Determinants of Growth in Transition Countries

Perhaps the most useful criterion for assessing success in the transition is the sustainable recovery of output, which can be achieved only by controlling inflation and liberalizing markets.

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TRANSITION is a dynamic historical process, imposing change on almost every element of society. Assessing the progress of a great number of countries during transition is a complex undertaking in any area, including economics. Success in recovering output, however, readily suggests itself as a useful unifying theme for economic assessment, not least because of the importance policymakers in transition economies attach to output growth and its immediacy for the welfare of everyone in those countries. Based on extensive econometric analysis, this article identifies factors that have inhibited or encouraged the expansion of output and points out several lessons for achieving consistent and sustainable economic growth.

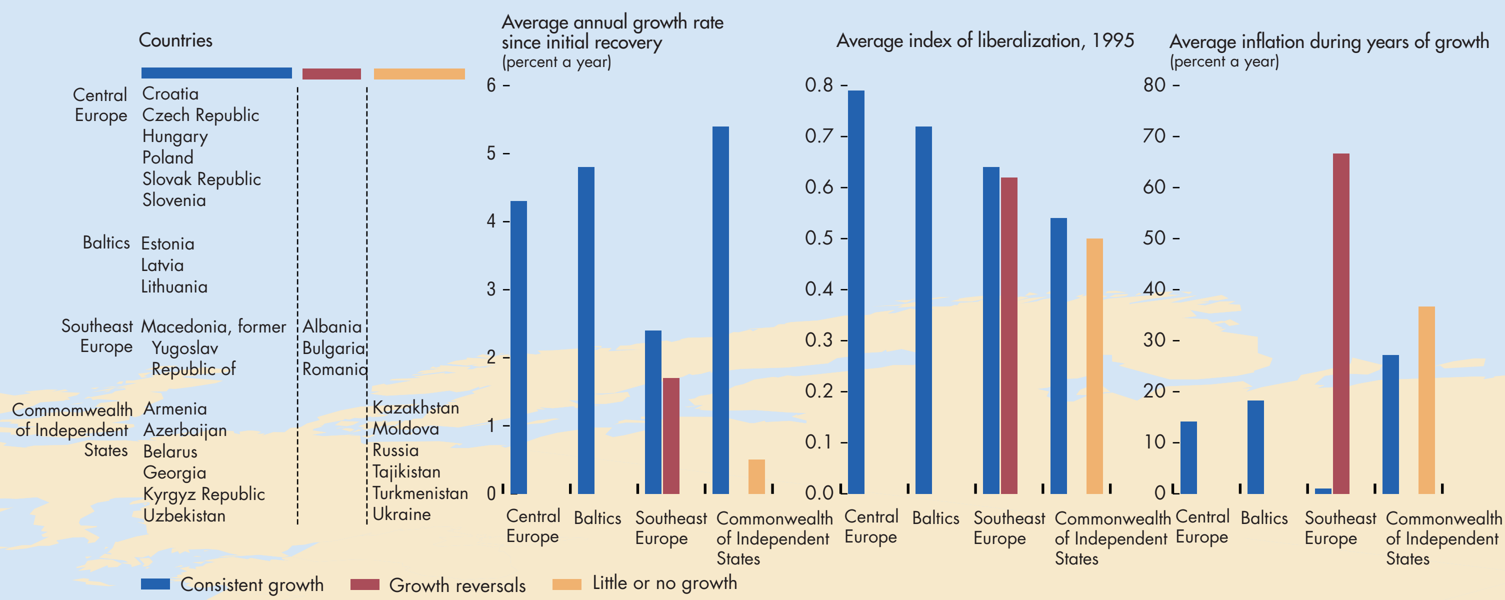
What does transition mean?

In a broad sense, transition implies

- liberalizing economic activity, prices, and market operations, along with reallocating resources to their most efficient use;
- developing indirect, market-oriented instruments for macroeconomic stabilization;
- achieving effective enterprise management and economic efficiency, usually through privatization;
- imposing hard budget constraints, which provides incentives to improve efficiency; and
- establishing an institutional and legal

Chart 2

Economic performance by country groups



Source: Authors' calculations.

framework to secure property rights, the rule of law, and transparent market-entry regulations.

Factors behind growth

No one pattern characterizes the growth experience of the transition economies. Indeed, substantial differences exist among the countries of Central Europe, the Baltics, and the 12 members of the Commonwealth of Independent States (CIS), although the Baltics share some characteristics with the other two groups, specifically, the deep decline of the CIS and the earlier recovery of Central Europe. It is useful, however, to view the 25 transition countries as falling into several categories: those with consistent growth, those with growth reversals, and those with little or no growth (Charts 1 and 2).

Do the transition economies differ all that much from one another? What elements in their structure and development shed light on their differing rates of growth? Regression analysis done in an underlying study allows us to draw a number of conclusions.

