CHAPTER 3

MACROECONOMIC POLICIES AND ACHIEVEMENTS IN TRANSITION ECONOMIES, 1989-1999

Stanislaw Gomulka[183]

3.1 Introduction

The primary purpose of this paper is to consider and answer the following questions:

- How far have the transition economies of central Europe and the former Soviet Union been able to establish the macroeconomic framework needed for sustaining investment and economic growth?
- What distinguishes the more successful from the less successful: initial conditions, the political environment, the state of institutions?
- How far have weak or missing institutions hampered effectual policy-making?
- Have macroeconomic policy dilemmas been intensified by weak institutions?
- Has too much emphasis been placed on lowering inflation – or reducing it too rapidly – at the expense of economic growth?
- What lessons can be drawn for those transition economies which are still struggling to achieve macroeconomic stability and economic growth?
- Under the emerging economic system, what is the potential contribution to growth of the technological convergence (catching-up) factor?

These specific questions are addressed in section 3.3 of the paper.[184] The wider issues of reform strategy and the content of the main macroeconomic policies are discussed in section 3.2. The transition countries covered in this survey are listed in table 3.2.1. They are divided into two groups: 13 central European and Baltic countries and 12 members of the Commonwealth of Independent States (CIS). This division is motivated, in part, by similarities in the choice of reform strategies made by the countries in each group. Table 3.2.1 also gives two GDP estimates for each country in 1998, one based on market exchange rates and the other based on purchasing power parity (PPP) exchange rates. The latter estimates are used to obtain each country's weighting. These weightings are then used in section 3.3 of the paper to produce weighted averages and absolute mean deviations for the main macroeconomic variables, as well as weighted econometric estimates of the correlation coefficients between output falls and inflation rates, all for the years 1991-1998.

The PPP estimates of GDP imply that, in 1998, the combined weighting of the CIS region was 3.7 per cent of the world economy and that of the central European and Baltic countries 2.4 per cent.

3.2 An overview of reforms and policies

(i) Reform strategy

The reform of the economic system which occurred in central Europe and the former Soviet Union in the 1990s has been fundamental, involving major changes of institutions, types of ownership, corporate governance, laws, modes of interpersonal behaviour and attitudes to work. Some institutions were cut in size or closed down, others expanded or created. These institutional changes were superimposed on massive changes in relative prices and the pattern of foreign trade; the latter changes caused, in turn, major shifts in the composition of output. In terms of institutions, skills, prices and products, there was therefore a large distance between the initial point (where a given post-socialist economy found itself just before the reform) and the end point of its intended transition. Reform strategies have addressed the content, the sequence and the speed of reforms required to effect this transition.

In adopting a broad reform strategy and specific policies, a transition country had to take into account its particular economic circumstances and political

[183] The author wishes to acknowledge the debt to the organizers of the UN/ECE Spring Seminar, especially to Paul Rayment, for proposing the theme and the main questions of this paper. The final version benefited from the discussion at the seminar's meeting. I am particularly grateful to the four official discussants, George Kopits, Silvana Malle, Joze Mencinger and Leonid Grigoriev, and to Zdenek Drabek and Vincent Koen for their stimulating comments.

[184] All except the final question were formulated by Paul Rayment, Director of the Economic Analysis Division of the United Nations Economic Commission for Europe, on behalf of the Seminar's organizers.

TABLE 3.2.1

Population and GDP data for 25 transition economies of central Europe, the Baltic states and the CIS, 1994 and 1998

	1994	1998			
	Population (millions)	GDP per capita, (thousands PPP$)	GDP (billion PPP$)	GDP (billion $)	PPP$/$
Albania	3.4	2.9	9.9	3.2	3.1
Bulgaria	8.4	4.8	40.3	10.9	3.7
Croatia	4.5	6.8	30.6	21.9	1.4
Czech Republic	10.3	12.5	129	56.0	2.3
Estonia	1.5	7.6	11.4	5.4	2.1
The former Yugoslav Republic of Macedonia	2.1	4.4	9.2	3.3	2.8
Hungary	10.3	10.2	105	47.8	2.2
Latvia	2.6	5.6	14.6	6.9	2.1
Lithuania	3.7	6.4	23.7	10.8	2.2
Poland	38.5	7.7	296	148	2.0
Romania	22.7	5.6	127	38.5	3.3
Slovakia	5.4	9.8	52.9	20.4	2.6
Slovenia	2	14.3	28.6	19.1	1.5
CIS					
Armenia	3.6	2.2	7.9	1.8	4.3
Azerbaijan	7.5	2.2	16.5	4.0	4.1
Belarus	10.4	6.1	63.4	14.4	4.4
Georgia	5.5	3.3	18.2	5.3	3.4
Kazakhstan	17	4.3	73.1	25.2	2.9
Kyrgyzstan	4.6	2.3	10.6	1.6	6.5
Republic of Moldova	4.4	1.9	8.4	1.9	4.4
Russian Federation	148	6.5	962	275	3.5
Tajikistan	5.8	0.9	5.2	1.2	4.2
Turkmenistan	4	3.2	12.8	1.7	7.6
Ukraine	51.9	3.2	166	43.7	3.8
Uzbekistan	22.4	2.1	47.0	13.1	3.6

Source: GDP per capita in PPP dollar terms from IMF, *World Economic Outlook* (Washington, D.C.), October 1999. GDP (1998) levels in dollars at market exchange rates are from EBRD, *Transition Report* (London), 1999.

constraints. Such a strategy had typically six major components: *micro-liberalization* (especially with regard to prices, trade and entry), *macro-stabilization* (especially with regard to inflation, public finances and foreign debt), *structural changes* (especially privatization and international trade), *new market institutions* (especially with regard to commercial codes, property rights and the financial/capital markets sector), *safety nets* and *external assistance*. The first four were crucial components of any reform package. Soaring unemployment and the elimination of most subsidies to households required a complete remodelling of the welfare system. With the exception of the former German Democratic Republic (GDR), and to some extent also Bulgaria, Poland and parts of the former Yugoslavia (Bosnia, Kosovo) external assistance was typically small and of limited impact.

The inherited circumstances fall into two categories, common and country-specific. As the reform policies and transition paths have exhibited some basic similarities among countries, the common category would seem to have dominated. Nevertheless, the variations in country-specific circumstances were substantial enough to have a major impact on the choice of overall reform strategy as well as specific policies.

The similarities were possibly greatest with respect to micro-liberalization and certain important structural changes, notably reorientation of foreign trade and privatization. Somewhat unexpectedly, the greatest differences initially emerged in the area of macroeconomic policy. These differences, however, narrowed in the second half of the 1990s.

Three broad reform strategies may be distinguished: "shock therapy", rapid adjustment and gradual change. The shock therapy approach was only really applied in the former GDR. Although this strategy offered the potential for a fast reallocation of resources, it proved far too costly in the short and medium term to be of interest to any other post-communist country.[185] At the other end of the spectrum is a gradual strategy. This has been pursued successfully by China since the late 1970s. However, in conditions of a total (economic, institutional and political) crisis, virtually the only choice open to the former Soviet Union and central Europe was a form of rapid adjustment. A *strong* variant of it (variant S below) was adopted by some countries, e.g. Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia, and a *weak* variant (variant W) by most other countries, particularly Russia and Ukraine. The differences between the two variants have been substantial, especially during the first few years of transition.

(a) Rapid adjustment: the stronger variant (variant S, most central European and Baltic countries)

One way of defining this variant was formulated by V. Klaus, the then Prime Minister of the Czech Republic, in the shape of 10 commandments.[186] They are as follows:

(i) Reforms in post-communist countries are the outcome of a complex social and political process, and cannot therefore be pre-planned or socially engineered by any one person or centre;

(ii) The role of foreign aid is marginal;

[185] J. Kornai, "Ten Years After *The Road to a Free Economy*" (the author's self-evaluation), paper presented at the World Bank's Annual Conference on Development Economics (Washington, D.C.), 18-20 April 2000, suggests that, in the early 1990s, "many participants in the post-socialist transformation suffered from an obsession with speed", and notes that "excessive emphasis on speed leads to impatience, aggressiveness and arrogance". He uses mass-privatization programmes in the Czech Republic and Russia as examples. However, the actual policies of many reformers were often much less radical than their rhetoric. This applies also to possibly the most influential reformers of the region: Balcerowicz, Gaidar and Klaus.

[186] V. Klaus, *The Ten Commandments of Systemic Reform*, Group of Thirty Occasional Paper, No. 43 (Washington, D.C.), 1993.

(iii) An economic shock, meaning a large fall in output, is inevitable;

(iv) Dramatic actions are required to impose a restrictive macroeconomic policy, liberalize prices and foreign trade and establish a process for privatization;

(v) A restrictive macroeconomic policy must be sustained;

(vi) The price shock resulting from price liberalization must be vigorously defended and must survive;

(vii) Economic restructuring requires comprehensive privatization;

(viii) Transformation costs must be widely shared;

(ix) Successful transformation requires the opening of markets to foreign goods and the free flow of peoples and ideas;

(x) Successful transformation requires successful politicians.

These commandments well encapsulate the views of a substantial body of reformers – both decision-makers and their advisers, in the early 1990s. However, actual developments provide the basis for significant modifications to this original formulation.

The choice of reforms, while certainly the outcome of a political process, has been limited by the overriding goal of imitating or even replicating the well-known solutions, in terms of both institutions and policies, of market-based capitalist economies. Moreover, reformers can have, should have and usually do have specific reform blueprints for achieving this goal. These blueprints have been useful even if the timetable, the sequencing and the methods of their implementation may have changed under the weight of political pressures.

With respect to foreign aid, the main reason for its marginal role for most countries has been the size of their economies. Using the 1998 PPP exchange rates, the combined GDP of the former Soviet Union and central Europe, on the eve of the reforms, was some $3,500 billion (the data in table 3.2.1 imply that it was $2,300 billion in 1998). The investment needed to restructure economies of that size, so as to regain the pre-reform level of GDP, is probably of the same order of magnitude. The combined resources of the IMF, the World Bank and the EBRD available to transition countries, by comparison, are small and, in any case, can be provided only on a commercial basis, and therefore are subject to performance conditions which economies in transition cannot easily meet. Only transfers to the former GDR have been really large in relation to its GDP and, indeed, have been several times larger than the total aid extended to all other transition countries. However, the impact on economic recovery has been moderate. Moreover, in the case of Russia, it was not an extension of external financing but its discontinuation, following the crisis of August 1998, that forced the adjustments in domestic policies which accelerated the reform process. Still, there are a few countries, e.g. Bulgaria and Poland, in which foreign aid, especially in the form of partial debt cancellations, has been important and helpful.

Commandments four to seven formed the core of reform efforts. Short-term gains (if any) arising from conducting a loose macroeconomic policy turned out to be small, while medium and long-term gains from establishing a stable macroeconomic environment are commonly thought to be large. Initially, the main objective of a stabilization policy may, and possibly should, be moderate inflation rather than stable prices. But once a country has moved from transformation to recovery and sustainable growth, a high quality macroeconomic stability becomes essential. This requirement applies, above all, to the candidate members of the European Union. A similar caveat can be made with respect to Klaus's seventh commandment, concerning the need for rapid privatization. In Poland, state-driven privatization has been slow. But a rapid autonomous growth of the original private sector has ensured that the total private sector accounted, in 1999, for about 65 per cent of GDP. Privatization of state owned enterprises (SOEs), while usually helpful, may thus not be as necessary as some reformers initially believed. The quality of privatization has proved to be very important, and there is a trade-off between speed and quality.

The tenth commandment has also proved to be an overstatement. Successful politicians can be helpful, but not necessary for a successful transformation. Reform must be legitimized through a democratic political process. This is vital. But the initial legitimization was provided by the collapse of the communist system. This collapse offered a window of opportunity, the Balcerowicz period of "extraordinary politics", to initiate the kind of reforms which could not be easily reversed under the more hostile political conditions which prevailed later on. The socially costly phase of transition took place at a time when democratic institutions were in their early infancy. Consequently there were (and in most cases, still are) typically too many small parties with ill-defined policies, the division of power between the main central institutions has often been unclear and many politicians lack experience of efficient communication with the electorate. Such circumstances can produce confusion and political instability, which hinder the process of economic reform and pose a continual threat to democratic politics. The result has been frequent changes of government and, in many cases, legislation slowdowns. However, such frequent changes have also provided an opportunity to employ, in the cause of reform, the combined political capital of a large pool of politicians during the socially most costly phase of transformation.

From today's perspective, it is also noticeable that Klaus's formulation understates the importance of the

task of creating a new legal and institutional environment and a new culture of habits and attitudes, which a modern market economy requires. This task has been particularly important in the countries of the former Soviet Union.

The more successful transitions of the central European and Baltic countries are associated with the S-variant of the rapid adjustment model. One of the most successful countries has been Poland, where real GDP in 1999 was one quarter higher than at the beginning of the transition in 1989 – by far the best result in the region. After a contraction of about 15 per cent in 1990 and 1991, the economy has grown at an average rate of 5 per cent per annum. Estonia, Hungary Latvia, Lithuania, Slovakia and Slovenia have also experienced rapid growth in the last few years.

The Polish model of transition consisted of five main elements:[187]

- complete liberalization of *de novo* private sector entry into almost all areas of economic activity (January 1989 and January 1990);
- adoption of the pre-1939 commercial code (1982) and abolition of communist party organizations in SOEs, which gave real power to the workers' councils that had formally exercised it since 1981 (end 1989);
- very rapid price liberalization (during 1989 the share of freely determined prices rose from 25 to 90 per cent);
- introduction of hard budget constraints on SOEs and a sharp reduction of inflation to a moderate level, through fiscal, monetary and wages polices (January 1990), followed by gradual disinflation;
- current account convertibility of the currency and almost complete foreign trade liberalization (January 1990).

The Polish programme was gradual in many important respects: it took 10 years to reduce inflation to below 1 per cent a month, mass privatization was limited mainly to small enterprises, social transfers have been large (pensions increased substantially in relation to wages) and budget deficits remained significant throughout the 1990s. The results of the programme were, on the positive side: the fast introduction of market prices based on relative scarcity and world prices for traded goods; a financial squeeze on SOEs, which forced them to rapidly release excess labour *and* physical capital (known as *asset privatization*); the maintenance of a minimum tolerable level of effective corporate governance in SOEs (due in part to the workers' councils); and the very rapid development of the *de novo* private sector. On the negative side, the restructuring of public services and public finances has been inadequate, limiting the growth of domestic savings and investments.

