Introduction

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This book is the product of the international joint project on *Structural Adjustment Policies in the 1990s: Experiences and Prospects,* sponsored by the Institute of Developing Economies, Tokyo. *Structural adjustment* is regarded as a broad policy package which combines macroeconomic stabilization and microeconomic structural reforms. The former includes conventional adjustment policies such as fiscal and monetary tightening and exchange rate realignments, while the latter consists of sector-oriented structural measures and other miscellaneous deregulation measures. In the case of "transition economies," the building of judicial and accounting rules also constitutes an important part of structural adjustment.

The 1980s were the decade of structural adjustment in developing countries. A series of external shocks hit these economies and turned many of them into unprecedented turbulence. For example, most of Latin American economies were known to suffer from this "lost decade" mainly because of the "debt problem." The structural adjustment is regarded as a package of various policy efforts to get out of the predicament, to rehabilitate suffering economies and to resume growth in the coming decades.

The predicament was, however, not shared uniformly among developing economies. Rather the economic performance widened its gap between them dramatically. East Asia was no exception in implementing structural adjustment after the second oil shock, nevertheless it has been often found in stark contrast with Latin America in terms of economic performance since the 1970s. What ultimately differentiated their performances?

On the other hand, since the late 1980s almost all former centrally-planned economies have been witnessed to shift to a "market economy." Economic reforms for these economies have been prescribed along the line with structural adjustment. Here, again, we have observed another contrast between transition economies in Europe and Asia, the former in economy-wide distress and the latter with vigorous growth. What can we learn from those experiences?

The purpose of the project is to review the experiences of structural adjustment, to reassess its impact on developing countries and then to search for new perspectives for development strategies. A quest for desirable development strategy has recently received a new stimulus both from academic and policy fronts. The former can be represented by the new growth theory and the latter by the East Asian Miracle.

In the recent past, structural adjustment has often been criticized as neglecting country-specific and/or situation-specific differences. Careful country studies have become urgently needed. Deeper understanding of institutions and political considerations have become substantially important. These are part of the reasons why we arrange chapters by region instead of by sector or by policy field.

As Bruno [1995] correctly puts it, we must "minimize the residual country-specific factors" and make our perceptions "operational across broad array of countries and experiences." The composition of the book is the following: It consists of four parts and eleven chapters. Part I gives a global perspective for the topic. Part II concentrates the experience of China in transition to a market economy. Part III scrutinizes Latin American experiences. Then, Part IV extends diverse experiences in Central and Eastern European Countries (CEECs).

1. STRUCTURAL ADJUSTMENT AND ECONOMIC GROWTH

Part I consists of two chapters which discuss structural adjustment policies, development strategies, and sources of economic growth from a global and comparative point of view.

1.1 Stability with Growth: Multiple Paths to Development

Chapter 1 by *Akira Kohsaka* discusses *structural adjustment as a development strategy,* reviewing the experiences of structural adjustment, reassesses its impact on developing economies, and pursues for a new perspective of development strategies. Two main episodes of structural adjustment are analyzed: One is the policy responses to external shocks by developing economies in the 1980s, and the other the transition of former centrally-planned economies (CPEs) to market economies in the 1990s. Both episodes are deeply linked to the very basics of development strategies.

Reviewing individual experiences of external shocks and corresponding policy efforts in the 1980s, the author points out the possible tradeoff between macroeconomic stabilization and structural reforms across differential economic structures. He argues that macroeconomic stabilization instead of microeconomic liberalization was the source of successful (failing) adjustment in East Asia (Latin America), because macro stability with sustained growth proves the manageability of government and helps establish confidence of market participants on the system. In other words, stability with growth constitutes indispensable part of "invisible market infrastructure."

The experiences of transition economies have proved that the straightforward application of structural adjustment is naive and harmful. The reform is not partial, but systemic, or even revolutionary, in introducing a new ownership system based on private property rights, a new corporate system by privatization, a new banking system instead of the mono-bank, and a new fiscal and social security system. The difference between these economies and other developing countries is not a matter of degree, even though their means and objectives appear to resemble each other.

