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Recent Developments in Eastern Europe and their Implications for Latin American Economies

Notes for remarks by

John W. Crow
Governor of the Bank of Canada

at the

XXVII Meeting of
Central Bank Governors
of the American Continent
Punta del Este, Uruguay
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> *"The father said to his servants, 'Bring forth the best robe, and put it on him; and put a ring on his hand, and shoes on his feet:*
>
> *And bring hither the fatted calf, and kill it; let us eat, and be merry:*
>
> *For this my son was dead, and is alive again; he was lost, and is found.' And they began to be merry."*

Parable of the Prodigal Son
St. Luke, Chapter 15:22-24

International agencies and major industrial countries have recently announced a number of ambitious proposals, designed to provide financial support for the dramatic political and economic changes taking place in Eastern Europe. The enormous interest and enthusiasm that these proposals have generated is understandable, given the obvious strategic importance of Eastern Europe, as well as the strong historical and cultural ties that bind these countries to Western Europe and North America. Their commitment to move towards a political system based on democratic principles and an economy based on free market precepts, clearly has a significance that goes beyond the economic benefits that their international supporters can expect to receive if these bold initiatives succeed.

In many respects, Eastern Europe appears at the moment very much like the returned prodigal son, with the major industrial countries and international agencies playing the role of the forgiving and benevolent father.

1. <u>Cause for Concern</u>

The past ten years have been extremely difficult for all Latin American countries. Access to private international capital markets has all but disappeared and real per capita incomes have fallen by as much as 50 per cent, as these countries have struggled to service and hopefully reduce the crippling external debt that they accumulated over the previous decade (Table 1).

Although the level of economic activity in major industrial countries has generally been much stronger than many observers had expected, the macroeconomic environment facing heavily indebted countries has recently become more threatening. World interest rates have risen in response to growing inflationary pressures in the industrial countries, and may have to rise further. In addition, the demand for many LDC exports has started to slow, following seven years of steady growth in the world economy. Prices for non-energy commodities have also weakened in the past year, causing a deterioration in the terms of trade of many Latin American countries (Charts 1 - 4).

In these circumstances, "debt fatigued" commercial banks and other private lenders are understandably reluctant to extend new credit (Table 2). Borrowing from the official sector also seems to have become more difficult, at least when judged by the flow of net new lending to Latin America. In large part, this reflects the heavy lending that was undertaken by multilateral agencies in the early 1980s. Some reversal in capital movements might have been expected as these loans were repaid, though reduced concern over the systemic risk that Latin American debt might pose to the international financial system may have also contributed to the decline in both public and private lending. Provisioning by commercial banks in industrial countries has limited the risk to national banking systems, allowing commercial banks to adopt a harder line in debt negotiations. Budget conscious governments also seem less able or willing to increase their bilateral lending and aid.

The situation in Eastern Europe, aside from the evident political uncertainty in the region, would appear to be more favourable. With a few notable exceptions, external debt to GNP ratios among these countries are typically much lower than those in Latin America. Moreover, private and official creditors appear to be very sympathetic to their needs, welcoming if nothing else the change of venue that this new challenge provides, and perhaps remembering the dramatic recovery that Western Europe made after World War II with the assistance of the Marshall Plan.

Although commercial banks remain wary of new Eastern European commitments, owing to their previous costly ventures in Poland and Yugoslavia, significant short-term capital inflows were nevertheless recorded in Bulgaria, the German Democratic Republic and Hungary during the first six months of 1989 -- well before the latest wave of "East Europhoria" took hold (Table 2). These countries have also attracted substantial direct investment over the past year and have initiated a number of joint ventures with large Western firms.[1]

With regard to official financing in Eastern Europe, several recent developments are worth highlighting (Table 3). These include:

(1) A French proposal, strongly supported by the E.C. and other industrial countries, to establish a European Bank for Reconstruction and Development.

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1. More than 300 joint ventures were registered with foreign firms in Hungary last year.

The EBRD would be modelled after the International Bank for Reconstruction and Development and would have an initial capitalization of U.S.$7 billion to U.S.$12 billion.

(2) A commitment from the World Bank to provide up to U.S.$7.5 billion to Poland, Hungary, Yugoslavia and Romania over the next three years.

