive than so-called single-issue labels, such as 'recyclable', 'biodegradable' or 'non toxic', they do not yet reflect an integrated life-cycle assessment of relative environmental quality.

A broad variety of product categories has been chosen for the award of labels. Out of concern over landfill disposal, for instance, the Canadian programme awards labels for re-usable cloth diapers. Eligible diapers must be home-washable and able to endure a minimum of 75 uses. Many of the 15 product categories of the Canadian programme address products made from recycled goods (such as paper, newsprint, and insulation materials). The Japanese programme labels returnable bottles, so long as a system for collection is established. And many of its 31 product categories involve recycled products and those which reduce domestic waste (such as home composters). As the German programme has been issuing labels since 1978, its 64 product categories now cover a host of products, from low-noise mopeds and electronically operated shower facilities to asbestos-free brake linings. All present and planned labelling programmes accept applications from foreign producers (12% of the labels issued by the German programme have gone to foreign firms).

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As the recent flurry in the public and private sectors attests, there is a good deal of optimism in the international community for environmental labelling. But these programmes do have their limitations. Even with its long record of operation, the German programme has issued criteria for only a tiny fraction of the product categories potentially eligible.

Thus labelling programmes cannot realistically expect to address most, or even a sizable fraction of, consumer goods. Moreover, their success ultimately depends upon the fidelity of the green consumer. While consumers may happily choose a labelled product over a similar unlabelled one, will environmental friendliness become increasingly unimportant if the price of the product rises or its performance and quality drop?

And, indeed, some environmentalists have questioned whether 'green consumerism' is a concept that is self-contradictory. In a world of diminishing resources and overburdened ecosystems, they argue, the proper goal should be to consume more wisely and, indeed, to consume less.

In spite of these concerns, labelling programmes do offer hope as an innovative environmental protection tool: a voluntary market-based instrument which allows simple supply and demand to inject environmental concerns into both consumer purchasing decisions and corporate decision-making. Heightened public interest offers a rare opportunity to aid the consumer in improving the environmental quality of products. The labelling programmes have seized this opportunity and, given wise planning and continued consumer interest, perhaps in the coming years the environmental quality of a product will be regarded as one of its integral characteristics, no different from its safety and quality. ■

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Whatever Happened to the Public Sector?

Howard Oxley

For some OECD countries 'rolling back the state' was a political priority for the 1980s. And all of them sought to improve the efficiency of public-sector goods and services. So what impact has that fiscal consolidation had on the size of the public sector? How much have governments eased or changed regulations in the public utility sector and reduced public ownership? Have policies aimed at improving the performance of the sector through management reforms and more use of market mechanisms reached their objectives? And how can public spending be controlled in the 1990s?[1]

During the 1980s government policies shifted perceptibly. There was increased emphasis on spending restraint and improving the results of government expenditure. Efforts were made to reduce the distorting effects of tax systems. And regulatory reform was undertaken in a number of economic activities. These changes reflected a variety of factors: the economic environment, the seemingly inexorable rise in spending, voter resistance to higher taxes, large deficits and public debate over the appropriate role of government.

Figure 1 shows that there has been considerable success in the primary objective of reducing the size of government deficits. By 1990, the OECD average had fallen to 1½% of GDP, compared with over 4% of GDP in 1984.

In contrast, success in reducing the size of the government sector has been less marked. Spending and taxes as a share of OECD GDP at the end of the 1980s, as measured by the cyclically adjusted ratio of spending to GDP, gives a good idea of underlying trends. On this measure, government spending in the OECD area rose sharply up to 1983–84 and remained broadly stable thereafter (Figure 2). The increase over the decade was nevertheless considerably smaller than in the 1970s, when it climbed by 5½ percentage points.

About half of the growth in government spending in the OECD area over the last decade resulted from higher debt-interest payments as government debt rose – one cost of postponing the reduction in public-sector deficits. The remainder was largely related to spending on the 'welfare state', in spite of proportionally diminishing 'dependent' age groups. Nonetheless, income transfers continued to expand as a share of GDP, the largest contribution coming from pensions, with health spending not far behind.

Governments attempted to offset these increases by reducing subsidies and capital transfers to enterprises, cutting public

