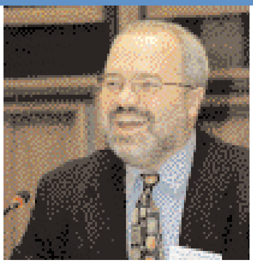
IMF Managing Director Michel Camdessus greets Yegor Gaidar, former Prime Minister of Russia.

Vadim Khoubanov, National Bank of Azerbaijan



Marko Skreb, Croatian National Bank

Miroslav Hrncir, Czech National Bank

A Decade of Transition
An Overview of the Achievements and Challenges

To take stock of the accomplishments of the transition economies over the past 10 years and identify the challenges ahead, in February 1999 the IMF organized a conference for high-level officials from transition countries, academics, and staff members of international organizations. This article highlights the key issues discussed at the conference, some of which are explored further in the articles that follow.

Saleh M. Nsouli

SINCE the fall of the Berlin Wall nearly a decade ago, the former centrally planned economies of Central and Eastern Europe and the Baltics, Russia, and other former Soviet Union countries have made major strides in moving toward market-based economies. Initially, this historic transformation was accompanied by considerable price and output instability. Stabilization programs supported by the IMF and the World Bank helped contain this instability in many countries and bolstered the momentum for structural reforms. Yet the challenges that remain are enormous, as demonstrated by the problems Albania, Bulgaria, and Romania encountered during 1996–97, and by the crisis that beset Russia in 1998.

The tone of the IMF conference, "A Decade of Transition: Achievements and Challenges," was set by Michel Camdessus, the IMF's Managing Director, in his opening remarks. He pointed to the progress made, but cautioned that "we are clearly far from the end of the road. . . . Now, most countries can turn to the much more difficult and time-consuming task of implementing second-generation reforms." He highlighted one specific task for the future: "enforcing the rule of law and fostering a culture that respects and, indeed, welcomes a framework of law, regulation, and codes of good practice."

The record

The record thus far was reviewed, with a focus on such issues as disinflation, growth, public enterprise reform, budget constraints, governance, capital flows, banking sector reform, the underground economy, and income inequality. (See box for a list of the presentations made at the conference.)

The economic literature on the transition process has grappled with two critical questions on disinflation. First, how rapid has disinflation been during transition? Second, what effect has disinflation had on output? In fact, Carlo Cottarelli and Peter Doyle found that disinflation had been achieved quite rapidly in many of the transition countries. The median inflation rate in the Central and Eastern European countries dropped from 84 percent in 1992 to about 9 percent in 1995. Disinflation was achieved even more rapidly in the Baltics, Russia, and other former Soviet Union countries, where the median inflation rate fell from 1,210 percent in 1992 to 60 percent in 1995. The two groups of countries converged to a median inflation rate of 11–12 percent by 1997. But the reduction in inflation, with a few exceptions, has not been sustained, and inflation has resurged in some countries.

Despite such rapid disinflation, no general evidence was found that disinflation had been a factor in depressing

Dariusz Rosati,
National Bank of Poland

Werner Riecke,
National Bank of Hungary

Anvar Saidenov,
Kazakh Investment Agency

Pietro Garibaldi, Jeromin Zettelmeyer,
Ratna Sahay, and Nada Mora of IMF staff

output. Four factors played a key role in limiting the impact of disinflation on output: there was considerable political support for disinflation and price liberalization; stabilization policies were introduced early; comprehensive fiscal consolidation underpinned disinflation in a number of countries; and the various monetary frameworks were appropriately flexible. In fact, rather than depressing output, the resulting moderate- and low-inflation environment had, in due course, a positive impact on growth.

