Commentary: Public Sector Deficits and Macroeconomic Stability in Developing Economies

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Sebastian Edwards' paper explores a number of issues relating to fiscal policy and savings, with special reference to privatization and pension arrangements in Latin America. As I know little about Latin America, I have little disagreement with him. Rather than comment directly on his paper, I shall attempt to complement it by reference to the transition economies of Central and Eastern Europe which I know a little better. Like most speakers this morning, I will not offer many concrete solutions to our problems.

As Sebastian reports, concern about growth has recently increased in transition economies including those of Eastern Europe as the writings of Janos Kornai of Hungary illustrate, not to mention the speeches of Chernomyrdin or Kuchma. Nevertheless, a clear lesson from their experience is that stabilization and growth do not conflict, as is shown by the figures in Table 1. They show that virtually without exception, no country has resumed growth without first getting inflation below 75 percent per year. Equally, virtually all the ten or so countries still inflating at over 100 percent per year are still contracting. Moreover, as we shall see, no country has succeeded in achieving stabilization and resumed growth without fiscal consolidation.

Nevertheless, transition, even where successful, has not been easily achieved as the data on output and unemployment levels in Table 1 show. I should enter a caveat about the data whose deficiencies

Table 1
Recorded Output: Cumulative Falls, Turning Points, Recovery, and Unemployment

Country	Cumulative Fall %	Turning Point	Recovery %	1995 Index	1994 Unemploy-ment	1994 Inflation % per year
Albania	35	1992/3	25	80	..	16
Armenia	65	1994	neg	35	26*	1,100
Azerbaijan	55 so far	not yet	NA	45	..	1,800
Belarus	45 so far	not yet	NA	55	2.5	1,875
Bulgaria	20	1994	4	83	13	122
Croatia	25	1994	5	80	18	-3
Czech Republic	20	1993	8	86	3	11
Estonia	25	1993/4	11	83	2	42
FYR Macedonia	40	1995	neg	60	19	54
Georgia	80 so far	not yet	NA	20	..	7,000
Hungary	17	1993/94	5	87	10	21
Kazakhstan	65 so far	not yet	NA	35	9	1,000
Kyrgyzstan	45	1995	2	56	..	87
Latvia	45	1994	6	58	7	26
Lithuania	55	1994	6	48	2	44
Moldova	55	1995	neg	55	..	111
Poland	8	1992	17	108	17	30
Romania	25	1993	7	80	11	62
Russia	50 so far	not yet	NA	50	2	205
Slovak Republic	25	1993/4	9	82	15	12
Slovenia	13	1993	12	97	14	18
Tajikistan	70 so far	not yet	NA	30	..	-45
Turkmenistan	40 so far	not yet	NA	60	..	1,100
Ukraine	50	1995	2	51	0.5	401
Uzbekistan	20 so far	not yet	NA	80	0.3	423
Eastern Europe	14	1993	8	93	11	35
CIS	50	not yet	NA	50	..	1,250

neg = negligible, NA = not applicable, .. = not available.
*1993 data.

in this area are probably even greater than those Sebastian refers to in his paper.

The countries of Eastern Europe are much farther behind in transition to the market and recovery from the 20 percent fall in output that seem to characterize even the smoother paths of the more rapidly reforming countries. The slow or late reforming countries of the former Soviet Union have reported output falls of over 50 percent and have not yet clearly touched bottom. Monetary stabilization has involved sustained high real interest rates and threatens some of the financial problems Sebastian mentions which may spill over into the public sector and its finances as we have seen in Mexico.

More immediately, the falls in output have serious fiscal consequences which are difficult to disentangle from those of other aspects of reform and transition, such as the new value added taxes and the question of compliance by the new private sector to which Sebastian refers. In several states of the former Soviet Union such as the Ukraine, the shadow economy is said to account for 25 percent to 50 percent of economic and financial activity.

