LATIN AMERICA AND EASTERN EUROPE: ECONOMIC REFORMS IN ABNORMAL TIMES

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Abstract. The basic problem involved in IMF's recent adjustment programs and in World Bank's structural reforms derives from the fact that they are designed to deal with normal situations, whereas most developing countries, particularly in Latin America and Eastern Europe, face today abnormal times. The standard critique against IMF stabilization programs was that they did not take into due consideration the specificities of developing countries, but, in so far as countries developed and became capitalist economies this critique lost part of its relevance.

The basic problem involved in IMF's recent adjustment programs and in World Bank's structural reforms derives from the fact that they are designed to deal with normal situations, whereas most developing countries, particularly in Latin America and Eastern Europe, face today abnormal times. The standard critique against IMF stabilization programs was that they did not take into due consideration the specificities of developing countries. Washington economists assumed that there is just one economic theory, valid everywhere, and from it they derived standard policy recommendations. This critique is stil valid, but it is necessary to acknowledge that the economic development that took place in the world in the last fifty years reduced the weight of it. Economies where capitalism was just being introduced at that time, are today well established industrial capitalist societies, even that still underdeveloped ones.

A second critique is related to the fact that particularly IMF and more recently also World Bank tend to use just inadequate economic theory and to derive from it improper economic policies. Economic theory - neoclassical microeconomics, monetarist macroeconomics - would be inadequate not only because it is based on false assumptions about the behavior and efficiency of markets, but also because they often reflect neo-liberal ideologies about the minimum state that practice denies everyday.

The third critique has to do with imperialism, or, more broadly and mildly, with conflicting interest. IMF and other aid institutions in the First World would represent the interests and ideologies of the developed nations, that would often be in conflict with the national interests of the developing countries. This fact may still be valid in some circumstances, as the debt crisis evidenced, but the general thesis that the national interests of the developed countries are essentially in conflict with the interests of the developing ones is false. Mutual interests are more usual than conflicting ones.

Yet, in the endeavor to help the developing countries - and now the ex-communist ones - the representatives of the developed world, and particularly institutions like the IMF and the World Bank that are supposed to perform this role, may make serious mistakes. These mistakes may originate in the "monoeconomics" assumption that development economics so well criticized, may derive from the ideological adoption of policies that did not prove effective even in the developed countries, may emanate from conflicting interest between the North and the South. In the 1980s and early 1990s, however, a forth and more important source of equivocated policy recommendations can arise from the fact that Latin America and Eastern Europe endures abnormal times.

Abnormal Times

The crisis that these two regions face today cannot be just explained with "fiscal indiscipline" and "excess state intervention", as the Washington consensus affirms. Indeed fiscal indiscipline or economic populism is a problem, but it is a normal problem, that in Latin America coexisted with growth for many years. Since the early 1980s, however, what emerged was a much more serious problem: the fiscal crisis of the state and the collapse of the former development strategy. The state lost credit and is unable to guarantee the national currency. The model of state intervention - the import substitution strategy -, that for many years was effective in promoting industrialization and growth, exhausted its virtualities and turned into a major obstacle to the efficient allocation of resources.

No doubt, the state grew too much in Latin America and particularly in Eastern Europe, but today the problem is not excess state intervention, but the incapacity of the state to perform its economic role. The excessive and distorted growth of the state, the emergence of a fiscal crisis, and the exhaustion of the old development strategy led to a deep crisis of the state. Suddenly the governments that manage the state in Latin America were paralyzed. They were victims of a political crisis whose origin was essentially in the economic realm - or, more specifically, in the economic-institutional sphere. The state was not able anymore to adequately perform its political and economic roles. Particularly it was not able to warrant the money it creates, to assure the well functioning of markets, to regulate them and supplement their failures.

The outcome was a deep economic crisis, whose cause is usually related to excess state intervention, but that actually is due to faltering or ineffective state action. In Latin America the country that more deeply suffered the crisis was Peru. This country is a paradigmatic case of crisis of the state. An informal, non-desired process of privatization, reduced to less than half the size the state apparatus, as government was not anymore able to collect taxes and to manage the state-owned enterprises.

