DEPARTAMENTO DE ECONOMIA

PUC-RIO

TEXTO PARA DISCUSSÃO
N.º 290

STABILIZATION PROGRAMS IN DEVELOPING COUNTRIES: OLD TRUTHS AND NEW ELEMENTS

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OUTUBRO 1992

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November 1991

Outline

Economic policy lessons accumulated from the stabilization and adjustment attempts in the 1980s, mostly from the many failures but also from the fewer successes. The purpose of this paper is to draw the lessons of these experiences as well as from the many technical debates on how much professional convergence there si on stabilization issues. The debates on the early short-term IMF programs are reviewed first. A presentation is made of the so-called Washington consensus, as embedded in the current medium-term joint IMF/World Bank adjustment packages. Heterodox stabilization experiments are also discussed. A tentative conclusion is then derived about what would constitute today's prevalent view on growth-oriented stabilization programs for developing countries. New themes which have entered the agenda of debate such as policy shocks vs. gradualism, sequencing of policy reforms, permanent fiscal adjustment and public sector reform, coordination of private sector investment decisions, temporary price controls and income policies, nominal anchors and financial safety nets, debt reduction and debt relief, are reviewed. Some conclusions are drawn on the role of policy-based official lending.

Resumo

Várias lições podem ser tiradas a partir das tentativas de estabilização e ajuste estrutural nos ano oitenta, tanto dos numerosos fracassos quanto dos mais raros êxitos. Este trabalho resume lições dessas experiências assim como dos debates por elas ensejados. Em primeiro lugar, são revistos os antigos programas do FMI. Faz-se um resumo do chamado consenso de Washington tal como definido implicitametnte nos pacotes de ajuste patrocinados pelo FMI e Banco Mundial. Experiências heterodoxas também são examinadas. São avaliados os elementos constitutivos da visão dominante sobre programas de ajuste com vistas ao crescimento econômico em países do terceiro mundo. São finalmente postos em perspectiva os novos temas que compõem agora a agenda de debates tais como: gradualismo vs. tratamento de choque, sequência de reformas, ajustes fiscais permanentes e reformas mais ambiciosas para o setor público, coordenação das decisões de investimento do setor privado, controles de preços e políticas de rendas, âncoras nominais e redes de segurança financeiras, reduções ou simples perdão de dívidas.

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An earlier version of this paper was prepared for the Department of International and Social Affairs of the United Nations to serve as a background paper for the UN Secretery-General Report (United Nations, 1991). The authors are indebted to Marcelo P.Abreu, Helga Hoffmann and Barry Herman for valuable comments.

INTRODUCTION

Interruption of economic growth has been a traditional cause for political resistance to stabilization policies. The 1980s were a decade neither of adjustment nor satisfactory growth for most developing countries. In fact, third world countries showing most significant growth in the eighties had already undergone a thorough reshuffling of their policies prior to the world debt crisis in the eighties (Korea, Thailand, Turkey) or had managed to protect themselves from the excesses of external debt dependence (China, India, Colombia).

A repetition in the 1990s of the experience of the 1980s cannot be discarded, as the most likely candidates to exhibit significant and steady growth are the few countries which may have already adjusted to the post-debt crisis by the first two years of the decade. Lack of perseverance in doestic adjustment efforts and a dearth of external financial support underlie the many frustrated stabilization attempts of the last decade. Even in the rare cases where a modicum of price stabilization was obtained, economic stagnation continued to be the rule. The response to stabilization attempts has been "stagnationist" rather than "exhilarationist", in Lance Taylor's terminology (Taylor 1988c). The more recent difficulties of economic restructuring in Eastern Europe epitomize and dramatize the long-standing adjustment difficulties observed in Latin America and Africa. The problems of operating a quick transformation of economic systems, marred by distortions and lack of market incentives, are now clearer than ever.The last decade was frustrating in economic results, but rich in economic experience. Economic policy lessons accumulated, mostly from the many failures but also from the fewer successes. A better understanding became available about what works and what does not work in terms of stabilization policies.

Many professional seminars were promoted in the past years to discuss this experience, from the Fund/Bank 1987 Washington Seminar on Growth-Oriented Structural Adjustment (Corbo, 1987) to the February 1991 Gaborone conference sponsored by the Association of African Central Banks and the IMF (Helleiner, 1991a). In these seminars individual countries' experiences were subjected to professional scrutiny in response to the need for improved efficiency in multilateral policy-based lending. Unresolved issues abound and generalizations are hard to obtain,but a minimum of professional convergence has been reached on themes that only ten years ago were object of fierce doctrinaire debate.

Old truths reaffirmed their validity, but many new elements were added to our understanding of growth-oriented stabilization in developing countries.The purpose of this paper is to draw the lessons of these experiences and debates. The next section discusses where we stand in terms of the professional convergence on stabilization issues. The debates on the early short-term are made of the so-called Washington consensus, as embedded in the current medium-term joint IMF/World Bank adjustment packages. Heterodox stabilization experiments are also discussed. A tentative conclusion is then derived about what would constitute today's prevalent view on growth-oriented stabilization programs for developing countries.

The third section deals with socio-political aspects of stabilization policies in developing countries. These tended to be neglected in the past, but are today recognized as central for the success of such stabilization efforts.

The fourth section is the longest of the paper. It elaborates of thirteen new themes, which have entered the agenda of debate on stabilization policies for developing countries during the last decade. These themes are as follows: (1) policy shocks or big bangs vs. gradualism, (2) scope vs. intensity of policy reforms; (3) sequencing of policy reforms; (4) permanent fiscal adjustment and public sector reform; (5) coordination of private sector investment decisions; (6) public investment in infrastructure; (7) industrial policy; (8) policy stability and sustainability; (9) temporary price controls and income policies; (10) nominal anchors and financial safety nets; (11) debt reduction for middle income countries; (12) debt relief for low income countries; (13) special problems of formerly socialist economies.

Most of these themes are controversial, but we nonetheless try to extract from their presentation and discussion a set of conclusions, which are presented in the last section, on the role that policy-based official lending could play in support of growth-oriented stabilization programs in developing countries.

2. PROFESSIONAL CONVERGENCE

Until the first oil crisis of the mid-seventies, the Bretton Woods institutions had clearly defined roles. The IMF was in charge of redressing temporary balance of payments dislocations, through the provision of stabilization loans; the World Bank was in charge of promoting development, through the provision of long term loans for infrastructure investment projects.

The early stabilization programs sponsored by the IMF, specially in Latin America, had a simple diagnosis of the balance of payments and inflation difficulties of these countries. The fundamental problem was excess government spending, which was at the root of both the international reserve losses and the domestic inflationary pressures. A complementary problem was overvalued exchange rates, supported by quantitative import controls, and designed to artificially reduce the costs of imported wage goods and industrial inputs. Finally, private savings were being repressed by the maintenance of negative real interest rates, supported by discriminatory credit rationing.

