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Timing and Sequencing of Reforms:
Competing Views

by

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TIMING AND SEQUENCING OF REFORMS: COMPETING VIEWS

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TIMING AND SEQUENCING OF REFORMS: COMPETING VIEWS*

Abstract

Opposing recommendations with respect to key sequencing issues characterize the controversy between the advocates of the orthodox (technocratic) approach and the recently popularized political economy approach. It is suggested that the concept of credibility provides in many cases a fruitful link between both categories of proposals. Historical lessons as well as the recent experience of developing countries and economies in transition support this view and help determine the proper reform sequence. Stressing the role of initial conditions, different sequencing tactics are recommended for developing countries and post-socialist economies. In particular, the optimal order of domestic financial market reform and privatization differs for both groups of countries.

I. INTRODUCTION

It is relatively easy to establish and widely agree on an extensive catalogue of reforms that are necessary prerequisites for economic liberalization in developing countries or for converting a former centrally planned economy into a potentially successful market economy.¹ A simultaneous and instantaneous implementation of all the relevant reforms would be recommended within a standard textbook economy. However, administratively it is impossible to carry out all reforms immediately. Some distortions will inevitably remain in some markets for some time. Short run rigidities in wages and prices, and immobilities in the movement of resources can result in short run falls in real income, real wages and employment and can lead to undesired and unsustainable distributional consequences. Institutional constraints and possible temporary negative side effects of comprehensive reforms contribute to the incapability and unwillingness of governments to reform all markets simultaneously. Consequently, the appropriate timing and sequencing of reforms becomes a major issue.

The main purpose of this paper is to address three gaps in the sequencing literature. Firstly, political economy aspects have only recently been taken into consideration when discussing the appropriate reform sequence. A more detailed comparison of standard neoclassical

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¹ Williamson [1992a, p. 13] provides such a list of reforms.

arguments and political economy aspects is largely missing. Secondly, the explicit integration of credibility aspects is still very much in its infancy in the sequencing literature, although credibility aspects have frequently been stressed as being important for comprehensive reform programs. Thirdly, most investigations are exclusively concerned with either developing countries or with post-socialist economies. When the developing countries' experience is used as a basis for recommendations on the proper reform sequence, the potentially far-reaching implications of different initial conditions are often neglected.²

Following this introduction, Part II starts by briefly sketching out competing views on the appropriate timing and sequencing strategy. Despite the large number of individual proposals two basic approaches are identified that lead to opposing recommendations with respect to key sequencing issues: the orthodox (technocratic) approach and the recently popularized political economy approach.³ It is argued that the credibility of government policy might provide in many cases a useful link between both categories of proposals and helps determine the proper reform sequence. Support for this hypothesis is presented in Part III, where the optimal position of specific policy reforms is investigated in the sequencing strategy. The preconditions, effects, and interdependencies of different policy reform areas are analyzed systematically. The focus is on fiscal and monetary stabilization, domestic financial market reform, the optimal order of external liberalization, and the timing of privatization. In each section, the implications of the orthodox view are first contrasted to those of the political economy approach. In a second step, the consequences of credibility aspects are stressed and the link to the implications of both approaches is worked out. Country experiences help identify the appropriate reform sequence, by stressing the crucial role of initial conditions. In Part IV, the optimal speed of adjustment is evaluated. Finally, Part V summarizes the main results.

II. SEQUENCING OF ECONOMIC REFORMS: STYLIZED PROPOSALS

1. Competing Views on Sequencing Strategies

The first wave of sequencing literature was entirely related to developing countries, primarily in response to reform failures in Latin American countries. The focus was on specific issues, such as the sequence of stabilization programs, financial market reform and trade reform, or the optimal sequence of trade reform and the liberalization of capital flows.

² See for instance Winięcki (1992b) in his book review of McKinnon (1991).

³ Terminology is adopted from Lal [1987].

With the ongoing changes in Central and Eastern Europe a second wave of proposals emerged, related to economies in transition. Although the substance of the envisaged reform efforts in post-socialist countries overlaps with those that have been taken up before in many developing countries, the challenge facing post-socialist countries is undoubtedly broader and the task more demanding. The lack of market institutions, the need for fundamental microeconomic reforms, the extent of domestic price liberalization and the sheer quantity of firms to be privatized are of major concern and have to be taken into account in any comprehensive sequencing proposal. Table 1 reflects the larger scope of sequencing proposals as well as the greater variety of individual proposals related to economies in transition.

Table 1 - Schematic Views of Selected Sequencing Proposals*

	Institutional Reform ¹	Domestic Price Liberalization	Fiscal/Monetary Stabilization	Domestic Financial System	Privatization	Trade Reform	Capital Flow Liberalization
Developing Countries							
Corden (1987)			1			1/2	2/3
Edwards (1984, 1990)			1	2		3	4
Fiel (1990) ²			1	1		2	3
Frenkel (1982)						1	2
Krueger (1981/84)			1	1		1/2	2/3
McKinnon (1982)			1	2		3	4
Lal (1987)			1	1		3	2
Schweickert (1993)			1	2		1	3
Economies in Transition							
Buch (1992)				1		1	1/2
Dornbusch (1991b) ³	1	4	2	5	3	4	3/4/5
Fischer/Gelb (1991)	1	2	1	4	1/3 ⁴	2	5
Gelb/Gray (1991)	1	1	1	3	1/3 ⁴	1	3
Hinds (1991)	1	2	1	3	1/4 ⁵	2	
Lipton/Sachs (1990)	1	1/2	1		3	1/2	
McKinnon (1991)		3	1	2		3	4
Nuti (1991)	1	1	1		2	3	4
Roland (1990)	1	3	3	2/4	2	3/4	2/3/4
Rybczynski (1991)	1		3	1	2		
Siebert (1991)	1	3	2	3	3	3	

* Only broadly defined reform areas are considered. If they do not exactly match with the analysis in the respective proposals, the closest category is chosen. Number 1(5) stands for the reform area that should be initiated first (last). The ranking refers mostly to the starting time of reforms so that different reform steps may well overlap. Obviously, the necessary time of reform may differ. Identical ranking indicates that these areas should be initiated at the same time. More than one ranking indicates that no unequivocal grouping appears possible, e.g. because the broad categories considered here are subdivided into smaller units in the respective proposals. Some analyses refer only to specific aspects of the sequencing issue. In this case, the remaining columns are not marked.

¹Includes e.g. legal system, property rights, contract law, company law. - ²This sequencing strategy refers less to an own proposal, but is presented as a typical sequence for developing countries. - ³This sequence relates more to a big bang "7 day program". - ⁴Small scale privatization and large scale restructuring and privatization respectively. - ⁵Privatization of enterprises and privatization of banks, respectively.