The crisis of the state in Latin America and Eastern Europe was translated into economic stagnation, high rates and inflation, and, in the limit cases, hyperinflation. A crisis like that means that the economic systems in these regions face abnormal times. Face extraordinary, extremely difficult challenges. The state must be reformed. The fiscal crisis must be overcome. Fiscal discipline must be restored. Structural reforms aiming to reduce the state, to privatize, to liberalize trade, and to deregulate become urgent. But these reforms should start from the assumption that in abnormal times remedies cannot be the same suited for normal ones.

The Standard Explanation

In abnormal times normal remedies will most likely be inefficient, i.e., highly costly, or just ineffective. The rewards they offer, if any, are not proportional to the austerity they impose. In some cases they will be perverse, producing outcomes opposite to the desired ones. Thus, it is not surprising that reforms will often fail or will be abandoned. Yet, when this happens, a standard explanation is offered: fiscal adjustment and structural reforms failed for political reasons. The economic programs are sound, but they are hindered by populist and nationalist politicians. This is just part of the truth. For sure there are political problems. But they do not represent the main problem.

The contention that economic problems have essentially political origin has several sources. Yet I would emphasize here only two inter-related ones: arrogant monopoly of rationality and naive confusion of economics with social engineering.

It is self-reassuring to believe and say that we have the monopoly of rationality - the rationality imbedded in economic theory. It is rational to have fiscal discipline, to limit expenditures to what is produced, to behave parsimoniously and save, to limit sate intervention and preserve the efficient allocation of resources by the market. Thus, when these tenets are not obeyed, it is easy to attribute the deviant behavior to wicked political interests.

Politicians certainly have part of the responsibility for the crisis. But some questions must be made. First, who represent these political interests? Aren't usually cartels of large business firms, of unions, or of middle class interest groups? And aren't these cartels or economic coalitions economic agents to be considered by economy theory and policy? Second, even when government's economic policy decisions specifically convey political interests, when they reflect electoral politics, does this mean they are just wrong and unacceptable, as the arrogant monopoly of rationality attitude assumes? Or may we say that they also reflect the unconformity of the people with the inefficiency, i.e., with the unduly high costs involved in the proposed economic reforms?

This question leads us to the social engineering assumption. All economic problems will be indeed be political if economic policy may be equated to or reduced to a branch of engineering - actually, of bad engineering. By reducing a social science to engineering, we will be able to abstract people from it. By downgrading it to bad engineering, we will be able to ignore the costs involved. What matters are the outcomes: to honor the debts, to achieve price and balance of payments stabilization, and, last, whenever possible, to resume growth. Romania's former dictator, Ceausescu, for instance, had no doubt about the engineering content of economic policy. It was this belief plus absolute dictatorial powers that entitle him to fully pay Romania's debt before the 1989 democratic revolution in Eastern Europe.

Actually, when the costs involved in a given economic policy are too high, the decision not to adopt it will be rational rather than "political". Reforms that are inefficient - whose costs are higher than its rewards - are just wrong. In recent times the inefficiency of monitored economic reforms in Latin America and Eastern Europe has been noticeable. This inefficiency if not ineffectiveness have many sources, but a major one is the limited capacity of Washington economists to recognize the prevalence of abnormal times.

Debt and Inflation

Three examples will help to make clear my point: first, the debt crisis; second, the stabilization of high inflations; and third, the big bang approach to Eastern Europe. In the three cases IMF, the World Bank, and more generally, orthodox economists are unable to offer appropriate policies as long as they try to offer standard solutions to exceptional situations.

The failure of the Washington economists to seize the weight of the debt crisis when it emerged in the early 1980s and to offer solutions to it is well known. Still in 1984 some well respected economists continued to insist that it was essentially a liquidity crisis, when it was quite obvious that it was a very serious balance of payments problem coupled with a fiscal crisis of the state. As late as 1988 the same economists in Washington were advocating a fully voluntary solution aiming the reduction of the outstanding debt, when it was clear, as the Brady Plan partially acknowledged, that the debt reduction had to be administratively negotiated. The inability of Washington economists to size up and offer appropriate solutions to the debt crisis derived essentially of the conflicting interests of the creditor and debtor countries, but additionally it was originated in the bureaucratic conservatism of the multilateral institutions, that are not prepared to deal with exceptional situations.