The stabilization programs of the Fund were thus oriented by two fundamental prescriptions: balance the budget and get the prices right. Cuts in government overspending, maxidevaluations, and positive real domestic interest rates, would allow a suppression of the rationing mechanisms for foreign exchange and domestic credit allocation, while resolving the balance of payments and inflation difficulties (see IMF, 1987).

The original Fund view by and large ignored the existence of domestic structural problems and adverse external environments. The first, as manifested by slow price responses, foreign exchange shortages, and reduced domestic savings, according to the Fund doctrine were the consequences of wrong economic policies, underlying an overambitious

State-led import substitution industrialization effort with populist overtones. External difficulties were also disregarded by the Fund with the argument that developing economies were very small vis-a-vis the rest of the world and hence faced an infinitely elastic external demand for their exports and an infinitely elastic external supply of foreign capital: if they did not export more or attracted more foreign investment it was because domestic incentives were wrong (see Killick, 1984).

The Fund was also quick to respond to the critique as to the short-term nature of its financial support. It was designed in Bretton Woods as a monetary institution, not a development institution. Long term loans was the World Bank's business. The profile of the two institutions, however, became increasingly intertwined, when the World Bank started emphasizing policy-based lending in the early eighties, having started lending for structural adjustment in 1980 (See Michalopoulos, 1987 and Bacha, 1988). In response to the first oil shock, later reinforced by the second oil shock, the 1979 interest rate shock, the back-to-back worldwide recessions of 1980 and 1982, and the 1982 collapse of international bank lending to developing countries, by the end of the 1980s adjustment lending represented 31% of the Bank's total lending commitments (Jaspersen and Shariff,1990).

This sequence of negative external shocks, comparable in magnitude only to those of the 1930s, made it clear that developing countries adjustment efforts faced an extremely adverse external environment. A major structural adjustment effort was required, and this could not be achieved only with the traditional Fund medicine.

The accumulated experience with Fund programs also indicated several limitations of the traditional prescription. Among them, some of the most salient are as follows. First, the recommended maxidevaluations proved to be inflationary in a context of real wage resistance, as a consequence of which program countries frequently did not manage to meet the Fund's inflation targets. Second, maxidevaluations frequently caused significant drops in domestic demand, which were not compensated by export increases, thus accentuating the country's recessive tendencies. The maxidevaluations also tended to affect negatively the government budget, in cases in which foreign trade activities were not taxed and the size of the public sector external deficit was large. Fourth, budget adjustments made under the pressure of meeting three-month targets frequently proved to be short-lived. In the short-run, governments generally succeeded only in deficit repression, often obtained through the suspension of much needed but easy to cut investments in social and economic infrastructure; growth-oriented deficit suppression, as required for sustained price stability, would require a longer term horizon. Fifth, private savings did not respond positively to the very high real interest rates normally accompanying Fund programs: on the contrary, the financial fragility brought about by the impact of high real interest rates frequently led to bankruptcies and financial collapses, besides also increasing the costs of servicing the government domestic debt.

In this reconsideration of the required content of Fund programs, the contribution of the World Bank was to emphasize that, besides stabilization, developing countries also needed **structural adjustment** to be achieved, according to the Bank, by the adoption of liberal economic policies

(Corbo and Fisher,1991). Three new tenets were thus added to the original two-pronged Fund prescription. The new Bank/Fund adjustment doctrine, which became known **as the Washington consensus** (Williamson,1990), has five principles:

* **budget balancing,**
* **relative prices correction,**
* **trade and foreign investment liberalization,**
* **privatization, and**
* **domestic markets deregulation**

Trade liberalization was to be typically achieved in a sequence of moves, starting with the replacement of quotas by tariffs, followed by a process of tariff unification, and finally a programmed reduction of the unified tariff, until reaching substantially free trade a few years hence. Foreign investment liberalization essentially meant non-discriminatory treatment vis-a-vis investment by domestic residents.

Privatization involved in the first place the devolution to the private sector of formerly private firms which for one reason or other fell in the hands of the public sector. Second, the closure of loss-making public enterprises, with the establishment of bankruptcy proceedings to deal with such cases. Third, the transfer to the private sector of large public firms which were in the past thought to be of "strategic" importance. Domestic markets deregulation involved policy actions in goods market, labor markets, and financial markets. Typically, the objective would be to free these markets from government controls, letting prices to be freely determined by supply and demand. Mechanisms to guarantee free competition and a prudent bank regulatory framework should however be established. Deregulation would also involve the introduction of an adequate legal system for the protection of property rights, as well as the prevention of the abuse of market power. One welcome consequence of this expanded agenda was the recognition by the Bretton Woods institutions, that adjustment in developing countries was a much more complex task and would take much longer than originally envisaged in the early Fund doctrine. Stabilization and balance of payments problems could not productively be dealt with a short-term perspective, but should rather be viewed as an integral part of the development challenges facing the developing countries. A bias however remained in the view that building the confidence of the private sector, through a combination of fiscal discipline and liberal economic policies, was all that was required for a successful growth-oriented adjustment effort.

Conceived as a counterpoint to such optimist biases of the Washington-based multilateral financial institutions, the **heterodox stabilizations**, which became popular in the 1980s, tried to incorporate inflation rigidities and slow price responses into a new policy framework, thereby ascribing an enhanced role to direct government coordination of prices and incomes (Ocampo, 1987, Bruno et al. 1988). The need for rational controls, which attempted not to violate equilibrium price movements, but only those derived from backward looking expectations, led to policy

recommendations for price and exchange rate controls and de-indexation. Heterodox programs also tended to downplay the need for an early fiscal adjustment, on the theory that substantial fiscal gains would be generated by successful price stabilization, as a consequence of the Olivera-Tanzi effect acting on reverse, and of the seignorage revenues accruing as a consequence of the remonetization of the economy.

Victims of their own earlier promises of an **expansionary stabilization**, many heterodox attempts fell in the trap of outright abandonment of fiscal adjustment and ended up in the road of hopeless populism. Premature reflating of the economy, inadequate changes in relative prices, disregard of economic incentives to recover investment, and abuse of temporary import liberalization (as a means to repress domestic prices in the presence of inappropriate exchange rates), are the main elements defining the inconsistency of several attempts at heterodox stabilization. The Peruvian case, under Alan Garcia, epitomizes the worst outcome of such experiments, although different dosages of the same ingredients are found in Brazil's Cruzado Plan and Argentina's Austral Plan. (see Kiguel and Liviatan, 1991)

The failure of the **populist experiments** with expansionary stabilization helped to sober up the IMF critics. A better understanding was obtained of the "narrow limits of the possible" in the short-run, as well as of the need of a thorough public sector reform, to maintain the much-needed government investments in social and economic infrastructure, without the need to resort to inflationary financing.