These are the only four countries in Eastern Europe that are currently members of the IMF and the World Bank. Other Eastern European countries have indicated an interest in joining, however, and presumably would receive similar assistance from both the IMF and the World Bank once they had programs approved.[2]

(3) A 13-month stand-by credit for SDR 545 million from the IMF to help support a program of comprehensive macroeconomic reform in Poland.

This credit has been combined with a U.S.$500 million bridge loan from major BIS central banks; structural adjustment loans worth U.S.$360 million from the World Bank; and a U.S.$1.0 billion stabilization fund, financed with grants and soft loans from the G-24 to help reform the Polish foreign exchange market, as well as other bilateral assistance.[3]

Other developing countries, aware of the increased attention that government expenditures are receiving in many industrial economies, are naturally concerned that the financial assistance which is being provided to Eastern Europe, either bilaterally or via multilateral institutions, might reduce the

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2. Czechoslovakia and Bulgaria have already applied for membership.

3. Hungary has also reached agreement with the IMF on a U.S.$160 million, one year stand-by facility. The agreement is expected to be signed March 14.

funding that is available to them. Moreover, there could also be concerns that as the Eastern Bloc countries begin to integrate themselves into the world trading system, they will specialize in the same manufactured goods that Latin American countries currently rely on for much of their external trade.

2. Grounds for Optimism

Fortunately, other factors are at work which suggest the situation is not nearly as serious as the earlier discussion might have indicated -- at least in the short run. Most important in this regard is the considerable economic and political influence that Latin America enjoys relative to Eastern Europe by virtue of its size and its proximity to the world's largest economy, the United States. Like Eastern Europe, it has strong historical and cultural ties with both North America and Western Europe (in particular Spain and Portugal). In terms of population and production, it exceeds Eastern Europe by a wide margin (provided one excludes the U.S.S.R., Table 4). Moreover, its resource endowment is arguably much greater.

While the aid and financing that have been promised to Eastern Europe may initially seem quite generous, it is important to bear in mind the substantial assistance that Latin America has already received, and will continue to receive, from international agencies and the major industrial countries (Tables 3 and 5). Indeed, the Managing Director of the IMF and the President of the World Bank have both promised that the credits extended to Eastern Europe will not be made at the expense of Latin America and Africa.

These institutions have been lobbying aggressively for a significant increase in their funding on the basis that more credit will be needed to ensure that no developing region suffers. It is not unreasonable to assume that the enthusiasm surrounding recent events in Europe may actually facilitate the funding process and, in the end, make more money available to Latin America than would have been possible otherwise.[4]

As a practical matter, of course, liquidity has not been a binding constraint in terms of IMF and World Bank lending activities in Latin America over the past ten years, despite the added pressures that the debt crisis has placed on these institutions. A more fundamental problem has been the lack of supportable projects and policies.

In any event, official lending was never expected to be a substitute for private financing, but was instead designed to function as a catalyst. Until stronger macroeconomic and

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4. In this regard, it is worth noting that the Inter-American Development Bank has recently been given a U.S.$26.5 billion increase in capital and is expected to lend an additional U.S.$6.0 billion per year to Latin America.

structural adjustment policies are enacted in many countries, it is questionable whether much could be accomplished by further infusions of official funds. Debt reduction and new lending in such circumstances would only serve as a palliative.

3. <u>Challenge for the 1990s</u>

Trying to anticipate future economic developments is always difficult. Such an exercise is especially risky in the case of Eastern Europe, owing to the particularly uncertain political environment in this region and the fact that prospective economic events will be determined importantly by political forces which seem to be shifting week by week. As a result, any analysis of the effects themselves, let alone the impact that they might have on Latin America, is necessarily very speculative. Nevertheless, it is possible to identify certain risks and challenges that will have to be faced in coming years.

As was noted earlier, short-run constraints on official financing are unlikely to be a critical concern. All of the major international agencies have indicated a willingness to provide increased financial assistance, and the "peace dividend" associated with improved East-West relations should allow industrial countries to direct additional funds to developing regions. Cuts to defense spending might also reduce budgetary and inflationary pressures in industrial countries and help bring about a reduction in world interest rates. The latter would probably represent a more significant benefit to heavily-indebted countries than either increased foreign aid or additional lending. Whether or not these favourable short-run factors materialize, however, is likely to be less important than the more fundamental influences that are considered below.