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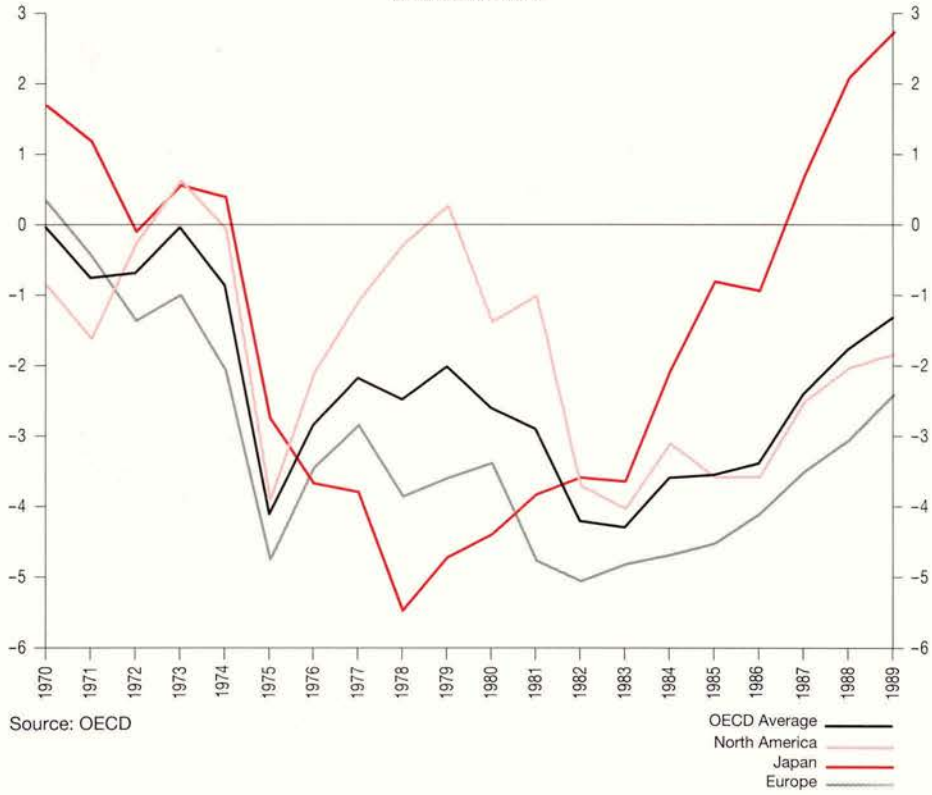
Substantial sections of the telecommunications sector in OECD countries have been deregulated.

British Telecom

1. See Howard Oxley, Maria Maher, John P. Martin, Giuseppe Nicoletti and Patricia Alonso-Gamo, **The Public Sector: Issues for the 1990s**, ESD Working Paper, No. 90, December 1990; available free of charge from the OECD Economics and Statistics Department.

Figure 1
GENERAL GOVERNMENT NET BORROWING
% of GDP/GNP



Source: OECD

investment, and by controlling the public sector wage bill. Growth in public employment also slowed in many countries.

Regulatory Reform and Privatisation

Another way in which governments sought to reduce their influence over economic activity was by deregulation and privatisation, primarily in public utilities – gas, water, electricity, transport and telecommunications. These changes reflected a growing perception that much regulation was unnecessary or had undesirable effects. In naturally competitive sectors, as in transport, regulation impeding competition tended to keep costs high and reduced the incentives for firms to respond to changing market conditions. Progress has been varied. Restrictions on entry, prices to be charged and the routes to be serviced have now largely been lifted in North America. But progress has been much slower in Europe and Japan although some sub-sectors, such as road transport, are now effectively deregulated in most OECD countries.[2]

Changes are also occurring in other sectors where regulation had been justified in the past on the grounds that large single firms could reduce unit costs of production through economies of scale. New technologies, which often permit efficient operation on a small scale, and a deeper appreciation of the benefits of competition have promoted change. For example, substantial areas of telecommunications services, such as installation, consumer equipment and special communications services are now being supplied by new firms. Even transmission of calls has been opened to the market in Japan, New Zealand and the United States. In electricity generation, as smaller-sized plants are now becoming cost-competitive with larger units, new firms and a more competitive environment are appearing in a few countries.

Concern over the weak performance of public enterprises has led to two types of modification in institutional arrangements. First, governments have made changes to get closer to the way private firms operate, by:

- separating public enterprises more clearly from government (corporatisation)
- giving their management specific, well-defined goals (for example, the pursuit of efficiency and profitability)
- instituting better managerial incentives and more independence to achieve them.

More and more local government services are being put out to contract.

Decout/R.E.A.

2. See Eric Lacey, 'Regulation or Competition in Road Transport?', **The OECD Observer**, No. 167, December 1990/January 1991.

Second, there has also been a sustained privatisation campaign in some countries where it is believed that overall efficiency would benefit from private ownership. The most extensive sales of public-sector assets have taken place in the United Kingdom and New Zealand (Figure 3).

