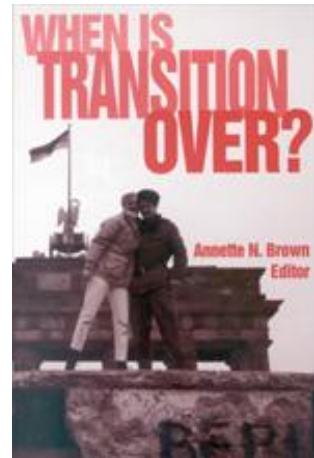




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2 The End of Transition?

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When is transition over? That question was frequently asked as we prepared the *1996 World Development Report: From Plan to Market*. We did come up with an answer. Transition is over when the problems and the policy issues confronted by today's "transition countries" resemble those faced by other countries at similar levels of development.

Why this answer? Is there not a more definitive benchmark? Some have suggested that transition ceases with membership in the European Union (EU). This Eurocentric approach, however, overlooks the vast differences between transition countries. The Czech Republic and China have little in common except that they were planned socialist countries dominated by the Communist Party. Vietnam's level of development is far from that of Hungary, and the latter is much more developed in economic and social terms than Turkmenistan. Such differences—and many others—have influenced countries' choice of transition paths and the outcomes from their reforms.

The differences are also important for the endpoints of transition. After the initial phases of liberalizing the controlled economy and attaining or maintaining macroeconomic stability, deep institutional change is essential for the transition process. Even comparing countries that have been market economies for long periods, formal market-supporting institutions are typically far stronger in those nations that are more developed and have higher income levels. Few poor countries have well-functioning legal systems, or effective, well-regulated financial markets. The extent to which institutional development needs to precede and set the stage for growth, rather than to simply follow rising income, is a debated question, and one can find examples suggesting an emphasis on one or the other of these sides. Nevertheless, the relationship between income levels and formal institutional development points to the fact that transition has different endpoints for the

countries concerned as well as different starting points. Like automobiles, market economies come in many different models. The Democratic Republic of Congo (formerly Zaire) and Switzerland are each, in its own way, market economies.

Whatever the endpoint, transition countries are not there yet. Considering individual countries, we see features of their transition process that may extend out a long way into the future. The Czech voucher funds, for example, will provide a distinctive dimension to ownership for some time. Countries such as Romania and Armenia, which privatized agricultural land in small parcels to households, will need to undergo an extended period of consolidation to achieve a long-run equilibrium distribution of commercial landholding. The reverse is the case in countries such as Russia, where large state farms were transformed into huge joint-stock corporations, resulting in a distribution of landholding unlike that in any other market economy, where farms are on average far smaller and are usually owned by families, even if formally incorporated. In some countries, such as Poland, it will take time to resculpt the role of the state in social protection towards the patterns typical of the more industrial market economies—even as these patterns are themselves evolving.

To better focus on where the transition countries are relative to the “reform frontier,” let us consider the following questions. How far have transition countries come along various dimensions of reform, and what has driven reforms in diverse groups of countries? How have differences between countries influenced the response to reforms? What is the remaining agenda for the countries in these groups? Transition is an ongoing process, and our evaluation of the reforms and their consequences must still be tentative—but we know a lot more than we did a few years ago.

MOVEMENT TO THE MARKET

Transition involves a lot more than freeing prices, but liberalization of the planned economy is at the core of the transition process. Here, we can consider three groups of countries: the advanced reformers in Central and Eastern Europe, the later reformers in the former

Soviet Union, and the East Asian cases, China and Vietnam. The first and third groups started reforms before the second, and, in addition, many in the first group of countries liberalized their economies very rapidly. Reforms, however, affect economies over a period of time rather than instantaneously and therefore need to be sustained: cumulative exposure to reforms is more important than the immediate situation. By 1996, as a result of these differences in speed and timing, the cumulative exposure to market forces since the initiation of reforms (that is, the number of reform-years expressed on a comparable basis) was perhaps twice as great for the more advanced of the reformers in Central and Eastern Europe than for typical countries in the former Soviet Union. The East Asian countries—despite the incomplete nature of their reforms—had also exposed their economies to market forces to a substantial extent.

Transition countries can also be compared along other policy dimensions: how far have they come, for example, in legal reform, in reducing the role of the state in production, in creating a market-based financial system, or in changing the social protection function of the state towards a role compatible with a market system? When this comparison is made, a broad pattern develops, suggesting that, in general terms, institutional evolution away from the planned model goes hand-in-hand with cumulative exposure to liberalized market forces. For example, no country has moved significantly towards creating a market-based financial system without sustained liberalization of the pricing mechanism for goods and services.

