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ECONOMIC LESSONS FOR EASTERN EUROPE FROM LATIN AMERICA

José María Fanelli
Gary McMahon

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I. INTRODUCTION

Approximately ten years later most countries of Eastern Europe are currently going through the same process of economic and social transformation which many Latin American countries began in the early 1980s[1]. Given the large variety of Latin American experiences, it would seem, therefore, that Eastern Europe has a great deal to learn by studying Latin America. However, few eastern eyes seem to have turned to the southwest. While one can only conjecture why this has occurred, it is likely that most of the attention has fallen on Western Europe -due to its proximity and for historical reasons- and on Southeast Asia -because of the recent spectacular success stories. It may also be due to a general ignorance of Latin America, a region about which few economists in Eastern Europe have much knowledge, and the tendency to think of it as a somewhat wealthier Africa.

Very roughly speaking, Latin America (specially its bigger countries) is the region in the world with which Eastern Europe has the most similarities. Income levels are in the same general area as is infrastructure development, industrialization, and the levels of human capital. Of course, there are also at least three major differences. Eastern Europe does not have a large marginalized indigenous group as do many countries of Latin America. Also, state ownership of the means of production, while pervasive in Latin America, never reached anywhere near the levels of Eastern Europe. The social safety net -largely due to the guarantee of employment- was also much stronger in Eastern Europe, although this is no longer the case in much of that region.

Another important common feature to the two regions is the significant level of macroeconomic instability. But, while this is a relatively recent phenomenon in Eastern Europe, Latin America shows a long tradition of macro instability. Consequently, the countries of the latter region have accumulated an ample experience regarding stabilization policies that can be valuable for Eastern Europe, which has much less experience in the design and implementation of adjustment policies in a market economy. A country like Russia, for example, which is presently on the brink of

[1] Note that when we speak of Eastern Europe in this paper, we are including Russia.

hyperinflation can learn a lot from the virtues and flaws of the anti-inflationary policies implemented in Bolivia or Argentina to stop high inflation processes. There are also valuable lessons to be learned on the relationship between structural reform and stabilization. Since the mid-eighties, in the context of high instability created by the debt crisis, many Latin American countries have been launching structural reforms aimed at reducing the role of the state and liberalizing the economy. Given that it is a fact that in Eastern Europe, the transformation process is also bound to be carried forward in a highly unstable macroeconomic context, the analysis of the sequence of stabilization and structural reform measures in Chile, Mexico or Argentina in recent years can be highly relevant for the former socialist countries. Indeed, the experience of Latin America may be valuable not only regarding the relationship between reform and stabilization, but also for the design of the sequencing of the structural reform process in itself. The analysis of the successes and failures of the Southern Cone liberalization attempts of the late seventies, for example, can be specially illuminating to avoid the perverse interactions among the opening of the capital account, trade liberalization and financial deregulation which were observed in Argentina, Chile and Uruguay and which ultimately led to the collapse of the liberalization attempts in those countries in the early eighties.

Given this mix we believed that there was a lot for Eastern Europe to learn from Latin America in economic policy, but we had some misgivings. While both regions were quickly moving from state directed, closed economies of varying degrees to market-based, open economies, it may well be that the differences noted above were more important than this broad similarity.

Nevertheless, we decided to invite four economists from Eastern Europe to different countries in Latin America for 2 weeks in December, 1992. Each spent one week in a "sister" institution and then went to Santiago for a two-day conference, followed by another week in the sister institution. This allowed them to become quickly immersed in the Latin American economic literature and to see for themselves the degree of development of much of Latin America. The latter was even more important than we thought it would be in breaking down misconceptions and making the researchers receptive to the comparison.

Each researcher focused on a different aspect of economic policy. The pairings and topics were: Hungary-Chile-Privatization; Poland-Brazil-External Trade and Finance; Czech Republic-Mexico-Fiscal Policy; and Russia-Argentina-Monetary Policy and Stabilization. In April, 1993 the East Europeans presented the papers that they had written at a conference in Prague. Their counterparts made comments which were integrated in final drafts. The Latin Americans then made comments again which are appended to each paper.

The way of attacking the problem varied considerably, however, both with regards to thematic scope and country coverage. While all of the Europeans tended to focus on their counterpart country in Latin America, they all to some degree brought in other countries in the region. However, while all focused to a large degree on their own country on the Eastern European side of the comparison, two of the researchers almost did so exclusively (Poland and Russia) while the others were more ecclectic. In addition, on the thematic side there was a tendency to look at the whole package of stabilization and structural policies and stray away from a narrow concentration on their thematic topic. This was especially true in the cases of Russia and Poland, fairly true in the case of the Czech Republic, but much less so in the case of Hungary. Nevertheless, it would only be slightly incorrect to say that we have four case studies on stabilization and structural reform, each, however, attacking the problem from a different entry point.

This paper is a summary and synthesis of the papers and the comments and is organized as follows. Section II contains summaries of what we perceived to be the main results from each of the studies, including the comments. It is divided into four parts devoted to privatization, fiscal policies, stabilization and monetary policy, and the role of the external sector and finance. In each part, after presenting the results of the papers, we evaluate the issues concerned, incorporating some of the more recent literature on reforms in Latin America and Eastern Europe. Section III makes a general assessment of the lessons from Latin America to Eastern Europe regarding stabilization and structural reform and presents some conclusions. Before we begin, however, we would like to caution that this paper makes no attempt at being a survey of the literature on the subject, but concentrates on the IDRC funded study and a few other selected documents.

II. THE CASE STUDIES

a. Privatization

The first section of the paper by Janos Hoos (1993) of Hungary examines the reasons for and process of privatization in Latin America in the last two decades. Hoos begins with an examination of the experience of Latin America. He follows this analysis with a discussion of privatization in Eastern Europe, with the emphasis on Hungary, Czechoslovakia, and Poland. The paper concludes with a section on the lessons that Eastern Europe (EE) can learn from Latin America (LA).

The two overriding reasons for privatization in Latin America were for economic efficiency and fiscal balance considerations. The ideological shift in LA in the 1980s meant that the government is now seen by many as only responsible for what the private sector cannot or will not do. Greater efficiency can be obtained by leaving production largely in the hands of the private sector. Moreover, greater equity can also be achieved with the social participation that occurs through the democratization of capital. That is, public enterprises are inherently inefficient as they do not have to worry about making profits, and they are inherently inequitable as they are captured by the better off classes in society.

Losses generated by state owned enterprises (soe's) have also often accounted for significant portions of the fiscal imbalance within a given country. Therefore, privatization will help the long-run fiscal balance of the government. However, the short-run fiscal deficit is often one of the driving forces behind privatization. At the heart of much of the macroeconomic instability which plagued LA in the 1980s were large fiscal deficits. Significant parts of these were due to new expenditures in the form of debt payments to domestic and international bondholders; another important reason for the negative balances was the decline in tax revenues which accompanied the instability.[2] With few other short-run options to close the fiscal deficit, some governments began to

[2] See........ for an explanation of these revenue declines.

sell off their assets; ie privatization. In Mexico, Chile, and Argentina, for example, proceeds from privatization played a major role in meeting the fiscal needs until other sources of revenue could be obtained. In fact, Argentina today (and Mexico to a lesser extent) is soon to face the problem of how to replace these privatization revenues on a long-term basis.

Hoos also documents a number of other reasons for the emphasis on privatization in LA. Specific divestments are often undertaken more for ideological reasons than on efficiency grounds. They are seen as giving signals to the private sector that they are to play the lead role in economic growth and that the government is serious about the "market friendly" reform. On similar grounds, in a climate of great uncertainty the government may choose to privatize some firms in order to give to the private sector relatively easy sources of investment. There may be no need for major start-up costs and monopoly profits to be obtained, at least in the short-run. Privatization can also lead to a deepening of stock markets, especially when some type of popular capitalism is used in the divestiture process. Finally, privatization also tends to improve relations with international financial agencies and commercial banks, which can play an important role in building up investor confidence in a country.

In his paper Hoos describes in some detail the many different forms that divestiture assumed in LA. These included direct sale, partial sale to employees, stock market sales, popular capitalism, partial sales to foreigners, and sales to pension funds. The main point here is that privatization can occur in many different ways and a country should not feel bound to follow one or two of them. The type of privatization undertaken will very much depend on the type of firm and the economic and institutional situation of the country.

Nevertheless, privatization has often run into serious problems in LA. The biggest of these are a lack of transparency and the regulation of non-competitive industries. Chile in the 1970s is the most prominent example of the selling off of soe's in a very non-transparent manner which resulted in catastrophe. By allowing very high concentration of ownership, the government exposed the country to enormous economic risk, especially as the firms and commercial banks were owned by the same conglomerates. In fact, the

money to buy the companies was often obtained on loans from the conglomerates to themselves. This concentration of ownership was one of the prime factors for the enormous depression in 1982-83.

The regulation of non-competitive industries has often been implicitly done by liberalizing trade at the same time as privatization is occurring. However, this remedy can be very ineffective if the goods are non-tradables or if the regulatory body has little experience or power of enforcement. The problem is often exacerbated by the generous conditions used to attract the buyers in the first place.

Privatization in EE has had similar objectives to LA, with however more emphasis being put on the need to spread and promote ownership. Nevertheless, the efficiency and fiscal balance objectives have been just as prominent as in LA. The magnitude of the problem, however, is much larger than in LA. Generally, one is speaking of privatizing firms worth about 50% of GDP in 3 to 4 years versus firms worth 10% of GDP in 8 to 10 years in LA. Moreover, while EE governments face some of the same problems as in LA, they have many other difficulties to confront.

