Framework of a Macroeconomic Policy in the Quasi Market Economies: Possibilities and Necessities

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I. Introduction

As it is well known the European Community has worked out a plan to form a single internal market by 1992 by removing all barriers which hinder the free circulation of productive factors - goods, services capital and labour forces. The aim of creating a totally free European market is to promote specialisation in the Community and so to strengthen the world market position of the national economies in the member states. Increasing efficiency requires free competition in all sectors and branches. Since there are countries in the Mediterranean region which are full members of the Community, and others that are non-members but are strongly connected with the European Community, economic policy in this region has to tackle all tensions and imbalances that will be ushered in after 1992. Demand within Europe is expected increase rapidly, but the Mediterranean countries would only be able to avail themselves of this new and extended demand only if they are competitive in structure, quality and prices.

The region shows a very mixed picture. Among the Mediterranean countries there are highly developed market economies, full members of the EC, low or middle income developing countries, with very different potential to improve their economic performance. The annual growth rate of the GDP was between 1.5% in Yugoslavia and 6.8% in Egypt. As to the Resource Balance all countries have shown a deficit as a result of their poor net export results. Due to the chronic deficit of the trade balance and almost continuous deficit in the current account, external financing plays a key role in these countries.

Since foreign credits have always been the most important way of external financing and the countries in question could hardly rely on foreign direct investments, their indebtedness has risen continuously over time. Foreign direct invest-

ment in the region accounted for only $1.2 billions in 1980 and $0.8 billion in 1987, while the value of new disbursed credits reached the level of $23 billions. Two countries of the region belong to the so called highly indebted countries, but there are others whose financial position - in spite of their preserved "solvency' - is very weak as well. With the exception of the highly developed market economies - namely France and Italy - the Mediterranean countries are confronted with a very serious problem: how could they transform their economic policy, the whole system of macroeconomic management in order to improve their world economic position, to prevent the further weakening of their position when the single European Market will be established.

Economic philosophers emphasise that each crises has some positive element. Frequently crises compel policy makers to take the necessary measures which were resisted in the past. In the socialist countries for example, the transformation of the economies is now being accepted, but the task is not easy. This is also to an extent true of Mediterranean developing countries trying to transform their economies to take advantage of the post 1992 expansion in demand.

These countries are being forced to adopt qualitative changes in their policy. They have to apply totally new instruments which they have never operated and have to carry out a qualitative transformation of their administrative-bureaucratic economic control.

There is no absolutely certainty as to the effects of the policies being adopted. All economic measures have some risk. To what extent and when a given economic measure has a desirable effect on the economic processes can be estimated only within a considerable margin of error.

II. General Aspects of Macroeconomic Policy

Macroeconomic policy is at present in a difficult situation. There are countries with highly developed economies and others with a low level of development. More and more countries are confronted with problems which cannot be solved by measures deriving from the "classical" economic theories. The crises of economic policy and the disappointment with traditional economic theories have become a world phenomenon. Although the severity of the problem and perhaps their manifestations differ, all countries throughout the world have to seek answers to the following general questions: Which are the most important tasks of economic policy? How can economic policy makers summarise them in a clear form? What should be the targets of economic policy? What are the best forms in which to express quantitative targets? How can the targets set be consistent with the economic realities of the country? What should be the main instruments of economic policy?

Should the market instruments be mainly financial ones or administrative ones? What role should international relations play in forming economic policy?

The answers to the above questions are strongly connected with the kind of economic system under discussion. From an economic point of view the following groups can be outlined:

1. Economic management:

a. market economies
b. bureaucratic-administratively controlled economies
c. "quasi" market economies

2. Participation in world economy:

d. open
e. closed
f. partially opened

Different combinations of 1. a, b, c and 2. d,e,f, exist side by side in the present world economy. The most important and commonly used groupings are the following:

- open market economies (a and d)
- bureaucratic-administratively controlled closed economies (b and e)
- partially open quasi market economies (c and f)

III. Characteristics of Quasi Market Economies

Market and quasi market economies (QMEs) differ from each other in that the latter group of countries employ more limited market instruments to reach their targets. Since QMEs tend to be relatively undeveloped with a primitive market structure, administrative measures are essential - but because of the administrative control of these economies, markets cannot develop and operate fully. As long as direct, bureaucratic market intervention by the governments remains extensive, the development of markets has a disturbing unbalance and some markets develop faster than others. This makes the task of policy makers even more difficult.

