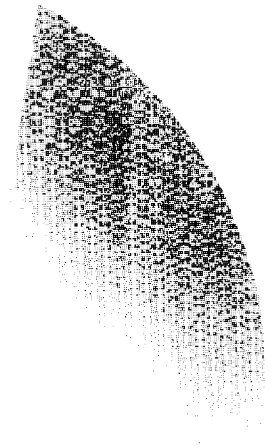
# Part One

# The Challenge of Transition



COUNTRIES EMBARKED ON TRANSITION FROM VERY different starting points. This part of the Report first considers the patterns and progress of reform, broad outcomes, and the influence of country-specific factors relative to the choice of policies (Chapter 1). The core reforms in transition include liberalizing prices, markets, and new business entry, and implementing programs to regain or preserve price stability. But countries cannot ignore their history and geography, and this legacy, together with political developments, profoundly affects both the relative importance of different market reforms and how policymakers approach them.

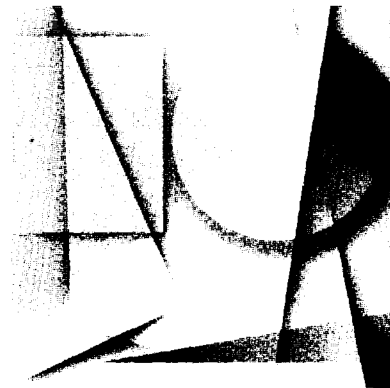
Liberalization and stabilization are closely interrelated (Chapter 2). The freeing of markets is the basic enabling reform from which all the potential benefits of transition flow. But market price signals cannot do their work in an environment of

severe macroeconomic imbalances and high inflation. Stabilization is thus a vital complement to liberalization in fostering productivity and growth during transition—and beyond.

Creating property rights and incentives and a mostly private economy is a second challenge (Chapter 3). Here, too, initial conditions matter. Some transition countries will have a much more urgent need to privatize than others. But there can be competing objectives and difficulties in creating an effective and popular program.

A third major challenge—vital for social and political as well as economic reasons—is to relieve poverty and address the other ill effects of transition on particular groups (Chapter 4). Many gain from transition, and depending again on the starting point and context for reforms, transition can be accompanied by declining poverty from day one. But the vast adjustments involved in a change of economic system can also have adverse implications for many. The losses they suffer need to be addressed through effective social policies and measures that encourage sustained growth.

# Patterns of Reform, Progress, and Outcomes



How can governments approach the array of reforms required in transition? To pose the issue clearly we simplify reality and present two starkly contrasting, stylized approaches. The first is to launch a rapid, all-out program, undertaking as many reforms as possible in the shortest possible time. The second is to change by way of partial and phased reforms.

Each path offers its own distinctive pattern of risks and rewards. But many countries embarked on transition in no position to choose between the two. A country's starting circumstances, both economic and political, greatly affect the range of reform policies and outcomes open to it. Within this range, however, the clear lesson of the past few years' reforms is that, regardless of the starting point, decisive and consistent reform pays off.

## Two paths of reform

The all-out approach aims to replace central planning with the rudiments of a market economy in a single burst of reforms. These include rapid price and trade liberalization, accompanied by a determined stabilization program to restore or maintain price stability; a quick move to current account convertibility; the immediate opening of markets to entry by new private businesses; and initiating, at least, a wide range of other changes, such as the privatization of state-owned companies, the demonopolization of industry, and the reform of accounting standards, the tax system, the legal system, the financial sector, and the civil service.

Poland's rapid reform in 1990 and many of the programs launched elsewhere in CEE and, after 1992, in the NIS have approximated this comprehensive model. East Germany's exceptional "instant" transition following unification with West Germany comes closer still (Box 1.1). The rationale of this approach is well captured by the assertion of President Václav Havel of the Czech Republic that "it is impossible to cross a chasm in two leaps." Reformers wanted to minimize the duration of the inevitable pain and quickly sever the links between the state and the productive system, to guard against backsliding and stagnation.

In line with this reasoning, the ethos of the all-out approach is that wherever rapid change is feasible, it should be attempted. Experience in Poland and elsewhere shows that some changes can indeed occur overnight. Markets can be liberalized, restrictions on small business lifted, and exchange controls abolished—all with the stroke of a pen. Stabilization measures can also be implemented rapidly, even with a simple range of policy instruments. Yet most other reforms are inherently slow. Formal privatization may be accomplished in one or two years, but changing the fundamental governance of large firms almost always takes longer. And developing market-supporting institutions such as legal and financial systems takes years, even decades, because it involves such a fundamental change in skills, organizations, and attitudes. Complexity is not always the only reason reforms may be delayed: politics can also impede the process, as often happens in reforming social programs.

With different reforms moving at different speeds, even the fastest reformers will find that the economy is riddled with inefficiencies at first. Many firms are operating without effective owners; information and legal systems have not yet adapted to market mechanisms; private firms and farms have trouble getting bank credit; governments find it difficult to tax emerging sectors to make up for lost revenues from declining ones.

### Box 1.1 East Germany: The instant transition

At the time of unification eastern Germany had a quarter of western Germany's population but contributed a mere tenth of its gross domestic product. Unification provided a market-proven institutional and legal framework and a large contingent of experienced practitioners. It also made available incredibly vast resources—close to $700 billion—to fund both investment and social transfers. However, East-West wage differences needed to offset low productivity in the East soon proved socially and politically infeasible. Wage hikes catapulted eastern German unit labor costs to the highest in the world. The result was mass unemployment, made politically palatable by social transfers that ensured that the living standard of the unemployed was higher than that of employees before unification. But for early retirement and other programs, unemployment would have been over 30 percent.

The former German Democratic Republic is starting to emerge from the trough of adjustment, and the firms that have survived constitute a highly competitive core. But few of the unemployed are likely to find jobs. Transition has relegated an entire generation to the economic sidelines.

Is the solution then a go-slow approach? Not necessarily. Governments need to push through a critical mass of rapid reforms to build credibility and change the behavior of people and firms, locking in these reforms and stimulating new ones. Also, in certain circumstances, reformers need to move quickly to exploit a narrow window of opportunity for dramatic change.

The second model, of piecemeal and phased reform, might start with localized experiments, which are expanded as perceived successes emerge. A few repressed sectors such as agriculture are liberalized up front. After these first steps, markets are slowly but steadily extended to other parts of the economy as the institutional building blocks of a market system are put in place.

