Panel Discussion

Second Generation Issues in Transition: From Stabilization to Growth

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It is a mark of the success of the transition process that we are already into the second generation only five years after the first was born. It is another mark of the success of the process that it is not receiving a great deal of attention. In the same week this April, the IMF Board agreed to large standbys with both Russia and Ukraine--events which even a year ago would have generated banner headlines. This time the programs received polite but almost blase welcomes.

There are at least two interpretations of the title of this session. We could be asking what we can tell the second generation of reformers--countries such as Turkmenistan, North Korea and Cuba--based on the experiences of the first generation. Alternatively, we could be asking what are the problems facing transition economies who have made it through the first phase of reform, and are now moving on into the second stage of the transition process.

I will address both interpretations, and focus mainly on stabilization, inflation and growth. The good news bottom line is that the data by and large support the view that stabilization is good for growth, and that early stabilization is better than later stabilization. In addition, I will

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1/ First Deputy Managing Director, IMF. This is an edited version of remarks presented at a panel discussion at the World Bank's Annual Conference on Development Economics, May 2 1995. The views expressed are those of the author and not necessarily those of the International Monetary Fund.

briefly discuss the role of exchange rate anchors, and finally touch even more briefly on the sustainability of the reform process.

The most important news about the transition process is that, according to official data, several transition economies are already growing, among them the Baltic countries, Croatia, the Czech Republic, Hungary, Moldova, Poland, Slovakia, and Slovenia. If we also include the performance of the unrecorded economy, presumably these countries started growth at least a year earlier, and perhaps other countries are growing too.

One important lesson of transition--and this is certainly a lesson for the late reformers--is that stabilization is good for growth. It is almost an iron law that stabilization is needed for growth, more specifically, that no transition country has begun to grow without first reducing inflation to the low single digit per month range. However Romania did begin to grow while inflation was high. There is also a strong relationship in the opposite direction: countries that have stabilized have generally seen growth a year or two later. The evidence on this latter proposition is convincingly presented in an important paper by Alan Gelb, Martha DeMelo, and Cevdet Denizer,1/ which shows a one-year lag between lower inflation and higher growth.

There does seem to be something special about the transition economies that have begun to grow: for instance, they tend to be more democratic, they entered communism unwillingly, and they were in the soviet empire for a shorter time. While that is true, we should not make too much of the point, because it is quite likely that Russia and some of the slower reformers will start growing within a year or two.

1/ "From Plan to Market: The Patterns of Transition", forthcoming as a World Bank working paper.

Gelb, DeMelo and Denizer also show that countries that reform faster, have a more rapid initial output decline than those that are slow to reform. This is certainly consistent with the behavior of output in the early years of transition for countries such as Ukraine and Belarus, which were slow to reform. But within three to five years, the cumulative output loss for the rapid reformers proves to be lower than that of countries that have been slow to reform.

The data suggest that countries that reform earlier have higher inflation as prices are liberalized, typically in the context of a monetary overhang. Whether there is a price explosion depends on the initial conditions. Czechoslovakia, for instance, did not have a price explosion, though its inflation rate was higher at the beginning of the reform process than it is now.

Does the fact that tight macro policies seem good for growth mean that it is impossible to be too tough on monetary and fiscal policy at the beginning of the transition process? Recall that only two to three years ago the Calvo-Coricelli view that output declines were caused by a shortage of credit was very popular. To some extent, the view that tight monetary policy has been responsible for output declines in transition economies confuses real and nominal rates of growth of credit: typically you do not get more real credit by expanding nominal credit more rapidly. I do believe it is theoretically possible to have too tight a monetary policy at the beginning of a stabilization and reform process, particularly in light of the remonetization of the economy that will take place at some point. However the political equilibria that have obtained in the transition economies have not permitted excessive tightening, so that in most economies tighter credit and fiscal conditions would not have produced worse outcomes.