A context of reduced divergence between previously irreconcilable approaches became apparent more recently. This professional convergence is in part a consequence of a reflection on the failures of the most extreme versions of both orthodox and heterodox programs. But in part it is also a reflection on the successes of experiments which managed to blend both orthodox and heterodox elements.

Thus, Israel, since 1985, and Mexico, since 1987, have managed an adequate blend of orthodox and heterodox components in their stabilization programs (Bruno and Pitterman, 1988, and Dornbusch, 1988). These programs emphasized fiscal discipline and market-oriented policies, but did not shy away from the adoption of incomes policies as a means of achieving rapid deflation with reduced output losses. Brazil in the mid-sixties is an early example of a successful incomes policy supported stabilization program.

The successful industrialization drives of Taiwan and South Korea also helped to temper the enthusiasm of the Washington consensus participants on the power of purely liberal economic policies to promote growth-oriented adjustment. These cases confirmed that fiscal discipline and trade orientation are essential ingredients of successful adjustment efforts, but they also showed the importance of the coordinating role of the government in the areas not only of human development (health and education),but also of technological adaptation, provision of long term finance, and in the design of a performance-oriented industrial policy (Wade, 1988 and Amsden, 1989).

In the subject of trade policy, the original source for the generalized recommendation for more openness was the survey of 41

economies analyzed in the 1987 World Economic Report. The evidence on the association between openness and growth has since then been qualified by several studies. Singer and Gray (1988) analyzed an extended version of the data set used by Kavoussi (1985) and challenge the universality of the policy implications contained in the 1987 World Bank Report. The regressions run by Edwards (1991) tend to add confidence in the causality, as he concludes that trade interventions, as measured by deviations from Edward Leamer's (1984) estimates of Heckscher-Ohlin's trade patterns affect growth performance negatively. The context of endogenous growth models used by Edwards may help to give empirical support to the perhaps more balanced view that it is through the encouragement of exports rather than liberalization of imports that growth performance may be enhanced by more outwardly oriented trade regimes, as put by Helleiner (1989).

Finally, general recommendations on trade policy regimes for developing economies can't help passing a judgement on what is hapenning to the general economic environment in terms of trade and financial flows in the world at the time trade policy is enacted. Taylor (1988a) reflects on the existing evidence of the successful growth experiences vis-a-vis the prospects for growth of trade and financial flows for the 1990's to conclude that "some degree of inward orientation may be a wise choice." This important qualification has been reinforced by Chakravarty and Singh (1988) in the context of large countries like India, China, which had not been included in the World Bank sample of Asian economies.

3. SOCIO-POLITICAL DIMENSIONS

The analysis of the experiences with structural adjustment and stabilization policies in the eighties have led to another consensus: the importance of local government's "ownership". The basic idea is very simple: there is little chance that the best of policy-packages may succeed in a country if the government in charge of its implementation does not see the package as expressing its own intent. This simple idea has important practical implications both for the design of policy strategies and for the discussions between multilateral agency officials and local authorities on the details of the programs. It means, for example, that there is little hope for the successful implementation of policy moves that had been decided upon after "negotiation of conditionalities as in a bazaar" (Helleiner,1991).

Adjustment policies tend to be costly in political terms, subjecting local governments to a series of pressures. These pressures usually stem from at least three sources: beneficiaries of the previous status quo, transient bearers of the burdens of adjustment in terms of output losses, sectoral unemployment and investment dislocations and, of course, skeptical critics whose voice gains resonance with the time elapsed before results are recognized as beneficial. One important reason for the early abandonment of policy reform is that the government itself -- or the majority coalition --may not be convinced it is in the right economic policy track, being at best convinced that it has to display some discipline to enhance the "goodwill" of donors, creditors or international partners. This means that the fragility of domestic political support is one of the weakest points of most adjustment reforms. Whenever this reason is sufficiently strong, serious consideration of measures to strengthen the political coalition supporting the program may add to the program's chance of survival and success. This approach may have some advantage over the "teaching the locals a lesson" approach.

Another source of political resistance that may conspire against the chances of success of the program is the negative (short-run) effects on the low-income groups. This may be specially serious when policy moves are very radical to start with, and therefore tend to provoke serious sectoral dislocation of resources and employment, for a period of time which may turn out to be politically unsustainable. This suggests that safety nets should be developed to protect the poor from the short run dislocations of the stabilization program.

Poverty levels and social indicators have to be explicitly considered as a constraint to enactment of policies, otherwise adjustment will at best be seen as a costly, and in many cases unjustified manner, to have access to foreign exchange, in the case of dollar-starving poor economies. No political support for rational economic policies will be constructed, but rather the incentives will be to devise ways to circumvent multilateral agencies' "odd conditionalities".

A wide gap exists between the need for policy adjustment of an organized market economy to a new set of international constraints and the need for policy reform of most developing economies after a decade of frustrated macro policies, low economic growth and aggravating social conditions. Existing imbalances tend to reinforce and strengthen one another, as policy distortions pile up as a result of protracted adjustment. After a long period of artificial controls, not only market distortions may be the rule and rent-seeking opportunities develop profound roots in the institutional and social codes, but their removal may require more than legislative changes and political will. It requires consistent policies for a long period in which

actual results will not be available to guarantee political sustainability of those initiating the programs.

This is particularly dramatic when policy reforms take place in the wake of a major change in economic rules regarding property rights and the role of the state. In a significant number of Sub-Saharan countries, the frustrated attempts after de-colonization to build socialist economies on top of deep-rooted tribal customs have now been replaced by equally frustrated hopes to create capitalism overnight. There seemed to be a hope in some countries that the mere announcement of the new regime, with the support of international multilateral agencies, would suffice to flood the country with foreign capital. In the present situation regarding international flows of private capital it is unlikely that sufficient voluntary investment will be forthcoming for all countries just because their governments managed to approve legislation welcoming foreign capital. This certainly does not mean that the legislation should not be passed, but that political support for it should not be based on false hopes, otherwise the stability of the rules concerning private investment is jeopardized. And this stability is perhaps the most important requirement for the attraction of foreign capital.

The conclusion is that the likelihood of a possibly long period between the adoption of a policy package and its political rewards needs to be taken into consideration in choosing the strategy to carry on the program. First, there are little gains in making a government team swallow a program the contents of which it does not believe in, to start with. Second, measures to prevent eventual temporary negative effects of the program on the lower income groups should be reckoned among the program costs to prevent foreseeable negative effects to develop into a strong political coalition against the program. The economic stabilization effort should not be an excuse for a narrowing down of the number of meaningful actors influencing the country's destiny. Third, external support for reasonable measures based on an inconsistent political coalition may be unproductive, as frequent changes in policies may be required which will not be supported by the initial coalition, thus leading to higher uncertainty. Fourth, the loyalty of the team implementing the program should be evaluated not only in terms of its commitment to the logic of the program but also in terms of the impacts of the measures on their own status, role and professional fulfillment in their societies.