The three main additional difficulties in EE are a lack of capital, the absence of clear property rights, and a very inadequate infrastructure in the form of a legal and institutional framework. Generally in LA there has not been a great problem in finding buyers for privatized firms; the question is more how to go about it. However, given the poor institutional framework, lack of property rights, and small amounts of domestic capital, it is often difficult in EE to find a buyer at any price. Until financial responsibilities are clarified, including the problem of bad debts to the banking system and between firms, this may continue to be the case. Like in LA they also have the problem of facing protected markets, especially the European Community, but unlike LA, the newly privatized firms in EE very frequently have to begin exporting goods very quickly, due to the small size of the internal market and the collapse of the former export market of COMECON.

The three main techniques of privatization in EE have been: (i) spontaneous or from below; (ii) active or driven by the state; or (iii) voucher plans with free mass transfer.

The second and third are similar to the experience of LA, although EE countries have tended to resort to voucher plans of one sort or another more frequently than LA, primarily due to the objective of "spreading capitalism". The first refers to the process by which workers and managers more or less take over the soe and buy it out. While this sounds fine in principle, the reality has been that it has led to enormous abuse. First, the managers and workers generally have inside information with regards to the true worth of the company and have often "sold to themselves" at fire sale prices. Second, given that the privatized firms often need to be restructured, one of the main ingredients of which is significant labour "shedding", this is impeded by the workers controlling the companies. The end result has often been that the nomenklatura ends up with bargain-priced companies which then continue on as they always have.

The reality of privatization in EE has to date been much less than what was envisaged. While it has been relatively easy to privatize small firms via auctions, larger firms still remain largely in the hands of the state. Hoos emphasizes that this is due to constraints on both the supply and demand sides. That is, there is the need to clarify the legal and institutional framework before putting firms on the block and the need to find buyers. The demand problem is particularly severe with regards to domestic buyers, a problem exacerbated by the understandable reluctance of governments to sell everything off to foreigners. Connecting both constraints is the difficulty in the valuation of enterprises in a country with no financial markets to speak of and tremendous uncertainty in all markets.

In the section on lessons for EE from LA, Hoos began by noting some of the most important differences -public ownership in EE is 80% to 90% versus 10% to 20% in most LA countries, in LA prices bear some relation to scarcity, and LA has well-established concepts of property, ownership, title, and contracts. Nevertheless, he believes that EE has a lot to learn from the Latin American "experiment" of the 1980s.

First, privatization is an integral part of an economic reform package. It is a means not an end. It should be seen as part of the redefinition of the state which the government is carrying out. In this aspect, the governments should not aim at short-term revenue maximization but take a longer perspective. It also must be consistent with the

other reforms. For example, privatization without price liberalization should be avoided as it becomes impossible to value the assets of the firms.

Second, privatization should be approached slowly. If it is undertaken without the proper institutions, we saw that there is the possibility of widespread corruption and chaos, as has happened in LA. In EE the damage from ill-conceived privatization would likely be much worse. In addition, if you try to move too fast your may end up in a situation like Brazil where the government totally missed its targets and lost credibility in the process.

Third, a stable macroeconomic situation should be a prerequisite before an ambitious privatization program. Again, without a stable economy it becomes very difficult to value the assets of a firm and have a good idea of the potential profitability.

Fourth, due to the regulatory problems, the government should concentrate on traded goods sectors first. At the same time the government should be building up regulatory capacity in anticipation of more difficult privatizations.

Fifth, use flexibility in the methods of privatization. There is no method that is superior in all situations. It is likely that every country will want to have a portfolio of divestiture processes. There are two things, however, that they should all have in common -transparency and a reliance on cash, not debt.

Finally, for both humanitarian and political grounds, there is the need to deal adequately with workers that lose their jobs. In many cases privatization will lead to large scale layoffs. If unemployed workers are not reintegrated into the economy, they are likely to resist the privatization process and perhaps derail it.

Raúl Saéz (1993) was largely in agreement of Hoos's assessment of the similarities and differences of the two regions. However, he thought that two other differences should be added. First, LA has a long experience in dealing with foreign investors. Second, economies in LA are not structured on the basis of large vertically and horizontally integrated monopolies, thus making the regulation problem even more

pressing in EE. Despite the differences, he found that they were facing many of the same issues -optimal sequencing, methods of divestiture, choice of buyers, financing of purchase, and the resulting market structure. In all of these areas EE had much to learn from the LA experience.

While he agreed in theory with Hoos's timetable of privatizing small firms first, followed by those in tradable sectors, and then moving on to larger service type firms, he believed that in practice it would probably be necessary to tackle several fronts at the same time. It was also urgent to break up monopolies before privatization and to "renationalize" soe's in countries in which workers and management had taken over de facto. Saéz stressed that once property rights were allocated, it would be very difficult to undo them; accordingly, it was necessary to get them right before privatization and not try to sort them out later.

Along the same lines, he emphasized the importance of regulation, especially of the financial system. Once again if you try to regulate after the fact, special interest groups will have formed which will try to block you. Finally, he noted that the type of divestiture would often play a significant role in the final market structure. Therefore, it was necessary to be thinking of the instruments to be used when looking at the regulatory process.

Three important conclusions follow from our previous analysis of Hoos' paper. First, the most important reasons for privatization in Latin America -economic efficiency, fiscal balance, ideology, market deepening and the spread of capitalism- are also playing a prominent role in Eastern Europe. Second, the problems faced in LA also have their counterpart in EE -concentration of ownership and regulation, methods of divestiture, asset valuation and transparency being the four most important. Third, the major differences are related to the lack of capital, property rights, and an adequate legal and institutional framework in EE. On these last items it is not clear that LA has a lot to offer EE that cannot be more easily obtained elsewhere.

With regards to the challenges and problems which are similar in the two regions, the question then becomes one of scope. Given the much bigger privatization effort

needed in EE, does the LA experience really offer concrete lessons? We think that it does for two reasons. First, the difference in magnitude, while very large, is not as large as it first appears. Much of the private sector in LA depended (and often continues to depend) on government regulation and procurement. One wit has neatly summed it up by saying that in LA it is necessary to privatize the private sector first.[3] Second, while privatization is proceeding much more slowly than envisaged in EE, in some Latin American countries (for example Argentina) the opposite has been the case; therefore, the magnitude of privatization in any given year may not be too different in size and hence, the LA experience could be valuable.

At least LA offers many lessons on how go about and technically do the job. Almost all imaginable types of privatization have been tried, so there is a large pot to draw from. Two additional features that make the Latin American experience valuable are: one, the sequencing and scope of the privatization process have shown a wide diversity, and two, the macroeconomic context within which this process has taken place has greatly varied from country to country.

Mexico, as Hoos has noted, probably has a lot to teach with regards to the sequencing of privatization. Its relatively successful experience was based on privatizing small firms first, and then moving on to larger ones. Cardoso (1991) notes that this learning by doing experience has been quite successful. The case of Bolivia, on the other hand, can give some insights into the relationship between stabilization and privatization. Although as Hoos emphasized, stability makes privatization easier, it has not been the case in Bolivia. Bolivia succeeded in stabilizing the economy in the mid-eighties but, as Morales (1991) describes, its privatization process has been very slow due to a number of familiar reasons: small stock markets, high interest rates, problems of valuation, and worries concerning the concentration of ownership. A more in-depth study of Bolivia could give some insights into the problems ahead for some of the smaller EE countries, such as Bulgaria and Romania, where privatization is going very slowly.

The recent Argentine experience may be another important source of relevant lessons for EE, especially regarding the problem of the trade-off between speed of

3 Glade, as quoted in Cardoso (1991:18).

divestiture on the one hand, and equity and efficiency on the other. Unlike the majority of LA countries, Argentina adopted a kind of big bang approach to privatization. The process has been highly effective in reducing the role of the State in direct production in a very short time span. In the last **three** years practically all existing public enterprises have been sold. The assets divested in the 1990-93 period amounted to 16.2 billion dollars, which represents around 7 percent of GDP (Fanelli and Machinea, 1994). There was not a well pre-defined sequencing in terms of small/large firms or tradable/non-tradable producers and there were no worries about the participation of foreign investors. Given the considerable magnitude of the public property divested as compared to the small size of domestic capital markets, foreign investors have had a prominent role. Foreign investment accounted for 60 percent of the total proceedings from privatization. The Argentine authorities have given priority to the objective of minimizing the duration of the process while maximizing revenues which were, in turn, used to finance the restructuring of the government balance sheet. The bulk of the revenues from privatization were used to reduce the stock of public debt and to finance the public deficit (especially at the beginning of the stabilization plan launched in early 1991). Undoubtedly, the costs incurred in terms of efficiency and equity have been important. Specifically, there was no time to define a sound regulatory framework and the process has led to a greater concentration of property.

It could be argued that, given the lack of capital in EE, many of the LA experiencies are not too relevant and that it seems likely that the heavy reliance on the voucher system, which has been used only marginally in LA, will continue -not so much so as to spread capitalism, but because there are no ready buyers. The argument is basically correct. However, the LA experience shows that if the international situation is favorable, investment funds can be, to a certain extent, endogenously generated by the privatization process. This is obvious regarding foreign direct investment which has played a key role in LA. But funds for investment can also be endogenously generated if the reform contributes to changing the portfolio decision of domestic investors by opening new investment opportunities. In LA, during the debt crisis of the eighties, the high level of international interest rates fueled capital flight and discouraged investment in domestic real assets. This aggravated the lack of investment funds faced by most LA countries and was one of the most important factors restraining structural reforms.