Table 1 is only a first approximation to the underlying proposals. The effort to classify alternative proposals in a unified schematic framework is limited by overlapping reform categories, situation specific sub-recommendations, and a number of "if ... then" recommendations. Furthermore, most authors stress that all reforms have to be close to each other in time. Notwithstanding these limitations, several similarities as well as the main controversies with respect to key sequencing issues can be identified:

- The necessity to start immediately with the implementation of institutional reforms is generally stressed for economies in transition.⁴ In contrast, institutional reforms do not play the same prominent role in the developing countries sequencing literature, because of more favorable initial conditions in this respect.
- The need for an early fiscal and monetary stabilization is widely accepted for developing countries. This view is, however, not unanimously shared in the case of post-socialist economies. In particular, Roland (1990) argues against an immediate stabilization in the transformation process.
- Trade reforms should be closely linked to fiscal and monetary stabilization in developing countries as well as in economies in transition. Whether a stabilization-first-strategy or a simultaneous implementation of stabilization and trade reforms is recommendable remains controversial. In economies in transition, the initiation of trade reforms should be closely related to price liberalization.
- The reform of the domestic financial system enjoys high priority on the reform agenda in developing countries and is closely related to fiscal and monetary stabilization. This recommendation sharply contrasts with the wide disagreement concerning the appropriate position of financial market reforms in the transformation process. While some authors favor an early financial market reform, others suggest postponing financial market reform until the end of the program.
- For economies in transition, the optimal order of privatization remains controversial. While some authors suggest that domestic price liberalization and/or stabilization should precede privatization, others recommend the reverse sequence. The distinction between small-scale and large-scale privatization as well as the distinction between the privatization of enterprises and the privatization of banks plays an important role.

⁴ Since it is widely accepted that basic institutional reforms should be started immediately, they are not considered in this analysis, which focuses on opposing views. For institutional reforms see e.g. Winiecki [1992a].

- A fairly wide consensus of opinion is that the capital account of the balance of payments should only be liberalized in a last step. This mainstream advice for developing countries and economies in transition is, however, challenged by Lal [1987].

The stylized summary of sequencing proposals shows that, in particular, Lal [1987] and Roland [1990] reach conclusions that deviate widely from mainstream advice. Both authors explicitly base their preferred sequencing strategy on political economy considerations, whereas most other authors rely on orthodox assumptions. In the following, the basic assumptions of both approaches are contrasted, in order to establish the basis for the subsequent systematic analysis of the different implications of both approaches for the appropriate sequencing strategy. It is suggested that the credibility of government policy plays a crucial role in both approaches and may provide a fruitful link between them. Furthermore, the different recommendations for developing countries and economies in transition suggest that the pre-reform conditions are significant factors, which therefore will be given special attention.

2. The Orthodox Approach and the Political Economy Approach: Basic Assumptions

The orthodox (technocratic) approach is based on the standard neoclassical assumption that a well-informed and benevolent government tries to maximize some social utility function subject to the existing administrative and technological constraints. Thus, the technocratic approach aims at identifying the welfare-cost minimizing reform sequence.

Not surprisingly, clear-cut proposals based on theoretical considerations are difficult to obtain. Second-best considerations suggest that partial reforms may worsen rather than improve the economic situation as long as some distortions remain in some areas. From the macroeconomic point of view, the development of key variables may differ under alternative sequencing strategies, including the path of the real exchange rate, production, and unemployment (Edwards, 1984).⁵ The ideal sequence depends on the intertemporal social objective function. Nonetheless, Table 1 reflects that some consensus has emerged with respect to key sequencing issues among those who base their arguments on orthodox considerations.

Critics of the orthodox approach stress its failure to incorporate political economy aspects.⁶ Instead of interpreting policymakers as social-welfare maximizers, the authorities have to be viewed as a group of self-interested individuals, who maximize their own utility. Facing the

⁵ Theoretical frameworks for analyzing the welfare effects of structural adjustment policies include Edwards [1989a] and Lal [1989].

⁶ Recent analyses that stress political economy aspects include: Lal [1987], Roland [1990, 1992], Van Wijnbergen [1991], Rosati [1992], Wyplosz [1992].

threat of being dismissed from office or not being re-elected, policymakers are, to a large extent, influenced by interest group activities. The implementation of market-oriented reforms is not always pareto-optimal. At least in the short run, not everybody will win from the policy-change [Roland, 1990]. Any policy measure may imply a redistribution of personal income and decision-making power. The pro- and anti-reform attitude of individuals or groups depends on their expected welfare under the alternative regimes. A large number of individuals may put a high weight on the immediate results of the reform efforts. It is the behavior of the more short-sighted individual that will determine the development of political constraints. As a result, the government's discount rate may be higher than that of society as a whole [Lal, 1987]. According to these political economy considerations, the first measures to be implemented should benefit a majority and only hurt less-organized groups in order to reduce political constraints. Up-front benefits may then create room for the implementation of measures that may cause economic conditions to deteriorate temporarily. Roland [1990, p. 22] draws the conclusion that "sequencing tactics requires that the phases of transition are ranked in order of decreasing popularity and increasing political difficulty".

3. The Role of Credibility: A Possible Link between the Orthodox and the Political Economy Approach

The credibility of government policy has been stressed repeatedly as being fundamental for successful reforms.⁷ Here it is argued that the credibility of the reform program may play a crucial role in the orthodox as well as political economy approach and therefore may provide in many cases a useful link between both frameworks. Credibility is defined in a broad sense.⁸ A policy lacks credibility if private expectations about future policies deviate from the government's explicit or implicit announcement of future policy measures. As a result, private agents are reluctant to adjust to welfare increasing policy measures in the intended direction or with the desired intensity.

At first glance, credibility problems should not arise in the orthodox framework, where the government's motivation to undertake reforms is simply to increase social welfare. As long as every agent knows that the government is benevolent, doubts about the authorities' objectives will not emerge. Usually, an altruistic government does not have any incentive to act surprisingly.⁹ If, however, the public does not know the government's final objectives with any certainty, the credibility of the authorities' reform program becomes important. A lack of

⁷ See e.g. Rodrik [1989, 1992], Funke [1991], Nunnenkamp/Schmieding [1992], Nunnenkamp/Funke [1992], Schmieding [1992b]. The behavioral approach of Sell [1989] is closely related to credibility aspects.

⁸ For alternative definitions see e.g. Guidotti/Végh [1992].

⁹ Theoretically, it might be possible that a benevolent government tries "to cheat", if private decision making is distorted. In this case, however, society as a whole should be better off *ex post* and satisfied with the government's "cheating".

credibility has effects similar to macroeconomic distortions, such as existing regulations, subsidies or taxes that do not aim to correct market failures [Funke, 1991]. Hence, the possibility of an additional macroeconomic distortion has to be taken into account when identifying the welfare-cost minimizing reform sequence.

In the political economy approach, the potential role of credibility is more obvious, although not always explicitly considered. It depends to a large extent on the credibility of the reform step whether a specific well-suited policy measure quickly reveals its positive effects. Private agents will only react in the intended way if the credibility of the specific measure is high. Taking credibility aspects into account may lead to a different sequencing strategy compared to the recommendations of the political economy approach. Political breakthroughs, as in the beginning of the transformation process in East Central Europe in 1989, may contribute to large public support and may be accompanied by high reform credibility for some time. If reform credibility is initially high, it may be advisable to start with politically more difficult tasks. In contrast, it may be better to start with politically more feasible measures, if reform credibility is low, as presumably is the case in many Latin American countries due to negative experiences with failed reforms in the past.

In the following sections, major reform steps and their optimal sequence are analyzed, stressing the different implications of the orthodox and political economy approach. The link to credibility aspects is worked out. Historical as well as recent experiences help identify the appropriate reform sequence. The following discussion assumes that the pre-reform conditions in developing countries are characterized by internal and/or external "disequilibria". In the case of economies in transition, the starting conditions are taken as of approximately 1989 and reference is made to the current situation.