Developed open market economies as well as less developed QMEs have their own special difficulties as to the optimal form of policy control. The former, in spite of their long experience and wide range of financial instruments, must struggle with forces which are difficult to control and fine-tune. This is especially so because domestic markets in developed open economies are interrelated with international markets.

QMEs have additional problems associated with the fact that resource allocation tend to be more insensitive to market forces. Economic agents - households and

entrepreneurs - are unused to responding to such "fine" signals like a small change in the interest or exchange rate. Either they simply fail to notice it, or they hope for some official compensation.

However in some cases, the reaction of market agents is far more in QMEs than in developed economies. The backward stage of market development, the insufficient knowledge of market forces and control or simply the mistrust in them, may easily lead to totally irrational and unexpected reactions. The use of administrative instruments, state subvention on a case-by-case basis, state subsidies in prices, extra bonus for exchange rate fluctuations may be the cause of seemingly irrational behaviours in QMEs.

Moreover market economies typically have to cope with problem of oversupply, while QMEs have to tackle chronic excess demand, giving rise to shortages. Fundamental imbalances characterise both types of economy, but in different directions. Which situation is worse than the other could be debated, but the chronic tendency of excess-demand definitely calls for a special economic policy.

In the case of developed market economies, the theoretical base for deriving an "optimal" framework of macroeconomic control more or less exists. The theory of macroeconomic policy for QMEs, which are in a transitional phase, moving from centrally planned, totally administrative management towards an economic system based on the relatively free play of market forces, is however rather poor. Furthermore the logic, the sequence of ideas, the conceptual system of these theoretical constructs are totally different from those applied in developed market economies. As previously mentioned a given type of economic management or economic system has a fundamental influence on economic policy, its targets, and instruments, their combination and importance.

The most important and special characteristics of QMEs are the following:

- there is a significant difference in the level of development of different domestic markets for goods, money, capital, labour and foreign exchange, even though these are interdependent;
- due to serious imbalances both in the domestic economy and in external relations, the development of national markets cannot follow the same path as that followed by developed countries in the past. In the classical market economies the development of markets was a gradual process, following the real financial and credit needs of the goods markets. The strengthening of all other markets was a logical consequence. In the QMEs there is what may be termed as an artificial movement towards market liberalisation giving rise to an corresponding need for liberalization of trade and payments, as well as the opening of exchange markets. This means that exchange markets are being opened in spite of the undeveloped

stage of capital markets of QMEs.

In such countries, market forces prevail only to a limited extent during the transitional period. Their effects are often suppressed or compensated by administrative measures, and the market agents expect the existence of such official compensation.

Financial policy has no real tradition in such countries, and no information is available as to the behaviour of market participants. The correlations among the different aggregate economic variables are practically unknown. Policy makers must tackle uncertainties simultaneously on all markets. This, coupled with the political uncertainties in such economies, leads to a very dangerous situation with too frequent changes in the policy instruments and the continuous temptation to return to administrative measures when the market fails to deliver.

The transitional period in QMEs is generally characterised by serious political tensions. The increased reliance on market forces requires not only a fundamental change in economic thinking, but a change in the relationships among political, ideological and economic factors. Debate related to these changes tends to be strongly connected with political and ideological discussions sometimes encouraging more radical economic changes, and sometimes preventing even the minimum economic programme. In some instances, a gradual approach may easily become an empty phrase, causing delays in the liberalisation of market processes.

The necessity of change in economic management arises generally at a time when economic results are not encouraging. In case of QMEs the total qualitative transformation of economic policy becomes necessary in a crisis situation. Rigidities which had accumulated for decades, sometimes have to be dismantled quickly.

IV. Framework for Macroeconomic Policy in the QMEs

The main characteristics of disequilibrium in the QMEs can be represented as follows:

a. Over-expenditure: $C + I + G > Y$

b. Savings Shortage: $I + G > S$

c. Trade Deficit: $M > X$

d. International Debt: $C_M = M + D_S + X$
but
$\Delta D_S, > \Delta X , \Delta Y$

e. Stagflation: $PY_{t1}/PY_{to} > 1$ but $\Delta Y < 0$

where symbols with sign Δ indicate growth rate of the variable.

