CHAPTER 6

Economies in Transition Around the World

THE REMARKABLE WORLDWIDE MOVEMENT toward reliance on competitive market forces continued during 1990. Fundamental reforms were put in place in several Eastern European countries. Dramatic economic and philosophical transformations were also under way in many nations in the Western Hemisphere. Many countries were embracing democracy, discarding their centrally controlled or state-dominated economies, and moving toward systems in which private ownership of property predominates and most resources are allocated through markets. The pace of change has been great, but events in 1990 also demonstrated that the task of transforming failed economies is formidable. This chapter focuses on the transformation process as it is unfolding in Eastern Europe and Latin America.

The transitions under way in Eastern Europe reflect the failure of command systems to provide either political freedom or a decent standard of living. The massive historical experiment conducted throughout the 20th century that contrasted market-oriented and centrally planned economies has ended with the economic failure of communism. A little over three decades ago Nikita Khrushchev, then Premier of the Soviet Union, boasted "We will bury you," in reference to the alleged superior economic performance of the Soviet Union. Today, although accurate comparisons are difficult, recent estimates of per capita gross national product (GNP) in the Soviet Union have been as low as $1,780, less than one-tenth of per capita GNP in the United States. The contrast between the two systems in Germany is even more stark. Starting from the same point at the end of World War II and sharing a common culture, East and West Germany went two different ways. West Germany achieved one of the highest standards of living in the world, while East Germany became an industrial wasteland with rundown, outmoded factories and a poisoned environment.

Renewed respect for democracy and market forces is also sweeping the Western Hemisphere. A "quiet revolution" in the way that Latin American policymakers seek solutions to their countries' complex problems has taken hold. Almost every country in the region has begun to move away from policies, pursued for decades, that discouraged trade and gave government an extensive role in the economy. Instead they are turning toward economies less controlled by government and more reliant on market forces. The President has recognized the tremendous opportunity presented by these changes with his Enterprise for the Americas Initiative, which is aimed at expanding trade, investment, and growth in the hemisphere, as well as with his commitment to conclude a free-trade agreement with Mexico.

Change also has become apparent in other regions. Nations as diverse as New Zealand, Benin, and Mongolia engaged in debates about far-reaching market-oriented reforms. Several African countries have adopted programs that encourage private markets and reduce government management of the economy. A push for privatization in the mid-to-late 1980s reversed the trend toward increased state control of the economy in Western Europe, with the United Kingdom and France leading the way. The success of the newly industrializing economies of Asia—Hong Kong, Singapore, South Korea, and Taiwan—has offered strong evidence of the gains from outward-looking policies that reward entrepreneurship.

These worldwide changes promise to settle intellectual debates that have persisted for decades. During the 1960s and 1970s the "convergence hypothesis" held that the capitalist and communist systems would eventually evolve toward each other, with the final result a hybrid of the two systems. In Latin America, it was argued that policies that insulated the economy from world markets and expanded the role of government would promote quick industrialization. It is now unmistakably clear that these hypotheses have been rejected. The developed market economies are clearly not evolving toward socialism, and the leaders in Eastern Europe and Latin America are not trying to find a hybrid "third way." These leaders instead push for market-oriented economies with individual choice and private property rights as the foundations of progress and prosperity.

It is impossible to predict the speed or even the eventual outcome of the reforms now under way. The collapse of communist and military dictatorships presents enormous opportunities to improve living standards for hundreds of millions of people, but those opportunities come with no guarantees of quick success. As command systems collapse, they must be replaced with systems that provide appropriate incentives to producers and consumers. Fundamental reform needs time to work, and dislocations are inevitable.

Economic change can be difficult even in well-developed market economies, as was discussed in Chapter 4. Change is even more difficult when it is dramatic and revolutionary. In emerging democracies, economic transformation must make its way within the context of policy debates that accompany the expansion of political freedom. These debates may slow the reform effort at times, or even create backlash against the reforming government, but they impart legitimacy to the new economic system. If governments are to build and sustain popular support for market-oriented reform, there must be widespread understanding of how much there is to gain and realistic expectations about the difficulty of the task ahead. In the longer run, history strongly suggests that decentralization of economic power in a free-market economy will support both prosperity and democracy.

FORCES FOR CHANGE

The pressure for market-oriented change was reflected clearly in developments in Eastern Europe and Latin America during 1989 and 1990. In Eastern Europe, 1989 closed with Poland and Yugoslavia planning ambitious adjustment programs that were put in place in early 1990 and that quickly reduced high inflation rates, stabilized foreign exchange rates, and eliminated shortages. East and West Germany were unified on October 3, 1990, less than a year after the fall of the Berlin Wall in November 1989. By the end of 1990, both Czechoslovakia and Hungary had announced plans to accelerate their reform efforts. In Latin America, Chile's new democratic government took office in March 1990 committed to continuing the country's program of economic reform. Mexico's current government accelerated reforms that were begun in the mid-1980s, while Argentina, Peru, Venezuela, and a number of other countries initiated significant market-oriented reforms.

The fall of the Berlin Wall and the events that followed raised hopes and expectations around the world. *More than anything else, the undying and universal desire for political freedom motivates the tremendous upheaval in Eastern Europe and the ongoing struggle for democracy in Latin America.* But the denial of economic freedom also crystallized discontent. The yearning for economic freedom has been evident in the vibrant underground economies of South America, where enormous amounts of effort are devoted to avoiding onerous regulations and licensing requirements. The simple freedom to make choices in everyday life has a value beyond its positive effects on living standards.

THE FAILURE OF ECONOMIC POLICIES

A fundamental motivation for change in Eastern Europe and Latin America was the failure of their economies to perform adequately. *The economic policies followed in these countries failed because they were unable to provide adequate incentives for producers to supply efficiently the goods and services that consumers wanted to buy.* In a well-functioning market economy, producers must make goods that consumers want; otherwise, their products go unsold and their businesses fail. Producers also have an incentive to produce those goods efficiently—that is, at the lowest possible cost for a given quality—because they can keep the savings gained by reducing costs. If demand increases, prices rise, encouraging producers to produce more and consumers to consume less. If demand falls, the process happens in reverse. In smoothly functioning markets the price moves to equate, at the margin, the value consumers place on the goods they purchase with the value of the resources used to produce them. This process, repeated for countless goods and services, ensures that the economy's scarce resources are used efficiently to satisfy consumer needs and desires.

Interference in the operation of the market breaks this crucial link between producer cost and consumer value. In Eastern Europe and Latin America, widespread use of price controls, reliance on inefficient public enterprises, extensive barriers to competition with the rest of the world, and government regulation of production and investment have all obstructed the normal operation of markets. The lack of enforceable property rights, whether through legal restrictions in Eastern Europe or through inadequate protection in Latin America, severely limited incentives for entrepreneurs.

In Eastern Europe, production levels were, until recently, decreed by central plans. Consequently, there was no reason to expect that the output produced met the wants or needs of the population. Surpluses and shortages occurred regularly, but managers had little incentive to adjust their production as long as quotas were met. Government investment choices caused chronic underproduction of consumer goods, leading to widespread rationing and long lines at shops. Incentives to innovate were almost completely absent, except in the defense sector. But the command economies proved unable to transfer their high levels of defense technology into improvements for consumers.

Production and investment controls were less extensive in Latin America than in communist regimes, but government intrusion into economic decisions was still pervasive. As in Eastern Europe, inefficient public monopolies were common, and public funds were channeled into favored industries regardless of the economic consequences. High tariffs and nontariff barriers protected inefficient enterprises. The proliferation of government-owned firms combined the natural inefficiency of monopoly with the waste and misallocation too frequently found in public enterprises.

Price controls and subsidies have been common in both regions. Where prices were set administratively, they were usually poor guides to the efficient allocation of resources. Price controls on agricultural products have kept food prices down but reduced output. Subsidies in Latin America and Eastern Europe have distorted production and consumption decisions, leading to shortages and bottlenecks.

The prevalence of inefficient public enterprises and unsuccessful attempts to limit subsidies and other expenditures have contributed to large fiscal and external trade imbalances for many Latin American and Eastern European nations. Many of these countries lack a broad-based, efficient tax collection system and face limits on the public's willingness to hold government debt. Borrowing abroad has proven to be no answer: In the absence of sound policies, large external debts can result in capital flight and discourage foreign investment where it is desperately needed. Large deficits, therefore, lead to pressures for excessive money creation, eventually causing rampant inflation in most countries.

Some economies in both regions were also weakened by the burden of high military spending. Although estimates are imprecise, perhaps as much as a fifth of the Soviet Union's output may have been allocated to the defense sector in recent years. This massive effort, moreover, was ultimately ineffective, as free world governments matched or exceeded Soviet capabilities throughout the 1980s.

REPERCUSSIONS OF ECONOMIC POLICY FAILURES

The impact of these policies on living standards was devastating. Per capita income in Poland is now estimated by the World Bank to be about $1,860, compared with an average of $17,470 in the major industrial countries. In Argentina and Peru, real per capita incomes in 1988 were virtually unchanged from 1965 levels. Mexican real per capita income grew during most of that period, but nonetheless declined after the 1982 debt crisis. Meanwhile, the newly industrializing economies of Asia followed an export-oriented strategy, and real per capita income grew at an average rate of nearly 7 percent a year between 1965 and 1988. Although some of these Asian governments directed private activity using taxes, subsidies, and other means, such interference was far less extensive than in many other developing countries, private entrepreneurship was encouraged, and world prices generally guided decisionmaking.