III. TIMING AND SEQUENCING OF INDIVIDUAL REFORMS

1. Fiscal and Monetary Stabilization

As revealed by Table 1, large consensus exists that fiscal and monetary stabilization should be granted high priority. This is true for developing countries in particular. Roland (1990) challenges this view for former socialist economies. As stabilization is closely linked to price liberalization in economies in transition, here, both reforms are analyzed together.

From the orthodox point of view, the suggestion to stabilize early in the reform process is based on the assumption that the information content of prices is higher in a relatively stable environment. High and volatile inflation may distort relative prices and therefore reduce the value of these market signals [Hayek, 1935] and lead to further disruption. A prior external liberalization that takes place under wrong market signals would counteract an efficient

resource allocation [e.g. Genberg, 1990]. Moving resources in and out of sectors bears considerable adjustment costs. Thus, it appears recommendable to start with basic macroeconomic reforms.

In developing countries the most urgent need remains to tackle budgetary problems, which form a major threat to disinflation [e.g. McKinnon, 1991]. Concrete measures to reduce the budget deficit to a level which is compatible with price stability have to be undertaken immediately. These measures include expenditure cuts, tax reforms and the improvement of the tax collecting mechanism.

The macroeconomic starting conditions in Central and Eastern Europe as well as the remaining socialist economies differ remarkably from the typical situation in developing countries. Most importantly, socialist countries are characterized by administered prices. Administered prices have to be liberalized in order to remove the significant distortions of relative prices. Initial monetary stabilization is directly related to the removal of hidden and repressed inflation.¹⁰ At the same time, tax arrangements have to be restructured soon, because revenues depend to a large extent on profits from state-owned enterprises. A delay of tax reforms may lead to the emergence of large fiscal deficits that would form the basis for future inflation.

The political economy approach challenges the view that stabilization should be undertaken immediately.¹¹ Roland [1990] explicitly refers to post-socialist economies, but similar arguments hold for developing countries. Political opposition is likely to develop and may delay or even halt the whole program if stabilization involves substantial short run costs, such as an initial drop in output or increasing unemployment. Starting with a politically costly measure would clearly violate the demand of the political economy approach to start with reforms that create up-front benefits.¹²

However, it is open to question whether early stabilization efforts necessarily result in considerable short-run costs. The credibility of the reform program plays a crucial role in determining whether short run costs of stabilization programs are high or low, and how much time is needed to stabilize the economy. If reforms are credible, the costs of disinflation can be reduced by changing inflationary expectations [Agénor/Taylor, 1991; Dornbusch, 1991a]. A high reform credibility helps transform private agents behavior "from being backward-looking to being forward-looking" [Edwards, 1991, p. 16]. To the extent that this credibility

¹⁰ For an analysis of the advantages and disadvantages of alternative methods to eliminate a monetary overhang see e.g. Edwards [1991].

¹¹ For a more comprehensive analysis of the political economy of stabilization see e.g. Nelson [1984].

¹² Furthermore, the danger exists that a perceived need for up-front stabilization is used as a pretext to delay remaining reforms by a non-benevolent government.

effect is significant, the positive effects of the anti-inflation program, namely the establishment of the public good "stability", can be achieved quickly and sustainably without a (substantial) fall in output and an increase in unemployment.

The above analysis reveals that credibility aspects provide a fruitful link between the implications of the political economy approach and the orthodox approach. An early stabilization is recommendable, from the orthodox as well as political economy point of view, if the perceived benefits of such a policy are high and the political costs are low. The political costs will be lower, if governments inherit sufficient credibility or are able to establish credibility.¹³ The perceived benefits are likely to be higher, the more unstable the initial conditions are. This suggests, that the perceived benefits of a successful stabilization program in developing countries are higher compared to former socialist economies, where the public was less aware of inherent instabilities, because of the hidden and repressed inflation.¹⁴ The individual situation depends on the type of stabilization program, whether a simple orthodox program is initiated or a specific currency-reform that protects e.g. lower incomes [Roland, 1990]. However, once prices are liberalized and open inflation or even hyperinflation emerges, as currently in Russia, the perceived benefits of stabilizing the economy also become high in post-socialist economies.

Historical lessons as well as lessons from recent stabilization successes in developing countries support the view that stabilization programs can be successful without high political costs and within a relatively short period of time.¹⁵ The significant negative output and employment effects in Central and Eastern Europe point to institutional deficiencies, which have largely been neglected, rather than to negative effects directly associated with stabilization.

The most prominent historical experiences of stopping hyperinflation abruptly refer to several European countries in the 1920s, including Austria, Hungary, Germany and Poland [for a detailed description see Sargent, 1982; Dornbusch, 1992b]. Despite many differences in detail, the price level was stabilized quickly in all four countries. The credibility of stabilization efforts was enhanced in several ways. Institutional reforms, namely the establishment of central banks that were largely prohibited to finance government expenditure, expenditure cuts as well as the improvement of the tax systems laid the foundation for these successes. Furthermore, financial reconstruction in Austria and Hungary

¹³ Rodrik [1989] and Funke [1991] discuss several possibilities to enhance credibility.

¹⁴ In Poland, however, hyperinflation started before the transformation process began.

¹⁵ Notwithstanding the following evidence, it has to be kept in mind that often several stabilization failures preceded the finally successful attempt. Stressing distributional consequences, Alesina/Drazen [1991] analyze theoretically the expected timing and delays of stabilization programs.

was supported by the intervention of the League of Nations and resulted in binding commitments of the governments. Both countries accepted a commissioner general, who monitored the fulfillment of the commitments. The effects on employment are more difficult to assess. The available figures, however, suggest that unemployment increased only slightly in Austria and Poland. It decreased in Germany, whereas the evidence for Hungary is inconclusive.

Bolivia, Mexico and Argentina are three more recent examples, where high inflation rates have been tackled successfully within a short period of time. In Bolivia, the economic situation has remained relatively stagnant, whereas the Mexican and Argentinean programs were accompanied by recovery and growth. Again, several measures were implemented to increase the credibility of the stabilization programs. In Argentina the Austral was pegged by law to the US\$ starting from April 1991.¹⁶ After some success had been reached on the inflation front, a new currency was introduced (1 Peso: 10000 Austral:1US\$). This provided an additional signal from the government to reinforce its commitment to low inflation. In Mexico, the program was based on the Economic Solidarity Pact, which was an agreement between the government, labor unions and entrepreneurial organizations [Kate, 1992]. The inflation rate, as measured by the consumer price index, fell from the monthly peak of 15.5 per cent in January 1988 to 1.0 per cent in autumn 1991. The decline in inflation was not accompanied by significant additional losses in output, and recovery soon started [Aspe, 1992].¹⁷

All told, the above experiences reveal that under situations of extreme inflation in developing countries, the success of stabilization policies can be reached within a short period of time and can quickly be accompanied by positive output effects, if reform credibility is ensured. Orthodox as well as political economy considerations suggest that stabilization measures should not be postponed under such circumstances.

