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## 71 Transition economies: lessons for development

*Ruud Knaack and Henk Jager*

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### **Introduction**

'Transition' is a designation that is widely used for the transformation of state socialist countries, characterized by state-controlled economies and political dictatorship, into democratic market economies. Transition started to receive intensive attention when a number of countries freed themselves in 1989 from either particularly the Soviet control (think of Poland, Hungary, Czechoslovakia, East Germany and the Baltic states) or mainly domestic tyranny (such as Romania and Albania). Transition was extended in 1992 to the former Soviet Union (FSU) states, also dubbed the Commonwealth of Independent States (CIS), after the disintegration of the Soviet Union in December 1991.

We also will consider countries such as China and Vietnam as transition economies, though there is a reason to exclude them. In China and Vietnam political power remained in the hands of the leaders of the communist parties. In contrast, the member countries of the FSU and the Central and Eastern European (CEE) countries have undergone a dramatically rapid democratization process – with some exceptions, such as Belarus, Turkmenistan and Uzbekistan. If a high speed of political turmoil were a determining feature of transition, countries such as China and Vietnam would stay out. The differences between the outcomes in, on the one hand, the countries in CEE and of the FSU and, on the other hand, China are striking. From the countries of the first group, only three countries were able to recover from the 'transition depression' of gross domestic product (GDP) after ten years. However, China did not experience a decline in GDP in any year from 1978 onwards – China's transition period – while it had a high and stable annual GDP growth figure in the order of 8 percent on average. It is, of course, quite interesting and informative to analyze the reasons for such economic divergences. For that goal, we will not employ a rapid political transformation as a distinctive feature of transition, so that we will focus on economic transition.

At the start of transition in Europe, around 1990, knowledge about the preferred materialization of the transition process was partly borrowed from the experience obtained from the process of economic growth in

developing countries. Now, more than 15 years later, there is ample information about the transition process to consider the reverse question: What are the lessons of this transition from practice for developing countries that are eager to give additional spurs to growth? The search for these lessons is the aim of this chapter. The chapter consists of three parts. It starts with a short history of political developments, mainly in Russia, the motor of state socialism after World War II. The next part describes the stylized facts of the transition process in the countries in CEE and of the FSU, and China as well. The following part discusses the lessons for developing countries that can be drawn from the transition process.

### **A short political history**

After the October Revolution of 1917, the Bolsheviks found all political power in an internationally isolated and underdeveloped country rested in their hands. They considered it their main task to industrialize the country at full speed, using internally raised investment funds. It was for this purpose that the Soviet planning system was created (Knaack, 1996).

The Soviet Union experienced a 'golden age' in the 1950s. The country grew rapidly, propelled by increases of capital, labor and raw materials. Economic growth directly benefited consumers as their diet and housing improved apace (Schroeder, 1992). Space flights and Nobel prizes symbolized the achievements of Soviet science.

However, from the 1960s onwards, the Soviet economy settled on a slower growth path. According to Ellman and Kontorovich (1992, pp. 10–12), there are three explanations for this slowdown of economic growth. First, a loss of control of the economy. If an economy becomes more complex, coordination from above becomes increasingly difficult. Second, a reduction in the growth rates of both the volume and the productivity of production factors. One could not, for example, increase the participation rate of women any more, and also stocks of natural resources were running out. Third, a weakening of the 'entrepreneurial spirit'. In a command economy, pressures from above provide the main source of dynamics in an economy. Brezhnev's policy of 'stability of the cadres' represented a codification of the process of slackening the pressures from above.

Declining growth rates alone cannot explain the collapse of the Soviet Union at the end of the 1980s. According to Kornai (1992), the command system was still able to guarantee the population a decent way of life. What caused the crisis was its weak economic performance relative to that of the USA and other Organisation for Economic Co-operation and Development (OECD) countries. The dynamic efficiency argument was the *raison d'être* of the Soviet Union. Consequently, the relatively poor growth figures of the 1980s threatened the political legitimacy of the whole system.

Economic reform under Gorbachev must be understood as part of his effort to revive and modernize the Soviet economy. The results of the reform process were disappointing, mainly because Gorbachev's policies were not feasible (Hewitt et al., 1987). But his policies also had unintended consequences. This happened especially for his glasnost policy intended to unmask bureaucrats sabotaging the reform process.<sup>1</sup>

On 1 November 1989, the Berlin Wall fell. From that moment on in CEE one country after another unlinked itself from the Soviet dominance and started a process of conversion from a centrally governed economy to a market economy. On 30 June 1990, the two parts of Germany were officially reunited and the German economic, monetary and social union was created. In Czechoslovakia, the Velvet Revolution ended the ruling of the Communist Party in November 1989. The new government of Prime Minister Klaus introduced a series of measures as from 1 January 1991, aimed at the integration of the Czechoslovakian economy into the world economy. The Soviet Union was also contaminated with this spirit of the time. After the breakdown of its economic system the new rulers strove for a rapid transition towards a new system characterized by market relations, private ownership, and a liberal democracy. After the abortive *coup d'état* of August 1991, the Soviet Union disintegrated and Yeltsin became President of the new Republic of Russia. On 2 January 1992, the Gaidar administration introduced a number of market reforms, which inflicted an enormous shock to the Russian economy.