The principal long-run challenge facing Latin American countries, I would suggest, centres on international trade. Over the next few years, Eastern Europe could easily become a major international producer and exporter of manufactured goods. Together with the Asian NIEs, and other rapidly developing economies in the Far East, they would present a serious competitive challenge to Latin American countries. Although the latter might also benefit from increased trade with Eastern Europe and the general expansion in world economic activity that would result from perestroika, there could well be appreciable downward pressure on market shares (Table 6).

However, a number of obstacles must be overcome before Eastern Europe can become important in world trade. The first is the lack of experience with concepts such as private ownership, decentralized decision-making and market-determined prices. The second is an absence of appropriate instruments and institutions for implementing fiscal and monetary policies. These macroeconomic tools, in particular monetary policy, are an essential part of Eastern Europe's transition to a market-based economy. They will provide the means by which authorities can control domestic spending and protect the value of money, a critical element in their new economic system, given the importance of price signals (as opposed to bureaucratic fiat) for resource allocation.

Despite these handicaps, Eastern Europe has at least one very important advantage working in its favour vis-à-vis other developing economies. This is the quality of its labour force. Average education levels and literacy rates in the region are typically much higher than those in Latin America, for example (Table 7). In addition, Eastern European countries have shown a willingness to introduce up front the kinds of difficult structural changes that will be necessary if they are to become world class economies. This willingness is perhaps a reflection of their bitter experience with alternative, centrally planned, systems and their determination to break with the past.

Poland's reform program has been one of the most ambitious in this regard. Its government intends to implement all of the measures needed to move to a market-based, democratic system within a two-year period. Monopolies, inefficient state-owned enterprises, generous indexation practices and wasteful government subsidies have all been targeted for special attention. Poland has also asked West Germany for assistance in restructuring its central bank and establishing a sound domestic currency. The German Democratic Republic (admittedly a special case) has gone even further, and is actively pursuing full economic union with West Germany and adoption of a common currency. While the programs in other countries are more gradualist in nature, their governments appear equally committed.

Latin American countries wanting to compete successfully in world markets and attract the private investment inflows required to sustain real growth, will be travelling the same road as their Eastern European counterparts. In this regard, the example provided by Eastern Europe may actually have a salutary effect; increasing support for the difficult but very necessary measures that have already been enacted in some countries, and encouraging others to follow.

Ultimately, economic development depends crucially on sound internal policies, and only incidentally on the availability of official external financing. Though this is a familiar story, events in Eastern Europe have brought it into sharper relief.