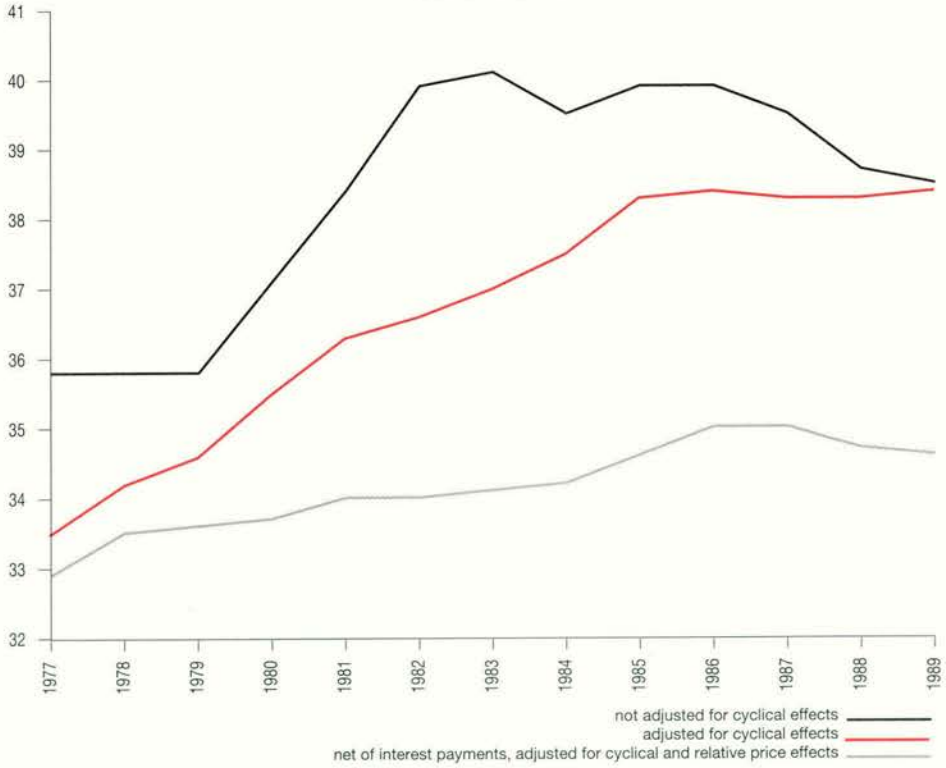
The advantages of regulatory reform have been clearest where firms face other competitors, with no single firm in a dominant position. For example, the deregulation of transport has led to a major improvement in efficiency and a reduction in prices in many sub-sectors. Even in activities such as telecommunications, where the scope for competition now appears much larger than formerly thought, the entry (or threat of entry) of new firms has led to lower prices and the more rapid introduction of new technology.

The same is true of privatisation. In purely competitive markets it appears, in general, to have yielded significant gains in efficiency. But with public-sector monopolies, assessment is more complex because most sales have only taken place recently and have often gone hand in hand with new regulations.

Increased Efficiency in Government Services

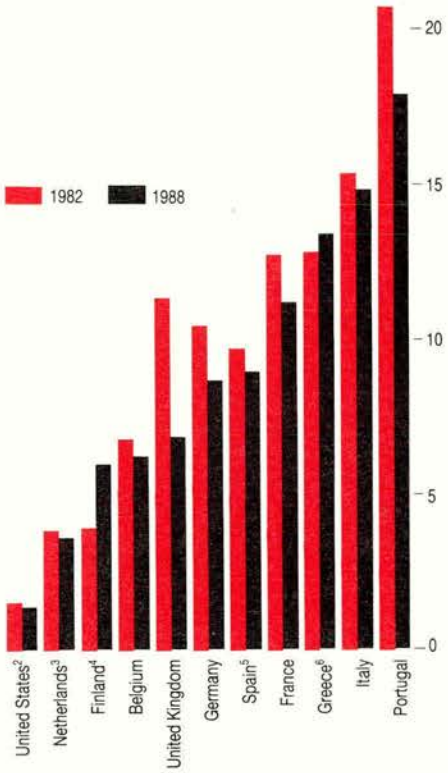
In the initial stages of restraint, as governments strove to bring expenditure under control, emphasis was placed on meeting strict budget targets. This often required expenditure cuts, sometimes of an across-the-board nature. But having achieved this restraint, governments also found themselves confronted by growing complaints over the quality of public services. Increased emphasis on improving the efficiency and effectiveness of remaining spending – in other words on minimising costs and maximising results – has been one consequence. It has not proved easy to achieve, for two reasons. First, government goals – such as 'better health' – are not easy to define and measure. Second, information on what impact particular programmes and inputs or individual performance have on achieving these objectives is very difficult to obtain within a bureaucracy. Both factors make it hard for public-sector managers to know how to allocate resources in the most cost-effective manner. ▶

Figure 2
TOTAL GOVERNMENT EXPENDITURE – OECD AVERAGE[1]
% of GDP/GNP



1. Excluding Belgium, Iceland, Ireland, Luxembourg and Turkey.
Source: OECD

Figure 3
SIZE OF PUBLIC ENTERPRISES, 1982 AND 1988[1]
% of GDP/GNP



1. Average of value-added, employment and gross capital formation.
2. Value-added and employment only.
3. Employment only.
4. Share in period ending in 1986.
5. Share in period beginning in 1985.
6. Average of gross capital formation and employment.

Note: For technical reasons, these data are of limited use for cross-country comparisons.

Source: *Centre européen de l'entreprise publique*; Survey of Current Business (United States); State Owned Companies in Finland, 1986 (Finland)

Two main paths have been pursued to try and overcome these problems: introducing management methods that have proved themselves in the private sector; and using more of the information and incentives provided by competitive markets.

Reforming Management Techniques

Management reforms have stressed increased devolution of decision-making to spending ministries and operational managers, the creation of information systems to help managers monitor progress in achieving goals, the provision of incentives to managers to reduce costs, and remuneration packages designed to improve performance.