Some East Central European countries have already opted for drastic reform measures. After the Polish experience at the beginning of 1990, Czechoslovakia, Bulgaria, and Romania implemented programs that resembled the Polish shock approach.¹⁸ Prices were liberalized almost completely. At the same time, tight monetary policy and wage ceilings were implemented to ensure macroeconomic stabilization. Due to the lack of foreign exchange reserves, Bulgaria and Romania opted for floating exchange rates, whereas Poland and

¹⁶ Obviously, laws can be disregarded or sometimes easily changed. These measures increase credibility only to the extent that the political costs of exit rise.

¹⁷ Chile's 1970 stabilization program is the only recent exception, where high inflation was successfully reduced with a gradualist approach. However, Bruno [1992] points to the high social costs of this gradual experience and doubts whether this strategy would have been feasible under a democratic regime.

¹⁸ Bruno [1992] evaluates the first experiences in Central and Eastern European countries in detail.

Czechoslovakia started with fixed rates.¹⁹ Quite surprisingly, fiscal surpluses emerged initially, especially in Poland and Czechoslovakia. Profits increased temporarily, because of falling real wages, gains in material inventories as well as the large up-front devaluation in Poland. This, however, does not present an argument against early tax reforms. Fiscal problems emerged as soon as these favorable temporary phenomena disappeared.

Despite the initial success in reducing or precautioning hyperinflation, output collapsed, employment declined and inertial inflation has remained high. The reasons for these relatively unfavorable developments remain debated. Advocates of the J-curve effect of transition argue that the initial recession is nearly inevitable in any transformation process [Siebert, 1991]. Others stress negative demand effects, including the collapse of CMEA trade and consumer goods hoarding before price liberalization [e.g. Brada/King, 1992]. Calvo and Coricelli [1992] point to credit supply constraints in the transition. Raiser [1992] critically evaluates the alternative explanations of the recession in the case of Poland and stresses the importance of still existing soft budget constraints²⁰ to account for the persistence of macroeconomic imbalances even after stabilization. Perverse incentive structures at the micro-level render stabilization less credible and more costly. These specific policy failures do not provide an argument for postponing stabilization. Political opposition did not develop immediately, because interest groups need time to develop and were not yet organized at the beginning of the transformation process. Furthermore, drastic reform measures helped signal the governments' commitment to reform. Hence stabilization is one crucial element of providing coherent and credible market signals to economic actors in the transition phase. To work effectively, however, it needs to be complemented by other measures early in the reform process.

2. Domestic Financial Market Reform

The desirability of a sophisticated and liberalized financial system is not questioned among most economists. Financial markets contribute to an efficient allocation of capital and foster efficiency and economic growth. Nonetheless, very different policy recommendations for developing countries and post-socialist economies have emerged with respect to the sequence of financial market reform [see Table 1]. For developing countries most authors favor an early financial market reform. In contrast, the opinions differ widely for economies in transition. This partly reflects that the necessary reform tasks in developing countries and post-socialist economies differ significantly. In developing countries financial market reform

¹⁹ The appropriate exchange rate regime during a stabilization program remains controversial. The existing pros and cons of alternative exchange rate regimes can also be classified according to more technocratic arguments, political economy arguments, and credibility aspects [see e.g. Lal, 1987; Agénor, 1991; Schmieding, 1991; Schweickert/Nunnenkamp/Hiemenz, 1992].

²⁰ The concept of soft budget constraints was introduced by Kornai [1980].

is primarily related to the liberalization of financial markets,²¹ i.e. the abolition of interest rate ceilings. In post-socialist economies basic institutional reforms, including the cleaning-up of the banks' balance sheet from the inherited debt, are of utmost importance. Because of these differences, financial market reforms in developing countries and in economies in transition will be analyzed separately. Developing countries are considered first. In this case, orthodox, political economy, and credibility aspects support the view that stabilization and domestic financial market liberalization should be carried out at around the same time.

From the orthodox point of view a first prerequisite for domestic financial market liberalization in an inflationary environment is to regain control over the fiscal deficit. Repressed financial markets²² in developing countries are typically the consequence of high budget deficits. The financing of large fiscal deficits by the inflation tax necessitates high reserve requirements and low interest rates on deposits to maintain the base on which the inflation tax is collected [McKinnon/Mathieson, 1981]. Therefore, financial market liberalization is only sustainable when the fiscal deficit is under control or the necessary measures to regain fiscal control have seriously been started. Financial market liberalization requires the abolition of interest ceilings on deposits and loans as well as a reduction in non-interest bearing reserve requirements that reduce the spread between deposit and lending rates.

At first glance, a financial market liberalization may have mixed effects from the political economy point of view. The abolition of access to subsidized credits worsens the situation of privileged borrowers. Even if it is feared that borrowers will demonstrate their dissatisfaction, this does, however, not provide an argument against an early financial market liberalization. If necessary, the distributional consequences of financial market liberalization can be spread over time, by converting older implicit subsidies into explicit subsidies that become part of the government's budget [Lal, 1987]. Furthermore, if substantial substitution takes place between the informal market and the newly liberalized financial market, savers benefit from higher interest rates and/or less uncertainty.²³

Credibility considerations support the view that financial market liberalization should be closely linked to fiscal and monetary stabilization. A close link may signal to the public the government's willingness to continue its anti-inflationary policies in the future. In contrast,

²¹ Reducing inflation may already improve the efficiency of regulated financial markets by diminishing the size of distortions, if interest rate ceilings are not adjusted accordingly [Corsepius 1989]. However, this is not a financial market liberalization.

²² Terminology goes back to Shaw [1973], McKinnon [1973].

²³ This is true, even if a large informal market exists, where market rates are already paid. Savers would not channel their savings to the official financial market if they would not benefit from this shift (e.g. higher certainty, or deposit insurance).

delaying financial market reforms would increase private doubts about the government's true objectives under such circumstances. A financial market liberalization prior to fiscal and monetary stabilization would clearly be inconsistent and thus also incredible. A domestic financial market liberalization cannot be sustainable, as long as the government has to rely on the inflation tax to finance government expenditure.

In contrast, some financial market reform before or at least simultaneously with monetary and fiscal stabilization is necessary to enable a smooth adjustment process in post-socialist economies. During communism the banking system was passive and credits were provided automatically at trivially low or zero interest rates, if necessary to fulfill the earlier established plans [McKinnon, 1991]. Firms could not freely spend the deposits they owned. As long as formerly established credit lines - particularly to unprofitable enterprises - are unchanged or banks don't face the incentive to grant loans on the basis of market oriented behavior tight monetary policy may not be able to reduce the volume of credit to the public, thus undermining stabilization. A monetary stabilization may be more difficult to obtain, as long as some financial market reform is not undertaken.

From the orthodox point of view, the cleaning up of the balance sheets of firms and banks should be granted high priority.²⁴ Because of the former passivity of the banking system, the inherited debt burden has hardly any relation to the underlying assets. Thus, debt cancellation does not create serious moral hazard problems under these specific circumstances nor does it have any negative impact on outside actors [Dornbusch, 1991b]. It is, however, necessary that the banks' incentive system is immediately altered after debt cancellation. The prolongation of a perverse incentive system could restart the whole process. Among other things, credit skills, new payment systems, an independent auditing and prudent government supervision for financial intermediaries would have to be established first, before an efficient financial system could start to exist. To speed up the adjustment process, Schmieding [1992b] suggests importing the basic elements of already well-functioning foreign banking systems. By allowing foreign banks to establish subsidiaries additional knowledge spill-overs could occur.²⁵

From the political economy point of view, the fear remains that immediate financial market reforms along with the introduction and enforcement of bankruptcy rules may lead to massive

²⁴ Beside a simple write-off of old debt, the bad debt problem can also be reduced with an initial (very) high jump in the price level as a result of the removal of the monetary overhang. However, this only solves the stock problem, but does not solve the flow problem.