During the last decades C+I+G, i.e. domestic absorption (A) was generally higher than real output. This was the result of different factors. Net expenditure of the government budget deficit and private expenditure on consumer goods played a significant role in the steady imbalance. Although there were periods when a great deal of investment was halted, the proportion of expenditure on investment fluctuated and because of the stagnation or decrease in the real output itself, this cut in investments did not result in the decrease of overconsumption. The value of G+I usually exceeded the given value of S; partly due to the low level of domestic saving, partly to the considerable rise of G.

Government expenditure in general, but especially the net value of it, compared to Y, had a strong upward tendency. Export income did not finance imports, which necessitated a continuously growing external financing of trade deficit. External financing was mostly available through borrowing. Foreign direct investment, contrary to all efforts from the beginning of the 70's, played a more limited role in offsetting the deficit on current account. The continuous rise of debt (D_s) inevitably led to serious weakening of the solvency or international liquidity of the countries in question.

A dynamic investigation of the general economic situation would show an even more critical situation. Y was stagnating or sometimes decreasing owing to the temporary restrictions of I and C. The efforts to restrict domestic demand did not give rise to an improvement in the trade balance and the relative growth of net X, but to the inevitable stagnation or decrease of real output.

Growing imbalances in the domestic markets, i.e. rising shortage of goods and services and money and labour, together with the simultaneously strengthening "overconsumption" and the strong decrease of real wages and salaries testify to the urgent need of economic policy changes.

The failure of bureaucratic economic management can be proved by the fact that the huge amounts of foreign debt had hardly eased the structural tension between demand and supply. Therefore administrative restrictions in domestic absorption have not led to a significant export expansion. The volume of "potentially" exportable goods rose, but actual export income lagged far behind expectations.

As a natural consequence of excess demand and or permanent overconsumption, inflationary pressure has generally strengthened. Irrespective of whether inflationary pressure was accompanied by the increase of the price level, or was administratively suppressed - inflation has become the most serious problem. Inflationary pressures, together with a stagnation/decrease of Y, manifest clear symptoms of stagflation, well known in the developed market economies as well, during the 70's.

Economic policy in QMEs must tackle the following problems:

A. Domestically

- how to abolish overconsumption, or in other words the optimalisation of the relative values of C, I, G;
- how to ensure the stable and steady growth of output, i.e. the optimalisation of the absolute levels of C, I, G;
- how to combat inflationary pressure without further restriction of economic growth;
- how to stimulate domestic capital accumulation and promote its rational allocation;

B. Internationally

- how to preserve solvency, to fulfill debt obligation;
- how to optimalise debt management policy;
- how to encourage foreign direct investments in order to assure the stable rise of Y and to cover capital shortage;
- how to assure improvement of the trade balance, supporting X by an active trade policy;
- how to introduce a liberalised import system in order to achieve real competition on the domestic market and to avoid further worsening of the trade balance;
- how should current payments be liberalised and which form of convertibility is necessary and possible in the given situation.

Main Targets of Economic Management

The main targets of the "New Keynesian Framework for Macroeconomic Policy" for developed open market economies can be summarised as follows:

- a steady stable growth path for the money GDP by maintaining a suitable level of total monetary expenditures on the country's products;
- a target value for national wealth, for wealth accumulation, for the suitable distribution of the country's products between current consumption and capital formation;
- exchange rate target, whereby the rate is not fixed but adjusts to prevent excessive swings in the foreign balance of goods and capital flows.

Evidently, these are final goals for any economy. If they are successfully attained, real incomes would rise steadily, with a promising future in terms of capital formation and exchange rate adjustment mitigating external shocks. The question as to whether or not such targets can be attained by QMEs is however debatable.

The problem is that these targets alone are not enough. Economic targets have a

double function: they set the course of policy making and help the society to keep government policy under an objective and steady control. To successfully carry out these functions, QMEs need to supplement these final targets with "intermediate" ones.

Taking into consideration the special characteristics and problems of the QMEs the following intermediate targets can be proposed:

Balanced growth of domestic absorption
Control of Goverment and Consumption Expenditure
Price changes should not exceed growth of output
A healthy debt servicing ration
Liberalization of imports
Control of exchange rates

The need for intermediate targets is clear. Economic policy needs a fixed aim, a so called target on each area, which forms an essential precondition for the final targets.

