

# **Chapter 5**

## **Transition to a National and a Market Economy: A Gradualist Approach**

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The transition in Slovenia has been described as gradualist.<sup>1</sup> Indeed, gradualism was, in a sense, a natural heritage of previous systemic changes, embodied in the country's initial economic conditions and consistent with its political history. The transition process in Slovenia cannot be disentangled either from the legacy of the Yugoslav type of socialism or from the disintegration of SFR Yugoslavia. Although the reasons for that disintegration remain dominated by political and ethnic considerations, the prospects of transition and accession to the European Union were among the major real arguments for Slovenia's secession. The preoccupation of Slovenia's political leaders, government, and people with the disintegration of SFR Yugoslavia and the creation of a new country slowed and softened the transition measures undertaken as well.

This chapter is structured as follows. The first section describes the repeated failure of attempts at reform and transition in SFR Yugoslavia. The second deals with preindependence policy activities and systemic changes in Slovenia, which were characterized by cautious responses to uncertainty. The concluding section analyzes some of the dilemmas and controversies of Slovenia's transition.

### THE FAILURE OF TRANSITION ATTEMPTS IN SFR YUGOSLAVIA

Economic reform in SFR Yugoslavia (including Slovenia) began in the 1950s, long before those in Central Europe. After 1945, four distinct "socialisms," defined in terms of the formal allocation of decision-making authority in the economy, can be distinguished in SFR Yugoslavia's history: "administrative socialism" (1945–52), "administrative market socialism" (1953–62), "market socialism" (1963–73), and "contractual socialism" (1974–88). The last of these rejected both the market as the basic mechanism of resource allocation and macroeconomic policy as the means of indirect regulation of economic activity. Instead it insisted that these be substituted by other mechanisms: social contracts, enterprise self-management agreements, and social planning. The concept was, however, never put into practice; the statutes regulating the behavior of economic units in accordance with contractual socialism either were abolished, explicitly or implicitly, soon after they appeared, or remained irrelevant to the actual functioning of the economy.

The breakdown of contractual socialism and the political vacuum after Tito's death in 1980, the rise in oil prices, and the tightening of world financial markets set in motion what, in the early 1980s, developed into a deep economic, social, and political crisis in SFR Yugoslavia. For the first time, and despite a proven ability of Yugoslav

policymakers to adapt systems and redefine socialism to daily needs, SFR Yugoslavia found it impossible to move in any direction. The country reached a point at which economic reform could only increase the inconsistencies between the economic and the political system. A radical economic reform would require, above all, a separation of political and economic power, yet political considerations permitted only modest changes. The reform attempt of 1982, therefore, produced a long-lasting stalemate. The economic situation worsened and economic growth disappeared, while inflation and unemployment rose and the current account deficit grew.

In May 1988 Prime Minister Branko Mikulić introduced an economic stabilization program based on liberalization of prices, imports, and foreign exchange markets as well as on restrictive fiscal and monetary policy and wage controls. However, it soon became apparent that the government was unable to assert discipline over fiscal and monetary policy. In October the last of the anchors—the wage controls—slackened when urgent measures were added to ease social tensions. The government resigned and was succeeded by that of Ante Marković, which eagerly continued economic reform and launched a new stabilization program.

Also in 1988, while Party ideologists and economists continued to speculate about new types of socialism, the Mikulić government declared its inability to deal with the country's economic problems with the policy measures available within the existing system and established a commission to launch a new systemic reform. Contrary to expectations, the reform proposals of the Mikulić Commission were radical, although theoretically confused and inconsistent. They began with the premise that social ownership of the means of production was at the heart of the country's economic problems and urged that the so-called nonproperty concept of social property—whereby everyone and no one was the owner of property—be abandoned. The commission also proposed that the existing relationship between management and labor be replaced by the recognition that those who provide capital are entitled to management and profit sharing rights. But although the commission recognized the need for private property, its proposals formally insisted that social property remain the predominant form of ownership.

A general outline of economic reform, called "The Principles of the Economic System Reform," was adopted in October 1988, and the legal conditions necessary for the reform were created by amendments to the constitution the following month. Systemic laws regulating the economy and labor relations, adopted in 1988 and 1989, were even more radical than the proposals of the commission. The two most important laws, the Foreign Investment Act and the Enterprise Act, passed in late December 1988, formally abrogated the

existing economic system based on self-management and social property. They reestablished the company as a legal entity fully responsible for its own business operation and introduced four types of ownership: social, cooperative, mixed, and private. The Social Capital Act, enacted in 1989, gave workers' councils the right to sell their enterprises to private owners.