²⁵ Foreign competition is, however, only advisable, if domestic banks have been relieved from the competitive disadvantage of the inherited debt. Furthermore, the prior establishment of clear-cut property rights remains of utmost importance. As long as potential borrowers can offer only limited collateral because of missing property rights, efficient banking is seriously hindered.

unemployment and rising workers' opposition. Even if long-term unemployment can be avoided, frictional unemployment could still increase and encourage political opposition by workers with a very short time horizon. Roland [1990] concludes that it might be preferable not to enforce bankruptcy rules immediately after price reform. While a capital market should already be developed at an earlier stage, it appears preferable to impose automatic bankruptcy rules only at a later stage.

The credibility perspective, however, supports the orthodox view. Stopping old lending habits and altering the banks' incentive systems increases the credibility of the whole transformation process. Clear signals may encourage the private sector's incentives to adjust to the new political environment, and thus output costs and unemployment costs may be reduced by an immediate financial market reform. A postponement of financial reforms would decrease the credibility of any other reform measure. In particular, stabilization is more difficult as long as lax credit conditions prevail. These basic institutional financial market reforms should be implemented prior or simultaneously with stabilization [see also Rybczynski, 1991]

Despite the overall importance of financial reforms during the transformation process, reform progress is still lagging behind in many Central and Eastern European countries.²⁶ In Poland, Hungary, and Czechoslovakia governments did not release banks from the inherited bad debt. Although the bad debt burden was nearly wiped out in Poland after the hyperinflation in 1989/90, it reemerged as banks continued to conserve old linkages and habits. The allocation of credit still remains biased in favor of state owned enterprises. Several measures have been advocated to improve the credit availability for private enterprises, including the implementation of quotas or direct credit ceilings for state-owned enterprises. It remains crucial to accelerate the solution of the bad debt problem, the recapitalization of banks as well as the privatization of banks.

3. Trade Liberalization

Politically acknowledging the potential benefits of trade reform after decades of import-substitution, trade policy in many developing countries shifted towards freer trade during the last few years. Table 1 reveals that the principal controversy is whether trade reform should be implemented simultaneously with fiscal and monetary stabilization or only after stabilization. Here, it is put forward that most arguments brought up against a simultaneous stabilization and trade liberalization can be rejected on empirical grounds. Trade liberalization and stabilization should generally be implemented at the same time.

²⁶ For a more detailed analysis see e.g. Schmieding/Buch [1992].

From the political economy point of view, trade reforms appear difficult to establish and should only be started after stabilization. Trade liberalization typically hurts specific interest groups, which are usually well organized and powerful. The movement of resources from the losing sectors to gaining activities may create temporary unemployment and thus create larger political opposition. Even surprise effects, such as an "overnight trade liberalization" may not necessarily undermine the political power of enterprises, which may force the government to re-introduce trade restrictions [Newbery, 1992]. If both reforms are undertaken simultaneously political opposition to the stabilization program and opposition to the trade reform may unite. While the opposition to the stabilization program may be widespread, its effectiveness may be lower compared to the usually better organized anti-trade reformers. The unification of both interest groups might hinder both reform steps. Furthermore, the public may not be able to identify the real cause of recession, if e.g. only stabilization leads to increasing unemployment. In the eyes of the public trade reforms also become associated with unemployment and resistance to trade liberalization will increase in the future [Falvey/Kim, 1992].

Some orthodox arguments support the political economy point of view. Opponents to a simultaneous implementation of both reforms argue that trade reform would still take place under wrong market signals as long as high inflation distorts relative prices significantly [Fischer, 1986]. Furthermore, successful trade liberalizations should be supported by a depreciated real exchange rate [McKinnon/Mathieson, 1981]. As long as the primary source of macroeconomic instabilities, namely the budget deficit, has not yet been successfully tackled, the deficit may induce an undesired real exchange rate appreciation, which induces resource shifts to the non-tradable sector [Michaely, 1991]. Finally, the availability of tariff revenues may facilitate macroeconomic stabilization because the budget problem is easier to handle.²⁷ Thus, the initial conversion of non-tariff barriers into equivalent quotas and the simultaneous announcement of a phased tariff reduction may appear advisable.

However, remaining orthodox arguments support a simultaneous implementation of stabilization and trade reforms. The delay of trade liberalization would perpetuate the inefficiency costs of large divergences between domestic and international prices [Krueger, 1981]. For economies in transition the main argument in favor of a simultaneous trade reform is that enterprises immediately face world prices and considerable re-adjustment costs may be avoided in the ongoing transition period. Fiercer world-wide competition increases the pressure on domestic producers, including still existing monopolies, to increase efficiency. Liberalizing trade ad hoc is the easiest way to introduce competition [e.g. Genberg, 1990]. Credibility considerations support this view. The simultaneous implementation of a

²⁷ Falvey and Kim [1992] discuss sequential trade liberalizations.

stabilization program and trade liberalization may signal the government's commitment to reform and encourage the overall reform process.²⁸

Empirical evidence for developing countries reveals that unemployment costs related to successful trade liberalizations are usually much smaller than generally expected [Michaely/Papageorgiou/Choksi, 1991, p. 271]. The fears of the political economy perspective seem to be exaggerated. The impact on unemployment does not seem to depend on the intensity and speed of trade liberalization. In some cases, even positive employment effects could be observed. For example, the Argentinean trade liberalization under Martínez de Hoz was accompanied by an unprecedented fall in the unemployment rate [Cavallo/Cottani, 1991, p. 320].

One further interesting example is the recent Mexican program. Until 1985, when the liberalization program was first implemented, the economy was highly protected. The envisaged gradual opening was pushed ahead two years later and coupled with a stabilization program [Dornbusch, 1992a; Kate, 1992]. Mexico's entrance in the GATT increased the program's credibility and maximum tariffs were lowered to 20 per cent within the Economic Solidarity Pact. Trade reformers did not have to fight against strong political opposition. In contrast, the initially perceived positive welfare effects of cheap consumer durables seem to have increased the public's willingness to reform [Kate, 1992].

Strong political opposition was also not observed in Poland, when stabilization and trade liberalization were simultaneously implemented in January 1990. At the beginning of the transformation process interest groups were not yet well organized. Large reform steps are the appropriate measure under such circumstances.

The above discussion shows that trade liberalization should not be postponed. In general, a simultaneous stabilization and trade liberalization is recommendable.

4. Capital Account Liberalization

The overall aim of a capital account liberalization is to improve opportunities for intertemporal trade and cross border portfolio diversification [Fischer/Reisen, 1992]. From the orthodox point of view, it is nearly unchallenged wisdom that the capital account of the balance of payments should not be liberalized prior to the trade account and requires a liberalized domestic financial market to distribute capital inflows efficiently [see Table 1].