### **Stylized facts of the transition process**

#### *Central and Eastern Europe and the former Soviet Union*

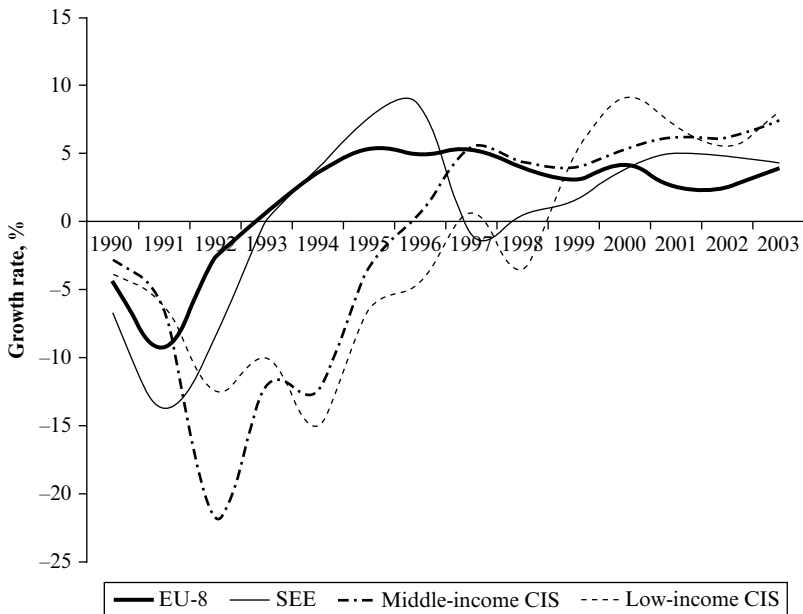
The processes of change in the countries of CEE were not based on a blueprint showing how a formerly communist country ought to be restructured as a capitalist country. According to the prevailing opinion, that was not necessary. Due to the German unification, East Germany took the West German legislation and rules over at one stroke and Eastern German enterprises were privatized at a quick pace. Other countries had the possibility to copy a large part of the existing and tried and tested recipe as applied earlier by, for example, Spain at its accession to the European Union and developing countries at their integration into the world economy. It was the recipe developed by the International Monetary Fund (IMF) and the World Bank (Taylor, 1993) and is often dubbed the Washington Consensus.

The Washington Consensus comprises the 'Holy Trinity' of stabilization, liberalization and privatization (Rutland, 1999). This Consensus initially was advice for a reform agenda for the Latin American countries at the end of the 1980s to adapt their policies and institutions.<sup>2</sup> Applied to the former

communist countries at the time, this trinity would read as follows. 'Stabilization' refers to the need to reduce inflation, both open and suppressed, to create a currency with a stable external value, and establish balance-of-payments equilibrium. To achieve these goals, a standard package of fiscal and monetary measures was recommended, together with price liberalization so as to eliminate suppressed inflation. 'Liberalization' means the freeing of enterprises and individuals of the old planning institutions. The initial expectation was that the disappearance of these planning institutions would create space for the new market institutions to arise spontaneously. 'Privatization' was considered crucial for both political and economic reasons. Politically it would create powerful interest groups with a stake in transition and, for that reason, strongly opposed to the old system. In addition, it would secure active support from the West. It was thought, moreover, that only privately owned enterprises could operate successfully in a market economy. The collapse of the communist regimes in CEE after 1989 and the dissolution of the Soviet Union in 1991, spread optimism about the chances of rapid economic growth.

The transition process appears to have several characteristics, both intended and unintended (Campos and Coricelli, 2002; Ellman, 2005; Knaack and Jager, 2007). First, all countries of the former Eastern bloc faced a dramatic fall in output. The individual country patterns of recession and recovery cover the years 1989–97. They have largely been of the L-curve shape (sharp fall, followed by slow recovery), rather than the initially hoped-for J-curve type (small fall, followed by fast growth). Figure 71.1 displays the growth rates of real GDP in the years of transition for the distinct country groups. The strongly negative GDP growth rates for each group in the first years of transition indicates that real GDP levels should exhibit L-curves. The fall of investment expenditures, especially for inventories and housing, was even larger than the fall in real GDP. Defense expenditures on equipment and materials have declined sharply as a proportion of GDP, especially in the countries of the FSU. Consequently, during the period of falling output, private consumption has declined only moderately relative to production in most transition economies.

Second, a large inter-country variation in the adjustment patterns is observable, with large differences in both depth and length of the L-curve. According to Figure 71.1, for the whole group of CEE countries the average growth rate already became positive again in 1993, after a depth of –9 percent for the sub-group EU8 (the first eight CEE countries that joined the European Union, that is, Poland, Hungary, the Czech Republic, Slovakia, Slovenia and the three Baltic States) and –14 percent for the countries in the sub-group SEE (or South-Eastern Europe), both in 1991. The CIS, however, only experienced for the first time since 1989 positive economic growth in



Source: World Bank (2005, p. 17).

Figure 71.1 GDP growth rates for four regions in CEE and the FSU, 1990–2003

1997. The low-income CIS countries had their depth in economic growth in 1992, with a decline in GDP of over 20 percent, and the middle-income CIS countries in 1994 with a negative growth rate of 15 percent. The variation in the cumulative fall of real GDP per country in the beginning of the transition process has been large. It ranges from moderate for Poland (6 percent, in two consecutive years of output decline) to high for Russia (40 percent, in seven years of consecutive years of output decline) and extremely high (over 60 percent fall) for Armenia (63 percent, in four consecutive years), Moldova (63 percent, seven years) and Georgia (78 percent, five years).