Nonetheless, virtually every country in the region experienced a substantial decline in recorded output with the onset of transition. According to Oleh Havrylyshyn and Thomas Wolf, the initial output loss reflected the collapse of the highly centralized and inefficient production and distribution network of the command economy, while there were inevitable, long time lags in reallocating resources to more efficient uses in a decentralized system. The differences in initial conditions and policies led to a much greater decline at the beginning of transition in the Baltics, Russia, and other former Soviet Union countries than in the Central and Eastern European countries. But after about three years of decline, output in most countries has been growing for several years. There are a number of exceptions, however. Albania, Bulgaria, and Romania began growing three to five years into the transition period but suffered reversals during 1996–97 because they failed to undertake some important structural reforms. Kazakhstan, Moldova, Russia, Tajikistan, Turkmenistan, and Ukraine have registered little or no growth after eight years of transition, for various reasons, including civil conflict, the decline in world oil prices, weak policies, and the spillover effects of Russia's crisis, which itself reflects political uncertainties and an unfinished structural reform agenda.

By contrast, the experience of the East Asian transition countries—notably, China—is considerably different in terms of growth and inflation. Sanjay Kalra, Torsten Sløk, and David Robinson observed that the stronger performance of the East Asian countries reflected not only more favorable initial conditions but also far-reaching reforms in a number of areas—agriculture, in particular—undertaken quite early in the process.

The reform of the public enterprise sector has often been patchy and inconsistent in the transition economies, according to Nicholas Stern, and, as a result, unprofitable enterprises have continued to operate. Furthermore, as John Nellis pointed out, too much was promised—in Russia and elsewhere—of privatization. Some had viewed privatization as a sufficient condition to bring about a new liberal order. Privatization was often pursued without due attention being given to whether the necessary supporting systems for private enterprise were in place, to the length of time it would take to put such systems in place, or to the likely consequences of privatization in their absence.

The difficulties and setbacks suffered by Russia during transition were examined by former Prime Minister Yegor Gaidar, who argued that they were due to the inability to move effectively from a system of "soft" budget constraints with "hard" administrative constraints to the decentralized market system, which is characterized by hard budget constraints with little administrative and political interference. In Russia today, however, both the budget and the administrative constraints have become soft, he explained. Even when privatized, enterprises have not been subjected to hard budget constraints owing to institutional weaknesses. Consequently, the opportunities for rent seeking—that is, unproductive profit seeking—are in place, but incentives for enhancing efficiency are not. To reduce corruption and enhance efficiency, market discipline under hard macroeconomic constraints is key. However, Gaidar emphasized, macroeconomic discipline has been absent in Russia, and the resulting lax fiscal and monetary policies have proved unsustainable.

The record of fiscal reforms in the 1990s has been mixed. According to Vito Tanzi's analysis, the East European and Baltic countries have, in general, made rapid progress while the other countries have been less successful as a group in establishing fiscal institutions and in controlling fiscal imbalances. In the pre-transition economies, revenue sources generated very high tax levels (at times up to 50 percent of GDP) without the need for a full-fledged tax administration, and tax liabilities tended to be vague ("soft") rather than well-defined obligations. The particular characteristics of the centrally planned economies made the collection of these taxes relatively simple. The impact of the transition on the traditional revenue system was dramatic: the information that the plan had provided was eliminated; the number of potential taxpayers that tax administrators had to deal with increased sharply; and incomes and production were created in areas, such as financial markets, that had not existed under the previous system and that often involved foreigners. Because of these changes, the old systems cannot simply be reformed. Rather, totally new tax systems, capable of operating in the new environment, are needed.

New tax systems, however, require not just new tax laws but also new fiscal institutions and new skills. Often the personnel, schooled in the old ways, are the main obstacle to change. The incentives for these individuals are to maintain the old system. The tax system has come to be seen as a tool that should do many things, including supporting failing enterprises, sustaining employment by allowing loss-making enterprises to pay wages instead of taxes, and stimulating nonproductive activities. In some ways, the tax system replaced the plan as the key instrument for economic and social policy. Thus, in some of these countries, taxation has continued to be soft. In addition, in many of these countries, especially the larger ones, public spending levels have remained very high as shares of GDP, and there has not yet been a well-thought-out policy of shrinking the role of the state.