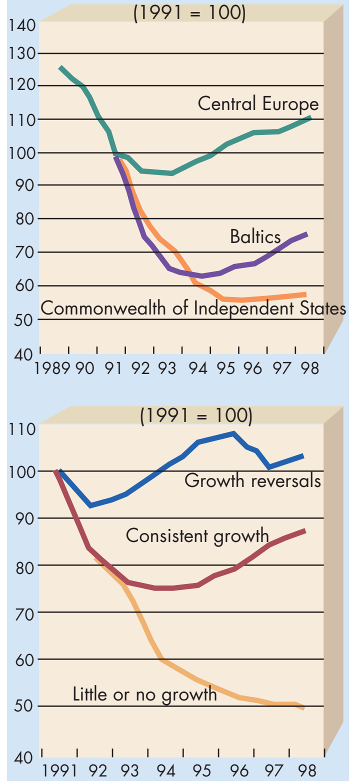
• The three groups differ considerably from one another in growth rates, with the Central European and the Baltic countries showing a solid, steady rate of over 4 percent a year, while CIS countries as a whole, and those countries that have undergone economic reversals, give evidence of much less progress. These uneven growth rates suggest that differences in initial conditions, such as having less distorted economic structures or closer similarities to market economies, may be important determinants of subsequent progress. But while initial conditions do matter—as the contrast in performance between Central Europe and the CIS shows—they are less relevant for growth than are differences in policy during the transition. Growth rates in the group of CIS countries that show progress are very high, because several small economies (Armenia, Azerbaijan, and Georgia) that initially suffered economic decline in the wake of conflict and civil unrest are rebounding from very low bases.

Growth has generally been more vigorous and has certainly come sooner in countries that have controlled inflation. Countries with consistent growth have, on average, much lower inflation rates.

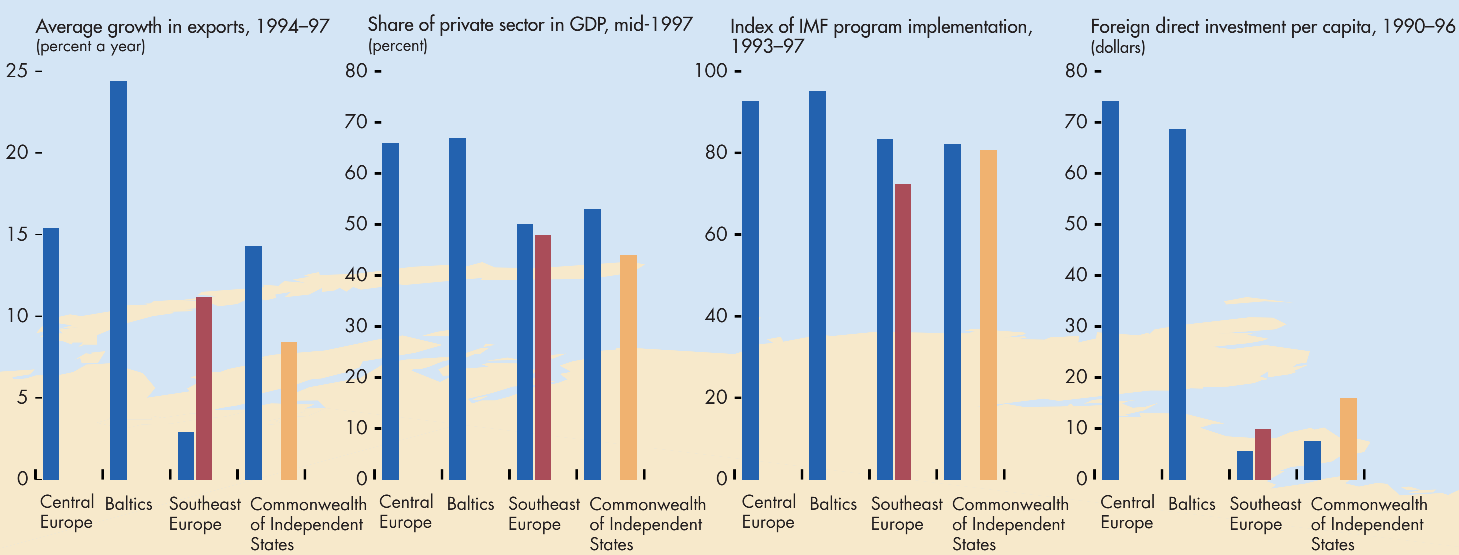
Another key determinant of progress is the degree of reform or market liberalization. An analysis of the liberalization of prices, the financial sector, and external trade, and of enterprise reform indicates a distinctly higher liberalization index in the Baltics and Central Europe—that is, in the countries with much better growth performance—than in countries that have suffered growth reversals or have experienced slower growth.

