

## **Ten Years of Transition: Looking Back and Looking Forward**

### **Introduction to IMF Staff Papers**

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The rise and fall of central planning is one of the great themes of 20<sup>th</sup> century economic history. At its peak almost half the world's population lived in economies that described themselves as being centrally planned and not even the most hostile critics of the system predicted how quickly it would begin to unravel in the late 1980s. But over the succeeding decade tens of countries began the often painful transition to a predominantly market economy, and many have travelled very far down that road.

So much so, that it, at the beginning of the 21<sup>st</sup> century, is increasingly inappropriate to still label many of those countries "transition" economies. Cuba and North Korea are the only significant economies that still profess allegiance to state ownership and central planning. It is a good time therefore to look back at what we have learned from the transition experience, and to look forward, to the challenges that now face these economies.

### **Performance during transition**

Although important reforms began in the 1960s in Hungary and in the 1980s in China, Poland's economic reform program in 1989 was the first attempt at a comprehensive rapid move to a market economy. No-one believed that the process would be painless. It was obvious that output and employment would fall initially as economic conditions were stabilized and as structural reform moved resources from unproductive to productive uses.

But the adjustment turned out to be much more painful than expected. In the transition economies of central and eastern Europe, the Baltics, Russia and the other countries of the former Soviet Union, output fell by more than 40 per cent on average and it was at least two years after stabilization programs were put in place before growth resumed. Both the depth of the initial recession and the strength of the subsequent recovery varied widely from country to country. Only a handful have seen output recover to pre-transition levels. In contrast, the transition economies of east Asia managed to maintain strong growth throughout the transition period, allowing them to enjoy big cumulative gains in output.

Econometric analysis of the factors determining economic performance in the transition economies of Europe and the former Soviet Union – making use of the measures of structural reform developed by the European Bank for Reconstruction and Development – reveals some striking lessons<sup>1</sup>. Growth was affected by several initial conditions affecting the economy, including for instance how long it had been in the Soviet bloc and its dependence on previous

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<sup>1</sup> Fischer and Sahay

trade patterns. This helps explain why output fell further in the CIS and Baltic countries than in central Europe - because there were larger price and wage distortions in place which had to be unwound through the reallocation of resources and structural adjustment.

But while initial conditions were important in determining the size of the initial recession, they had less influence on the subsequent recovery path. Here the strength of reform efforts was the dominant factor. Indeed, the evidence confirms that the basic strategy advocated by market-oriented proponents of reform a decade ago was correct. Namely, that both stabilization and structural reforms – particularly price liberalization and the small-scale privatization of state enterprises – contribute significantly to growth. The faster these reforms are implemented – and the more consistently they are pursued – the quicker the economy pulls out of the initial recession and the stronger the subsequent upturn in growth.

In addition to falls in output, the early phase of transition was also marked by big price increases in most countries. This reflected both liberalization and the effect of the monetary overhangs inherited from the Socialist era. Falling output and fiscal restructuring widened budget deficits, which in turn fuelled inflation as the authorities monetized them. The resulting macroeconomic instability was particularly virulent and persistent in the CIS countries. Most transition economies had achieved reasonable price stability by the mid-1990s, but in several there were setbacks later in the decade. In these reform fatigue saw government debt and bad loans in the banking sector mount up, eventually leading to a loss of confidence among foreign and domestic creditors. This in turn led to disruptive currency and banking crises. Of the setbacks, the Russian crisis of 1998 was clearly the most serious.

But across the transition economies as a whole, the situation is now clearly improving. Between last year and this year alone, growth has more than doubled to nearly 5 per cent and inflation has more than halved to less than 20 per cent. So in terms of macroeconomic stabilization, much has been achieved. But experience has differed widely from country to country - depending in large part on policy effort.

The same is true of structural reform. Progress has generally been most impressive in central Europe and most disappointing in the CIS and East Asia. It has also varied widely from one policy area to another. Reform is most advanced in the privatization of small-scale enterprises, the elimination of price controls and the liberalization of foreign trade and exchange. But less has been achieved in the regulation and supervision of financial sectors, enterprise restructuring and the reform of governance in the public and private sectors.