Thus it is essential to control domestic expenditure so that overconsumption is avoided. Overconsumption which accumulated during the past years has led to the unbearable debt burden of QMEs. It is also clear, that the fulfilment of this target in itself cannot guarantee an improvement of the economic situation.

It is also essential to identify the elements of domestic absorbtion causing the problem of overconsumption. It must be clearly stated how much "sacrifice" private consumers, investors and the government need to make, with particular emphasis on the government target. Social obligations of the government should be fulfilled but in combination with a full structural reform of the budget.

The target for the relative level of inflation may give rise to debate. Why not place the control of prices changes (ΔP) as a target target, why is it proposed to control price increases in relation to output increases? In other words why focus on the ratio $\Delta P / \Delta Y$?

As suggested previously, QMEs are struggling with stagflation. While real output stagnates, or decreases, P is steadily increasing. In this situation a simple price index target is not really helpful, because by itself it does not say anything about the results of anti-stagflationary policy. This can be assessed only in relation to the growth rate of Y. The success of economic management depends not only on the anti-inflationary actions, but on the effect it has on aggregate output. A decrease in P and an increase in Y is more encouraging than a decrease in the rate of inflation combined with a further decrease in Y. The main point is that the target should give

some real information about the achievements of anti-stagflationary policy.

The debt-service to export ratio (D_s/X) target is related to the efficiency of debt management policy, in connection with export results. This target determines a limit above which the relative value of D_s must not rise to avoid further external financial shocks. In case of highly indebted countries one of the most important task of the government is to avoid insolvency. But it must not result in justifying a policy which maintains solvency "by all means". It goes without saying that a country which usually has a trade deficit, - taking into consideration long term interests of the economy - cannot tolerate a very high debt service ratio. There is no general rule of course as to what value this ratio should take, since this would depend on the special circumstances of particular economies.

The target for import liberalisation is required in the special circumstances of QMEs. The opening of the relatively undeveloped markets to international competition is an urgent need of outward oriented economic policy. In view of the chronic Balance of Payments deficit, a gradual process in import liberalisation is however essential. Otherwise there is the risk that import demand may rise at too fast a pace.

Should importers receive a clear promise from the government as to the schedule of import liberalisation expressed in a concrete target, then there is a chance that the market would remain much more quiet. Some increases in the value of imports and so a growing temporary imbalance between X and M, cannot be excluded, especially at the beginning. But the danger of a sudden and drastic rise in the import value will surely be reduced.

Exchange rate targets are of basic importance. With respect to the serious Balance of Payments problems of QMEs, the continuous control of actual exchange rate is one of the most effective instruments the governments should resort to during the process of increased reliance on market forces.

Controlling exchange rates may in some ways be easier and in some ways more difficult than in the market economies. It may be easier because there is no market with undesirable exchange rate movements for the official policy to fight against. The difficulty originates from the absence of market information about the exchange rate elasticity of domestic demand for foreign currencies. Prices on the black markets or abroad - if any- do not give reliable guidance to the real value of the home currency. Even if exchange markets are highly developed, governments may and should intervene in some restricted way to avert extreme fluctuations in the exchange rates. This need is even stronger where the markets are in an initial stage.

V. Reaching the Targets

The intermediate targets are not independent preconditions of the final targets. There are very strong cross-relationships among the different short and longer term aims. A given target combination does not imply an exclusive direction which the policy measure is to be aimed at. The value of each target and instrument change has to be planned with utmost care in respect of subsequent direct or indirect effects.

The investment share target (I/Y) can be considered as a qualified precondition for the final targets. There is a direct link with national wealth and an indirect link with real incomes (money GDP). It is therefore of crucial importance whether and how the necessary level of I/Y can be assured. How could the structure of domestic expenditure be changed in favour of investments? Which measures promise the decrease of net government expenditure and the prevention of a rise in consumption?

In case of QMEs monetary policy actions do not seem to be the most suitable form of attempting to control the economy. Decreasing the rate of interest may increase planned investment, nevertheless C and or G may remain unchanged. If Y stagnates neither C nor G would fall to a significant degree, necessary to compensate for the rise of I so as to avoid overconsumption and a further rise in trade deficit. On the other hand it must be emphasised that the required restructuring of domestic absorption does not mean automatically that $\Delta(C+G) = \Delta I$. Rather it must be based on $\Delta G = \Delta I$. Of course demand restructuring has to affect the level of C as well but in the case of QMEs the government has to take the "lion's share"of the cut.