Then, how can we reconcile contrasting economic performances between former CPEs in Asia and Central Europe? The author points out, as sources of the difference, different initial conditions in industrial structures, macroeconomic situations, and pre-reform regimes, as well as different policy strategies in the pace of reform and the role of government. For instance, China had been larger in agriculture, smaller in a state sector, more stable in macroeconomy, less dependent on the CMEA regime as well as being slower in liberalization and deregulation.

Furthermore, the author emphasizes the positive effects of increasing interdependence through trade and capital flows in the Asian region, of orthodox functional development strategies in East Asia, and of their "regional externalities" on economic growth. Thus, drawing on these East Asian experiences, he concludes that there is *no unique all-weather or ready-made policy package* for transition as well as development in general, and that an appropriate policy strategy to an individual developing economy must depend on initial conditions, policy management and external environments, which is thus required to be *order-made*.

1.2 Capital Accumulation vs. Productivity Growth

The *new growth theory* or *endogenous growth theory* has recently shed new lights on the determinants of economic growth as well as possible roles of government policies. As is always the case, new theories produce new problems. First, while the "capital fundamentalism" has been criticized, there seems little agreement on the importance of capital accumulation in the development process. Second, although we have had a consensus on the importance of stable macroeconomic management and reduced microeconomic distortions, we do not know exactly how and through what channels these policies affect the growth process.

Chapter 2 by *Barry Bosworth, Susan M. Collins and Yu-chin Chen* tackles these issues by adopting an eclectic method combining a growth-accounting framework and an *ad hoc* cross-country regression analysis. They, first, construct data on the stock of physical capital and measures on the educational attainment of the workforce instead of relying on proxies such as the investment rate or school enrollment rates. Then, they use this data within the framework of the growth-accounting, which enables them to distinguish the influence of various policies on *factor accumulation* and *total factor productivity* (TFP) growth.

A large sample of developing and industrial economies are covered by the analysis over the period of 1960-92, and the roles of initial and external conditions and of macroeconomic and trade policies are examined. As to the accounting framework, the authors find, first, that conventional proxies for capital accumulation such as investment rates and school enrollment rates tend to understate the importance of capital accumulation as a source of economic growth, and, second, that total factor productivity plays a major role in explaining the divergence of growth between Sub-Saharan Africa and Latin America on one hand, and industrial countries on the other. They find also that the East Asia enjoyed rapid productivity growth compared to other developing economies, although slower than in the industrial countries.

Furthermore, the authors not only reconfirm the importance of stable macroeconomic policy and outward oriented trade policy, but identify the channels through which these policy measures affect. They suggest that budget deficits work through slower capital accumulation, real exchange rate volatility primarily through lower factor productivity growth, and open trade policy through both channels.

2. SO FAR, SO GOOD?: CHINA

Part II focuses on four aspects of the transition process of China to a market economy, namely, 1) fiscal reform, 2) financial development, 3) the development of Township-and-Village enterprises (TVEs), and 4) the role of Foreign Direct Investment (FDI). China has been often referred to as a successful case of structural adjustment, gradualism, a partial and/or experimental approach, etc. Is it true and will it be true in the coming years? Is there any other factors/aspects that should have been told by now? These are the main concerns in Part II.

2.1 Declining Fiscal Integrity

Fiscal reforms consist of an overall cut in subsidies as well as revenues from state-owned enterprises (SOEs). In view of a significance and prevalence of SOEs under the soft-budget constraint, this kind of reforms tend to expand the budget deficit rather than vice versa, while it needs time and resource to enlarge the tax base and to introduce new tax instruments, especially in transition economies.

Chapter 3 by *Eiji Tajika* discusses the fiscal development in China in the post-Mao period and identify the possible danger of the "emerging coalitions between local governments and state enterprises." One of the most important objectives of fiscal reforms is to sever the linkages between state-owned enterprises (SOEs) and central and local governments. But the result is that the declining SOEs have weakened "fiscal integrity" of both central and local governments. In particular, the central government "has continuously lost its resource allocation function."