The incapacity of the Washington economists to confront the high inflations that arise from the fiscal crisis of the state is another example. If we adopt as criterion the intensity of the inflation rate, there are three types of inflation: regular or small inflation, high or inertial inflation, and hyperinflation. Standard economic theory, taught in the First World universities and used by the multilateral institutions uncritically, has only remedies for regular inflation: invariably a combination of fiscal and monetary policy. They know about hyperinflation, but have nothing to say about it, except that the remedy is essentially the same recommended for regular inflation, the only difference being in is of intensity of the treatment. As to inertial inflation, to inflation rates that remain chronically at 5, 10 or even 20 percent a month for long time, the phenomenon only began to be recognized by the best macroeconomists in the First World in the late 1980s, while in Latin America the respective theory was fully developed in the early 1980s. But Washington and particularly IMF continue to officially ignore it.

Hyperinflation is always connected with extreme fiscal crisis. The state is literally bankrupt, public debt is very high and public credit, non-existent. In these circumstances the only alternative to end with hyperinflation is, besides adopting radical fiscal discipline, to introduce a monetary reform that will include the cancellation and/long term consolidation of a large part of the public debt, a monetary reform and the convertibility of the new money. Yet, this kind of shock treatment is not in the text books. It will not be part of the Washington recommendations, particularly the debt cancellation aspect.

On the other hand, the essential characteristic of inertial inflation is that it exclusively derives from the phased character of price decisions in an economy where inflation is already high. Standard inflation theory usually relates inflation with excess demand and the increase of money supply. The neo-structuralist theory of inertial inflation attributes it to the informal indexation of the economy that economic agents tend to rationally adopt to protect them of the on going inflation, affirms that it is autonomous from demand, and asserts that the money supply, in these context, is endogenous. Consistently, it affirms that besides fiscal and monetary policy, it will be necessary to directly influence price decisions through some kind of incomes policy. When inflation, besides inertial is high, characterizing the prevalence of abnormal times, a shock, that came to be known as "heterodox shock" will be unavoidable. This is today well known. High, inertial inflation ended in Israel (1985), in Mexico (1987), in Argentina (1991) in this way. In the last case, since inertial inflation was combined with hyperinflation, it was necessary to include in the heterodox shock the cancellation of public debt and the freeze (legal convertibility) of the exchange rate. In Brazil the several shocks failed essentially because they were not accompanied by fiscal adjustment nor backed by a minimum social agreement on wages.

Nevertheless, the IMF continues to ignore these simple facts. In Brazil, where inertial inflation is particularly strong, IMF supported informally in 1990 and formally in 1992 a orthodox stabilization plan that only caused recession, and not to the decrease of the inflation rate, that, according to the approved program, should obediently lower to decelerate to 10 percent in August and 2 percent in December 1992, but that, in fact, remains stable at a 20 percent level for months and months. Afterwards, the inability of the government to meet the monetary targets and the insufficient fiscal adjustment were blamed. For sure, fiscal adjustment could (and should) be stricter than it was. There is a lot to do in the fiscal area. But it’s important to note that between March 1990 and today (August 1992) the Brazilian Treasury presented a cash surplus, and that the budget deficit target with IMF was met in the first quarter 1992.

Brazil: IMF Targets and Reality (1992)

	Inflation (%)	
	Target	Actual
January	26	26,5
February	23	24.8
March	20	20.7
April	17	18.5
May	14	22.5
June	12	21,4
July	10	21.7
August	8	-
September	6	-
October	5	-
November	3	-
December	2	-

Public Deficit (billions, first semester 1992)	
Target	Actual
11,400	11,384

In other words, the economic stabilization program endorsed by the IMF in Brazil has been extremely inefficient, as its costs were and are being very high in terms of a deep recession, while its results are none. And, additionally, inconsistent, as the contradictory results in terms of inflation and budget deficit demonstrate.

"Big Bang"

My third example, related to economic reforms in Eastern Europe, deserves a special section. Here again the failure of the reform programs that are being proposed to the ex-communist countries derives essentially from the inability to understand and find solutions when the economies of the countries that are supposed to be helped face abnormal times. But, while in the case of the foreign debt and of inertial inflation and hyperinflation the failure arises from the fear to adopt more radical measures, in the case of Eastern Europe the problem lies precisely in the temptation - quite easily understandable on an ideological stand point - to restore capitalism with one stroke.