In countries where certain key structural reforms were delayed - notably the elimination of soft budget constraints and the liberalization of trade and prices - inflation has tended to be higher and more protracted and the recovery in output has been less robust. The most successful strategy seems to have involved rapid privatization of small-scale enterprises, followed by more gradual privatization of large-scale enterprises - once commercial legislation has been put in place to ensure sound corporate governance structures and adequate competition (or regulation in the case of natural monopolies).

The more successful reformers have further strengthened their position by gaining rapid access to foreign capital markets and direct investment, thereby reducing their reliance on financing from governments and international financial institutions. At the other extreme, the problems of the less successful reformers – notably Russia - were exacerbated by capital flight.

One increasingly widespread criticism of the reform strategy in the transition economies - and of western support for it - is that too little thought was given to the institutional foundations that market economies require. For example, sound legal and regulatory systems, and well-functioning tax administrations. In fact, the importance of these elements was recognised from the beginning, as is clear from the joint study of the Soviet economy published by the leading international financial institutions in 1991<sup>2</sup>.

Nonetheless, it is probably true that once transition was under way, policymakers and advisors gave institutional questions less attention than they should have done, relative to the pressing macroeconomic challenges. In part this may be because the difficulties involved in implementing institutional reforms were underestimated. There was a lack of experienced personnel and the relevant administrative capacity in many countries was limited. As well as being time-consuming and complicated, institutional reform also requires both government officials and private sector agents to shed long-ingrained social practices and modes of behaviour. This sort of cultural change is neither quick nor easy to secure.

### **Why is Asia different?**

Before turning to policy challenges for the future, it is worth examining briefly why the experience of the east Asian transition economies - in particular China - has been so different. Most indicators suggest that progress on structural reform in east Asia has been relatively modest, yet output performance has been far superior to even the best reformers in Europe and the CIS. Some observers have argued that the lack of structural reform in China shows that a gradualist approach to reform is better than a rapid one. Others have argued that China's success has come about despite gradualism rather than because of it, and that the strong output performance there reflects favorable initial conditions and political stability.

It is certainly true that one of the most conspicuous differences between the transition process in east Asia and elsewhere is that in the former it was undertaken by incumbent governments, rather than coinciding with a period of political upheaval. The reform process in China began in the late 1970s, with modifications to the traditional planning system. The present objective of developing a socialist market economy was not formally adopted until 1993. Reforms have been gradual but far-reaching. They have remained on track in part because they were initiated and implemented in a stable political climate, a luxury not on offer elsewhere.

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<sup>2</sup> A Study of the Soviet Economy (IMF, World Bank, OECD, EBRD: Paris 1991)

The east Asian transition economies were also able to increase output by drawing on a large pool of surplus labor in the agricultural sector. By permitting greater private sector activity in agriculture and relaxing entry into industry in rural areas, it was possible to increase output substantially without employment falling sharply. In contrast, in most other transition economies, adjustment required large-scale job shedding from big state-owned enterprises. In addition to beginning their reforms earlier, the east Asian countries had also diversified their trade patterns earlier, so demand for their exports was less affected when the long-standing trading relationships within the Council of Mutual Economic Assistance collapsed in 1991.

But China's success has been secured at a price. Reform of large state enterprises has been relatively slow, contributing to a serious worsening of their financial position. This in turn has resulted in a substantial accumulation of non-performing loans in the state-owned commercial banks. The authorities have made significant progress in privatizing small enterprises and reducing the level of non-performing loans in state banks, but much remains to be done to restructure large enterprises and to develop a sound and market-oriented commercial banking system. Accession to the World Trade Organisation means that these problems will have to be tackled with increasing vigor in the future. This in turn will impose fiscal burdens, underlining the need to strengthen the country's budgetary position.

### **The challenges ahead**

What about the challenges facing the other transition economies? Consider first the relatively successful reformers on the European Union accession track. And then the less successful performers, where the reform process in some cases appears to have stalled.

The EU has accepted 10 transition economies as full candidates for accession – Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, the Slovak Republic and Slovenia. Many of them have been relatively successful reformers, which many observers attribute to their underlying historical affinity to western Europe. With central planning introduced only in the late 1940s, there was still considerable understanding of how a market economy works. The political upheavals of the late 1980s were seen as an opportunity to return to a western European model. Embodying this aspiration, the incentive of joining the EU created a powerful external anchor that has helped keep reform on track.