The real problem, however, lies not in the "impoverishment of governments" as a whole, but in the "loosened fiscal integrity of the central government." In fact, "provinces are now fiscally left on their own for mobilizing resources in their jurisdiction." Thus, it seems natural for provincial governments to resort to the profits of state enterprises in exchange for their protection and preferential treatments, which "could lead to wasteful regional protectionism." Finally, assessing the 1994 tax reform, the author points out that the strategic conflict exists between the central and local governments mainly because of postponed SOE reform or *gradualism*.

2.2 Fragmentation and Duality in the Financial System

Financial development in China since 1979 has been remarkable at least in terms of mobilization of financial resources to the financial system as well as management of controlling domestic inflation. As to the allocation of these resources, however, there seems little progress in efficiently financing both working and fixed capital formation.

Chapter 4 by *Masanori Okura* discusses the role of the banking sector in China, especially its function of resource allocation during the transition process to a market economy. After reviewing the recent development of the Chinese financial sector, he finds two important aspects in the allocation of financial resources across provinces and sectors.

First, he shows that the cross-province mobility of resources has been significantly limited and, particularly in the case of state-owned "national specialized banks," the cross-province mobility of financial resources is not only limited, but biased in favor of state-owned enterprises. In fact, provincial investment is highly positively correlated with its savings. Similarly, in the case of the "specialized banks," provincial loans are highly positively correlated not only with its deposits, but also with output shares of its state-owned enterprises (SOEs) and loss-output ratios of these SOEs. In other word, the flow of financial resources across provinces through state-owned banks is more or less limited and their role in resource allocation is significantly biased for SOEs.

Second, he suggests that the rapidly growing township-and-village enterprises (TVEs), however, have become increasingly dependent on the Rural Credit Cooperatives (RCCs) since the latter were allowed for increased managerial autonomy in the mid-1980s. Indeed, RCCs have become important both quantitatively and qualitatively, which tend to strengthen the dual structure between state and non-state sectors within the financial system.

2.3 Dynamism in the Non-State Sector

TVEs have become regarded as an engine of growth of China since the mid-1980s. *Chapter 5* by *Hiromi Yamamoto* reviews the development process and the performance of TVEs. Non-agricultural activities of the communes were grouped into TVEs from 1979. The terms of supervision of TVEs have become diverse across regions. TVEs are quite different from SOE with respect to weak principal-agent relationship and hard budget constraint. The corporate governance of TVEs is far from transparent, though. Observing the increasing conversion of TVEs to shareholding cooperatives, they may grow out of the present transient forms in the near future (Wing Thye Woo [1995]).

It has been recognized that FDI could be an engine of growth of developing countries. China is one of the developing countries which has begun to give a serious consideration to the role of FDI in the process of development as well as transition to a market economy. *Chapter 6* by *Yumiko Okamoto* reviews the trend of FDI inflow in China and discusses the role of FDI in its economic reform. The author suggests that FDI has contributed to the increasing role of non-state sector by enhancing its productivity through possible spill-over effects on technology.

3. VOLATILITY MATTERS: LATIN AMERICA

Part III discusses Latin America. Latin America has been known to be an experiment field of structural adjustment or "Washington consensus" package of policy reforms. *Chapter 7* by *Michael Gavin* tries to see "whether the reforms have paid off." Surveying economic developments in the region during the 1990s, he argues that the benefits of reform materialized eventually, but slowly, while little is discussed microeconomic aspects of reform and their interactions with macroeconomic developments . Then, the author narrows down his focus on one aspect, out of many, of the reform process, namely, the increased macroeconomic stability.

Conducting a Barro-type long-term cross-country regression analysis, the author finds that both external volatility (in the terms of trade) and domestic volatility (due to fiscal and monetary policies) have adversely affected economic growth, and suggests that, if Latin America had been as stable as industrial economies, their productivity growth would have been 1 percent per year higher than it was.

Furthermore, as to the determinants of volatility in the real exchange rate, real GDP and policies themselves, the author finds that macroeconomic volatility has been caused by both external and domestic shocks and that the stability of institutions and policy regimes also matter. Finally, he suggests that domestic financial deepening appear to be a "shock absorber" against macroeconomic volatility.