This requirement arises from the fact that QMEs tend to have a relatively high level of G, which derives mostly from the system of wide scale state subsidies. The reduction in C/Y is necessary to avoid a general crises of confidence in the government policy. In many QMEs, state subsidies on a large scale, compensate the low profitability of the (mostly) state owned enterprises and have in themselves an anti-market character. If increased reliance on market forces is a real policy aim, not an empty slogan only, the decrease of G/Y is fundamental. The extensive use of subsidies - accompanied, of course, by a very high level of taxation - work against market forces and basically hinder economic efficiency. With widespread subsidisation of production, it is not possible to verify whether and to what extent a given line of production is profitable or not. Very frequently the end product is inefficiently produced in terms of price and quality.

Although there is a significant overdemand in QMEs, the solution does not lie in restricting but in restructuring it demand. Interest rate policy, if appl;ied in QMEs

would not probably be sufficiently effective, since its impact on the main culprit, namely the share of G, would not probably be significant. Fiscal policy is more promising towards this end.

Fiscal Policy

To assure an expected rise in the value of I/Y - basically at the expense of G - a complex fiscal policy may be required. It must be emphasised however that control must be operated on both sides of the budget account.

Fiscal instruments, devised to change the relative weight of C, I and G, naturally concern government expenditure and revenue/tax policy as well. The QMEs' most important economic problem lies in the budget where the composition and the level of government expenditure are matters of concern. The extraordinary high level of expenditures, together with the very high level of its absolute value devoted to "economic" activity do not promote liberalization. There is an urgent need in QMEs for the governments to cut their expenditures, primarily on direct economic activities. There is no need to cut government expenditure at the expense of social welfare only. State subsidies to companies at a loss and the costs of the huge central administration and defence expenditure, assure a sufficient buffer which could leave social expenditure relatively untouched and may even result in an increase in this area.

On the other side of the coin, tax policy can significantly assist in the realisation of the targeted change in the structure of domestic demand. The adjustment of all tax rates is an appropriate instrument in controlling demand structure. Since the cost-push element of wage setting is not so strong as in case of the developing market economies, a rise in the tax rates would not necessarily lead to an equal increase in inflationary pressure on wages and prices. However, the specific economic conditions in QMEs may not permit an increase in tax rates. On the contrary, most probably selective cuts in tax-rates may be a better option to attain certain demand structure targets. Consequently fiscal policy through tax changes alone would not probably bring about the necessary changes in the demand structure. Changes on the expenditure side of budget account are also necessary.

A general cut in the expenditures and selective changes in the rate of different taxes are the tasks fiscal policy must fulfill. The necessary tax measures intended to stimulate an increase of I and I/Y - would clearly result in a lower level of government income. For this reason the decrease of the government expenditures is essential. In the circumstances in which QMEs find themselves, fiscal policy is of extreme importance for stimulating investment only if it involves a reduction of the G/Y ratio.

The target of $\Delta P / \Delta Y$ plays a central role in the economic management. It is a fundamental precondition of all other targets, and at the same time it is the function of all the targets given. The positive difference between the growth rates of the price level and output must be gradually diminished. Inflation outpacing economic growth implies a steady excess demand, which real output can reach. Owing to special reasons in QMEs, excess demand sometimes occurs with an actual fall in output.

As already stated, the QMEs are characterised by a continuous excess demand, causing ever increasing inflationary pressures. What factors are responsible for the inability of QMEs to raise their output to the level of domestic demand? There are a number of possible answers, generally related to the rigidities caused by administrative-bureaucratic factors and to capital shortage. Because of these factors it is difficult to expand the productive capacity in the necessary measure, in an efficient manner and at the right time.

It should also be be pointed out that the imbalance between supply and demand has a strong structural character. Should the structure of supply adjust itself to the determinants of demand, disequilibrium on the goods market would be eliminated. But in QMEs, production is not guided by those market forces which in developed economies give rise to relatively fast response of supply to changes in the structure of demand.