This strategy relies on there being scope to reap large productivity gains from the first, partial reforms. These, in turn, raise incomes, so building momentum for further, more difficult reforms in a self-reinforcing process. Gradualist reformers must also be able to sustain the reforms over an extended period and to contain the side effects of liberalizing the economy selectively. Because the market and the plan must coexist for a time, individuals and companies will have a strong incentive to seek economic rents by shifting goods or financial resources from the low-priced, controlled segment of the economy to the high-priced, liberalized segment. The government must be able to keep a tight grip on both the macro- and the microeconomy, supervising those activities still covered by the plan and imposing stiff penalties for noncompliance.

The phased approach—summarized by Deng Xiaoping's phrase, "feeling the stones to cross the river"—is essentially the path followed by China. After the death of Mao Zedong and the denunciation of the Cultural Revolution, China's initial reforms in 1978 opened the door to joint ventures and began to liberalize prices, first at the margin and then more extensively. Most early reforms focused on the rural economy. The household responsibility system, initiated locally to decollectivize agriculture, was extended to other regions. The government raised rural incomes by increasing agricultural producer prices. It then relaxed restrictions on "nonstate" industrial firms (those owned by local governments and collectives) and permitted new entry into a wide range of businesses. New rural township and village enterprises (TVEs) were permitted and encouraged to operate on market principles. The share of output produced by private and nonstate enterprises rose sharply. By 1984 reforms had spread to the urban economy. Local governments were granted greater fiscal autonomy. Management of state enterprises was reformed, as their source of finance moved from the state budget to the banking system. Restrictions were progressively eased on trade and foreign investment, and a variety of institutional reforms were begun, including the re-creation of a central bank. Meanwhile the role of the plan was progressively reduced. Reforms accelerated in 1994 and 1995, particularly with regard to taxes, company law, and foreign trade.

#### *Choices and constraints: Different macroeconomic starting points . . .*

The fact that there are two model routes from a planned economy to the market does not mean that all countries are in a position to choose between them. As noted above, to attempt a phased reform, governments need to be fairly sure that its initial effects will be positive, and that they are able to keep control of the economy in its partly liberalized state. Policymakers in most of CEE and the NIS were in no position to deliver either.

First, earlier attempts at partial reform in these countries, including the Soviet Union, had failed to raise efficiency, largely because they were too limited to affect incentives. Perhaps partial measures that shifted authority from planners to enterprise managers, such as those proposed in the 1960s, would have succeeded had they been implemented early and decisively enough, when the productivity crisis was just beginning to emerge. But the several CEE countries that did persistently seek a "third way"

between planning and capitalism never found one that led to sustained growth. It is hard to believe that the Soviets would have succeeded where the Hungarians could not.

The second, more important reason why gradualism was not an option in CEE and the Soviet Union was that by the second half of the 1980s the Soviet planned economy was disintegrating from within. In 1986 the Soviet Union launched *glasnost* (political relaxation) and *perestroika* (economic restructuring). *Glasnost* permitted the resurgence of democratic movements and long-repressed nationalism and an outpouring of criticism of the government. *Perestroika* itself involved little reform and was followed by measures to boost investment in the face of shrinking resources. The result was inflation and foreign indebtedness rather than higher productivity. Wages rose sharply relative to official prices, just as they did in Poland and most other CEE countries in the last years of the old regime. With greater enterprise autonomy and continuing subsidies, the Soviet fiscal deficit reached 11 percent of gross domestic product (GDP) by 1988. Bank deposits swelled because there were few goods to buy, creating a monetary overhang.

By 1990 deliveries of inputs were falling well short of planned levels, and black market prices and exchange rates were many times higher than official ones (Table 1). The situation worsened dramatically in 1991, as the deficit soared to an estimated 28 percent of GDP. A monetary reform (involving the freezing and confiscation of financial assets), launched in January 1991, was the last desperate attempt to absorb the monetary overhang without a price explosion. It failed dismally. The planned trade system dissolved. And then the Soviet Union collapsed. The volume of trade among CMEA members and between Soviet republics fell 70 percent. This chaotic environment, combining a disintegrating economy with a rapidly weakening government, allowed no scope for gradual reform. For these countries the all-out approach was the only one available.

*. . . And the role of different political heritages*

The degree of macroeconomic disequilibrium is not the only factor affecting a country's choice of reform path. Noneconomic factors—politics, history, culture, and geography—can also be very important.

Citizens' attitudes and loyalties toward pretransition regimes varied greatly, depending on how their countries had become socialist. Before the revolutionaries came to power, Russia had been an empire ruled by an autocratic czar, Mongolia had been a theocracy, Vietnam a colony, and China had experienced warlordism following the end of the Qing dynasty in 1912. In these countries, governments dominated by the Communist Party arose mainly from internal political movements and, in China and Vietnam, from nationalist efforts to rout Japanese and French colonizers.

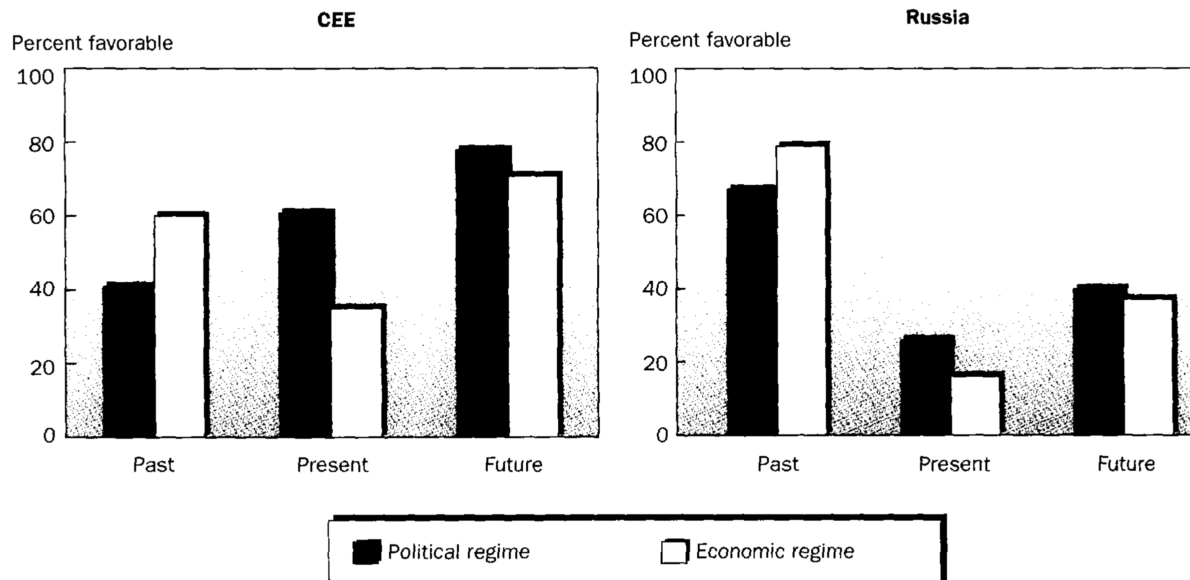
In marked contrast, in the Baltic states and in much of CEE, socialist governments were supported from without and maintained by the Soviet political and military machine in part through repression. Many people deeply resented the Soviet presence, and the legacies of democracy and markets remained strong. Geography is also important: these countries are close to Western Europe, had been exposed to European political norms and culture, and want to join the European Union. The "political breakthrough" after 1989 was therefore particularly strong in these countries. Political reform largely drove their economic reforms, creating a distinctive linkage that might not apply more broadly, to countries in different circumstances. In 1993, widespread support for political breakthroughs in most CEE countries moderated perceptions that the accompanying economic reforms were having an adverse impact (Figure 1.1). Russians surveyed a year later, in contrast, were far more pessimistic about both political and economic progress in their country.