This broad parallelism between market and institutional reforms is not precise enough to determine the answer to all pressing policy dilemmas: for example, at what stage is it appropriate to liberalize financial markets? However, it does serve to show the limited value of the debate on whether market or institutional reforms should come first. Certainly, the efficiency of market economies reflects the strength of their underlying institutions, meaning that a sudden liberalization of markets risks pitchforking a planned economy into a very inefficient market mode of operation. Some analysts therefore argue that market reforms should only proceed after the institutional underpinnings of markets are present. Yet, market-supporting institutions cannot develop without clear demand for their services. Without market discipline and private creditors, for example, countries will not develop the

capacity to administer bankruptcy laws; without private shareholders, the capacity to enforce minority ownership rights will remain undeveloped. Incomplete liberalization or attempts to sustain the status quo can also inhibit the development of market-supporting institutions: the case has been made, for example, against attempts to sustain the ruble zone rather than moving rapidly to a system of market-clearing national currencies in the former Soviet Union.

Thus, there are strong synergies and bidirectional causality chains between elements of the transition, so that, to be effective, reforms typically have to proceed across a fairly broad front. This interdependence of policies is one of the factors that distinguishes transition from the more normal process of selective policy reform within an established market system.

What, then, has driven reforms? The answer seems to be a mixture of three factors. The first is the steady decline in efficiency of the planned economy relative to market systems. Sharply falling productivity became evident in the Soviet Union in the early 1960s, and, by the end of the 1980s, the Soviet economy had essentially stalled, despite high investment rates. The quality of machinery exported from Eastern Europe to Western Europe declined steadily relative to that of machinery from market economies, as shown by a persistent fall in its value per unit of weight to a little over one-third of market economy levels. Propelled by a very high forced savings rate, China's growth was appreciable, yet, especially in rural areas, consumption lagged and living standards fell considerably behind those of the rapidly growing market economies in the region.

The second factor driving reform is political change. Across Central and Eastern Europe and the former Soviet Union, the timing and intensity of economic reforms, as measured by estimates of liberalization and other indicators, correlate closely with indicators of political change, as assessed by advances in civil liberties and political freedoms. Such change was perhaps the major driving force for reforms in Central and Eastern Europe, and it is no accident that economic reforms progressed faster in countries such as Estonia, Poland, and the Czech Republic, where political changes were the most radical. Fundamental political change created an opening for radical economic change, a so-called "period of extraordinary politics" devoid of effective pressure groups able to oppose the adverse impact that economic

reforms would have on many established sectors and enterprises. In addition, optimism on the political side due to expectations of rejoining Western Europe provided an important stabilizer in the initial, difficult, transition years. Countries such as China and Uzbekistan, in contrast, were far less ready to subject the industrial core of the planned economic system to the full market forces unleashed by reforms.

Macroeconomic crisis is the third factor that has shaped the approach to reform and its speed. As tight political control and the planned economy began to erode in Central and Eastern Europe and the former Soviet Union, so macroeconomic imbalances grew. This situation was propelled forwards by weakening central controls on wages and on the investment demands of state enterprises, in the face of the limited supply of goods and services made available by the stagnating economy. Financial balances began to build up in household and enterprise savings accounts. Representing claims on resources that had been made available to the planned economy, these large involuntary holdings or “money overhangs” would have rendered attempts at slow liberalization very difficult, and they also had important inflationary consequences when prices were released. The money overhang was especially severe in the common ruble zone of the Soviet Union. It was significant in some of the Central and Eastern European countries but less so in others, and it was negligible in China, where, in contrast, households were underfinancialized at the start of reforms.

Because of the range of imbalances, the pace and phasing of reforms differed between countries. Driven by a combination of political changes and severe macro-imbalances, many countries in Central and Eastern Europe and the former Soviet Union initiated rapid liberalization programs, followed by fiscal and monetary policies aimed at stabilizing the price level. Inheriting high open inflation, reformers in Vietnam also initiated swift, if more limited, changes. China’s reforms, in contrast, opened with quick steps to partially liberalize the rural economy and to decollectivize agriculture; thenceforth, changes were in phases and relatively cautious, encouraging the entry of new nonstate firms but sustaining the core of the previous, state-owned enterprise system.

REFORM OUTCOMES

In Central and Eastern Europe and the former Soviet Union, the typical response to liberalization was high inflation associated with sharp economic contraction. The extent of the latter is debatable; indexes of economic activity that overemphasized the shrinking heavy industrial sectors and underweighted the emerging small-scale manufacturing and service sectors imparted a negative bias. Nevertheless, the representative country recorded early output losses of 20–40 percent of gross domestic product (GDP) and inflation rates that peaked at several hundred percent, although there were wide variations around these figures. Not all of the output loss necessarily translated into welfare losses: heavy industry, especially that connected with the military sector, had been greatly overbuilt, and lost output was probably a social good rather than a calamity. Still, the sharp decline in major enterprises created severe stress for those working in the relevant sectors.