Third, like output, the level of foreign trade in transition economies has followed a pattern of decline and recovery. In the countries of Eastern Europe, foreign trade declined by 62 percent in the period 1990–93 and then rose to 71 percent of 1990's export level in 1998. As for trade redirection, the share of the Western countries in the export of the CEE countries has increased tremendously. It nearly doubled from 35.8 percent in 1992–93 to 67.5 percent in 1998–99 (World Bank, 2002, p. 7). For the CIS countries this share did not change at all: it remained at 28 percent. On the other hand, the



former CMEA trade collapsed.<sup>3</sup> Appropriate exchange rate changes to promote competitiveness proved to be a useful help in redirecting and promoting foreign trade. For example, the Czech Republic was successful in redirecting its trade to the West by devaluating its currency by 50 percent. In contrast, East Germany could not benefit from devaluation at all. Instead, it suffered from a managed real revaluation. Given the one-to-one substitution of the West mark for the East mark, in practice the competitiveness of East Germany badly worsened, creating mass unemployment.

Fourth, the sectoral composition of GDP in current prices changed during transition in favor of services and away from manufacturing. Largely this was due to the relatively larger contraction of manufacturing during recessions. However, productivity gains in the manufacturing sector and, therefore, declining relative prices of manufacturing products during economic recoveries also contributed to this sectoral change.

Fifth, during the transition the participation rates in the labor markets changed rapidly. Under communism, the participation rates were high, in particular for women. During the transition there was a significant increase of flows out of the labor force, especially for women and older persons near to retirement age. At the same time, officially registered unemployment rates increased much faster in Eastern Europe relative to the FSU countries. Labor also moved in great numbers from the state sector to the private sector. In contrast, geographical labor mobility remained very low.

Sixth, the production fall in the formal sector led to sharp increases of the official unemployment rates. Across the transition countries, the employment rates differed widely. The outcome for a specific country strongly depended on whether or not the loss of employment in the old enterprises was compensated by the creation of jobs in new (*de novo*) enterprises. In transition countries where restoring sustained growth has proved relatively illusive, new enterprises account for a low share of employment and value added – both between 10 and 20 percent (World Bank, 2002, p. xxv). According to the World Bank, in practice the transition process proves only to get momentum when the share of medium- and small-scale enterprises in the national employment is more than 40 percent. The CEE countries reached this percentage in 1996. In this respect, the countries of the FSU stayed behind. In these countries the growth of small-scale enterprises stagnated completely; here the share of small enterprises did not rise above 20 percent. Both the government and the Mafia seem to be responsible for that, as they viewed the new enterprises as cash cows instead of centers of new economic initiatives that have to be stimulated.

Seventh, a major result of the transition has been the emergence of a large informal sector. Partly, this concerns new enterprises, which wish to escape the attention of bureaucrats and tax authorities. Partly, it concerns

enterprises that already existed under the old system. These enterprises undertake substantial volumes of activity 'off the books' and make extensive use of barter trade. In addition, there has been a widespread informalization of the labor market. This takes the form of, for instance, unilateral determination of wages and conditions by the management of the firms, regardless of laws about these matters. Other examples are employers that disregard paying wages on time, and employees that do not receive maternity leave, are not protected from dangerous working conditions and are not represented by trade unions.

Eighth, a dramatic result of the transition has been a huge increase in relative and absolute poverty, as well as income inequality. According to the World Bank (2002, p. 8), between 1990 and 1998 the population living on less than US\$1 a day in the CEE and CIS regions increased from 1.5 to 5.1 percent. It was the only area in the world for which this share increased in that period (in the poorest area worldwide, that is, sub-Saharan Africa, the share remained stable at 47 percent). The norm of US\$1 is in effect not appropriate for the transition region as the costs of living are higher there than in other regions. Think, for example, of the cost of heating. Adapting the poverty line for region-specific costs, the World Bank estimates that between 1987–88 and 1993–95, the share of the poor in the total population in the FSU and CEE rose from 3 percent to about 25 percent, and in number of persons from 7 million to 89 million. This means that the transition process pushed more than one-fifth of the population below the poverty line. A group of the population that was particularly badly affected was children. Pensioners also suffered heavily. As a survival strategy, the population in all countries involved put much time and energy into cultivating food in the many allotments. For example, in 1996 this line of food production was estimated to yield 43 percent of Russia's total food production. The deterioration of the living conditions led also to demographic changes. There has been a striking increase in mortality, concentrated among adult men in Russia and Ukraine. This increased the gender gap in life expectancy (in Russia women have a life expectancy that is 13 years longer than men). There was also a dramatic decline in birth rate and an increase in emigration. The combined effects of the current trends in mortality, birth rate and migration are that the population in many countries in CEE and the FSU declines.

Poverty increased not just because of the fall in output, but also due to greater income inequality in all European and FSU transition countries. Table 71.1 contains these developments over time in the years 1987–98, expressed through the Gini coefficients. Without any exception, the countries included in the table had a higher Gini coefficient, and thus a more unequal income distribution, at the end of that period. The CIS exhibited,

*Table 71.1 Income inequality during transition*

Countries	Gini coefficient of income per capita		
	1987–90	1993–94	1996–98
<i>CSB</i>	0.23	0.29	0.33
Bulgaria	0.23	0.38	0.41
Croatia	0.36	–	0.35
Czech Republic	0.19	0.23	0.25
Estonia	0.24	0.35	0.37
Hungary	0.21	0.23	0.25
Latvia	0.24	0.31	0.32
Lithuania	0.23	0.37	0.34
Poland	0.28	0.28	0.33
Romania	0.23	0.29	0.30
Slovenia	0.22	0.25	0.30
<i>CIS</i> <sup>a</sup>	0.28	0.36	0.46
Armenia	0.27	–	0.61
Belarus	0.23	0.28	0.26
Georgia	0.29	–	0.43
Kazakhstan	0.30	0.33	0.35
Kyrgyz Republic	0.31	0.55	0.47
Moldova	0.27	–	0.42
Russian Federation	0.26	0.48	0.47
Tajikistan	0.28	–	0.47
Turkmenistan	0.28	0.36	0.45
Ukraine	0.24	–	0.47

*Notes:*

— Not available.

a. Median of countries with data.