In QMEs the profit made in certain lines of production does not reflect demand conditions, due to artificial support by the government or to insensitivity to market forces. Consequently a decrease of income, either from the lower prices or from the reduced sales, may not prompt the producers to adjust accordingly. Under real market conditions, and with a suitable monetary control, structural imbalance in the goods market would not lead to a continuous and steadily rising inflationary pressure. The relative absence of these factors in QMEs is the major source of the growth of excess demand and inflationary pressure in such economies.

The major task in such countries is therefore to moderate the disequilibrium between demand and supply by (a) controlling the further growth of demand and (b) stimulating the necessary structural changes in output.

The $\Delta P/\Delta Y$ target requires economic control both on the demand and on the supply side of the market; quantitative control of demand and basic structural changes on the supply side. It would be totally unrealistic if economic policy were to aim at immediate and full stabilisation. The task requires a targeted gradual decrease of inflation relative to the actual growth of the real output. In this way, reaching the desired level of $\Delta Y/\Delta P$, economic policy can fulfill the final target of a non-

inflationary steady growth path of money GDP.

Fiscal policy is often considered at attractive because of its direct effect on quantitative and structural control of aggregate domestic demand. Although, as already noted, the scope of Monetary policy may be more limited in QMEs, it can also have a role in helping QMEs to achieve the targets related to $\Delta P/\Delta Y$.

Monetary policy has a two-fold function namely:
(a) to reduce inflationary pressures and
(b) to stimulate structural change and quantitative growth in Y.

Generally speaking we cannot be sure beforehand whether a change in interest rates is going to be inflationary or anti-inflationary. The effects of such changes depend on the given circumstances and on expectations.

During the 80's empirical evidence in the QMEs shows that the rise of interest rates did not ease inflationary pressure. When the traditional low and stable level of interest rates began to rise , there were changes in the velocity of money, as money holders considered rising rates as a sign of alarm.

Interest rate policy could however play an important role in restructuring the economy. A selective credit policy could be introduced in order to achieve the necessary structural changes in Y. This can be coupled with policies related to the minimum reserve ratio and credit ceiling policies.

Capital Shortage

QMEs tend to suffer from capital shortage. A significant part of this shortage was created by the system of subsidies, which enabled producers to obtain finance even if their profitability was very low and the enterprises were loss-makers. There was therefore gross misallocation of investment resources, with potential profit making ventures remaining unserved.

The changes of relative interest rate (compared to its previous level) would influence credit demand. Although interest rate elasticity of credit demand is steadily changing and can only be estimated with a considerable margin of error, it can be stated that as interest rates increase credit demand would decrease if market forces are allowed to operate. If there are severe disturbances in the operation of the credit markets, one can hardly speak about any real correlation between the two factors.

As to the efficiency of investments, the real consequences of interest rate changes

cannot be evaluated in isolation, since other factors, such as the tax structure, have to be considered. A lowering of interest rates may not stimulate investment if taxation is unduly prohibitive. In QMEs this is a very serious problem. Accounted profits are fully misleading, and owing to the complicated system of state intervention (subsidies and different taxes) even the most thorough investigation cannot give a realistic picture about effectiveness.

The combined use of interest rates and domestic credit controls have to serve two seemingly contradictory purposes to reach the target rate of $\Delta P/\Delta Y$ namely (a) deflation, i.e. controlling P (restraining its rise) and (b) reflation stimulating a rise in Y.

In fact, the above dilemma may not be as impossible to solve as at first glance, since, as shown earlier, the correlation between interest rates and aggregate demand is very low. So any change in interest rates could be aimed at the reflation purpose without damaging the deflation purpose.

The use of interest rates in QMEs however may only have a limited effect. Since the actual credit market effects of interest rate changes are rather unpredictable, monetary control should rely more on selected domestic credit ceilings, instead of applying some interest rate rules. Domestic credit "limits" should be adjusted to the requested expansion of economic activity and interest rate changes assure that the credit limits should be used to the full.

Exchange Rates

In connection with exchange rate policy economic requirements are rather contradictory. As liberalisation proceeds, the exchange rate affects more and more economic factors. The growing links between domestic and external markets gradually strengthen the relationship between home and international prices of goods, prices of money and capital.