In December 1989 the Marković government launched a new "shock therapy" stabilization program. A fixed exchange rate, tight monetary policy, and wage controls were to be its pillars. However, overvaluation of the dinar, weakness of wage controls, and a fiscal overhang existed from the very beginning. In the first two quarters of 1990, economic performance was satisfactory. In June, however, fatal mistakes were added to those of the previous December, when the government pumped money into the agricultural sector through selective credits and nearly doubled the salaries of federal employees. This triggered a general race of wages upward. By the middle of 1990, the program was left without any nominal anchor except for the fixed exchange rate. Private and public sector spending increased dramatically during the summer and stayed high, while economic activity plummeted. This made price stability unsustainable, and in the third quarter of 1990, prices escalated. Severe monetary restrictions imposed during the previous quarter pushed the economy into critical illiquidity, large-scale barter, and a recession without deflation. Exports dropped, imports grew, and the trade deficit soared. October 1990 saw the beginning of a run on the banks, as depositors sought to withdraw their deposits in foreign exchange, and foreign exchange reserves, the last redoubt of the stabilization program, decreased dramatically.

These attempts to change the economic system were accompanied by political changes. The legalization of political parties in 1989 created the preconditions for free elections and parliamentary democracy in the republics. The results of these elections in May 1990 further divided the country; the emergence of nationalistic governments and quickly growing animosity between Croats and Serbs accelerated the country's disintegration. All attempts by the federal government to halt the deterioration of the economy and the threatening political developments were blocked by the republics. The country ceased to exist as a functioning economic entity—taxes were not collected, money was "printed" elsewhere (the required reserve ratios were ignored), and special duties were assessed on "imports" from other republics. In addition, the republics began to frame their own economic systems, which differed considerably. Under these circumstances the collapse of economic reform and of the stabilization program was unavoidable. In the autumn of 1990, SFR Yugoslavia began to collapse as a country as well.

However, despite the failure of systemic changes and macroeconomic stabilization at the federal level, the former constituent republics retained advantages (compared with other former socialist countries) for a successful economic and social transition. Most of the preconditions for such a transition—decentralization, price liberalization, openness to the outside world, and diversification of ownership—were at least partly met before the political and ideological collapse of socialism and of the federation.

### **PREINDEPENDENCE POLICY ACTIVITIES AND SYSTEMIC CHANGES IN SLOVENIA: CAUTIOUS RESPONSES TO UNCERTAINTY**

Slovenia proclaimed its independence on June 26, 1991. This proclamation coincided with unresolved disputes over customs duties. Yugoslav federal authorities intervened in an attempt to seize control of the borders. The federal army was, however, badly surprised by the Slovenian resistance. After a week of fighting, a cease-fire and an agreement, under which Slovenia postponed the implementation of independence for three months, were attained. On October 8, 1991, Slovenia became fully independent and introduced its own currency, the tolar.

Independence put an end to the tense and uncertain political and economic developments of the 1980s and, especially, of 1990. The economic policy of the Slovenian government elected in May 1990 was based on the supposition that both the prevailing economic policy and the existing economic system were inadequate and unstable and that the federation was facing political turmoil.<sup>2</sup> What remained unknown was the precise way in which SFR Yugoslavia would disintegrate and when. Consequently, the government decided to pursue an economic policy aimed at three major goals: the survival of the Slovenian economy in the period of stabilization and transformation, the construction of a market-oriented economic system, and the gradual takeover of economic policy tools from the federal government.<sup>3</sup> Pragmatism and gradualism were the pillars; they were the principles to be used to ascertain the socially bearable costs of transition, facilitate timely adaptation to highly uncertain political decisions, and generate suitable responses to the economic policies of the federal government.