Radical economic reform has proved easier when political change has been rapid and fundamental, as in much of CEE and the Baltic states. Citizens who supported the new political systems in these countries also supported market-oriented economic policies. Traditional bastions of power in the previous systems—the state enterprises and the ministries that ran them—were weakened, and at the outset few interest groups were organized to oppose reform. A window of opportunity—a period of "extraordinary politics"—opened in which far-reaching changes could be initiated with little opposition. But individuals have also made their mark. Most decisive reforms have reflected the vision of one leader or a small and committed group. Similar political breakthroughs occurred in a few countries far from European influence, such as the Kyrgyz Republic and Mongolia, where exceptional political leaders came to power and pushed through decisive reforms. Not all countries, however, had such a strong political breakthrough, and some new states saw other priorities. Ukraine's first independent governments, for example, were preoccupied with asserting a national identity, and reform there accelerated only after severe and prolonged economic decline.

As extraordinary politics becomes ordinary, the path of reform steepens. Political interest groups form, and pressure arises from those who bear the costs of change. As structural and institutional reforms unfold, they involve more decisionmakers and require collaboration from more people; the number of players multiplies and the process gets more complicated. But reform also creates winners and new interest groups with strong pro-market leanings. The public must constantly be reminded of the reasons for change and informed about progress to date. With the notable exception of the Czech Republic, few governments have really been effective in this respect.

***Russians remain more gloomy about the future.***

**Figure 1.1** Public attitudes toward political and economic reform in Central and Eastern Europe and in Russia




Note: Data are results of opinion surveys, taken in seven CEE countries in 1993 and Russia in 1994, seeking views on past (socialist), present, and expected future (five years hence) regimes. Source: Rose 1995a, 1995b.

Surveys have shown falling approval of the market economy in many countries. But it is not clear how much this reflects views about the reforms themselves and how much it was a reaction to the pain of economic dislocation and adjustment. Both radically reforming governments and less radically reforming governments have been turned out of office. The return to power of former socialists has sometimes slowed reforms, but as yet no replacement government has tried to dismantle the market-oriented approach of its predecessors. Indeed, late-1995 surveys in CEE showed rising popular support for the current—and expanding—market system. In the more advanced reformers the political debate has moved toward entitlement programs, familiar political terrain in long-established market economies. At least in CEE, politics are becoming normal.

This is not to say that economics and politics always develop together harmoniously. If economic outcomes benefit only a few, if the return to growth is too long postponed, and if corruption comes to be seen as endemic, the losers will justifiably react. In many transition economies, for example, managers of state enterprises have used privatization to transform their control rights into property rights, leaving ordinary citizens out in the cold. This has deepened public cynicism about reform and undermined the legitimacy of the postreform economic system. Polls in December 1991 suggested that just over a quarter of Russians disagreed with the proposition that ordinary people would benefit from the introduction of private property. By March 1995 over two-thirds disagreed. Establishing a social consensus will be crucial for the long-term success of transition—cross-country analyses suggest that societies that are very unequal in terms of income or assets tend to be politically and socially less stable and to have lower rates of investment and growth.

## Progress and outcomes

How have the varying paths to reform—conditioned as they have been by history, politics, and economic and institutional starting points—been reflected in progress and outcomes to date?

*Progress of reform*

In assessing progress we look at four broad dimensions: liberalization, property rights and private ownership, institutions, and social policies. First, consider liberalization. The full length of each bar in Figure 1.2 estimates the degree to which the country in question was a market economy in 1995. The measure is approximate and covers three areas: domestic prices and markets, foreign trade and currency convertibility, and openness to new business entry. By 1995 many countries in CEE and the NIS were essentially market economies, with open trade, current account convertibility, and liberal policies toward new entry and private business. A few still retained extensive price and export controls and state trading monopolies—in some cases after announcing reform programs that were not carried through. With more extensive controls on foreign trade and entry, the East Asian countries were less liberalized than the more advanced reformers in CEE and the NIS.

However, a snapshot of one year is far too short a period to capture the economic impact of a process of liberalization. Some countries started their reforms far earlier than others. Therefore the purple segment of each bar shows countries' average level of liberalization in the period 1989–95, recognizing that some countries had freed elements of their economies even before 1989. The CEE countries and the NIS and Mongolia are categorized into four groups by this measure, reflecting both the extent of liberalization and its longevity. The economies of some countries were severely affected by regional tensions, including blockades and in some cases war. These countries are marked by asterisks in Figure 1.2.

With their earlier start, the East Asian countries have been almost as exposed to market forces as the CEE countries, on average, during the last seven years. But within CEE and the NIS wide variations are seen. Since 1989 Russia's economy has had about half the exposure to market forces as the leaders in Group 1 in Figure 1.2, and some other NIS have barely emerged from the planning system.

Another dimension of transition is ownership reform (Figures 1.3 and 1.4). Here, too, there has been great change. In nine countries in CEE and the NIS the private sector now accounts for over half of economic activity. Governments still maintain sizable stakes in many firms classified as private, but with plausible allowances for unmeasured unofficial economies (which Figure 1.3 does not account for), most countries have passed the halfway mark. The shift to a private economy reflects both the entry of new firms (often using old assets from the state sector) and the privatization of state firms. Ownership in China has also diversified substantially toward a wide variety of forms (Chapter 3). Vietnam is the only country in the sample where the state sector's share has risen since 1989, but many enterprises counted as state firms are in fact joint ventures with private (mainly foreign) partners.

Both across countries and across types of assets within countries, large differences are observed in the degree of privatization and the effectiveness of private ownership (Figure 1.4). These differences reflect a variety of country-specific and historical factors, as well as complex political issues that arise as wealth is redistributed. As discussed in Chapter 3, successful transition involves initiating a process of change toward an efficient pattern of ownership. An initial transfer of title is only the beginning of the story.