Progress in introducing management reforms has been slow. Private-sector management tools have to be adapted to this new environment partly because of the wider and more complex range of goals to be achieved in the public sector. Information systems, which are necessary for improving management decisions, remain rudimentary, although some countries have introduced 'accrual accounting',[3] the better to estimate the total costs of inputs, and 'intermediate output indicators' (such as numbers of letters answered per day, or of unemployed people successfully placed in jobs) to help assess performance. Incentives have been increased in some cases by reducing job protection and making pay more closely related to performance. But the impact of the latter has probably not been large: government wage scales are often compressed to begin with and the additional pay is generally small. Personnel evaluation systems and career development, seen as a central element in improving incentives in big private firms, are often weak or absent.

The devolution of responsibility has also proved difficult and the tension between centralised control and decentralisation remains. On the one hand, there is a trend in many countries to give more responsibilities to spending ministries and for budget agencies to spend less time on detailed budget control and more on setting priorities, fixing global targets and initiating management responses to get the desired results. On the other, many important decisions – such as pay and employment conditions – are still taken centrally and the primary concern of many administrations continues to be meeting budgetary ceilings. The discretionary power of managers further down the hierarchy in the spending ministries is still modest: for example, there are only limited possibilities of switching between capital and current spending and between budgetary years (thereby preventing the rush to spend remaining funds before the budget year ends).

3. Accrual accounting costs all of the inputs, including capital, helping to judge how efficiently capital is being used. Formerly, the capital costs of a given spending programme were generally ignored. An alternative approach is to charge individual ministries for the costs of the capital used at commercial rates (e.g., rents of office space or computers).

Damoret/R.E.A.

Road transport, too, has seen widespread deregulation.

More Recourse to Markets

There is a growing realisation that in a wide range of public services markets can provide governments with information on costs and better ways of going about providing services. Many experiments are being tried in OECD countries.

First, putting selected government services out to contract is becoming more widespread, particularly at lower tiers of government where the services lend themselves better to this approach. The public-sector supplier is usually allowed to bid for the contract, too, and in some cases proves to be the lowest-cost producer. Where markets are competitive and, hence, the information on costs is more accurate and readily available, governments will find it easier to choose the best supplier. This is likely to be the case, say, in garbage collection where there is typically a large number of contractors spread over numerous municipalities.

Judging which contract is the best becomes more awkward when there are only a few suppliers, where it is difficult to specify fixed-price contracts in advance and to evaluate which firm will prove to be the most competitive. A good example is the defence industry, where technology is often new or untried. It is difficult to judge which firm will perform the best and, because firms are unwilling to accept all the risks, the total cost. An increase in international competition in such activities – spurred among other things by the creation of the internal market in the EC – is likely to pay major dividends. Contracting out and checking to ensure that the contract is fulfilled is not cost-less. Transaction costs will increase where it is difficult to judge the quality, where potential costs of default are high and where frequent tendering is necessary to ensure competitiveness.

Voter resistance to higher taxes has helped produce a shift in government priorities.

Thomas Ribolowsky/R.E.A.

Jacques Pavlovsky/Sygma

Can vouchers improve the supply of social services?

Second, user-charges are coming to the fore as the view has gained ground that those who benefit from services should pay more of the cost. As it stands, demand exceeds supply for most free or highly subsidised services – such as roads, cultural activities and public housing – leading to queuing. In some cases, the people who benefit most from government support are not necessarily those who governments most want to help. For example, higher education is often provided free to ensure open access for the poor. But in truth, in virtually all OECD countries, high-income groups are far and away the largest beneficiaries of government spending on education. Nonetheless, if charges for government goods and services are to be widely accepted, innovative measures will have to be introduced to address the associated problems of equality of access and the impact on income distribution. In Australia, for example, university fees have been introduced to cover one-third of the total teaching costs, but students are able to pay back the money they borrow via the tax system once their income rises above the national average.

Third, the use of vouchers is being extended to help raise quality and efficiency through competition among suppliers. Vouchers exist implicitly each time an individual is partly or fully reimbursed for the purchase of a specific good or service – in, for example, the choice of a doctor (public health insurance), food (food stamps) or housing (rent subsidies for low-income groups). They increase the choice open to recipients, reinforce competition and pass the monitoring of quality from governments to consumers choosing in a competitive market.

Several OECD governments are now considering whether vouchers can be extended to health and education by permitting the person or institution paying for the services to choose between alternative producers (indeed, France already has a voucher system of sorts). But it is widely recognised that markets in these areas are not perfect – partly because the availability and nature of the information makes it difficult for the consumer to know if the right choices are being made.

What Further Reforms?

Reforms in the public sector are important and have to be sustained: pressures on government budgets are unlikely to abate over the coming decade. First, there may be some catch-up in public-sector wages and investment. Many governments are finding it difficult to keep or recruit workers, particularly those with better qualifications, because of competition from the private sector. Some kinds of infrastructure have been run down and increased public investment in selected activities may provide large social benefits (reducing the congestion in cities, for example, and repairing public buildings or roads). Combining these with other policies (road pricing, for example, to help reduce congestion) could temper overall investment requirements.