From the very beginning, the government of Slovenia implicitly supported the federal stabilization program by imposing relatively efficient wage controls and by reducing (compared with the rest of SFR Yugoslavia) public consumption. However, increasing discrepancies in federal economic policies adversely affected the export sector and soon prompted demands for changes in the stabilization program.<sup>4</sup> These

demands included devaluation of the dinar, reductions in federal taxes and spending, efficient control of wages, corrections to monetary policy, and redemption by the federal government of Iraqi debt to Yugoslav enterprises. Pleas for increased participation of the Slovenian government in federal economic policy were ignored. The Slovenian government therefore introduced measures to prevent bankruptcies, including postponing tax payments, issuing export subsidies, and redeeming part of the Iraqi debt from the budget of the republic by issuing government bonds. In January 1991, following the disintegration of the fiscal system (in September 1990 Serbia and Slovenia failed to transfer the proceeds of federal sales taxes to the federal budget), a trade war (in October 1990 Serbia imposed special deposits on all payments to Slovenia and Croatia), and Serbia's raid on the monetary system,<sup>5</sup> Slovenia demanded changes in economic policy, rejected federal proposals to enhance the power of the federal government, and, for the first time, proposed principles for the division of financial and non-financial assets and liabilities between Slovenia and the rest of SFR Yugoslavia.<sup>6</sup> The demands were again ignored. When the National Bank of Yugoslavia ceased to intervene on the foreign exchange market, Slovenia reacted by introducing its own quasi-foreign exchange market with a flexible exchange rate.

Systemic changes in Slovenia were made cautiously as well. Two types of statutes were introduced: the first facilitated the functioning of a normal market economy, and the second formed the basis for the transition to independence. In the first group, a system of direct taxation based on simple, transparent, uniform taxes was introduced in December 1990; the first normal budget of an independent Slovenia was presented to the National Assembly in February 1991; and a new system of indirect taxation was being prepared. The federal government did not object to these changes. In addition, statutes regulating the monetary and financial sector were prepared, and provisional notes were printed to enable swift adjustment toward what was then still an uncertain political independence. This policy of slow and pragmatic adjustment proved successful; within a year, Slovenia not only increased its relative competitiveness (as measured by unit labor costs) with the rest of SFR Yugoslavia by 35 percent, but also established sovereignty in the fiscal and foreign exchange systems and prepared the institutional arrangements for a "new" country.

Slovenia, as part of SFR Yugoslavia, shared the latter's advantages and disadvantages compared with other socialist countries in Eastern Europe, in particular a rather unique economic and political system based on ideas of social property and enterprise self-management. Owing to a decades-long series of reforms during SFR Yugoslavia's existence, many of the essentials for a successful transition were at least partly met before 1989: enterprises were autonomous, basic market

**TABLE 5.1 SELECTED INDICATORS OF THE SLOVENIAN ECONOMY  
AT INDEPENDENCE**

(millions of dollars unless stated otherwise)

<i>Indicator</i>	<i>Value in 1991</i>
Area (thousands of square kilometers)	20.2
Population (thousands)	1,996
Employment (thousands)	823
GDP per capita (dollars)	5,900
Foreign debt	1,955
Debt-to-exports ratio (percent)	31
Debt-to-GDP ratio (percent)	15
GDP at market prices	11,778
Exports of goods and services	5,828
Imports of goods and services	5,269
Private consumption	6,019
Public consumption	1,543
Gross domestic investment	2,238
Change in inventories	754

*Source:* Planning Office of the Government of Slovenia, 1991.

institutions existed, and the system of macroeconomic governance enabled the use of many standard economic policy tools. Slovenia itself had some specific advantages: it was the richest part of Eastern Europe, with an ethnically and socially homogeneous population, a diversified manufacturing sector, a predominantly private agriculture, a partly privately owned services sector, well-established economic links with Western markets, and a good geographic position. Furthermore, Slovenia was never fully integrated into SFR Yugoslavia; it was quite autonomous in terms of infrastructure, with its own access to the sea as well as its own pipelines, railways, telecommunications, and electrical grid, and its trade patterns with the rest of SFR Yugoslavia resembled its trade patterns with the rest of the world. Table 5.1 summarizes the basic statistics of the Slovenian economy at independence.