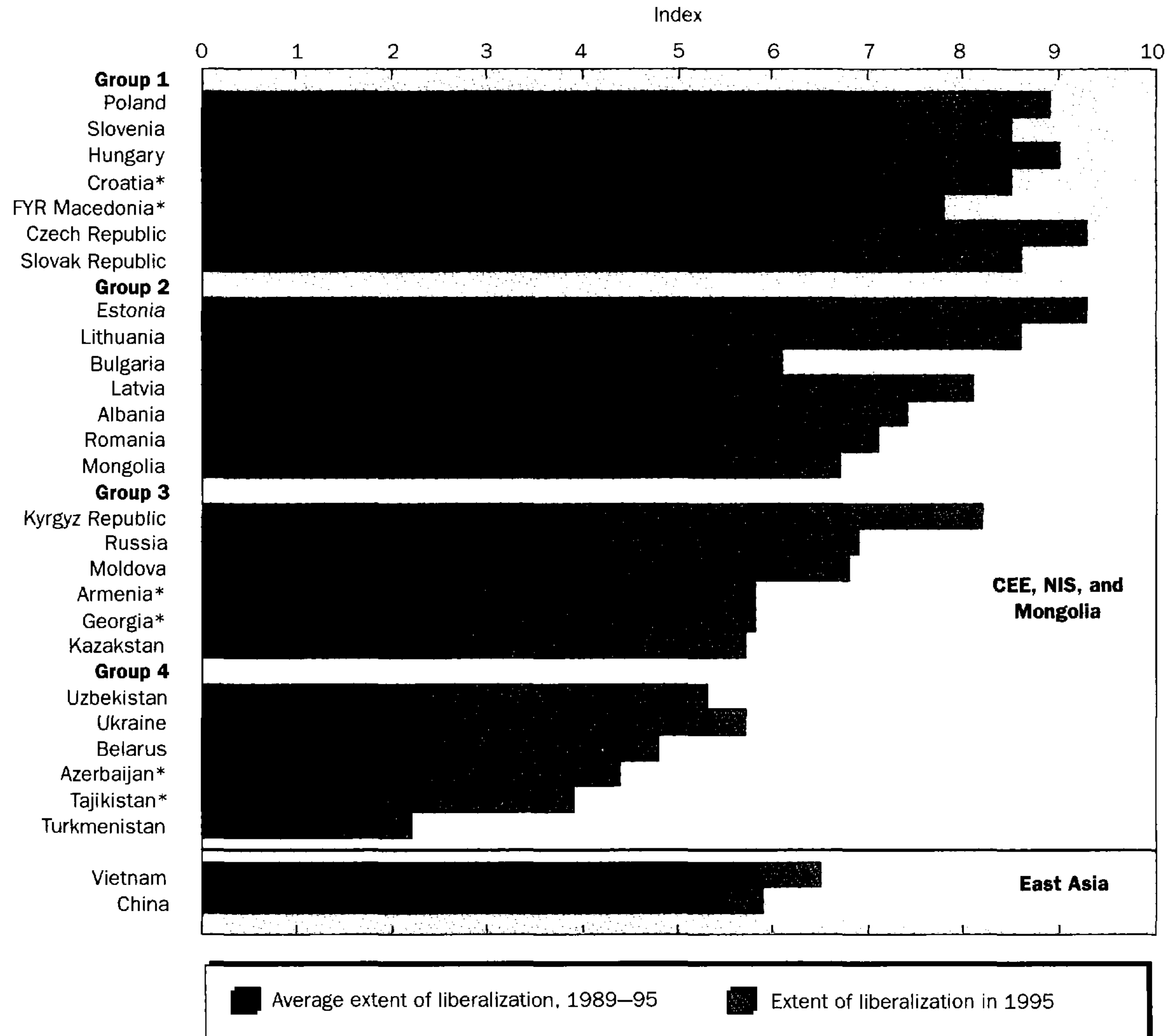
Institutional reforms are also affected by initial conditions (Box 1.2). Their relative progress across countries is closely associated with the extent and duration of liberalization (Figure 1.5), partly because macroeconomic reforms, as well as ownership reform, tend to create demand for institutional change. Yet even where policy change is rapid, institutional change is slow, and transition will not be complete until institutions effectively underpin markets. There are severe bottlenecks:

- All countries have taken steps to reform the legal framework, but the extent and coherence of reform vary. The reform of judicial institutions and enforcement mechanisms lags far behind, and corruption has become an acute concern in some countries. These are areas of high priority for the future.
- More advanced reformers now have some banks capable of delivering services at least comparable to those available in middle-income countries, but they also have a substantial share of financial assets in poorly functioning banks. Serious conflicts of interest plague many financial systems, and in most countries the scope of market-based finance is limited by poor debt recovery mechanisms. Virtually all countries have many nonperforming loans, which pose a major policy dilemma.
- Most governments have substantially reoriented their roles to meet the needs of a market economy, but in such critical areas as tax administration, public administration, and fiscal decentralization, reforms are still at an early stage in many countries. This has hurt the economy and in some cases has adversely affected regional equity. The power and administrative authority of central governments have diminished in some countries with the considerable, and sometimes chaotic, decentralization of revenues and functions to subnational governments. There is frequent confusion over the roles of the executive, the legislature, and the constitutional courts.

Institutional development is also crucial for sustaining the momentum of reform in the Asian planned economies. China's banks, for example, are less market-based