Second, spending on the environment seems set to rise, both to clean up pollution in the public sector (nuclear waste disposal is one example) and in the private sector when a polluter has gone into liquidation and cannot be made to repair the damage to the environment. Finally, social spending is also likely to continue its upward trend till the end of the decade. There are several reasons: public pressure to keep pensions and other transfer payments rising in line with average incomes; continuing and increasing demand for health services; significant kinds of 'new poverty', as with single parents; the aim to upgrade education and training; and increasing calls for subsidised child care.

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Increased government efficiency and private-sector supply are unlikely in themselves to be sufficient to meet these pressures for higher public spending. Demands for further increases seem likely to originate in areas of social policy where governments find it difficult or undesirable to delegate responsibility to the private sector. A review of these programmes seems urgent, particularly given the long lead-times required for introducing modifications. The aging of the population, particularly after the turn of the century, may require adapting existing pension systems – for example, by raising the age at which retirement benefits become payable and by modifying the indexation methods.

In transfer programmes covering the population of working age (for the unemployed, for example) governments may be able to reduce overall spending by integrating labour-market (training) and income-support policies, with the aim of getting recipients back into active employment as quickly as possible. Income-testing and targeting of programmes is another policy option, but such policies may bring problems of their own by creating the 'poverty traps' that lower work incentives. ■

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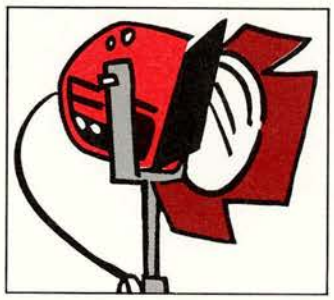

Spotlight on Spain

Panayotis Thomopoulos and Raymond Torres

Spain's entry into the European Community on 1 January 1986 gave its economy an even bigger boost than was expected – leading to a steep rise in demand and activity. Over the past five years, Spain has enjoyed the highest rate of investment-led output growth in the OECD area, following a decade of dismal economic performance, during which the unemployment rate shot up from 3.5% in 1975 to a peak of 22% in 1985.[1]

But by the middle of 1989, after three years during which growth (of 5%) clearly outpaced capacity and domestic demand soared at annual rates of 7–8%, the economy was showing serious signs of overheating. The process of disinflation, marked by a reduction in the inflation rate differential between Spain and its EC partners, was reversed, while the current account balance, which had been in surplus up to 1986, was running deeper into deficit. Spain's cost and price competitiveness was deteriorating rapidly, not only because of renewed inflationary pressure but also as a result of the steady appreciation of the peseta.

To rein in the exchange rate and underline its commitment to a sustained anti-inflationary strategy, the government took the peseta into the Exchange Rate Mechanism (ERM) of the European Monetary System (EMS) in June 1989. This created a more stable policy and monetary environment, discouraging speculative capital inflows, helping to narrow the wide interest-rate differentials between Spain and her main EC partners and dampening inflationary pressures. Since then, the peseta has consistently been the strongest currency in the EMS, and the Spanish authorities have had at times to intervene in the foreign exchange markets to ease the upward pressure on it.

Entry into the EC has clearly been a real tonic for the Spanish economy, and developments since then have been in marked contrast to the particularly depressed decade that preceded it. After the Socialist government took office in 1982 firm policy foundations were laid for rapid, sustainable growth aided by wage moderation and market-oriented reforms. Even so, and despite some improvement in performance in 1985, on the eve of Spain's entry into the EC there were 2.5 million more people on its unemployment registers than in 1975 and output and investment remained relatively depressed.

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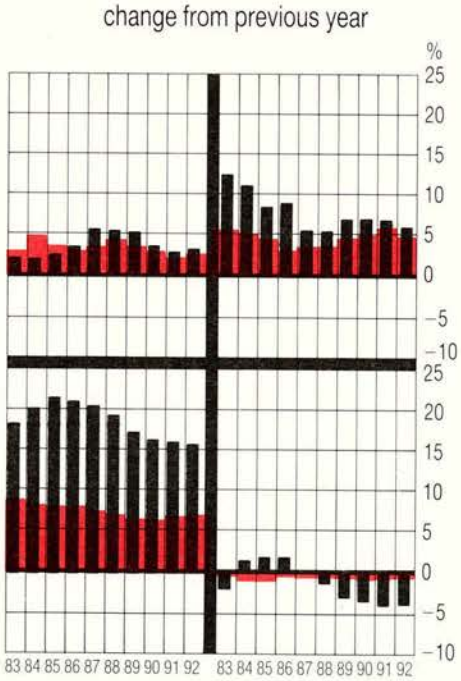
INDICATORS