CSB is the acronym of Central and South-East European countries and the Baltic States.

*Source:* World Bank, 2002, p. 9.

on average, a much larger increase than the CSB (Central and South-East European countries and the Baltic States). The Gini coefficient of Hungary hardly increased, whereas Armenia showed the largest increase. The picture of changes in the Gini coefficient in the years after 1998 (until 2003) is divergent: for example, Poland and Romania experienced further increases in the coefficient, for Hungary there is no change, while Russia and Armenia exhibit substantial declines in the coefficient (see, World Bank, 2005, p. 15).

Ninth, growth of crime and the widespread criminalization of society has been a significant feature of transition. This has been particularly

marked in the FSU. In some countries, kleptocracy has been an important part of the political system. In these countries, there are also close links between the criminal, political and business worlds. This is connected with the inability of the state to perform even its night watchman functions. Hence, the supply of property protection and rule enforcement are privatized, that is, taken over by criminal organizations.

Tenth, during transition the old institutions collapsed, creating an institutional vacuum (Schmieding, 1993; Knaack, 1996). As the transition experience has advanced, it has become clearer that the disparity between the rapid progress in liberalization and privatization and the slow development of institutions that support markets and private enterprises directly and negatively affects overall economic performance.

### *China*

The reform processes in the countries of Eastern Europe and the former Soviet Union can be better evaluated when we compare them with the reform process in China. It is interesting to compare, for example, Russia and China, because there are so many similarities between them as economies in transition and yet the outcomes of the transition process were so different. As said before, the fall in GDP in Russia in the period 1991–94 was more than 40 percent, while in the period 1978–2002 the annual growth rate in China was 9.4 percent. During this period in China, the per capita income of rural and urban population, measured at constant prices, increased 5.3 and 4.7 times, respectively (Lin, 2004). How can we explain these differences?

There are many similarities between Russia and China as economies in transition (Buck et al., 2000). These include the enormous geographical scale, abundance of cheap labor, and large potential markets to attract foreigners. In addition, both countries inherited similar economic and political ideologies from their Stalinist and Maoist periods, with a common emphasis on Party control, high defense budgets, large industrial enterprises, heavy bureaucratic and tariff protection against manufactured imports, and subsidized public services.

Of course, there were important differences too. The main difference was the economic structure. On the eve of the start of the transition process (in Russia in 1991 and in China in 1978) China was largely an underdeveloped and rural country with 71 percent of the workforce active in agriculture, despite heavy industrialization efforts in the 1950s and 1960s. Russia was an industrialized country with only 13 percent of the population working in agriculture. China's financial system was also relatively underdeveloped.

To some extent, these differences in initial conditions and structural characteristics can explain the divergence of transition policies. Since

agriculture was the biggest sector, accounting for 37 percent of output and 71 percent of employment, agriculture was the biggest Chinese economic problem in 1978. It explains why the transition process started in agriculture and gradually spread to industry. When China started its transition in 1978, initially the government did not question the feasibility of the old system. Its attempt was simply to improve the system by giving agents in collective farms and state enterprises some autonomy so that a closer link between personal rewards and individual efforts could be established. Agricultural prices were raised substantially, mandatory quotas for sown area and output eliminated, and compulsory procurement quotas reduced, with the sale of above-quota output on free markets and increased possibilities for so-called sideline activities. Finally, the commune system gave place to the family responsibility system, accounting for 94 percent of the peasant households in 1984. In response to these reforms, per capita grain production rose by one-sixth between 1978 and 1985, the per capita output of cotton rose by two-thirds, and that of oilseeds, sugar and tobacco doubled (Balassa, 1987, p. 411).

With respect to industry, the Chinese government adopted a dual-track policy, liberalizing the entries to the labor-intensive sectors, but also creating conditions to address the viability issue of those firms in the capital-intensive high-priority sectors. The enterprises that were most able to take advantage of the entry option were collective enterprises sponsored by local governments, particularly in rural areas. These township and village enterprises had started already in the Maoist period, but expanded rapidly after 1978. They already produced 33 percent of total industrial output in 1991. Private firms then produced 11 percent, implying that the share of the state sector reduced to a mere 56 percent of total production (Naughton, 1994, Table 1). These developments in industry had two effects. The intensified competition resulted in the disappearance of monopoly rents and the occurrence of a division of labor between the state and non-state sectors. The state sector increasingly consists of large firms in heavy industry, while the non-state sector consists of medium-sized and small firms in light industry.

The success of the reforms in agriculture and industry had a positive effect on the macroeconomic stability of the economy. Formal rationing was in place for more than 20 consumer goods in 1978, accounting for more than 50 percent of consumer expenditures. Shortages of even the basic commodities were common. Shortages of consumer goods disappeared quickly, even though price controls remained in place in China. These policies had two effects: there was a significant increase in living standards and, therefore, an increase of popular support for the reform measures. Due to high saving rates of the Chinese population, there was no collapse of

investment in China, but a dramatic change in the way these investments were financed. Savings by government and by state enterprises has dropped sharply, while savings by private business and households has increased sharply. By the late 1980s, households were saving 15 percent of their income, compared with 2 percent before 1978.