Over time, the weaknesses of the political and economic systems of Eastern Europe and Latin America and the contrasting success of market-oriented economies became readily apparent. Once momentum for fundamental change began to build, ideas flowed easily across national borders. The information technology revolution allowed ideas to spread more quickly than ever (for example, most East Germans could receive West German television before the Berlin Wall fell) and created pressure for change that overwhelmed the communist governments of Eastern Europe.

EARLY ATTEMPTS AT REFORM

As the economic problems in Latin America and Eastern Europe worsened, piecemeal reforms were attempted, but these efforts were doomed to failure. Many Eastern European countries experimented with reforms that coupled economic decentralization with partial price decontrol. The premise was that, with reduced central control, state-owned firms would be run as if they were operating in well-functioning markets. Although aggregate planning goals were still announced, individual enterprises could set their own planning targets and were made responsible for output decisions and trade in raw materials and other inputs. In addition, the system of price controls was made more flexible, and some small-scale private enterprise was allowed.

These early reforms went furthest in Hungary during the 1980s, where they helped create a sector of small-scale private businesses. They were also attempted to varying degrees in Yugoslavia beginning in the 1950s, in Czechoslovakia during 1966–68, and in the Soviet Union beginning in 1987. The People's Republic of China initiated a more comprehensive reshaping of its economy beginning in 1978, which also incorporated decentralization, relaxation of price controls, development of a small private sector, significant tax reforms, and the partial reopening of the economy to international trade (Box 6–1).

Early reform efforts by Latin American countries typically followed their debt crises of the early 1980s. These reforms concentrated on restoring the confidence of domestic and foreign investors by reducing inflation and the fiscal deficit and improving the trade balance. Argentina and Brazil, for example, both confronted extremely burdensome external debts, recessions, and high inflation rates. In response they adjusted their currency exchange rates to make their goods more competitive in world markets and initiated various plans to curb the escalation of wages and prices.

In both Eastern Europe and Latin America, *these early efforts failed to produce the desired results, in large part because they did not adequately restore or put in place the foundations of well-functioning market economies.* Private property rights were generally absent in Eastern Europe, severely limiting profit incentives and discouraging entrepreneurship, and state-owned monopolies were retained. In Latin America efforts to reduce trade imbalances were not coupled with policies to remove barriers to competition in domestic markets, to break up state-owned monopolies, or to improve efficiency by privatizing public enterprises. Fiscal deficits continued to run out of control and to generate inflation because enterprises owned and managed by the government had no incentives to control costs, and there was capital flight from many countries.

Box 6-1.—Economic Reform in China, 1978–90

The People's Republic of China initiated a comprehensive reshaping of its economy beginning in 1978. Reforms began in the agricultural sector and were later extended to the industrial sector. Direct planning controls were relaxed, economic decisionmaking was decentralized, more private activity was permitted, and more prices were allowed to be set in markets. In addition, there was a move to open the Chinese economy to world markets. The practice of ordering all firms to remit most of their profits to the state was gradually replaced with a broad-based system of taxes on profit. Low marginal tax rates were used to encourage investment and provide incentives for management and workers to take efficiency-improving measures.

Chinese reform produced important successes. Agricultural output grew at an annual rate of 8 percent from 1979 to 1984 before slowing, compared with an annual growth rate of 2 percent from 1958 to 1978. The share of state enterprises in total production fell from 81 percent to 60 percent between 1979 and 1987, reflecting the greater dynamism and growth of private enterprises. The share of goods subject to mandatory planning and state-fixed prices fell from two-thirds to one-third by 1987. Remaining price controls, however, reduced the impact of the reforms by distorting the input and production decisions of firms. In some cases, local authorities hindered the implementation of reforms. Furthermore, the tragic events in Tiananmen Square in June 1989 and the ensuing political crackdown led to a slowdown in the pace of reform. In some areas, central control was reasserted and the reforms rolled back.

SUMMARY

- The trend toward market-based economies stems in part from clear, historical evidence that government-dominated economies simply do not work well. Even where markets exist, extensive government interference discourages private initiative and can cripple the economy.
- Early attempts at economic reform focused either on decentralizing economic decisionmaking or on macroeconomic stabilization; they foundered largely because they did not include the positive incentives that come from private ownership and competition.

PRINCIPLES FOR ECONOMIC REFORM

There is no established policy package for reform—no universal blueprint exists—so each country must design its own transition to a healthy market economy. A growing consensus has emerged, however, on a number of principles necessary for successful reform: establishing sound fiscal and monetary policies, removing domestic price controls, opening the economy to international market forces, creating property rights and private property, promoting domestic competition, and reforming and limiting the role of government.

No modern economy has completed a successful reform implementing all these principles at once. It has been difficult enough for countries to succeed in implementing one or two of them when others were already in place. Latin American countries began their transitions with more of the elements of a market economy than the countries of Eastern Europe. In both regions, the pace of events has raised expectations that the transformation can occur quickly and easily, but the sheer magnitude of the task indicates that perseverance and patience are required.

MACROECONOMIC REFORMS

Three of these principles—establishing sound fiscal and monetary policies, removing domestic price controls, and opening the economy to international market forces—are often described as macroeconomic reforms because they apply to the entire economy. They are central to creating the conditions for economic stability. They are also essential to successful structural reform in both Eastern Europe and Latin America. In Poland and Yugoslavia, macroeconomic reform has succeeded quite rapidly in reducing inflation to lower levels. But implementing these macroeconomic principles is not, by itself, adequate to produce a healthy market economy. Indeed, without structural reform to introduce a competitive private sector into the economy, macroeconomic reforms will not succeed in restoring sustained growth.

Macroeconomic reforms can produce rapid output growth when the basic structure of a market economy is in place. That is what happened when the West German economy was rebuilt after World War II (Box 6-2). The West German program coupled price decontrol and monetary reform. It succeeded almost immediately in increasing economic activity, leading the way to the postwar German "economic miracle."

Establishing Sound Monetary and Fiscal Policies

Any successful reform effort must involve sound monetary and fiscal policies. Otherwise, producers and consumers lack a firm basis for planning—there is no hope of fostering long-term invest-

Box 6–2.—The 1948 West German Erhard Reforms

At the end of World War II, the German economy lay in ruins. Industrial output in 1948 was one-third its 1936 level because of a massive disruption in production and trade patterns, even though capacity had been increased by capital formation in the intervening years. Economic disruption was aggravated by wartime money creation, pricing controls, and uncertainty about economic policy. Each day vast crowds traveled to the countryside to barter food from farmers; an extensive black market developed; and cigarettes replaced currency in many transactions.

The extensive reform package of June 1948 created a new currency, the deutsche mark. Most currency and bank accounts were converted at a rate of 100 to 6.5, but debts were converted at a rate of 10 to 1. In addition, price controls were lifted on most goods, a restrictive monetary policy was adopted, tax rates were lowered, and incentives were provided for investment. Much of the credit for the reform went to German economic advisers, foremost among them Ludwig Erhard.

These reforms almost immediately established sound and stable macroeconomic conditions. Consumer prices increased 20 percent between June and December of 1948, but inflation then subsided to an average annual rate of just over 1 percent between 1949 and 1959. Goods that had been hoarded or sold only in the black market became generally available. Real industrial production increased 40 percent in the second half of 1948 and grew an average of 11 percent annually between 1949 and 1959. Real GNP and productivity also grew rapidly. But the reform was not painless: unemployment rose from 3 percent in the first half of 1948 to more than 10 percent in the first half of 1950.

Macroeconomic reform could not have produced such impressive results if West Germany after the war had not had key structural elements in place. It had the legal framework necessary for a market economy, many intact businesses, and highly skilled workers and managers. Restrictive fiscal policies in place since 1946 helped set the stage for the reforms to succeed. In addition, the Marshall Plan and private aid from abroad were critical during the initial reconstruction phase. By the early 1950s, however, foreign aid had diminished; robust economic growth worldwide and the Korean war stimulated demand for German exports and fueled economic growth.

ment and economic restructuring in the extremely uncertain climate created by high and volatile inflation.

One lesson from countries that have successfully ended hyperinflation, including West Germany after the war, is that *strong fiscal discipline is critical to ensure price stability*. Otherwise, fiscal deficits arise that increase the pressure to print money. Fiscal success, of course, requires tight controls on government spending and credit policies. In particular, the government must limit the subsidies it gives to consumers and to loss-making state enterprises. State enterprises must face so-called "hard budget constraints"; the government must not cover the losses they may incur. Fiscal discipline will then allow the implementation of a monetary policy aimed at preventing excessive money creation and providing a steady supply of credit to the economy.

Achieving price stability requires establishing effective mechanisms for controlling the growth of money and credit. As a first step, this requires central banking reform, particularly in Eastern European countries. It is widely agreed that the central bank should have a high degree of independence from the central government, so that it can resist political pressures to finance government spending with money creation and can pursue the objective of price stability. Independence could prove particularly important during the transition period, when uncertainty and inflation pressures may require a strong anti-inflation stance, with tough limits on money growth.

In addition, controlling the growth of money and credit requires a sound banking system, as discussed below. Central banks play an important role in monitoring the banking system and in serving as lenders of last resort. Establishing and controlling the total supply of credit to the banking sector will help to ensure that state enterprises face a hard budget constraint. Adequate supervisory capabilities also must be developed early. The collapse of the Chilean financial system in the late 1970s, for example, had its origins in inadequate supervision of external borrowing and domestic lending by Chilean banks.

The tax system should be designed to raise revenues so that the printing press is not used to finance necessary government spending. Such a tax system should limit distortions to prices and economic incentives. Establishing a broad tax base allows marginal tax rates to be reduced. Tax revenue in Latin America is often generated from only a few sources, such as tariffs, and can be highly distortionary. An exception is Colombia, which has one of the most advanced income tax systems in the developing world, with a broad-based value-added tax and sophisticated adjustments for the effects of inflation. Other countries, such as Bolivia, Chile, and Jamaica, are now experimenting with broad-based income taxes, value-added taxes, or excise taxes.

