CAMBRIDGE

Cambridge University Press
052158177X - Macroeconomic Stabilization in Transition Economies
Edited by Mario I. Blejer and Marko Skreb
Excerpt
More information

INTRODUCTION

Stabilization After Five Years of Reform: Issues and Experiences

Mario I. Blejer and Marko Škreb

> Stability is not everything, but without stability, everything is nothing.
>
> Karl Schiller
> Former German Minister of the Economy

More than any other single event, the fall of the Berlin Wall in November 1989 symbolized the beginning of the process of transformation of the economies of Central Europe and of the former Soviet Union from centrally planned, command systems to liberal, market-oriented economies. Although the "transition from socialism," as this process of transformation has been labelled, is centered around fundamental economic changes, transition is a multifaceted phenomenon that encompasses complex structural, institutional, and behavioral adjustments that go well beyond the realm of economics. For many countries, the demise of socialism signaled not only the start of a period of economic modifications but indeed the beginning of their nation-building process.

The analysis of the nature and causes of these tumultuous events has challenged virtually all established modes of studying human relations, from the purely ideological to the highly technical. Although transition is not an exclusively economic phenomenon, economics has taken center stage in the study of the postsocialist transformation; a complete new branch of economics – the *economics of transition* – has developed, focused on explaining and providing advice concerning this unprecedented process. Moreover, a special international financial institution, the European Bank for Reconstruction and Development, has been created to support and enhance the transitional process.

A large body of literature dealing with these subjects has appeared and numerous conferences have addressed these issues, so there is

© Cambridge University Press www.cambridge.org

CAMBRIDGE

Cambridge University Press
052158177X - Macroeconomic Stabilization in Transition Economies
Edited by Mario I. Blejer and Marko Skreb
Excerpt
More information

obviously no scarcity of empirical material on transition. However, no definite analytical framework has been established and much of what is discussed is largely based on conjecture, most of it immediately superseded by new hypotheses or rendered obsolete by current developments. This is to be expected since we are dealing, to a large extent, with unforeseen events and with a set of unfamiliar questions. The lack of historical precedents has hindered analysts' ability to draw viable conclusions relevant to the current circumstances of Eastern Europe and the former Soviet Union. The uniqueness of each country's experience, from its initial conditions to the specific nature of the constraints faced by their policy makers, makes generalized conclusions even more difficult to attain.

This does not imply, however, that one cannot try to understand the process of transformation. Because economists are dealing with a set of atypical problems does not mean that predictions and inferences cannot be made or that traditional analytical tools are not useful. In fact, after more than six years of reforms, an analysis and a comparison of actual experiences – and a detailed study of the design, implementation, and results of the various reform programs – could help to elucidate some of the most pressing questions and to draw some important theoretical and practical conclusions.

From the many dimensions of the transformation process, *macroeconomic stabilization* is the one where taking stock and deriving common lessons could be critical, and where the variety of experiences and results to date may allow extraction of the most valuable theoretical and policy insights. It is also the area where an early evaluation of the results could lead to conclusions that may help to avoid the repetition of mistakes. In the stabilization area, comparisons between the experiences of transition and market economies seem more relevant; the lessons obtained could lead to cross-fertilization and even to the advancement of general economic knowledge that could shed new light on existing theoretical debates.

Macroeconomic stabilization involves the achievement and maintenance of a reasonable degree of price stability and external balance, as well as a sensible rate of economic growth. In principle it could be claimed that macroeconomic stabilization is not an intrinsic component of postsocialist transition and would be relevant in this context only to the extent that the initial situation, at the outset of reforms, involved important macroeconomic imbalances. Yet in practice, for reasons that stem from the nature and functioning of the socialist

© Cambridge University Press www.cambridge.org

CAMBRIDGE

Cambridge University Press
052158177X - Macroeconomic Stabilization in Transition Economies
Edited by Mario I. Blejer and Marko Skreb
Excerpt
More information

system as well as from conditions created by the transition itself, all the postcommunist economies did emerge from their previous regimes with various – and sometimes very significant – degrees of macroeconomic imbalance (with inflation and output collapse the primary manifestation) that needed to be corrected. Therefore, macroeconomic stabilization has always been a major ingredient of the transition process.