CHART 1

REAL GDP/GNP FOR THE G-7 COUNTRIES*

YEAR-OVER-YEAR GROWTH

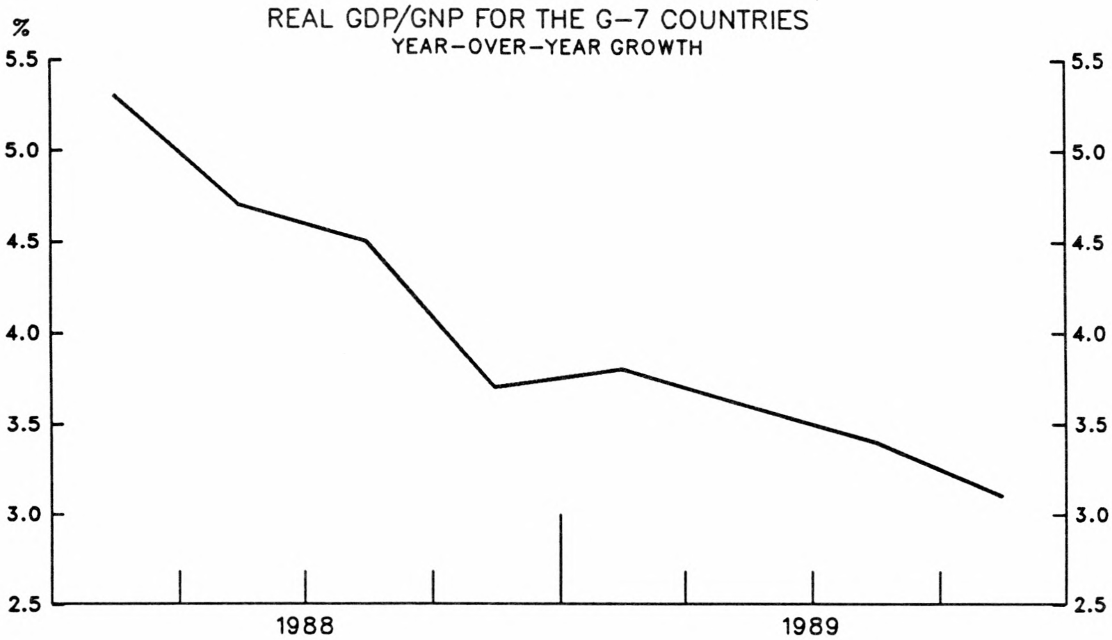
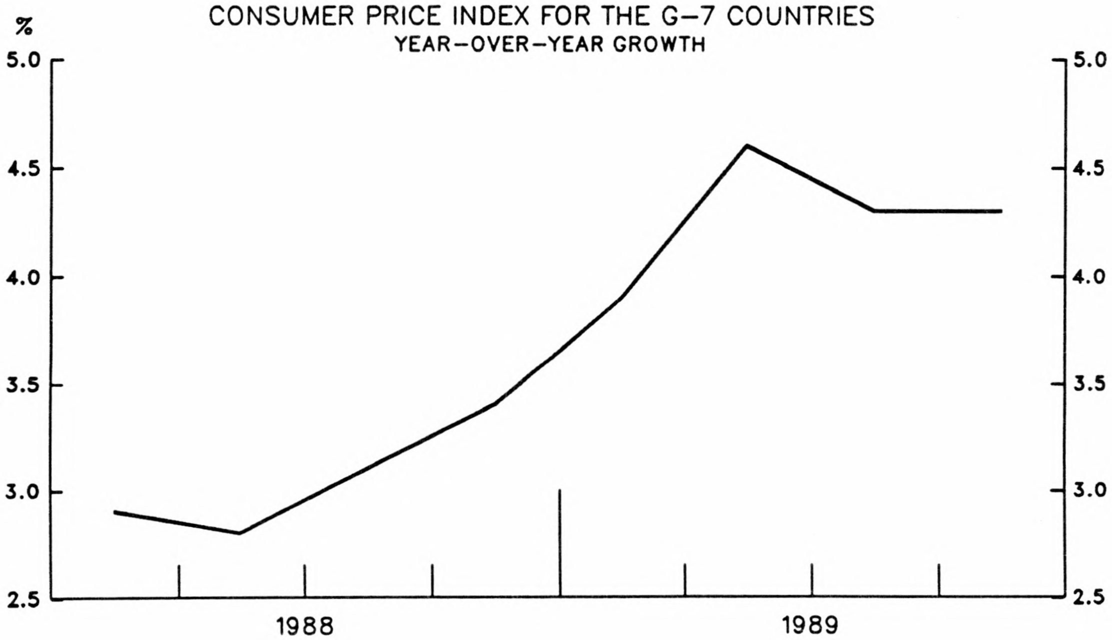