***Countries have liberalized at different speeds and at different times, but the late starters are catching up.***

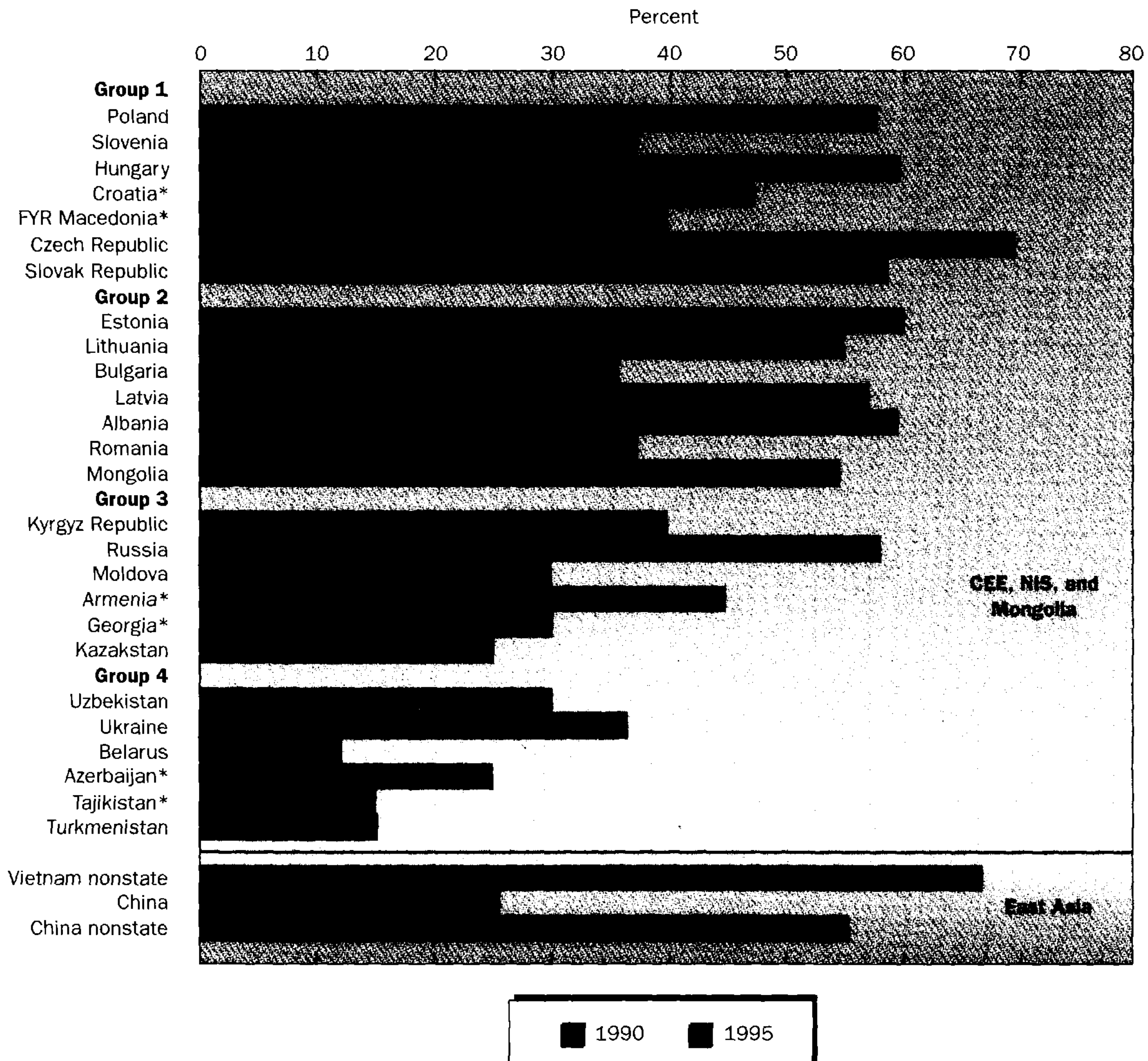
**Figure 1.2** Economic liberalization by country




Note: Bars indicate the extent to which policies supporting liberalized markets and entry of new firms prevailed in 1995 and on average over 1989–95. Asterisks indicate economies severely affected by regional tensions between 1989 and 1995. The index is a weighted average of estimates of liberalization of domestic transactions (price liberalization and abolition of state trading monopolies), external transactions (elimination of export controls and taxes, substitution of low to moderate import duties for import quotas and high tariffs, current account convertibility), and entry of new firms (privatization and private sector, or nonstate, development). The weights on these components are 0.3, 0.3, and 0.4, respectively. Initial estimates for the three components were based on comparative information in World Bank and other reports. These were revised following consultation with country specialists as well as experts with a comparative perspective across a number of countries. For the twenty-five countries in CEE and the NIS the transition indicators and accompanying text in EBRD 1994 and 1995 provided a further basis for calibration. Nevertheless, any such index is judgmental and necessarily approximate. See also the De Melo, Denizer, and Gelb background paper.

***The private sector has grown rapidly.***

**Figure 1.3** Private sector output as a share of GDP



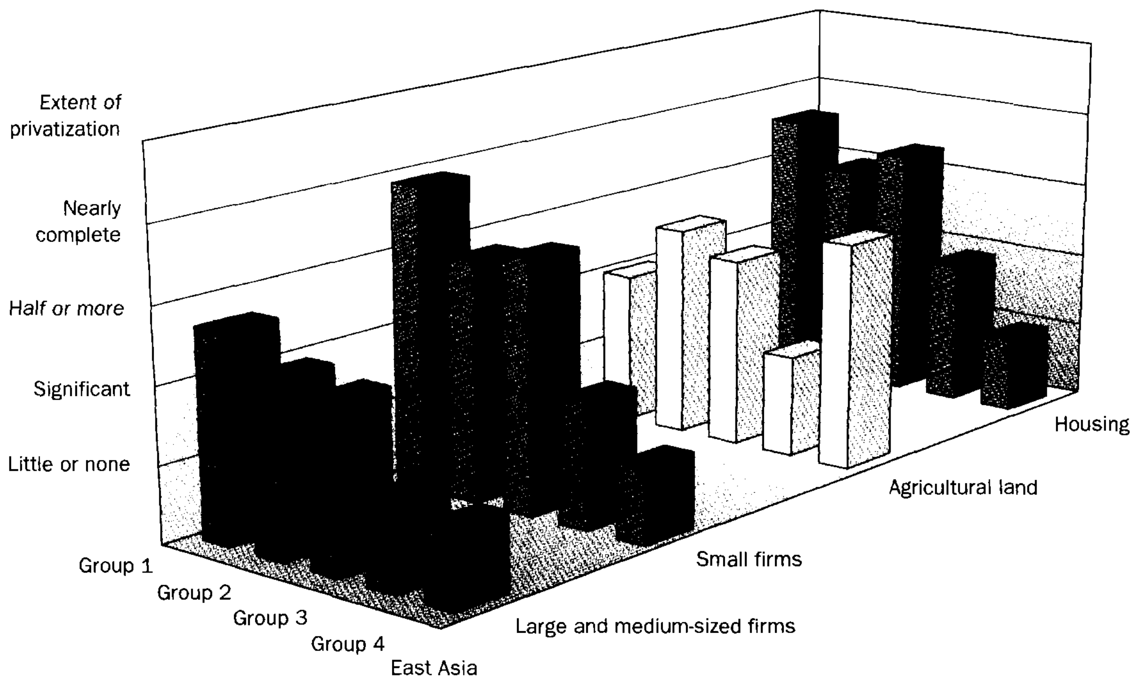

Note: Firms are considered private if less than 50 percent state owned. For Vietnam, the nonstate sector excludes public-private joint ventures. For China, the nonstate sector includes collectives and TVEs as well as private firms; agriculture is considered private in 1995, although land is held through long-term leases. Asterisks indicate economies severely affected by regional tensions between 1989 and 1995.
Source: EBRD, IMF, and World Bank data; official data.

than those of CEE, because many loans are still allocated through a central credit plan.