Three to four years after reforms, however, things looked rather different. Inflation had been contained and brought down to moderate levels in many countries, and an expanding private sector, heavily oriented to services, was growing rapidly enough to be capable of offsetting the continued contraction of state industry. In about half of the countries in Central and Eastern Europe and the former Soviet Union, private business accounted for over 50 percent of economic activity by 1995, a remarkable increase from its share of 10–15 percent only a few years earlier. This gain was due both to new entry and, in many countries, significant privatization of the state sector using a variety of mechanisms. After bottoming out, many economies were beginning to expand again. Notably, growth resumed more strongly, and inflation came down more rapidly, in countries that liberalized their economies most resolutely, while the turnaround was more delayed in countries reforming in a hesitant manner. From a structural perspective, by the mid 1990s the leading reformers in Central and Eastern Europe had begun to approach the distribution of economic activity characteristic of market systems.

In contrast with this U-shaped pattern, China and Vietnam experienced rapid growth from the start of their transition. These nations

maintained inflation at moderately low levels (in Vietnam's case, after initially bringing it down from high levels).

What has shaped the varying response of transition countries to their reforms? Has it simply been different policies? Or, have the outcomes of reform reflected variations among countries in terms of their initial conditions? The differential impact of policies and initial conditions is still a contentious question, and econometric study to disentangle their effects is only now becoming possible. Nevertheless, elements of the story are starting to be clear.

Abstracting from the political dimension, the heavily industrialized countries in Central and Eastern Europe and the former Soviet Union faced a very difficult choice. If they liberalized their economies, major segments, including massively overbuilt industries, would be exposed as hopelessly uncompetitive. There would then be pressure to subsidize these industries, to sustain output, and especially to preserve jobs. Where would resources come from for subsidies? The state enterprises were themselves major sources of fiscal revenues. On the financial sector side, sharp price increases resulting from the pent-up money overhang would wipe out savings, reducing the willingness of economic agents to continue to supply resources through the banking system. Bringing inflation down to levels where markets could function effectively and private investment needed to "grow the new economy" would not be discouraged would therefore require decisive action to cut subsidies, which would be very difficult until the state severed its links with the enterprises and allowed market forces to operate freely. The choice, given severe structural imbalances and a monetary overhang, has therefore been either rapid liberalization followed by cutting state subsidies and stabilizing the economy, or an extended period of economic contraction while trying in vain to protect the old industrial sector.

The interaction between policies and performance was very different in China. With far smaller state employment in relative terms and no pent-up purchasing power, China was able to reap large efficiency gains from rural reforms. These were then channeled towards accelerating industrialization, both by supplying resources to construct new "township and village" industries and by creating a rapidly growing market for industrial goods. At the same time, high savings out of rising incomes could be directed to the state enterprises through the bank-

ing system, cushioning them against the steadily increased competition with the nonstate sector as nonagricultural markets were progressively liberalized. This protection gave even laggard Chinese enterprises more time to adjust but stored up a problem for the future in the form of a large volume of nonperforming loans in the banking system.

Could an alternative policy have worked in Central and Eastern Europe and the former Soviet Union? For example, suppose governments had first privatized a wide range of small assets to absorb the money overhang and at the same time had reimposed tight control on wages and investment to prevent excess demand from reemerging. This policy in turn might possibly have paved the way for a more controlled process of reform, with gains from the growth of new sectors offsetting steady losses and contraction of old ones. Such a scenario might have been possible in theory, although the large relative size of the overbuilt sectors and the painful institutional changes needed—for example, to reform Soviet-style agriculture—would have rendered it very difficult and perhaps no less painful than the process that actually took place. However, such a hypothetical process was out of the question in the face of the essential springboard of the transition in Central and Eastern Europe and the former Soviet Union: weakening governments, followed by the breakdown of the political system itself.

Within this broad sweep of experience, there have been other contrasting outcomes. Geography and history have played important roles: recovery is easier for a country such as the Czech Republic, which has long borders with rich market economies, than for the Kyrgyz Republic, isolated in Central Asia with most communications routes going through Russia. Russia itself has been slower to recover than expected. One reason may be that the energy sector was the major provider of subsidies to other sectors under the planned system: with liberalization, benefits to the energy sector have flowed into relatively few hands, widening the disparity in the distribution of income and fueling an increase in imports and an export of capital that has left poorly equipped light industry and agriculture behind. Widespread corruption and conflicts over corporate governance have also increased the barriers to private investment and growth. Perhaps we now have too many explanations for transition outcomes! But at least we understand the factors better, even if we do not know their exact relative weights in determining the results.