CHART 2

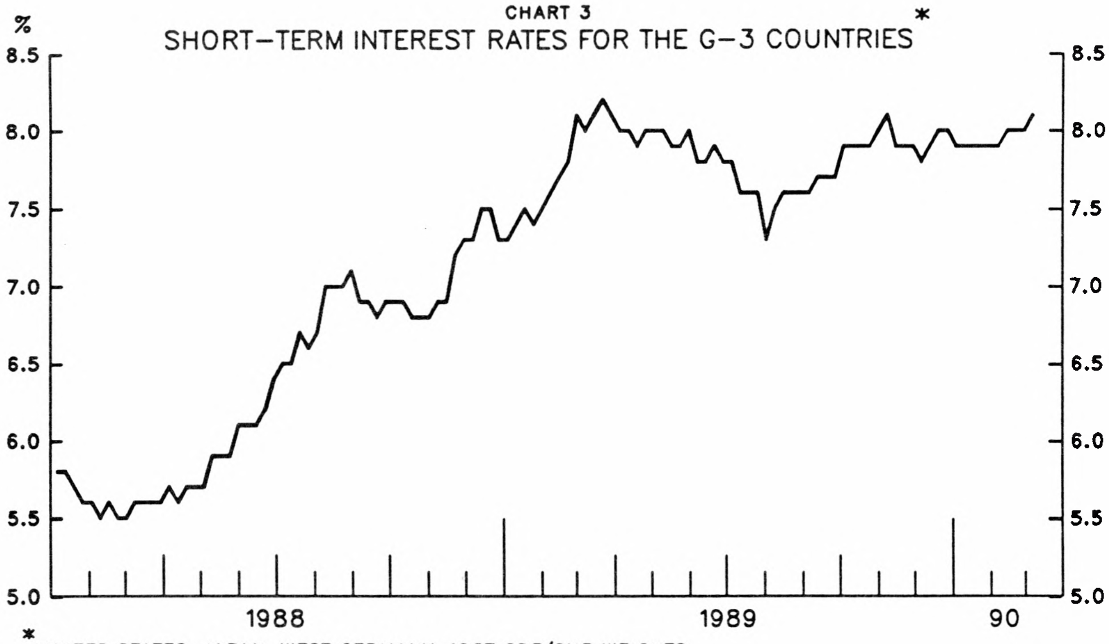
CONSUMER PRICE INDEX FOR THE G-7 COUNTRIES*

YEAR-OVER-YEAR GROWTH



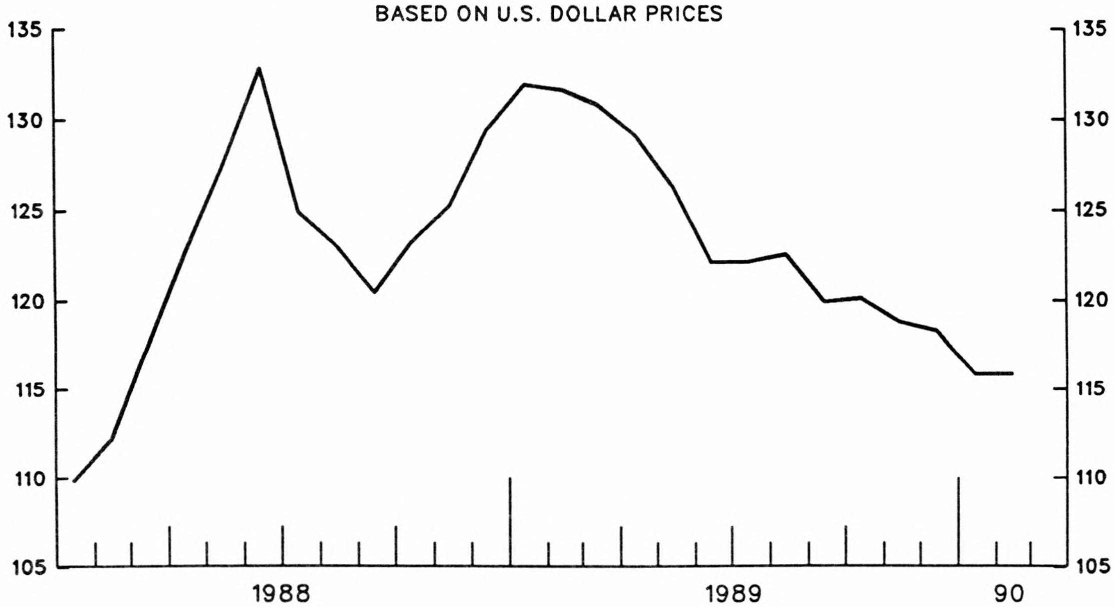
*UNITED STATES, JAPAN, WEST GERMANY, FRANCE, UNITED KINGDOM, ITALY, CANADA; 1987 GDP/GNP WEIGHTS.

CHART 3
SHORT-TERM INTEREST RATES FOR THE G-3 COUNTRIES*



* UNITED STATES, JAPAN, WEST GERMANY; 1987 GDP/GNP WEIGHTS.