Eastern Europe, as Latin America, faces a debt crisis that turned into a fiscal crisis of the state. The exhaustion of a statist strategy of industrialization took place in Latin America as well as in Eastern Europe. Thus it would be possible to imagine that similar economic reforms will work in both regions. The only difference would be in the fact that statism went much farther in Eastern Europe than in Latin America. Thus the liberal reforms aiming to privatize, liberalize and deregulate should be more radical, should consist in a "big bang".

There are at least two basic mistakes here. First, although the crisis in both regions is essentially a crisis of the state, in Eastern Europe this crisis is more profound. It is false that the difference in state intervention is just a question of degree. There is a difference of quality. In Latin America, except Cuba, the economic system was always capitalist, in Eastern Europe, statist. In Eastern Europe the mode of production was not socialist or capitalist, but statist. The ownership of the means of production belonged collectively to the bureaucratic class that controlled the state. Differently from Latin America, where it was always clear the distinction between the state and civil society, in Eastern Europe everything was mixed. Not only production but the whole society was statist.

While in abnormal time macroeconomic reforms, aiming to stabilize prices and the balance of payments, as well as political reforms directed to restore democracy must usually be radical to be successful, microeconomic reforms intended to change fully and abruptly the whole economic and social system, make no sense. The transition from statism to capitalism, that is taking place in Eastern Europe, is revolutionary. It changes the structures of the economy and society. In this context, structural reforms must understand the meaning and the pace of the revolution that is taking place and be gradual.

The objective is to establish in the region a capitalist system, but this cannot be made overnight. First it is necessary to clearly separate the state from the business enterprises; to create a state and a civil society. This may eventually be done through privatization, but at least in a first stage it would be more expedite and less conflicting to transform the state-owned enterprises in corporations controlled by autonomous institutions or foundations that would represent civil society. Second, it is necessary to increase - not to decrease - the strength of the much smaller state that will remain after the state-owned enterprises were excluded from the old state. The new state that is emerging is demonstrating to be much weaker than their counterparts in the developed countries. Thus, it will be particularly important to build the capacity of the state to develop its own inputs: the ability to tax and the capacity to host a competent and small bureaucracy and representative political elite. A strong state will be essential not only to guarantee justice and order, to back the local currency, to assure balance of payments equilibrium, to supply education and health services, to promote technological progress, but also to institutionalize the markets where the business firms are supposed to operate. As there was not capitalism in Eastern Europe, there was no state in the capitalist sense, much less markets. The state must be reformed, the markers, built from scratch. This is a long process that a "big bang" can only mix up.

Conclusion

The multilateral agencies in Washington perform a decisive role in the developing countries and now in Eastern Europe. It is a double role: to finance and to advise these countries in the road to stabilization and growth. Yet, this role is plagued with shortcomings. It is the task of the developing countries to have these shortcomings clear. Their economic elites, however, tend to be so subordinated to the dominant ideas in the developed countries, that it is difficult to them to criticize the Washington views.

In this paper I added to the well-known critiques to the policy recommendations coming from Washington an additional one: they have an enormous difficulty to deal with abnormal times. This critique is particularly relevant today because Latin America and Eastern Europe face a deep crisis of the state - a fiscal crisis and a crisis of strategy of state intervention - that led to high rates of inflation and economic stagnation.

To support this fact, I presented three examples: the attitude of the multilateral agencies in relation the debt crisis, to high inflation in Latin America, and to the transition from statism to capitalism in Eastern Europe. In Latin America, where the fiscal crisis of the state and high inflation require shock treatment, debt cancellation or consolidation, and social agreement, the Washington economist limit themselves to propose fiscal discipline and tight monetary policy. Contradictorily, in Eastern Europe, where the transition from statism to capitalism implies a structural revolution, Washington tries to solve the problem with standard macroeconomics plus shock privatization and trade liberalization, ignoring that first it is necessary to define a much smaller state, separated from the rest of the economy, and second to strength this state, so that markets can be eventually created and developed.