As the general public and many politicians continued to recite popular slogans about how badly Slovenia was being “exploited” within SFR Yugoslavia, the Slovenian government was already calculating what the true costs and benefits of independence would be. The liabilities included a reduction in the size of the domestic market (and thus reduced interest on the part of foreign investors, among other things), a diminished supply of raw materials from the rest of SFR Yugoslavia, the termination of foreign trade links that Slovenia had through Yugoslav enterprises (and vice versa), and a likely loss of property in other parts of SFR Yugoslavia. It was also evident that

**TABLE 5.2 STRUCTURE OF SALES AND PURCHASES OF THE SLOVENIAN ECONOMY, 1990**

(percent of total)

<i>Item</i>	<i>Within Slovenia</i>	<i>To/from other Yugoslav republics</i>	<i>To/from other countries</i>
Sales	57.3	24.8	17.9
Purchases	63.2	21.6	15.2

*Source:* Planning Office of the Government of Slovenia, 1991

issues such as how to apportion the Yugoslav foreign debt, the domestic debt denominated in foreign exchange, foreign exchange reserves, and the nonfinancial assets of the federation, and how to arrange the succession of the 2,500 different bilateral and multilateral agreements on export quotas, transport licenses, air controls, and so on, might take years to be resolved. The benefits, in contrast, were more potential than actual: as an independent state, Slovenia could steer clear of FSR Yugoslavia's continuing political turmoil, improve the prospects of its own transition, undertake appropriate economic policies, and ease its entry into the European Union. In the fall of 1990 the potential benefits of Slovenia's secession came to clearly exceed the economic and social costs, and independence became the "emergency exit" condition for democratic development and systemic transition.

Most of the potential benefits of independence listed above turned out to be real, whereas most of the costs proved to be overstated. It was the virtual disappearance of the Yugoslav market of 23 million people that has been by far the most important and difficult to overcome (Table 5.2).<sup>7</sup> Calculations intended to determine how much of Slovenia's trade with the other former Yugoslav republics would be lost because of new customs barriers and increased competition proved irrelevant; in the turmoil of war, trade simply disappeared.

Slovenia's quest for monetary independence began in June 1990 and concentrated on three issues. First, what would be the consequences of its unilateral decisions for the functioning of the financial system and for relations with other countries and international institutions? Second, what were the possibilities of a monetary system within a Yugoslav confederation (at the time still considered a viable solution)? Third, what were the prospects of eventual monetary independence? After the Serbian raid on the monetary system in December 1990, however, these questions became largely moot, and discussion shifted to the name, pattern, and most appropriate moment for the introduction of a Slovenian currency.<sup>8</sup>

Preparations on a functional level continued as well; before the end of 1990, for example, provisional notes were printed. At the same time,



temporary solutions to handle the repercussions of a fixed, overvalued dinar and to cope with the advancing hyperinflation were explored. These efforts are best illustrated by the Law on the Introduction of a Parallel Currency, drafted on February 4, 1991. It envisaged a parallel currency pegged to the Austrian schilling; the new currency would enter circulation through foreign transactions and would float against the dinar. The concept of a parallel currency was abandoned, however, in favor of creating "certificates of import privileges," which involved a much simpler and less risky approach—in particular, it would not expose Slovenian banks to the likely wrath of the federal authorities. The system functioned in the following manner: an exporter who, for example, sold foreign exchange to a bank at the official exchange rate would get a certificate that was salable and would allow its buyer access to the foreign exchange. The fixed official exchange rate plus the price of the certificate equaled the flexible rate. At the same time, the black market in foreign exchange was abolished by its *de facto* legalization. Finally, the "Slovene ECU," a measure of account to which parties in economic transactions could adhere, was introduced in May 1991, less than two months before the proclamation of independence. Its value was to be determined by the average weekly price of the foreign exchange certificates on the Ljubljana stock exchange. Slovenia thus indirectly established an independent currency area with a floating exchange rate within the Yugoslav monetary system based on a fixed exchange rate.

Microeconomic restructuring has been considered, alongside privatization and macroeconomic stabilization, to be the third pillar of transition. A twofold transition, from a regional to a national economy and from a socialist to a market economy, was accompanied in Slovenia by structural changes from a manufacturing toward a services economy. Restructuring has likewise not been centrally organized; rather, it has been managed by enterprises themselves. In the first period of transition, that is, during the transformational depression, the essence of restructuring consisted of "firing and retiring," combined with *ad hoc* government interventions in cases of large troubled enterprises. This continued when the bottom of the recession had been passed, but at a slower pace.