THE AGENDA TO COME

What of the future? What are the remaining issues on the reform agenda? Phase 1 reforms involving the introduction of market forces and the opening of economies to private firms are well on the way in all but the least advanced transition countries. Phase 2 reforms, including those of the legal system, of the financial system, and of government itself, involve institutional change as well as the virtual creation of new professions, such as lawyers, bank supervisors, and accountants capable of functioning in a market economy. The necessary institutional change runs deep, extending down into the educational systems of the transition countries as well as to courts, banks, and governments themselves. Therefore, it cannot be a rapid process.

At the risk of generalization, the reform agenda can be discussed according to the three groups of countries. All have a great deal of economic promise. Central and Eastern European countries can benefit from “catch-up” with their large, rich, market-economy neighbors. The former Soviet Union can exploit an abundant natural-resource and human-capital base far more effectively than hitherto. The crises of late 1997 notwithstanding, the East Asian transition countries also have strong bases to tap, including a hardworking, educated population, a tradition of high saving, and proximity to a region with high long-run growth potential. Yet, to achieve their potential as market economies, all three groups face major challenges.

The leading reformers in Central and Eastern Europe are well along with Phase 1 changes. Phase 2 includes harmonization with the EU in preparation for accession. The primary challenge remaining is to reduce the role of the state in their economies to the point where this does not constitute a serious constraint on competitiveness and growth. State spending, largely for social programs and, in particular, pensions, still comprises close to 50 percent of GDP in some of the countries, as large as before transition. This high share has been sustained by a heavy, and distorting, tax structure that, among other things, creates a strong disincentive to hire labor through the formal economy. Competitor countries at similar income levels, including those in the Far East, impose substantially lower fiscal burdens on their productive sectors, making space for far higher levels of investment.

The challenge in much of the former Soviet Union is very different. The collapse of the Soviet Union seriously undermined the capability and the credibility of governments. Fiscal revenues fell sharply, and governments lost effectiveness in administering law and order as well as in the area of social protection. The credibility of Russia's policy regime, as viewed through a survey of businesses, ranked with the poorest in the world and fell far short of that viewed as prevailing in the Czech Republic. In some cases in the former Soviet Union, property rights have been reallocated towards the private sector on a massive scale, as in Russia, but the distributional and corporate governance consequences of the mechanisms used have been contentious. In some cases, as in agriculture, formal privatization has not yet led to an effective reallocation of rights towards individuals. Reforms in the former Soviet Union are therefore at a more elemental state than in the more advanced countries in Central and Eastern Europe.

Despite very rapid growth, China faces a pressing set of issues, including a massive deferred agenda of urban reforms. These include changes in the social security system (even in the late 1990s, Chinese enterprises are still largely responsible for pensions, housing, and healthcare, making it difficult to close them down) and the banking system, which is burdened by a massive "black hole" of nonperforming loans. The announcement of a \$35 billion bond issue in February 1998 suggests an approach towards the problem posed by the stock of bad loans; however, measures to stem the flow of new bad loans would have severe implications for many enterprises that depend on continued lending. Some 100 million workers in nonstate firms are outside the formal social system yet no longer tied to agriculture; a "floating population" of some 70 million has broken down previous constraints on labor mobility. In addition, the state's ability to redistribute resources from growing coastal provinces towards poor remote regions needs to be restored; central government's fiscal revenues have fallen throughout the reform period, reaching low shares of GDP by the mid 1990s.

Finally, let us consider social factors arising from transition that may affect post-transition performance. Experience so far suggests that the process of transition is not easily reversed. Even the return of ex-socialists to power in certain countries in Central and Eastern Europe and the former Soviet Union has not caused the economic

reform clock to be turned back, although it has, in some cases, slowed the pace of change. What kinds of economies and societies will the transition countries turn out to be? Will the distribution of property emerge as sharply unequal? Property rights to large assets have been difficult to disperse rapidly on a wide scale, except perhaps through the use of voucher schemes as implemented in the Czech Republic. Yet experience shows that, if formal property rights are not allocated rather early in the transition, they tend to become appropriated anyway by powerful individuals or groups as the hold of the state on the economy weakens. Related to this question is that of the social and economic impact of increasing income inequality. From initially low or moderate levels, Gini coefficients¹ have tended to increase for most countries in transition, somewhat in Central and Eastern Europe and sharply in the former Soviet Union. Cross-country studies of market economies suggest that nations with highly unequal income distributions perform relatively poorly, in part because distributional concerns fuel social tensions that cause policies to be less stable. Here is a major challenge for many of the transition countries in the future.

NOTES

NOTE: The material for this lecture is based on the World Bank *World Development Report 1996: From Plan to Market* (Oxford: Oxford University Press) and associated research. The lecture, however, expresses the views of the author. It does not necessarily represent the views of the World Bank, its executive directors, or the countries that they represent.

1. The Gini coefficient is a measure of the inequality of income distribution.

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