CHART 4
COMMODITY PRICE INDEX, EXCLUDING ENERGY**
BASED ON U.S. DOLLAR PRICES



** UNADJUSTED FOR SEASONAL VARIATION, 1981=100.

TABLE 1

EXTERNAL DEBT -- 1988
(Millions of U.S. dollars)

	Total external debt	As per cent of GNP	Long-term debt	of which: Official*
A. Eastern Europe				
Bulgaria	6,100	24.7	n.a.	n.a.
Czechoslovakia	6,600	11.4	4,324	1,225
East Germany	20,400	22.4	n.a.	n.a.
Hungary	19,561**	75.0	16,791	1,560
Poland	42,137	61.2	33,661	22,064
Romania	2,790	5.7	1,946	1,496
Yugoslavia	21,684	34.4	19,341	6,670
Sub-total	119,272	31.3	74,063	33,015
U.S.S.R.	39,273	4.7	25,776	10,702
Total	158,545	13.0	101,839	43,717
B. Latin America (Major Debtors)				
Argentina	58,936	60.5	49,544	8,760
Bolivia	5,456	135.5	4,651	3,771
Brazil	114,592	30.7	101,355	24,612
Chile	19,645	96.6	16,121	4,338
Colombia	17,001	46.5	15,392	8,124
Ecuador	10,864	113.3	9,378	3,631
Mexico	101,566	58.0	88,665	16,022
Peru	18,579	47.3	13,898	6,256
Uruguay	3,825	50.1	3,039	659
Venezuela	34,657	58.4	30,296	451
Other	42,342	77.8	34,237	23,054
Total	427,463	54.4	366,576	99,678

Source: The World Bank, World Debt Tables 1989-90.

* Long-term liabilities owed to official creditors (both multilateral and bilateral).

** Total debt figures revised upward to include U.S.$2.0 billion under-reporting.

TABLE 2

OUTSTANDING EXTERNAL BANK CLAIMS * -- 1989
(Millions of U.S. dollars)

	Total	Net Change, Dec./88-June/89
1. Eastern Europe		
Albania	268	1
Bulgaria	7,221	691
Czechoslovakia	4,284	89
East Germany	15,301	418
Hungary	10,938	296
Poland	9,306	-600
Romania	423	-330
Yugoslavia	7,885	-958
Sub-total	55,626	-393
U.S.S.R	39,615	4,802
Total	95,241	4,409
2. Latin America		
Argentina	31,800	-2,600
Bolivia	425	-2
Brazil	73,428	-1,212
Chile	9,858	-736
Colombia	6,350	-583
Ecuador	4,855	-11
Mexico	65,255	-2,668
Peru	4,103	-392
Uruguay	1,917	-75
Venezuela	25,258	-259
Total	223,249	-8,538

Source: OECD and BIS, Statistics on External Indebtedness, January 1990.

* Includes official and officially guaranteed or insured trade-related claims of banks and non-banks in 22 OECD countries.

TABLE 3

OFFICIAL AID AND FINANCING FOR EASTERN EUROPE: NEW COMMITMENTS
(Millions of U.S. dollars)

	Multilateral			Bilateral
	BIS	IMF	World Bank	
Poland	500	715	2,500*	3,000-3,500**
Hungary		(208)	1,000*	1,500***
Yugoslavia		(600)	2,000*	
Romania			2,000*	
Total	500	(1523)	7,500*	4,500-5,000

* Maximum amount that the World Bank is prepared to commit over a three-year period provided certain conditions are met.

** Includes U.S.$1 billion stabilization fund; a DM3 billion (U.S.$1.6 billion) package of economic assistance from Germany (including export guarantees and write-offs of earlier loans to Poland); loans from the European Investment Bank; and other bilateral aid.

*** Includes a guaranteed loan from Germany, a loan of U.S.$1.14 billion by the European Commission, and an aid package of U.S.$100 million proposed in the 1990 budget of the European Economic Community.

( ) Amount of stand-by agreement reached in principle with the IMF but not yet approved by the Fund's Executive Board.