²⁸ It may be argued that drastic reforms are perceived as being unsustainable and, thus, producers will be reluctant to adjust their production according to relative world market prices. Furthermore, consumers may face an incentive to import more goods, if they expect import barriers to be reinstalled in the future. This, however, only stresses the need to support the credibility of the reform program by further measures, such as GATT membership.

The orthodox objections to an early capital account liberalization aim in two opposing directions: the fear of the negative effects associated with capital inflows and the fear of the negative effects associated with capital outflows. The first category of orthodox arguments includes immiserizing capital transfers, the costs of remaining distortions, overborrowing, and undesired real exchange rate effects. The second group of arguments is mainly related to the possible occurrence of capital flight. The direction of capital flows depends mainly on whether financial markets are liberalized or repressed.²⁹

Capital inflows to a distorted economy as a result of a capital account liberalization may be immiserizing and may lead to a reduction in welfare [see e.g. Johnson, 1968; Brecher/Diaz-Alejandro, 1977]. Furthermore, asset markets typically adjust faster than markets for goods [Frenkel, 1982]. As the costs of a distortion depend on the size of the distortion and on the amount of transactions that take place in the presence of the specific distortion, the expected larger transaction volume in the case of a capital account liberalization supports the view that the trade account should be opened prior to the capital account. The early opening of the capital account can, furthermore, lead to a welfare-reducing moral hazard type of behavior of private agents [Edwards, 1984]. If the private sector anticipates that part of its losses will ultimately be covered by the government, rational private agents have an incentive to borrow above the socially optimal level. Government bail-outs are practically institutionalized as soft budget constraints in post-socialist economies [Mihaljek, 1988].³⁰ In addition, increased capital inflows may lead to a real appreciation of the domestic currency at a time, when the relaxation of trade restrictions would be better supported by a real exchange rate depreciation [McKinnon, 1973].³¹ This undesired effect could be aggravated by short-term speculative capital inflows that lead to an overshooting of the real exchange rate.

Given the current debt situation in many Eastern European countries as well as developing countries, the overborrowing scenario does not seem to represent a major threat against a capital account liberalization. Artificially low or negative real interest rates in repressed financial markets increase the pressure for capital flight [Edwards, 1984]. Massive capital outflows reduce the basis for financing domestic investment as well as domestic debt. As long as capital controls are maintained, the amount of capital flight depends on the effectiveness of these controls. Even if controls can be easily circumvented, the complete abolition of capital

²⁹ For a more detailed discussion see e.g. Edwards [1984], Mihaljek [1988], Michaely et al. [1991, Chapter 15] and Buch [1992]. The standard orthodox arguments are only reviewed briefly, because they have already been discussed extensively in the literature.

³⁰ Kornai [1990] suggests that foreign borrowing should be prohibited for state-owned enterprises.

³¹ Yet, theoretically capital inflows do not necessarily lead to a real appreciation, when they are primarily used to finance imports and do not result in an excess demand for nontradables. Still, using a data set for 12 developing countries, Edwards [1989b] finds empirical support for the view that capital inflows result in a real appreciation of the domestic currency in developing countries.

account restrictions is likely to increase capital flight because the remaining risks associated with illegal transfers are removed. Although the possible depreciation of the domestic currency under flexible exchange rates supports trade reforms, it may counteract domestic efforts to stabilize the economy. In a fixed exchange rate regime, the increased pressure on international reserves may ultimately lead to the abandonment of the regime. This analysis reveals that the capital account should only be opened after the domestic financial market has been liberalized [Edwards, 1990]. Nonetheless, capital mobility may require high interest rate differentials to persuade residents not to move their capital abroad.³²

In his political economy approach, Lal [1987] has challenged the wide-spread consensus that the capital account should be opened only in a last step.³³ He stresses the positive implications of an early capital account liberalization, namely the smoothing of the adjustment process, and possible positive real wage and real employment effects.³⁴ However, in Lal's proposal the opening of the capital account is combined with the announcement of a phased trade liberalization. To the extent that this announcement is credible, long run investment decisions are determined by relative world market prices instead of distorted domestic market prices. In this case, capital transfers are always welfare improving. Temporary restrictions, e.g. taxes on short term capital flows might be used to tackle the remaining inefficiencies arising from diverging private and social rates of return from the point of view of investors with a short time horizon.

Lal's [1987] analysis shows that the credibility of the reform program clearly matters and provides a fruitful link between the arguments of the orthodox approach and the political economy approach. If the announcement of trade liberalization is not credible, investments will still be guided by distorted relative domestic prices. It is only possible to smooth the adjustment process if foreign investors and creditors are confident in the reform process. A low (domestic) reform credibility can lead to effects similar to financial repression even if the domestic financial market is liberalized at an earlier stage. Thus, the liberalization of the domestic financial market is a necessary but not sufficient condition for a successful capital account liberalization.

³² Similar to the case of trade liberalization, obviously not all capital controls have to be lifted simultaneously. The process of capital account liberalization can be sequenced itself [see Fischer/Reisen, 1992].

³³ Some advocates of the orthodox view do not deny that an early liberalization of capital flows may cushion frictions that emerge during the liberalization process [see e.g. Krueger 1981, 1984; Mihaljek, 1988]. Nonetheless, in their view, the above list of possible negative impacts outweighs the potential benefits of an early capital account liberalization.

³⁴ In a standard two-good two-factor model along with a monetary model Lal [1989] shows that removing capital market distortions in the presence of trade and labor market distortions will increase real output and real wages.

The empirical evidence remains inconclusive due to other inconsistencies during the reform programs. Chile was the only Southern Cone country³⁵ which roughly followed the orthodox recommendations [McKinnon, 1982]. After having controlled the fiscal deficit, foreign trade was liberalized. The capital account was only opened in a third step, after domestic financial market liberalization. The program was accompanied by changes in the exchange rate regime. Starting with a crawling peg, Chile advanced to a pre-announced exchange rate regime and finally fixed the exchange rate. The subsequent failure of the program cannot be directly related to the sequence. Closer analysis has pointed to the crucial role of the exchange rate regime. The maintenance of fixed exchange rates when wages were indexed to past inflation and lax domestic financial market regulations contributed to the failure of the program [Hiemenz/Langhammer 1989]. The negative effect of fixing the exchange rate was reinforced by the choice of the anchor (US\$), which at that time started to appreciate in world markets.

Some examples exist, where the reverse sequence took place. The reforms in Uruguay started with the deregulation of domestic financial markets and the opening of the capital account. Until the late 1970s, the program was quite successful. In particular, a real overvaluation of the currency was not observed. The initial avoidance of major imbalances appears to contradict conventional wisdom. The failure of the program did not start before the tablita was established and government deficits began to increase again. The inconsistent exchange rate policy may have contributed to its failure. In Argentina the capital account was also liberalized without substantial trade liberalization but before the fiscal stabilization was achieved. Since this combination along with a pre-announced exchange rate regime was clearly inconsistent and thus not credible and sustainable, the program failure can not be directly related to the order of external liberalization [Lal, 1987].