It is unsurprising that investment in these countries has fallen even more sharply than output as shown in Table 2. Sebastian Edwards discusses the links between domestic saving and domestic investment which might be weakened by the international capital market. He does not, however, discuss the extent to which domestically and foreign-financed capital expenditures are substitutes from the point of view of the transition economy. Greg Mankiw mentioned the difference between gross domestic product (GDP) and gross national product (GNP) yesterday. I believe that the objective should be convergence in GNPs per capita, not GDPs, and a simple model suggests that domestic savings are likely to be about ten times more effective in this respect than foreign investment whose direct return accrues to the foreigners. There is a problem here about the wide gap between estimated returns to capital and real interest rates, which cropped up in discussion of the Ball-Mankiw paper yesterday.

Table 2
GDP and Gross Domestic Investment Over the Transition
1989-1994

	GDP Level 1988-89	GDP Level 1993-94	GDP Change in Level 1989-94	Investment Share of GDP 1988-89	Investment Share of GDP 1993-94	Investment Change in Level 1989-94
	(a)	(a)	(b)	(c)	(c)	(b)
Albania (e)	100	65	-35%	6%	14%	-24%
Armenia	104.02	36.11	-65%	36%	9%	-91%
Azerbaijan	96.85	64.63	-33%	22%	21%	-35%
Belarus	103.48	70.90	-31%	28%	34%	-6%
Bulgaria	98.77	68.56	-31%	34%	22%	-55%
Croatia (e)	100.00	76.00	-24%	16%	15%	-25%
Czech Republic (e)	100.00	79.00	-21%	27%	27%	-21%
Estonia	101.72	69.14	-32%	33%	26%	-47%
Fyrm (e)	100.50	58.00	-43%	17%	15%	-45%
Georgia (e)	100.00	25.90	-74%	NA	NA	NA
Hungary	100.06	82.24	-18%	26%	21%	-35%
Kazakhstan	88.00	56.00	-32%	14%	11%	-34%
Krygyzstan	102.00	62.00	-40%	38%	NA	NA
Latvia	102.84	56.50	-45%	36%	16%	-76%
Lithuania	101.77	46.07	-55%	31%	18%	-74%
Moldova	103.74	51.41	-50%	31%	6%	-90%
Poland	100.18	88.65	-12%	32%	16%	-57%
Romania	97.07	66.77	-31%	28%	25%	-38%
Russia	100.76	56.24	-44%	33%	28%	-54%
Slovak Republic	100.52	75.51	-25%	30%	21%	-47%
Slovenia (e)	100.00	86.10	-14%	17%	19%	-12%
Tajikistan	99.00	36.00	-63%	11%	NA	NA
Turkmenistan	96.00	75.00	-21%	26%	NA	NA
Ukraine	101.95	57.11	-44%	25%	5%	-88%
Uzbekistan	102.26	61.64	-40%	28%	27%	-42%

(a) GDP Index, 1989=100, average over the period
(b) Percentage change over the entire period, 1989-94
(c) Gross Domestic Investment share in National Account Statistics
(e) Data refer to 1990 and 1993
Sources: World Bank, *World Tables 1994*. World Bank, Country Briefs, 1995. Data for Albania, Croatia, Czech Republic, Fyrm, Kazakhstan, Krygyzstan, Slovenia, Tajikistan, and Turkmenistan are from IMF, *Recent Economic Development*, various issues 1994-95.

The value of foreign investment, about which the transition economies of Central and Eastern Europe are somewhat ambivalent, lies particularly in the transfer of associated technologies, skills, and know-how, which are difficult to unbundle from it. Edwards' economic findings are supportive of a virtuous circle view of savings and growth, which is in some tension with theories of convergence advanced by Barro and others. Elsewhere, Sebastian, and also Jeff Sachs in a recent Brookings Paper on Economic Activity from which Tables 3 and 4 are culled, have related the convergence question to indexes of countries' openness to trade and capital. This suggests that convergence applies to open transition economies, which are thus receptive to formal and informal technology transfer.

Certainly the prospects of the Central and Eastern European countries' enjoying German or Japanese post-World War II virtuous circles of saving, investment, and growth seemed initially implausible. Whereas Germany had low consumption relative to the medium-term capacity of its damaged capital stock—which offered high returns to repairs—the Eastern Europeans had unsustainably high consumption relative to the capacity of their old system as their high fiscal deficits, foreign debt, and falling investment attest. Moreover, the Germans were demoralized, uncertain, and fearful of the future while the Eastern Europeans entertained unrealistic expectations about the speed at which material convergence in living standards would follow political change. That despair is a better launch pad for growth than is euphoria parallels the benefits Michael Bruno and Robert Johnson found in hard landings yesterday.