TABLE 4

EASTERN EUROPE AND LATIN AMERICA
-- A COMPARISON OF POPULATION AND GNP --
(1988 data)

	Population (000s)	GNP[e]* (U.S.$ millions)	GNP per capita[e]* (U.S.$)
A. Eastern Europe			
Albania	3,145	n.a.	n.a.
Bulgaria	8,995	24,655	2,740
Czechoslovakia	15,610	58,100	3,730
East Germany	16,665	91,000	5,460
Hungary	10,604	26,086	2,460
Poland	37,873	68,890	1,819
Romania	23,052	49,331	2,140
Yugoslavia	23,552	63,119	2,680
Sub-total	139,496	381,181	
U.S.S.R.	285,659	837,806	2,933
Total	425,155	1,218,987	
B. Latin America (major debtors)			
Argentina	31,506	83,040	2,640
Bolivia	6,917	3,930	570
Brazil	144,369	328,860	2,280
Chile	12,760	19,220	1,510
Colombia	30,007	37,210	1,240
Ecuador	10,154	10,920	1,080
Mexico	83,593	151,870	1,820
Peru	20,681	29,185**	1,440**
Uruguay	3,004	7,430	2,470
Venezuela	18,759	59,390	3,170
Other	50,756	54,433	1,072
Total	412,506	785,488	

Source: The World Bank Atlas 1989

e Estimate.

* The exchange rate data used to calculate the U.S. dollar values of "GNP" and "GNP per capita" in certain Eastern European countries have been selectively adjusted to recognize evident differences between the official values of the exchange rates and the values that might obtain if rates were market-determined. Given the lack of satisfactory exchange rate information, the results are, of necessity, very approximate.

** Based on 1987 data.

TABLE 5

OUTSTANDING LOANS TO THE IMF AND THE WORLD BANK -- 1989
(Millions of U.S. dollars)

	IMF*	World Bank**
1. Eastern Europe		
Hungary	456	1,976
Romania		2,184
Yugoslavia	686	5,123
Total	1,142	9,283
2. Latin America		
Argentina	3,099	5,121
Bolivia	135	754
Brazil	2,422	16,413
Chile	1,270	2,334
Colombia		6,396
Ecuador	325	1,355
Mexico	5,091	14,756
Peru	758***	1,712
Uruguay	201	921
Venezuela	771	1,138
Total	14,072	50,900

Sources: IMF, International Financial Statistics, February 1990; and The World Bank Annual Report 1989.

* Includes all outstanding stand-bys and arrangements under the Extended Fund Facility as of November 1989.

** Outstanding as of 30 June 1989.

*** In arrears to the IMF.

TABLE 6

TRADE SHARES -- 1988

	Percentage of international trade with	
	Latin America	Eastern Europe
United States	12.8	0.9
Germany	2.3	4.7*
E.E.C.	2.2	4.6
All Industrial Countries	4.4	2.5

Source: International Monetary Fund, Direction of Trade Statistics Yearbook 1989, Washington, D.C.

* Does not include trade between East Germany and West Germany.

TABLE 7

ILLITERACY RATES AND EDUCATIONAL LEVELS: -- EASTERN EUROPE AND LATIN AMERICA --

	% of 12-17 year-olds enrolled in secondary school	Illiteracy rate % of population
A. Eastern Europe		
Albania	70.0	5.0 or more
Bulgaria	100.0	5.0 or more
Czechoslovakia	37.0*	5.0 or more
East Germany	78.0	5.0 or more
Hungary	70.0	5.0 or more
Poland	80.0	5.0 or more
Romania	79.0	5.0 or more
Yugoslavia	82.0	8.8
Average	74.5	5.0 or more
B. Latin America		
Argentina	74.0	5.0 or more
Bolivia	37.0	25.8
Brazil	38.9	22.3
Chile	70.0	5.6
Colombia	56.0	11.9
Ecuador	55.0	17.6
Mexico	55.0	9.7
Peru	65.0	13.0
Uruguay	71.0	5.0 or more
Venezuela	46.0	13.1
Average	56.8	12.8

Source: The World Bank, Social Indicators of Development 1989; and The World Bank Atlas 1989.

* Figure for Czechoslovakia may be underestimated by as much as 40 percentage points, since many Czech adolescents enrol in apprenticeship programs that do not award diplomas and would therefore be excluded from the survey.