Nonetheless, in the nineties, when the international situation changed, in countries like Argentina the privatization process gained momentum because the fall in the international interest rate turned investment in domestic real assets much more profitable. In a favorable international setting, then, privatization can be a means to stop capital flight by opening investment opportunities in the domestic economy. It is obvious that privatization, by allowing the private sector to buy existing assets, could deviate capital from new and highly profitable projects. But if the latter kind of projects are scarce or do not exist, privatization could be a good way to channel funds which would otherwise be invested abroad. This role of privatization in stopping capital flight can be very important in some EE countries. In Russia, for example, capital flight is absorbing a significant part of the foreign exchange generated by the exports of raw material sectors, as Karagodin highlighted in his paper.

Revenues have been a major concern in many Latin American countries. As noted they have been crucial in closing fiscal deficits in the short-term in many LA countries. However, it is not clear that they have such a strong role to play in EE, partially due to a general lack of capital and partially due to the problems of valuation. Even in LA valuation has posed large difficulties. Part of the difficulty lies in the fiscal deficit itself. Given the macroeconomic instability that usually accompanies large fiscal deficits and the uncertainty about future tax liabilities, it can be very difficult to assess the profitability of a firm. Needless to say, these problems are magnified tremendously in EE where the equilibrium relative price structure and real exchange rate are largely unknown quantities.

Indeed, if the recent German experience is taken into account, it seems that there is a trade-off between the speed of privatization and the importance of its contribution to budget equilibrium. The rapid divestiture process in Germany has generated a mounting fiscal **deficit** which in 1992 was around 1.2 percent of GDP (Schwartz and Silva Lopes, 1993).In sum, despite the enormous fiscal problems facing many countries in EE, it does not seem likely that privatization will play a major role in closing any short-term gaps.

The experience of the Latin American countries also shows that the need to maintain fiscal equilibrium can, indeed, put additional constraints on privatization. In

Hoos' paper and in the literature on privatization, a point which is generally missing is that even successful privatizers like Chile and Mexico have not sold state-owned firms processing natural resources like copper and petroleum. This was so because those public enterprises play a key role in financing the government and its privatization would have required a major change in the tax and expenditure structures. In the case of Chile, for example, a huge part of public expenditures were directly or indirectly financed by the proceeds from copper industries during the debt crisis. The alternative to privatization chosen by the Chilean government was that of decisively improving efficiency in copper production via significant increases in public investment. In the context of the eighties, marked by severe private investment funds scarcity, it seems to have been a wise decision. The Chilean experience can be very relevant for the case of Russia, for example, where oil and other natural resources show great growth potential if the required investment is made. The current context of institutional disarray of Russia, nonetheless, greatly differs from Chile in the eighties and, consequently, the first problem to be solved there seems to be how the government can regain control on the rents generated by natural resources in order to finance both investment and the stabilization process in general. Beyond the differences in the institutional situation in LA and EE, nonetheless, the preceding argument tries to highlight the point that it is very important to analyse not only why public firms were privatized but also the reasons (primarily macroeconomic) why some state-owned enterprises were not divested.

Finally, we would like to mention some areas which we think could have been discussed at further length -the privatization of banks and the related problems of bad debts. One of the biggest challenges facing EE is how to privatize banks given the large portfolio of bad debts that they usually hold. Similar situations have occurred in LA countries -most notably Chile, Argentina and Uruguay in the early 1980s- with a slight twist; that is, the banks were private but had to be bailed out by the government or face the risk of the destruction of the entire financial system. A comparable response in EE would be for the government to assume the bad debts of the firms by, for example, issuing government bonds to the banks when the latter are privatized. As Levine and Scott (1992) argue, while this would have obvious implications for the fiscal deficit, the fact is that the government will have to bail out many of the failing state banks in any case. Their proposed solution could greatly reduce uncertainty and increase the credibility of the reform program.

b. Fiscal Policy

Vratislav Izak (1993) of the Czech Republic analyzed the lessons that EE, with a strong emphasis on the Czech and Slovak Republics, could learn from LA, with an emphasis on Mexico, in the realm of fiscal policy. In his paper he begins with the role of fiscal policy in stabilization, then looks at revenue and expenditure policies in the two regions, and finally discusses tax reform.

Izak found two main lessons that EE should learn from LA with regards to fiscal policy and stabilization. First, tight fiscal policy is a necessary but not sufficient condition for macroeconomic stability. Fiscal balance has never proven enough to bring inflation down to acceptable levels as inertial forces have proven resistant to purely orthodox schemes. Generally some heterodox elements such as "social pacts" or a nominal anchor are necessary. Second, for countries undergoing deep structural changes, attempts to reactivate unused capacity by running a fiscal deficit are likely to just result in high inflation and even lower output. In EE the cost of macro imbalances is even likely to be greater given the large amounts of uncertainty that exist.

The second part of Izak's paper looked in detail at the transition in public revenues and expenditures in Mexico and Czechoslovakia. While the details are available in the paper, some aspects need to be highlighted. First, the reduction in Mexico's fiscal deficit was more due to a reduction in government spending than an increase in tax revenues. This reduction was largely in the area of public investment, transfers, and subsidies. In general, health and education expenditures fared relatively well. In the late 1980s a large decrease in debt servicing was also crucial for fiscal balance. This followed due to the drop in international interest rates, debt rescheduling under the Brady plan, and the fact that the proceeds from privatization were largely used to retire domestic debt. Second, attempts by Mexico in the mid-1980s to move from the inflation tax to a financial repression tax (by forced savings of government bonds at negative interest rates) led to financial disintermediation. When the government moved

to market rates in 1987, the real interest rates were very high with strong negative consequences for future fiscal deficits. Only when it was decided to use the proceeds from privatization to retire this debt were the fiscal accounts put on a solid footing. Izak saw a strong lesson for EE in the Mexican experience as there is a strong temptation for EE countries to move away from money financing into debt financing. If interest rates are unrealistic, the development of financial markets will be hampered; if they are realistic, there will be repercussions for future fiscal deficits. EE countries could then find themselves in the situation of many LA countries in which they need to sell their assets just to pay off past debts.

In the area of tax reform, both EE and LA are trying to copy OECD types of systems. However, the initial conditions are very different. LA tax systems, despite their narrow bases, are anchored in market-based economies. Their main problems have to do with a plethora of exemptions, high inflation, and vulnerability to external shocks. EE tax systems generally treat income very differently depending on its sources and are greatly lacking in transparency. Moreover, the capability to administer taxes commonly found in market economies is almost completely lacking. In this respect, Izak saw one of the main lessons coming out of LA is that you have to deal with administrative and evasion issues right from the start. In some cases you even have to give them first priority.

In his comments Carlos Urzúa (1993) of Mexico emphasized institutional and cultural factors. For example, with regards to tax evasion he believes that the perception by the public that the government is honest is perhaps the most important factor. He also thinks that the VAT will not work well in the less industrialized and less centralized countries of EE and the former USSR. The administrative demands of a VAT are relatively high and it will be difficult to implement in countries which are undergoing a vast number of gigantic structural reforms at the same time.

He also stressed the equity implications of a tax system. Although East European countries may feel that they are already quite equitable so do not have to worry very much about the distributional implications of their tax system, stabilization and structural reforms can have very large distributive effects. As seems to be happening in Russia, for

example, the distribution of income at the end of the process can be very different than at the beginning. Moreover, the instability itself can generate large swings in income distribution. The VAT, in particular, may have significant regressive effects. Unfortunately, there have been no good studies of its welfare impact in Latin America.

From our point of view, the main lessons emphasized by Izak for EE from LA regarding the role of fiscal policy in stabilization are highly relevant. We agree with the dangers of debt financing of the government budget, the necessity for simplifications of the tax system, and the importance of tax administration. We also believe that one of the main lessons coming out of LA is that tight fiscal policy is a necessary but not sufficient condition for stabilization. Indeed, these conclusions are consistent with the ones of the literature on stabilization in developing countries.

It must be taken into account, however, that although there seems to be a certain consensus in the literature on the fact that inertial forces are generally too strong to be tackled by fiscal policy alone, this by no means downgrades the importance of fiscal balance. In a paper in which he compares some of the experience of Eastern Europe, Latin America, South Korea, and China, Solimano (1992) notes that the last two have often had large current account deficits, like LA, but have always kept the fiscal deficit within manageable bounds. Fanelli et. al. (1991) also shows that the stability and growth performance of LA countries during the debt crisis was tightly correlated with the evolution of the fiscal deficit and the quality of fiscal policies. During the eighties, Chile and Colombia, which showed a much better performance in terms of stability and growth, were able to bring the fiscal deficit under control and administered taxes and expenditures in a more efficient way as compared to Brazil and Argentina. The latter two countries did not succeed in sufficiently reducing the fiscal deficit and, therefore, were unable to stabilize their economies in spite of the significant adjustment effort made in terms of reductions of domestic absorption.

One point that deserves to be emphasized is that the control of the fiscal deficit in LA is so important because of the weaknesses of the financial structure. Even ignoring the possible negative effects of large deficits on the real side of the economy, the fiscal disequilibrium cannot be large if there is a low degree of financial deepening. Given the

smallness of the market for government bonds in the typical LA scenario, debt financing causes a rise in interest rates which has strong repercussions on future deficits as well as crowding out private investment. In a situation where credit is rationed, the latter factor becomes all the more important. Dornbusch (1990) has argued that tight money is no substitute for fiscal reform. A restrictive monetary policy in the presence of a high deficit tends to increase interest rates which make the deficit worse due to the interest that must be paid on outstanding government debt and any new borrowing. If we take into account that the degree of financial deepening and of financial fragility is worse in the typical EE country than in LA, it is clear that there is a lot to learn from both the mistakes and the achievements of LA countries regarding the coordination of fiscal and monetary policy.