The dynamics of the non-state enterprises exerted a heavy pressure on the state enterprises and triggered a state policy of managerial reforms. These reforms had some success. For example, during the 1980s the output of the state enterprises grew 7.7 percent annually – though other ownership forms of production exhibited even more rapid growth rates. Total factor productivity also grew in the state sector, although less than in the non-state sector. As a result, the state sector is still less competitive than the non-state sector. The relatively low export levels in the state sector compared with the export levels of comparable firms in the West are a clue to that (Buck et al., 2000, p. 393). The continued government subsidization and protectionism of the state enterprises through low-interest loans and monopolistic practices is both cause and consequence of this disappointing competitiveness. The government hopes to eliminate these distortions in the near future.

China also put into effect a policy of opening up to the outside world, but the scope of the opening to the outside world was only expanded gradually. The first step was to set up special economic zones in the south near Hong Kong and Macao, as laboratories for market reforms. Enterprises in these zones had the right to retain most of the foreign exchange they earned and were more flexible in firing workers. Furthermore, foreign investors in these zones could repatriate profits and own land. After the successful performance of these zones, a number of coastal cities were opened, followed by economic areas along some rivers, such as the Yangtze River, and along the borders, and finally capital cities of the various provinces were turned into open cities. In the first years, it was especially the ‘overseas Chinese’, including Taiwanese, who made use of the new possibilities. Later China could welcome a huge influx of foreign direct investment (FDI), also compared, for example, with Russia. In the period 1989–95, Russia attracted FDI to the amount of \$3.9 billion, or \$1.1 per capita, in 1995. In the same period, China received \$121.7 billion of FDI, equivalent to \$18.2 per capita (Buck et al., 2000, p. 384). Virtually all FDI was in the form of joint ventures. Joint ventures were made possible, although the government limited foreign ownership and control of businesses. In the late 1970s, foreign involvement was limited to 35 percent of any venture. This was raised to 49 percent in 1985, while from 1988 onwards majority foreign ownership is allowed, though still subject to state approval. The joint ventures were crucial for the success of the Chinese reform process, because the foreign

companies delivered the technological knowledge for the Chinese partners to produce goods that could compete on the world market.

An important difference between China and the CEE and the FSU is that in China the Communist Party kept control, while in the other transition countries the power of the Communist Party dissolved in favor of a democratic political system. The main argument of the Chinese leadership is that the continued rule of the Communist Party guaranteed social stability, which is conducive for the success of the economic reform. Leaders occupied with competing for power would create uncertainty about whether or not the economic reforms would be continued. This is not to say that there were no political reforms in China. Actually, economic reform often contains some elements of political reform. In the case of China, there was devolution of power from the center to the provinces. This empowerment of the regions has created what is now the major driving force behind economic reform (Woo, 1994, p. 289).

### **Lessons to be learned**

For most economists and politicians the depth and duration of the depression which accompanied the transition process in CEE and the FSU came as a surprise. The initial idea was that the removal of the overwhelming apparatus of political control over economic activity could only imply additional prosperity in the medium term. The previous system was characterized by a myriad of distortions, and the removal of most of them would lead to a vigorous impulse to output. This optimism was not a monopoly of neoclassical economists. Well-known heterodox economists, like Janos Kornai, also held this view (Campos and Coricelli, 2002). This raises the question of how to explain this anomaly.

### *Economic stabilization*

As mentioned before, in order to suppress open and hidden inflation, most transition countries adopted a standard package of restrictive fiscal and monetary policy (sometimes supported by exchange rate and income policy). Experience has shown that, despite widespread initial skepticism, such packages – if persisted in – are successful in reducing macroeconomic instability (Ellman, 2005). However, the time for the package to work may be far longer than anticipated. For example, Poland implemented the stabilization package at the beginning of 1990, but only nine years later inflation fell below 10 percent. Moreover, this restrictive macroeconomic policy may contribute to a sharp decline in output and welfare, as happened in Russia after the unsuccessful attempt at shock therapy by Prime Minister Gaidar. As a result, Kornai (1994) argued – writing on the Hungarian situation where inflation was about 20 percent – that growth must be the main

economic objective when the danger of accelerating inflation does not exist anymore. Stiglitz (1998) strengthens this view, summarizing the evidence that only high – and not moderate – inflation is costly: When countries cross the threshold of 40 percent annual inflation in an upward direction, they fall into a high-inflation, low-growth trap. Below that level, there is little evidence that inflation is costly. Recent research even suggests that low levels of inflation may improve economic performance relative to what it would have been with zero inflation.

### *Optimal sequencing*

Economic stabilization is a prominent part of the discussion on the optimal order of reforms. The transition process of the 1990s has intensified and widened this discussion, which previously was concentrated on the reform process in developing countries. It concerns reform on three levels of aggregation. On the highest level of aggregation, it is about the optimal order over time of economic liberalization, economic stabilization, privatization and the creation of supporting institutions, necessary for a smooth working of the markets. On a lower level of aggregation, the optimal-sequencing discussion focuses the order over time of the different parts of economic liberalization, in combination with economic stabilization. Here one distinguishes the liberalization of domestic goods and labor markets, international trade, domestic financial markets, international capital flows, and the foreign exchange market. On the lowest level of aggregation, the focal point is the optimal order of domestic sectoral reform: agriculture prior to industrialization, or perhaps the other way around?