In Eastern Europe, fundamental administrative mechanisms for collecting taxes are largely absent or primitive. The old regime received revenue through its ownership of enterprises and was able to transfer funds through simple accounting entries. As economic decisionmaking was decentralized and private firms increased in importance, government revenues deteriorated. Tax and collection systems will need to be established that can generate reliable sources of revenue for the government as the old sources of funding diminish.

In economies that have suppressed inflation and allocated goods through rationing, the stock of domestic monetary assets outstanding is often unsustainably large. *Where such a "monetary overhang" is present, macroeconomic stabilization requires that it be reduced.* If consumers and producers hold large cash balances, decontrolling prices could lead to an inflationary surge in demand. The government could reduce the monetary overhang by selling real assets, such as housing, or financial assets, such as government bonds. This approach is not confiscatory, may help establish the government's credibility, and creates markets. The privatization of real assets is a high priority, but it may be difficult to sell these assets quickly, as discussed below. The sale of government bonds at market interest rates helps to establish a bond market, which in turn gives the monetary authorities an instrument to control the money supply.

Bonds must be serviced, and so using bond issues to resolve the monetary overhang could worsen the fiscal deficit. During the transition, bond issues may need to pay high real interest rates, which would lead to higher interest payments on national debt. That in turn could cause lenders to be concerned about the government's ability to service its debt. If a government chooses to sell bonds to deal with the monetary overhang, it is critical to adopt monetary and fiscal polices that are both credible and strong.

Because buyers must be assured that government bonds will be serviced in full, governments should consider using whatever assets they have to support these bonds. Countries could use their available resources—such as copper, gold, or future oil revenues—to back bonds wholly or in part. Such bonds would be tradable, and legal mechanisms would be developed to assure the public that the assets would be available to service the debt.

Currency reform is an alternative approach to reducing the monetary overhang; this was the approach postwar Germany used successfully. In a currency reform the central government replaces existing monetary assets with new assets, usually of lesser value. A confiscatory currency reform is a tax on holders of currency and other financial assets. Such a tax will provide few benefits unless it is part of a comprehensive economic reform package. Repeated currency reforms can disrupt economic activity, reduce the government's credibility, and contribute to a loss of confidence and capital flight.

Removing Domestic Price Controls

In economies with extensive price controls, prices bear no relationship to economic value, defined either by domestic costs or by international prices. By comparison, in market economies production and investment decisions are decentralized, and flexible market prices guide economic activity. However, concerns about sharp price increases, particularly for staples such as bread, lead some to suggest delaying price reform, at least until after measures have been taken to deal with the monetary overhang. *The problem with delaying price reform is that output will decline as the command system is dismantled unless the old system is quickly replaced with an incentive system based on accurate prices to encourage efficient production.* Economies in transition thus need early and comprehensive price decontrol.

Wages are a key price that must be liberalized. In a well-functioning market economy, wages are free to adjust so that valuable skills are rewarded and workers are encouraged to shift to occupations and regions where they are most productive. Until enterprises are operating under market incentives, however, they have little reason to set wages appropriately or to restrain their costs. Consequently, to avoid a wage-price spiral during the transition period, temporary and limited restrictions on wage increases in state enterprises may be desirable. Once firms face market constraints, all wage limitations should be eliminated to allow wages to move to their appropriate levels.

Financial markets also should be liberalized so that savers receive an adequate return and investors face correct incentives when making investment choices. As a first step, at least, *interest rates should be positive after adjusting for expected inflation.* Government intervention in financial markets, particularly in Latin America, often led to negative real interest rates and was a major contributor to poor investment decisions and capital flight.

Opening the Economy to International Market Forces

Another key principle of macroeconomic reform is to open the economy to international market forces by establishing currency convertibility and liberalizing trade. Currency convertibility has more than one definition, but here it refers to the ability to trade the country's currency, at market exchange rates, for foreign currency (and goods) either at home or abroad. To say that a currency is convertible does not mean that trade is free. Western industrial countries with convertible currencies retain tariffs and other barriers to trade. Thus, the benefits to a reform program from convertibility of the currency should be thought of as part of the larger process of eliminating restrictions on international transactions.

The transformation to a market economy cannot be successful unless a country's currency is a credible medium of exchange and convertible within its borders. In the Soviet Union today, certain cities and republics restrict ruble purchases by nonresidents and erect trade barriers against each other. Certain deposit accounts are not convertible for currency. The January 1991 Soviet currency reform further reduced confidence in the ruble. These costly distortions are reflections of the fundamental failure of existing economic policies.

Convertibility for international trade and other current account transactions, along with other measures to liberalize trade, is a critical early reform. It increases the range of goods that can be purchased by consumers and producers. It may also expand domestic production by increasing the availability of imported inputs and capital goods. Further, convertibility moves domestic prices toward market-determined world prices, guiding domestic enterprises toward efficient production and investment decisions.

Opening the economy to international market forces also helps create a competitive environment in two important ways. First, it helps expose firms to the discipline of the international market. That is particularly important in smaller countries where the efficient operating scale of firms in some industries is large relative to the size of the domestic market. Without foreign competition, state enterprises in these countries may face little domestic competition at the start of a reform effort, allowing them to remain viable by raising prices at the expense of consumers. External convertibility and trade liberalization therefore are also pro-competitive policies that can enhance productivity.

Second, opening the economy to international forces allows new domestic firms to overcome domestic barriers to competition. For example, reducing tariffs on vehicle imports allows small-scale private transporters to compete by importing trucks from abroad.

A potential problem with early convertibility is that firms likely to be viable in the long run might experience severe financial difficulties during the transition from controlled to world prices. The balance of payments also could deteriorate until the supply side of the economy responds to the new market incentives and exports rise. Both of these problems could be addressed by converting existing trade barriers into temporary tariffs—sometimes called the tariffication approach. This approach has several advantages: It replaces a potentially complex array of existing trade distortions with a single gap between domestic and world prices, makes the degree of protection more transparent, and sets the stage for eventual tariff reduction.

With the support of the World Bank, a number of Latin American countries have made important progress in opening trade as part of their reform efforts. Bolivia and Mexico, in particular, replaced quotas and nontariff barriers with reduced, uniform tariffs. In a number of countries, more competitive exchange rates and the elimination of export barriers contributed to a significant increase in nontraditional exports. Argentina and Peru have eased exchange restrictions that had led to black markets for foreign exchange in recent years.

Many economists support focusing initially on convertibility for trade and other current account transactions while temporarily delaying convertibility for international capital flows. They argue that remaining market distortions or a lack of confidence in the economic future of the country could lead to capital flight. But capital account convertibility must not be delayed too long. External convertibility on capital transactions may be important in providing venture and working capital to private firms during the transition. It also facilitates the import of foreign know-how.

One historically important example in which the import of foreign technology was the centerpiece of a reform effort followed the Meiji restoration in Japan in 1868. Spurred by a desire to emulate the economic success of the West, Japan within a remarkably short period of time overhauled its central government, changed what was being taught in its schools, and shifted the energies of its people toward commerce. The linchpins of the Japanese transition were the concentration on importing foreign technology and technical assistance, the development of a transportation infrastructure conducive to commerce and trade, and the privatization of government production facilities. Entire factories were imported, along with technical advisers who operated the machinery until Japanese workers and managers were capable of doing it on their own.

Full convertibility for international capital flows may be delayed without obstructing the reform process when other measures to attract foreign investment are in place. Hungary adopted a foreign investment law that guarantees repatriation of profits. As a result, it seems to have taken the lead in Eastern Europe in attracting foreign capital. As discussed further below, the creation of Enterprise Funds for Hungary, Poland, and Czechoslovakia reflects the Administration's emphasis on ensuring that adequate financing is provided to newly emerging private sectors.

When a reforming government decides to make its currency convertible for some set of international transactions, it must also choose between fixing the exchange rate or allowing it to move freely to its new equilibrium level. Authorities may choose to fix the exchange rate as part of a comprehensive stabilization package. If backed up by a credible noninflationary monetary policy, a fixed exchange rate may help reduce inflation expectations and thereby ease the transition to price stability. Choosing an appropriate level for the fixed rate is not easy, however. The higher the fixed value of domestic currency relative to foreign currency, the cheaper are foreign goods relative to domestic goods. Thus, while a high exchange rate reduces initial pressure on inflation by holding down the prices of imported goods, a low exchange rate enhances the competitiveness of domestic firms in world markets and reduces the likelihood of large trade deficits. Letting the exchange rate move freely to a new equilibrium allows the market to balance these opposing forces.

STRUCTURAL REFORMS

In addition to the principles discussed above, comprehensive reform requires structural measures. Private property and privatization should be institutionalized, domestic competition must be promoted, and the role of government must be reformed and limited. Most reforming countries of Eastern Europe have been slow to adopt these principles, which are central to the development of markets. Latin America already has private property rights and private firms, but many nations in the region could benefit greatly by promoting domestic competition, accelerating privatization, and continuing to redefine the role of the public sector.

Property Rights and Private Property

A successful transition to a market economy requires that private property rights be firmly established and that a legal system be developed to define and protect these rights. In addition, productive assets must be put into private hands through the process of privatization. Otherwise, producers have no incentive to respond to prices and to take risks, and the reform effort will fail to generate increased supplies of products consumers want to buy.