1. Private consumption deflators.
2. National definitions.

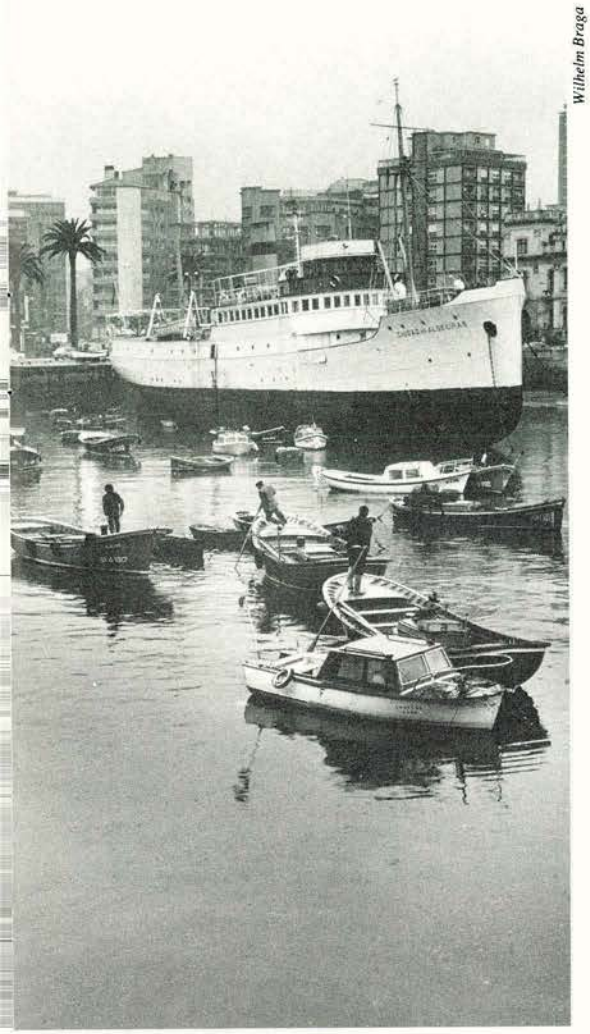
From Protectionism to Trade

EC membership gave Spain virtually unrestricted access to a market that in purchasing power was 15 times larger than its own. And other EC countries stood to benefit from the dismantling of Spain's high import barriers and the opening up of a market with high potential demand for both consumer goods and investment. At the time, the Spanish economy was one of the most protected in the OECD area, with foreign trade accounting for just 15% of GDP, one-third less than the Community average.

The low volume of imports was due to high customs duties (on average 6% of non-oil imports), low turnover taxes on domestically produced goods (equivalent to an implicit tariff on imported goods of around 8%), and the application of quotas to about one-quarter of imported products (including motor vehicles, textiles, clothing and colour televisions). The combination of 'explicit' and 'implicit' tariffs gave Spain a degree of protection that was three times higher than the EC average.

The low volume of exports is less easy to explain. The Preferential Agreement signed between Spain and the EC in 1970 had reduced tariffs on most Spanish goods entering EC countries to a low 3%, while quantitative restrictions on imports from Spain were rarely and only briefly

1. **OECD Economic Surveys: Spain**, OECD Publications, Paris, 1991.



Wilhelm Braga

Spain – a buoyant economy.

applied. It may simply have been the unintended consequence of Spain's own import restrictions and induced import substitution. In effect, protectionism appears to have strongly influenced the structure of exports and imports, hampering the specialisation of Spanish industry and giving it no incentive to look for economies of scale. As a result, industrial companies and facilities in Spain had remained small: in 1985 the average manufacturing plant employed a mere 13 people, and 80% of the manufacturing workforce was employed by firms with fewer than ten workers.

Although Spain is still in a transitional phase of EC membership, there has already been a dramatic fall in protection rates, except on food products. Almost 40% of the difference between Spanish tariffs and the EC common external tariff was eliminated within three years of entry, and further reductions each year will bring Spain fully into line with the EC foreign trade regime by the end of 1992. By contrast, in applying the Common Agricultural Policy Spain has had sharply to increase its tariffs on food imports from third countries. Trade creation effects, especially in industrial products, were considerable. In food, there has been a shift in the composition of imports, with the proportion supplied by non-EC countries falling from 78% in 1985 to 55% in 1989.

Lower import barriers and strong domestic demand growth have led to a sharp increase in import penetration since 1986. The value of total non-oil imports, which up to then had been around 10% of GDP, jumped to 15% within four years. This was mainly due to increased imports of manufactured goods; they accounted for some 21.5% of total apparent consumption of manufactures in 1989, up from 15.1% in 1985. Another stimulus has come from a shift in the composition of demand towards fixed investment, which has a particularly high import content in Spain.

On the export side, tariffs and non-tariff barriers against most Spanish products entering other EC countries have been substantially reduced or completely eliminated, except for fruit, vegetables and fats, which are still severely restricted. They are the strongest sectors of the country's agriculture and accounted for 7.5% of its non-energy exports in 1989. Moreover, these restrictions will not be fully lifted before 1996.

A Boom in Investment

Spain has traditionally welcomed the inflow of foreign capital, and it removed its few remaining controls on foreign direct business and real estate investment a year before EC entry (although some still apply to specific sectors, such as defence, air transport, media and communications). On the other hand, restrictions were recently imposed on foreign borrowing by the Spanish corporate sector to reduce the upward pressure on the peseta, which has been encouraged by the liberal regime governing capital movements. Investment in Spain, which was already attractive because of the high interest rate differential, was given an added guarantee by ERM membership.