Sebastian's econometric work also finds a role for political factors of stability and polarization. Stability was initially low in Eastern Europe as the broad coalitions that had toppled Communism fragmented into government and loyal opposition. Subsequently, the resurgence of former Communists may have reflected increased polarization, though fortunately, there have been few, if any, readings on Sebastian's assassination index outside the banking sector and those few countries in which civil war has broken out.

Table 3
Post-Communist Countries with Year of Opening

Country	Year of Opening
Hungary	1990
Poland	1990
Bulgaria	1991
Czech Republic	1991
Slovak Republic	1991
Slovenia	1991
Albania	1992
Estonia	1992
Romania	1992
Croatia	1993
Latvia	1993
Lithuania	1993
Belarus	1994
Kyrgyzstan	1994
FYR Macedonia	1994
Moldova	1994
Armenia	closed
Azerbaijan	closed
Georgia	closed
Kazakhstan	closed
Russia	closed
Tajikistan	closed
Turkmenistan	closed
Ukraine	closed
Uzbekistan	closed
Yugoslavia	closed

Source: European Bank for Reconstruction and Development (1994).

Table 4
Growth Rates of the Transition Economies
(in Percent)

Country	Strength of Trade Reform	Year of Trade Reform	Cumulative Growth 1989-94	Growth 1994
		Strong reforms		
Hungary	4	1990	-17.94	2.00
Poland	4	1990	-9.23	5.00
Bulgaria	4	1991	-26.41	1.40
Czech Republic	4	1991	-15.49	3.00
Slovak Republic	4	1991	-19.53	5.00
Slovenia	4	1991	-13.26	5.00
Albania	4	1992	-22.89	7.00
Estonia	4	1992	-29.15	5.00
Romania	4	1992	-30.79	3.00
Croatia	4	1993	-31.04	1.00
Latvia	4	1993	-39.52	3.00
Lithuania	4	1993	-55.44	2.00
Average			-25.89	3.53
		Moderate reforms		
Kyrgyzstan	3	1994	-42.30	-10.00
Russia	3	closed	-47.29	-15.00
Average			-42.61	-12.50
		Weak reforms		
FYR Macedonia	2	1994	-51.30	-7.00
Moldova	2	1994	-54.30	- 25.00
Armenia	2	closed	-61.60	0.00
Kazakhstan	2	closed	-51.01	-25.00
Uzbekistan	2	closed	-11.75	-3.00
Average			-45.99	-12.00
		Weakest reforms		
Belarus	1	1994	-35.93	-22.00
Azerbaijan	1	closed	-54.32	-22.00
Georgia	1	closed	-85.35	-35.00
Tajikistan	1	closed	-70.37	-25.00
Turkmenistan	1	closed	-38.29	-20.00
Ukraine	1	closed	-51.36	-23.00
Average			- 55.94	-24.50
Overall average			-38.63	-7.58

Source: European Bank for Reconstruction and Development (1994, 1995) with national sources for Bulgaria for 1994.

Privatization and its proceeds feature frequently in Sebastian's story. He usually calls the proceeds 'revenue' although he acknowledges the arguments that they do not contribute to government's permanent income. He does not, however, develop an argument I believe to be important for using a comprehensive public sector cash flow revenue concept in the early stages of transition. That is that they have no capital market and, as John Taylor and Michael Bruno have mentioned, deficits then have to be monetized. The sale of state assets is the only alternative to the printing press in the Ukraine, though not in the United Kingdom.

Nevertheless, Central and Eastern European countries have benefited less from this than have the Latin countries because they have relied much more heavily on the issuance of vouchers and especially in the former Soviet Union, their distribution to workers and managers.