4. NEW ELEMENTS

The wealth of economic experience with stabilization policies in developing countries added many new elements to the older debates. Most of these new themes are still controversial. In what follows we try to make a balanced presentation of the issues involved, but whenever our views on the subject are strong, we do not shy away from presenting our own conclusions.

4.1 SHOCKS VERSUS GRADUALISM

The controversy of shocks versus gradualism first arose in the context of the old Fund stabilization programs. The consensus that finally seems to have come out of these debates, as enriched by the stabilization experiences of the eighties, are as follows. To fight an inflation spurt, in a normally non-inflationary economy, the best policy is a monetary shock, which reveals clearly to all economic agents that the

Central Bank is unwilling to accommodate inflationary behavior. To fight a chronic inflation, the same would be recommended, provided that the government deficit has been suppressed, and that a sharp deindexation of prices and wages can simultaneously be obtained. A lot can indeed be said in favor of a policy shock when stabilization is the sole issue. Curiously enough, the most enthusiastic defenders of "heterodox" (i.e., incomes policy supported) stabilization shocks in the eighties were the critics of the "orthodox" (i.e., purely fiscal and monetary) shocks of the old Fund programs. In the issue of stabilization, therefore, shock treatments seem today to command a consensus both from the orthodox and heterodox points of view. More recent debates about the advantages and disadvantages of a big bang of liberal economic reforms tend to blend two different issues: on one side, stabilization-cum-adjustment in the context of the post-debt crisis Fund-Bank packages, and, on the other side, the conversion of the formerly centrally planned socialist economies into profit-led capitalist economies.

In the case of stabilization-cum-adjustment, the evidence from the unequivocal successful cases - Chile today, Turkey in the eighties, Brazil in the sixties - and even of more moderate successes, like Ghana and Tanzania in the eighties, suggests that growth-oriented stabilization requires a lot of time, and hence much prudence in the introduction of liberalization reforms, regardless of whether the program started with a policy shock in the context of an IMF supported program or with a gradual home-grown approach.

In the case of the conversion of the formerly socialist economies, early enthusiasm for a big bang seems to be giving way to a more moderate approach, emphasizing the definition of a nucleus of essential policy changes, based on a careful analysis of specific country situations (see Williamson 1991). This change of heart occurred after a series of frustrated experiences with big bangs, like the Yugoslavian programs of the eighties and those implemented in the war-devastated economies of Guine-Bissau and Mozambique, not to mention the more recent case of Poland. Even in case of policy reforms proposing a less radical change than outright conversion to capitalism, the initial enthusiasm with policy shocks evolved towards a more carefully defined "sequencing" of policies. The essence of the evolution is a more pragmatic approach towards the definition of a sub-set of priority policy changes, this being viewed as a better strategy than adopting an encompassing policy package, which runs the risk of a demoralizing failure. This means, first, attaching more importance to the elimination of the bigger distortions, as for example, those generating a risk of hyperinflation, or causing a sharp curtailment of foreign-exchange supply. Second, placing a high value in sustaining near price stability - even when there is no immediate risk of hyperinflation - as a pre-requisite for a successful adjustment program, which involves leaving efficiency-raising measures to a second round of reforms.

The debate on shocks versus gradualism also evolved in the direction of a more meaningful and operational discussion concerning two dimensions of the policy dilemma, the scope and the intensity of policy changes.

4.2 SCOPE OF POLICY REFORMS

Recent economic reform experiences teach some important lessons about the scope of recommended policy reforms. First, the differentiated nature of the most obvious imbalances and distortions is critical to the definition of the measures to be

taken at the start of the program. Thus, hyperinflation menaces, witnessed in some Latin American countries, as opposed to foreign exchange starvation more typical of African economies, are easily recognizable as polar cases, requiring totally different policy priorities at the start of a reform program.

A country plagued with open or repressed hyperinflation may not be dollar-constrained in the short run, as the disorganization of the economy may have done the job of curtailing domestic absorption and imports, besides enhancing the attractiveness of export-related activities. A safety net of foreign exchange support may however be needed, in order to sustain an anti-inflationary shock which has to signal the independence of the government from inflationary finance.

A small country starving for foreign exchange exhibits a different picture. Removal of exchange distortions may simply generate a more disorganized economy if delays in supply response, and lack of credibility of governmental policies due to past failures are not taken into account when implementing, for example, a drastic cut in government expenditures.

Once the focus of the first moves of policy reform is decided upon, however, there remains the issue of intensity of each move: by how much to devalue to start with, by how much to correct public prices, to what extent should interest rates be raised, or should they be freed from controls, are examples of decisions concerning intensity of use of policy instruments. The decisions should take into account, first, that the stabilization policy game will be played for a long time in the future, and hence, short run advantages of big moves should be counterbalanced by the need of maintaining policy consistency for a long time. A second consideration is the political and economic strength of the groups negatively affected by the policy moves, as well as the possibilities open to the government to offer side payments to those losing with the measures. If the political economy is not right, prudence perhaps should be adopted in changing relative prices. A third consideration is that a relative price cushion, in the form of maxidevaluations and overadjustment of public sector prices, may give the government more room (in terms of foreign exchange supply and government revenues) to play with nominal anchors than otherwise would be the case. The conclusion is that the essential elements that should be included upfront in a policy package cannot be determined in advance, but depend on the perceived constraints to a minimally acceptable operation of the economy. In most cases, the imbalances that tend to clog the countries' markets and prevent the economic system to function in the short run are untrammelled inflation and acute foreign exchange shortages. The scope of the policy packages should try to concentrate as much as possible in removing the most visible constraints, and the intensity of the policy moves should take into consideration that the policy game will probably be played for a long time in the future. Rodrik (1989a) makes a similar point in the context of trade reform. This leads to the problem of sequencing.

4.3 SEQUENCING

Adjustment measures can all be announced in a single package, but not all of them can be introduced from one day to the next. This poses the problem of the adequate sequencing of reforms. The World Bank has been keen in stressing the need first to stabilize the economy, before adopting structural adjustment measures (such as liberalization, deregulation, and privatization), finally to invest and grow (Selowsky 1988).

The perception of the need for this type of sequencing seems to have been originally developed as a reaction to the failures of the so-called open monetarist experiments of the mid-seventies in the Southern Cone of Latin America. In these cases, liberalization measures tended to precede fiscal adjustment. These experiments proved to be short lived, ending in major balance of payments crises.

Latin America was also the scenery for a second group of failed policy experiments in the mid-eighties, the expansionary stabilization attempts in Argentina (Austral Plan), Brazil (Cruzado Plan) and Peru (Inti Plan). In these cases, temporary wage and price freezes were used, not simply as coordination mechanisms - which is the positive role that they might perform - but rather as inadequate substitutes for fiscal and monetary adjustment, which the governments of these countries were unable or unwilling to introduce and maintain.