It is evidently quite difficult to delineate the precise boundaries of stabilization policies during transition because, in practice, they interact closely with liberalization policies, with institutional adjustments, and with structural reforms. Nonetheless, it is still very important to distinguish and separate analytically the dominant features of the major macroeconomic developments and of the specific policy strategies that have been part of the transformation process. While recognizing the complexity of the interactions between structural and stabilization policies, this volume constitutes a substantial attempt to offer a comprehensive examination of postsocialist stabilization and to outline the principal inferences that can be derived from the experience to date.

In dealing with macroeconomic stabilization, the essays in this volume focus on five major issues: (1) the aggregative *trends* characterizing transition, particularly at the macroeconomic level; (2) the conception and strategy followed in the *design* of stabilization policies; (3) structural and external *constraints* faced by the economy; (4) *implementation* and instrumentation of specific stabilization policies; and (5) description and characterization of the *results* obtained.

The volume is divided into three sections. Part I contains four essays that are mainly concerned with the first three issues just listed (general macroeconomic trends, conceptual design of stabilization programs, and the nature of the constraints faced by reforms). Part II consists of seven detailed country studies, covering a wide range of experience and carefully examining the issues of design, implementation, and outcomes of stabilization programs. The volume concludes with an afterword that looks beyond the narrow aspects of stabilization to address some of the most important long-term issues connected with the process.

The opening chapter, by Martha de Melo, Cevdet Denizer, and Alan Gelb, is an ambitious undertaking aimed at analyzing the comparative experience of 28 transition economies over the 1989–94 period in order to draw conclusions about their progress regarding

© Cambridge University Press www.cambridge.org

CAMBRIDGE

Cambridge University Press
052158177X - Macroeconomic Stabilization in Transition Economies
Edited by Mario I. Blejer and Marko Skreb
Excerpt
More information

economic liberalization, inflation, and growth. Although the measurement of growth and inflation is relatively straightforward, the authors make a noteworthy attempt to develop a quantitative composite index for measuring economic liberalization. A "cumulative liberalization index" for each country is built by assigning numerical values, based largely on objective indicators, to the degree of domestic and external liberalization and to the extent that private-sector entry has been opened. The index is calculated to reflect both the intensity as well as the duration of reforms from 1989 onward.

Using their index, the authors obtain a number of important results regarding the patterns of transition. In the first place, they conclude that the extent of liberalization has a positive effect on the rate of growth of output. Second, it is observed that liberalization seems to induce an initial increase in inflation, but this increase is followed by a prompt and sustained decline. Third, there is marked negative relationship between inflation and output; that is, output recovery requires that inflation be reduced to moderate levels. Thus, their general conclusion is that liberalization is an important element in the success of stabilization policies and in prompting a resumption of output growth.

Two important policy implications arise from Chapter 1. First, fiscal pressures tend to be the most serious constraint on the road to stabilization; however, the more rapidly the economy is liberalized and reformed, the less binding this constraint becomes. In fact, rapid reformers have experienced smaller fiscal deficits. Second, the underdevelopment of monetary institutions and instruments has greatly limited the ability of monetary policy to play a central role in the stabilization process. As in the fiscal area, though, more-rapid reforms tend to reinforce the efficacy of this instrument and to enhance the ability of the government to cope with inflationary pressures. Although these implications are relatively straightforward and in accordance with conventional wisdom, the importance of the research by De Melo, Denizer, and Gelb is in providing quantified evidence and a solid empirical backing.

The opening chapter reconfirms the view that stabilization becomes a priority for the resumption of growth, but it also stresses that – in transitional countries – stabilization is rendered more difficult by the very acute output contractions often observed during the early stages of liberalization. The magnitude and the causes of these contractions are the subject of Chapter 2, by Robert Mundell. He

© Cambridge University Press www.cambridge.org

CAMBRIDGE

Cambridge University Press
052158177X - Macroeconomic Stabilization in Transition Economies
Edited by Mario I. Blejer and Marko Skreb
Excerpt
More information

observes that, between 1989 and 1994, the cumulative loss of output experienced by the economies of Eastern Europe and the former Soviet Union were on a scale never before experienced in modern history. After documenting the size of the output fall, Mundell elaborates on two central questions: What caused such an unprecedented contraction? Why have output contractions been so widely different across countries?