The lack of independence between fiscal and monetary policy in a context of low financial deepening suggests that the implementation of the fiscal reform in EE cannot imply the generation of (even temporarily) large fiscal deficits. As was the case in many LA countries in the past decade, this means that it is possible that effectiveness in tax collection must be given priority over efficiency. Izak noted that much of the success of LA tax reform was coupled to administrative changes. Despite the intent, it seems likely to us that it will be some time before most EE countries can have a structure similar to the OECD countries. Even the VAT, which is the centrepiece of many fiscal systems in LA, can be quite difficult to administer and typically has a long gestation lag. Numerous authors, including Burgess and Stern (1993), argue that a country should only move away from trade taxes to a VAT if the administrative capability exists. Given that the World Bank estimates that the administration costs of tariffs are 1% to 3% versus 5% for VAT and 10% for income taxes in a typical developing country, this appears to be good advice.[4] One would expect, in particular, that VAT costs of administration would be much higher than average in most EE countries. One of the recommendations coming out of an IMF seminar on transition economies was that it is very difficult to move to an optimal tax structure. In the short-term the countries should raise taxes however they can.[5] Once again Bolivia may have an important lesson here. When the government managed to quickly bring down hyperinflation, they enacted very heavy taxes on petroleum products

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[4] As reported in Greenaway and Milner (1991).

[5] See the IMF Survey, July 26, 1993.

in order to quickly reduce the enormous fiscal deficit. These have been replaced slowly over time by more conventional taxes.

Indeed, the necessity for a tight control on the fiscal deficit put severe constraints not only on fiscal reforms but on other structural reforms as well. Given the underdeveloped administrative capabilities of the tax bureau in Bolivia, if the government had privatized the petroleum company, it would have lost its only available instrument to achieve a rapid improvement and a better control of tax collection. According to Solimano (1992) there are liberalization measures acting in favor of budget equilibrium -such as the conversion of quotas to tariffs- which must be implemented at an earlier stage; but there are others like financial liberalization which -via increase in the interest rates and/or financial crisis- can have huge fiscal costs and consequently must be postponed.

One point that we would like to emphasize in addition to those raised by Izak is that the quality of the fiscal reform not only affects stability but also the growth potential of the economy. Particularly important is the fact that in LA after the debt crisis, those countries which were able to avoid strong and sudden reductions in public investment during the adjustment process were those which grew at a higher rate (Fanelli et. al. 1992). For example, Colombia and Chile recovered growth first and grew more than Argentina and Mexico even though the latter two countries implemented policies aimed at curtailing the fiscal deficit which were as severe as those implemented in either Chile or Colombia. The crucial difference was that Colombia and Chile managed to maintain the level of tax collection throughout the crisis and, consequently, were able to maintain a reasonable level of public investment without hampering budget equilibrium. In Argentina and Mexico, on the contrary, the crisis induced severe reductions in tax collection and, therefore, the only way to achieve reductions in the fiscal deficit was that of strongly undercutting public expenditures. Under such circumstances, public investment was the item which suffered the greatest fall because reductions in other current expenditures were much more difficult and conflictive from the political point of view. It seems that, in countries lacking a good infraestructure like those of the LA and EE regions, public investment plays a crucial role in supporting private efforts during the growth process.

In addition to the constraints posed by the necessity to avoid the collapse of public investment, in some EE countries and particularly in Russia, there is likely to be strong pressure to increase expenditures because of two factors. The first is environmental protection. For decades, the EE countries have been following a development strategy which has largely ignored ecological constraints and, as a consequence, environmental problems have currently reached a critical point. In a recent paper Zhukov (1994) estimates that in the case of Russia, a program for the treatment of dangerous nuclear and chemical weapons and for the protection of the population from Chernobyl-type reactors would cost around 3.5 percent of Russia's GDP per year. Total direct environmental expenditures in Russia at present are only 1.2 percent of GDP. A second factor that will probably have a strong effect on the budget equilibrium in the undergoing period of transition and political democratization is the process of redefinition of fiscal responsibilities between central and local governments. The experience of LA can again be valuable regarding this. Chile achieved a sustainable fiscal equilibrium, but expenditure and tax policies are designed and implemented in a highly centralized way. Brazil, on the contrary, is undergoing a period of strong fiscal disarray largely due to the fact that, after the reform of the Constitution in 1988, there was a dramatic increase in the local government's autonomy regarding expenditure decisions. In the case of Russia, in particular, the definition of a new and sustainable financial base for federalism (i.e. for the relationship between the Oblasti and the central government) is surely one of the most important issues on the fiscal reform agenda (Litvack and Wallich, 1993).

Finally, we would like to stress two items that were not given prominence in the paper by Izak -the interaction of macroeconomic reform and tax reform and the quasi-fiscal deficit. Tanzi (1989) has argued that the effects of macroeconomic reform on the fiscal deficit can easily swamp any changes arising from tax reform. In particular, this can be the case if there is a change in the real exchange rate, given that many government assets (rents on raw materials) and liabilities (foreign debt) are tightly linked to this variable. For example, Perry (1992) reports that devaluation in Argentina, whose government was a net external debtor, from 1980-83 directly cause the fiscal deficit to rise by 3.2% of GDP. On the other hand, devaluation in (net creditor) Chile from 1982-85 directly caused the fiscal deficit to fall by 7.1% of GDP! Likewise, price liberalization

oriented to correcting relative prices can result in the acceleration of inflation, as was the case in many EE countries, particularly in Poland and Russia. Via the Olivera-Tanzi effect, there could be sizeable reductions in the tax burden. In Argentina during the eighties, for example, the Olivera-Tanzi effect induced reductions in tax collections of more than two percentage points of GDP in periods of inflation acceleration.

The deficit generated by the Central Bank due to such occurrences as subsidizing foreign exchange and interest rates or supporting failing commercial banks has often been enormous in Latin America in the 1980s. However, one suspects that given the bad debt problem referred to above with respect to privatization, this quasi-fiscal deficit problem is only going to really come into its own in Eastern Europe. There are two obvious lessons from LA on the subject, both somewhat facile. First, the government should not try to hide it by not presenting consolidated accounts which include the financial sector. Second, it should take it very seriously right from the start. However, it is not clear that LA has any more concrete lessons for EE on the subject, given that the magnitude of the problem, both with regards to the bad debts and the lack of financial institutions, is far beyond anything that countries in the former region had to deal with.

c. Monetary Policy

Nikolay Karagodin (1993) of Russia was the author of the paper on the lessons for Eastern Europe, with a strong emphasis on Russia, from Latin America. More than the first two papers that we have looked at, his analysis focused very much on stabilization policy as a whole, although much less on structural adjustment. He begins by examining the different types of stabilization policies in Latin America -orthodox, heterodox, and what he calls a pragmatic combination. He then analyzes in more detail the Southern Cone experience of the late 1970s. The last two sections are on the conditions for a sustainable stabilization and the failed monetary reform in Russia in 1992.

Karagodin asks whether austerity is enough for stabilization and finds that in LA the answer was no. Inflation inertia and the related problems of credibility and coordination prevented inflation from reaching the desired levels. As people often

expected the programs to fail, prices and wages were set on this basis. Moreover, no one wanted to be the first to cut the rate of increases of his prices or wages. To make matters worse, stabilization plans were often accompanied by programs of structural reform -in particular, trade liberalization. Generally, this led to real exchange rate depreciation which not only put more pressure on the rate of inflation but the fiscal deficit is often closely tied to the exchange rate.[6] The main lessons for EE to learn from the experience of LA with orthodox programs are: (i) Money-based stabilization plans have a high cost in terms of output and employment; (ii) Attempts to stop moderate inflation with an orthodox plan in countries with a long tradition of indexation are unlikely to be successful; and (iii) Floating exchange rates are not very compatible with price stabilization due to their direct effects on inflation, the effects on the fiscal deficit, and the instability that they are likely to generate, including speculative runs on the local currency.[7]

Before looking at more obvious heterodox plans, Karagodin analyzes a number of exchange rate based orthodox stabilizations. While these were mostly more successful than the first group, they almost always led to problems because of the real appreciation that they entailed. As domestic inflation generally did not come down completely to international inflation rates, the exchange rate slowly and surely appreciated. Often there were consumption booms of imports in anticipation of a future depreciation. While generally in favour of such plans, Karagodin's main conclusion is that a fixed nominal exchange rate cannot be used as an anchor for too long and eventually the country must replace it with other instruments, such as a crawling peg combined with more traditional monetary and fiscal instruments.

Finally, on the subject of orthodox stabilizations, he notes that in the cases of the two successful orthodox stabilizations there were very definite reasons for their success. In Bolivia you had a country without a history of high inflation which was suffering from hyperinflation. As the country had become almost completely dollarized, fixing the exchange rate was almost enough in itself. The Chilean success of 1983-84 not only

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6 For a detailed discussion of this issue, see Tanzi (1989).

7 See Karagodin (1993:8). Note that at the end of each of the first 5 sections, Karagodin contains a summary of the lessons for Eastern Europe from Latin America.

followed a long period of austerity but was greatly helped by the fact that a depreciation of the currency had very positive repercussions for the fiscal deficit due to the importance of the state copper enterprise, CODELCO. In both cases the country was also very much aided by either large inflows of external aid (Bolivia) or debt rescheduling (Chile). These developments gave the governments more time to deal with the long-term fiscal deficit problem.

In the section on heterodox stabilization, Karagodin mainly discusses the failed Austral and Cruzado plans of the mid-1980s. He notes that the early success of these income policy based plans was soon loss due to the misalignment of relative prices. Nevertheless, there is a lesson to be learned in that the plans were able to bring inflation down quickly without the customary recession. However, it is necessary to quickly move to fiscal and monetary restraint in order to support the plans. In particular, little was done in either Argentina or Brazil during these plans to address the problem of the fiscal deficit.