Private property and property rights are most notably absent in the command economies of Eastern Europe and the Soviet Union, where economic activity was based on the idea that almost all property belonged to the state. Although small-scale entrepreneurial activity was tolerated in some Eastern European countries in recent years, most control over the allocation of resources remained in the hands of the government. The public debate about private property in the Soviet Union has also been a political debate about commitment to change following 70 years of indoctrination about the evils of profit and capitalist enterprise. During Lenin's New Economic Policy of the 1920s, reforms encouraged private producers, especially farmers, to expand production. Many farmers successfully raised output and prospered, only to have that very success considered criminal during the Stalinist purges and collectivization drives of the late 1920s and 1930s. As a result, the most successful farmers and entrepreneurs were punished by expropriation of their property, exile to labor camps, and, in many cases, execution.

In Latin America, the institution of property rights has long been established but has not always been well respected. Government nationalization of industries, sometimes through expropriation, is one aspect of a legacy of not respecting property rights. More recently, inefficient and slow legal systems have discouraged private entrepreneurship.

Privatization of state enterprises is an urgent, albeit complex, task. The task is more difficult by several orders of magnitude than the privatizations that have occurred in developed market economies over the last 10 years. In Eastern Europe, for example, the government owns most of the land, buildings, and machinery. There are enormous benefits to transferring ownership to the private sector even though local citizens generally have little savings to invest, financial markets are not sufficiently developed to provide credit, and the widespread sale of domestic equity to foreigners raises political concerns. An added consideration is the widespread belief that those who profited under the old regime—and who, therefore, are among the few who can afford to make large equity investments—do not deserve to benefit from those activities.

Privatization requires expertise in accounting, financial markets, and the law. In most cases, the books of large government enterprises bear no relation to economic reality. That may make it easier for insiders to purchase these firms at very favorable prices and realize large gains. Concerns about such "sweetheart deals" have slowed privatization in both Eastern Europe and Latin America. Perhaps not surprisingly, in Eastern Europe the "spontaneous" or decentralized privatization of small enterprises and the development of new private firms has far outpaced government efforts to privatize large-scale enterprises.

In nearly all Latin American countries the process of privatization has recently accelerated. A number of countries have privatized enterprises as part of debt-for-equity programs. In 1990 Argentina and Mexico completed privatization of a number of large state firms and announced others, and other countries such as Chile and Costa Rica also stepped up their privatization efforts. Throughout the region, however, some of the largest enterprises remain in government hands and will be difficult to privatize or restructure, partly because of resistance from labor unions.

One question is the order in which to privatize enterprises. The Polish reform plan up to this point has been based on the "conventional" view that companies with positive net worth should be privatized first. Enterprises that are money losers, have high debt burdens, or are expected to need significant internal restructuring before they become viable are to be privatized later after the restructuring takes hold. By contrast, the reform plan in Yugoslavia is focused on privatizing loss-making industries first, presumably because this approach would reduce the subsidies the government must pay.

There are several possible methods of privatizing enterprises that can be used in conjunction with each other. Enterprises can be sold to workers or to the highest bidder, or deals can be individually negotiated and then presented to the government for approval. Another method is to distribute vouchers to the general public that allow citizens to purchase portions of firms at favorable rates, either directly or through investing in holding companies that accept management responsibility. The favorable equity implications of widespread domestic ownership has inspired Czechoslovakia to consider this latter approach. Poland is favoring a "menu" approach: In some cases, a combination of methods could be used in a single privatization, while in other cases the enterprise may choose among the legally allowed options.

A crucial element of the reform agenda must be the creation of a private housing market. In much of Eastern Europe the decay of the housing stock and a desperate lack of available housing creates real impediments to the free movement of workers. In many instances, workers cannot move to areas where there are jobs, because there is no housing for them and their families. Creation of a private housing market could be an important first step toward both improving labor mobility and raising living standards. Housing should be privatized, and builders and investors allowed to purchase land for construction. Property also must be transferable so that existing and new housing can be efficiently allocated.

Promoting Domestic Competition

Another principle for a successful transition involves a range of measures to create not only private, but also competitive industries. Desocializing without also demonopolizing confers little benefit. Actions to promote competitive domestic market structures include restructuring existing firms, facilitating the entry or establishment of new firms, and putting in place an antitrust policy to promote competitive domestic markets. In addition, as noted above, competition can also come from abroad.

Competition is generally enhanced if existing state-owned enterprises are split into smaller, viable firms before privatization. Unrelated or unprofitable activities can be jettisoned, and monopolies can be split into separate, competing firms. The restructuring of viable firms may also involve adoption of new technologies and the reallocation of labor and capital to new uses. Accounting and financial techniques must be brought to bear to ensure that firms are operating on a sound financial basis.

Private sector activity can also be encouraged by the sale of assets of state enterprises to the private sector. Consider the challenge of creating transportation industries, such as trucking. In most command economies, firms produce many of their own inputs including transportation services. Thus, most trucks are owned by large state enterprises that have little incentive to compete with each other. If a state enterprise is divided into several viable firms and its trucks are sold outright, their purchase by entrepreneurs could aid the development of a private distribution system.

Barriers to the creation of new firms must be removed. In Eastern Europe there has been rapid growth of new firms over the past year but the public sector continues to dominate. These new firms are usually small and often are at a disadvantage in competing with the state enterprises for inputs and credit, but they have proved very successful where the efficient scale of firms is small or where entrepreneurship is important.

Policies to protect competition also are required. While it is natural and desirable to want to sweep away many regulations as vestiges of the government-dominated systems that reforming countries have rejected, laws are needed to ensure that creation of a private sector does not merely replace a public monopoly with a private one. A basic antitrust law aimed at preventing cartel behavior by firms producing the same product and mergers that create monopoly is essential.

During the transition, basic banking and credit market functions must be developed quickly. In command economies, banks mainly serve a bookkeeping role, allocating credit as directed by the central government plan. Retail banking as understood in market economies barely exists. The use of checking accounts is limited, and check clearing can take weeks. An important early role for the central banks of Eastern Europe can be to help create and then monitor a payments system. The economies of Eastern Europe also will need a competitive banking system that provides access to credit for new and restructured firms.

Well-developed financial markets serve other roles as well. They allow risks to be shifted to those who are most willing to bear them. They allow firms to diversify and hedge and to mobilize private savings. Yet, many of the existing banks have distorted balance sheets from years of financing state enterprises without concern for creditworthiness. Reform requires a tremendous amount of expertise; systems and methods of credit evaluation and ways to manage risk must be introduced. Technical assistance from abroad will be useful in creating efficient banks.

Reforming and Limiting the Role of Government

A successful transition to a market economy in Eastern Europe requires a complete overhaul in the role of the government, to reorient it toward the tasks appropriate to a market economy. In Latin America, reduced government involvement in the economy would free resources for private use, allowing the private sector to grow and prosper, reward investors, and raise funds for investment. Some tasks, such as putting a sensible tax system in place, as discussed earlier, are formidable. Important new functions for reforming governments range from collection of meaningful economic data to environmental regulation.

The government must also develop a social safety net. As economic restructuring takes place, many workers will lose their jobs because inefficient enterprises are likely to be shut down or to fail to become viable under private management. Although these dislocations are a prerequisite for building a more productive economy, the hardships that fall on workers and their families can and should be cushioned. Unemployment compensation and worker retraining are effective approaches to dealing with these problems, and they can also help to minimize worker resistance to reforms. Many features of a well-designed, targeted social safety net, such as unemployment insurance, are also important to encourage workers to incur risks and change jobs in response to labor market signals. Labor mobility is critical if contraction of the state sector is to free workers for private sector activities.

Governments should facilitate the establishment of a sound education system that can produce a work force able to build and operate a modern market economy. One advantage held by some of the Eastern European countries, such as Hungary and Poland, is the relatively high level of education of their workers. With educated, well-trained labor forces, one of the essential requirements for a growth economy is in place. Sound training in business and economics is also required. It is important that the policymakers and populace understand the economic rationale for market-based reform, for without popular support, reform programs will not succeed.

SUMMARY

- Certain fundamental principles—formulating sound monetary and fiscal policies, removing domestic price controls, opening the economy to international market forces, ensuring property rights and private property, creating competition, and reforming and limiting the role of government—are essential for a successful transition to a healthy market economy.

- Numerous countries have attempted the difficult task of implementing one or more of these principles. But no modern economy has implemented all principles at one time.
- Latin America starts with more of the elements of a market economy in place than does Eastern Europe. In both regions, however, healthy market economies require both macroeconomic and structural reforms.
- Macroeconomic reforms provide a stable economic backdrop for the planning decisions of investors and entrepreneurs. Such reforms allow prices, wages, and interest rates to respond to domestic and world market forces, which helps to assure that the economy's resources are allocated productively and in accordance with peoples' wants.
- It is essential that economic reform elicit competitive, private-sector activity. Structural reforms contribute by firmly establishing private property rights, putting productive assets into private hands, and promoting competitive behavior through, for example, antitrust laws.

IMPLEMENTING ECONOMIC REFORMS

The preceding discussion of economic principles to guide the transition to a market-oriented economy highlights the complexity and difficulty of the reform effort. What methods should be chosen? Which principles should be emphasized first? How rapidly should the reforms be implemented? These choices are difficult enough from a technical viewpoint. They are made even more difficult by the need of new democratic governments to build popular support for reform.

The temptation to underestimate the difficulty of the task ahead must be resisted. The legacy of state control will take time to overcome. Even successful reform will require a difficult transition period, as workers and other resources are reallocated to productive uses based on market-determined prices. In Eastern Europe, in particular, after 40 or more years of job security, unemployment, even if modest by Western standards, may be quite frightening. If unrealistic expectations are generated by the promised benefits of market reform, support for the necessary changes could collapse.