The Hungarian model has been similar. The same five main elements of reform were introduced as enacted and implemented in Poland, although their implementation was somewhat more gradual and workers councils had little importance. However, the bankruptcy law that was enacted and implemented has been possibly the most radical in central Europe. Also the growth of the domestic *de novo* private sector tended to be in services rather than in manufacturing, where there was a fairly rapid development due to foreign direct investment (FDI). A larger external debt burden and poorer macroeconomic policies meant that stabilization of the GDP contraction took longer than in Poland and – more significantly – the start of rapid growth was delayed by five years (until 1997).

Slovenia was also somewhat of an exception on two counts: earlier, pre-transition reforms had been more substantial than elsewhere in central Europe and the initial crisis was much more limited. Hence a more gradual transformation was feasible and, indeed, adopted in the early 1990s.

Following the adoption of such programmes, the experience of successful transitions indicate that growth can resume quickly and can proceed at a rapid pace. This growth has been driven almost entirely by *de novo* private sector development, rather than through the restructuring of SOEs, privatized or otherwise.[188] *De novo* private activity was at first predominantly domestic and concentrated in services. But as time went on, in all successful countries it came to involve significant foreign direct investment and to expand into manufacturing industry.

The experience of the central European and Baltic countries demonstrates the following: the usefulness of pre-existing rules and institutions (workers' councils, a commercial code, a legal system); the importance of macroeconomic stabilization and the accompanying imposition of hard budget constraints; and the importance of the liberalization of prices, trade and entry for growth of new private enterprise.

(b) Rapid adjustment: the weaker variant (variant W, most CIS countries)

[187] This description of the programme and the model follows that given by M. Dabrowski, S. Gomulka and J. Rostowski in "Whence reform? A critique of the Stiglitz perspective", London School of Economics and the Central European University, 2000, mimeo. More details of the model may be found in S. Gomulka, "The Polish model of transformation and growth", *The Economics of Transition*, Vol. 6, No. 1, March 1998, pp. 163-171, and in M. Dabrowski, "Ten years of the Polish economic transition 1989-1999", paper presented at the Fifth Dubrovnik Conference on Transition Economies: *Ten Years of Transition: What Have We Learned and What Lies Ahead* (Dubrovnik), 23-25 June 1999.

[188] J. Rostowski, *Private Sector Development, Structural Changes and Macroeconomic Stabilization: The Case of Poland 1998-93*, London School of Economics, Centre for Economic Performance, Discussion Paper, No. 159, 1993, and S. Gomulka, op. cit.

In Russia, the 1992 attempt at sharp budget hardening, disinflation and full liberalization of prices, trade and entry, the Gaidar plan, failed. This meant that enterprises were subsequently under less pressure to divest physical assets and to shed labour they did not need, thus effectively denying *de novo* private firms the resources they needed for their development. The failure to liberalize thoroughly kept the set-up costs for new firms high. For several years large subsidized credits and entry barriers undermined the credibility of the strategy, inducing capital flight, creating opportunities for tax avoidance and criminal asset stripping, as well as slowing down the restructuring of old firms. The Russian reform was nevertheless radical, since by and large prices and wages were liberalized quickly. As a result, markets started to develop, taking over from the planners the informational and coordination roles. A large-scale privatization programme was also initiated early on and implemented quickly. This embarking on privatization before full liberalization (involving not just product prices, exchange rates and interest rates but also trade and entry terms), and before the hardening of budget constraints for enterprises and disinflation, was the key characteristic of the reform strategy adopted by Russia and most other CIS countries in the first few years of transition. However, these differences between variants S and W have narrowed in the late 1990s.

(ii) Was the output collapse inevitable?

The phenomenon of large falls in output in the economies of central Europe and the former Soviet Union during their systemic transformation in the 1990s is one of the most researched – yet one of the most controversial. Kornai proposed the term "transformational recession" to indicate that these falls were directly related to the change of the economic system rather than to transition policies. However, these falls occurred against a background of rapid growth in China and Viet Nam, which had also been introducing fundamental changes in their economic systems. This may indicate that the falls were related not merely to the systemic transformation as such, but also to its speed. Stiglitz, among others, argues that the speed of transition was a choice variable, and that choosing high speed was a major error.[189] In a recent survey of evidence and interpretations of the recession, the present author suggested that, unlike in China and Viet Nam, in the countries of central Europe and the former Soviet Union (and Mongolia) the rapid speed was forced principally by the initial conditions of their deep and all-embracing (economic, institutional and political) crisis.[190] In the survey, I identified four classes of specific causes of output falls: 1) massive and rapid changes in relative prices in conditions of limited resource mobility; 2) the elimination of excessive real aggregate demand to establish buyers' markets; 3) the collapse of captive markets within the former CMEA area; and 4) the collapse of the arms industry and of state financed investments in housing, energy, agriculture and the infrastructure. Relative prices changed mainly as a result of rapid price and trade liberalization, sharp increases in interest rates, large up-front devaluations and considerable harmonizations of turnover and border tax rates.

A sharp price liberalization caused large supply-side and demand-side shocks that reduced outputs and increased prices. However, the high speed of price liberalization was in part a consequence of the collapse of central planning institutions, since this collapse created the need to establish immediately a market-based coordination mechanism, of which market-clearing (free) prices were an essential part. A fairly rapid liberalization of prices, trade and entry was also needed to enhance competition and initiate structural changes

In the initial period of transition, economic developments in the former Soviet Union and central Europe reflected not so much the quality of current reforms, but the pre-reform crisis conditions, which had led to the collapse of the Soviet style economic, military and political system. In Russia, because of this crisis, industrial output had already started to fall sharply in 1991, still under the old system. Whether reform had taken place or not, this fall would have presumably continued as the system unwound, as the experience of slow and/or late reformers would indicate, e.g. Belarus, Bulgaria and Romania. The collapse of the Warsaw Pact (and the associated contraction of the defence industry), the CMEA (and the associated contraction of trade) and the USSR itself (and the associated disruption of intra-Soviet production links), were all the largely inevitable consequences of earlier events in Russia and elsewhere. The reduction in the output of the defence and defence-related industries alone, according to one knowledgeable source, accounts for 60 per cent of the fall in industrial production in Russia.[191]

In his forceful challenge to the merits of fast liberalization and stabilization, Stiglitz accepts that, according to economic theory, reducing price distortions through price and trade liberalization and price stabilization, should, in addition to improving incentives through privatization, "have moved countries closer to their production possibilities curve".[192] The problem for

[189] J. Stiglitz, "Whither reform", paper presented at the World Bank Annual Bank Conference in Development Economics (Washington, D.C.), 1999, and "Quis Custodiet Ipsos Custodies?", paper presented at the World Bank Annual Bank Conference on Development Economics – Europe (Paris), 1999.

[190] S. Gomulka, "Output: causes of the decline and the recovery", in P. Boone, S. Gomulka and R. Layard (eds.), *Emerging from Communism: Lessons from Russia, China and Eastern Europe* (Cambridge, MA, MIT Press, 1998).

[191] Y. Yassin, "Defeat or retreat? Russia's reforms and the financial crisis" (Moscow), 1999, mimeo.

[192] J. Stiglitz, op. cit.

him is that "output should have soared – instead it plummeted". Much of his challenge to the conventional theory is motivated by this apparent contradiction. However, Stiglitz ignores the arguments which associate output falls in the initial phase of transition mainly with unusually large inherited (structural and price) distortions and with the institutional crises which forced the tempo of price liberalization. Despite wide differences in reform policies, the cumulative falls in industrial output, at 40-60 per cent, were not just large but also similar between countries. He also ignores the fact that, as Aslund, Boone and Johnson first showed,[193] the speed of macroeconomic stabilization had a significant effect on the time profile of decline, but had little impact upon the magnitude of the cumulative fall of output. These falls tended to be larger in the countries that were slow in bringing inflation to moderate levels, say to below 40 per cent per annum. The evidence is too weak to suggest the presence of causality from higher inflation to larger cumulative output falls. It is probably more likely that the countries (mainly within the former Soviet Union) which were subjected to larger supply-side and demand-side shocks also experienced larger output falls and, simultaneously, higher inflation. (I shall return to this point in section 3.3(v).) Nevertheless, apart from increasing inflation, the main effect of a loose macroeconomic policy would appear to have been, in most cases, to reduce the rate of fall and, therefore, to extend the length of the transformational recession.[194] However, as the EBRD, *Transition Reports 1995-1999* note, the evidence goes to support the proposition that, in the countries which liberalized and stabilized to a greater extent, output not only stopped falling earlier, but also started to recover faster. (I shall return to this last point in section 3.3.)

The medium-term purpose of the reforms is to restructure transition economies in favour of activities producing more value added per unit of primary inputs (of labour and capital). If restructuring needs had been small, real wages highly flexible and labour and capital resources easily moveable, then large output falls would have been unnecessary to effect such a restructuring. However, restructuring needs were, in fact, exceptionally large and the mobility of resources was quite limited. In such circumstances unemployment, although it does involve short-term costs, performs a positive signalling role, by making it clear to people that they have to either change skills and move to higher productivity work or accept lower real incomes. Therefore, the welfare cost associated with a temporary rise in unemployment can be thought of as a form of investment needed to achieve a permanent welfare gain from a better allocation of labour and other resources.

(iii) Money has been the key nominal anchor

In most countries of central and eastern Europe it was assumed that the stabilization of liberalized prices must be based on the standard International Monetary Fund approach, with an important role as nominal anchors assigned to an incomes policy and – when feasible – a fixed exchange rate, in addition to restrictive fiscal and monetary policies. In the event, however, the supply of credit to governments and enterprises proved by far the dominant nominal anchor, with the exchange rate and the incomes policy playing only supportive roles.

Two related broad conclusions can be drawn from the evidence regarding the experience of disinflation in transition economies. One is that fiscal fundamentals, that is, the size of the budget deficit of general government and the way it was financed, have been the key to disinflation (tables 3.2.2 and 3.2.3). The other is that the policy of a fixed nominal exchange rate was helpful but not essential, and that, in any case, its survival was strictly conditional on a sound fiscal policy.[195] Also, "the transition record suggests that innovative exchange rate arrangements can provide only a brief interval during which sound fiscal discipline needs to be put in place for controlling inflation".[196] With respect to the exchange rate, low levels of international reserves and the poor credibility of macroeconomic policies just before the start of transition, forced large up-front devaluations in all countries except Hungary. The result was that, initially, world prices offered little discipline for domestic prices. A restrictive incomes policy was intended to achieve a targeted inflation rate with other policies being less restrictive and, hence, a somewhat smaller recession. However, given the large changes and uncertainties, it has proved difficult to coordinate incomes policy with the main (fiscal and monetary) macroeconomic policies. In Poland in 1990 and Czechoslovakia in 1991, for instance, those main policies were initially so restrictive that in most enterprises incomes policies were not binding. In the former Soviet Union the authorities took the view that a restrictive incomes policy could not be implemented for political reasons. In the CIS countries the politically dependent central banks, in their credit policy for enterprises, were initially concerned above all with the level of economic activity, typically the chief domain of governments. As noted earlier, in the first few years of transition, the CIS governments ran large budget deficits

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[193] A. Aslund, P. Boone and S. Johnson, "How to stabilize: lessons from post-communist countries", *Brookings Papers on Economic Activity*, 81(1) (Washington, D.C.), 1996, pp. 217-315.

[194] On this point, see also EBRD, *Transition Report 1999* (London), p. 64.

[195] D. Begg, "Disinflation in central and eastern Europe", and S. Gomulka, "Comment on Begg", in C. Cottarelli and G. Szepary (eds.), *Moderate Inflation: The Experience of Transition Economies*, IMF and National Bank of Hungary (Washington, D.C.), 1998.

[196] P. Desai, "Macroeconomic fragility and exchange rate vulnerability: a cautionary record of transition economies", *Journal of Comparative Economics,* Vol. 26, No. 4, 1998, pp. 621-641.

which were monetized (table 3.2.3). The consequence was wage-price inflationary spirals and (near) hyperinflations.

In the initial years some central banks made successful use of the instrument of credit limits. Deploying this instrument means that real interest rates need not be high – although they should not have been as negative as they were in most of the former Soviet Union. These rates may have to be higher in the intermediate stages of transition when credit limits are lifted and the real exchange rate has had the time to appreciate. During that stage high interest rates became the key policy instrument for protecting bank savings and restraining wage inflation. However, in the advanced stage of transition, higher credibility and capital account liberalization have resulted in increased international capital mobility. This in turn forces some convergence of high domestic interest rates to low world interest rates.

TABLE 3.2.2

Key macroeconomic indicators for the central European and Baltic economies, 1991-1998

	1991	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*
GDP growth *(per cent)*								
GDP-weighted averages	-10.7	-4.1	-0.3	3.7	5.6	3.9	2.7	1.8
GDP-weighted absolute mean deviations	2.9	5.0	3.2	1.6	1.9	2.1	4.6	3.9
Inflation, CPI *(per cent)*								
GDP-weighted averages	109.9	183	115	29.9	24.2	21.3	46.1	12.0
GDP-weighted absolute mean deviations	77.0	208	131	14.0	11.7	11.4	54.1	8.3
General government budget balance *(per cent of GDP)*								
GDP-weighted averages	-3.2	-4.8	-3.4	-3.2	-3.0	-3.2	-3.1	-3.1
GDP-weighted absolute mean deviations	3.8	2.6	2.9	1.9	1.3	1.3	0.9	1.1
General government expenditures *(per cent of GDP)*								
GDP-weighted averages	..	47.3	45.7	44.7	43.8	43.4	43.1	43.1
GDP-weighted absolute mean deviations	..	4.9	6.5	5.2	4.5	4.7	5.2	3.0
Gross reserves *(months of current account expenditures)*								
GDP-weighted averages	1.9	2.1	2.5	3.0	4.4	3.9	4.1	4.5
GDP-weighted absolute mean deviations	0.9	1.0	0.8	0.9	2.0	1.7	1.4	1.8
Broad money *(per cent of GDP)*								
GDP-weighted averages	..	47.2	44.7	44.6	44.8	45.7	44.5	43.8
GDP-weighted absolute mean deviations	..	15.5	16.8	16.6	15.2	14.5	12.4	11.7
Lending rate *(per cent)*								
GDP-weighted averages	..	141	45.9	35.7	27.7	45.9	25.4	24.4
GDP-weighted absolute mean deviations	..	196	26.3	16.4	9.3	42.2	9.4	10.0

Source: Author's calculations based on official data, as reported in EBRD, *Transition Report 1999* (London). The GDP weights are from table 3.2.1, using the PPP GDP estimates.