### POSTINDEPENDENCE TRANSITION DILEMMAS AND CONTROVERSIES

The fact that gradualism prevailed in Slovenia's macroeconomic policy and systemic restructuring does not imply that there was a general consensus. On the contrary. Gradualism implied that certain rather specific political, social, and economic features should be used

in the transition. This became a disputed issue: the majority of domestic economists considered the legacy of the past an exploitable advantage; to many foreign and a minority of domestic economists, however, it would impede rather than assist the transition. The controversy over shock therapy versus gradualism also surfaced in the preparations for independence. The shock therapists, led by Slovenia's foreign advisers, proposed an overwhelming package that would encompass both the measures needed for independence and those needed for the transition. The gradualists, in contrast, suggested the separation of independence from transition.

Gradualism was consistent with soft changes occurring in the political sphere, the pillars of which can also be found in the process of pre-1989 democratization. Already in the 1970s, the League of Communists had evolved into a sort of conglomerate of the bureaucratic elite. Its members only pretended to believe in socialism and could easily adapt to any changes and to any system of values.<sup>9</sup> Indeed, the first steps toward transition were initiated by political "softness," which emerged in the early 1980s and became more evident in Slovenia than in other parts of SFR Yugoslavia. At the end of the 1980s, a basic consensus on democratization was achieved without any formal negotiations between the new political actors and the existing political elite. This development explains why the transition was smooth and peaceful, why the members of the former elite became an ally of the emerging civil society against the Yugoslav authorities, why no revenge was taken on them, and why they adapted so quickly and successfully to change. Also, the former economic elite (that is, the enterprise managers) retained or even strengthened their position in society. The coalition of the two elite groups ensured the exchange of economic and political support and enabled both to become the winners in the transition process.

One should not neglect, however, the impact that academic economists had on the Slovenian transition model, both indirectly, by participating in public and academic debates and often stubbornly rejecting foreign advice, and also through their direct involvement in the creation of the macroeconomic framework for the new country.<sup>10</sup> The reasons for the stubborn rejection of "Western" advice differed. Unlike other socialist countries, SFR Yugoslavia had been an open country; many economists had studied abroad, acquiring a solid understanding of mainstream Western economics, and were therefore not easily awed by foreign advisers. Most had participated in rather free debates on economic reform in the 1980s; thus they were not surprised by the breakup of socialism, and most shared a lack of ideology with the former political and economic elite of the country.

The privatization issue caused a major controversy within the government, divided politicians, and became the root of political

instability. Two major approaches to privatization, embodied in what became known as the Korže-Mencinger-Simoneti Act and the Sachs-Peterle-Umek Act, competed for support. The former called for decentralized, gradual, and commercial privatization, which the government would only monitor; the latter advocated massive and speedy privatization administered by the government and relying on the free distribution of enterprise shares. Supporters of the decentralized approach believed that the legacy of the previous system of social property and enterprise self-management could and should be exploited in the transition, and that the adoption of the centralized method would nullify the advantages of the de facto independence of enterprises and decentralized decisionmaking that the previous economic system had securely established. They also argued that Slovenia had a relatively well functioning economy, that unnecessary shocks should be avoided, and that enterprises themselves should be allowed the right to decide on the pace and method of privatization within the alternatives provided by law. The advocates of the centralized approach insisted that the socialist past was to be swiftly forgotten, and that speedy distributional privatization would immediately create the ownership structure of a Western economy and improve corporate governance in a way that would be fair to all citizens.

The controversy was a political rather than an economic one, the root of the matter being who should control the economy. Adoption of the decentralized approach would presumably allow control to remain in the hands of existing managers, and thus in the hands of the former political elite, whereas the centralized approach would transfer control to the government and thus to the new political elite. The controversy resulted in a stalemate. Although the National Assembly passed two out of three required drafts of the decentralized version of the privatization act, the political leaders of the coalition parties prevented the final draft from coming to a vote. After a year and a half of maneuvering and debate in the legislature and the mass media, the controversy was resolved by the adoption of a proposal that can be considered a compromise. The Ownership Transformation Act, passed in November 1992, combined the decentralization, gradualism, and diversity of privatization methods of the first approach with the free distribution of vouchers called for under the second.