A very useful empirical analysis of the transition lessons of the optimal order of the highest aggregation level is Beyer (2001). His data set consists for each of 14 CEE countries of the months in which they switched to the new regime, the majority of their prices were liberalized, their most substantial attempt for stabilization was undertaken, and a new or adjusted constitution was adopted (as an indicator of a country's new institutional system). By using groups of countries with a similar order of reform it appears that the sequence over time of stabilization, privatization and liberalization is significantly the best sequence in terms of GDP level six years after the system switch. Beyer dubs this sequence the *graduality approach*. Slovenia and Hungary have followed this adjustment path. These two countries started the reform process with constitution-building. If instead liberalization took place together with stabilization at the start of the reform process, Beyer considers the adjustment process would be a *'big bang'* approach. The countries that belong to this group (Albania, Bulgaria, the Czech Republic, Poland and Slovakia) display a worse development of GDP relative to the gradualists, but a significantly better outcome than the



transition countries that liberalize and/or privatize before stabilization. Early privatization appears to work badly, as Belarus, Romania, Russia and the Ukraine witness. However, Estonia and Lithuania are counter-examples.

The previous paragraph gives the important clue for optimal sequencing at the lower level of aggregation: that stabilization should in any case not come after liberalization. This gives a strong support to the earlier literature on optimal sequencing for developing countries, which concluded that stabilization should be carried out first, followed by liberalization. The standard outcome of that literature with respect to the optimal sequence within liberalization is: domestic goods and labor markets, international trade simultaneously with unifying the exchange rate and realizing the equilibrium value of that rate, domestic financial markets, and finally, freeing international capital flows from border restrictions.

The transition gives some support to this optimal order, though only of an anecdotal character. The anecdotes that follow have to do with the space for the exchange rate to find its equilibrium value in time. In former East Germany, the unification with West Germany implied a 'big bang' liberalization and the introduction of a unified, but highly overvalued currency from former East Germany's viewpoint. The politically motivated choice of a one-to-one conversion of the East mark into the West mark resulted in a huge deterioration of competitiveness of former East Germany and a concomitant disaster with respect to its GDP, creating mass unemployment. This outcome gives support to the earlier-mentioned optimal liberalization order, which requires that the exchange rate is able to reach its equilibrium value in the process of trade opening.

The collapse of the CMEA trade soon after the start of transition and the resulting loss of jobs in the big state enterprises had to be counterbalanced by an increase of exports to mainly the West and the creation of new jobs by small and medium-sized enterprises. The Czech Republic, for example, was successful in both respects. The large devaluation of its currency resulted in a strong swing of its foreign trade to the West and the process of 'small' privatization contributed to strong employment growth in the private sector. Obviously, the Czech Republic also profited from its geographical position and the possibilities of the tourist industry, especially in Prague.

Like East Germany, Russia has opted for, ultimately, a less successful road. As with the Czech Republic, it devaluated its currency in 1992, but made the mistake to choose a more or less fixed exchange rate of the rouble against the dollar under conditions of high internal inflation. The cause was that Russia had already liberalized international capital movements before the economy was sufficiently stabilized. The potential instability was the lax policy stance on fiscal deficits. Large capital inflows initially allowed

the government to finance a continuing fiscal deficit at relatively low interest rates. This can be considered the so-called good equilibrium (see Gros and Steinherr, 2004, p. 243). However, in the meantime, for Russia the debt-to-GDP ratio increased and so did the country's debt service burden. This development gradually undermined the country's credibility. Reinforcing simultaneous developments were a growing overvaluation of the rouble, in response to the large capital inflow, and inflationary pressure, due to capital inflow as long as the central bank stabilized the exchange rate. Both reinforcing developments usually worsen the country's current account over time – in a gradual, but inevitable way. The real appreciation of the rouble did not lead so much to a deterioration of the trade balance, given the strong export potential of the gas and oil reserves. But this appreciation resulted in the crowding-out of the Russian industrial production in line with 'Dutch disease' features. Industry became more and more expensive and lost its possibilities to export. The industrial loss of sales became still more severe because the real rouble appreciation stimulated the Russian consumers to opt for cheaper foreign consumer goods. In this state the country was ripe for a shift in expectations leading to the so-called bad equilibrium (see Gros and Steinherr, 2004, p. 243). Given the openness of the capital account, Russia was exposed to sudden withdrawals of foreign capital. This fear became reality during the summer of 1998, after which the rouble collapsed and a severe economic crisis occurred.

With respect to the third level of aggregation and the concomitant optimal sequencing of sectoral reform, the different reform roads of China and Russia are informative. From the success of the economic reform process in China, some economists concluded that the Chinese road of agriculture first was also applicable to Russia. By starting the reform in industry, Russia was unable to gain the credibility that probably would have come if it had started the reform process in agriculture. This position is debatable. The situation in China and Russia was quite different. In China, the agricultural sector was the biggest sector, accounting for 37 percent of the output and 71 percent of employment. In Russia, the agricultural sector employed only 13 percent of the labor force and generated 18 percent of gross national product (GNP). Moreover, relative to China the Russian agriculture was much more mechanized. It is much easier to assign property rights to the individual plots that farmers have been working on than to assign property rights to the capital equipment that workers have been using jointly.

However, the argument gains weight when we include in agriculture the activities of the townships and village enterprises. In the 1990s they already produced 33 percent of industrial output. Including the private sector, the enormous dynamism of the non-state sector had a positive effect on the

supply of consumer goods and the living standards of the population, and therefore created popular support for the reform measures. A rapid growth of the non-state sector can also absorb the unemployed in the state sector. This happened also in the Czech Republic. In the period 1989–1995, about 25 percent of the workers in the state sector left that sector. They could easily find new jobs in the new private sector, especially in the new service sector. Especially in the Prague area, the new private sector showed amazing growth. A recent report of the World Bank (2002) confirms the importance of the stimulation of the non-state sector in an early phase of the reform process. According to this report, a key for economic growth in transition countries is the shift from capital-intensive to labour-intensive enterprises. The last group consists overwhelmingly in small enterprises (with a maximum of 50 workers). According to the World Bank, the transition gets momentum when the share of medium- and small-scale enterprises in the national employment is more than 40 percent. China fulfils this condition, as well as to a lesser extent some CEE countries.