Economic growth has resumed in most of the accession economies, while inflation is moderate or declining. Relatively large budget and current account deficits remains a source of concern, however. On the structural side, for the most part these countries have successfully liberalized trade and foreign exchange systems and privatized many small- and large-scale public enterprises. There has also been significant progress in liberalizing prices. But there has been less progress on competition policy, governance, enterprise restructuring and the development of financial institutions. In 1999 the European Commission said that six of the 10 accession economies in effect had functioning market economies. Lithuania and the Slovak Republic were "close", Bulgaria had made good progress from a poor starting point, but the situation in Romania remained "very worrying".

Even the best performing accession economies have policy challenges to confront if they are to make the most of EU membership and minimise its risks. For example, all applicants still need to see significant adjustments in their industrial and occupational structures, trade patterns and financial sectors. All of these will occur more smoothly and at lower cost if measures are taken to increase the flexibility of product and labor markets. More also needs to be done to strengthen the institutions that support market activity. In particular, concerns about judicial systems, banking system weaknesses and corruption need to be addressed.

Outside the EU accession group, the remaining transition economies face an even more challenging policy environment. For many of them, the legacy of central planning and the transition process continues to hamper macroeconomic policymaking. Rudimentary financial systems complicate the task of setting monetary policy, while high government spending and inefficient tax collection put upward pressure on budget deficits. Fiscal problems are exacerbated by the non-transparent nature of some spending, notably implicit subsidies to existing enterprises. Some countries - like Belarus, Tajikistan, Turkmenistan and Uzbekistan - still maintain large subsidies to enterprises, widespread price controls and restrictions on capital movements. Reliance in these countries on central banks to support government budgets, the banking system and enterprise subsidies is fuelling high inflation and macroeconomic instability. Thoroughgoing structural reforms are the only cure.

All transition economies need to press ahead with structural reform and institution-building, but the task is particularly pressing in those economies - including virtually all the CIS - where reforms have been partial, slow or stalled. The precise mix of reforms required differs from country to country, but there are common challenges in three areas:

- *Enterprise restructuring:* Inefficiencies and loss-making activities in large-scale enterprises remain a serious drag on the economy. In Russia and other CIS economies, the problem lies mainly in newly privatised firms where there has been little incentive to restructure - the ability to amass arrears and take advantage of subsidised energy has maintained soft budget constraints. In China and Vietnam, the problem lies more with state-owned enterprises, where borrowing from state-owned banks is financing overcapacity and debt accumulation. In both cases hard budget constraints need to be combined with stronger social safety nets to ease the social costs of adjustment.
- *Financial sector reform:* In Russia and other CIS economies, the banking system remains small and underdeveloped. An action plan is needed to deal with those banks that remain insolvent, as well as to develop the sector by stimulating wider private ownership and greater competition. Better regulation and supervision will be required to guard against abuses, including insider lending. Reforms of the legal and regulatory environment are also necessary, but these will inevitably take some time. In China, the banking system is much bigger and deals with a large proportion of domestic savings, but channels much of its lending to state-owned enterprises. Non-performing loans are being transferred from the four state banks to asset management companies, which will strengthen their financial position. But it will be important to ensure that a fresh bad loan problem does not emerge. This means developing a commercial credit culture in the banks and strengthening

- regulation and supervision. The prospect of WTO accession underlines the need for action here, as it will give foreign banks full national treatment by 2005.
- *Transforming the role of the state:* More needs to be done to establish and enforce the "rules of the game" for a market economy, especially in the CIS and east Asia. This means strengthening tax systems and tax administration; improving fiscal transparency and government accounting; and reforming relationships between central and local government. It will also require continuing reform of expenditure policies, phasing out subsidies and strengthening social spending programs. Making sure that public sector institutions function properly is also essential, which will require that the correct incentives are put in place for the people who run them.

In many transition economies, progress in these areas is being held up by the resistance of vested interests. These have arisen because enterprising individuals have found that they can make higher profits by obtaining privileges in a system marked by continuing government intervention than by setting up risky new ventures in untested markets. Elites therefore favor reforms which strengthen their position, such as privatization and macroeconomic stabilization. But they oppose those which weaken it, like liberalization and institution-building. The result is that the reform process stalls mid way.

Overcoming this problem is no easy task. Pressure to do so could come from a variety of sources: strong political leadership, pressure from a growing middle class or pressure from foreigners seeking to compete in domestic markets. The international financial institutions also have an important role to play in the advice they give and the reforms they support.