The investment boom has been one of the most remarkable features of the first five years of Spanish membership of the European Community. Its volume, which had declined by 20% between 1975 and 1984, has nearly doubled since 1985, partly reflecting the fact that the long-term downward trend in rates of return on capital has been reversed. Investment has been one of the fastest-growing components of aggregate demand and a major contributor to the rise in the GDP growth rate (foreign investment alone may have contributed up to a third). It has also had positive supply-side effects which, together with the opening of domestic markets to foreign competitors, has reduced the inflation proneness of the Spanish economy.

On a less positive note, EC membership has led to an excessive real appreciation of the peseta and the shift in the current account balance from surplus into deficit. The government could have limited the adverse effects on the country's international competitiveness and the resulting deterioration in the foreign balance by an earlier tightening of fiscal policy.

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The buoyancy of the economy since 1986 has enabled Spain to narrow its per capita income differential vis-à-vis other EC countries, from 29% of the EC average in 1985 to 22% in 1990. But government, business and the unions must all play their part in keeping demand under control, contributing to the fight against inflation and in retaining Spain's competitive edge – a necessary condition if the Spanish economy is to sustain economic growth. This will enable further progress to be made towards lowering unemployment and close the gap in living standards between Spain and other EC countries. ■

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Portugal

Bénédicte Larre and Axel Mittelstadt

Inflation aside, Portugal's macro-economic performance over the past five years has been very satisfactory. It has had an average annual real GDP growth rate of 4½, one of the highest in the OECD area. The unemployment rate is the lowest since the end of the 1970s, well below the OECD average. Thanks to buoyant exports and capital transfers from the European Community, the current-account deficit is still much smaller than at the time of the previous cyclical peak in the early 1980s.[1]

On the other hand, inflation, which had been falling rapidly since 1984, has picked up again. There has been double-digit inflation since 1988, and the inflation differential with the EC average is now nearly 9 percentage points. Likewise, fiscal consolidation, which had made rapid progress after 1984, has slowed, particularly if no account is taken of the exceptional impact in 1989 of the tax reform, when tax revenue was boosted by the overlapping of tax payments under the old and new systems. In 1990 the fiscal deficit as a percentage of GDP widened again.

The Macro-economic Dilemma

The upsurge in inflation has cast doubt on the government's ability to bring the inflation rate down to the EC average and has, by the same token, made its declared goal of joining the European Monetary System (EMS) more difficult. The gradual deregulation of financial markets – although desirable in itself – has certainly made monetary management more awkward during the transitional period. That said, it is certainly because of the ineffectiveness of attempts to tighten monetary policy that inflation has picked up again.

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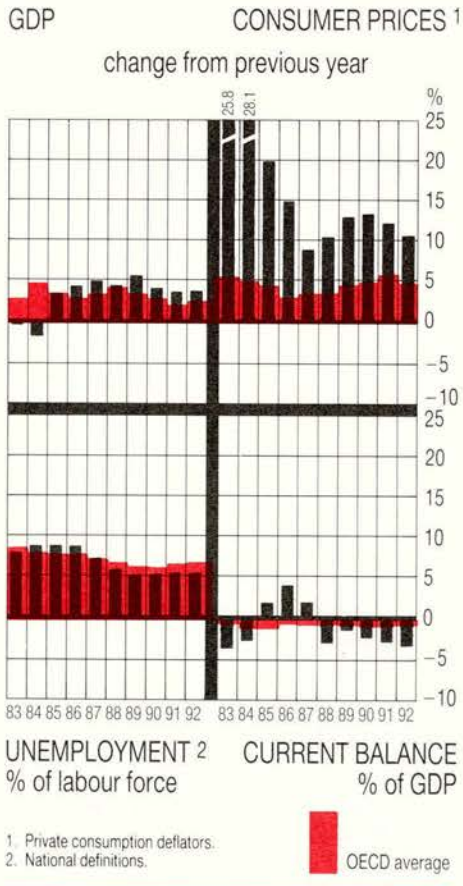
The inability of the monetary authorities to contain inflation can be partly explained by the instruments used to try to curb domestic demand. They raised interest rates and at the same time persisted with the policy of pre-announced monthly depreciations of the currency, the implicit rate of depreciation being well below the interest rate differential vis-à-vis Portugal's main trading partners. The progressive lifting of controls on international capital movements led to large inflows of capital, undermining the authorities' efforts to curb domestic demand and thus the pressure on prices.

INDICATORS



They thus face a continuing dilemma: they cannot control interest rates and the exchange rate simultaneously without maintaining controls on international capital movements. But as the liberalisation of international capital movements is an important element in the process of European economic integration – a process in which Portugal is resolved to participate fully – political reasons would make it difficult to control these movements, which would be undesirable in any case on grounds of efficiency. Similarly, quantitative controls on domestic credit growth are inconsistent with the government's declared objective of moving progressively to indirect methods of monetary control.

In consequence, if anti-inflation policy is to be effective, the monetary authorities have no alternative but to keep real interest rates and real exchange rates high – at least temporarily. The more internationally mobile is capital, the larger should be the role of the real exchange rate in the transmission mechanism of monetary policy.