Compared with China and the Czech Republic, the position of the small and medium-sized enterprises in Russia is delicate. In the years 1995–97 employment in Russian businesses with a maximum of 50 employees fell officially by 50 percent. Disappointing productivity growth cannot be an explanation. On the contrary, these firms often had good performance (Commander et al., 1996, Chapter 8). The true explanation is the ‘grasping hand’ of the Russian government and the Mafia. They compelled small enterprises to pay highly unpredictable taxes and regular payments to their ‘protectors’. This explains why the transparency of government behavior and a reduction of risks in the business environment are important determinants of the success of the reform process.

### *Institutions*

After the fall of the Berlin Wall in 1989, in principle all CEE countries followed a liberalization process directed at the breaking down of the planning systems. It was expected that markets would arise spontaneously as soon as the old planning bureaucrats disappeared. In other words, the policy-makers expected that a process of ‘organic growth’ would create the political and economic institutions necessary for the smooth functioning of a market economy. Obviously they trusted that the fundamental propensities of human nature to ‘truck, barter and exchange one thing for another’, as postulated by Adam Smith, were not foregone during the decades of communist rule (Knaack, 1999, p. 357).

However, they did not take into account the fact that proper functioning markets require an institutional infrastructure and that it takes a lot of time before the new institutional system and the persons who have to work in

those markets are adapted to the new circumstances. A clearly delineated system of property rights; a regulatory apparatus curbing the worst forms of fraud, anti-competitive behavior and moral hazard; a moderately cohesive society exhibiting trust and social cooperation, the rule of law and clean government – these are the social arrangements that economists usually take for granted, but which were absent in the transition economies (Rodrik, 2000). Not only must new institutions be created, but they must also prove their value during a time-consuming process of trial and error. Each economic transition process is fundamentally an incremental process, during which the country constantly experiments with new forms and finally keeps that form which is satisfactory. In this way, the existing institutional structure actually improves.

The abolition of the old planning system in one stroke without the construction of new institutions of a market economy has irrevocably led to an institutional vacuum. That vacuum has many forms (Knaack, 1999, p. 363). The old rules lose their value, but the enterprises have not yet learned how to behave in the new situation. Further, the information structure of the old system disappeared, while the new market signals were not yet fully developed. For the enterprises it was difficult to find new customers, and when they finally succeeded it was difficult to assess their creditworthiness. As a result, the enterprises operate in an environment characterized by an extreme uncertainty.

It is obvious that the institutional vacuum must be filled. In the CEE countries and the countries of the FSU this happened in different ways. In the case of East Germany, the country took over in one stroke the institutions of West Germany. The Czech Republic profited heavily from the neighborhood of the large markets of Germany and Austria, and the country also learned quickly from the international trade relations. Moreover, from 1995 onwards the Czech Republic gradually adopted the *acquis communautaire*, the legal structure of the European Union. It must be stressed that imported blueprints do not do their work instantaneously. The main reason is that blueprints are highly incomplete. Much of the knowledge to operate with the blueprints has not been written down and has to be learned. However, blueprints give a direction for knowledge acquirement.

Russia did not have these advantages. For a big country, it has a surprisingly huge international trade. However, nearly all export is energy and raw materials. Actually, these are the features of a small and open developing country. With regard to the possibility of the import of institutions it only had to fulfil the requirements of the IMF when it borrowed some money. Consequently, much more than the other small CEE countries, Russia had to fill the institutional vacuum on its own terms. Given the fact that the

creation of new institutions is a time-consuming process, one can understand that it fell back on its old routines and that, given the weakness of the state, organizations such as the Mafia also filled the vacuum.

Compared with the CEE and FSU countries, the problem of the institutional vacuum in China was less acute. First, we have to remember that after the reforms of 1978 the overwhelming majority of the economic relations in China was still shaped and guided by the official planning system. Only in a very gradual way was there a shift from the planning system to more market relations. Consequently, firms and individuals had enough time to adapt to the new circumstances and to learn the rules of a market economy. Second, insofar as the enterprises in the economic zones had to obey immediately the rules of the market, they could profit from the experiences, knowledge and economic networks of the so-called 'overseas Chinese', businessmen especially from Hong Kong, who invested heavily in the zones. Third, sales in the big cities of agricultural surpluses and light industry products of the village enterprises need relatively little organization and structure. Permission from the local authorities to sell on a street corner or a square is sometimes enough. This also explains why, for example, in the Czech Republic it took so little time to start small enterprises in the service sector.