This second set of failed expansionary experiments taught that the old virtues of fiscal discipline, monetary stringency, and right prices may not be sufficient but they are indeed necessary ingredients of any serious stabilization attempt. Growth resumption is the final objective, but it cannot be reached from the start, before some critical intermediate steps are undertaken.

The first set of failed open-monetarist experiments taught, first, that fiscal adjustment has to precede liberalization, otherwise speculative runs are inevitable. Second, that deregulation should start in those markets which adjust more slowly, i.e., the labor market should come first, then the goods markets, and finally, the financial markets. Otherwise, the tendency will be for overshooting of exchange rates and interest rates, given that financial markets are much faster to react to price stimulus than the other two.

Derepression of financial markets has in fact been a frequent component among the objectives of structural reforms. The basic aim is clear: to create conditions for interest rates applying to different forms of debt to reflect rates of returns and asset preferences of wealth-holders. The hope is that, with a movement in the direction of competitive financial markets, rates of return on capital will reflect relative scarcities so as to make more attractive those uses of capital which make the best out of the existing investment opportunities. Typically, repressed markets are too regulated, varying from a complete public sector monopoly of financial intermediation to direct controls over transactions or ceilings on borrowing and lending rates, protection of domestic banks, proliferating curb markets, and a wide range of direct channeling of (compulsory) funds to government-defined investment priorities. Derepression in this context usually means freeing interest rates on loans from financial intermediaries and returns on financial assets, so that a higher proportion of private savings may be channeled through financial markets. This is one example where wrong sequencing may be disastrous. Financial markets tend to be excessively regulated and with abundant distortions almost everywhere; hence, the temptation towards premature deregulation may be strong. The result of premature deregulation may be higher volatility of interest rates induced by speculative behavior, increased uncertainty as to the costs of loans without any favorable counterpart in financial deepening, widespread "financial thinking" in private business far before flexibility in the savings/investment intermediation is achieved, and, finally, facilitated capital flight in the presence of high uncertainty in domestic markets before foreign capital can be captured under the new policy regime.

4.4 PUBLIC SECTOR REFORM

One critical juncture in the sequencing of reforms relates to fiscal adjustment. The point is that a durable fiscal adjustment takes time to achieve. What can be done in the short-run are temporary stop-gap measures, such as a one-time step increase in public sector prices, infrastructure investment reduction, payment delays to domestic creditors and suppliers, postponement of salary adjustments to government employees, external public sector debt moratorium. This is deficit repression, not deficit suppression. With these measures, even if the 3-month performance criteria monitored by the IMF can be met, the fundamental fiscal inbalance problem would remain unsolved.

"Deficit suppression" involves divestiture, deregulation, tax changes, debt consolidation, changed personnel policies, and an incentives-focussed public sector administrative framework. It also involves putting in place a new monetary regime, capable of avoiding the emergence of quasi-fiscal deficits in the Central Bank accounts, even when the fiscal accounts of the central government are under control (Tanzi 1987).

This means that permanent fiscal adjustment requires deep institutional changes in the way that the central government operates and interacts with other public sector entities and with the private sector. What is needed is the suppression of the potential budget deficit that lies behind all the contingent government liabilities built through the years, in the context of a statist soft-budget economic regime, in favor of different interest groups both inside and outside the public sector. Budget deficit suppression requires in fact a thorough "public sector reform", involving at least two elements: measures to improve the efficiency of the economy and measures to increase public savings. This requires broadly understood fiscal reform, usually involving debt restructuring (domestic and foreign), elimination of rent-seeking entitlements, closure of hopeless state enterprises and adoption of a more adequate tax system. But it usually involves also the elaboration of constitutional rules and a performance-oriented regulatory framework for State intervention which makes irresponsible deficit spending more difficult and rules of the game for private investors more stable.

The problem is that permanent fiscal adjustment as illustrated by the tasks behind public sector reform, takes time; in the beginning of the program, only temporary measures are at hand. But the implication is that the introduction of a deep public sector reform program cannot wait for stabilization to be achieved; for this will not happen until economic agents are convinced that a permanent fiscal adjustment is taking place. Hence, the critical role that sectoral adjustment loans, designed to support a thorough reform of the public sector, may have in the design of stabilization programs.

4.5 PRIVATE INVESTMENT COORDINATION

One of the main lessons of experience is that stabilization in chronically high inflation countries is a process that takes time, not a year or two, but more likely a decade or so (Kiguel and Liviatan, 1988).Once a state of chronic inflation gives way to a process of true hyperinflation, as in Bolivia in the early eighties, inflation may fall rapidly, almost instantaneously, once a sharp disinflation program is implemented (Morales 1988). This is because such economies become substantially dollarized, in

terms of price and wage setting and financial assets. In these cases, a sharp fiscal adjustment accompanied by the pegging of the domestic currency to the dollar are able to produce an almost instantaneous price stability.

Even in such rare cases, however, in order to avoid a collapse of the stable exchange rate regime, fiscal overkill and supertight money seem to be required, to establish confidence in the new economic policy stance. These contractionary policies are however inimical to the generation of an adequate economic climate for growth restoration.

Chile is perhaps the only example of a chronic inflation country which has managed to successfully stabilize its economy (but even today with inflation rates in the 20% a.a. range !). The lesson that can be drawn from Chile is that curing chronic inflation by orthodox methods can be successful but the treatment may take a decade or even more. During this period, fiscal and monetary discipline must be maintained persistently. It is persistence rather than the specific policies (types of exchange rate or wage policies) which seem to be the key to success. The main drawbacks of this success are the low average growth rate and the severe crises which shook the Chilean economy along the way (Corbo and Solimano, 1991).

The successful stabilization experiences of Chile, and the still ongoing ones of Israel and Mexico, confirm the old truths that fiscal austerity, competitive real exchange rates, sound financial markets and deregulation are required for stabilization, and that they provide the preconditions for growth resumption. These cases however show a need to distinguish between the necessary and the sufficient conditions. Adjustment is strictly necessary, but it may not be sufficient. Because they have an "option to wait" (see Dornbusch, 1990), asset holders tend to postpone repatriation of capital flight and investors to delay initiating projects. This creates an important coordination problem, a new element in growth oriented stabilization programs, that traditional approaches do not normally recognize.

Because physical investment is partially irreversible, rational behavior by the private sector calls for withholding investment until much of the residual uncertainty regarding the success of the reforms is eliminated. Without investment, reforms are less likely to prove sustainable; but investment will not be forthcoming in the presence of uncertainty as to future policies. Hence, the discomforting conclusion that the success of policies may depend in no small part on the psychology of private sector expectations.

A reform can end up being reversed for no other reason than a shared expectation that it will not last. Even if the initial expectation is not based on underlying fundamentals, it can prove self-fulfilling. This is particularly troubling today in Argentina, Brazil, and Peru, where economic agents, after having witnessed a series of failed stabilization attempts, prefer to wait before making irrevocable investment decisions.