The next section looks at two plans which contained (or contain) a pragmatic combination of heterodox and orthodox elements -the Mexican stabilization of 1987 and the Cavallo plan which began in 1991. The plans had a number of similarities, including nominal exchange rate anchors- although a crawling one in the case of Mexico, an emphasis on trade liberalization to keep inflation down, and tight monetary and fiscal policies. The main differences were the importance of a tripartite social pact in Mexico and the introduction of the Convertibility Law in Argentina. This law obliged the government to convert Argentinean pesos one for one for American dollars and was meant to give confidence in the peso and the continuity of the plan. While both plans have achieved a great deal of success, they have led to real appreciation of the exchange rates in both countries and very large current account imbalances. The lessons that Karagodin (1993:20) draws for Eastern Europe are: (i) A stabilization plan needs to use all the available tools at the country's disposal and should be tailor made; (ii) While it may be necessary to limit the flexibility of some key prices, this should not be overdone; (iii) A social pact is a useful way of distributing the costs of stabilization; and (iv) Too much import liberalization can threaten external equilibrium and ultimately destroy the stabilization plan.

In his discussion of the Southern Cone experience of the late 1970s, Karagodin highlights a couple of elements. First, full liberalization of interest rates during a period of high inflation generally leads to very high real interest rates. Second, liberalization of external capital flows before domestic stabilization can lead to enormous swings in the capital account of the balance of payments -depending on the current state of expectations. If in addition real interest rates are high, the situation becomes especially destabilizing.

In the next section Karagodin discusses the important social and political aspects necessary to sustain stabilization. Stabilization is an exercise in coalition building. There are generally severe or significant effects on output and employment so it is necessary not to alienate too many important social groups. A strong executive power also seems to be a prerequisite as it is needed to make unwilling social groups make the necessary sacrifices. While the type of government does not seem very important, countries in the transition to democracy must carry the extra burden of dealing with the pent-up distributive expectations. In addition, some groups will probably have to be compensated for their losses. On all of these fronts, stabilization is made easier if there is sustained external financing.

In his analysis of the monetary reform of Russia which began in January, 1992, Karagodin first points out that it was very similar to orthodox plans in LA, with many of the same results. The failure of the tight monetary policy to bring down inflation was due to a number of reasons: (i) High degree of monopolization. In monopolized sectors, prices went up and quantities down; (ii) Prices of raw materials, which historically had been held well below international prices, rose rapidly; (iii) Very tight credit policy resulted in a huge increase in real interest rates; (iv) Given the uncertainty and the general lack of credit, investment fell dramatically; and (v) The problems in military industries were even worse as demand dropped off enormously.

Instead of inefficient producers dying, there was only a big accumulation of arrears to suppliers. In fact, other industries were not allowed to stop supplying bankrupt customers. Finally, in mid-1992 there was a need for a massive monetary injection to

provide the credit for these bankrupt firms and inflation soared.

Karagodin sees a number of lessons from LA directly for Russia. First, stabilization via monetary instruments is not enough. It is necessary to obtain fiscal balance and also stabilize the exchange rate. However, these are both very difficult in present day Russia as much of the economy -and accordingly much of the taxable income and foreign exchange- is in the underground economy. Even in primary products, which are the main source of foreign exchange, most of the profits are going through illegal channels and ending up in foreign bank accounts. It is imperative, according to Karagodin, that Russia greatly curtail capital flight.

Second, given the giant fall in production which is inevitable during the transition process, Russia needs access to large amounts of external aid. Without such resources, the costs will be too high and there will be too much opposition to the reforms.

The third lesson from LA which seems especially pertinent to Russia is the need for a strong executive power. Since the transition process began, Russia has been plagued by a series of weak governments which are not able to push any reforms through without seriously compromising their goals. Only an executive which is able to bring together the disparate elements into some form of social coalition seems likely to succeed in the foreseeable future.

José María Fanelli (1993) from Argentina first noted that while external support was often necessary for a successful stabilization plan, it was only forthcoming if the plan was orthodox -and these did not have a very good track record. He argued that the sustained stability that many LA countries have recently experienced has been due to the renewed availability of external credits, much of which due to the low U.S. interest rates.

He also believed that Russia had much to learn from LA on sequencing as it was structurally adjusting in a situation of macroeconomic disequilibrium, a juggling act often performed in LA. In such situations structural reforms were often pursued primarily because they reduced the macro imbalances. Structural reforms are often at odds with

market liberalization -for examples, the Convertibility Plan in Argentina, the de facto nationalization of Chile's financial system in the early 1980s, or the Mexican social pact with its tight controls on prices and wages.

Finally, he argued that Russia should put its efforts in market creation, not market liberalization. In a country where there are, for example, no short-run financial assets to hedge against inflation or long-run assets for the smoothing of government expenditure, it was a bit facile to speak of freeing markets and makes many of the questions traditionally examined under the heading of stabilization policy rather meaningless. To meet these challenges the state would have to play a large role in the upcoming years; hence, the need for a strong executive power existed.

We will now discuss some qualifications and extensions to Karagodin's paper. Given the underdeveloped character of the financial system in EE countries, monetary policy has a limited role to play and financial liberalization is almost reduced to the liberalization of external capital flows. However, there are a few more specific points that we would like to bring out[8].

Karagodin, in particular, stressed the fact that a money-based stabilization had little success in Latin America at a very high cost in employment and output. Inertial factors were usually so important that the monetary brakes could not do the job. Whether this is the case in EE will depend on the importance of inertial factors in these countries coupled with the expectations generated. While in general one would expect the former to be much less serious in EE, the negative expectations caused by any further deepening of the current depressions could be disastrous.

The most pressing immediate problem that most EE countries faced in the monetary sphere was the large monetary overhang caused by the years of queuing and rationing. These overhangs caused price shocks of various sizes when prices were liberalized. The belief (or hope) was that these would be once-and-for-all jumps which

[8] We will not exhaust the issues related to monetary and financial policy here. Many of the pertinent issues will be covered in the next two subsections on the external sector and stabilization and structural adjustment.

would result in a new equilibrium where the demand and supply of money were in equilibrium. However, in many cases, this has only happened slowly or, as in the case of Russia, is not happening at all. LA has only one good example to offer with regards to this problem -Chile in 1973. With a monetary overhang of about 500%, the government tried to get rid of it via price liberalization but without monetary reform. There was a large price jump, followed by several years of high and moderate inflation. Inertial factors proved too strong and the relatively closed economy of the time meant that international prices did not play a decisive role in keeping inflation down[9].

But, even if the monetary overhang problem were resolved in one way or the other and/or the inertial factors were not important, one question would still remain: Is it possible for EE countries to have a monetary policy in the sense in which this policy tool is usually conceived of in a capitalist economy? In order to assess this question, there are three features of the financial system in the EE countries which are likely to be present for a long time and hence must be taken into account.

The first is the lack of a developed market for government bonds. As was mentioned before, it is very difficult to think of an independent monetary policy in a context in which the reduced size of the bond markets render open-market operations and/or the financing of the deficit via bonds non-feasible in practice. The LA experience -characterized by the difficulties to develop wide bond markets- teaches us that, beyond the obstacles posed by inertial factors, more often than not monetary restraint fails simply because monetary authorities cannot keep the monetary base under control. The most frecuent reasons for this are two. On the one hand, tough monetary policies tend to be recessionary and the fall in the activity level widens the fiscal deficit. This is reinforced by the fact that in the typical stabilization package, monetary restraint is normally accompanied by devaluation which is contractionary in LA. Under such circumstances, the impossibility of fulfilling the government's borrowing needs in the domestic credit markets ultimately leads to the monetization of the deficit and hence to the loosening of monetary policy. On the other hand, it is normal that monetary restraint results in marked increases in interest rates. In a context of very low financial deepening, this usually induces large financial disequilibria in the banking system and the Central Bank is

[9] See Edwards (1991) for an analysis of this experience.

obliged to act as lender of last resort thereby relaxing the control of monetary aggregates. In LA, this monetary trap can only be by-passed if the stabilization package is supported by foreign credit -making it possible to finance the deficit by means of increasing foreign indebtedness- and/or if the devaluation has a positive effect on the fiscal budget. Brazil and Argentina -with their tax structures tightly related to the domestic activity level- are the best examples of the difficulties for having an independent monetary policy, while Chile -and to a lesser extent Mexico- represents the opposite case because of the positive fiscal consequences of devaluation. If one takes this into account, Sachs's recent dramatic complaints regarding the lack of external support to Russia's stabilization effort can be easily understood (Sachs, 1994).

The second feature of the EE economies that casts doubts on the effectiveness of monetary policy is the lack of a suitable definition of property rights. The existence of a "grey zone" regarding property rights implies that there is no clear definition of the agent's budget constraints. This tends to create an economy populated by agents facing a "soft" budget constraint. Given that monetary contraction can only restrain effective demand by tightening the budget constraint, if the latter is ambiguously defined, contractionary monetary policy is likely to have no effects in reducing expenditures. The "bad debts" problem is the most important manifestation of this fact. In the textbook example, monetary contraction creates an excess demand for loanable funds in the banking system which is supposed to generate a deflationary trend by inducing an excess supply for goods. But, if the agents can "finance" their expenditures by forcing state banks or other public enterprises to accommodate any demand for credit, it is obvious that the excess demand for loanable funds will never occur. The recent failure of the Gaidar stabilization attempt in 1992 in Russia is a good example of this point. The program, based on monetary restraint as a means of stabilization, led first to the accumulation of bad debts and afterwards to the loss of control of monetary expansion by the authorities which were ulimately obliged to validate inflation (Karagodin, 1993; Ofer, 1992).