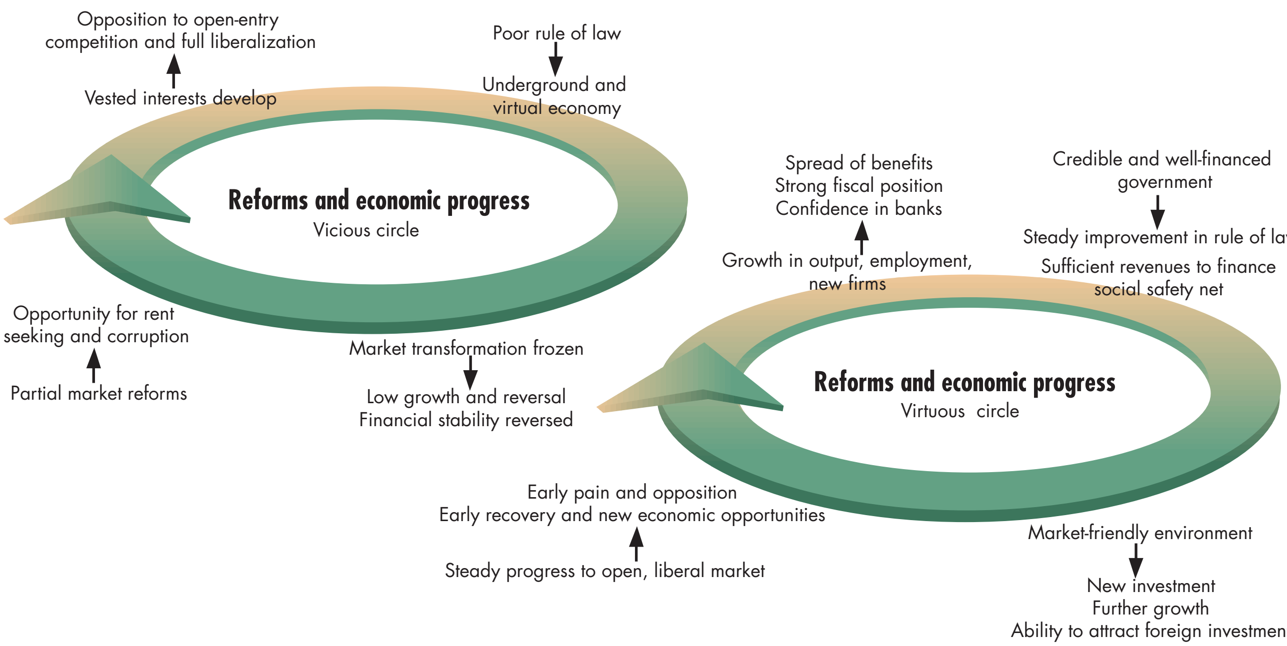
Chart 1

Growth in transition economies



Sources: National authorities; and IMF staff estimates.





Countries that liberalized prices early and comprehensively have experienced the earliest output recoveries. Output has also increased rapidly in countries with high average growth rates of exports, suggesting that opening an economy to outside influences and stimulating output to generate exports are important determinants of growth.

The share of the private sector in GDP is distinctly larger for countries with rapid and consistent growth than for those with slow and uneven growth. As always, exceptions to the rule can be found. Russia, for example, has made great strides in privatization but exhibits little or no growth. The shortcomings of its approach to privatization are perhaps one reason why growth did not follow. (See the article by John Nellis in this issue.)

Foreign direct investment appears to play a role. This investment is highest in the successful economies of Central Europe and the Baltics, where it amounts to \$70–\$75 per capita. That the causation does not run from growth to foreign investment is suggested by the fact that even those CIS countries that have enjoyed consistent growth have not attracted anything like the same amounts of foreign direct investment.

A significant score on an index of effective implementation of IMF programs appears to be strongly correlated with growth performance. This finding should not be interpreted as suggesting that good performance on IMF programs is all it takes to achieve growth. Rather, countries that do well under IMF programs also have made the commitment to do well in promoting general economic reform and stabilization, creating an environment conducive to vigorous economic growth.

Further observations on growth

First, the period of transition can usefully be divided into the early so-called decline period (1990–93) and the later growth period (1994–98). The statistical fit for most variables is far stronger for the growth period than for the period of decline.

Second, the influence on output of many key variables—the reform index (based on World Bank and European Bank for Reconstruction and Development (EBRD) work), for instance—is again far stronger in the growth period than in the first period.

Third, those who suggest that reform is painful are absolutely right. Output declines, and does so more sharply in fast reformers, but early reforms pay off in terms of earlier recovery and more robust subsequent growth (Poland is a case in point). The regression results noted above confirm this payoff. In the first (decline) period, the relationship between growth and reform traces a U-shaped curve: the growth rate is higher (or the rate of decline lower) in countries with strong reform programs as well as in those with very limited reform programs. In the second (recovery) period, the relationship is uniformly positive: growth is slowest in the least advanced reformers, somewhat faster in those that are moderately advanced, and fastest in the most advanced reformers.