Note: Inflation is the within-year change (December to December). General government: central, local and extra-budgetary funds. Broad money includes cash in circulation, current deposits and time deposits, in both domestic and foreign currencies.

TABLE 3.2.3

Key macroeconomic indicators for CIS economies, 1991-1998

	1991	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*
GDP growth *(per cent)*								
GDP-weighted averages	-6.2	-14.3	-9.6	-13.7	-5.3	-3.3	1.0	-2.9
GDP-weighted absolute mean deviations	2.7	2.1	2.0	2.6	2.5	2.1	1.7	2.4
Inflation, CPI *(per cent)*								
GDP-weighted averages	155	2 391	2 431	514	151	30.2	15.1	70.6
GDP-weighted absolute mean deviations	10.5	303	2 435	471	51	13.2	8.1	29.4
General government budget balance *(per cent of GDP,*								
GDP-weighted averages	-36.5	-15.9	-10.4	-6.4	-7.6	-6.8	-5.1	-5.3
GDP-weighted absolute mean deviations	10.2	3.0	2.6	1.1	2.2	1.9	0.8	1.3
General government expenditures *(per cent of GDP)*								
GDP-weighted averages	..	64.8	45.2	44.0	35.6	37.1	38.2	35.0
GDP-weighted absolute mean deviations	..	9.1	4.0	3.5	3.3	5.2	4.4	4.0
Gross reserves *(months of current account expenditures)*								
GDP-weighted averages	..	..	..	1.6	2.6	2.5	2.6	2.0
GDP-weighted absolute mean deviations	..	..	..	0.8	0.7	1.0	1.0	0.6
Broad money *(per cent of GDP)*								
GDP-weighted averages	..	39.3	25.4	19.2	13.7	12.8	13.9	16.6
GDP-weighted absolute mean deviations	..	3.3	6.4	5.8	0.9	1.1	0.9	1.9
Lending rate *(per cent)*								
GDP-weighted averages	..	..	..	..	191	65.2	36.6	39.6
GDP-weighted absolute mean deviations	..	..	..	..	49	5.3	4.2	3.9

Source: As for table 3.2.2.

Note: As for table 3.2.2.

(iv) The exchange rate policy

The freedom to set the exchange rate was initially tightly constrained by low levels of international reserves and an urgent need to win credibility for the new policy of full current account convertibility at a uniform rate. It was desirable to have a regime of a fixed nominal exchange rate in order for the rate to serve as an anchor for domestic prices, thus reducing inflationary expectations and inflation itself. However, the countries which adopted such a regime had to strongly devalue up-front to ensure a sufficiently competitive rate, so that reserves would increase. As I have already noted, such devaluations opened up large gaps between domestic and foreign prices, thereby undermining the role of the exchange rate as an anchor. In Russia (and many other CIS countries) international reserves were too low and monetary and fiscal policies too lax to contemplate nominal exchange rate pegging. A floating exchange rate regime was therefore adopted. However, the need to build up reserves meant that Russia and other floaters could not adopt a pure float. Once the reserves become sufficiently large as a result of interventions in the exchange market, the case for a pure float is stronger. A broad generalization would be that, at the (early) stabilization stage of transition, a concern with disinflation favoured nominal exchange rate pegging, while at the (later) advanced stage, when inflation was already low, the need to limit the destabilizing effects of capital inflows favoured a more flexible exchange rate regime, including a pure float as an extreme option. Between these two stages, both the inflation rate and the level of reserves would be moderate, and the concern to remain competitive favoured the adoption of an exchange rate regime that combined some flexibility in nominal terms with some stability in real terms. The regime chosen for this intermediate stage was typically a crawling band, with the pre-announced rate of crawl linked to anticipated inflation. This rate would therefore decline as disinflation progressed, while the band would be narrow initially and widen over time to a maximum of the ERM-2 size of ±15 per cent. To limit the domestic cost of any external shock, it was also desirable to peg to a basket of currencies, reflecting the composition of trade flows, rather than to any single currency.

Exchange rate movements in all transition economies, with the notable exception of Hungary, have followed a similar path, with a sharp depreciation at the start of transition followed by gradual real appreciation. Such a path is hardly surprising given the initial conditions: low levels of international reserves, large risks associated with transition, inexperienced policy makers, no record of convertibility and typically poor credibility of policies.[197]

Several countries adopted a currency board, under which nominal pegging is combined with full backing of the base money by international reserves. The key benefit of such an arrangement is a sizeable instant gain in credibility. This lowers immediately inflationary expectations, which in turn reduce market interest rates, both nominal and real. As the experience of the Baltic states in the early 1990s and Bulgaria in 1997 showed, falls in interest rates could be large and rapid. In the short term, lower interest rates reduce the cost of servicing debt, both private and public, which in turn reduces both the stock of under-performing assets of the banking sector and the budget deficit of the government, thus further improving credibility. A currency board also helps to instil confidence among investors and hence supports recovery of the enterprise sector.

However, the strait-jacket of the currency board deprives the macroeconomic framework of any flexibility with respect to the exchange rate. This, and indeed any fixed nominal exchange rate regime, may mislead the private sector into believing that the exchange rate risk is completely absent. The result is an in-built tendency to contract a large foreign debt, which was the case not only in South-East Asia but also in the Czech Republic. This tendency is particularly strong in countries with weak financial institutions, to which category most transition countries still belong.[198] Such a debt, whether public or private, in turn produces a risk of an attack on the currency, which, if successful, leads to sharp devaluation and stagflation.

3.3 A detailed discussion of specific issues

(i) The macroeconomic framework: what progress?

To be conducive to investment and growth, the macroeconomic environment has to meet several criteria. I shall first articulate these criteria and then use them for an evaluation of the progress which the 25 transition countries have made during the 1990s.

The criteria that, I suggest, would be desirable to meet are as follows:

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[197] Economic and other factors which underlie exchange rate movements in transition economies are discussed by L. Halpern and C. Wyplosz, "Equilibrium real exchange rates in transition economies", *IMF Staff Papers*, Vol. 44, No. 4 (Washington, D.C.), 1997, pp. 430-460 and by the Symposium on Exchange Rates, *Journal of Comparative Economics*, Vol. 26, No. 4, December 1998. The main reason for Hungary being the exception was, probably, the country's high standing among foreign investors at the start of transition. Specific issues with respect to the exchange rate policy of the transition economies which are candidates for membership of the European Monetary Union (EMU) are discussed among others, in G. Kopits, *Implications of EMU for Exchange Rate Policy In Central and Eastern Europe*, IMF Working Paper WP/99/9 (Washington, D.C.), January 1999.

[198] S. Fries, M. Raiser and N. Stern, "Stress test for reforms: transition and east Asia 'contagion'", *The Economics of Transition*, Vol. 7, No. 2, July 1999, pp. 535-567, find that the transition countries with large public or private sector imbalances and low reserve cover of short-term debt are more vulnerable to contagion and that these weak fundamentals have their origin in inadequate structural and institutional reforms. A good comparative discussion of risk indicators for the banking sector in six transition economies of central and eastern Europe is provided in S. Kawalec, "Banking sector systemic risk in selected European countries", CASE Report No. 23 (Warsaw), 1999.

(i) The inflation rate to be in the moderate range of 10 to 40 per cent, with a good prospect of it falling below 10 per cent and remaining in the 0 to 10 per cent range;

(ii) The general government budget deficit to be reduced from the initial 5 to 30 per cent of GDP for most countries to a level below 3 per cent of GDP, with a high premium given to a policy of a budget surplus;

(iii) The public debt to be stable at a level significantly below 60 per cent of GDP;

(iv) General government expenditure to be reduced from its pre-transition level of some 50 to 60 per cent of GDP to a level in the range of 30 to 40 per cent of GDP;

(v) Official reserves of foreign exchange to equal at least four months of imports of goods and services, exceed total (public and private) short-term foreign debt, and be equal to at least one third of public foreign debt;

(vi) Direct taxes (especially profit taxes) to be low, together with social insurance contributions providing revenues of less than, say, 20 per cent of GDP;

(vii) The monetization of the economy to be substantial, equal at least to 30 per cent of GDP;

(viii) The lending rate to be below 20 per cent in nominal terms and below 10 per cent in real terms.

The first three criteria are those of the Maastricht treaty. They are not independent. If D is public debt, Y is GDP, P is the price level and)D is the budget deficit, fiscal sustainability requires that the ratio D/PY be constant, which implies that:

$$\frac{\Delta D}{PY} = (\boldsymbol{p} + g)\frac{D}{PY} \qquad \ldots (1)$$

where B is the rate of inflation and g is the growth rate of GDP. The left hand side of (1) is the budget deficit as a proportion of GDP, and D/PY on the right hand side is the targeted debt-to-GDP ratio. For most of the EU member countries, the rate g is expected to be low, say 3 per cent. The maximum budget deficit of 3 per cent is thus consistent with the maximum debt of 60 per cent only if the inflation rate is maintained, in this case, at 2 per cent. Transition economies are expected to grow at a rate (significantly) higher than 3 per cent. Those countries which intend to join the EMU will need to meet the Maastricht criteria on inflation and the budget deficit, hence equation (1) implies that they will have to keep public debt at a level (significantly) lower than 60 per cent of their GDP.[199] Criteria (ii), (iv) and (vi) are also related. Their common motivation is to increase national savings and improve the incentives for work and investment. Criterion (v) is intended to reduce the exchange rate risk and criterion (vii) serves to indicate that the banking sector has developed sufficiently to intermediate effectively between savers (mainly households) and investors (mainly enterprises).

The differences between the two groups of countries can be noted in tables 3.2.2 and 3.2.3. Compared with the central European and Baltic countries, in the CIS countries both inflation and budget deficits have been much higher, but public expenditures have declined more sharply. Gross reserves have increased to adequate levels in the central European countries, but still remain very low in the CIS region. The ratios of broad money to nominal GDP have been remarkably stable, at moderately high levels, in the central European and Baltic countries, but they declined sharply, as one would expect, during the high inflation period in the CIS region where they now stand at very low levels. Despite these significant differences, a considerable convergence has taken place in macroeconomic conditions between and within the two groups, together with a sharp improvement over time in both.

In terms of the eight macroeconomic criteria, the central European and Baltic countries are close to meeting the criteria with respect to the variables in table 3.2.2. The data on public debt and taxes also indicate compliance with the criteria for these two additional indicators. For the CIS region, the macroeconomic balance is still fragile, and the macroeconomic environment, while no longer as hostile to growth as it was in the early 1990s, needs to be significantly improved to become growth-friendly. The financial crisis of August 1998 revealed the extent of Russia's macroeconomic imbalance. However, following this crisis, policy adjustments in Russia and elsewhere in the CIS have contained its destabilizing effects, restored equilibrium and, consequently, reduced further the gap in performance between this group and the central European and Baltic countries.

(ii) What distinguishes the more successful from the less successful countries?

I propose to measure the success of reforms in the transition countries by their ability to recreate the (institutional, legal and economic) conditions for rapid and sustainable growth. This ability is indicated by the increase in output since the start of recovery. It is this yardstick which differentiates strongly the Baltic states from, for example, Russia and Ukraine within the former Soviet Union, and much of central Europe from much of the former Soviet Union. It is natural to ask about the factors underlying these differences: are they initial

[199] Fiscal sustainability in transition economies has been discussed recently by several authors, e.g. W. Buiter, *Aspects of Fiscal Policy in Some Transition Economies under Fund-Supported Programs*, IMF Working Paper WP/97/31 (Washington, D.C.), April 1997.

TABLE 3.3.1

GDP growth and reforms in the central European, Baltic and CIS economies
(Per cent, index)

	Growth (per cent)		*Reforms (index)*	
	1998 from lowest level	*1989-1998*	*Liberalization*	*Stabilization*
Albania	43.1	-14	3	5
Bulgaria	3.5	-34	3	5
Croatia	20.6	-22	3	5
Czech Republic	12.7	-5	5	5
Estonia	25.7	-24	5	5
The former Yugoslav Republic of Macedonia	5.3	-28	3	3
Hungary	16.2	-5	5	5
Latvia	14.0	-41	3	5
Lithuania	19.8	-35	3	5
Poland	42.5	17	5	5
Romania	1.8	-24	3	5
Slovakia	32.9	–	5	5
Slovenia	25.7	4	5	5
CIS				
Armenia	31.8	-59	3	3
Azerbaijan	17.9	-56	1	3
Belarus	22.6	-22	1	3
Georgia	29.2	-67	3	3
Kazakhstan	–	-39	3	3
Kyrgyzstan	20.4	-40	3	5
Republic of Moldova	–	-68	3	5
Russian Federation	–	-45	3	3
Tajikistan	5.8	-58	1	3
Turkmenistan	4.2	-56	1	3
Ukraine	–	-63	1	3
Uzbekistan	6.1	-10	1	3

Source: EBRD, *Transition Report 1999* (London).

Note: Early liberalizers are given grade 5. They are defined as countries that had achieved "complete price liberalization, full current account convertability and almost complete small-scale privatization". Late liberalizers achieved these thresholds after 1993. They are given grade 3. The remaining countries are given grade 1. With respect to stabilization, countries are divided into early stabilizers, those which stabilized before the end of 1993, and late stabilizers (all other countries). The grades given are, respectively, 5 and 3.

conditions, the state of institutions or the political environment?