Sebastian documents the low savings rates in Latin America which he places at the bottom of the class of classes. In fact, the Latin rates he cites are similar to those of the United States and the United Kingdom, which are at the bottom of the Organization for Economic Cooperation and Development (OECD) class. I suggest that this reflects the Japelli/Pagano mechanism by which ready access to consumer credit reduces savings and slows growth. Edwards plays down this argument, possibly because the relevant aspects of financial development and sophistications are not only difficult to measure but the relationship may be U-shaped. Up to a certain point, more effective capital markets are unambiguously beneficial. Beyond a certain point, their sophistication or extension may be damaging to growth if not to welfare, as Ball and Mankiw point out.

As Sebastian and others have said, funded pensions also fit into this picture, but he does not mention the possibility in former centrally planned economies where everything belonged to the state, that the state could endow new occupational pension schemes with former state assets in the process of privatization. The size of their assets relative to their state-assigned obligations give some control over savings. Admittedly, no country has pursued this route at all systematically.

Finally, in this connection, let me focus on the applicability of Sebastian's conclusions to the Central and Eastern European countries.

> (l) Tax reform does not boost revenue in the short term. This is true. I am uneasy, though I have made a somewhat similar suggestion myself, about his suggestions that tax rates in general be planned to be cut as revenue comes good, as this could have adverse intertemporal incentive effects tending to defer investment, though this danger is diminished by the low credibility and durability of governments in most European transition economies.
>
> (2a) Investment is easier to cut than current expenditure—especially transfers—yes.
>
> (2b) Transferring functions and infrastructure to the private sector requires clear regulatory frameworks—yes.
>
> (3) The financial sector can be a source of instability and fiscal imbalance—yes. Many see this as a major threat in the near term and the problem of bad debts and bankruptcy have still not been resolved in Eastern Europe.
>
> (4) Central banks shall be independent—probably premature in Central and Eastern European countries, especially those of the former Soviet Union, where capital markets are inadequately developed to allow the separation of fiscal and monetary policy.
>
> (5) The banking sector and its regulations are crucial—yes and not yet secured.

These comments have led me to fulfill Tom Davis' expectations that I would suggest how developing and transition economies can reduce their budget deficits. What data I have in hand are presented

Table 5
General Government Balances and Expenditures
(Percent of GDP)

	1989	1990	1991	1992	1993	1994	1995
				Bulgaria			
Balance	-1.4	-12.7	-15.1	-14.5	-18.5	-7.0	-7.0
Expenditure	61.4	64.3	50.7	47.3	51.0	44.0	NA
Czechoslovakia (Czech and Slovak Republics after 1992)							
Balance	-2.8	0.1	-2.0	-3.3	1.4	1.0	NA
					48.5	46.0	NA
					-7.5	-4.0	NA
Expenditure	64.5	60.1	54.2	52.8	50.0	40.0	NA
				Hungary			
Balance	-0.8	0.8	-4.4	-6.9	-6.7	-7.7	0.5
Expenditure	61.0	57.5	58.3	63.4	60.5	NA	NA
				Poland			
Balance	-7.4	3.3	-6.5	-6.7	-2.9	NA	NA
Expenditure	48.8	39.8	48.0	50.7	48.4	NA	NA
				Romania			
Balance	8.4	1.2	0.6	-4.6	-0.1	-3.0	-2.0
Expenditure	42.7	34.3	40.4	42.2	31.0	NA	NA
				Russia			
Balance	NA	NA	-31.0	-18.8	-8.0	-11.0	-8.0

Note: NA: not available.
Source: EBRD

in Table 5. Generalization is difficult. Bulgaria and the Czech and Slovak Republics, but not Hungary, have cut expenditure sharply. So has Romania, but it started with a budget surplus as Ceausescu pursued his debt repayment policy.

In the former Soviet Union, the key is to moderate the severity of the formal fiscal regime while extending it to the shadow economy. No easy task.

Also, unlike much of the discussion yesterday and earlier today, responsibility for social support needs to be assumed by the government from enterprises. Tom Davis, himself, mentioned at lunch yesterday that it was the social consequences of the closure of enterprises responsible for kindergartens, clinics, and pensions that Victor Gerashchenko, then chairman of the State Bank of the U.S.S.R., cited in this room some years ago as his excuse for excessive credit creation.