4. A TREASURY OF LESSONS: CENTRAL AND EASTERN EUROPE

Part IV covers four aspects of the transition process in Central and Eastern European countries (CEEC), namely, 1) privatization of state-owned enterprises (SOEs), 2) exchange rate policies and macroeconomic management, 3) fiscal issues in the transition process, 4) corporate finance and the financial system. As Portes [1996] points out, the experience of CEECs could have valuable implications for China or other transition economies. Because, "although CEECs started from different initial conditions and proceeded along different paths, the various reform strategies seem now to have converged and to face similar problems."

4.1 Privatization: Does Ownership Matter?

Privatization of state-owned enterprises has been regarded as a corner stone in the transition to a market economy in CEECs, because a success in the reform of SOEs would lead to macroeconomic stability through an improved budget balance on one hand, and to an improved resource allocation through increased efficiencies in enterprise management on the other. Indeed, privatization had been seen as an instrument to increase economic efficiency, but it has turned out to be not always true.

Chapter 8 by *Gerard Roland* focuses on the effect of privatization of SOEs on microeconomic efficiency and on enterprise behavior. The author argues that, while the corporate governance is crucially important to maintain managerial efficiency under separation of ownership and control, privatization does not necessarily solve this corporate governance issue, particularly in transition economies. He points out three reasons: 1) a weak control over enterprise management due to dispersed ownership, 2) the concentration of managerial expertise on and monopoly of information by former SOE managers and planning officials, 3) non-competitive environment without any threat of bankruptcy.

Then, by conducting case studies in the privatization experience in CEECs in terms of four dimensions of privatization methods, the author draws four general lessons: First, it is important to have a great number of options with regard to the privatization methods. The outcomes tend to be very different from the initial design. Second, similar privatization plans have varying successes in different countries. Third, differences in speed of privatization have not affected the extent of restructuring nor the speed of growth of the private sector share. Fourth, different privatization policies have a different macroeconomic impact.

Finally, based on the diversity of these experiences, he warns against hasty imitation of policies, while emphasizing the positive incentive effects of announcement of large-scale privatization and the importance of macroeconomic stabilization and corporate governance arrangements in enterprises.

4.2 Exchange Rate Arrangements

CEECs have adopted all the possible exchange rate regimes. This reflects the divergent views of policy makers regarding the proper choice of exchange rate arrangements, although there is a fundamental similarity among those economies. They had operated under multiple exchange rates without currency convertibility, and faced the systemic change under very high inflation rates.

Chapter 9 by *Charles Wyploz* discusses exchange rate management and related macroeconomic management issues in CEECs. The author presents six "stylized facts" by adapting the Burns-Mitchell business cycle methodology of putting together data along a common time scale. These facts are: 1) Inflation declines faster from lower initial levels among exchange-rate-fixers (fixers, hereafter) then floaters. 2) Both fixers and floaters undergo a massive real appreciation following the initial devaluation. 3) The introduction of a fixed exchange rate at the time of price liberalization has a powerful moderating effect on the initial burst of inflation. 4) There is a clear employment cost of adopting an exchange rate anchor. 5) The exchange rate anchor exerts a powerful restraining influence on fiscal and monetary policies. 6) Real cash balances increase steadily among fixers while they decline among floaters.

4.3 Short-Run Fiscal Dilemma

Except for the Czech Republic, CEECs have suffered from worsening fiscal balances. *Chapter 10* by *Fabrizio Coricelli* reviews fiscal developments in CEECs, highlighting the interplay of fiscal variables and the restructuring process. Distinguishing "fast" and "slow" reformers in these economies, the author finds that fiscal pressures become stronger during the transition process, and they are more acute in the "fast" reformers. This is because governments face an important trade-off, that is, excessively tight budget may yield perverse effects, slowing down restructuring.

The nature of the fiscal crisis in CEECs is characterized by the weak link between aggregate outputs and budget deficits on one hand and by combination of reduction in subsidies cum increased social expenditures on the other. The author points out the dependence of this fiscal development on the pace of reforms, particularly the asymmetric effect of the transition on revenues and expenditures, which leads to increasing fiscal imbalances.