Mundell suggests six possible reasons for the loss of output: (1) flawed national statistics that do not correctly measure the rapid growth in private-sector output and overlook the probable increase in informal sector production that is brought about by economic liberalization; (2) the elimination of soft budget constraints that, combined with strict monetary policies, resulted in high real interest rates and strict credit restrictions; (3) the pervasive bureaucratic and red-tape legacies of the communist era that, combined with the scarcity of the appropriate human capital, resulted in negligible supply responses from the private sector; (4) collapse of foreign trade following the disintegration of the CMEA (Council for Mutual Economic Assistance) and of the Soviet Union; (5) deterioration of the terms of trade in a number of countries; and (6) lack of sufficient foreign support. Mundell suggests that all these factors have, to varying degrees, contributed to the reduction of output. But in his view the main cause behind the enormous collapse is the extraordinary decline in foreign trade and the effect of the foreign trade multiplier on both demand and aggregate supply. Mundell claims that the disintegration of export markets immediately reduces the capacity to import intermediary goods, inputs, spare parts, and machinery, leading to the emergence of bottlenecks and scarcities that result in the breakdown of the production chain.

The second question concerns the causes for the differential degree of contraction across countries (e.g., the cumulative decline of output over the 1990–93 period varied from less than 18% in Hungary to more than 80% in Georgia). Mundell enumerates four interrelated factors that influence the magnitude of output loss. He postulates that output declines will be larger when (a) the level of industrialization is higher, (b) the stock of human capital is lower, (c) the economy is more open, and (d) the country is more urbanized. Of course, specific country conditions (such as religious strife, war, and political unrest) have played a role, but initial structural conditions seem to be the most reliable predictors.

© Cambridge University Press www.cambridge.org

CAMBRIDGE

Cambridge University Press
052158177X - Macroeconomic Stabilization in Transition Economies
Edited by Mario I. Blejer and Marko Skreb
Excerpt
More information

Chapters 3 and 4 stress the essential role played by state-owned–enterprise reforms in increasing the chances of success for stabilization programs in transition economies. It is generally agreed that the reform of state-owned enterprises is essential for the successful implementation of macroeconomic stabilization, but it is also evident that microeconomic restructuring and privatization are time-consuming and lengthy processes that cannot be completed overnight. Because stabilization policies cannot be postponed until the enterprise sector has been significantly restructured, interim procedures are required to moderate the inflationary pressures arising from that sector. Marcelo Selowsky and Matthew Vogel consider one such interim procedure in detail. They argue in Chapter 3 that large, loss-making enterprises must be isolated from the banking-system credit circuit and that budgetary resources should be directly allocated to finance the public goods that such enterprises are currently providing. In the socialist system, budgetary support for enterprises and cross-subsidization among them were common features, but a substantial number of money-losing enterprises become inviable as reforms and liberalization are set in motion. The authors argue that a significant number of large enterprises cannot be immediately closed down because they provide such public goods as artificial employment, public utilities, and social services to workers and their dependents. Political pressure to keep these enterprises alive is strong. The problem is worse in economies where no resumption of growth is imminent and so workers cannot be expected to be relocated as part of the normal evolution of the labor market. However, if those enterprises continue to borrow from the commercial banking system as before, they will have little incentive to restructure. Therefore, the best strategy may be first to isolate the enterprises from banking credit and second to allocate explicit resources to the budgetary provision of the public goods provided by these enterprises. Enterprise isolation programs can be, it is claimed, an efficient tool to achieve the needed downsizing.

Although there has been some experience with this procedure (in countries such as Albania, Kazakstan, and Kyrgistan), the authors warn about the dangers and tradeoffs present in the process. Selowski and Vogel argue that there is an appropriate sequence in the allocation of fiscal resources: they should first be used to support the downsizing of enterprises, and only later for the recapitalization of banks. If recapitalization of banks occurs before downsizing then there may

© Cambridge University Press www.cambridge.org

CAMBRIDGE

Cambridge University Press
052158177X - Macroeconomic Stabilization in Transition Economies
Edited by Mario I. Blejer and Marko Skreb
Excerpt
More information

be a delay in restructuring, significant moral hazard could be generated, and the stabilization process could be jeopardized.