The cumulative changes in output between 1989 and 1998, and between its lowest point and its level in 1998, are shown in table 3.3.1, where the countries are also graded according to their commitment to liberalization and stabilization. Several countries achieved significant recoveries in GDP growth, but some of them are not reform related. Internal conflicts led to very deep recessions in Albania, Armenia, Azerbaijan and Georgia; subsequent improvements in political stability would have contributed much to the recovery of their economies. There are also two countries, Belarus and Kyrgyzstan, where substantial recoveries may have been artificial, as they reflect in part the postponement of the needed structural changes.[200]

There are a substantial number of empirical studies which attempt to explain the wide variation in the rate and length of recovery. These studies fall into two broad groups, one based on macroeconomic data and the other on enterprise data. One of the latest comprehensive studies in the first group, using a general-to-specific modelling approach, finds some evidence in support of "the pre-eminence of structural reforms over both initial conditions and macroeconomic variables in explaining cross-country differences in performance and the timing of the recovery".[201] In particular, more liberalized economies grow faster. However, as the periods of recovery have been short for most countries, econometric results are not yet stable. The wide differences in performance within countries suggest that initial conditions might be more potent than indicated by aggregate data. Indeed, another recent empirical study, using a somewhat different statistical method, finds that growth performance during the 1990s was "substantially determined by initial conditions, both directly and indirectly through their impact on structural reform".[202]

The periods of positive growth have been short for most countries, but especially for the three main CIS countries – Kazakhstan, Russia and Ukraine, and for Bulgaria and Romania in south-east Europe. These five countries (together with the Republic of Moldova) are clearly the least successful of all the 25 transition countries in table 3.3.1. Recovery in both the Czech Republic (1997-1999) and Hungary (1995-1996) has suffered from unexpected macroeconomic instabilities. The long pause in recovery in the Czech Republic has prompted a reappraisal of the virtues of rapid voucher-type privatization. It is this negative experience of the Czech Republic and the much better growth performance of Poland, Estonia and, more recently, Hungary, which has led to the "new wisdom", namely that the success of transition depends above all on a rapid creation of conditions – institutional, legal, microeconomic and macroeconomic – which are conducive to the development and growth of a new private sector (including FDI). From this perspective, it is clear that

[200] According to the Belarus Minister of Economy, economic growth "during the second half of the 1990s was substantially initiated by additional loading of old manufacturing facilities and was boosted … by emission credits [which] allowed Belarus to preserve her manufacturing potentials and to solve some important social problems", V. Shimov, report presented at the UN/ECE Spring Seminar (Geneva), 2 May 2000.

[201] A. Berg, E. Borensztein, R. Sahay and J. Zettelmyer, *The Evolution of Output in Transition Economies: Explaining the Differences*, IMF Working Paper WP/99/73 (Washington, D.C.), May 1999.

[202] E. Falcetti, M. Raiser and P. Sanfey, "Defying the odds: initial conditions, reforms and growth in the first decade of transition", London School of Economics and EBRD (London), May 2000, mimeo.

with the exception of some authors, notably Kornai,[203] the early conventional view overestimated the positive impact on performance of a fast privatization of SOEs and, by the same token, failed to appreciate sufficiently the key role that a completely new private sector would play in the recovery and growth.

Given the central role of the new private sector in recovery and post-transition growth, it is worth noting the presence of wide international differences in the domestic/foreign composition of that sector, with Hungary and Poland at the extremes and Estonia somewhere in between. In these three countries, strong liberalization policies with respect to prices, trade and entry were adopted early, and in conjunction with a policy of harder budget constraints and increased competitive pressures on SOEs. Poland was also helped by the presence of a sizeable private sector outside agriculture at the beginning of transition.

(iii) How far have weak or missing institutions hampered effectual policy-making?

In the first decade of the transformation, the institutional deficiency was severe, and this added an additional dimension of difficulty to policy-making. Macroeconomic management was particularly difficult in the new countries of the former Soviet Union, which initially lacked their own currencies and central banks and where international reserves were almost non-existent. With the exceptions of Hungary and Slovenia, the introduction of personal taxes and the replacement of turnover taxes by a proper VAT could not take place at the start of the transition. The capital market was initially almost non-existent and its development has been slow. The result of these two types of deficiency was that budget deficits were larger and their financing was to a greater extent achieved by outright monetization than would otherwise have been the case. Large or hyperinflations wiped out most bank savings in all but a few transition countries, thus limiting the role of the banking sector in economic restructuring. Politically independent bank supervision did not exist under the old system, and its necessarily gradual establishment during the transition meant that in many countries it was too weak to prevent bank failures. High rates of inflation and poor banking practice must have been major factors underlying low bank savings, the flight from domestic money, and the use of parallel currencies (especially dollars and deutsche marks).

Given these extreme initial circumstances, it is remarkable that it took the new countries of the former Soviet Union only some four to five years to establish the basic institutional framework needed to conduct a reasonable macroeconomic policy – by creating central banks, new currencies, bank supervision, international payments systems, new taxes and tax collection systems, stock exchanges, securities commissions, labour exchanges and new social benefit systems. The result has been a vast improvement in the macroeconomic environment of those countries in the second half of the 1990s. Nevertheless, the new central institutions still lack high quality personnel, and they have yet to establish a tradition of trust and behaviour based on transparent and stable rules, consistent with long-term public interest and market principles.

The ultimate success of transition will depend on the establishment of appropriate market institutions supporting macroeconomic stability, entrepreneurship and competition. Such institutional changes are inherently slow and depend on the political commitment to reform of governments and parliaments, and on their practical effectiveness in implementing reforms and policies. This commitment was clearly stronger and its effectiveness probably greater in the central European and Baltic countries than in the CIS. This difference reflects not only the longer and stricter socialist central planning in the CIS, but also a much stronger influence of the European Union in the central European and Baltic countries, including (in contrast to the CIS) the pull of the strategic aim of membership of the European Union.

(iv) Have policy dilemmas been intensified by weak institutions?

In several instances, weak institutions led to a renewal of macroeconomic instability or to a serious threat of such an instability. A clear case was Albania in 1996, when the rapid growth of a pyramid system led to a general crisis of confidence and almost to civil war. Another, and more important, example was the case of Bulgaria in 1997, when poor banking supervision led to a sharp growth of underperforming assets. This in turn forced interest rates to such high levels that the cost of servicing Bulgaria's public debt became unsustainable. There were two policy options for Bulgaria (and the IMF). One was to inflate away this debt by a non-equivalent currency change or by printing a great deal of money, and then introduce a stabilization programme. The other was, effectively, to abolish the central bank and introduce a currency board in its place. Such an institutional reform meant replacing domestic monetary control by nominal exchange rate targeting and depriving the government of the option of monetizing its budget deficit. The currency board option was, in fact, adopted on the assumption that the gain in credibility would be large enough to bring about sharp falls in both inflation and interest rates. This assumption was vindicated by actual developments. Currency boards had been adopted earlier by the Baltic states for similar reasons. However, the most spectacular institutional failure was in Russia. There, poor cooperation between the executive and the legislative branches of government, the weakness of the tax administration and

[203] J. Kornai, *The Road to a Free Economy* (New York and London, Norton & Co, 1990).

lax expenditure controls led to excessive short-term foreign borrowing in 1997-1998, and resulted in a financial crisis in August 1998. In Poland, during the early stage of transition the central bank operated a system of credit limits for commercial banks, a practice which was discontinued only with the development of an interbank money market. The performance of transition economies and, indirectly, the conduct of macroeconomic policies, were also influenced by weak corporate governance and uncertainties with respect to enforcement of contracts, including those concerning property rights. These factors have probably contributed to the phenomenon of capital flight from Russia and may account for the limited amount of foreign direct investment in most countries of the CIS. The recent prolonged recession in the Czech Republic (1997-1999) is also difficult to explain without reference to the quality of the corporate governance of the country's enterprises, following its coupon privatization programme. Finally, banking supervision may have been inadequate to prevent the growth of underperforming loans in many countries, including the Czech Republic and Romania. This in its turn required repeated and expensive recapitalizations of state owned banks by governments.

(v) Has too much emphasis been placed on lowering inflation – or reducing it too rapidly – at the expense of economic growth?

As I discussed elsewhere, the first IMF-supported programmes for Poland and Russia placed much emphasis on a swift disinflation.[204] But these programmes tended also to underestimate the severity of the supply and demand shocks associated with the institutional crisis and price liberalization, and did not sufficiently appreciate the fact that such shocks would at the same time sharply reduce output and be highly inflationary. For the years 1992-1998 and for all the 25 transition countries listed in tables 3.2.2 and 3.2.3, there is a fairly strong association between the fall in output and the inflation rate, as shown in the following equation (t-ratios in parentheses):

$$g^{i}_{Y,t} = 15.5 - 4.5 \log_{10}(1 + \eth^{i}_{t-1}) - 7.80 \log_{10}(1 + \eth^{i}_{t})$$

(3.6) (-4.6) (-7.9) … (2)

$N = 175$, $R^2 = 0.61$, $i = 1, 2 \ldots 25$

$$\log_{10}(1 + \eth^{i}_{t}) = 1.4 - 0.01 g^{i}_{Y,t-1} - 0.04 g^{i}_{Y,t}$$

(5.3) (-2.2) (-9.2) … (3)

$N = 200$, $R^2 = 0.53$, $i = 1, 2 \ldots 25$

In these two equations, $g_{Y,t}$ is the percentage change of GDP in year t and $_t$ is the percentage inflation rate, divided by 100, in year t. N is the number of observations and i the number of the country. For the purpose of estimation, both g_Y^i and ^{i} have been weighted by the square root of the countries' share in total GDP, expressed in terms of PPP dollars.[205] These estimates indicate that last-year's inflation reduces current growth and last-year's fall in output increases current inflation. However, the tightest association is between current output falls and current inflation. This evidence supports the view of the transformational recession as being essentially of the stagflation type, whereby both output falls and inflation increases had to a significant extent common causes.

The policy mix required to achieve disinflation under such circumstances is one of a tight fiscal policy combined with an accommodating monetary policy. The disinflation process may also have to be gradual to accommodate more easily large changes in relative prices. In practice, disinflation was swift only in Croatia. In the central European and Baltic countries – with the exception of Romania in 1993 and 1997 and Bulgaria in 1997, which experienced strong inflation reversals – the disinflation process has been more or less gradual. However, most CIS countries failed to keep their budget deficits under control and, consequently, experienced periods of very high inflation, even hyperinflation. As already noted in section 3.2, in those countries the recession has been prolonged and the recovery either has been modest or has not yet materialized. Thus, in practice, the clear failure of macroeconomic policy was limited mainly to the CIS countries in the years 1992-1994 (in Tajikistan and Turkmenistan this continued in 1995).

At the advanced stage of transition, the rate of disinflation is constrained by international capital mobility, which limits the freedom of central banks to set and maintain interest rates much above the world level. The attendant dilemmas are well known. If the exchange rate is fixed, a restrictive monetary policy induces capital inflows, as borrowers substitute foreign for domestic debt and foreign investors buy domestic assets. The sterilization of such inflows is possible but expensive, and therefore has its limits. If the exchange rate is floating, capital inflows induce an appreciation of the domestic currency. This helps to reduce inflation in the short term, but may also lead to a large current account deficit and, therefore, increases the risk of a sudden devaluation and higher inflation in the medium term. Borrowers in transition economies have little experience in estimating the exchange rate risk. Misjudgements are especially likely when expectations are being formed during prolonged periods of real effective appreciation. The appreciation trend is a feature of transition and is sustained by several

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[204] S. Gomulka, "The IMF-supported programs of Poland and Russia, 1990-1994: principles, errors and results", *Journal of Comparative Economics*, Vol. 20, No. 3, 1995, pp. 316-346.

[205] For a linear system of the form: $y_j = \; a_i x_{ij} + e_j$, the standard ordinary least squares (OLS) estimates of the parameters $a_1, a_2 \ldots a_n$ minimize $\;(y_j - \; a_i x_{ij})^2$. Weighted OLS estimates minimize $\; w_j(y_j - \; a_i x_{ij})^2$ or $\;(w_j^{½} y_j - \; a_i\, w_j^{½} x_{ij})^2$, where $\; w_j = 1$. This is equivalent to estimating a system in which the original variables are rescaled by the square roots of their respective weightings.

factors, the two crucial ones being depressed exchange rates at the starting point and rapid improvements in productivity and rates of return during the subsequent transition. Productivity improvements are particularly rapid in countries where reforms have been successful. Such countries are also credible candidates for membership of the European Union and, for that reason, attract more FDI than others, giving further support to the appreciation. Such circumstances call for an interest rate policy that is not very restrictive, and place an even bigger burden on governments to conduct a restrictive fiscal policy. However, if such a fiscal policy is not adopted, any attempt to disinflate quickly by means of highly restrictive monetary and exchange rate policies, may easily backfire, as it would cause a large current account deficit which may at some point trigger a crisis of confidence and result in stagflation. A short-term gain in the rate of disinflation is then obtained at the cost of an increased risk of macroeconomic instability. During the run up to EU membership, short-term foreign debt tends to increase rapidly. It is therefore prudent during this period to keep international reserves high and increasing, even if this concern about stability causes a certain slowing down of the rate of disinflation.[206]

(vi) What lessons can be drawn for those transition economies still struggling to achieve macroeconomic stability and economic growth?

The lessons which I propose to draw from these 10 years of transition are as follows:

(i) Most former SOEs, especially the large ones, have suffered from the British Leyland/Rover syndrome: the accumulation of structural problems of such magnitude that they are not amenable to significant "strategic" restructuring nor capable of rapid growth whatever their new ownership and regulatory framework. Given the financial, managerial and other constraints, and poor positive incentives, such enterprises – unless taken over by large foreign investors – are mainly capable of only "defensive" restructuring;

(ii) The success of transition depends above all on the rapid creation of conditions – institutional, legal, microeconomic and macroeconomic – which are conducive to the development and growth of a new private sector, domestic and/or foreign;

(iii) This development of this new sector is facilitated by increased competition through price liberalization, permitting SOEs to sell capital assets, imposing hard budget constraints on them, encouraging FDI and lowering the entry barriers to new businesses. The number of these businesses outside of agriculture should be about 0.5 million per 10 million of the population, and the small- and medium-size enterprises should eventually account for some 50 to 60 per cent of GDP;

(iv) The inflation rate need not, and initially should not, be very low, but it must not be high (not more than 40 per cent per annum), and it should be seen to be converging to the EU level;

(v) A disinflation policy should involve all the key macroeconomic components: fiscal, monetary, the exchange rate and (when applicable) wages and benefits. Given the close link between budget deficits and money growth in transition countries, a tight fiscal policy is necessary. But it may not be sufficient, and other policies should be used in supporting roles. The cost of disinflation is lower if the monetary authorities are politically independent. Although an extreme solution, currency boards can be useful;

(vi) The choice of an exchange rate regime is not very important from the point of view of an anti-inflation policy, but it helps to have, at some point, a moderately or even fully flexible regime, in order to provide the private sector with better information about the exchange rate risk and so establish a better defence against speculative capital inflows and an excessive growth of private foreign debt;

(vii) The essential institutional basis for a stable macroeconomic environment includes, apart from an independent central bank, a solid regulatory framework for financial institutions: banks, insurance and pension funds and stock exchanges;

(viii) To attract foreign direct investment and eliminate capital flight, external credibility is vital. In order to build up this credibility, the exchange rate should be competitive most of the time to ensure that international reserves are high in relation to imports and foreign debt, especially short-term debt;

(ix) Fiscal policy, in order to be consistent with the stability objective, should aim to meet the Maastricht criteria with respect to the general government budget deficit and public debt. However, if the policy is also to serve developmental objectives, it should additionally aim to keep taxes (and therefore public expenditures) low in relation to GDP and, within public expenditures, should favour spending on education and infrastructure at the expense of social transfers, defence and subsidies;

(x) The high rate of structural unemployment requires changes in the labour code to increase flexibility of labour markets, e.g. by reducing hiring and firing costs. It also requires an active role of governments in education and training.

