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MACROECONOMIC POLICIES AND ACHIEVEMENTS IN TRANSITION ECONOMIES, 1989–1999

1. Introduction[1]

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[2]. 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.

[1] 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 three official discussants, George Kopits, Silvana Malle and Joze Mencinger, and to Zdenek Drabek and Vincent Koen for their stimulating comments.

[2] 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.

2. An overview of reforms and policies

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 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 also to some extent 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 the 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 really applied only 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[3]. 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.

[3] 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.

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[4]. 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 person or centre;
(ii) The role of foreign aid is marginal;
(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

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

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 had often been unclear and many politicians lacked 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[5]:

- 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 positive results of the programme were: 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

[5]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.

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 acounts: 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[6]. *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)

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.

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 Vietnam, 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

[6] 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.

major error[7]. In a recent survey of evidence and interpretations of the recession, the present author suggested that, unlike in China and Vietnam, 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[8]. 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[9].

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»[10]. The problem for 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 crisis 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[11], 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[12]. However, as the EBRD, *Transition Reports 1995–1999* note, the evidence goes to support

[7]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.

[8]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).

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

[10]J. Stiglitz, op. cit.

[11]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.

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

the proposition that, in the countries which liberalized and stabilized to a greater extent, the 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.

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[13]. 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»[14]. 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 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.

[13]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.

[14]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.

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[15].

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[16]. 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.

[15]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.

[16]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.

3. A detailed discussion of specific issues

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:

(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:

$$\frac{\Delta D}{PY} = (\pi + g)\frac{D}{PY} \qquad (1)$$

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[17]. 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

[17] 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.

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.

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 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[18].

There is 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»[19]. 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»[20].

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

[18] 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.

[19] 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.

[20] 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.

and macroeconomic – which are conducive to the development and growth of a new private sector (including FDI). From this perspective, it is clear that with the exception of some authors, notably Kornai[21], 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.

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

In the first decade of 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.

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

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 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 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.

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[22]. 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):

$$g^i_{Y,t} = 15.5 - 4.5\log_{10}(1+\pi^i_{t-1}) - 7.80\log_{10}(1+\pi^i_t) \quad (2)$$

(3.6) (–4.6) (–7.9)

N = 175, R^2 = 0.61, i = 1, 2.....25

$$\log_{10}(1+\pi^i_t) = 1.4 - 0.01\, g^i_{Y,t-1} - 0.04\, g^i_{Y,t} \quad (3)$$

(5.3) (–2.2) (–9.2)

N = 200, R^2 = 0.53, i = 1, 2.....25

In these two equations, $g_{Y,t}$ is the

[22] 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.

percentage change of GDP in year t and π_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 π^i have been weighted by the square root of the countries' share in total GDP, expressed in terms of PPP dollars[23]. 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 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 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[24].

[23] 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.

[25] 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).

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 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.

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

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

foundations/structural reforms are important for both stability and growth[25]. 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[26]. 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.

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[27]. These regression results are as follows:

$$g_Y=-2.22+0.195(I/Y)+5.63\ \log_{10}(y^{US}/y)-5.92\ \log_{10}(1+g_p)$$

$$(-3.6)\quad (7.9)\quad (14.5)\quad (-6.8)\quad \ldots(4)$$

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.

[26]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.

[27]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).

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 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.

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.

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.

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: As for table 3.2.2.
Note: As for table 3.2.2.

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: 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 3.3.1 **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.

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.