The conclusion is that there is a need for a "coordination mechanism" that overcomes the competitive market tendency to wait. Political economy considerations need to be brought in. What markets consider a sufficient policy action may simply be beyond the political scope of democratic governments. If governments went far enough to create the incentives that would motivate a return of capital and the resumption of investment on an exclusive economic calculation, the implied size of real wage cuts might be so extreme that now, on political grounds, asset holders might consider the country too perilous a location (Dornbusch, 1990).

In the aftermath of a major macroeconomic shock competitive markets by

themselves may be unable to restore a good equilibrium. A coordination mechanism as provided by a sensible "industrial policy" seems to be necessary for growth resumption after stabilization is achieved.

The option value of waiting approach also highlights the critical role that stabilization loans may have in helping reformist governments to get through with their programs. A decisive step in that direction would be the support of industrialized countries for the suspension of external debt service for a substantial period of time. This could provide the necessary "financial safety net", not only to dissuade potential speculative attacks, but also to induce investors to reverse capital flight and start investment projects.

The 1985 Israeli stabilization exemplifies the point. The US$1.5 billion stabilization loan provided by the US was never disbursed, in the sense of being transformed into imported goods; but then this does not mean that it was useless; on the contrary, without such insurance, probably the Israeli government would have fallen prey of a speculative attack on its currency and would not have been able to buy the time necessary to set the stabilization effort on solid grounds (Bruno and Pitterman, 1988).

4.6 NUANCED APPROACH TO PUBLIC INVESTMENT

An outcome of a significant number of stabilization attempts in the eighties was a reduction in investment (Helleiner, 1990, Serven and Solimano, 1991). Although an obviously undesired phenomenon for developing countries as a whole, in some cases, specially in the sub-Saharan economies, this contraction was a consequence of a previous period characterized by high but inefficient investment expenditures (Ndulu, 1990). The combination of inefficient parastatal enterprises with inadequate foreign advice and tied-aid explains the waste connected with some African investment booms. Decreases in investment, in such cases, may signal a better use of scarce resources and future improvement in growth prospects.

In most other cases, however, reduction in investment has occurred as an unforeseen response of total investment to a decline in public investment as a consequence of cuts in the fiscal budget. The conventional wisdom in earlier programs was that a reduction in public investment, accompanying austerity measures affecting public expenditure as a whole, would make room for private investment, which had previously been crowded out by excessive government capital outlays in presence of limited savings. Government investment would thus advantageously be replaced by profit-oriented private investment, with positive gains on overall productivity of capital spending due to a better use of scarce savings.

Empirical evidence obtained in the eighties (Blejer and Kahn, 1984, for example) regarding complementarity between public and private investment calls attention to the fact that decreases in public investment may be detrimental to private investment in the long run even if public investment may dislocate private investment in the short run. The quality of public investment seems to be a critical growth-inducing factor particular in cases where an inadequate infrastructure requires the development of bulky public projects to enhance private profitability prospects, as noted by Greene and Villanueva, 1991.

Cuts in government outlays which have important positive crowding-in effects, in the context of indiscriminate attempts to reduce public expenditure, may turn out to have two undesired consequences for private investment: interruption of feasible

projects due to delays for lack of complementary infrastructure works and increased uncertainty.

Negative long-run consequences of adjustment programs could therefore be largely prevented, if indiscriminate reductions in public investment were replaced by a more judicious analysis of priorities concerning investment programs. Growth performance following adjustment programs could be improved by a better knowledge of the complementarities between public and private investment in adjusting countries.

In this context, privatization can be a meaningful way to conciliate the need to preserve important projects, within the limitations of the government's restricted financial possibilities.

There is also the need to reverse the squeeze of the government's financial capacity which has occurred as part of the process of the deterioration of the fiscal deficit. The deficit can be seen as the excess of public investment over public saving. Public revenues in excess of government consumption and debt servicing has declined in virtually every country. The recovery of public savings has become one of the important yet neglected issues of fiscal adjustment in the context of post-debt crisis stabilization programs. As external debt became ultimately public, even where it started as predominantly private, servicing the debt absorbs public savings and this is specially important in countries where the government is a net buyer of foreign exchange, as well as an important investor or source of long term finance for the private sector (Werneck, 1991). A redirected emphasis on the recovery of public savings, should result in a smaller negative effect of stabilization and adjustment policies on the country's rate of investment, public as well as private.

4.7 INDUSTRIAL POLICY

A sensible industrial policy may be a potential coordinating mechanism, capable of reducing the uncertainty that constricts private investment in the aftermath of stabilization experiences. The ingredients of such policies are not easy to spell out except in very general terms.

Empirical evidence provided by available comparative studies (Serven and Solimano, 1991) tends to reinforce the view that the issue of private investment behavior following stabilization policies goes beyond the question of "private versus public investment" as mentioned in the previous item. It bears upon the government's ability to convey clear-cut and sustainable views on issues such as the relative roles of private firms and government enterprises, as well as on its ability to define long term investment priorities receiving sustained political support, as expressed into practical legislation and effective governmental action.

There is no substitute for a clearly defined set of **structural policies** as a means of increasing the private sector's expected profitability and reducing the variance of the long run scenarios projected by potential investors. Thus, basic definitions concerning strategic issues - such as property rights, development of human resources, and stimulus to acquire the scientific capabilities to absorb and adapt technological progress - are present in all cases of long run success of stabilization and adjustment policies.

In every case of high investment rates, as in Korea, Thailand and Singapore, the closeness of the connections between a growth-oriented government and a profit-motivated business community helped to strengthen private investment through direct channels, such as special credit allocations, but also through sustained

support for the appropriate education of the working force at all levels.

4.8 GETTING THE POLICIES RIGHT

In a context of broad policy reforms, private investors may become more responsive to the variance than to average expected profit levels. Policy reforms that appear desirable on standard economic grounds will backfire when they induce doubts as to their likely survival (Rodrik, 1989b). Reform packages which emphasize **policy stability and sustainability** are likely to bring greater payoffs in terms of investment and growth than **incredible policies** (Calvo, 1986), which may correctly focus on economic liberalization and getting the prices right, but without attention to their impact on the government budget, the supply of foreign exchange, or to the uncontrollable reactions of affected interest groups.

A revaluation of successful experiences of the past years in terms of growth performance after early adjustment policies (Lau 1986, Amsden 1990) has contributed to qualify previous conclusions about the value of non-interventionist policies to explain the success stories of outward-oriented market-based fast growth economies of East Asia.

The emphasis on the importance of the **quality of government intervention** seems to encapsulate the essence of a more balanced conclusion about those success stories. At stake is specially the ability of governments to follow incentives oriented policies that do not go against market signals, even if prices have to be subjected to distortions derived from the presence of subsidies and protective barriers.