With this in mind, Portugal recently modified its exchange-rate policy to make it more flexible, and the changes have already pushed up the nominal exchange rate. The bigger the rise in the nominal exchange rate – required for the escudo to appreciate in real terms so as to eliminate surplus demand – the easier it will be to attain the 10¾% inflation target set for 1991 and to continue disinflation. Indeed, another reason for an improvement in the real exchange rate is that it would allow the authorities to set more ambitious targets for inflation, and thus to speed up the process of bringing the inflation rate

1. **OECD Economic Surveys: Portugal**, OECD Publications, Paris, 1991.

into line with the EC average. The gradual depreciation of the nominal exchange rate in recent years was not sufficient to offset the inflation differential, and resulted in an appreciation of the real exchange rate.

Further fiscal consolidation is an important government objective in its own right. Determined action along these lines can help to ensure that the monetary restraint required does not cause excessive pressures in the money market, thereby putting a disproportionate share of the adjustment burden on interest-rate sensitive components of demand (fixed investment, for example) and the sector exposed to foreign competition.

Progress with Structural Reform

In terms of growth and job creation, Portugal's performance has been quite remarkable. Admittedly, it was helped by the international situation, but there were also more fundamental reasons, the authorities having taken far-reaching initiatives to modernise the economy. The large amount of funds that Portugal receives from the EC, which are used mainly for financing infrastructure investment and training programmes, have helped to modernise the economy and should continue to do so as long as they are used in an economically rational manner.

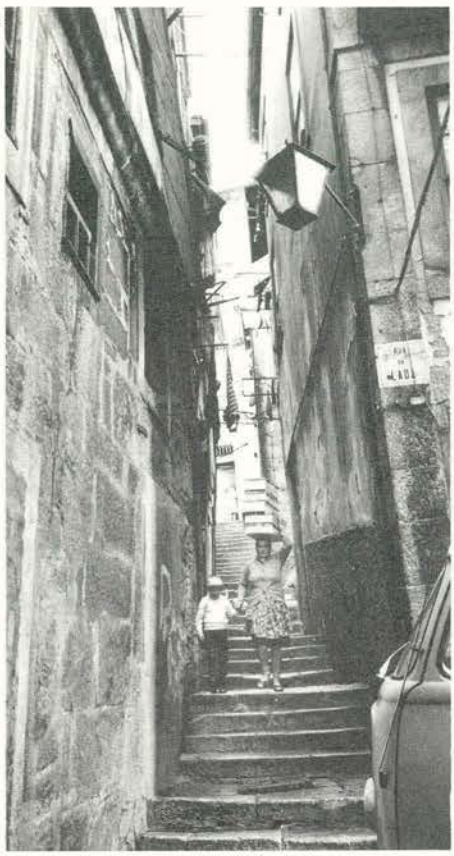
Micro-economic reforms have been implemented to improve the functioning of markets and social and economic infrastructures. In 1986 the government decided to abolish certain public entities and to pay its arrears to public enterprises; as a result, the financial performance of public enterprises improved and, more generally, fiscal consolidation was facilitated. A law on land reform was passed in 1988, paving the way for the privatisation of some of the collective farms. A new labour-market law adopted a year later eased the requirements for individual and mass redundancies, while at the same time improving support for the unemployed.

Capital markets have expanded rapidly, and new institutions and financial instruments created. The banking and insurance sectors have been opened up to private enterprise and foreign competition.

Following the introduction of a value-added tax in 1986, the archaic system of direct taxation was reformed in 1989 and tax-collection procedures improved. There is no doubt that these reforms have increased the efficiency, transparency and fairness of the tax system. The authorities recently embarked upon a privatisation programme which they hope will play a decisive role in speeding up productivity gains in a number of key sectors and reducing the public debt/GDP ratio in the medium term. Banks, insurance companies, breweries and cement manufacturers have been the first to be privatised. The largest industrial enterprises, however, still have to undergo major financial, administrative and physical restructuring before they can be privatised.

Since 1985 investment, particularly in manufacturing, has been accompanied by rapid growth of imports of capital goods. In 1989 and 1990 foreign direct investment in industry (in, for example, transport equipment) and also in tourism, banks and insurance increased considerably. The underlying productivity gains in the corporate sector during the second half of the 1980s attest to the improvement in supply-side conditions.

Wilhelm Braga



Portugal is attracting more foreign direct investment in tourism.

Medium-term Strategy

In the awareness that adjustments are required urgently if Portugal is to participate fully in the process of EC integration, in July 1990 the authorities adopted a medium-term adjustment plan called 'QUANTUM'. This plan, which was drawn up just before the onset of the Gulf crisis, sets out a strategy for bringing inflation down to EC rates over a five-year period. It duly emphasises the necessity of a severe tightening of fiscal policy in 1991, together with a restrictive monetary policy. The decision taken in October 1990 to abandon the policy of predetermined exchange-rate adjustments has made this second target much easier.

Recent institutional changes, strengthening the independence of the central bank and ending the government's automatic access to central bank credit, should also make anti-inflation policy more credible and effective. The economic and social agreement signed in October 1990 was an important step in this respect; contractual wage increases in the private sector were calculated on the basis of an inflation target of 11% in the first quarter – which could be revised later – excluding the impact of the oil shock. These measures, by moderating inflationary expectations and reinforcing the credibility of medium-term policies, increase the chances that inflation will start to come down again. ■

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