Following external and internal liberalization, the transition economies had large and growing current account deficits, which were financed largely by capital inflows. An examination of capital flows to 25 transition economies between 1991 and 1997 by Pietro Garibaldi, Nada Mora, Ratna Sahay, and Jeromin Zettelmeyer showed that during the 1990s net capital inflows to transition economies were sizable and, on a per capita basis, similar to those to Latin American countries and the more advanced Asian economies. They were much higher on a per capita basis than those to other developing regions. The distribution of inflows across countries, however, was not uniform. The more advanced transition countries generally received higher net inflows, while Russia was a net capital exporter. Generally, capital inflows at the beginning of the transition period consisted largely of exceptional financing, but their composition later shifted to favor foreign direct investment and other private capital. This would indicate that official and private debt relief did indeed help the transition economies to adjust and reform. The econometric analysis demonstrated the importance of perceptions of country risk and institutional obstacles (such as government red tape) in determining foreign direct investment flows.

A survey of banking sector reforms in the Baltics and Eastern Europe by Lajos Bokros shows that corporate governance, competition, and prudential regulation and supervision play a critical role in the transition to a market economy. The transition countries that have been strong performers share a number of features. Of particular importance are effective foreign and domestic bank entry and exit regulations, which facilitate the entry of foreign banks, thereby fostering competition, encouraging the development of increasingly sophisticated financial products, and strengthening the domestic banking system. In contrast, the financial sectors in the weak performers lack competition and sector-specific expertise; have low-quality assets, significant state ownership, and low levels of corporate lending; and operate in an unstable macroeconomic environment. The transition countries with inappropriate incentive structures that encourage the accumulation of risky assets in pursuit of quick profits have made the least progress with bank restructuring.

Some of the transition countries have large underground economies. According to Simon Johnson and Daniel Kaufmann, overregulation, corruption, and a weak legal system often drive businesses underground. Aggregate data and microsurveys show that in Russia and Ukraine, unofficial output constitutes 40–50 percent of total GDP, while in most of Eastern Europe it is under 20 percent. The difference across countries is due primarily to variations in the degree of institutional weaknesses and government corruption. As a result of the growing underground economy, tax revenues have fallen, and the quality of public administration has declined accordingly, further reducing firms' incentives to be "official."

The transition from a planned to a market economy has been accompanied by one of the biggest and fastest increases in income inequality ever recorded. Branko Milanovic showed

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The following presentations were made at the conference:

Lajos Bokros, World Bank: "Banking Sector Reforms in Eastern Europe."

Michel Camdessus, IMF Managing Director: "A Decade of Transition: Achievements and Challenges."

Carlo Cottarelli and Peter Doyle, IMF: "Disinflation in Transition Economies."

Pietro Garibaldi, Nada Mora, Ratna Sahay, and Jeromin Zettelmeyer, IMF: "What Moves Capital to Transition Economies?"

Oleh Havrylyshyn and Thomas Wolf, IMF: "Growth Experience in Transition Economies."

Simon Johnson, Massachusetts Institute of Technology, and Daniel Kaufmann, World Bank: "In the Underground."

Sanjay Kalra, Torsten Sløk, and David J. Robinson, IMF: "Inflation and Growth in Transition: Are the Asian Economies Different?"

Branko Milanovic, World Bank: "Explaining the Increase in Inequality During the Transition."

John Nellis, World Bank: "Is It Time to Rethink Privatization?"

Nicholas Stern, European Bank for Reconstruction and Development: "Challenges for the Next Decade of Transition."

Shigemitsu Sugisaki, IMF Deputy Managing Director, Concluding Remarks.