The lessons to be drawn when one compares the success stories with the obvious failures or even with the aborted successes of the seventies lead to a simple but frustrating conclusion: government interventions may either enhance or hamper market opportunities. How to foster the first type of intervention and repress the second is a complex **political economy question** for which there seems to be no simple answers. Some economists conclude that the requisites for a "good" government intervention are so extreme, that they prefer to live with the market imperfections. Others conclude that these imperfections are too pervasive in developing countries, and that the task to formulate and implement market enhancing intervention policies is a must for growth recovery.

4.9 TEMPORARY CONTROLS

Attempts at stabilization based on direct price controls or more narrowly defined **incomes-policies**, which disregard fiscal and monetary discipline, have been by and large very unsuccessful. A strong argument in favor of temporary controls remains nonetheless: successful stabilization attempts based on "fundamentals" may gain political support and imply less output loss when incomes policies are used to avoid unfavorable effects stemming from backward-looking expectations and institutional rigidities in contracts, which are the rule rather than the exception in countries with a long inflationary experience (Kiguel and Liviatan,1991).

The weakness of the approach based on temporary controls in search for more political support is that they tend to be self-perpetuating. The political economy of the situation is such that there always seems to be a good case for postponing fiscal adjustment and extending price controls.

A sensible administration of price controls is a critical determinant of the success of a stabilization attempt. Suppose, for example, that a freeze on government prices, the exchange rate and some reference wage has been part of the initial stabilization package. If an unfavorable inflationary shock occurs, the pegged values will look more and more incredible and therefore a wave of pessimistic expectations may ruin the stabilization effort. Pressure for devaluing depends of course on the perceived timing of balance of payments deterioration vis-a-vis the possibilities of finding foreign finance and this may turn out to be crucial to the policy options faced by the government.

The same problem emerges when the public sector deficit prospects deteriorate because public sector tariffs and prices are part of the nominal anchors. The consequences for the stabilization effort will depend on complicated and hard to estimate computations regarding the short-run versus the long run effects of inflation on the fiscal budget.

When stabilization fails, an overextension of price controls is bound to bring a posteriori the worst consequences in terms of distortions, institutional instabilities, and overall damage to government credibility, with negative repercussions for future stabilization rounds.

4.10 NOMINAL ANCHORS

The long term purpose of an adjustment program is to create conditions for the flourishing of an institutional set-up in which a flexible economy may develop into a prosperous one. In such a set-up, relative prices in general and the real price of foreign exchange in particular should be able to signal economic scarcity. The stabilization of the real exchange rate may however conflict with the need to stabilize the nominal exchange rate to ensure a rapid desinflation. This is the nominal anchor aspect of exchange rate policy (Kiguel and Liviatan, 1990). Supose that fiscal stabilization is taking place, hence the Central Bank is no more being forced to adopt a passive monetary policy to finance the budget deficit. Should the Central Bank define its monetary policy in terms of a money target or an exchange rate rule? If inflation were in fact to stop suddenly, real money demand would increase significantly, hence some monetary accomodation would be necessary: prefixing monetary expansion targets under these circumstances would be difficult if not impossible. But a monetary expansion could safely take place by monetizing foreign exchange inflows, at a fixed nominal exchange rate. In this case, the Central Bank would simply be remonetizing the economy with a marginal 100 percent reserve backing. Fixing the nominal exchange rate is an attractive option in that it establishes an immediate focal point for coordinating price expectations and price setting.

Moreover, in an economy which has gone through a long period of disorganizing inflation and unsustainable balance of payments prospects, it may be unfeasible to define and implement a credible economic policy unless a fairly stable prospect for the exchange rate is offered as a nominal anchor: an element of economic calculus, and a substitute for wildly divergent expectations concerning nominal values.

In some concrete experiences, such as in Mexico, a fixed exchange rate played a significant supporting role in defining the minimum consensus around the possibilities of stabilization. This is particularly relevant, when the economy has already undergone a strong fiscal adjustment, when relative prices are not perceived as unsustainable, and when the benefits of reduced variability clearly outweigh the

risks of enlarging the distortions which may be associated with maintaining a fixed exchange rate in a world of floating rates.

Although some previous overdevaluation, such as that preceding the Mexico experiment in 1987, is obviously helpful at the onset of the stabilization attempt, there seems to be no substitute for strong external support from either bilateral or multilateral lending agencies. When local money cannot credibly be anchored in firm precommitments of local policy makers to disinflation at all costs, the best confidence building alternative to ensure the inward mobility of flight capital may come from the existence of stand-by external finance.

4.11 DEBT REDUCTION

One common feature of the post debt crisis adjustment programs was the limited size of the favourable changes in flows -- such as primary budget deficits, trade account deficits -- which could rapidly be obtained in a growth oriented context. The costs of servicing a **debt overhang** turned out to be simply too high to be compensated for by sustainable primary budget surpluses or trade surpluses (Bresser-Pereira, 1991). The limitations of traditional policies, aimed at controling domestic absorption in the presence of a high and hard to finance external debt, had a domestic counterpart in the difficulties to control and reduce the domestic public sector debt.

In countries which have experienced a long period of high inflation, virtually no public debt finds voluntary holders in the domestic market, and the consequence is that policies aimed at reducing the stocks of debt are needed to complement flow-oriented deficit reducing policies.

External debt reduction and restructuring are also essential inputs to stabilization programs in heavily indebted developing countries. The debt reductions offered by the Brady Plan are recognized as insufficient; deeper cuts in commercial bank debt will be required for the second layer of countries that are waiting in the wings, and with increasing interest arrears, for Brady Plan operations.

Industrial countries would need to approve fast the Trinidad Terms for official debt reduction of the low income countries. The Toronto Terms are recognized as totally insufficient by the World Bank among others. Middle income countries' debts to official agencies should receive the same treatment that has been given to Egypt and Poland.

Debt of the least developed countries to the international financial institutions can not be left out of debt reduction operations. The costly fiction that such credits cannot be restructured or reduced needs to be abandoned, if necessary at the cost of selling part of the IMF's gold holdings.

4.12 AFRICAN DEBT RELIEF

Many African countries are currently experiencing adjustment programs which have revealed themselves extremely difficult to sustain and disproportionately frustrating in terms of the overall relief from the pressures of foreign exchange collapse. Debt relief started as a response to African problems, and a good deal more will have to be forthcoming.

Two aspects may be considered from a general perspective, from the recent experiences: the first is that the expected time for results should be fairly long in the case of African economies -- as well as of some similarly war-devastated economies in

Latin America. The second aspect is that the domestic costs of **long debt rescheduling negotiations** are unsustainably high.

The first aspect poses a real challenge to the multilateral agencies: a significant effort should be made to define special rules concerning the time frame of policy-based loans for such economies. This requires special funding with more flexible time spans and a carefully designed system of monitoring and provision of policy advice, with the maximum use of locally based research capability.