The third characteristic we would like to highlight -as a constraint to monetary policy- is the tendency for the economy in many EE countries to increase its dollarization due to the absence of domestic assets that can act as an effective inflation hedge. The

question of allowing the economy to dollarize is one that many countries in LA and EE have had to confront. One of the main reasons for allowing dollarization is to reduce capital flight. However, dollarization and capital flight have similar results in that they both reduce the domestic monetary base -either by increases in velocity or simple substitution- and reduce the amount of the inflation tax. Therefore, a country dependent on revenues from this source will have to be careful as to how it moves. Although the end result may be similar, the higher transaction costs of capital flight may make this the preferred option. Dornbusch and Reynoso (1989:89) also argue that dollarization makes the domestic banking system very vulnerable to devaluations and tends to lead to an overvalued exchange rate. The experience from Latin America suggests that dollarization can be very helpful for stabilization but it generally means that most bank deposits will be in foreign currencies until full credibility is restored to the economy.

It must be taken into account, nonetheless, that the authorities are not likely to be free to choose whether to dollarize the economy or not. The LA experience of the eighties seems to show that some degree of dollarization is an inherent feature of highly unstable contexts and, what is more important, that dollarization tends to remain even after a successful stabilization. In many Latin American countries (Uruguay, Argentina, Peru and Bolivia) during the years of high inflation which followed the debt crisis, there was a huge reduction in the demand for money and a permanent increase in the demand for foreign currency. This feature did not disappear in Bolivia and Argentina after the inflation rate was dramatically reduced. The Argentine case is particularly relevant regarding this. After three years of stability, the inflation rate is now around five percent per year. The fall in the inflation rate induced a marked remonetization of the economy. The process of remonetization, nonetheless, has shown two important features that suggest that the consequences of the previous crisis has been only partially reversed. First, the liquidity coefficient in pesos is currently lower than what it was when the inflation rate was one hundred percent per year. Second, the most dynamic component of the demand for domestic assets was the demand for dollar-denominated deposits (the so-called "argendollars") and therefore the major part of the newly generated credit is also denominated in dollars. As a consequence, dollar-denominated financial assets at present account for more than 50% of total domestic financial assets. In sum, a kind of hysteresis effect acting against the recovery of the demand for domestic assets seems to

be present in the post-stabilization period. A similar story could be told in relation to Bolivia and, **mutatis mutandis**, for the cases of Uruguay and Peru.

The irreversibility of the dollarization process -and of its counterpart, the fall in the demand for domestic assets- brings further constraints to the implementation of an effective monetary policy into the picture. It is obvious that, since the Central Bank only controls the supply of pesos, the greater the degree of dollarization, the more reduced the capacity to implement an independent "national" monetary policy.

From what we are saying it follows that it is necessary to implement a deep change in the EE countries' financial structure, not only to allow a better allocation of resources but also to make stabilization easier. Is financial liberalization a feasible alternative? From our point of view, financial liberalization does not appear promising in the current situation of most EE countries.

The Southern Cone experience of financial liberalization resulting in high interest rates has been repeated in a number of Asian countries, with similar results of lots of bankruptcies and the need for a government bailout of the banking system. In their large study of financial liberalization in Asia Cho and Khatkhate (1989) argue that it should never be used as a stabilization device as it will just make things worse. The question for us is how relevant this is for EE with its very underdeveloped financial system. Leite and Sundararajan (1990) argue that if there are many other market imperfections, interest rate liberalization will result in a very wide spread. It is also likely to be necessary to restructure many banks that would fail due to a liberalization of interest rates. The speed of the reform should depend partly on the ability of the government to recapitalize weak institutions and design and introduce new monetary instruments, particularly those that can act as an inflation hedge.

Attempts to liberalize the financial systems in Eastern Europe have seemed to stumble upon other more important obstacles. First, in countries which have broken up large state banks, the new smaller institutions have often become associated, officially or otherwise, with certain firms and sectors, resulting in a Chilean like situation where firms are lending to themselves through the banks they control. In addition, credit restrictions

have been circumvented, as Karagodin noted above, by interenterprise trade credits. In Russia, for example, firms are afraid that if they do not give these credits, their suppliers will go bankrupt and they will be unable to continue as they do not have access to foreign exchange[10]. Once again it seems that the bad debt problem has to be cleared up before this difficulty can be adequately addressed. Perhaps, Fanelli and Frenkel (1992) are correct when they comment that a well-developed financial sector is more an indicator of development than a causal factor.

d. External Trade and Finance

Andrzej Slawinski (1993) discussed the lessons for Eastern Europe, with a strong emphasis on Poland, from Latin America in the areas of external trade and finance. Similar to Karagodin, above, his analysis was very much centred on stabilization, emphasizing however the role that the external sector could play in the stabilization process. His paper first looked at adjustment policies in LA, then in Poland, and finally he addressed the question of the lessons learned.

In his introduction, Slawinski (1993:3) says that: "The main lesson for Eastern Europe [with regards to the external sector] is that external liberalization goes through a long period of stabilization". He bases this conclusion on his subsequent analysis that whenever stabilization failed, there was backsliding on the liberalization of the external sector. He begins this analysis with a long section on the Southern Cone experience in the late 1970s and early 1980s, focusing on Chile and Argentina. He saw a number of lessons for EE in these "experiments". First, liberalization with underdeveloped financial markets can lead to misaligned relative prices, especially the exchange rate and interest rates. Second, capital market liberalization if it leads to inflows can cause an exchange rate appreciation which moves production to non-tradables, the exact opposite intent of the original move to trade liberalization. Third, without control of the fiscal deficit, trade liberalization has very little chance of success. Fourth, and by far the most important, the Southern Cone experiments showed that an attempt to stabilize via external liberalization and "the law of one price" is much more difficult than believed at the time due to the

[10] See the World Bank Country Report on Russia (1992).

problems of overshooting and expectations.

Slawinski next looks at the cases of Brazil and Mexico in the 1980s. In the first half of the 1980s Brazil tried a number of attempts at orthodox stabilization based on tight monetary policy and big devaluations. Despite major success in the current account, inflation remained very high due to indexation. That is, one had a case of very successful trade liberalization which did not stabilize the macroeconomy. A big part of the Mexican stabilization plan in 1987 was trade liberalization. Unlike in the Southern Cone about 10 years earlier, the law of one price seemed to hold. However, a great deal of this success was due to the tripartite social pact which was negotiated at the same time as the trade liberalization. In the earlier cases of Argentina and Chile there had been no agreement on how to distribute the costs of liberalization and stabilization. A lesson that comes out of the comparison of Brazil and Mexico, in addition to the importance of some sort of social consensus, was the important role that external debtors can play. Mexico was given substantial debt relief at the time of its stabilization cum liberalization policy, while Brazil found itself with no external support and no possibility of significant capital flows.

The 1990s is a period in which we are seeing an increasingly successful integration of LA economies with the rest-of-the-world. Trade liberalization and stabilization have been completed successfully (or almost so) in more and more countries of the region, and have usually reinforced one another. Their success has been to such an extent that large capital inflows have come to the region, significant portions of which are going into investment in most cases. The only large negative factor is that there has been as strong appreciation of the currency in many countries, supported by these inflows, which is making it more difficult to export. However, in many cases this may be more a sign of maturity as the economy is moving towards a new long-run external equilibrium and should not cause undue alarm.

In the early 1990s Poland experienced much of the same history as Brazil on the external front. It had a huge foreign debt and high inflation -which was hidden in the form of a large monetary overhang. Large devaluations in the early 1980s helped out tremendously with the trade balance but the government was unable to get the fiscal deficit and monetary situation under control. Also, similar to Brazil, debt servicing was

putting an enormous burden on the fiscal deficit.

In 1989 the government began the first large scale reform of the economy. In short order the country was experiencing hyperinflation due to the large rise in liberalized food prices, the introduction of wage indexation, and, most important, the premature liberalization of the foreign exchange market. The latter led to widespread dollarization, reducing tremendously the monetary base from which to obtain the inflation tax. The end result was the foreseeable hyperinflation.

In 1990 a tough adjustment plan called the Balcerowicz plan was introduced. Wage indexation was restricted, financial policies were very restrictive, and a convertible currency was introduced with a fixed rate of exchange with the US dollar. The intent of this plan was to reduce domestic absorption and free up resources for export, very similar to Mexico and Brazil in the 1980s. By limiting wage indexation and restricting access to credit, firms were forced to export. However, the success of such a plan depends a great deal on the ability for firms to redirect their sales from domestic to foreign markets as well as a high mobility of factors of production between sectors. The recessions characteristic of Latin America in the 1980s were partially due to the fact that these conditions were only partially fulfilled. In EE economies such as Poland, they were hardly fulfilled at all. The result was a very large fall in production. Nevertheless, inflation was reduced tremendously and the current account deficit moved into surplus.

Very shortly, however, the government found itself in a situation which many LA countries had experienced -the exchange rate was slowly appreciating. To slow down the appreciation of the exchange rate and the deterioration of the current account, the government introduced a crawling peg. However, the rate of devaluation was slightly less than inflation, so the problem persisted. The government was reluctant to devalue the currency as it had not been able to get the fiscal deficit under control and a devaluation would add to the cost of debt servicing. At the same time, expectations of a devaluation led to high real interest rates, pushing many firms towards bankruptcy. In many cases the only source of funds for firms was its own export earnings. It was beginning to look like the Southern Cone syndrome all over again.