Exchange rates influence the basic economic processes directly. In the transitional period, liberalisation of the market for goods and services probably reaches a more advanced level than that of money markets. From this point of view the exchange rate policy could be aimed at decreasing the relative rate of increase of domestic prices. It would mean some overvaluation of the currency or at least the stability of the real exchange rate, but not necessarily effecting the real exchange rate. Looking at the target with respect to the structure of domestic demand, certain requirements have to be served by an exchange rate policy. In order to stimulate investment activity, import requirments must be satisfied in volume and at suitable prices. Rising import prices due to a decrease of the real exchange rate would tend

to discourage investment.

Unfortunately, the export side requires a different exchange rate policy, it is often argued, competitiveness would improve with a decrease in the real exchange rate. If we accept the traditional "elasticity" approach, export income may rise following the fall of exchange rate. Although this is often stated in theory, there not much empirical support with respect to QMEs. If the deficit on foreign trade is of structural nature, declining exchange rate will not stimulate exports - they will only result in a worsening of the terms of trade, giving rise to a shrinking of Y and stronger inflationary pressures.

In case of the relatively undeveloped QMEs, the elasticity of exports and imports would tend to be very low, espeically on the import side. The elasticity of import demand with respect to import prices would also be very low in QMEs due to the fact that the imported products tend to be essential and/or non-substitutable with domestic products. A devaluation, therefore, is hardly the right approach for reducing the trade deficit and promoting the growth of Y.

It is similarly questionable whether the lower real exchange rate would stimulate foreign capital owners to invest their capital in the given country.

All in all, the optimal level of exchange rate and the exchange rate target raise difficult questions. The price of the currency concerns all intermediate targets, which require therefore a compromise in the exchange rate policy. The exchange rate cannot be used exclusively for anti-inflationary policies or for promoting structural changes in Y; such aims would theoretically require some overvaluation. On the other hand, it cannot be stated with certainty that an overvaluation of the currency is desirable, because this would effect export competitiveness giving rise to a reduction in exports, even if only to a small extent. Therefore exchange rate targets must be in the zone which causes the least damage.

As to the exchange rate target, policy makers in the QMEs are confronted with three problems. The first is that for a long period exchange rate has played no economic role at all and this, coupled with the still deformed domestic prices system, renders it s extremely difficult to verify the level or even the zone at which to target exchange rate.

The second is related to the the special dilemma in QMEs which face inflation together with a trade balance and current account deficits. It is debatable which imbalance the exchange rate should be aimed at: domestic or external? In the QMEs, where structural problems play a far more important part in correcting the trade deficit than do prices, the choice is much more limited.

Should the authorities divert the exchange rate from itsdesirable level or zone, assuming that these are known, in order to help anti-inflationary efforts, they must be very cautious since a perceptible overvaluation might be inconsistent with the balance of payments problems.

Thirdly, even if the direction and extent of changes in the exchange rate have been decided, there is the question of the instruments to be applied. How and by which means could the target be achieved? This, at first glance appears to be a very easy task since there is only one officially determined exchange rate. In reality it is not so easy. Monetary authorities may dictate the exchange rate, but it is their task to meet fully the demand for currencies at the given prices. The gradual liberalisation of imports and the progressive evolution of exchange market characterise the transitional period. As soon as an exchange market comes into existence and a steadily growing proportion of foreign exchange transactions takes place on the market, the exchange rate target requires a very active intervention policy from the authorities.

In order to bring actual exchange market rates to the target level, QMEs cannot rely on interest rate policy in a direct way, as developed market economies do, since the money and capital markets tend to be less liberalised and therefore in the first stages of the transformation one cannot expect that exchange rates would respond to interest rate changes.

VI. Conclusion

This paper has focussed on the special characteristics of Quasi Market Economies. It has been noted that the major difference between these economies and the developed market economies is that the policy options in the former economies are more restricted, principally due to the underdeveloped nature of their markets, the high degree of government intervention and the rigidities which are often structural in nature. Although quasi-market economies tend to face more severe economic problems than the developed ones, they have fewer instruments at their disposal to solve their problems. Some of the dilemmas encountered by the policy makers in QMEs were highlighted in the paper. It has been suggested that a principle objective of QMEs should be to control inflation and at the same time promote economic growth. Restraint in government expenditure coupled with changes aimed at stimulating investment and liberalizing the markets have been advocated as the basis for a macroeconomic policy framework for QMEs.