Reforming social policy is politically difficult in all countries and, except for the introduction of unemployment benefits, has not typically been a prime focus early on. Indeed, where such reform has taken place it has often been reactive, impelled by fiscal shortfalls. Social policy reform is a high priority for the future (Chapters 4 and 8).

***Privatization has been uneven.***

**Figure 1.4** Privatization by type of asset and country group




Note: Data are for 1995 and are simple averages of estimates for the countries in each group (see Figure 1.2). Source: EBRD 1995; World Bank staff estimates.

Governments in CEE and the NIS need to develop policies to cope with increased labor mobility, and, frequently, increased poverty within relatively tight budget constraints. Similar considerations apply to the East Asian reformers, which must find ways to respond to an increasingly mobile and industrial rural population that is still outside the formal system of social benefits. China's urban enterprises still bear the burden of pensions, medical care,

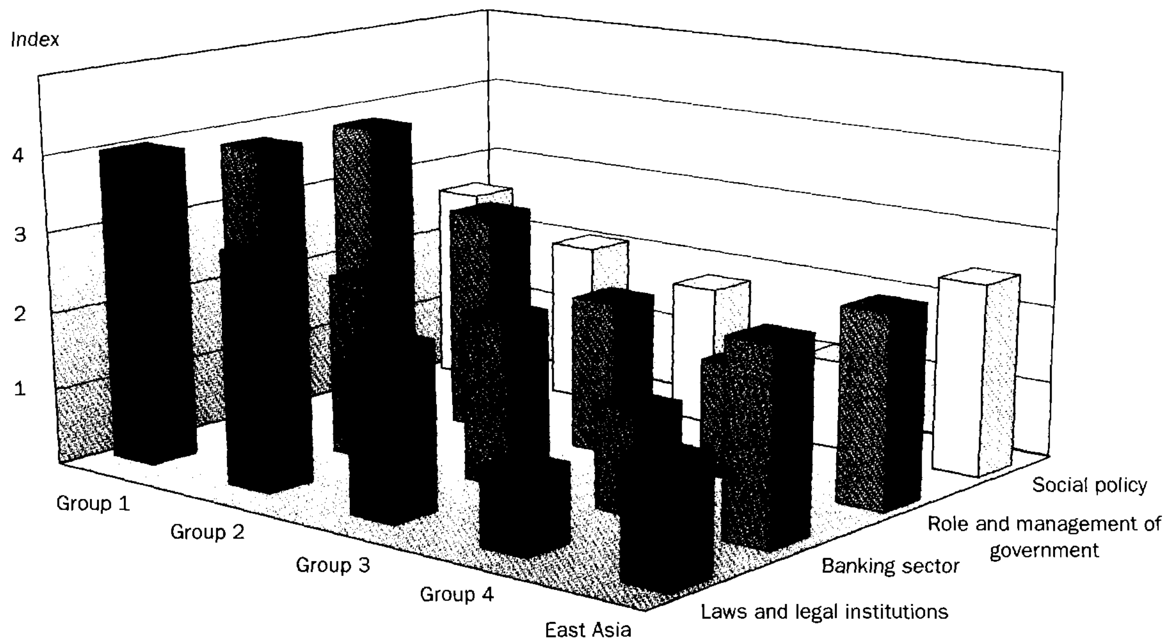
## Box 1.2 Initial conditions and institutional reforms

Institutional legacies differed from country to country at the outset of transition. Some countries retained a cadre of people with memories of market rules and institutions. Their skills helped to rebuild institutions—for example, Poland had never lost the knowledge of prewar law, and Polish professors had continued their interchanges with Western universities. Similarly, CEE government agencies dealing in international trade developed a familiarity with market-based contract law that proved useful when the time came to reform domestic legislation.

Many new states, however, have had to create market and government institutions from scratch. Sometimes the absence of an institutional legacy can actually be an advantage—for example, Slovenia was free to start from a clean slate as it built new institutions such as its central bank, and the experience of the Baltic countries shows that designing new budget or tax laws may be easier while governments are still unencumbered by entrenched entitlements and interest groups. On the other hand, implementing new institutions—whether they be customs agencies, accounting and auditing practices, or treasury and debt management systems—requires large human, technical, and financial resources in all transition countries, and in this regard the new states face a massive additional burden.

***Markets fuel demand for new institutions.***

**Figure 1.5** Institutional and social policy reform by reform type and country group




Note: Data are for 1995 and are simple averages for the countries in each group (see Figure 1.2). The *laws and legal institutions index* measures the scope and quality of new legislation and development of judicial institutions: 1, little progress on either; 2, some progress on laws, little on institutions; 3, some progress on both; 4, extensive progress on both. The *banking sector index* measures the independence, skills, and credit allocation practices of the better segment of banks, as well as the functioning of supervision and payments systems: 1, little change; 2, some initial progress; 3, system functioning fairly well but with limitations; 4, system functioning fairly well and with a larger segment of better banks. The *role and management of government index* measures the market orientation of government and the effectiveness of public sector management (see Figure 7.1 for specific indicators): 1, little change; 2, significant reform; 3, substantial reform; 4, advanced reform. The *social policy index* measures progress in pension reform, reduction of subsidies, streamlining and targeting of income transfers, and divestiture of social assets: 1, no reform; 2, limited reform; 3, modest reform; 4, substantial reform. Source: EBRD 1994, 1995; World Bank staff estimates.

and housing—partly because reforms have yet to resolve many difficult problems of the state sector.

*Economic and social outcomes*

Three features stand out in the range of transitional outcomes to date. The first is the large variance in performance among three sets of countries: the more advanced reformers in CEE and the NIS, the less advanced reformers in this region, and the East Asian reformers. Second, and cutting across these differences, is the clear message that sustained and consistent reform pays off. Third, addressing the social outcomes of transition requires both economic growth and social policy reform.

In CEE and the NIS, liberalization and stabilization policies have produced the main immediate effects. Other reforms take longer to show results, although it is increasingly clear how important they are to maintaining hard budget constraints and backing up these policies—success depends on the interplay of reforms across a number of areas. Freeing prices rapidly eliminated shortages, and phasing out subsidies to rein in overspending subjected firms to financial discipline and forced some initial

restructuring. But freeing prices also caused a burst of very high inflation in all countries except Hungary, where most prices had been liberalized before 1990. CEE and the NIS have seen large declines in output, especially in countries exposed to severe regional tensions (Table 1.1). Yet official data overstate the output decline. They largely fail to include output from informal sectors, whose growth provides a substantial cushion in some countries against declines in formal sector output and employment. Furthermore, some of the lost output consisted of goods no longer wanted (Box 1.3), so that measured output changes are not necessarily good indicators of well-being.