[206] These issues are discussed comprehensively by several authors in Z. Drabek and S. Griffith-Jones (eds.), *Managing Capital Flows in Turbulent Times: The Experience of Europe's Emerging Economies in Global Perspective* (Armonk, NY, M. E. Sharpe, 1999).

These 10 lessons overlap with the following conclusions reached by Wyplosz in his own recent survey: it has paid to start early and move fast; macro-stabilization is a prerequisite for growth; the exchange rate regime is largely irrelevant for disinflation; and microeconomic foundations/structural reforms are important for both stability and growth.[207] But the additional matters that I am emphasizing are the links between policies and the growth of the new private sector, and the importance of the exchange rate policy for competitiveness, credibility and stability.

Recent comparative empirical studies of enterprise performance, in CIS countries on the one hand and in the more successful countries on the other, attempt to identify the key underlying factors. According to Johnson, McMillan and Woodruff, macroeconomic stability is not sufficient for private sector growth, and an essential institutional feature for entrepreneurship to develop is the presence of a legal system sufficiently strong to secure property rights.[208] Such a feature, however, is probably only one of several necessary conditions. After all, the legal system is the same throughout Hungary or Poland, but private sector development is still weak in the countryside and small towns, and heavily concentrated in the capitals and major cities where the supply of labour skills and infrastructure facilities is high and where there are more individuals with entrepreneurial abilities.

(vii) What are the long-term growth prospects for transition economies?

In most of these countries, the institutional reforms of the 1990s have created a microeconomic and institutional environment conducive to the effective use of their entrepreneurial capital. In such countries, the magnitude of international technology transfer can be assumed to be related positively to both capital accumulation and the development gap. This transfer may also be expected to be greater in countries that have succeeded in creating and maintaining a stable macroeconomic environment.

Elsewhere I have reported the results of an empirical test of such propositions, using the post-Second World War data for 20 countries in western Europe, Latin America and the Pacific rim.[209] These regression results are as follows:

$$g_Y=-2.22+0.195(I/Y)+5.63\log_{10}(y^{US}/y)-5.92\log_{10}(1+g_p) \quad \ldots (4)$$
$$(-3.6)\ (7.9)\qquad (14.5)\qquad\qquad (-6.8)$$

where t-ratios are indicated in parentheses, and where R^2=0.80. In this relationship, the time unit is a 10-year period, and g_Y is the percentage growth rate of GDP, I/Y is the gross investment/GDP ratio, y is the per capita GDP at purchasing power parities, and g_p is the percentage rate of inflation (of the GDP deflator) divided by 100, all variables being 10-year averages.

In the regression equation (4), $\log(1+g_p)$ equals approximately g_p (expressed as a fraction of 100), so it tells us that an increase in the trend rate of inflation by a percentage point reduces the trend growth rate of GDP by 0.06 per cent. The inflation rate is strongly correlated with the inflation variance, so the latter may also serve as an instrumental variable for instability factors.

For those transition economies which are EU candidates, the ratio y^{US}/y equals about 4, and $\log_{10} 4$=0.6. Thus, according to this Gomulka-Dumas equation, the catching-up factor could contribute about 3.4 percentage points to their current growth of GDP. For a EU candidate country with an I/Y ratio in the range of 20 to 25 per cent and an inflation rate of 10 to 15 per cent, the growth equation predicts a GDP growth rate ranging from 4.7 per cent (for I/Y equal to 20 per cent and g_p=15 per cent) to 5.8 per cent (for I/Y equal to 25 per cent and g_p =10 per cent). A further increase of the I/Y ratio by 5 percentage points, to 30 per cent, would raise the growth rate to 6.8 per cent and a reduction of the inflation rate by 7 percentage points, to 3 per cent, would raise it further to 6.9 per cent. However, after a decade of growth at between 5 to 7 per cent, the ratio y^{US}/y would decline from the present level of 4 to about 3, reducing the contribution of the catching-up factor by 0.7 percentage points, and reducing the growth rate from 6.9 per cent to 6.2 per cent, by the year 2010.

This exercise is not intended to provide precise estimates of the growth rate for specific time periods and specific countries. The purpose is rather to estimate the potential trend growth rate on the basis of the broad and long-term experience of a group of countries thought to be representative of medium-developed and market-based economies.

The estimates reported in table 3.3.2 should be interpreted in this spirit, as an indication of the possible growth rate for the countries listed over the next 50 years, given the declining role of the "advantages of backwardness" factor. Policy options are represented by two savings ratios.

The important role of capital accumulation in this growth projection is indicated by an implicit assumption that international technology transfer is proportional to investment. This assumption may be realistic when the

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[207] C. Wyplosz, *The Ten Years of Transformation: Macroeconomic Lessons*, CEPR Discussion Paper, No. 2254 (London), March 2000.

[208] S. Johnson, J. McMillan and C. Woodruff, "Entrepreneurs and the ordering of institutional reform: Poland, Slovakia, Romania, Russia and Ukraine compared", *The Economics of Transition*, Vol. 8, No. 1, March 2000, pp. 1-36.

[209] S. Gomulka, "Growth convergence: a comment on Warner", London School of Economics, 1999, mimeo (forthcoming in a book edited by L. Orlowski, to be published by Elgar).

TABLE 3.3.2

GDP growth and relative GDP per capita for selected transition economies
(United States GDP per capita = 1)

	s=20						*s=30*					
	0	*10*	*20*	*30*	*40*	*50*	*0*	*10*	*20*	*30*	*40*	*50*
Russia												
g_Y	..	4.66	4.09	3.65	3.29	3.02	..	6.24	5.34	4.63	4.07	3.63
$Y_t/(1.02)^t$	0.22	0.29	0.36	0.43	0.50	0.55	0.22	0.34	0.49	0.65	0.81	0.96
Poland												
g_y	..	4.33	3.83	3.44	3.13	2.89	..	5.91	5.08	4.42	3.91	3.50
$Y_t/(1.02)^t$	0.26	0.33	0.40	0.47	0.53	0.58	0.26	0.39	0.54	0.70	0.86	1.01
Ukraine												
g_Y	..	6.03	5.17	4.50	3.97	3.55	..	7.61	6.43	5.49	4.75	4.16
$Y_t/(1.02)^t$	0.11	0.17	0.23	0.31	0.38	0.45	0.11	0.20	0.31	0.46	0.62	0.78
Czech Republic												
g_Y	..	3.37	3.07	2.84	2.66	2.52	..	4.94	4.32	3.82	3.43	3.13
$Y_t/(1.02)^t$	0.41	0.48	0.54	0.59	0.64	0.68	0.41	0.57	0.73	0.89	1.04	1.18
Hungary												
g_Y	..	3.77	3.39	3.09	2.86	2.67	..	5.34	4.63	4.07	3.63	3.28
$Y_t/(1.02)^t$	0.34	0.41	0.48	0.54	0.59	0.64	0.34	0.49	0.65	0.81	0.96	1.11

Source: Author's estimates on the basis of equation (4), and under the assumption that the United States GDP per capita will be increasing at a constant rate of 2 per cent per annum.

Note: 1998 is the initial year, t denotes years from 1998, s is the investment/GDP ratio in per cent.

technological gap is large, in the first 20-30 years of the projection. In the closing years of the period, declining returns to capital must set in, so the projection in table 3.3.2 is then less realistic.

After the first decade of transition, domestic savings tend to be low in most transition countries. This is so, essentially, for two reasons: the inherited policies of large social transfers and the negative effect on incomes of the transformational recession. Following the first wave of reforms (liberalization, stabilization and privatization), the transition countries can turn to implementing reforms and policies intended specifically to promote savings. These include pension reforms, whereby state pensions are sharply reduced and private pension schemes established, and tax reforms intended to lower sharply both subsidies and direct taxes on individuals and companies.

The European Union candidates should also be able to attract foreign direct investments in volumes that are significant in relation to GDP. The macroeconomic risks to investors could be reduced further, and substantially, once the new EU members become a part of Euroland. When this happens, and only then, domestic savings should no longer be a constraint on investment, and hence no longer a constraint on growth.

Public investments have a significant contribution to make in promoting growth in all those areas in which positive externalities are present. These include, typically, physical infrastructure, research and education. Public spending in these areas has been radically curtailed during the first decade of the transition. A reduction of social transfers is also needed for the purpose of reversing this trend.

(viii) Concluding remarks

In all the transition countries covered by this paper, the liberalization and stabilization measures of the 1990s have been fundamental in helping to foster a rapid expansion of the new private sector, a contraction and restructuring of the state sector, and a profound reorientation and rapid growth of international trade. In most of these countries, GDP per capita was about 15 to 30 per cent of the level in the United States at the beginning of the twentieth century, and is still at about the same level at the end of the century. The economic transformation of the last decade has contributed significantly to meeting the strategic aim of creating an economic system that should enable these countries to make substantial progress in closing this income gap in the twenty-first century.

Dramatic macroeconomic imbalances and extraordinarily large structural distortions have been the key problems that the 25 post-socialist countries of central Europe and the former Soviet Union inherited and have had to face and solve during the first decade of their transition. The reform packages which most central European and Baltic countries have adopted, broadly corresponded to the severity of the macroeconomic crisis and the magnitude of these inherited structural problems. They aimed at regaining macroeconomic stability quickly, rapidly liberalizing prices, trade and entry, and establishing an infrastructure of institutions and laws capable of servicing a well-functioning, competitive market economy. The reform strategy adopted by most of the CIS countries embraced considerable, but less extensive PTE

liberalizations, and placed rapid privatization before macroeconomic stabilization. In those countries structural distortions were initially larger, private sectors smaller, and earlier market reforms more limited. These more hostile initial conditions had a major impact on reforms, policies and the progress of transition. However, the differences in reform strategies between the two groups of countries and within each group narrowed considerably in the second half of the 1990s.

Discussion of chapter 3

3.A George Kopits

This retrospective survey addresses a number of important macroeconomic questions in the decade of transition from socialist central planning. Leaving aside some presentational points, let me expand the coverage of Professor Gomulka's paper and elaborate with regard to five interrelated issues: impediments to macroeconomic stabilization; shock therapy versus gradualism; stabilization and growth; policy prescriptions; and finally, the role of the IMF in the transition.

Impediments to stablization

A key to our understanding of the lack of effectiveness of traditional macroeconomic policy tools in the early stages of the transition is the absence of a fully developed transmission mechanism (broadly defined), which is taken more or less for granted in a market-based economy. In turn, the development of transmission channels rests on institution building.[210]

While, from the very outset, interest rate policy has been useful in influencing the saving behaviour of households, it was totally impotent in containing borrowing by state owned enterprises as long as the latter were not subject to a hard budget constraint and bankruptcy risk. Likewise, bank lending could not be affected in the absence of market-based instruments and effective regulation and supervision of financial institutions. As a fallback, quantitative credit limits were used (with apparent success) to restrict enterprise borrowing; however, nothing impeded these enterprises from financing themselves by accumulating inter-enterprise credits and tax arrears, a process much like excessive monetary expansion. Exchange rate policy, normally utilized (through a devaluation) to induce a switch in consumption from tradeables to non-tradeables and in production from non-tradeables to tradeables, was not particularly effective in the presence of price controls which prevented the pass-through from world prices to domestic prices.[211]

Fiscal targets, in the form of reductions in the budget deficit, were largely ineffective in containing the public sector borrowing requirement (PSBR) as long as the central budget deficit represented only a part of the PSBR, the rest being accounted for by numerous extra-budgetary accounts and local governments, which escaped any attempt at fiscal discipline. Moreover, excessive emphasis on cash accounting resulted in reliance on payment arrears (including of wages and pensions) to meet budget deficit targets.

In the face of such impediments to stabilization through traditional tools, it was necessary to improvise by resorting to crude proxies to implement macroeconomic stabilization. One such tool was tax-based incomes policy – preferably in the form of a highly progressive tax on increases in the wage-bill, such as Poland's *popiwek,* to encourage some efficiency in employment – as a substitute for the missing hard budget constraint. Admittedly, this proxy was exposed to considerable erosion over time. More generally, the combination of an undeveloped transmission belt and the lack of reliable parameter estimates (given an insufficient track record of stable behavioural and technological relationships) often led to application of a higher dosage than would normally be required of the available measures to achieve a specified macro target.

Nevertheless, it is interesting to observe how far some of the advanced transition economies have moved since the beginning of the transition in this regard. For example, the recent adoption of inflation targeting by a few of these countries would have been unthinkable without some stability in the nexus – albeit still being tested – between interest rate policy and inflation.

Shock therapy versus gradualism

This issue has not only attracted considerable attention in policy-making and academic circles, but also in the popular press. Professor Gomulka correctly views the former East Germany as an extreme case of shock therapy as it moved from being a paragon of disciplined central planning to full EU membership, and to full participation in the EMS, practically overnight. Yet, apart from this rapid opening-up process, the shock came mainly in the form of the wage adjustment encouraged by west German unions (undoubtedly to protect jobs in their own ranks). Coupled with massive budgetary transfers, this led to what might be regarded as one of the worst cases of Dutch disease, with the resultant loss in competitiveness and huge structural unemployment.

Far less obvious, however, is the shock therapy experienced by the tradeables sector in some of the more advanced economies in transition, such as Hungary. In fact, far from being a case of gradualism, as it is often

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[210] For an earlier discussion, see G. Kopits, "Monetary and fiscal management during the transformation", in H. Blommestein and B. Steunenberg (eds.), *Government and Markets* (Dordrecht, Kluwer, 1994), pp. 231-246.