It is important to realize, however, that *the welfare of citizens in the Eastern European economies can be dramatically improved, even if output declines for a period of time.* Under the old regime, these economies often reported rapid output growth, but output was frequently mismeasured through the use of nonmarket prices that overstated the value of shoddy goods. More important, higher production did not necessarily improve living standards because the goods produced were not the ones that consumers wanted. If these countries have early success at producing the goods and services that individuals really want, actual well-being would no doubt rise far more than official statistics would show.

THE NEED FOR COMPREHENSIVE REFORM

The linkages and complementarity among many of the reform principles suggest that ideally they should be implemented simultaneously. Administratively, however, it is infeasible to do everything at once. Some changes are also clearly preconditions for others. For example, a legal infrastructure supporting both private ownership and the transfer of property rights is absolutely necessary to the process of privatization and the stimulation of private investment.

The most important characteristic of a successful reform program is that it be comprehensive and rapidly implemented. A command economy cannot be meshed with a market economy. Consequently, implementing half of a reform program achieves much less than half of the benefit of comprehensive reform. Half measures lead instead to confusion and falling output because productive individual incentives have not yet replaced the command system. Since a slow pace of reform will only prolong the pain of the transition and aggravate the inevitable disruptions, the reforms should be implemented as rapidly as possible.

There is general agreement that reforming countries must address first any existing problems of high inflation and severe balance of payments deficits. Without initial measures to reduce the uncertainty of the investment and production climate, attempts at privatization and price reform are unlikely to elicit the desired increases in private-sector investment and output. In short, the ability of the government to articulate and carry out a credible macroeconomic program provides an essential backdrop for private sector activity. Enterprise restructuring and privatization must, however, follow soon after.

Reforms such as privatization, price reform, and trade liberalization clearly go hand in hand. Privatization of monopolistic state enterprises, for example, could simply result in private monopolies that produce less and at higher prices than firms in a competitive setting, unless such entities are first dismantled or exposed to foreign competition. Trade liberalization and domestic price reform are closely related because world prices are usually the best guide to most internal price relationships. Domestic price reforms go hand in hand with privatization because managers cannot be expected to make sound investment, production, or employment decisions without rational price guides. In fact, it may not be possible to judge accurately the viability of many state enterprises until they have operated under market conditions with accurate price signals. Financial market reforms must also be under way and private sector financial institutions in place with a functioning payments system before investment decisions can be effectively transferred from government to private control.

EXAMPLE: REFORMING POLISH AGRICULTURE

The challenge of restructuring the Polish agricultural-food system illustrates the need for comprehensive reform. This sector begins with a solid base on which to build: Despite earlier collectivization efforts, privately owned farms accounted for 70–80 percent of land in agriculture and a similar percentage of output even before reforms began. Production is already diversified, and considerable export potential exists, but numerous structural impediments associated with the centrally planned economy must be removed to improve the sector's performance.

First, although most farms are considered "private," the lack of a well-functioning land-transfer system still hinders the consolidation of these small, uneconomic units (on average about 12.5 acres) into more efficient operations. Until recently, most land was transferred to the State Land Fund for reallocation, with political factors dictating who was allowed to purchase it.

Second, the lack of competition in the sectors providing agricultural production infrastructure, such as the farm input and processing sectors means that the incentives for efficient farm production decisions are missing. The input sector remains state-controlled: continuing inefficiencies and monopoly activity keep farm input prices excessively high, supplies for private farms inadequate, and input quality very poor. Until recently, farm inputs were provided only to farms that agreed to sell their output to state enterprises. That made it very difficult for a private marketing system to develop, even after private activity was authorized in the procurement sector and output prices were deregulated.

Food processing facilities are outmoded due to the lack of competition. Many facilities operate far below capacity and without concern for either the quality of the commodities processed or the foods produced. State slaughter facilities, for example, purchase pigs only according to weight—without taking into account fat content or other quality factors of potential concern to consumers. This system induces farmers to fatten pigs excessively and gives consumers meat containing large amounts of waste.

Third, inadequate capital markets and domination of foreign trade by state enterprises hinder the growth of private sector activity throughout the food distribution system. Modernizing existing plants requires capital and, therefore, capital markets and banks that lend long-term investment capital. Private enterprises must also have access to modern production inputs at reasonable prices. For example, setting up private meat shops was hindered by the lack of refrigerators, which only state retailers could import! Until access to international markets is achieved and transportation networks are demonopolized, private distribution, processing, and retail ventures can only expand slowly.

Fourth, freer trade of farm products is necessary to remove distortions in farm prices and to induce increases in farm output. Access to foreign markets for Poland's potential farm exports is as important as access to imported farm inputs, such as fertilizer. Lifting wheat export restrictions, for example, could help bring artificially depressed farm prices in line with higher world prices, encouraging increases in output and contributing much-needed foreign exchange.

This extended discussion of reform in Polish agriculture shows that private ownership of farms is only one step toward a well-functioning farm economy. For private farmers to take advantage of new opportunities, many other changes also need to be introduced. These include providing full property rights in land, competition in the distribution system, and access to international markets for both inputs and outputs.

SUMMARY

- Reforms must be comprehensive if they are to succeed. Rapid implementation is the best way to limit the inevitable disruption associated with reform.
- The success of reforms is best measured by their ability to encourage production of goods consumers want, not solely by changes in measured output.
- It is generally accepted that macroeconomic stabilization should be the initial priority for reforming countries with high inflation and severe external imbalances, but rapid structural reform must begin simultaneously or follow soon after.
- The difficulty of making a successful transformation is often underestimated. Realistic expectations about the benefits and costs of reform can sustain support for the adjustment effort.

EASTERN EUROPE AND THE SOVIET UNION

The degree to which the former command economies have implemented the basic reforms needed to effect a successful transition to a market economy varies significantly. This section summarizes the recent developments in several Eastern European countries where the reform process is well established and in the Soviet Union. Poland, Yugoslavia, and the former East Germany began their reform efforts in early 1990. Czechoslovakia and Hungary moved to accelerate their reform plans during the year. Bulgaria and Romania have not yet proceeded very far on the path toward economic reform and have faced considerable political uncertainty and disruption. In Bulgaria a political impasse delayed the adoption of a comprehensive reform program. Although reform was debated in Romania, and some privatization occurred, lack of public support during 1990 stalled progress toward implementing price reform and other essential elements of a comprehensive reform program. In the Soviet Union, hopes that comprehensive economic reform would be implemented quickly were dashed in late 1990 and early 1991 by an abrupt shift in government policy.

It is too soon to judge the full economic impact of reform programs. Even under ideal conditions, transition to healthy market economies will take time. Moreover, several external shocks affected the economies of Eastern Europe in 1990. It will take time for these countries to realize the benefits of the reforms taken to date.

POLAND, YUGOSLAVIA, AND EAST GERMANY

Although Poland, Yugoslavia, and East Germany took different paths, these countries had in common in 1990 programs focusing on macroeconomic reforms as the first step. Poland's program was the most ambitious and comprehensive. Enacted in January 1990, Poland's program emphasized quick measures to stabilize the economy, including price reform, steps to close the budget deficit, restraint of monetary growth, and establishment of a convertible currency at a fixed rate. The fiscal balance moved from a deficit of about 8 percent of GNP in 1989 to a surplus in 1990. The inflation rate dropped sharply but then settled at a higher than desirable level of about 5 percent a month. Authorities were able to stabilize the foreign exchange value of Polish currency and to maintain current account convertibility, while rebuilding the stock of foreign exchange reserves as exports to the West surged and imports fell. Activity in the newly emerging private sector appears to have increased significantly in 1990. However, reflecting a decline of about 25 percent in the sales of the socialized industrial sector, real GNP is reported to have fallen 12 percent in 1990. Measured unemployment had moved from negligible levels before the reform to above 8 percent.

The Polish program involves putting in place a far-reaching set of provisions to establish competitive industries and independent financial institutions. The privatization of existing enterprises moved slowly until late in the year, when the government completed its first large privatization and began the process of privatizing a number of other large companies, using a "menu" of different techniques. Finally, almost all price controls were removed, though wage flexibility was still limited by the central government through tax policy.

In 1990 the government of Yugoslavia embarked on a comprehensive program to stop soaring inflation. In its initial phase, the program devalued and fixed the nominal exchange rate of Yugoslavia's currency. Wages were temporarily frozen, while most prices were allowed to adjust freely, and import barriers were lowered. The 1990 program built on earlier structural and institutional reforms to recapitalize the banking system and restructure lossmaking state enterprises.

The initial results of the stabilization program were quite positive. Monthly retail price inflation fell from 64 percent in December 1989 to near zero in the second quarter of 1990, and the decline in real output was less than that experienced by Poland. By midyear, however, fiscal problems began to appear, reflecting inadequate controls over public sector spending. Monetary policy was eased under pressure from illiquid enterprises and workers' demands for faster wage growth. Inflation jumped up to the range of 8 to 10 percent a month. In January 1991 there were worrisome developments in the stance of monetary policy that cast further doubt on inflation prospects. Even more discouraging were the escalation of ethnic rivalry and signs of political disintegration, which threaten the chances of implementing a coherent program.

In the former East Germany, unification caused far-reaching changes in the economy. Adopting the currency and many legal and economic institutions of the former West Germany through unification has reduced many uncertainties that have plagued transitions in other countries. Nonetheless, output in the third quarter of 1990 was 30 percent below its level a year earlier, although not all the decline was due to the reforms. Unemployment rose to about 7 percent of the work force, and roughly 20 percent of the population was underemployed. Real wages rose, perhaps reflecting the need to dissuade workers from emigrating to the former West Germany, and labor productivity declined. Competitive problems for firms with outmoded equipment and products and substandard product quality, hidden prior to unification, are now a concern. On the other hand, the flow of investment from the western portion of Germany is expected to grow, supporting a rebound in growth in the medium term.