Vito Tanzi, IMF: "The Changing Role of Government During the Transition."

that, on average, inequality in Eastern Europe, the Baltics, Russia, and other countries of the former Soviet Union has increased rapidly, as measured by a rise in the Gini coefficient from 25–28 to 35–38 in less than 10 years. (The Gini coefficient is a measure of the equality of income distribution in a country, with 0 representing absolute equality and 100 representing absolute inequality.) In some countries, such as Bulgaria, Russia, and Ukraine, the increase in inequality has been even more dramatic, outpacing by three to four times the yearly rate of increase in the Gini coefficient in the United Kingdom and the United States in the 1980s. What are the factors driving the growth of inequality? First, wage inequality is greater in the new private sector than in the old, relatively egalitarian state sector. Second, incomes from self-employment and property, both of which are fairly unequal sources of income, have grown during the transition. And third, the incomes of former state sector workers who are now unemployed have declined, contributing to a "hollowing out" of the middle class.

Saleh M. Nsouli is Deputy Director of the IMF Institute.

The challenges ahead

The record of the past decade is thus one of progress by the transition countries, but it also underscores the challenges that still lie ahead, as pointed out by IMF Deputy Managing Director Shigemitsu Sugisaki in his concluding remarks. Although these countries have generally managed to reduce inflation and to experience a recovery in output, their situation remains fragile. There is potential for a resurgence of inflation, a weakening of output performance, and an intensification of external sector pressures. In this regard, the main challenges that were identified at the conference included fundamentally transforming the role of the state, moving enterprises into the market economy, pursuing banking sector reform, addressing the sharp inequalities in income, and strengthening the macroeconomic situation.

First, the role of government needs to be radically transformed. As pointed out by Vito Tanzi, to function well, market economies need governments that are efficient and evenhanded in establishing and enforcing essential rules for promoting widely shared social objectives, for raising revenues to finance public sector activities, for spending these revenues productively, for bringing required corrections to and controls over the working of the private sector, and for enforcing contracts and protecting property. Governments will need to establish rules of the game that are appropriate to market economies as well as regulations in such areas as private pensions and competition while eliminating most discretionary regulations, which are often relics of the command economy. Such actions would create an environment conducive to the efficient functioning of market forces, and would therefore be critical to fostering the growth of the private sector and shrinking the underground economy. They would also reduce the perception of risk, thereby helping to attract foreign direct investment. The great difficulty of creating basic institutions should not be underestimated, however.

Second, the process of privatization has to be improved. A strong institutional framework, as well as openness and transparency, are the keys to success in this area. Numerous actions have to be taken to streamline privatization. Downsizing and restructuring could take place through a reallocation of ownership and control, which could be facilitated by involving foreign investors. The transfer of labor and social obligations of old firms to new owners would need to be avoided. These steps would have to be reinforced by reorienting the role of the state to promote market discipline and putting in place effective bankruptcy procedures, while ensuring that financing be made dependent on a well-regulated and supervised financial sector and on good business practices. Such actions would effectively harden the budget constraints on enterprises.

Third, financial sector reform is fundamental to promoting growth, by improving the intermediation process and increasing efficiency in the allocation of financial resources. The progress made in giving greater autonomy to central banks represents a step in the right direction. However, creation of a competitive system open to foreign financial institutions and the enactment and effective implementation of strong prudential regulations are key components that still need to be addressed in many transition economies.

Fourth, severe income inequalities have to be tackled. Over time, institutional change and increased competition should help reduce economic rents and income inequalities. This process will take time, however, and governments will need to put in place well-targeted social safety nets for the most vulnerable segments of their populations.

Fifth, macroeconomic stabilization is essential to underpin structural reform and the recovery of economic activity and sustained growth. The empirical evidence shows that lower inflation rates are, indeed, associated with faster economic growth. Moreover, transition countries with persistent moderate inflation, as well as other advanced transition countries, now enjoy favorable circumstances for further disinflation. The threshold above which inflation involves significant output costs is now comparable in the transition countries to what it is in the industrial countries; therefore, a commitment to slowing inflation to industrial country levels over the medium term would be appropriate, especially in those countries aspiring to join the European Union. F&D