[211] This phenomenon was already present in the pre-transition stabilization programmes in Hungary and Romania.

characterized,[212] Hungary moved faster and went farther than most other transition economies in implementing key structural reforms: trade and investment liberalization, price liberalization, freedom of entry, and adoption of strict bankruptcy provisions. As a result, a number of large manufacturing SOEs engaged in traditional exports to the CMEA (for example, Videoton, Ikarusz, MOM) or in import substitution (coal mining, construction material) were practically dismantled in the early stages of the transition. This is reflected in the high unemployment rates and sharply declining employment in these activities during the period 1992-1995 (table 3.A.1). By contrast, employment remained practically unchanged in public administration, education, health care and public utilities – covering more than one fourth of the labour force.[213]

Exposure to market prices and the risk of bankruptcy disciplined the remaining enterprises (both privately and publicly owned), while the skilled labour force released by the defunct or shrunken enterprises was absorbed by foreign affiliates of multinational firms that began operating in Hungary, often in the form of greenfield investments, attracted by an investor-friendly environment that offered relatively stable and transparent rules of the game. Meanwhile, restructuring of the non-tradeables (mainly public) sector lagged far behind in a number of transition economies, including Hungary.[214] Needless to say, over time, the workforce in this sector has become politically eloquent in defence of acquired rights, delaying the completion of the transition process. Indeed, to this day, reform of the health care, pension, and educational systems, remains an unfinished agenda in most of the economies in transition.[215]

Stabilization and growth

As a corollary of the above two-track transformation process, macroeconomic policy tools have become more effective in the (mainly tradeables) sector that had not been sheltered from market forces, namely, in activities exposed to trade liberalization, foreign direct investment, price liberalization and bankruptcy risk. By the same token, institution building in the form of enhanced corporate governance, supported by the

TABLE 3.A.1

Unemployment and employment by activity in Hungary, 1992-1995
(Per cent)

	Unemployment rate (per cent of labour force)		*Employment (per cent change)*
	1992 QI	*1995 QI*	*1992 QI-1995 QI*
Tradeables sector			
Agriculture, forestry, fishing	9.8	14.2	-37.5
Mining	9.0	16.5	-40.2
Manufacturing	10.7	11.9	-19.7
Food products, beverages, tobacco	9.8	14.6	-25.7
Textiles, clothing, leather	9.9	11.1	-14.4
Wood, paper and printing products	9.8	9.7	-21.9
Chemicals	8.8	7.0	-9.2
Non-metallic mineral products	16.3	14.4	-23.5
Metallurgy, metal processing	11.7	16.0	-22.2
Engineering	11.4	11.3	-24.0
Transportation services	6.9	7.8	-9.4
Non-tradeables sector			
Electricity, gas and water supply	6.1	5.7	-5.5
Construction	19.7	18.3	-1.5
Domestic trade	8.1	9.3	-0.7
Lodging and food services	13.1	13.1	4.0
Postal, telecommunications services	4.1	4.0	-4.0
Financial insurance and services	1.5	4.3	22.0
Real estate, rental activities	8.4	6.8	-0.3
Public administration	5.5	5.9	14.0
Education	2.2	2.7	8.4
Health and social services	4.7	3.9	-1.1

Source: G. Kopits, "External implications of social and labour market policies", *International Economy* (in Hungarian), November 1995, pp. 65-73.

implementation of a commercial code, accounting and audit practices, a broad-based parametric tax system, and more recently, effective regulation and supervision of banking and securities markets, all constitute an indispensable framework for effective macroeconomic stabilization.

Obviously, it was in the tradeables sector where the transformation translated most rapidly into high and sustained growth. More generally, the growth performance during the transition is to be viewed as the weighted average of output decline in obsolete activities and of output surge in reformed activities. This, of course, is subject to an important measurement caveat: the fact that for various reasons the former has been recorded much more reliably than the latter explains a downward bias in published output performance.

Professor Gomulka correctly suggests that stabilization and growth tend to be mutually reinforcing, largely through a fall in the risk premium, which reflects increased policy credibility and time consistency. In turn, this leads to a surge in foreign direct investment inflows that, following a gestation period, are a major catalyst to growth in transition economies. Whereas initially inflows of direct investment finance imports of capital goods and semi-finished products, over time they result in import substitution or export creation, as local value

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[212] See, for example, K. Dervis and T. Condon, “Hungary – partial successes and remaining challenges: emergence of a ‘gradualist’ success story?” in O. Blanchard, K. Froot and J. Sachs (eds.), *The Transition in Eastern Europe* (Chicago, Chicago University Press, 1996).

[213] Except for the elimination of the workers’ militia, government employment was virtually unchanged from 1989 through 1995. G. Kopits, “External implications of social and labor market policies”, *International Economy* (in Hungarian), November 1995, pp. 65-73.

[214] Privatization of most public utilities and much of the banking system in 1995-1996 was an important step in the transformation of the non-tradeables sector.

[215] Clearly, redesign of these systems (i.e. eligibility for benefits, co-payments, quality of services, etc.) represents only part of the reform; the other, equally intractable, is the trimming and replacement of the existing unionized workforce.

added rises, with consequent productivity spillovers and externalities in the rest of the economy.

On the author's empirical analysis, it would be more convincing to venture beyond the equation estimates presented in section 3.3(v) of the paper, perhaps by attempting a fuller specification – allowing also for the influence of institutional factors – of the determinants of the key performance variable, namely, economic growth.[216] Incidentally, the use of the estimates presented in the paper to answer the query raised in the subtitle ("What are the long-term growth prospects…?") is highly questionable.

Ultimately, a major issue that needs to be addressed is the manner in, and extent to, which public policy can influence growth. For one thing, during the transition, important obstacles to growth have been the fiscal or quasi-fiscal wedges, comprised of high payroll tax rates for social security, in the labour market, and high financial intermediation costs, in the capital market. These wedges can be reduced through social security reform and bank restructuring, respectively. In addition, a decline in the public sector deficit and of indebtedness permits a fall in interest rates and seignorage, which in turn will permit a further reduction in financial intermediation costs.[217] Overall, cuts in these wedges will lead to high and sustained growth via familiar channels by raising the efficiency in resource utilization and potential growth – including through previously unexploited economies of scale. However, these determinants can only be effective if the institutional framework – which should provide clear and reliable rules of the game, including a hard-budget constraint – mentioned above is already in place.

Policy lessons

Apart from some general prescriptions, the paper is not altogether persuasive in some of its policy recommendations. In particular, adoption of the Maastricht reference values might not be useful as an immediate policy goal for most economies in transition. Although perhaps informative as an accounting device, the debt equation (or identity) shown in the paper is of limited usefulness as a rationale for the fiscal reference values currently in place. In fact, under the Stability and Growth Pact, the focus is on the pursuit of budget balance or surplus over the cycle, as distinct from the 3 per cent of GDP deficit limit intended to accommodate the operation of automatic stabilizers. Compliance with the balanced budget target should also help reduce the debt-GDP ratio. In more general terms, most of the numerical goals suggested in the paper seem somewhat arbitrary.

The norms of macro probity listed in the paper should be prescribed with an important caveat, especially following the experience of some economies in transition, notably the Czech Republic, where either explicitly or implicitly excessive priority had been assigned to displaying an attractive (almost Potemkin-like) macroeconomic performance until the collapse of the Klaus government. In particular, there should be a clear message that price stability, low unemployment, and high growth should not be pursued at the cost of postponing much needed structural reform. Thus, for example, at times it may be necessary to accept that relative price adjustments may translate into an inflationary spurt in the absence of effective tools of monetary restraint. By the same token, an insufficiently developed tax system may force temporary reliance on a moderate inflation tax, and, of course, enterprise restructuring cannot be pursued without a significant unemployment rate.

Role of the Fund

Professor Gomulka describes what he regards the "standard IMF approach" as anchored with "an incomes policy and a fixed exchange rate, in addition to restrictive monetary and fiscal policies" (section 3.2(iii)). However, in fact, Fund-supported programmes in the economies in transition have encompassed a wide variety of exchange rate regimes, including currency boards, different types of peg (fixed, crawling) subject to various band widths, as well as floating regimes. Monetary policy has been guided by alternative operational objectives: quantitative credit limits, inflation targeting, key interest rate setting, etc. Fiscal targets have spanned moderate deficits to surpluses. Although in general there was a clear promotion of trade liberalization, a number of programmes allowed for a temporary import surcharge, mainly for revenue reasons. Some programmes contained an explicit wage commitment, while most of them did not.

The only common denominator in Fund-supported programmes has been that they be cast in a consistent macroeconomic framework, with the purpose of achieving a sustainable growth objective – that is, sustainable under the external constraint faced by a given country. However, unlike market-oriented economies with a track record that yielded parameter estimates of key technological and behavioural relationships, in the economies in transition such parameter values were unknown or missing. Hence the need to assume plausible parameter values, such as a unitary velocity of money. Also, given the lack of appropriate institutional arrangements, especially a hard budget constraint and bankruptcy risk for enterprises, it was necessary to resort to second-best instruments, such as tax-based incomes policy, for containing domestic demand pressures.

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[216] S. Fischer, R. Sahay and C. Vegh, "Stabilization and growth in transition economies", *Journal of Economic Perspectives*, Spring 1996, pp. 45-66, and the more recent attempt to incorporate the effect of institutional factors in O. Havrylyshyn and R. van Rooden, *Institutions Matter in Transition, but so do Policies*, IMF Working Paper WP/00/70 (Washington, D.C.), March 2000.

[217] G. Kopits, "Midway in the transition", *Acta Oeconomica*, 1994, pp. 267-292.

3.B Silvana Malle

A decade of transition policy and reforms in central and eastern Europe and the CIS provides the opportunity for an overall assessment of the process and results obtained to date. It should also provide an insight into the policy mix that distinguishes successful from unsuccessful transition experiences. This is what the economics profession is currently trying to work out and Gomulka's paper is an excellent example of stocktaking of transition reforms.

Gomulka's paper is generally non-controversial and largely reflects the orthodox view of the transition process. However, while one can broadly agree with the generalizations expressed in terms of lessons from transition, the devil is in the details. And these should not be underestimated both for a sober assessment of what has been achieved so far, the difficulties of the transition process and the challenges which lie ahead in most countries.

In avoiding speculation about future challenges, the paper does not address the issue of whether transition can be considered to have been completed in most of the central European and Baltic countries that adopted the ideal model formulated by Vaclav Klaus as described by Gomulka. In other words, the paper does not discuss whether, from a macro-structural point of view, these countries are now fully equipped to face the challenges of globalization and further integration in the world economy and so able to withstand external shocks that could impair the apparent achievement of sustainable growth. The different repercussions of the international and Russian financial crises on the transition economies could have offered a test of the adequacy of (and I believe by and large support for) Gomulka's analytical basis for assessing the comparative success of transition policies in each country.

While Hungary and Poland ended 1999 with comparatively robust GDP growth rates of 4.5 and 4 per cent, the modest and narrowly based recovery of growth in the Czech and Slovak Republics, stagnation in Latvia and output falls in Lithuania and Estonia (-4.2 and -1.4, respectively) point to a higher degree of vulnerability to external shocks and underlying structural weaknesses.

That structural reforms are a necessary component of transformation is widely accepted, but the fact they need time to deliver results is often overlooked. Gomulka's emphasis on the role of the new private sector in promoting the conditions for sustainable growth, a conclusion supported by the experience of Poland, is correct, but somehow disjointed from the analysis of the conditions for the development of this sector. Incidentally, one should note that comparisons in this area are also difficult due to the different methodologies used in the statistical estimates. In some central and east European countries, for instance, individual private activity is included in the estimates, while in Russia it is not.

Gomulka's point is that (fast) privatization did not matter for the development of the new private sector. Nevertheless, the mode of privatization mattered. The liquidation and separation of assets from SOEs helped the formation of physical capital to start new business in Poland. But this may be only part of the answer. Two basic questions remain: (a) why has the new private sector developed in some countries, particularly in Poland and Hungary, while it is lagging far behind in the CIS? Is this the result of harder budget constraints on state enterprises and divestment of assets, micro-liberalization and structural reforms, or is it due to better institutions, a more friendly business environment, less corruption? How important is the credibility of the government?; and (b) why, after a decade of transition, have even the successful transition countries a much lower density of small- and medium-sized enterprises compared with more advanced economies? The most advanced economies have around half a million enterprises per 10 million of population: the problem for transition economies that lag much behind is how to reach this threshold. Gomulka's analysis does not help in drawing policy lessons in this field. Liberalization policies are necessary, but they may not suffice. Experience suggests that positive and visible developments start taking place only after a critical mass of reforms is in place, and policy interactions are favourable. But progress in transforming the real sector of the economy is slow in general, and catching up with advanced market economies in this area is likely to take a long time.

We also cannot exclude the possibility that initial (or country-specific) conditions matter, *ceteris paribus*, for creating a virtuous dynamics of growth. Country specifics come to mind in particular if China – which Gomulka does not discuss, although he makes a cursory reference to the latter's path of gradual adjustment – is brought into the picture. While SOEs in China have remained by and large unrestructured, under a largely unreformed political system, a new "private sector" including foreign funded enterprises has emerged and accounts comparatively more for the dynamics of growth. While one could argue that the Chinese diaspora has been crucial in providing FDI to mainland China – a missing factor in central and eastern Europe (although one may ask whether funding from Polish émigrés in the United States has not played a somewhat similar role in Poland) – other conditions must have been in place to convince foreign investors of Chinese origin to invest in China rather than elsewhere. In this context, the Chinese government's commitment to stabilization and the creation of conditions conducive to the growth of the new private sector, a commitment that Gomulka finds also in central and eastern Europe, seems to have played a role. But, contrary to the latter countries, the legitimization and credibility of reform in China was provided neither

through a democratic political process nor by the collapse of the communist system.

Concerning central and east European countries, one should not forget that both Poland and Hungary had moved towards liberalization and market-oriented reforms earlier in the 1980s. A comparatively advantageous geographic position and exposure to western developments and ideas also contributed to the collapse of communism and to the increased political debate that preceded the radical changes of 1989. A new leadership started to emerge in the 1980s and was crucial in speeding up economic transformation in the 1990s.