Among advanced reformers, vigorous stabilization programs have paved the way for declining inflation and a resumption of growth as reforms have taken hold. Thousands of new, competitive firms have entered the market. Many state firms have shrunk dramatically, and others have closed altogether. Production has shifted from industry to services, trade has been reoriented toward world markets, and foreign direct investment (FDI) inflows have risen sharply. By 1995 industrial labor productivity was a third higher than prereform levels in Poland and Hungary (Figure 1.6). Poland's growth rate of 7 percent in 1995 was led by the 15 percent growth rate of the private sector; the state sector declined by 3 percent.

The picture was different for the less advanced, or less decisive, reformers in CEE and the NIS, even though the scale of reforms in many of these countries has been large by conventional standards. Adjustment has been much slower, and inflation has remained high, although in most cases it has fallen substantially from earlier levels. But slower adjustment has not meant a smaller drop in output. In fact, output has often fallen by more than in the advanced reformers, and most of these economies are still contracting. These countries have not yet managed to achieve the critical policy mass needed for sustained macroeconomic stability and a resumption of growth (Chapter 2).

In contrast to the CEE countries and the NIS, both China and Vietnam have enjoyed spectacular growth throughout their reform periods (see Table 1.1). Vietnam adjusted to the demise of the CMEA and the loss of Soviet aid—which was not replaced from other sources—without a drop in output (Box 1.4). China's growth (although slightly overstated by official measures) was propelled by exceptionally high saving rates and by large gains in productivity that were partly due to reallocations of labor from lower- to higher-productivity activities. As in CEE and the NIS, much growth in China came from previously repressed sectors, including exports, services, and agriculture.

The social impact of transition has also varied. In CEE and the NIS many people have gained, and imports of high-quality consumer goods have boomed. But the combination of falling output and rising income inequality has led to large increases in poverty and growing insecurity in many countries. Life expectancy has fallen in many, particularly Russia and Ukraine, but has increased in the Group 1 countries (see Table 1.1). Infant mortality rates appear to have declined in many countries, possibly as a consequence of the sharp fall in birthrates in the region.

**Table 1.1** GDP growth, inflation, and social indicators during transition

| | Average GDP growth (percent per year) | | Average inflation (percent per year) | | Change in social indicators, 1989–94[a] (percent) | |
|---|---|---|---|---|---|---|
| **Country or group** | **1989–95** | **1994–95** | **1989–95** | **1994–95** | **Life expectancy** | **Infant mortality** |
| *CEE, NIS, and Mongolia* | | | | | | |
| Group 1 | -1.6 | 4.3 | 106.0 | 18.7 | 0.7 | -1.8 |
| Group 2 | -4.2 | 4.0 | 149.2 | 59.0 | -0.2 | -1.8 |
| Group 3 | -9.6 | -12.5 | 466.4 | 406.8 | -4.4 | 0.9 |
| Group 4 | -6.7 | -11.4 | 809.6 | 1,176.5 | -1.6 | -1.9 |
| Countries severely affected by regional tensions[b] | -11.7 | -7.5 | 929.7 | 1,328 | 0.5 | -2.7 |
| *Other transition economies* | | | | | | |
| China | 9.4[c] | 11.0 | 8.4[c] | 20.6 | 2.1[c] | -11.1[c] |
| Vietnam | 7.1[d] | 7.9 | 114.8[d] | 13.2 | 1.7[d] | -5.4[d] |

.. Not available.

Note: All data for recent years are subject to revision. See Figure 1.2 for the countries in each group.

a. Data do not take into account a possible rise in measured infant mortality rates due to the shift to international methodology in the NIS around 1993. *Social indicators are population-weighted.*

b. The countries asterisked in Figure 1.2 are taken out of Groups 1–4 and consolidated.

c. Data are for 1978–95.

d. Data are for 1986–95.

Source: IMF and World Bank data.

### Box 1.3 Data problems in transition economies

Many statistical systems in the NIS and CEE have not adapted to the new economic system. They often fail to capture the emergence of large "second" economies. Technical weaknesses, compounded by the effects of high inflation, also cause output to be seriously underreported. A recent revision of Russia's national accounts finds that they had overestimated the cumulative decline in 1990–94 by 12 percentage points. Reassessments of other countries, especially in the NIS, are likely to result in comparable revisions.

In addition, the previous pattern of trade and production in CEE and the NIS was highly inefficient. New goods (including consumer durable imports, which have boomed) command high quality premia relative to "comparable" old goods, many of which have no market value. Much previous production was directed toward military procurement, which was cut drastically in 1992. These qualitative changes, as well as the end of queuing, which previously absorbed up to four hours a day for many, make it even more difficult to assess the real welfare effects of the output changes that accompany a massive shift in economic regime. Social data have problems, too (see Box 4.1).

Living standards have risen sharply in the growing Asian reformers: the first stages of reform in China lifted almost 200 million people out of absolute poverty, a massive achievement. But the rise in urban-rural differences and increasing regional inequality have now weakened the link between economic growth and poverty reduction. This has led to rising concern about the distribution of gains from reforms (Chapter 4).