Malaysia and Indonesia present two more examples, where the capital account has been opened at an early stage. The capital account in Indonesia was first opened in 1971. Trade was only liberalized in the 1980s and interest rates in 1983. Nonetheless, Indonesia and Malaysia were successful in keeping inflation low and exchange rates competitive. Fischer/Reisen [1992] argue that capital controls would hardly have been effective, because Singapore served as a kind of informal financial market for both countries. Institutional particularities supported the positive development. Foreign exchange earnings from gas and oil exports were largely controlled in the past. These examples suggest that an early liberalization should not be postponed, if the specific locational situation of a country makes capital controls largely ineffective or prohibitively costly.

To sum up, the credibility of the reform program determines to a large extent whether foreign funds are used in a way that supports the adjustment process, or whether they undermine the

³⁵ Corbo/de Melo [1987] review the Southern Cone evidence in some detail.

adjustment efforts. Only if the reform program enjoys high credibility domestically and abroad, then a capital account liberalization before trade liberalization might be successful. The trade account should be opened first, especially if a lack of credibility characterizes the beginning of the reform process. This, however, is not to imply that the capital account should be opened after a long delay. In particular in economies in transition, a prohibition of long term capital inflows including foreign direct investment would hinder the learning processes of foreign investors and lenders about newly emerging profit opportunities [Funke, 1991]. Liberalizing at least long-term capital flows quickly may help smooth the reform process by facilitating the adjustment to the new incentive structure.

5. Privatization

Private ownership of firms is one essential and key feature of well-functioning market economies. Nonetheless, a simultaneous privatization of all relevant state-owned enterprises is hardly possible due to limited administrative capacity. Thus, besides the determination of the appropriate starting time in the whole reform process, the optimal sequence of different sectors or different firm sizes (large scale and small scale) plays a crucial role [Husain/Sahay, 1992]. Here, it is argued that small scale and bottom-up privatization is the most urgent task in post-socialist economies and should be started from the very beginning of the whole reform process. As already stressed in Section III.2, the privatization of banks should also be granted high priority.

From the orthodox point of view, recommendations are mixed. Some authors, including Lipton/Sachs [1990] proposed that privatization should be postponed until macroeconomic stability is achieved and major distortions have been removed,³⁶ in order to improve the information value of prices and to sell companies at their real market value. In contrast, others [e.g. Rybczynski, 1991; Fischer/Gelb, 1991; Hinds, 1991] favor some immediate privatization, because private property is at the heart of a newly emerging market economy. Small scale privatization appears to be much easier to start with than large scale privatization.³⁷ Privatization, however, only changes the behavior of the firm level, if at the same time the managers' incentive system is altered. [Pinto/Belka/Krajewski, 1992]. As long as banks face little incentive and capability to monitor a firm's creditworthiness partly due to soft budget constraints for firms, the managers' incentives are hardly changed. If adverse

³⁶ A joint analysis of three German research institutes has recently recommended a similar strategy for the transformation process in Belarus [DIW/IfW/IWH, 1992].

³⁷ An immediate and successful privatization of large scale enterprises may support temporarily stabilization efforts by increasing government revenues and by enabling the government to repay part of its outstanding debt [e.g. Genberg, 1990]. While this argument has some merits for developing countries, significant revenues are hardly to be expected from the sale of the "outdated" capital stock in post-socialist economies. Nonetheless, the state might be relieved from the need of continued subsidization.

selection is a dominant feature, loss making firms continue to borrow and positive supply responses may fail to appear. Thus, the privatization of banks as well as small scale privatization of enterprises should be granted high priority. Furthermore, the creation of new enterprises and the enlargement of already existing private entities should be immediately encouraged (bottom-up privatization).

The proposal to start privatizing small scale enterprises is well in line with political economy considerations. Small scale enterprises are more able to adopt to the new economic environment, because of fewer internal control problems, lower capital requirements, and a higher flexibility in the organizational structure. Enterprises that need less restructuring may be expected to generate positive employment effects in the near future, if they are independent from remaining input constraints [Roland, 1992]. Imposing hard budget constraints on small enterprises is relatively easy, because their failure would only cause minor political opposition [Agarwal/Nunnenkamp, 1992]. Although the immediate privatization of large enterprises may have the advantage that possible centers for political opposition are directly destroyed [Gelb/Gray, 1991], massive transitional unemployment with increasing pressure to renationalize enterprises may outweigh these advantages.³⁸

The credibility of the reform program may be supported by starting immediately with small scale privatization and bottom-up privatization. Numerous privatizations in the beginning of the reform process that reveal quick positive supply effects support public confidence. In contrast, the immediate start with large scale privatization might cause serious credibility problems, because the potential negative consequences with respect to unemployment may create doubts about the sustainability of the reform process.

The experiences in China and Hungary confirm that private initiatives in specific sectors, such as agriculture and services, may have quick positive supply effects while only a few interests are hurt. Further insights can be obtained from the Chilean privatization program which started in 1973.³⁹ At that time, the state sector amounted to almost one half of gross domestic product. The privatization process started when the economy was still protected and not yet stabilized. Although the employment effects are difficult to separate from other influences, no clear-cut evidence exists to the fact that privatization increases unemployment [Agarwal/Nunnenkamp, 1992]. However, the first wave of large scale privatization failed in Chile due to the non-existence of a regulating framework of basic rules and institutions. This

³⁸ One might argue that the political acceptance of the privatization process may depend to a large extent on the specific method of privatization. Public support of the whole reform program is weakened, if privatization results in an inequitable distribution of wealth. However, inequality cannot easily be linked to alternative methods, such as competitive bidding or vouchers schemes. Revenues from competitive biddings could, at least theoretically, be redistributed to the public through direct transfers or tax cuts.

³⁹ Agarwal and Nunnenkamp [1992] analyze the lessons of the Chilean experience for post-socialist economies.

supports the view that large scale privatization should be postponed until the basic institutional framework is in place.

The experience of Central Eastern Europe up to date⁴⁰ further suggests that small scale privatization makes much better progress than large scale privatization. Nonetheless, the overall pace of privatization is slower than originally anticipated. In Poland, only 1714 enterprises out of approximately 8500 had started or completed the process of privatization by mid 1992. In Czechoslovakia, it took roughly two years to implement the voucher scheme, the centerpiece of the Czechoslovak privatization program. The State Property Agency in Hungary, which was in charge of around 2000 enterprises in March 1990, had transformed approximately 20 per cent of these firms into private law companies by mid 1992.⁴¹

IV. SPEED OF REFORM

The discussions concerning the appropriate speed of reform programs focus on a dichotomy that may be described as "big bang" versus "gradualism". Theoretically, this debate concentrates on two aspects [Schmieding, 1992a]. On the one hand, it is related to individual reforms, such as trade liberalization. On the other hand, the discussion is explicitly related to the speed of the sequential implementation of different reforms. The following analysis will focus on the latter.

From the political economy point of view, policymakers are inherently interventionist and seem to favor gradualism with some believe a low risk strategy, because short run adjustment processes seem to be under control [Dornbusch, 1991]. However, this strategy is hardly sustainable, because the administrative capacity to successfully handle a gradual approach is often lacking. Continued over-regulation induces private evading activities that result e.g. in increased black market activities, currency substitution, and spontaneous privatizations. To regain control over the economy governments may be tempted to re-regulate and the economy may end in a vicious circle of partial deregulation and re-regulation. Furthermore, a gradual adjustment process allows unnecessary time for interest groups to increase counterproductive lobbying activities.