Under the Ownership Transformation Act, privatization was to be achieved by a combination of several methods: restitution to former owners; debt-equity swaps; transfer of shares to the Restitution Fund, the Pension Fund, and the Development Fund; distribution of shares to employees; manager and worker buyouts; public sales of shares or of whole enterprises; and the raising of additional equity capital. The

demand for enterprise capital was ensured predominantly by the distribution of voucher certificates to the population.<sup>11</sup>

Macroeconomic stabilization was another area of heated controversy.<sup>12</sup> The shock therapists, supported by the foreign advisers, proposed a package of sweeping reforms encompassing price stabilization, a fixed exchange rate, a balanced budget, and administrative restructuring of the manufacturing sector and of the banking system. All of this was to be part of the package of measures for independence, in the belief that the new country should start as a genuine market economy. The gradualists, in contrast, suggested that the issues surrounding macroeconomic independence, based on pragmatic economic policy and a floating exchange rate system for the new currency, be separated from those concerning the transition itself. It was hoped that such a policy would result in smaller output losses and lower unemployment by allowing some inflation.

The gradualists prevailed. The government document "P2" of April 15, 1991, dealing with the macroeconomic issues of independence, was also the key date in the creation of the new currency. It contemplated most of the provisions that were later applied: a rapid (within three to five days) conversion of dinars to a new currency, a 1:1 conversion rate, and a floating exchange rate.<sup>13</sup> Different solutions were proposed in the documents that followed during the summer of 1991.<sup>14</sup> These included a 10:1 rate for the conversion of dinars to the new currency and called for its pegging. The proposed changes emanated from the group led by Jeffrey Sachs, who had, in a document called "A Program for Economic Sovereignty and Restructuring of Slovenia" issued on March 21, 1991, proposed pegging to the German mark, the ECU, or a basket of currencies, to ensure a nominal anchor for a shock therapy stabilization program.<sup>15</sup>

Establishing a monetary system required choosing between a fixed and a floating exchange rate. Although economic theory does not provide a definitive answer to this question, the majority of experts either supported the view that a fixed exchange rate system suited the countries in transition better (Meltzer 1992) or proposed a crawling peg as an option (Bomhoff 1992). Slovenia, however, opted for floating after an abrupt drop in foreign exchange reserves in October 1990 revealed that a fixed exchange rate could not be defended. The debate over the proper exchange rate system nevertheless continued, encompassing the major theoretical quandaries familiar from the debate over optimum currency areas.

Two issues—the relationship between the real exchange rate and macroeconomic stability, and the anchoring role of the nominal exchange rate—divided participants. The theoretical pros and cons were used to defend different positions, and much less attention was addressed to actual arrangements in other countries. Also, the

debate over pegging versus floating reflected the two opposite general approaches to the transition in Slovenia: the radical and the gradualist. The former suggested a formal "shock therapy" stabilization program encompassing a fixed exchange rate as an anchor, a monetary policy that would support it, a balanced budget, foreign financial assistance, and restructuring of manufacturing and banking by the government. The latter suggested that economic policy should remain founded on the gradual construction of market institutions, with no formal stabilization program and only an indirect role for the government in restructuring the economy. A firm but flexible wage policy, strong restrictions on government spending (enhanced by the fiscal deficit, if required), a monetary policy enabling tolerable liquidity, a flexible exchange rate, reliance on foreign equity capital, and concessions for investments in infrastructure were the preferred economic policy instruments under this approach.

The linkage between the monetary and exchange rate systems was ultimately defined by the Foreign Exchange System Act and the Bank of Slovenia Act. These provided for the independence of the monetary authorities and treated the supply of money as an exogenous variable to be determined by the central bank. The exchange rate would consequently be endogenous. Slovenia thus established a system of managed floating of the type exercised mainly by developed market economies. Subsequent experience proved that floating was the right solution. Fixing the new currency unit to the currency unit of a country with low inflation would have ensured financial discipline only if the exchange rate "never" changed. This would have turned out to be illusory, because the basic conditions for exchange rate stability were not met.

In short, gradualism prevailed. Indeed, the reality since independence has been an even more gradual transition than the most enthusiastic gradualists had suggested, both in terms of economic policy and in terms of changes in the economic system.

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## NOTES

1. The dichotomization of transition patterns into "shock therapy" and "gradualist" models is inadequate for the classification of transition economies for two reasons. First, the observed patterns of transition were rather chaotic mixtures of systemic changes and changes in economic policies, some of which could be considered elements of a gradualist approach whereas others could be viewed as elements of shock therapy. Second, what was a shock for one country, for example, price and trade liberalization, was an element of a gradualist approach or even of initial conditions in another. What really mattered for the choice of tools and for the outcomes of transition were initial conditions.