If initial conditions do, indeed, matter, the question is to what degree should economic policy and institutional change be tailored to these specific conditions, as distinct from the generic mix of lessons for unsuccessful transition economies listed by Gomulka. In other words, the fundamental question is not whether the government should stabilize, consolidate the budget and create a good institutional environment for business, but *how* it should proceed in trying to do this under different conditions in different economies.

These questions are important for the CIS, whose transition paths are not thoroughly analysed in the paper. Gomulka concludes that CIS and central European countries have converged in the second half of the 1990s, basing his conclusion on the fact that the macroeconomic indicators of the two groups of countries are converging. This is, indeed, hard to believe, especially after the ripple effect of the Russian crisis throughout the former Soviet Union in 1998-1999. In some countries the reliability of official data is still questionable, but there are basic economic issues in all of them that have yet to find a solution. These include the timely payment of budgetary wages and pensions, a minimum degree of compliance with tax regulations, the use of national currency in domestic settlements, just to mention a few areas of concern – whereas these are no longer issues in central Europe. Their structural weaknesses do not justify optimism as to the sustainability of macro-stabilization policies in the CIS.

How countries should proceed in order to transform their economies leads me to draw attention to three points, among the 10 lessons for transition listed by Gomulka, and which he discusses in more detail in separate sections of his paper: the monetary and exchange rate policy, the Maastricht criteria, and the flexibility of labour markets.

In discussing monetary policy at the earlier stages of transition, Gomulka argues that some central banks used credit limits in order to avoid increasing real interest rates by too much. But he does not explain the rationale of this policy in a transition context, where, indeed, the problem was that inefficient and underdeveloped banking systems, together with the established links between large state enterprises and banks, would not have allowed interest rates to allocate lending according to creditworthiness. Credit rationing did not reduce the cost of credit, since the "shadow cost" of credit with rationing is higher than the actual real interest rate, but it did prevent continued lending to unviable enterprises. This policy, therefore, amounted to introducing somewhat harder budget constraints, in default of normal "market" discipline. In heavily indebted countries, however, this policy, by smoothing tensions over interest expenditure in the budget, may have reduced the pressure for sound fiscal management and contributed to an increased level of public debt. The increases in interest rates, after the demise of credit limits were by and large resisted by the fiscal authorities, the more so as they got used to easy budget financing. In that context, the independence of the central bank was crucial to withstanding these counteracting pressures.

Gomulka is correct in pointing out the need for an exchange rate anchor in transition economies. However, the discussion of this section would have benefited from better organization and greater clarity about the different types of "peg" adopted in the region; fixed exchange rates, crawling pegs, fixed parity and reference currency – dollars or deutsche marks or a combination of these currencies. Each exchange rate policy had, and continues to have, a different impact on the sustainability of short-term capital inflows, disinflation and fiscal management. This, in turn, raises the question of when and how far liberalization of capital movements should be allowed: a topic of major debate after the last international financial crisis which also needs to be addressed in drawing lessons for less successful transition economies.

The discussion of the exchange rate policy does not sufficiently emphasize the more stringent requirements of the currency board compared with a fixed exchange rate policy. While fixed exchange rate regimes still allow the central bank to carry out monetary policy and use monetary instruments, the whole idea of a currency board is that the country is really committed to a fixed parity and does not intervene in the monetary market. The currency board is thus fundamentally different from the normal fixed, but adjustable peg. What is also important to stress is that the failure of a currency board involves much greater systemic risk to the banking system than does exit from a normal pegged exchange rate regime. Therefore, while lower interest rates will reduce the immediate pressure on the budget, as Gomulka notes, the indirect role of the currency board should also be one of inducing sound fiscal management and preventing the accumulation of new debt. This, in turn, demands pursuing macro-structural policies, which are conducive to rapid productivity improvements and adequate budget revenues. If the economy as a whole fails to adjust to the straitjacket of the currency board (which would be evident through large current account and budget deficits in some "successful" transition countries), the fiscal

adjustment needed to maintain the currency board could be very demanding and socially disruptive.

This leads me to the next point: the Maastricht criteria. By and large, these criteria may provide a benchmark for government policy, but in themselves they do not suggest how policy should proceed to meet these requirements. Should the policy be one of slashing expenditure or increasing revenues? What is the right balance between the two? The specificity of each country, where demographic trends also matter, needs to be taken into account. Transition economies also need to be aware that watching the general budget deficit (central and local budgets plus extra-budgetary funds) is not sufficient if the underlying problems of the public sector at large are not forcefully dealt with. In many countries (including some of the so-called successful ones), banks and large-scale enterprises (whether strategic or not) are still state owned. The accumulation of liabilities in these sectors will be reflected, sooner or later, in the general government deficit, through tax and social contribution arrears and costly bank consolidation schemes. Thus, the interdependence of macro-structural reforms and management is crucial. The Maastricht criteria alone are not enough to do the job.

Finally, the point made by Gomulka on the need for labour market flexibility is more one of principle than practice. Labour markets in most transition countries are, indeed, rather flexible, particularly if compared with most EU countries. Dramatic structural adjustments have taken place that would be unthinkable without labour market flexibility. But more should be done to increase regional labour mobility within each country since unemployment is often concentrated in particular areas. Some countries have tried to tackle this problem by setting up free economic zones and special arrangements whose prospects are, at best, unclear. While there is need for better education and training to cope with the mismatch of skills and vacancies, as advocated by Gomulka, information, communications and transport infrastructures should also receive proper attention.

3.C Joze Mencinger

I have been participating in the endless transition discussions for more than a decade, first as an active participant, then as an observer. The discussions continue although the old division between shock therapists and gradualists has been replaced by the division between those who are happy with the results and those who are not; the former are optimists and the latter pessimists when future developments are being discussed. My comments are divided in three parts: a rather superficial discussion of the paper by Professor Gomulka is concentrated in the first; the second deals with the sustainability of growth in the central European countries; and major features of the rather specific transition in Slovenia are presented in the third.

Professor Gomulka's paper presents a valuable overview of macroeconomic policies in the transition process. Let me therefore address only those interpretations with which I disagree.

Was the transition a success or a failure, and in either case, why? Contrary to the author I share the opinion of Professor Stiglitz that the rapid speed of transition based on the Washington Consensus was a major mistake.[218] The transition from a socialist to a market economy, a counterpart to sweeping political and ideological changes, began without a clear assessment of the actual situation, without a fully worked out picture of the new economic system, and without suitable economic and social arrangements in place. Instead, there were explicit or implicit assumptions that the elimination of deformed non-market institutions, the restoration of market and private ownership, together with a laissez-faire free market mechanism, would instantly transform socialist countries into welfare states. New, mostly inexperienced governments were assisted by international financial institutions and western scholars who, in most cases, had learned about these countries from tourist brochures and journeys from the airports to Holiday Inn hotels. In addition, many domestic radicals and foreign advisers were ideologically and politically motivated, their major goal being the abolition of socialism and existing institutions rather than the gradual creation of a viable economic system and increased economic prosperity for everybody. In short, the previous "prevention of capitalist exploitation" ideology was replaced by what George Soros called "market fundamentalism".

Privatization was considered to be the cornerstone of transition; it was assumed that it would improve efficiency in the use of resources, enable fairness in the distribution of wealth and welfare, and contribute to the abolition of the mono-party system. The efficiency assumption of private property is rightly taken for granted; private property is a necessary condition for economic efficiency, but it is not sufficient if there are no owners responsible for the proper use and maintenance of capital assets. They cannot be created by decree. The validity of the second assumption, namely, that privatization will create fairness in the distribution of wealth and welfare is dubious, to say the least. Fairness is an extremely ambiguous concept (see the discussion on the social consequences of transition in Michael Ellman's paper in this *Survey*) as illustrated, for example, by the enormous variations in the degree of social protection provided by pensions and health care, even among the most developed welfare states. It is also true that the dominance of private property rights is a proper basis for a stable political democracy. However, new political and

[218] J. Stiglitz, "Whither reform", paper presented at the World Bank Annual Bank Conference in Development Economics (Washington, D.C.), 1999.

economic elites, created in the transition, and foreign investors have given a new meaning to what is proper privatization; in short, it should increase their political legitimacy, wealth and profits and these, therefore, became the criteria for evaluating the performance of ownership "restructuring". Actual privatization procedures therefore reflected the specific distribution of political power and the ideas of randomly chosen western "privatizers"; their privatization schemes however exhibited one common characteristic: they were grandiose administrative operations exceeding the dreams of central planners.

The creation of private property rights is only one step in the formation of a "normal" capitalist market system. The legal framework and market institutions which enable the "invisible hand" to replace administrative controls is also needed. Formally, the legal framework and market institutions similar to those existing in the developed market economies could be established quickly. Yet, the existence of such structures does not imply that the problems have been overcome; the development of market institutions in the west has been a gradual process of interactions between economic development, politics and the institutions of civil society and it is unlikely that formally the same institutions in a new market economy will operate just as they do in the developed market economies. The performance of market institutions crucially depends on norms and patterns of social behaviour.

For many reasons it is practically impossible to group the transition economies according to transition models. The commonly used division in a vast literature of "transformatology", between "shock therapy" and "gradualist" models, does not provide a basis for their classification. First, the patterns of transition were various mixtures of systemic changes and economic policies, some of which could be considered as elements of a gradualist approach while others could be considered as components of a shock therapy. Second, what was a shock for one country, for example price and trade liberalization, could be an element of a gradualist approach or even one of the initial conditions in another country which had had less price control or which had previously been rather open. The three-model grouping suggested by Professor Gomulka – namely, the shock therapy model followed by the former east Germany; the gradualist model presumably followed by the CIS countries; and the rapid adjustment model presumably followed in central Europe – does not provide a better classification. Furthermore, allocating a country to a particular transition model on the basis of the outcome of the transition and claiming, for example, that acceptance of the rapid adjustment model generated the relative success of the central European countries while adoption of the gradualist model led to failure in the CIS countries, is superficial. What really matters are the initial conditions; most CIS countries simply did not possess the institutions – or even memories of such institutions – required to introduce the elements of the rapid adjustment model. Indeed, one could argue that transition economies, particularly those in the CIS, have not followed any consistent model but rather have implemented a chaotic mixture of systemic changes and economic policies.

But let me turn to macroeconomic issues. I believe that the assessments of initial macroeconomic conditions in the central European and CIS countries were false from the very beginning. The so-called "monetary overhang" and shortages which existed in socialist economies disappeared overnight, eliminated by high inflation or hyperinflation, while basic policy prescriptions were based on the assumption that aggregate demand exceeded aggregate supply. Stabilization was therefore directed at closing the gap between demand and supply through restrictive monetary and credit policy, and rapid liberalization of foreign trade and prices, while anchoring the exchange rate and restraining wages and government spending. Such policies deepened the transformational depression,[219] and pushed more goods into the category of "pure socialist production goods" thus destroying domestic manufacturing industry and transforming many countries, notably Russia, into becoming providers of raw materials, and most of the other CIS countries without raw materials into third world countries. Luckily, due to social resistance, most countries were unable to follow this flawed advice.

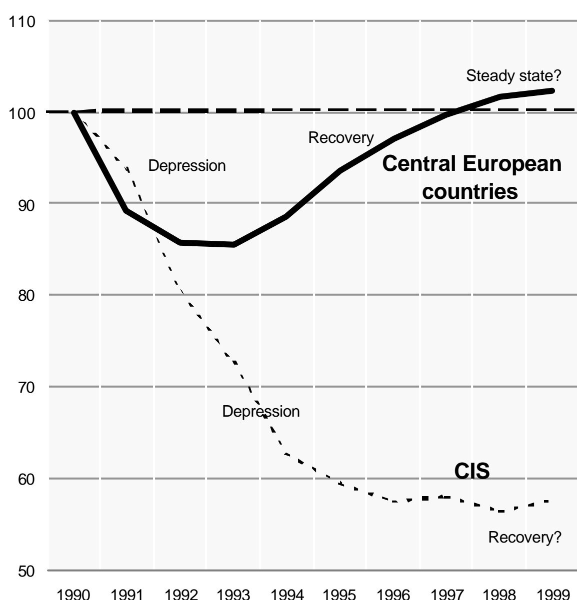
I agree with Professor Gomulka that too much stress was placed on stopping inflation in central Europe but I do not think that, in the initial stage of the transition, there was any relationship between growth and inflation, monetary policy and inflation, or budget deficits and inflation. In short, I am not convinced by his equations (2) and (3), although I would agree with his conclusion that falling output and inflation had common causes. I also very much agree with his assertion that the success of transition depends above all on the creation of the institutional, legal, microeconomic and macroeconomic conditions; the problem is that they cannot be created overnight. I also have problems with the theoretical foundation of the Gomulka-Dumas growth equation and its econometrics. This brings us to perspectives and sustainability of growth.

Let me start with the growth figures in tables 3.2.2 and 3.2.3 of Gomulka's paper. They are presented in chart 3.C.1 which indicates that in the central European countries the transformational depression bottomed out in 1993; there followed a short period of recovery which ended in 1996 when growth rates began to decelerate and then to stagnate at the level of production prevailing at the start of the transition. What about the CIS countries? Have they reached the bottom of the transformational depression? After a long period of decline, they grew by

[219] J. Mencinger, "Lessons from the transition process", *Empirica*, No. 20, 1993, pp. 189-204.

CHART 3.C.1

What after transition, 1990-1999

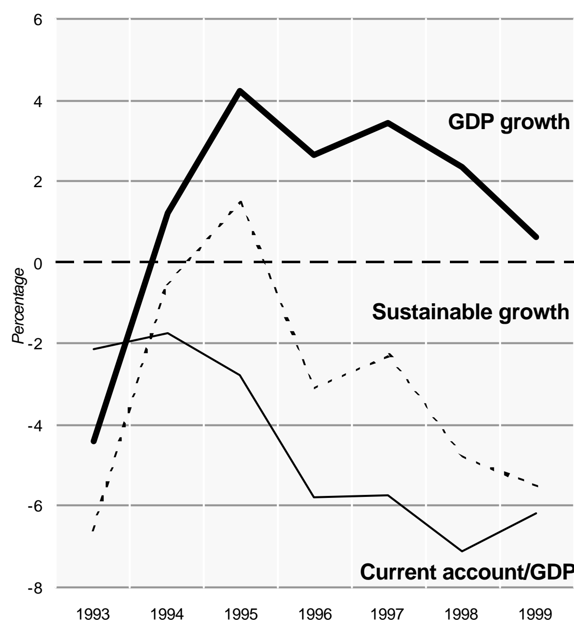


Source: Tables 3.2.2 and 3.2.3.