### *Political reform*

There is an intensive debate about the relationship between political regime type and economic performance. Based on the experience in a handful of economies in East and South-East Asia, which (until recently at least) registered the world's highest growth rates, under authoritarian regimes, one could conclude that economic development requires a strong hand from above. To embark on self-sustained growth, deep economic reforms are often needed, which cannot be undertaken in the messy pull and push of fragile democratic politics. The main argument is that economic reform necessarily imposes costs on some segments of society, and that political openness would provide the losers with the opportunity to form coalitions to stop the reform. An example of this occurred in 1992 in Russia when the apparatchik Chernomyrdin replaced the reformist Gaidar. The first new acts were to squeeze the thousands of small shops that had appeared since January 1992 and to extend cheap credits to the industries under the Ministry of Oil and Gas that Chernomyrdin had headed (Woo, 1994, p. 288). A strong and committed leadership can also push economic reforms against the interests of some interest groups. For example, Buck et al. (2000) describe that the Chinese Communist Party stimulated joint ventures with foreign partners against possible dissent of insiders of state enterprises excluded from the deals. The central authorities stimulated

foreign investors to select from the state enterprises the best physical and human assets to form joint enterprises, usually geographically separated from the unreformed parts of the state enterprise left behind. Normally, the incumbent manager and workers repel any outside investor, unless they are prepared to give employment guarantees for all branches of the enterprise, including those involved with social provisions.

This line of thought met a lot of criticism. Rodrik (2000), for example acknowledges that in effect the Asian countries have prospered under authoritarianism, but that many more have seen their economies deteriorate – think of Zaire, Uganda or Haiti. Moreover, some of the most successful economic reforms in South America were implemented under newly elected democratic governments – witness the stabilizations in Bolivia (1985), Argentina (1991) and Brazil (1994). Moreover, the transitions in the democratic European countries were more successful than the transitions in the authoritarian FSU countries, like Belarus, Turkmenistan and Uzbekistan. It is obvious that we cannot subtract from these examples a clear-cut answer about the relationship of political and economic reform. But it is evident that the reform process is helped when a strong government is able and willing to create the necessary market institutions and resist the interest, especially of the insiders in the state enterprises.

### **Conclusions**

After the fall of the Berlin Wall in 1989, one country after another in Central and Eastern Europe freed itself from Soviet domination and started a transition process from a centrally planned economy into a market economy. In this transition process, they followed the recipe from the IMF and the World Bank, developed earlier for developing countries, mainly in Latin America. In all transition countries in Central and Eastern Europe, the results were rather disappointing. In 1999, only three of all these transition countries surpassed the 1989 national income levels. The new countries that belonged to the former Soviet empire underwent an even more severe income fall. The national income reductions were much more profound than initially expected. When we compare these figures with China's experience, the difference is striking. China started its reform process in 1978, and for many years had double-digit positive growth figures without any intermediate fall.

The length and depth of the recession in most countries can be explained by the fact that the reform process was based on an incomplete theory about the functioning of a market economy. The policy-makers recognized too late the precondition for the functioning of a market economy, namely an institutional infrastructure, and the dynamics of the reform process, namely that it takes time before the new institutional infrastructure and the

persons who have to work in it are adapted to each other and the new situation. The collapse of the old planning institutions placed the enterprises in an extremely uncertain situation, in which it was difficult to find new customers and to decipher how trustworthy they were. From this perspective the length and depth of the depression depended on the time it cost to build new institutions, for example the new private property rights, and the time for the market players to adapt to them.

Our study also reveals that the negative aspects of transition can be compensated for, and in the Chinese case even more than fully compensated for if the authorities allow structural flexibility. This takes two forms. First, the speed with which the *de novo* enterprises can expand is important for the success of the transition process. This change is observable in the Czech Republic and especially in China. According to the World Bank the transition gets momentum if the share of medium-sized and small-scale enterprises in national employment is more than 40 percent. This condition is fulfilled in China. In Russia, to the contrary, the *de novo* enterprises were unable to expand. The government could not protect the new enterprises against the negative practices of the Mafia and the already existing big enterprises. Behaviour of the government itself, such as an erratic tax burden, also was counterproductive. Second, the loss of the export market that the COMECON was before the regime switch had to be offset by an increase of exports to mainly the West. The Czech Republic was particularly successful in this respect. The strong devaluation of its currency resulted in a strong swing of foreign trade to the West. China's export possibilities to the West also profited strongly from an undervalued domestic currency, the yuan. In contrast, Russia did badly in the 1990s due to an overvalued rouble, leading to a crowding-out of the traditional industry.

Besides these institutional lessons, which are also applicable to developing countries, the transition process in Eastern European countries and the newly independent countries that arose from the former Soviet Union also produced some lessons about the order of reform measures. Institutional adjustments and economic stabilization, both early in the reform process, prove to have positive effects on a rapid restoration of the pre-transition national income level. Late stabilization, in contrast, is devastating in this respect. A late adjustment over time of the exchange rate system towards more flexible – and thus less rigid, disequilibrium – exchange rates appeared to be economically costly in the transition countries: witness the negative experience of former East Germany and Russia, and the positive experience of the Czech Republic. This is an implicit support for the optimal sequence of liberalization steps as developed before the transition experience of the 1990s.

Summing up, the success of a transition process, and thus a development policy in general, not only depends on the building of a viable market

sector. It also depends on the existence of a strong government that is able and willing to create the necessary market institutions, fight the vested interests, and formulate an economic policy that aims at an immediate and thorough economic stabilization. Privatization and full liberalization can come later. As soon as domestic markets function, a rapid opening of international trade and stimulus of the international trade relations, including the introduction of a unified exchange rate which closely approaches its equilibrium value, should be focal points of economic policy.

## Notes

1. For example, latent nationalism was fuelled by new publications about the Chernobyl catastrophe and the contents of the Molotov–Ribbentrop pact.
2. See Williamson (2003) for an elaboration on the reform agenda, consisting of ten reforms, that John Williamson himself in 1989 labelled the ‘Washington Consensus’.
3. CMEA is the group of countries that belonged to the Council for Mutual Economic Assistance. The latter was the body that was supposed to govern trade among Soviet-bloc nations.

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