2. For more on Slovenia's economic policy after the May 1990 elections, see Mencinger (1991, 1994).

3. The greater part of the systemic framework for an efficient market economy was created in 1990 and 1991, that is, before political independence. A simple, transparent, and nondiscretionary system of direct taxes was introduced by the Income Tax Act and the Profit Tax Act. The statutes regulating the monetary and financial system, such as the Bank of Slovenia Act, the Banks and Saving Institutions Act, the Foreign Exchange Transactions Act, and the Rehabilitation of the Banks and Savings Institutions Act, were passed, together with the Declaration of Independence, in June 1991. After independence, the missing legal rules needed to guide economic behavior (company law), ensure a predictable bargaining framework (codes regulating business transactions), enforce rules, and resolve disputes (bankruptcy and competition) were added.

4. These demands were transmitted in a "Memorandum on Economic Policy in the Rest of 1990," sent to the federal government in August 1990.

5. The National Bank of Serbia, a branch of National Bank of Yugoslavia, allowed the banks in Serbia to ignore the required reserves ratio.

6. These proposals were communicated in a "Memorandum of the Executive Council of the Assembly of the Republic of Slovenia on its Standpoints about the Reorganization of Economic Relations in Yugoslavia."

7. In 1990 the sales of Slovenian enterprises to the rest of SFR Yugoslavia exceeded by almost 40 percent their exports to the rest of the world. Six years later, in 1996, trade with the successor countries of SFR Yugoslavia amounted to 11.8 percent of Slovenia's total foreign trade (16.7 percent of exports and only 7.5 percent of imports).

8. At the beginning of 1991, similar ideas appeared in other Yugoslav republics, notably Croatia, which at that time favored a monetary union among itself, Bosnia and Herzegovina, and Slovenia. The idea of establishing a Yugoslav currency board also circulated (see Hanke and Schuler 1991).

9. The liberalism of the Slovenian League of Communists in the 1980s made it possible for Slovenia to become a forerunner in political changes in SFR Yugoslavia. The stand of the Party on the issue of Kosovo, and the fact that its delegates left the Yugoslav League of Communists' Congress in 1989 and withdrew from it in 1990, characterize its behavior.

10. The creation of the monetary system remains so far an unchallenged success of the academic economists who commanded the first Board of Governors of the Bank of Slovenia, and who successfully rejected foreign advice and applied their own concepts. In addition, several academic economists have become ministers and state secretaries and taken other high positions in the new Slovenian government. Professor Marko Kranjec, the first finance minister of independent Slovenia, for example, introduced the new income tax system, created the first budget of an independent Slovenia even before its independence, and had an indispensable role in the creation of a monetary system. Another academic economist, Velimir Bole, has been for a decade the force behind practically all decisions involving monetary and fiscal policies.

11. Three laws added considerably to the scope of privatization. The Housing Act enabled the privatization of approximately 100,000 apartments; the Denationalization Act provided for the restitution of property nationalized under the Communist regime; the Cooperatives Act assigned 40 percent of shares in certain food processing enterprises to farmers' cooperatives.

12. The assessment of initial conditions by Western advisers and financial institutions was false from the very beginning. Although the so-called monetary overhang that had existed in the socialist countries disappeared practically overnight through hyperinflation, the basic tools for macroeconomic stabilization policies nevertheless evolved from the assumption that aggregate demand exceeded aggregate supply. Thus the advice of foreign advisers implied that the gap should be reduced by increasing supply and decreasing demand through restrictive fiscal and monetary policies and rapid liberalization of foreign trade and prices, while anchoring the exchange rate, wages, and government spending. Such policies could only augment János Kornai's "transformational depression" and push more domestically produced goods than necessary into the category of Leszek Balcerowicz's "pure socialist production goods," thus destroying domestic manufacturing and transforming many countries, notably Russia, into providers of raw materials, and most of the other countries of the former Soviet Union, lacking raw materials, into a hopeless situation.

13. The document also provided that the possibility of future pegging would depend upon the existence of foreign exchange reserves and settlement of Yugoslav foreign and domestic debt issues.

116 *Part I: The Road Toward Political and Economic Independence*

14. The author of this chapter, who was also the co-author of the document "P2," which was one of 17 documents dealing with independence issues, resigned the post of deputy prime minister in May 1991.

15. The Sachs group changed its views in favor of unrestricted floating in a memorandum on October 8, 1991, after the floating exchange rate system had already been introduced.