In April, 1991 Poland received a debt reduction package equal to about 50% of the present value. This greatly relieved pressure on the fiscal deficit and provided a very positive signal for foreign investors. The latter was especially important for Poland because at the time almost the entire amount of domestic credit was going to finance the fiscal deficit (as the inflation tax was very much circumscribed by the convertibility of the currency). Due to the shortage of domestic credit Poland is consciously not learning one of the lessons of LA; that is, capital market liberalization should be the last in the sequence of reforms. At a minimum, however, Poland should learn from LA that it should do its best to discourage very short-term, highly speculative inflows.

In his comments Marcelo Abreu (1993) of Brazil first remarked that Brazil could probably learn some things from Poland, although it was currently the exception in Latin America. Nevertheless, there were some important lessons from the numerous Brazilian failures of the 1980s for EE: (i) Pure monetarist policies are inefficient in a highly indexed economy; (ii) It is much easier to overcome a foreign exchange constraint than a fiscal constraint; (iii) The failure of one stabilization plan makes the next one all the more difficult; and (iv) High inflation makes it more difficult to persist with other elements of the reform package. As Slawinski noted, the way to external liberalization is through a long period of domestic stabilization.

He also noted that some of the countries in LA and EE which had succeeded or seemed to be succeeding had received favourable debt deals. He also put great emphasis on the fact that in Chile and Mexico economic reform had preceded political reform while in Brazil they are trying to do the reverse. He drew a parallel between this situation and the Russia versus China case. Nevertheless, in EE there was often massive political support for policies which moved away from those of the previous communist governments. He noted that economic good behaviour is generally quickly rewarded by the international business and financial communities, while political good behaviour is much less so.

Of all of the authors, it is Slawinski perhaps who has put more emphasis on the problems of sequencing faced by reform policies. In the area of trade and financial flows liberalization, he drew a number of very strong lessons for EE from LA. These include the

importance of macroeconomic stabilization beforehand, the negative effects of the liberalization of capital markets in terms of exchange-rate appreciation, the difficulties of stabilization based on trade liberalization, and the interdependence of the real exchange rate and the fiscal deficit.

The ironic part of his analysis is that at the end of the day he admits that Poland cannot follow one of the main lessons from LA. It needs foreign capital so badly that it has to liberalize capital markets a great deal and risks the danger of an exchange-rate appreciation which could offset its drive to increase exports. However, the evidence to date in EE suggests that the capital inflows are not going to be anywhere near the magnitude which entered LA in the late 1970s or early 1990s. The more real danger seems to be that of inflation being significantly above zero with a fixed exchange rate (or being higher than the sliding peg). Although it must be taken into account that either by wisdom or "luck" (i.e. because macroinstability during the liberalization process had induced an overshooting of the real exchange rate in relation to its equilibrium level), the "fixed" exchange rate in some EE countries, such as the Czech Republic or Poland, seems to have started at an undervalued level, which has considerably reduced any damage caused by a subsequent real appreciation.

We believe, nevertheless, that the dangers of real appreciation during the adjustment process should not be underestimated. It can determine the success or failure of important reform policies. This is specially so regarding trade liberalization because there is one important lesson from LA which does not seem to have been learnt by EE countries. In spite of the fact that in LA rapid trade liberalization with regards to both imports and exports had generally resulted in a short-run current account deficit of considerable magnitude, EE countries have put into practice ambitious programs of trade liberalization. Bruno (1992) and Solimano (1992) both argue that EE should have moved more slowly on tariff reduction, a move which likely would have been politically acceptable, both domestically and internationally, given the frail nature of their economies and the OECD barriers which they are facing themselves. In general, there was excessive optimism about the speeds of response to trade liberalization on the export side. Perhaps the reason for moving so quickly on tariff reduction was to try to reduce inflation by the "law of one price". However, a fairly flat tariff structure could have

done the same; that is, the law of one price plus, for example, 30%. In discussing the adjustment of the Russian defence-related enterprises Kuznetsov (1993) also suggests that during the restructuring process, some degree of protection via tariffs may be required. Given that the reallocation of productive factors is not instantaneous, the idea is to encourage factor reallocation by giving firm signals that there will be strong tariff reductions in the future while maintaining some protection in the short run in order to minimize the costs in terms of unemployment and the destruction of human capital. It could be argued that direct subsidies to the firms in the restructuring sectors would be better. However, in the present context of high fiscal deficits, institutional disarray and low administrative capacity of the state, this alternative does not seem to be feasible. Indeed, it is precisely because of this latter reason that exchange-rate appreciation should be avoided. A high exchange rate -not costly from the administrative point of view- is a suitable tool to protect those parts of the industry which deserves to be restructured. Furthermore, the higher the real exchange rate, the lower the level of tariffs required to protect potentially viable sectors.

Regarding restructuring and competitiveness, there are two additional lessons for EE from LA that deserve to be mentioned here. First, there is the general one, stressed by authors as diverse as Cooper (1991) and Helleiner (1990), that one of the most important factors in export expansion is the maintenance of a stable real exchange rate. Second, Meller (1992) indicates the role that promotion of non-traditional exports has played in the adjustment of the Chilean economy. In particular, he focusses on the forestry, fruit, and fishery sectors.

Slawinski has noted that Poland has found itself in an uncomfortable situation concerning the relationship between the level of the exchange rate, the current account deficit and the fiscal deficit. As we have noted, one of the strongest lessons to come out of LA was the importance of the relationship between a real devaluation and the fiscal deficit. Poland belongs to the group of countries whose government is a net external debtor, which means that a devaluation, which presumably helps the current account, hurts the fiscal deficit. Therefore, it has had to play a careful balancing act in this regard. Abreu would probably recommend that they worry much more about the fiscal deficit, turning their attention to the current account once the latter problem is on a firmer

footing. Although a good advice -specially if Brazil's experience is taken into account- it should be carefully assessed.

As has normally been the case in LA, the policy dilemma regarding the "correct" level of the exchange rate faced by the Polish government is very difficult to resolve. Specially if political economy considerations are brought into the picture: a lagging exchange rate is tempting because it can improve the fiscal situation "without visible social costs". In spite of this, the authorities should not lose sight of the fact that, in the long run, the social costs -particularly in terms of high unemployment- can be very high if real appreciation makes the required restructuring of the industrial sector more difficult or if it leads to an unsustainable current account deficit.

Indeed, the recent evolution of LA shows that this problem is far from easy. The question is not qualitative -i.e. to choose between fiscal and current disequilibrium- but one of degree: to follow an exchange-rate policy capable of maintaining an acceptable degree of macrostability in terms of the fiscal gap and inflation without hurting the economy's competitiveness. The evolution of economic policy in the nineties in Brazil and Argentina exemplifies two polar cases regarding this. Brazil has chosen to privilege external competitiveness via the maintenance of a high real exchange rate and, as a consequence, is the only important LA country today which shows a sizeable trade surplus. The costs of this policy in terms of fiscal disequilibrium and inflation have been very high. Argentina, in contrast, has managed to induce a strong disinflation and to achieve fiscal equilibrium following a policy based on a nominally constant exchange rate. The appreciation of the exchange rate which has resulted from this policy has brought about a large and increasing current-account disequilibrium. This strategy is highly risky because the country's vulnerability to external shocks -i.e. to a reversion of present large capital inflows- is very high. It seems that the optimal response to the trade-off between fiscal and current account equilibrium must lie somewhere in the middle of the road between these polar cases.

III. BY WAY OF CONCLUSION:

STABILIZATION, STRUCTURAL REFORM AND ECONOMIC POLICY

The project was designed to cover the areas that a priori we believed to be most important for Eastern Europe -fiscal policy, privatization, monetary and financial policy, and trade policy[11]. In this final section we would like to present what we consider to be the main conclusions that can be drawn from our work. By investigating each of the areas chosen we have naturally gone into the problem of the relationship between stabilization and structural adjustment, but it was made in a somewhat random fashion. That is why we have decided to present our conclusions on the subjects treated in this paper taking into account their relationship with the problems posed by the interactions between stabilization and structural reform. From the point of view of such problems, the most important issues are the order of implementation of the stabilization and reform policies (the problem of "sequencing") and the closely related question of the speed of the process (shock therapy versus gradualism).

EE has some major problems to deal with which did not exist or were much less important in LA. Among these we should include the general lack of institutions, the absence of an adequate legal framework, the massive scale of privatization, the problem of commercial banks, and the enormous bad debt problem. It is clear, nonetheless, that a necessary condition to be able to tackle the latter three problems is to achieve some degree of success in solving the first two. Institutional building, then, must be given priority in the sequence. And institutional building should begin with the reconstruction of the most important institution of capitalism: property. Without a clarification of property rights on the basis of a sound, clearly defined and enforceable legal system, it is unlikely that massive privatization of large firms take place or that the financial system develop. If

[11] One area which we had thought of covering but dropped primarily due to financial limitations was investment, both domestic and foreign. While the other topics cover aspects of this area, they do not go into it as fully as we might have liked. Obviously, this is an important question in Eastern Europe, especially given the difficulties of attracting foreign investment and of raising domestic investment. We also did not breach the area of labour market policy, which at the macro, institutional and micro levels will undoubtedly play a key role in the level and sustainability of economic growth in both regions. With this one exception, we believe that ex-post the main problems in economic policy facing Eastern Europe have been covered.

property rights are diffused, the badly needed contribution of foreign investors is unlikely to occur and national investors will prefer capital flight rather than either financial or productive investment within the country.