The orthodox point of view suggests that reforms should, in general, be undertaken quickly. In the absence of time consuming adjustment processes and adjustment costs a cold-turkey strategy would immediately result in long run efficiency gains. However, even including adjustment costs, a big bang strategy seems preferable [Rodrik, 1989]. The distinction

⁴⁰ Heinrich [1992, 1993] analyzes in detail the experience of Poland, Hungary and Czechoslovakia.

⁴¹ The book value, however, amounts to approximately 30 per cent. By Central and Eastern European standards privatization in Hungary is proceeding quite well. See Heinrich [1993].

between the speed of the implementation of a policy and the speed of the adjustment of the private sector plays a crucial role [Mussa, 1984]. If costs increase with the speed of implementation, a series of small adjustments minimizes total adjustment costs. However, in this case, rational private agents will choose to adjust slowly in response to credible policy changes even if the government opts for a cold-turkey strategy. On efficiency grounds, no reason exists to delay the implementation of reforms artificially [Rodrik, 1989].⁴²

From the credibility perspective further support in favor of speedy reforms can be obtained. Slow and gradual reform efforts may not be able to signal the government's willingness to reform, if a government lacks credibility, e.g. because of experiences with past reform failures. The analysis of Hiemenz/Nunnenkamp et al. [1992] reveals that partial reforms in developing countries are not successful, if governments lack credibility.⁴³ Under these circumstances, private agents are reluctant to undertake investment, which forms the basis for future growth. Partial reforms in a highly distorted economy are not sufficient for a sustainable improvement of the economic situation.

From an empirical point of view, arguments in favor of gradualism are hardly convincing. Advocates of a more gradual approach point mainly to the experiences of Hungary and China [e.g. Roland, 1992]. A real gross domestic product growth of nearly 10 per cent during the 1980s in China as well as high foreign capital inflows into Hungary (US\$ 1.5 bn in 1991 compared to approximately US\$ 600 million and in Czechoslovakia) seem to reflect some of the advantages of a gradual strategy.⁴⁴ It remains, however, doubtful, whether the high foreign capital inflows into Hungary can solely be attributed to the gradualist approach. A better institutional infrastructure as well as a more cooperative debt strategy have contributed to the country's higher attractiveness for foreign capital. The Chinese reforms are still too much in its infancy to finally evaluate the experience. Furthermore, looking at industrial production the case against a speedy implementation of reforms melts away. According to official data [PlanEcon, 1992], real industrial production fell in Poland by 24.3 per cent in 1990 and 16.0 per cent in 1991, compared to 9.5 per cent in 1990 and 21.0 per cent in 1991 in Hungary. Despite the different time pattern, Hungary experienced a similar drop in real production. Thus, the supposed advantages of a gradual approach can hardly be supported by the empirical evidence. A speedy and comprehensive implementation of reforms appears to be the only viable alternative.

⁴² To maintain political support for a speedy implementation of many reforms may require transfers from the gainers to the losers of reform in order to secure a more egalitarian income distribution [Roland 1992; Wyplosz, 1992].

⁴³ Only if credibility is high, as presumably in East Asian countries, gradual reform efforts have proven successful.

⁴⁴ Looking at the experiences in Central and Eastern Europe, Schmieding [1992a] critically analyzes the alleged advantages of a gradual approach.

V. CONCLUDING REMARKS

The timing and sequencing debate is a relatively new topic in economics. Opposing recommendations still remain with respect to key sequencing issues. This is reflected most prominently in the controversy between the advocates of the orthodox approach and those of the political economy approach. Here, it has been shown that the concept of credibility may provide in many cases a fruitful link between both approaches and may help determine the adequate reform sequence. Despite some experience in developing countries with alternative reform sequences, a simple transfer of these lessons to economies in transition may lead to wrong conclusions. The different initial conditions play a crucial role. Far reaching institutional reforms are a major prerequisite for any other reform step in economies in transition. Theoretical as well as empirical observations allow some further broad insights.

Starting under conditions of profound "macroeconomic instability" or even hyperinflation, an initial stabilization based on the necessary credibly implemented domestic fiscal reforms is indispensable. In general, stabilization efforts should be accompanied by a simultaneous trade liberalization. Historical lessons as well as lessons from developing countries show that in such cases first positive results can be reached within a short period of time. Large unemployment is not a necessary by-product, and thus political opposition can be kept small.

In developing countries, domestic financial market reform is primarily related to market liberalization, e.g. the abolition of interest rate ceilings. In post-socialist economies basic institutional reforms are of utmost importance, including the cleaning-up of the banks' balance sheets of the inherited debt and the abolition of perverse incentive structures. Due to the different tasks, opposing sequencing recommendations have to be made for both groups of countries. Domestic financial market reforms in developing countries before stabilizing the economy would be inconsistent and incredible, as long as domestic financial markets are regulated in order to sustain the tax-base for the inflation tax. The credibility of the reform program may be supported, by domestic financial market reforms that accompany or immediately follow the stabilization program. A postponement of financial market liberalization would undermine the credibility of the stabilization effort. In contrast to this situation, some financial market reform before or at least simultaneously with stabilization could have supported the overall adjustment process in former socialist economies, where the absence or inefficiency of financial intermediation represents a serious bottleneck for economic transition. It remains crucial to accelerate the solution of the inherited debt problem, to recapitalize banks, as well as to change the banks' incentive structure.

It is almost unchallenged knowledge that domestic financial market reforms have to take place prior to a complete liberalization of capital flows. Under most circumstances, the capital account should be opened after trade liberalization. Only if the reform program enjoys high credibility domestically and abroad, then an immediate capital account liberalization might be

successful. This, however, does not imply that the capital account should only be opened after a long delay. In particular in Central and Eastern Europe, a prohibition of long term capital inflows including foreign direct investment would hinder foreign learning processes about newly emerging profit opportunities and render the adjustment process more difficult due to a persistent lack of urgently needed foreign resources.

The privatization of large profitable enterprises may help support stabilization efforts in developing countries. It is likely that for economies in transition, immediate large scale privatization could have provoked political opposition by increasing unemployment. Small scale privatization as well as bottom-up privatization should be granted high priority. However, privatization will hardly reveal substantial positive output and employment effects as long as some financial market reform has not been implemented, a lending bias towards state-owned enterprises remains, and adverse selection is dominant.

A speedy implementation of reforms is preferable to a gradual approach. A gradual approach is hardly sustainable, because the administrative capacity to successfully handle a gradual adjustment is lacking. Interest groups should not be given time to increase counterproductive activities. Efficiency considerations as well as credibility aspects support this view.

To focus on competing views with respect to the proper sequencing strategy it seemed appropriate to restrict the analysis to the consideration of broad reform categories. Country-specific recommendations would have to take into account that every reform area may be subdivided into smaller reform steps, and thus may be sequenced itself. Furthermore, it has implicitly been assumed that the ultimate reform objective lies in the establishment of a market economy, which, however, in itself still encompasses a wide variety of alternatives. Nevertheless, these limitations only seem to stress further the central conclusion of this paper that a unified sequencing proposal for developing countries and post-socialist economies can hardly be established. The starting conditions of economic reforms were shown to be of crucial importance. They differ not only between developing countries and post-socialist countries, but also within these groups of countries. Hence, a case-by-case approach is necessary, taking into account the country-specific circumstances.

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