A substantial effort has been and is currently being made by the national economies as well as by multilateral agencies and many bilateral aid agencies in the direction of providing the region with much needed investment in human resources and academic research capable of improving economic management. Continuation of support for efforts such as those of the African Economic Research Consortium is essential if the specialized knowledge developed by locally based research is to be of service to increase efficiency in the use of domestic and international resources for the improvement of overall economic and social conditions in the region.

The second aspect refers to the long process of debt-related discussions and negotiations. Although some progress has been achieved in the past few years, there is need for more ample recognition of the costs involved, for some of the poorer countries, in having long and painful negotiations concerning a by and large unserviceable external debt. The consequence of the present state of affairs concerning negotiation rites is that scarce human and financial resources which could be used to improve economic management are being consumed in long and useless discussions.

4.13 POLICY REFORM IN FORMERLY SOCIALIST ECONOMIES

In countries where thorough institutional reforms are expected as part of a more comprehensive political change, such as is the case of installing a market-based system in formerly socialist economies, bold packages may be seen as a one-way ticket to a new regime. This does not mean, however, as recent experience in some African countries illustrate, that such packages are frustration-proof.

There are several conflicts in such context which have to be taken into consideration: price liberalization, exchange rate devaluation, and full monetization of salaries and wages involve the conversion of special buying rights, consumption cards and monetary compensations into comparable sums expressed in national currency with general purchasing power, and may disguise drastic changes in relative incomes.

The temptation to take the three steps - price liberalization, exchange rate devaluation, and full monetization of wages and salaries - at once is great, except that one usually cannot tell with a reasonable margin of error how much devaluation is necessary and there is seldom a "free market" for foreign exchange to which one might resort.

Removal of a dualistic pricing system has been occurring in several countries with different degrees of friction and success. Monetization of wages and salaries initiates the full exposure of inequalities, usually disguised behind a swarm of buying rights, access to imports at preferential exchange rates and loans from official banks under heavily subsidized interest rates.

Inflation may be generated from attempts at recovering real incomes by nominal corrections of wages and salaries, by overburdening the fiscal budget, and by printing money to finance the extra charges. Such **distributive conflicts** find an easy

way to inflation through soft budget constraints, and this may hamper an otherwise coherent initial adjustment attempt. A second round of adjustment is then required, with budget cuts, firing of government employees and more devaluation, defining a picture of institutional reform failures, which is far from being conducive to a social consensus.

The roadway leading to capitalism may turn out to be paved with inflationary spurts, fierce distributive conflicts and several rounds of stop and go. Evidence of the advantages of a gradual approach to institutional reforms seem to be far from convincing, but a long period of adjustment requiring strong external support seems to be unavoidable.

Moreover, drastic changes in the rules of the game are not necessarily more convincing where several shocks have been experienced, as part of repeated attempts to deal with long-established distortions and resistant inflation-perpetuating institutions.

These considerations add weight to some forlorn aspects of gradualism, as a steady course of consistent policies seems to be an essential ingredient to re-establish confidence in the country's governability and essential stability. Repeated failures of big-bang attempts may give rise to a dangerous mistrust not only in economic management but in the country's viability.

CONCLUSIONS FOR POLICY-BASED LENDING

Effective and sustainable policy changes have better chances to succeed in implementing growth-oriented stabilization with the help of foreign lending, and this seems to be the case in all success stories. It is however not clear whether external support should favor big-bangs. From the strictly orthodox "fundamentalist" viewpoint, the probability of success of policy changes should depend on the internal consistency of the policies as well as on policy credibility, which in turn depends positively on policy consistency. Long lags certainly may pose difficult challenges for the sustainability – political as well as economic – of policy reforms. But if one believes, as orthodox economists do, that there is little one can do to reduce lags in expectations, because they are related to the time economic agents take to learn that the government will not retreat, then the orthodox viewpoint favors the big bangs and tends to be pessimistic about the possibilities of using a less ambitious approach as a means of gathering political support and increasing the odds of success. A broadly based liberalizing shock and convincing cuts in government spending, for example, would be the only hopes for success in stabilization policies, no matter how long it takes for results to appear.

The best one could hope for in this context would be to shorten the time lags of the economy's response to fundamentalist policies through learning with other country's experiences. Unfortunately, the record of existing successes stops short of providing a reasonable "vade mecum" for economic policy prescriptions beyond the very general albeit important elements around which one may identify a minimum of professional convergence as previously analyzed.

This being granted, one must reckon with the evidence showing that slow results and deterioration of credibility of a big bang tends to contaminate new efforts, as policy package after policy package is abandoned, or reformulated with rather unsatisfactory results and little correction of long term economic conditions. A large proportion of failures in post-debt crisis adjustment have followed this pattern of stop and go with limited progress and increased instability. Killick and Manuel (1991) report that 50% of 242 IMF programs in the past decade have not been completed and find out that higher instability was the general result of non-implementation. If policy-based lending is not able to increase the chance of success with the passage of time, there is very little to recommend it.

One lesson of these experiences is that the "policy shock" package bias should privilege the time element, not the large scope. It should be able to relieve immediate constraints so as to gather support for what may be a long endeavor, although the announcement should include all the elements recognized as necessary for a consistent program. Temporary controls may be introduced, but keeping an eye on the populist temptations which tend to substitute the overextension of controls for the progress in attacking the fundamental causes of imbalances. If early reduction of some critical imbalance is not achieved, but the program is judged to be on the right track, supplementary finance to permit the program to stay on track is recommendable. "Tranching" of policy-based loans has been a traditional way to allow limited support for a policy move which is in the correct direction but the intensity of which is thought unconvincing. This may indeed be a convenient way to start a program whenever there seems to be strong political resistance to adjustment. Tranching may be a useful way to prevent partial adjustment packages to develop into nonsensical protracting of structural changes. Its most common pathology is however the definition of too short a

period between reviews.

Excessive conditionality can be another undesirable by-product of a program which is too encompassing. This has been a common source for "waivers" plaguing adjustment programs in the eighties. But the consequences may be more serious than mere bureaucratic congestion: credibility may be seriously impaired if too many targets require waivers.

Contamination of the credibility of "reasonable parts" of a program may arise from failures in the less feasible ones. A combination of ambitious scope with overoptimistic targets increase the likelihood that some result will be too far off the mark, thereby increasing the risk of contamination.

Conditionalities that are not fulfilled lead to long delays in disbursing, and a virtual harm to the package as a whole, which becomes underfunded. To the recommendation that tranching should be longer, one might add that it should also be parsimonious.

Policy-based lending should aim at increasing "stability, policy credibility and sustained government effort" (Helleiner, 1990). Government ownership is an essential pre-requisite for success. In order to bend the odds in favor of successful adjustment, multilateral lending to local government-owned programs must reward rational and pragmatic as opposed to populist economic policies. To achieve this, it is essential that the design of the program be based on an adequate diagnosis of the most important distortions and imbalances afflicting the country, and that there is concern with realistic targeting and timing for tranching, and with reducing the social costs of a long lasting structural adjustment.

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