CHART 3.C.2

Sustainability of growth, 1993-1999

(Per cent)



Source: EIPF (Ljubljana), statistical series, various issues.

a modest 1 per cent in 1997, which was followed by further decline in 1998 and another 1 per cent increase in 1999.

Discussion about the sustainability of growth in the CIS countries would appear to be premature, so let us therefore concentrate on the central European countries alone, i.e. on the 10 most successful applicants for EU membership. Inflation, interest rates, exchange rate regimes, the existence of financial institutions, financial deepening, the liberalization of capital flows and the state of privatization are among the most commonly used criteria in judging their performance, although they have proved to be at least questionable as most dramatically shown by developments in Russia or the Czech Republic. Instead, the macroeconomic performance of central Europe should be judged much more by the sustainability of growth in relation to the current and capital account. This is the criterion used in what follows: sustainable or intrinsic growth is defined as the growth of GDP increased by the share of the current account balance in GDP. This is thus the growth which an economy attains without reliance on foreign assistance, foreign loans or the sale of assets to foreigners. The usefulness of foreign "assistance" in the form of loans, acquisitions, portfolio or direct investments, with which a country may finance its current account deficit and development, is thus not discussed at all, while methodological problems related to double counting are neglected.

The combination of GDP growth and the current account balance in GDP for 10 countries has been changing from year to year. In 1993, which marks the end of Kornai's "transformational depression", four countries combined a decline in GDP with a current account deficit, two combined output decline with a surplus, in two growth was accompanied by a deficit, and two countries combined growth with a surplus. In 1994, four countries combined growth with a surplus. Since 1995, the shift to a combination of growth with current account deficits indicates that the applicant countries have relied more and more on foreign savings to finance their current account deficits. In 1997, only Slovenia maintained growth without a deficit on the current account, while in 1999 Slovenia was the only country where GDP growth exceeded the current account deficit in GDP.

The dynamics of these changes are shown in chart 3.C.2, where two broken lines represent average GDP growth and the share of the current account balance in GDP, and the solid line the sum of both variables, thus revealing the dynamics of sustainable or intrinsic growth as defined above. In short, the rather modest growth of GDP in the applicant countries which followed recovery from the transformational depression has been accompanied, since 1995, by a constant worsening of the current account; sustainable or inherent growth began to decline already in 1996. This is a warning that the vitality of the central European economies, i.e. their ability to grow without reliance on foreign savings, is weak and fading, a development which casts doubt on the assumption of convergence. In fact, the existing gap between the EU and central Europe might even widen rather than diminish, making a delayed accession even more difficult than a "premature" one.

TABLE 3.C.1

Macroeconomic performances of Slovenia, 1992-1999
(Per cent, million dollars)

	1992	1993	1994	1995	1996	1997	1998	1999
GDP real growth	-5.4	0.9	4.9	4.1	3.5	4.6	3.9	4.9
Unemployment rate *(per cent)*	11.6	14.4	14.4	14.0	13.9	14.4	14.5	13.5
Unemployment rate, ILO *(per cent)*	9.3	9.0	7.5	7.3	7.3	7.4	7.9	7.3
Exports of goods *(million dollars)*	6 681	6 083	6 828	8 350	8 370	8 407	9 095	8 608
Imports of goods *(million dollars)*	6 141	6 501	7 304	9 304	9 252	9 179	9 870	9 765
Trade balance *(million dollars)*	540	-418	-476	-954	-882	-790	-775	-1 157
Current account *(million dollars)*	759	192	600	-23	39	37	-4	-581
Inflation *(yearly averages)*	201.3	32.3	19.8	12.6	9.7	9.1	8.6	6.6
Public expenditures/GDP	43.1	46.2	46.8	45.7	45.2	44.6	45.6	46.0
Exchange reserves *(million dollars, end of year)*	1 164	1 566	2 764	3 426	4 124	4 377	4 767	4 103
Foreign debt *(million dollars, end of year)*	1 741	1 873	2 258	2 970	4 010	4 176	4 959	5 491

Source: Bilten Banke Slovenije, *Statistical Yearbook* (Ljubljana), various issues.

Let me turn to my country. Slovenia, when part of Yugoslavia, shared its advantages and disadvantages which arose from a rather specific economic and political system. Many of the essential conditions for a successful economic transition were, at least partly, met before 1989: enterprises were autonomous, basic market institutions existed and the government used some standard economic policy tools. Slovenia was by far the richest part of eastern Europe with a homogeneous, socially stable population, a diversified manufacturing sector, a predominantly private agriculture, a partly private service sector, well-established economic links with western markets and a favourable geographic position among its advantages (table 3.C.1).

The controversy of "shock versus gradualist" changes in the economic system arose in Slovenia during the preparations for independence and immediately afterwards. The "shock therapists", supported by foreign advisers, suggested an overwhelming package encompassing price stabilization, a fixed exchange rate, a balanced budget, administrative restructuring of manufacturing industry and the banking system, and centralized privatization. Gradualists, on the other hand, suggested decentralized privatization, gradual construction of missing market institutions, and a flexible economic policy based on floating the new currency. It was hoped that such a policy would result in a smaller loss of output and lower rates of unemployment at the expense of some inflation. Pragmatism and gradualism prevailed both in relation to economic policy and to changes in the economic system.

Slovenia has also been far less eager to attract foreign capital than other former socialist countries, which can be explained by the relative wealth of Slovenia's population and the outcome of privatization. On the other hand, foreign investors have not been queuing to enter the country: Slovenia's market is too small and real wages are too high.

An independent central bank (Bank of Slovenia), the prompt introduction of a floating exchange rate and benign neglect of inflation were the cornerstones of a successful stabilization, while the small currency area in absolute and relative terms and its sensitivity to economic performances in other countries have been the main obstacles to a sound monetary policy. During the initial period of consolidation, the Bank of Slovenia managed to determine the appropriate amount of money for the new country and to lower inflationary expectations. The budget has remained roughly balanced. When the squeeze in economic activity reduced public revenues and increased the need for social transfers, it was impossible to bridge the gap by running a budget deficit: financing it by printing money was ruled out, domestic savings were low, and borrowing abroad would further strengthen the tolar and reduce competitiveness. Consequently, the share of public revenues (taxes and contributions) in GDP had to increase and it stayed high. The tax structure was gradually changing, the replacement of sales taxes by VAT, after many postponements, being finally introduced in July 1999.

The economic development of Slovenia can also be divided into three distinct periods: the "transformational depression" of 1991-1993, the "recovery of 1993-1995", and a "steady state" thereafter. Independence had predictable economic effects induced by the dramatic reduction of trade with the former Yugoslav republics. Production declined by 9.3 per cent in 1991 and 6.0 per cent in 1992. Consequently, total employment fell by 5.6 per cent in 1992 and by 3.5 per cent in 1993. The so-called restructuring of the economy consisted mainly of "firing and retiring"; the number of unemployed nearly quadrupled in three years, reaching 137,000 in the last quarter of 1993; the number of pensioners doubled over the same period to 408,000. Both demanded enormous social transfers and the share of public expenditure in GDP increased to 48 per cent. At the same time a switch from the former Yugoslav to the "genuine" foreign market led to a trade surplus in 1992, which was a joint

result of increased exports and a large fall in imports, the latter due to the contraction in domestic demand and the breaking of links with the rest of Yugoslavia.

In 1993, the country reached the bottom of the depression. GDP increased slightly, and turned to growth of 4 per cent in 1994. While the period of rapid recovery ended in 1995, macroeconomic performance in the first decade of the country's existence can be considered satisfactory. Growth stabilized at some 3-4 per cent a year, unemployment acquired European characteristics based on asymmetric employment patterns,[220] prices have been gradually stabilized and the budget has remained roughly balanced. A surplus in services, until 1999, offset the deficit in trade, and foreign exchange reserves have until recently matched the foreign debt.

The double transition in Slovenia, from a socialist to a market economy and from a regional to a national economy, was accompanied by structural changes, from manufacturing towards services and from large towards small enterprises. Restructuring has been gradual, disorganized and managed by enterprises themselves. In the first period, the essence of restructuring consisted of "firing and retiring" combined with ad hoc government interventions in cases of large enterprises in trouble. Social stability has remained an important characteristic of Slovenia; it was founded on the regional dispersion of industry which, together with limits on land holding, has created part-time farmers as an important social group.

In short, it can be claimed that gradualism, pragmatism, and risk aversion in the wake of the devastation of the old system have created the proper mix for a rather successful transition in Slovenia.

3.D Leonid Grigoriev

When the problems of transition were being discussed at the end of the 1980s and early 1990s their complexity was not fully appreciated. We are now looking for the logic of transition, for the reasons behind each country's success or failure, and, indeed, for the definition of success. Professor Gomulka's paper takes a substantial step forward in bridging formal economic growth analysis and institution building. This has become a very topical issue over the past year. The very questions he asks are a clear sign that the econometric analysis of macroeconomic factors is important but not sufficient for understanding the transition process.

Is the resumption of economic growth a sufficient sign of a successful transition from plan to market or should we be looking for something more fundamental? In this respect I would support Ivan Berend's criticism of the implicit assumption that "…sustained economic growth and catching up with the west is an automatism, which starts to work when a country adopts the western market model".[221] The definition of success – from my point of view – should reflect at this point (after just 10 years) more progress in institution building than in GDP growth: to what extent have countries come close to building market institutions, to securing the basis of long-run, sustainable growth, to meeting global challenges (competition) and utilizing their national human capital. I agree with Professor Gomulka's definition of success as the "ability to recreate the (institutional, legal and economic) conditions for rapid and sustainable growth", but it is still too general to be instrumental. I would add that countries in transition have their own development agenda and will be looking for their own place in the global economy as soon as the immediate objectives of transition to democracy and the market economy have been achieved.

I want to make a short comment on the initial conditions in the CEE and CIS countries. Table 3.2.1 (after some recalculations) shows us the average GDP per capita (PPP value) in CEE countries in 1998 as $7.6 thousand versus $4.9 thousand in the CIS. Even allowing for the steeper decline in the CIS it highlights a visible historical difference between the two groups of countries. Poland, of course, is dominating the first group (with 34 per cent of the group's total GDP). As might be expected, the most successful transitions have been in the Czech Republic, Hungary, Poland and Slovenia (respectively, $12.5, $10.2, $7.7 and $14.3 thousand). Russia dominates the other group with 69 per cent of total GDP (by PPP value). Russia has a per capita GDP of $6.4 thousand and is struggling along. So, it is probably safe to assert that initial conditions matter. Implementation of the 10 commandments is unlikely to be universal across the region, given the differences in economic level and in the state of civil society at the start of transition.

The distinction between CEE and CIS countries should also take into account the well-forgotten collapse of the USSR. The CMEA countries experienced the external shock of simultaneously opening their economies and the destruction of their intra-CMEA ties in the early 1990s. The former Soviet Union republics had to adjust to yet another shock at the very start of transition. The economic and human resources of the newly independent countries varied considerably, as did their ability to manage their economic and social problems. The economic and social costs of a country's collapse need to be considered in a broader context – the lack of national banks and currencies were not the only problems. The collapse of countries was probably not envisaged in the 10 commandments.

The speed of institution building is now at the centre of international discussion. In the early 1990s the international financial institutions considered institution building as something coming after the initial economic reforms and strengthening them. Now the attitude is changing – the speed of a caravan depends on the lame camel. It is clear that reforms cannot wait for institution

[220] J. Mencinger, "Generating employment in economies of transition", in H. Pfusterschmid-Hardtenstein (ed.), *Die Zerrissene Geselschaft* (Vienna, Ibera Verlag, 1999), pp. 209-225.

[221] See chap. 2 of this *Survey*.

building; but without adequate institutions certain reforms cannot be sustained. The financial crisis of August 1998 in Russia is a good but not unique example of this. It is probably impossible to find a general solution to this problem. But in each field or industry the reformers must make all possible efforts to secure an adequate institutional basis for the reform.

Professor Gomulka makes an excellent distinction between the sequencing of privatization and macro-stabilization in the CEE and the CIS countries. He points out that privatization in the CIS was generally carried out rapidly but "before the full liberalization … [and] the hardening of budget constraints and disinflation". Obviously this contrasts with the slower and, I would add, more careful and traditional privatization in the CEE countries (with the exception of the Czech Republic). I agree with the key notion that: "The quality of privatization has proved to be very important, and that there is a trade-off between speed and quality". Here I have two questions. What prevented reformers in the CIS from understanding this simple notion from the very beginning? And why did early privatization in the CIS not help to tighten budgetary constraints for enterprises, which is what one would expect from theory: what was wrong, the reasoning or the techniques of privatization and its sequencing?

Another factor I would like to introduce into consideration of the outcome of reforms in the two groups of countries is the difference between the countries' economic structures. I cannot go into details here, but we should take into account the specific structure of the Russian and former USSR economies.[222] I call it "the triangle economy" to reflect two huge sectors of the economy, which are to a large extent specific to the USSR and Russia – fundamental sciences and defence, and the exporting, natural resource industries. My point is that the objective features (markets, sources of financing, etc.) of these two sectors and the subsequent interests of their owners (managers) are very different from those of general civil manufacturing, services and agriculture. This factor alone is enough to make the transition in Russia (and the CIS) quite different from the CEE countries. Quite a number of Russian economists believe that the blessing of natural resource endowments has not helped the transition in Russia.

Finally, the Russian economic crisis has dominated the CIS region, with Russia continuing to subsidize a few countries. It is hard to envisage rapid growth in the other CIS countries before a Russian turnaround. The unfortunate end of the macro-stabilization in Russia in 1997-1998 in the financial crash was due to the incomplete institutional transformation, delayed structural reforms and obvious miscalculations. But the crash brought economic policy back to a more rational framework at the expense of the collapse in the banking system. A fast turnaround in 1999-2000 in Russia would support the argument that economic policy matters but that there is no single, correct approach to institution building, macroeconomics and sequencing.

[222] L. Grigoriev, "To a new stage of transformation", *Voprosy Economiki*, No. 4 (Moscow), 2000; and "The results of economic transformation of Russia in the 1990s", *Survey of Economic Policy in Russia in 1999*, Bureau of Economic Analysis (Moscow), 2000, chap.1.