HUNGARY AND CZECHOSLOVAKIA

Reform proceeded less rapidly in Hungary and Czechoslovakia. Entering 1990 the problems of inflation and declining output were not as severe in these countries as in Poland and Yugoslavia. Thus, macroeconomic reform may not have appeared critical. However, as 1990 proceeded, the pressures for reform grew.

Many of Hungary's subsidies were removed, although those for a few key goods, including some food and energy products, remained. The external trade performance of the economy was good, with a hard currency trade surplus of near $1 billion in 1990, despite poor agricultural performance due to drought and the impact of the Persian Gulf crisis. However, inflation remained high at over 30 percent a year, and the size of the fiscal deficit is troubling. Official unemployment stood at 1.7 percent at year-end. Industrial production was down about 10 percent in 1990, but production by small firms boomed. The privatization program began to take hold in 1990 with the process of privatization under way for 20 large state enterprises. A second group of 20 firms to be privatized was to be announced in early 1991. Sales of small enterprises to individuals were brisk, and the government planned to privatize 16,000 small firms in the next 2 years. As 1991 began, Hungary was taking steps to implement a 3-year reform program, including an expansion of external convertibility for international trade transactions.

After a year of focusing on political and legislative reform, the Czechoslovakian Government implemented a comprehensive economic reform effort in January 1991. The program decontrolled about 85 percent of all prices, established partial convertibility for the international trade of goods, and tightened fiscal policy. Small business privatization through auction began in January, but legislation to allow privatization of large state enterprises had not yet been passed. Over the 12 months to September 1990, output fell about 3.5 percent, and unemployment remained below 1 percent.

THE SOVIET UNION

In late 1990 and early 1991 economic reform efforts in the Soviet Union appeared to come to a halt. The government's decision to devalue large denomination ruble notes, announced in January 1991, caused disenchantment and created uncertainty about future economic prospects. The threatened increase of KGB involvement in economic affairs is likely to stifle private incentives and entrepreneurship. These developments have dimmed hopes for market reform and further damaged an economy that had already deteriorated sharply in 1990. Official statistics estimated the decline in output for 1990 at about 2 percent, but the actual decline in living standards appeared to be much worse. Most of the reduction in output was in manufacturing, construction, and transportation. The problems in transportation reflected the critical nature of Soviet distribution problems; the collapse of the distribution system could lead to widespread food shortages in 1991 despite record harvests. The balance of payments on international transactions was expected to be in deficit by $14 billion in 1990. Arrears on loans from abroad may have exceeded $5 billion, and the fiscal deficit, which reached 8 percent of GNP in 1990, could rise further in 1991.

The Soviet Union remains an important trading partner of Eastern Europe. Therefore, the prospects of the region depend importantly on the health of the Soviet economy. But the recent retreat of economic reform in the Soviet Union raises concerns that its economy will continue to deteriorate and slow progress throughout Eastern Europe. Reforms initiated in 1987 began to dismantle the command system but did not replace it with market mechanisms or incentives. Fundamental change must occur if the Soviet Union is to reverse the deterioration in living standards.

CHALLENGES IN 1990 AND 1991

Several economic shocks complicated the reform efforts of the region in late 1990 and continued into 1991. Together they represent a formidable challenge to the region's democratically elected leaders.

The End of the East Bloc Trading Regime

The shift toward convertible currency trade at market prices within Eastern Europe and the Soviet Union in January 1991 presents a difficult challenge for the region. From 1949 until the end of 1990, trade between the countries of Eastern Europe and the Soviet Union was conducted essentially through bilateral barter arrangements governed by the Council for Mutual Economic Assistance (CMEA). The unit of account was the "transferable ruble," which could not be exchanged for any other currency. Trade was thus conducted at nonmarket prices, and trade surpluses were merely reflected in accumulation of transferable ruble balances. Over time, the effect was to reinforce central planning and make the Eastern Europeans and the Soviet Union more dependent on each other.

Although the nonconvertible currency system of CMEA was wasteful and inefficient, it is widely agreed that on average it benefited the Eastern European countries with respect to the Soviet Union over the past decade. Essentially, Eastern Europe received oil and natural gas from the Soviet Union at below world market prices. The effect of CMEA's end will vary across countries. Hungary has already had some success reorienting its trade toward the West, for instance, while Bulgaria, with fully 50 percent of its trade with the Soviet Union, faces a more difficult challenge.

Moreover, the former East Germany has sharply reduced its demand for Eastern European products, and concerns about the economic and political stability of the Soviet Union make the trade outlook even more uncertain. Eastern European countries are negotiating bilateral agreements governing trade among themselves and with the Soviet Union in 1991.

Other Shocks

The increase in the price of oil following Iraq's invasion of Kuwait in August was a significant shock to the economies of Eastern Europe. The task of estimating the impact of oil price shocks and designing policy options is difficult for developed market economies, let alone the economies of Eastern Europe. (Chapter 3 of this report discusses oil price shocks and economic policy.) Because these are economies in transition, the market mechanism—even in the countries where reform has gone furthest—does not work as quickly, smoothly, or efficiently as it does in industrial economies to adjust demand to the higher price of energy. Although the price of oil has fallen since October 1990 and especially since the start of Operation Desert Storm in January 1991, future oil prices remain uncertain.

In addition to the oil price effects, *Soviet shipments of oil to Eastern Europe fell approximately 20 percent in 1990 because of Soviet production declines.* Several Eastern European countries also were to receive oil from Iraq as debt payment. The international embargo on Iraq meant that this oil had to be replaced by purchases at world market prices. Some countries also lost substantial construction contracts and worker remittances from the Mideast.

Another adverse shock in 1990 was a drought that affected Southeastern Europe. Bulgaria, Hungary, and Romania were the most severely affected. The costs of the drought included the loss of crops and reduced livestock populations, as lack of feed grains forced many farms to send their animals to slaughter sooner than planned.

Implications for the Transition

Taken together, these shocks represent a formidable challenge to Eastern European governments. If sound policies are maintained and oil prices stabilize in a range not far from that prevailing prior to the 1990 Iraq invasion of Kuwait, these challenges should be manageable. However, these are pressing concerns, and they can create pressure to ease up on adjustment efforts. Delaying reform, however, would only aggravate the economic costs of these shocks and risk a return to the piecemeal reforms that were so unsuccessful in the mid-1980s. Countries that can build a consensus to accelerate reforms have much to gain.

SUMMARY

- Poland, Yugoslavia, and East Germany, starting from different circumstances, are all undergoing rapid transformations to a market economy. Although the output and unemployment costs of the transition have been greater than initially expected, the measures taken are the basis for a significant improvement in living standards in the medium term.

- Hungary and Czechoslovakia in 1990 adopted more gradual programs, but by the end of the year both had plans to accelerate their reform efforts.
- The apparent abrupt halt to reform efforts in the Soviet Union aggravated an economic situation that had deteriorated badly during 1990.
- Recent adverse economic developments complicate the efforts of Eastern European countries to make successful transitions to market economies. The challenge facing these countries is to maintain and intensify their reform effort, with the support of the Western industrial countries, despite the uncertainties they face in 1991.

REFORM IN THE AMERICAS

Major steps have been taken by governments throughout Latin America toward open, market-oriented economies and away from outmoded statist institutions. Prospects are now better than ever before for the integration of the economies of North and South America through broadly expanded trade and investment linkages.

RECENT HISTORY OF LATIN AMERICAN REFORMS

Most recent Latin American reform efforts are rooted in the adverse economic environment of the early 1980s and the failure of policies pursued for decades. By 1990, it was widely accepted that a new approach to solving the economic problems of the region was essential. Almost every country in Latin America now recognizes the need to move away from inward-looking policies, such as efforts to substitute domestic production for imports, toward trade-opening policies designed to strengthen competitiveness in world markets. The role of the public sector and of cumbersome state-owned enterprises is being widely reassessed, and deregulation and privatization have appeared on policy agendas throughout the region. As in Eastern Europe, correcting price distortions, reforming public expenditure and taxation policies, and improving the performance of financial markets are now important components of many of these countries' market-oriented strategies.

Much-needed and welcome political transformations are accompanying the trends in economic policy. Argentina in 1983, Uruguay in 1984, Brazil and Guatemala in 1985, Panama in 1989, and Chile and Nicaragua in 1990 are among the countries abandoning authoritarian regimes to join the ranks of Latin American democracies. Chile's new democratic government is effectively demonstrating that an open and democratic political system can reinforce the benefits of an expanding market economy.

The 1990s should be a decade of great opportunity for the region. With sustained world growth and expanded trade opportunities being sought through the Uruguay Round of multilateral trade negotiations and other Western Hemisphere pro-trade initiatives (discussed in Chapter 7), the restructured economies of Latin America have great potential to prosper. Perhaps most encouraging for the other countries of the region are the recent performances of Mexico and Chile, two countries at the forefront of the Latin American reform movement.

MEXICO

Mexico provides one of the best modern examples of a country engaged in economic restructuring. The difficult movement toward a more market-oriented, open economy has been under way for a number of years. *The reform process recently has been accelerated by the current President of Mexico, and the benefits of market-oriented reforms are now being realized.* The roots of the reform effort are different than in Eastern Europe, but Mexico did share some of the characteristics of the command economies. Public sector expenditures represented nearly 50 percent of GNP in 1982, for example, and the inefficiencies of the 1,150 state-owned enterprises, accounting for 25 percent of GNP in 1983, stifled economic performance. Mexico also maintained a restrictive import policy with extensive government control over trade and a highly overvalued exchange rate.