Fourth, investment alone does not ensure early growth and recovery—that is, one cannot force economic growth by increasing investment. Given that investment takes time to produce output, it is normal to see investment increases followed by growth increases two or three years later. One does not observe this pattern in transition economies, where investment-to-GDP ratios generally started rising only when growth began to recover. The explanation is that early growth is due to the efficiency gains resulting from appropriate reforms—that is, hard budget constraints and liberalization—that generate incentives for entrepreneurs to become more productive. This does not, however, mean that investment is unimportant. Some new investment, localized at the firm level or in a given sector, will be needed for initial growth. Furthermore, once recovery is well under way—as, for example, in Hungary or Poland—a higher level of investment becomes increasingly important if growth is to be sustained.

But until conditions for an efficiency-seeking market economy are in place, investment alone is not going to provide sustainable growth.

Lessons

We conclude by noting five lessons for countries seeking to achieve consistent and sustainable growth.

• The first is the least surprising and least controversial: sustained macroeconomic stabilization (that is, inflation control) is essential.

• The second lesson is "no pain, no gain." Delayed reforms can indeed defer the pain, but they also defer sustained recovery and increase the risk that growth will be reversed. At first glance, there appear to be certain exceptions. Belarus and Uzbekistan, for instance, have grown in recent years, yet their reform efforts, as measured by the index, were not strong. These countries exhibit some of the same characteristics as Albania, Bulgaria, and Romania (high inflation during growth, limited advances in reform) and may suffer reversals as those three countries did, but this remains to be seen.

• The third lesson is that there is no royal road to reform. In our analysis, we attempted to test whether any one of the individual components of reform by itself pointed the way. The answer was no. Basically, all the components show an individually positive correlation with growth, but when the overall index is examined, none has an overpowering impact. Thus, there is no one key, no panacea. One needs to implement all the different components of reform. Growth comes as a result of a great deal of effort by many people doing the right things over an extended period.

• The fourth lesson concerns unfavorable initial conditions. It is fair to ask whether relatively favorable initial conditions in Central Europe provided those countries with an opportunity to recover more quickly than the countries of the former Soviet Union. The answer, of course, is yes. Conversely, unfavorable initial conditions, such as a distorted industrial system, certainly have a negative effect on growth. However, that negative effect is by no means fatal and can be offset by comprehensive reforms. The best illustration of this may be the Baltic countries, which have achieved growth performances comparable to those of the most advanced reformers among the Central European countries. They had the same unfavorable initial condition of overindustrialization as most of the countries of the former Soviet Union and started far behind Central Europe. But, much more quickly than the CIS countries, the Baltic countries undertook reforms, achieved greater liberalization, and then achieved substantial rates of growth.

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• The fifth lesson concerns institutional development. The econometric analysis included a separate index for the development of a legal framework, which appears to play an important role in reform. The results suggest that developing an appropriate legal structure is indispensable, but not necessarily in advance of other reforms. However, if development of the legal system is delayed too long—if one puts off the implementation of the rule of law, enforcement of discipline, and security of property rights—then other reforms are unlikely to produce significant benefits.

What about the political economy?

Let us finish by relating this analysis to the political economy aspects of transition. It is all too easy for a country to find itself in a vicious circle in which initial steps toward market reform create opportunities for rent seeking and corruption. Vested interests that benefit from these opportunities very soon establish themselves and resist further reform steps, such as allowing open entry to the market, fostering competition, providing for full liberalization, and establishing a solid rule of law. As a side effect, an underground economy emerges. Limited competition, incomplete liberalization, incentives to go underground, and the uneven rule of law can freeze the transformation in its tracks. Slow economic progress, a reversal of growth, and a collapse of financial stabilization can easily result.

Countries' reform efforts can have a happier ending if they create a virtuous circle, allowing them to make steady progress toward an open, liberal market. Although there will be early pain, and political opposition because of the pain, there will also be earlier recovery and new economic opportunities. These opportunities can encourage output growth, and new firms and jobs will be created as the benefits of reform begin to spread. A stronger economy improves a country's fiscal position and engenders confidence in financial institutions. These conditions provide the basis for a credible and well-financed government, which, in turn, is able to impose the discipline of law, secure property rights, and provide an adequate social safety net. This market-friendly environment encourages saving, new investment, and further growth, thus completing the virtuous circle.

The contrast between the vicious and virtuous circles is stark (see boxes). The decisive factor that permits a country to move from the vicious to the virtuous circle is, in our view, the political will to impose the rule of law and establish the security of property rights. F&D