Prices in the transition economies, administered prices aside, appear to be reasonably flexible. When monetary policy is tightened in Russia, the effects on inflation appear with a lag of 3-4 months, rather than Milton Friedman's 18-24 months that is more typical in the United States.

Countries that have stabilized typically find themselves with inflation rates within the moderate range of 15 to 30 percent, and now face the same moderate inflation dilemma as countries such as Colombia, Chile or Israel have faced in the past. Inflation in the moderate range will decline in the face of tight macroeconomic policy, supported by wage restraint, and the use of an exchange rate anchor. However the last part of the journey to industrialized country inflation rates is difficult, and policymakers have to be sure to take advantage of every favorable price shock to try to lock in inflation reductions and make continuing progress.

What is needed to make the stabilization and growth gains sustainable? A key second generation issue for those who have already embarked on transition is fiscal reform. The decline in government revenues in most transition countries has been dramatic. Many governments, especially in the FSU, have been able to maintain macro balance only by holding back budget funds (sequestering), or building up arrears. The unintended consequence is credit creation through the central bank or arrear creation in the private sector. Rebuilding the fiscal system, on both the expenditure and tax sides, moving away from enterprise taxation to indirect taxes such as the VAT, customs, tariffs and later perhaps to direct taxes, is a high priority. So is the creation of a modern system of expenditure management and prioritization.

Another critical second generation priority for those already in transition is reform of the financial system. The banks are not yet playing

much of a role in financing investment in most of the transition economies. Unfortunately, there is a real chicken and egg problem here: the banks will not be sound if they lend to companies that are not sound, but the companies cannot develop without external finance. It is likely that there will have to be another round of bank portfolio- and capital-restructuring programs in many of the transition economies.

Another priority in many of the FSU countries is agricultural sector reform. So too is the continuation and deepening of privatization, particularly in reforming corporate governance in many countries.

Among the lessons from which the late reformers can benefit is how to deal with arrears. When the arrears problem first emerged, possible solutions included one-time monetization, a one-time netting operation, and complicated schemes for turning the arrears into tradable assets. But after several of these elegant one-time solutions had to be repeated, it has become clear that the best answer is tough-minded neglect. Firms should be left to work out how to deal with inter-enterprise arrears.

I turn briefly now to exchange rate anchors. It was once accurate to say that no major stabilization program had succeeded without an exchange rate anchor. But lately, several transition countries, such as Croatia and Kyrgizstan have stabilized their economies without pegging the exchange rate, and it is no longer true that the evidence unambiguously supports the need for an exchange rate nominal anchor in stabilizing rapid inflation.

In general I would still look to a temporary exchange rate anchor in trying to bring down inflation quickly. The Mexican experience has led many to believe that approach is very dangerous, but that is true only if the anchor is never moved--and the anchor analogy is precisely of something that moves but is not stuck fast in concrete. In Poland the initial peg was held

for a year; in Israel for a little longer. But it at some point becomes necessary to adjust the rate, and perhaps also the exchange rate regime, for domestic inflation rarely ceases immediately. In some of the transition economies, including the Baltics, real appreciations at rates of 20-30 percent per year seem quite sustainable. But at some point, countries that have not irrevocably fixed the rate, as in the quasi-currency board monetary systems, are likely to have to start allowing it to move.

Finally, a few words on political sustainability, which is the most amazing phenomenon of transition. Just two years ago, everybody was afraid of reversals in the postsocialist world: "If we don't support the Russians, the communists will come back, if not the communists, then the fascists will gain the upper hand all over Eastern Europe". Five years later, despite the fact that output declines have been far greater than anybody ever expected, despite all the difficulties, the notion of returning to the previous system seems to be far from anybody's mind -- except perhaps in some smaller, less developed former Soviet economies (and even those economies will in the end move towards markets). Even when former communists have been elected, they have continued the reform process, albeit with fits and starts. That is the most remarkable feature of what we have seen in this first generation of reforms: the lessons drawn by people who experienced the previous economic system have ensured that the reform process has continued despite the wrenching changes it has brought.