The restructuring of the state-owned enterprises entails, to a large extent, the acceleration of the process of privatization, and the techniques used to accomplish this latter task may give rise to unexpected complications that will have both micro- and macroeconomic effects. Some of the consequences of observed privatization patterns in transitional economies are discussed by Mario Nuti. Chapter 4 deals first with some general problems of corporate governance, and then focuses on a particular form of intrashareholder conflict that may occur when employees own enough shares to control the company.

In Nuti's opinion a shareholder (or stakeholder) conflict constitutes a problem when control is in the hands of stakeholders who, individually, own less than a balanced share. In that case, the problem may take the form of overemployment and overpay (i.e., labor compensation is set above the levels warranted by profit maximization) and the stakeholders may eventually appropriate the entire present value of the company. Moreover, Nuti views the problems of corporate governance in recently privatized firms as part and parcel of the wider transitional problem of establishing law and order, of ensuring the legal protection of contracts, and of fighting against organized crime.

Part II of the book is composed of seven country-specific studies that analyze in detail the conception, implementation, and performance of various stabilization programs implemented throughout Eastern Europe and the former Soviet Union. Broad generalizations are usually suspect in the study of transition economies. However, the range of countries covered in this section, the variety of strategies adopted, and the differences in initial conditions, resource availability, historical experiences, and political constraints make the sample quite significant for any attempt to reach policy lessons and analytical conclusions.

In Chapter 5, Stanislaw Wellisz analyzes the post-1990 Polish stabilization program. Three different periods of exchange-rate regimes in Poland are described: the fixed–exchange-rate period, the "crawl-cum-mini devaluation" period, and the "pure crawling peg" period. Wellisz's main conclusion is that inflation in Poland was fiscal-deficit–driven until mid-1993 but that the chief causes of subsequent inflation were the policy refusal to let the zloty appreciate in real terms and the failure to sterilize the rapid accumulation of foreign exchange

© Cambridge University Press www.cambridge.org

CAMBRIDGE

Cambridge University Press
052158177X - Macroeconomic Stabilization in Transition Economies
Edited by Mario I. Blejer and Marko Skreb
Excerpt
More information

reserves. Wellisz reaches the interesting conclusion that, at least in the Polish case, it might be better to finance the fiscal deficit through monetization. His argument is that the monetization of the deficit imposes a generalized inflation tax on all money balance holders (i.e., on everyone), whereas deficit financing by issuing new government debt crowds out private borrowing and reduces investment.

Chapter 6 deals with the case of Hungary, which is (among the transition economies) the country where reforms started earlier and were implemented gradually over a long period of time. However, macroeconomic stability has not been achieved, and the Hungarian economy is in the midst of a new stabilization effort. In his study, János Kornai places the current Hungarian economic policies in an historical and political economy perspective. Toward this end he outlines Hungarian developments in the last three decades and distinguishes the transformation path adopted by Hungary from that followed by other postsocialist countries. Kornai emphasizes four distinct Hungarian characteristics: (a) the greater emphasis placed in Hungary on the material welfare of its population; (b) the creation of a paternalistic welfare state, as measured by a higher ratio of social entitlement spending to GDP; (c) the implementation of a gradual and extended process of transformation and reform; and (d) the preservation of relative political calm. These factors are closely related and, in Kornai's view, led to the creation of a significant social debt with the rest of the world, and with its own future generations, in the form of legislative commitments to maintain the consumption levels of the current generation.

Within this framework, Kornai analyzes the stabilization strategy of the current Hungarian government. He singles out three key elements in this strategy: a radical devaluation of the currency at the beginning of the program, coupled with a preannounced crawling peg; a substantial cut in budgetary spending, particularly on social expenditures and on the welfare system; and an income policy aimed at curbing the growth of nominal wages. These three components mark, in Kornai's view, a clean break with the four main features just described that until now have set Hungary apart from the other transition countries. Kornai notes this curious reversal of roles: the Socialist Party now in power, having won the elections by emphasizing its social sensitivity, is carrying out an almost "Thatcherite" program, while the conservative opposition is fighting the program and defending the overblown welfare state and wage demands of

© Cambridge University Press www.cambridge.org

CAMBRIDGE

Cambridge University Press
052158177X - Macroeconomic Stabilization in Transition Economies
Edited by Mario I. Blejer and Marko Skreb
Excerpt
More information

workers. Although it is still too early to assess the results of this shift in the Hungarian approach, Kornai delineates three possible scenarios: a return to the "muddling through" of the previous decades; perseverance in the current policies, leading to the government's political downfall; or success after some delays. Kornai does not weigh the chances of these three scenarios but clearly supports the program, and views abandoning the previous approach as a prerequisite to putting Hungary on the road to sustained development.