Mexico's debt crisis—precipitated in 1982 when oil prices fell, interest rates rose, and holdings of foreign exchange dwindled—necessitated the imposition of stringent macroeconomic stabilization measures. To restore external balance and stem the outflow of private capital, the exchange rate was adjusted to reflect market forces, and domestic spending was reduced. External equilibrium was attained initially at the expense of price stability, real wages, growth, and employment. But the success of the effort facilitated the restructuring of Mexico's external debt service, which allowed attention to turn to curbing inflation and reviving economic activity.

Mexico's economic restructuring has focused on reducing the public sector's role, increasing external competitiveness, improving public finances, and modernizing the financial system. More than 750 state-owned enterprises have been privatized, merged, or liquidated, and subsidies to the remaining entities have been reduced. These actions brought greater economic and financial efficiency to the state-owned sector and helped reduce public sector expenditures below 40 percent of gross domestic product in 1989. Fiscal and financial system reforms have also been important. Tax policy reforms closed corporate tax loopholes and improved the tax collection system, banking activities were progressively exposed to market forces, and the goal of returning banks to private ownership was recently announced.

A major initiative to reduce trade barriers has promoted the efficiency and modernization of domestic industries and successfully contained inflationary pressures. The opening-up process was enhanced when Mexico reversed a longstanding antitrade policy by joining the General Agreement on Tariffs and Trade (GATT) in 1986. Extensive import-licensing requirements were largely replaced with tariffs, which were then lowered significantly.

After many difficult years recent economic performance has been fairly good. GNP grew about 3 percent in 1989, and is thought to have grown faster in 1990. Inflation last year increased somewhat from its 1989 level, which had been the lowest rate in 10 years. The increase in economic activity is fueled by new dynamism of the private sector, which has been both reflected in and fueled by strong growth in private investment and private capital inflows from abroad. After declining by a third between 1981 and 1983, real private fixed investment grew at an average annual rate of 5.6 percent between 1983 and 1989.

Mexico must still meet the challenge of sustaining economic growth—a necessity if widespread poverty is ultimately to be alleviated. The Mexican Government's commitment to market-oriented reforms is strong, although big hurdles are still ahead. The process of privatization, for example, has only recently been extended to the largest, most complex state-owned enterprises, such as the telephone system. The strong interest of the United States in Mexico's success is illustrated in the President's commitment to negotiating a free-trade agreement with Mexico (discussed in Chapter 7). The Administration strongly backed Mexico's commercial bank debt-reduction agreement completed in March 1990. This agreement contributed to a significant reduction in debt and debt service, and increased confidence in the economic policies of the Mexican Government.

CHILE

Chile is unusual in Latin America in that its current reform efforts build on the dramatic economic restructuring in favor of private enterprise and markets that took place in the mid-1970s. After the overthrow of the socialist government in 1973, the country switched from extensive state intervention in most economic activities to a system based on private initiative. Price controls were removed, trade barriers were reduced, financial sector liberalization was undertaken, and many state enterprises and financial institutions were privatized. However, Chile's transition to a market economy and the presence of an authoritarian government represented a contradiction that could not endure. *With the return to power of a democratic government in March 1990, Chile's strong free enterprise system is matched by a freely elected democratic government for the first time in nearly 20 years.*

Like other countries of Latin America, Chile suffered an economic crisis in the early 1980s. The country was battered by many of the same external factors that hurt its neighbors and developing countries all over the world, including a deterioration in its terms of trade (as the price of oil rose and the price of copper, Chile's chief export, fell), a rise in international interest rates, and a recession in the international economy. A heavy international borrower both before and after these factors came into play, Chile's debt-servicing difficulties became unmanageable as interest rates rose and foreign exchange earnings fell. Faulty macroeconomic policies included inflationary levels of debt-financed domestic spending and an overvalued exchange rate that encouraged imports and discouraged exports. These policies heightened the debt crisis and deepened the economic recession. Poor supervision of the banking system also contributed to the bankruptcy of many enterprises and a financial crisis.

As elsewhere, emergency stabilization measures were the first stage of economic reform. To redress the severe external and internal imbalances, the overvaluation of the exchange rate was ended with a sharp devaluation, and automatic wage indexation was suspended. Emergency measures included large public employment programs, debt rescheduling, and guarantees that private debt would be repaid. For a few years the government focused on cushioning the effects of the recession, discouraging capital flight, and improving the trade balance.

In 1985 the government moved to supplement emergency measures with a more comprehensive reform program aimed at improving several fundamental structural problems: the lack of export diversity, the low level of savings and investment, and a precarious financial system. The plan involved reducing import tariffs and strengthening export incentives; improving public finances through the sale of state enterprises, tax policy reform, and conservative public spending policies; and creating a more favorable climate for private savings and investment through tax, pension, and housing policy reforms. Bank supervision was strengthened, and banking reform began in the mid-1980s. As a continuation of banking and financial policy reform, the central bank was given greater autonomy in 1989.

Between 1984 and 1989 the Chilean economy emerged from the recession and grew at an average rate of 6.3 percent a year. Unemployment declined, real wages increased, inflation dropped, and exports other than copper, such as fruit, forestry, and fishery products, performed very well. Private savings improved significantly, too, rising from about 2.2 percent of GNP in 1984 to 9.6 percent in 1989. Although stronger world copper prices since 1987 helped buoy economic performance, much credit goes to the successful implementation of the reform program.

The new democratically elected government remains strongly committed to an open market economy with a low level of state involvement. It is also directing new attention to social programs to alleviate poverty. In carrying out its constitutional mandate, the government faces the challenge of meeting its social priorities while maintaining the strict fiscal policies that have helped reduce external debt. This Administration's strong commitment to improving trade and investment relations between the United States and Chile can help sustain Chile's efforts and contribute to their success.

SUMMARY

- Governments throughout Latin America are rejecting earlier models of economic development, which stressed inward-looking policies and extensive state ownership, for a market-based approach that emphasizes openness and private enterprise.
- Some of this reorientation stems from the debt crisis of the early 1980s, which prompted stringent stabilization measures and revealed the underlying weaknesses of the structures of these economies.
- Many Latin American countries have embarked on sweeping reform programs. Mexico and Chile are strong examples, and efforts are also being made in Argentina, Peru, Venezuela, and elsewhere.

THE ROLE OF THE UNITED STATES

In both Eastern Europe and Latin America, the Administration has provided strong support for the transitions to democratic societies and free-market economies. First and foremost, this effort involves continued leadership through promoting our democratic ideals, building support among other industrial countries for the reforms, and making clear that markets offer the best hope for sustained growth in living standards.

This leadership is backed up by humanitarian, technical, and financial assistance and endorsement of measures to open markets and expand trade. The Administration has assisted Bulgaria, Hungary, Poland, the Soviet Union, and other countries in coping with severe shortages of necessities, such as food and medicine.

The U.S. Government's economic technical assistance is designed to support strong and comprehensive reform programs including social safety nets. The Administration also has encouraged democratic institution building in Eastern Europe. That assistance has supported an independent press and electronic media, the democratic political process, and the rule of law (for example, helping to draft legislation and support for an independent judiciary). It has also supported social and cultural pluralism through educational programs and cultural exchanges.

The public discussion of how to help reforming countries has been focused excessively on the need for financial assistance, which is only one part of the answer. Absent sound reform policies, this money would most likely be wasted. *Assistance should be designed to mesh with and encourage the reform effort so that it is used to accelerate rather than delay necessary reforms.* While assistance must be responsive to short-term needs, it is important to develop long-term assistance priorities that reinforce the fundamental reforms needed to establish long-term, sustainable growth.

U.S. SUPPORT FOR EASTERN EUROPE

In Eastern Europe the Administration is committed to encouraging the rapid transition of centralized command economies to free market systems. A vital component of this commitment is economic technical assistance.

The U.S. technical assistance effort offers a range of options that countries in transition can choose from, depending on their needs. This range includes providing management training and market economics education, giving technical assistance on energy issues, and helping to set up banking systems. The U.S. Government, for example, has helped to establish a regional environmental center in Budapest and has provided assistance to reduce pollution in Krakow, one of Eastern Europe's most polluted cities. Much of the assistance is directed to the private sector rather than the government. Legislation in 1989 provided assistance to Hungary and Poland. In 1990, Congress approved legislation expanding the U.S. assistance effort to $439 million in fiscal 1991 and extending funds to other economies in transition in Eastern Europe.

Polish Stabilization Fund

A key element of U.S. Government support for Poland was a U.S. contribution to a $1 billion stabilization fund in January 1990. The U.S. Government provided a $200 million grant to the fund, with other governments contributing primarily in the form of loans or lines of credit.

The fund was designed to provide credibility to the Polish reform plan by supporting the Polish Government in its effort to stabilize the exchange rate. Reducing inflation was a cornerstone of the

Polish program, which included measures to open the economy to foreign competition, fix the exchange rate to the U.S. dollar, and make the Polish currency convertible. Given the uncertainties associated with this initial attempt to transform a centrally planned economy into a market system and the importance of adhering to a fixed exchange rate to break inflationary expectations, the fund appears to have bolstered confidence that the reform measures could and would be sustained. The fund was renewed for 1991.

Some people have questioned whether the stabilization fund represents an efficient use of official assistance, noting that Poland has not drawn upon the resources of the fund. The fact that the fund did not need to be used, however, suggests that it provided confidence and support for the Polish program.

Assistance to New Private Enterprises

Another element of the U.S. Government assistance effort is creation of Enterprise Funds. Funds were established in 1990 for Hungary and Poland, and in November 1990 the President announced that a fund would also be created for Czechoslovakia. These funds promote development of the private sector by providing grants and loans to entrepreneurs, making equity investments, and supporting technical assistance. They are thus an important source of venture capital to new firms.