Three conclusions follow: 1) A close connection can be found between the speed of reforms, the imposition of hard budget constraints and the increase in social expenditures. 2) The increase in social expenditures was the main force behind worsening budget deficits. 3) The need for initial transfers to losers to create support and foster reforms should have been recognized, and appropriate schemes designed.

4.4 Optimal Capital Structure and the Financial System

Under imperfect capital markets, investment and financing decisions by enterprises are interdependent. Taxes, bankruptcy costs and informational asymmetries between borrowers and lenders constitute the "imperfectness" of capital markets. *Chapter 11* by *Francesca Cornelli, Richard Portes and Mark Schaffer* examines the relationship between restructuring of enterprises in the CEECs and their capital structure.

Focusing on the issue of informational asymmetries in the context of CEECs, the authors conclude that banks are the only one left to play the role of monitoring the managers. Coping with the problems posed by the debt overhang of enterprises and the corresponding weak capital base of the banking system in CEECs, the authors asserts that these problems must be attacked directly and urgently at the top of sequence, instead of restraining bank lending before establishing effective fiscal and monetary controls as advocated by McKinnon [1993].

5. A QUEST FOR A NEW FUNCTIONAL APPROACH

So far, we have observed some countries failed in structural adjustment, though others did not, facing the same international environment. We could think of various reasons such as various initial conditions, diverse policy management, and regional environments. It might be easier to judge failures as failures. But, how can we distinguish between *true* successes, and *spurious* or *miraculous* successes? Can we learn any general lessons from those experiences?

5.1 Prospect of Former CPEs in Asia

We have seen that, as Portes [1996] puts it, "the Chinese experiment require a detailed and careful assessment of the specific conditions at the beginning of the reforms, and of the favorable factors that have arisen since, which may not be replicated elsewhere." Indeed, as to the future prospect of former CPEs in Asia, we find that we can learn richly from the experiences in CEECs.

First, Asian former CPEs had enjoyed the benefit of late-comers. Though their growth is remarkable, their initial income level was very low and their production is far from the international best practice level. Second, they have continued to postpone reforms associated with significant income redistribution including political regime changes, which must be faced at some point in the (near) future.

Finally, "regional externalities" based on rivalry in the Asia Pacific could become a source of regional disintegration as well as that of *de-facto* integration. This might be acute in the case of China. Considering its size, we might have to prepare for a soft-landing scenario or to construct a regional safety net.

5.2 The End of Ideology

Turning to possible general lessons, we seem to reach the end of ideological dichotomy, such as market vs. government, big bang vs. gradualism, and capital fundamentalism vs. productivity growth. Now we realize that market does not stand on its own without government supports, though either market or government could fail easily. We observe that big bang generates a huge *real* effect on income distribution as a cost for *potential* efficiency improvement, while gradualism could waste a huge efficiency loss with preserving the present income distribution more or less. We find that East Asia has attained unprecedented growth through both capital accumulation and productivity growth, while many developing economies failed to realize both fundamentals.

5.3 Stability Cum Growth and What?

We are facing acute problems of how to balance dual and/or complementary functions of each individual policy measures. One notable example is that of macroeconomic stabilization and microeconomic liberalization. Stability cum growth should forego microeconomic reforms, unless the necessity of the latter substantially chokes the former.

Of course, "the modernization of the state sector and the establishment of an institutional and legal framework for market activity is a precondition for a well-functioning market system (Portes [1996])." We should know, first, that the full-fledged market is a kind of a fictitious entity existing only in an textbook of economics, and, second, that it needs a lot of time and resources to build this kind of full-fledged market system.

The scope, strength, speed, sequence, and time horizon of policy measures must be taken into account in implementation. Straightforward, unconditional applications of a *tool kit policy package* could bring a disastrous result in a uncertain world. Outside advisors cannot be too careful in consultation in the case of developing and/or transition economies. We must study how to combine different functions of policies in different institutional settings.

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