Chapters 7 and 8 deal with the case of Croatia, the host country to the Dubrovnik Conference. Croatia has, indeed, achieved remarkable results not only in stopping very high inflation (from more than 1000% per year before October 1993 to less than 5% currently) but also, and probably more importantly, in maintaining price stability afterwards. The preparations for launching the program are explained in the essay by Nikica Valentić (Prime Minister of Croatia); the implementation and achievements of the adopted policies are discussed by Velimir Šonje and Marko Škreb. The central claim of the essay by Šonje and Škreb is that the link between the exchange rate and inflation was very important in explaining Croatia's high inflation prior to the start of the stabilization effort. At the same time, they claim, the strength of this link was instrumental in achieving rapid disinflation. Indeed, the high degree of dollarization of the Croatian economy proved to be crucial in reducing inflationary pressures and in eradicating inflationary expectations and inflationary inertia once the exchange rate was credibly stabilized. The correlation between exchange-rate fluctuations and rising price is, of course, not perfect, owing to a number of factors that include changes in the ratio of tradable to nontradable prices and alterations in the exchange-rate regime. After analyzing the various transmission mechanisms between exchange rates and prices, and after testing empirically the proposition that domestic price changes are largely determined by exchange-rate fluctuations, the authors conclude that exchange-rate depreciations did indeed act as a significant cost-push factor. Based on this conclusion, Šonje and Škreb claim that a regime based on a floating exchange rate that allows nominal rate appreciation once confidence is restored is a superior stabilization strategy for a country that needs to accumulate international reserves and improve its fiscal position.

Like Croatia, and like almost every other transitional economy, Slovenia at the beginning of its transformation faced high inflation

© Cambridge University Press www.cambridge.org

CAMBRIDGE

Cambridge University Press
052158177X - Macroeconomic Stabilization in Transition Economies
Edited by Mario I. Blejer and Marko Skreb
Excerpt
More information

and widespread external and internal disequilibria. In addition, as stressed in Chapter 9 by Velimir Bole, Slovenia had neither foreign exchange reserves nor access to foreign financial markets. It was not possible, therefore, to adopt a standard or conventional stabilization approach. Thus, Slovenia was forced to build its stock of foreign exchange reserves and to stabilize simultaneously. The adopted program relied strongly on the reshaping of the foreign exchange market and on the adoption of a floating-exchange-rate regime, combined with a restrictive monetary policy. Tight fiscal discipline was also imposed, with the result that inflation dropped dramatically, reserves increased, and the economy started to grow. However, because income policies were introduced late and were very partial in nature, the relative prices of nontradables rose rapidly. Given this factor and the probably excessive inflow of foreign capital, inflation in Slovenia has remained above 20% per year. On the positive side, a clear lesson from the Slovenian experience is that its openness helped to mitigate the costs of stabilization by averting a serious impact on economic activity and employment.

Chapters 10 and 11 look at countries that were part of the former Soviet Union. In Chapter 10, Ardo Hansson offers a comprehensive comparative analysis of macroeconomic stabilization in the three Baltic states: Estonia, Latvia, and Lithuania. Following an extensive description of their stabilization plans that highlights the radical differences in the strategies adopted, Hansson offers some important conclusions. First, the passage from very high to controlled levels of inflation was largely due to the use of conventional macroeconomic policies: after tightening monetary policy and balancing the budget, inflation fell sharply in the three countries. Second, in the short run, the credibility of the program was an essential ingredient for success: public perception that the authorities were committed to lower inflation was a crucial element in attaining a significant reduction. Third, if the behavior of the money demand remains volatile, Hansson suggests that the exchange rate is a better nominal anchor than the money supply. Fourth, the relative price adjustment required in transition countries is probably larger than in developing market economies and could therefore lead to more prolonged inflationary pressures. Hansson notes that the sudden opening up of small countries, such as the Baltics, creates the potential for huge capital inflows that could jeopardize the authorities' control over the money supply and therefore over inflation; this has been observed in other transitional countries such as the Czech Republic, Croatia, Poland, and Slovenia (and

© Cambridge University Press www.cambridge.org