Trade Measures for Eastern Europe

To promote market reforms and ensure that these countries face open markets, the Administration has concluded business and investment agreements with Poland and Czechoslovakia and granted most-favored-nation (MFN) status to Czechoslovakia in 1990. In January 1991, the President requested MFN status for Bulgaria. (MFN status had already been given to Hungary, Poland, and Yugoslavia.) MFN status ensures that the United States will provide tariff treatment as liberal as that provided to other trade partners, except those with which it has a free-trade agreement. The Administration is also negotiating bilateral investment treaties and is working to relax existing trade restrictions with a number of countries in the region. Expanded trade opportunities are critical to creating a supportive external environment for reforms. Therefore, the United States and other countries should examine ways to expand trade opportunities for Eastern Europe.

U.S. SUPPORT FOR LATIN AMERICA

The U.S. Government has long been active in providing technical assistance and supporting market-oriented reforms in Latin America. In June 1990 the President unveiled his Enterprise for the Americas Initiative (EAI) to expand free trade throughout the hemisphere and lay the foundation for long-term growth in Latin

America and the Caribbean. The initiative consists of three parts: trade, investment, and debt. Chapter 7 discusses the trade elements of the initiative. On the investment side, the President proposed that the Inter-American Development Bank provide loans in support of reform of the investment regime. The President has requested that the Congress authorize a 5-year grant of $500 million to provide further support for investment reform, particularly privatization. These efforts are aimed at developing the private sector and improving the environment for private foreign investment. In that sense, the initiative parallels the goals of the Enterprise Funds for Eastern Europe.

Latin America would also benefit through the EAI from reduction of the substantial debt owed to the U.S. Government. For some loans, the stock of debt would be significantly reduced, and interest payments on the amounts that remained could be paid in local currency and used by the country in support of environmental projects. Other loans could be sold to investors making equity investments in the economy. The reduction in debt and debt-service payments would be contingent on these countries pursuing economic reforms including an open investment regime. The debt reduction supported by the EAI complements continuing U.S. initiatives to reduce the burden of the region's commercial bank debt.

The EAI has been extremely well received throughout the region, where leaders have acclaimed the initiative as the most important opportunity in hemispheric relations in years. Persistent efforts both in the United States and in each Latin American and Caribbean country to follow through on the vision of the initiative will be required to bring about real results. The EAI is a significant addition to the Administration's ongoing technical and financial assistance programs in the region. Other Administration initiatives, such as the Andean Trade Preference Initiative and the proposal for a U.S.-Mexico free-trade agreement, supplement the EAI and are described in Chapter 7.

WORKING WITH MULTILATERAL INSTITUTIONS AND OTHER GOVERNMENTS

In his speech to the annual meetings of the World Bank and IMF in September 1990, the President stressed the central role the multilateral institutions can play in helping economic reform in the 1990s. Both institutions have long been involved in support of economic reform in Latin America and Africa, and both are expanding their efforts in Eastern Europe. In 1990 the IMF supported the reform programs of Hungary, Poland, and Yugoslavia. Bulgaria and Czechoslovakia joined the World Bank and the IMF in September 1990. (Czechoslovakia had been an original member of these institutions before withdrawing in 1954.) In January 1991 Czechoslovakia embarked on an IMF program, and new programs for Hungary and Poland are expected to follow soon (Box 6–3).

In addition, at the initiative of the United States, the IMF has modified its policies so that it can help Eastern European and other member countries cope with higher import costs and other adverse trade effects stemming from the Persian Gulf crisis. The Administration also participated in the quick establishment of the European Bank for Reconstruction and Development and encouraged the World Bank to expand its policy-oriented lending program in support of critical structural reforms. Through policy advice and lending, the international financial institutions will take a leading role and advance the interest of the United States and other countries as well.

At the Houston Economic Summit in July 1990, the President, on behalf of the heads of state of the seven leading industrial nations, requested that the IMF lead a number of international institutions in a study of the Soviet economy. That study, presented to the President in December 1990, provides a comprehensive analysis of the Soviet economy. The report recommends that dramatic market-oriented reform proceed quickly and concludes that, when reform begins, technical assistance, not large-scale financial aid, is essential to successful reform.

The effectiveness of the U.S. Government assistance effort is enhanced by effective cooperation and coordination with other governments. The stabilization fund for Poland is just one example. Another is the effort, now under way, to work with Poland's other official creditors to reduce Poland's stock of official debt. U.S. efforts to create a stable, growth-oriented global economy after World War II paved the way for others to join the ranks of global economic powers. These countries now can share the responsibilities of supporting this effort for the economies in transition. The President was instrumental in establishing a group of 24 Western governments (called the G–24) to coordinate assistance for Eastern Europe on a case-by-case basis in support of IMF-led adjustment efforts. The G–24 has already coordinated about $20 billion in grants, credits, guarantees, and technical assistance for Eastern Europe.

THE ROLE OF THE U.S. PRIVATE SECTOR

The private sector can contribute to reform in emerging market economies through several different avenues. The President announced on May 12, 1990, the creation of the Citizens Democracy Corps to channel voluntary assistance to Central and Eastern Europe. The President has appointed the steering commission, and it is beginning its work. Other organizations involve retired executives and financial sector experts. For example, the International Executive Service Corp organized a number of technical assistance

Box 6-3.— The Role of the IMF in Economic Reform

The International Monetary Fund, an organization of 154 member countries, provides technical assistance, policy advice, and financial support to countries undertaking extensive structural and macroeconomic reforms. IMF financial support is planned in conjunction with the government officials of the country itself and requires strict adherence to an agreed schedule of policy adjustments and quantitative performance targets. Disbursement of support funds is conditional on meeting these targets.

Types of Support. Standby arrangements are loans that focus on fiscal, monetary, and exchange-rate policies aimed at overcoming short-term balance of payments difficulties. Repayment is to be made in 3¼ to 5 years. Extended arrangements are loans that support medium-term (3 to 4 years) programs of macroeconomic and structural reforms. Repayment is to be made in 4½ to 10 years. Structural adjustment facility and enhanced structural adjustment facility arrangements provide resources to support medium-term (3 years) structural reform programs in low-income countries.

The Compensatory and Contingency Financing Facility. This facility provides IMF loans for the following purposes. The compensatory element provides resources to members to cover temporary export shortfalls or excessive import costs of certain foodstuffs due to price fluctuations beyond their control. The contingency element provides protection to members with IMF programs against potential future adverse external shocks beyond their control that could otherwise jeopardize their economic performance under their IMF programs. In 1990, at the initiative of the United States, the facility was modified to allow financing for higher oil import costs and certain other losses due to the Gulf crisis.

What is conditionality? To ensure that nations with IMF financial support make consistent and substantial progress in attaining program goals, the IMF and the member country agree in advance to quarterly or semiannual target levels for a number of policy variables, such as domestic credit creation, international reserves, and government budget deficits. A country's drawings on IMF resources are conditional on attaining these intermediate targets. If these targets are not met, the IMF usually requires corrective policy actions before additional drawings may be made.

missions in 1990. Volunteers, including nonprofit organizations and universities, have already made a substantial contribution.

Ultimately, governments cannot and should not be the main source of financing to the private sector in these countries. Private firms here and in other countries also play a critical role in supporting the transition. Eastern European countries are blessed with able, well-trained work forces but lack entrepreneurs and capital. Meanwhile, direct investment and other forms of long-term capital inflows will be the key to a successful transformation in Latin America. Over time, the number of attractive business and investment opportunities will grow as these countries move toward free markets.

SUMMARY

- Financial assistance alone will not resolve the difficult challenges facing the countries of Eastern Europe, the Soviet Union, and the developing countries of Latin America.
- The U.S. effort has focused on technical assistance aimed at making the transition a sustained success over the long term.

CONCLUSION

The worldwide movement toward market reliance and political freedom continues to gather momentum. Nations in Eastern Europe are dismantling their command systems and endeavoring to replace them with thriving private sectors. This task will be long and difficult, and both governments and their citizens must understand that decades of neglect and state control cannot be overcome without a painful transition period. Given sufficient time to work, comprehensive reform will improve living standards dramatically as producers begin to make efficiently the goods that consumers want to buy.

The Latin American countries do not operate under as high a degree of state control as did the communist countries of Eastern Europe, but they also need to undo the extensive damage caused by failed economic policies. In both regions, the normal operation of markets was obstructed through widespread government interference and reliance on inefficient public enterprises.

Successful economic reform requires the rapid and comprehensive implementation of several critical policy principles. Establishing sound monetary and fiscal policies, decontrolling domestic prices, and opening the economy to international market forces will set the foundation for economic stability. These principles must be accompanied by a set of structural reform efforts that promote efficiency and provide production incentives. The structural reforms require establishing private property rights and privatization of public enterprises, promoting domestic competition, and reducing and reforming the role of government.

The convincing lesson from earlier piecemeal reform efforts in both Eastern Europe and Latin America is that only comprehensive reform programs can hope to create dynamic, growing economies. Implementing only part of the needed reforms is likely to yield little benefit. Without comprehensive reforms, output may decline substantially because individual incentives to produce are absent, and living standards cannot be increased. The reforms should also be implemented as quickly as politically and socially possible, since delays only prolong the pain and disruption of the transition period.

Reform efforts under way throughout the world present an enormous opportunity to improve living standards of hundreds of millions of people. Financial and technical assistance from the United States and other developed economies, combined with perseverance and patience in the countries in transition, can ensure that these nations make the most of their great new opportunities.