Another necessary condition in order to tackle the deepest problems in EE is that of achieving a minimum degree of macroeconomic stability. Nonetheless, the common advice to stabilize first and then structurally adjust cannot be applied to EE -it is impossible to wait for the latter as it is happening in front of our eyes and, in any case, the former is probably dependent on it. Consequently, some degree of "overlapping" between stabilization and structural reform seems to be unavoidable. This implies that the true problem is that of selecting which reforms should be encouraged and which should, on the contrary, be delayed until stability is well-rooted. Given this caveat perhaps the two strongest lessons in this regard from LA are that you had better deal with the fiscal deficit as soon as possible and you should go very slowly with financial liberalization. Moreover, we would argue that fiscal reform will probably follow a sequence within the larger adjustment sequence as different possibilities reveal themselves. For example, early in the adjustment process very high taxes on goods such as petroleum may be necessary; privatization revenues may be of some importance in the next stage; and a more full-blown fiscal reform in the last stages. It is important to emphasize that an optimal tax system is not likely to be obtained for many years.

Another important conclusion from our study is that, during the process of stabilization and adjustment, the role of the exchange rate is often crucial. We have seen that a devaluation of the real exchange rate can have a very strong effect on the fiscal deficit in either direction. It is of fundamental importance that this relationship is well-known within a given country and that allowance is made for it. For example, if a devaluation has a strong negative effect on the fiscal deficit, trade liberalization will likely have to go much slower than otherwise (or fiscal reform much faster if feasible). The exchange rate may also play a strong role in the stabilization process, especially if it is used as an anchor. Once again this use of the exchange rate may be at odds with a quick trade liberalization. The lesson from LA in this regard is not to rely on the exchange rate as an anchor for too long as a real appreciation is likely to occur. Nevertheless, if the government's fiscal accounts benefit from a real appreciation, ceteris paribus the

duration of this anchor can be longer.

It is also important to begin trade liberalization at an early stage, although we have noted above that it may have gone too fast. According to Corbo (1992), taking into account the LA experience, the initial stages of trade reform should be the replacement of managed trade for open trade, the replacement of QR's for tariffs and the reduction of extreme tariffs. More important than trade liberalization per se, however, is the need to concentrate on two or three high potential sectors early in the game. These sectors can then provide an impetus (and surplus) to the economy at large. The World Bank (1992) country study on Russia, for example, notes the large potential of the oil and agricultural sectors in this country. In fact, this seems to be precisely the strategy followed by Viet Nam, one of the most successful transition economies in the world, which put a heavy reliance on oil and agriculture in the first stage of its structural adjustment.[12] In other words, the authorities should complement commercial policies with some kind of sectoral or industrial policies in order to make the opening of the economy more efficient and less painful in its effects on employment.

Where does privatization fit into the sequence? From our study it follows that the privatization of small-scale firms should be sped up while the privatization of large firms should be carefully planned even at the cost of delaying the process. This conclusion seems to be in accordance with the recent literature. For example, Fischer (1991), suggests that the key to the long-run transformation of the former socialist economies may lie less in the privatization of the very large industrial firms -some of them dinosaurs- than in the development of new firms and the growth of existing smaller firms. For that reason, rapid progress in other areas of the reform can be just as important to the development of a vibrant private sector as the privatization of large firms. Solimano (1992), on the other hand, suggests that massive privatization of large-scale firms can have either stabilizing or destabilizing macroeconomic effects. Likewise, given the importance of some large enterprises in the industrial sector, as in the case of Russia's defence-related sector, the privatization process should be coordinated with commercial and sectoral policies.

[12] For a summary of the Viet Nam experience, see the IMF Survey, July 26, 1993.

It does not seem likely that the liberalization of domestic financial markets can be undertaken until the commercial bank problem is rectified. If the price to pay for the institutional reconstruction of the banking system is maintaining it under the partial control of the state and keeping certain degree of financial repression, such a price may be worth paying. The only caveat is that negative interest rates should be avoided. Even McKinnon, one of the founding fathers of the financial liberalization approach, has recently recognized that the failure to recognize the need for official action to limit bank lending rates was partly responsible for the financial collapses in the Southern Cone (McKinnon,1991). In the same line, Stiglitz (1993) has recently called attention to the potentially positive role of the state in the financial system in developing countries. The rationale is that, in such countries, market failures are almost undoubtedly greater than in the more developed countries.

One of the most important lessons from LA is that full liberalization of the capital account is fraught with dangers and, consequently, should be delayed as much as possible. We have seen, nonetheless, that the desperate need for capital may force countries into a less than optimal sequence. This tension between the objectives of preserving financial and macroeconomic stability on the one hand, and the need for capital on the other, can indeed be an important source of economic policy dilemmas and macroeconomic distress in EE in the future. The main problem is that the increase in capital inflows which normally follows the opening of the capital account tends to induce both domestic currency appreciation and an excess availability of loanable funds which the typically weak banking system cannot efficiently allocate domestically.

Argentina and Mexico at present are good examples of this. In recent years, these countries have received large capital inflows and the greater availability of credit has stimulated important increases in investment. However, to the extent that capital inflows also produced a misalignment of relative prices, a good part of the increase in investment has been allocated to producing non-tradables. Likewise, the increase in the credit supply has also encouraged consumption and it acted against the badly needed recovery in national saving rates. Because of these effects on investment and savings, it is unclear wether these countries will be able to repay external credit in the future without significant macroeconomic adjustments.

One way out of this dilemma could be to rely on non-market sources of foreign capital. The availability of foreign aid and grants could play an important role in helping the countries of EE move to some sort of optimal sequence if they are attached to the compromise of maintaining a sensible structure of relative prices. The successful experience of Chile in the eighties -which received important amounts of non-market external credit stemming from multilateral organizations and simultaneously preserved a competitive exchange rate- can be a source of suitable lessons for both EE policy makers and the advisors of multilateral organizations.

Note that we have not mentioned labour markets in the above sequence. The study by Horton, Kanbur, and Mazumdar (1991) suggests that for better or for worse they tend to adjust themselves during major structural upheavals. Nevertheless, it is likely that the countries of EE will ultimately have to pay much more serious attention to the development of modern, skilled labour forces, but that analysis belongs to another paper.

Shock therapy has not had a very happy experience in LA except in cases of hyperinflation. Similarly, shock therapy seems to have been, with the exception of Russia (Ofer, 1992), good medicine for the monetary overhang problem which most EE countries were facing. However, as in LA, it is questionable whether countries had much to gain from a big bang. The need for institutional development and creation was so strong that wherever a big bang was tried, the response was much slower than expected, as Bruno (1992) has noted. Both Bruno (1992) and Fanelli (1993) commented that some of the highly imperfect CMEA structure should have been maintained in the early years of the adjustment, in order to soften the enormous blow that GDP suffered in all of the countries of Eastern Europe.

Another point in favor of gradualism is that it seems to be much more "growth friendly" than the big-bang strategy, as China's recent experience seems to be showing (McKinnon, 1993). Within a gradual framework of structural adjustment, there is much more scope to implement industrial policies for key sectors in order to minimize the costs of adjustment. In economies like Russia, a series of agreements with the main industries on targets for the contraction of output, levels of employment and on credit levels is badly

needed (Ofer, 1992). It should be kept in mind that the increase in the population's welfare is the ultimate goal of the process and, consequently, growth should be the outcome of the present efforts to transform the economic structure. And from the point of view of growth, the problem is how to ensure the formation of linkages from the leading and potentially booming sectors of the economy (such as oil, gas and forestry in Russia) to manufacturing (largely relegated currently to the former military complex) (Kuznetsov, 1993); and how to foster productivity increases in economies where in the past, as Solimano (1990) indicates, the low pace of technical progress has heavily contributed to explaining the slowdown in secular growth.

Indeed, it seems that after the first "heroic" stage during which the pace toward capitalism was accelerated at any price, a new consensus is emerging which is much more favorable to gradualism regarding both stabilization and structural reform. McKinnon has recently summed up the core of this new consensus. After praising the greater efficiency of the gradual strategy of China as compared to the Russian big-bang approach, he concludes: "In the short run, successful macroeconomic stabilization requires a major (re)centralization of the government's control over money and credit -and a reassertion of the primacy of the state-controlled banking system with the elimination of independent "wildcat" banks. Because of the special characteristics of socialist industry, price setting at the producer level -including the exchange rate- may also have to be recentralizaed as part of the stabilization package. So we have an unfortunate policy dilemma: to secure macroeconomic stabilization in the near term, important banking and commodity pricing policies may have to move counter to what most of us would like to see for the long-run liberalization of the Russian economy" (McKinnon, 1993: 23).

Gradualism, on the other hand, does not mean that economic policy should passively adapt to the current situation. It should be appreciated that some of the countries of EE and the former Soviet Union (including large parts of Russia) are moving so slowly in the adjustment process that it is more proper to call it incrementalism than gradualism. Such an incremental approach does not seem capable of obtaining sufficient momentum to make the process self-motivating.

From the economic policy point of view, the analysis contained in the case studies and this paper suggests that there are many lessons for Eastern Europe to learn from Latin America. Some of these lessons can be put to good use rather quickly while others will not likely be relevant until the institutional and legal framework in Eastern Europe approach those which exist in Latin America. For example, while the importance of keeping the fiscal deficit under control is an obvious lesson for EE from LA, the sequence of fiscal reforms necessary is likely to be quite different in the two regions. The importance of financial deepening is also an obvious implication of the Latin American experience, but it is really only something that most EE countries can dream about as they struggle to put together the most rudimentary financial markets.

Nevertheless, we think that it is a mistake to say that the initial conditions are so different that nothing of much practical use can be learned. Most Eastern European countries are on the same road as Latin America, just a few steps (or kilometres) behind. The "experiments" undergone in Latin America since the mid-1970s should help Eastern European countries avoid many of the potholes along the route. Finally, despite the natural temptation of Eastern European countries to look to Eastern Asia for lessons, we think that this could be less beneficial. They are even further behind on that path; moreover, the cultural context may be so different that it is hard to draw any practical lessons.

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