### Assessment—the interplay of choice and circumstance

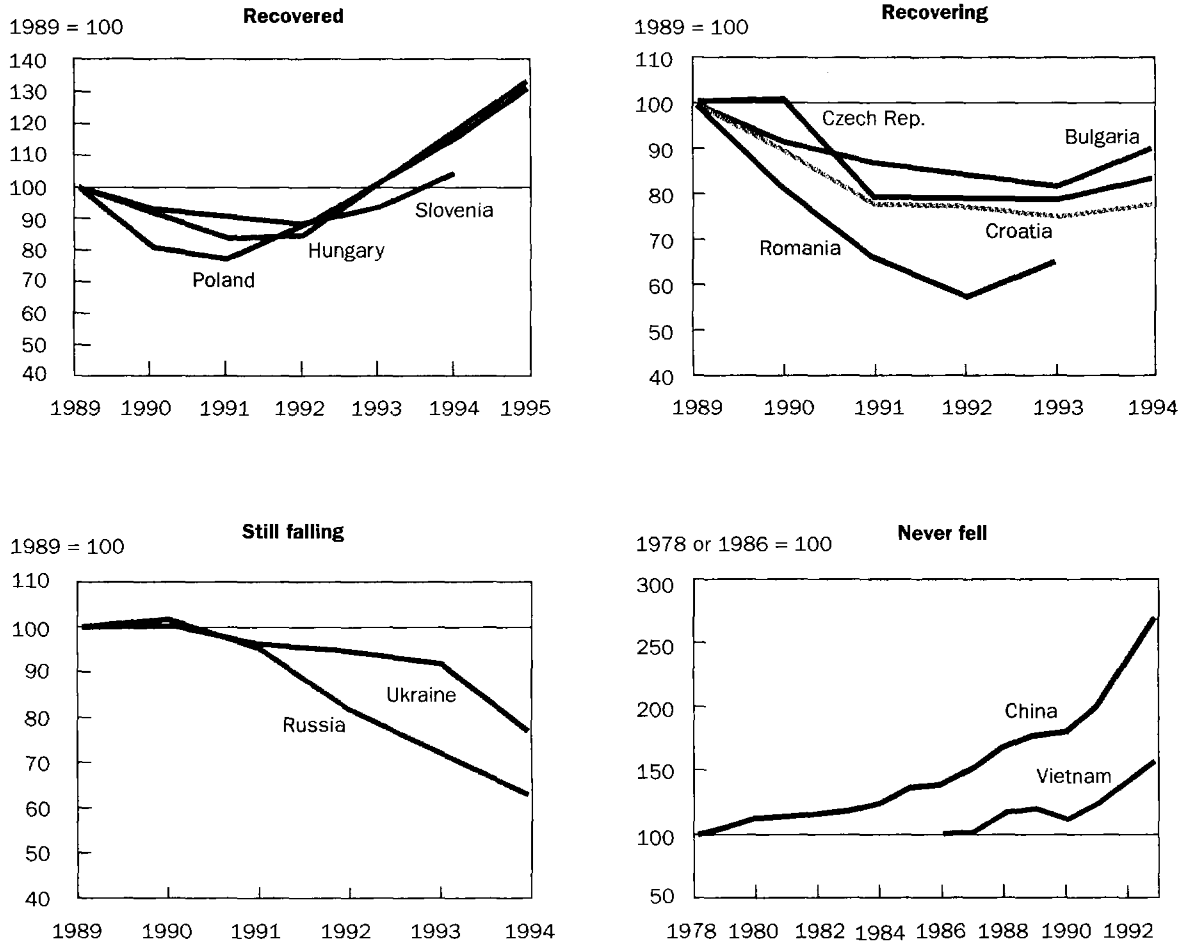
To what extent does the divergence of outcomes across CEE and the NIS reflect initial conditions as opposed to policy—the given rather than the chosen? Some countries, typically in CEE, started with more favorable macroeconomic, structural, and institutional conditions. These included lower inflationary pressures, less interdependence with the CMEA system, a more recent history of market economy, and a more favorable location for developing new trade links. Countries also differed in their levels of development, industrialization, and income. The Central Asian countries and Albania, in particular, were less developed and more rural than the others. And some countries achieving independence for the first time needed to construct the basic elements of statehood. Separating the contributions of initial conditions and policies is difficult. Ongoing research on this group of countries suggests that favorable initial conditions do indeed play a significant part in determining cross-country differences in outcomes but that, regardless of the starting point, constancy in reforms has been vital for restoring growth and containing inflation.

Why has China been able to reform in a partial, phased manner and still grow rapidly, whereas even vigorous reformers in CEE and the NIS have suffered large declines in output (but still outperform the slower reformers)? China's favorable initial conditions are the first piece of the puzzle. Its policymakers did not have to confront some serious obstacles that proved very difficult to turn aside in CEE and the NIS. This is not to imply that China's task was easy. It had to devise and implement a set of market-oriented reforms that gave growth-promoting incentives to farmers and workers while maintaining macroeconomic control and redirecting the interests of the bureaucracy toward supporting reform. These were and remain major achievements. But the transition challenge in China—and policymakers' tools for meeting it—were vastly different.

One way to bring this point home is to compare Russia and China (Table 1.2). When its transition began, Russia's economy was far more developed than China's, with income per capita eight times higher. Over 40 percent of the work force was in industry, and the state's social security system covered virtually the entire population. An elaborate and costly system of sectoral cross-subsidies propped up huge state enterprises and agricultural collectives. The energy sector played a key role in subsidizing both: implicit subsidies from energy production to the rest of the economy amounted to over 11 percent of GDP. A large share of Russian industry added negative value: input costs, valued at world prices, exceeded the value of output. Then trade with the CMEA countries collapsed, prices were liberalized, and demand for military goods declined as cold war tensions receded. The shock to the Russian economy was enormous. Shifting large numbers of people into new firms and formerly repressed sectors (including services) required deep structural adjustment and painful retrenchment in the state sector. Employees and managers exerted enormous pressures to continue subsidies and keep firms afloat, in part because enterprises had traditionally provided so many social services. The pain was intensified by the legacy of decades of planning that had resulted in extreme regional specialization, with many one-company towns. And with price liberalization and the scaling back

***Labor productivity is at new highs in some reforming countries, while others are behind the curve.***

**Figure 1.6** Labor productivity in industry in selected transition economies




Source: Vienna Institute for Comparative Economic Studies 1995; World Bank data.

of subsidies, agricultural output shrank by nearly one-fourth between 1990 and 1994.

Despite the industrialization efforts of the 1950s and 1960s, China was very poor and largely rural at the start of its reforms. Agriculture employed 71 percent of the work force and was heavily taxed to support industry. Social safety nets extended only to the state sector—about 20 percent of the population. Poor infrastructure and an emphasis on local self-sufficiency led to low regional specialization and large numbers of small and medium-size firms. The economy was far less centrally planned and administered than the Soviet economy. Local governments had greater power and developed considerable management capacity, preparing them for a more decentralized economy. Chinese industry also received subsidies, but cross-subsidization was less pervasive.

Because the agricultural sector had been so heavily repressed, freeing it up had immediate payoffs. Between 1981 and 1984 agriculture grew on average by 10 percent a year, largely because the shift to family farming im-

**Box 1.4 Vietnam: Bold reforms in an East Asian setting**

In the mid-1980s Vietnam's economy was growing slowly and suffering from hyperinflation despite massive Soviet assistance. A reform program (*doi moi*) was launched in 1986, starting with limited changes in the rural sector and accelerating in scope and pace in 1989. In a very short time reforms dismantled collectives and returned the land to family farming; liberalized most prices; allowed and encouraged new private businesses in many fields; opened the trade and investment regimes; unified the exchange rate and sharply devalued the currency; cut fiscal deficits and the growth rate of domestic credit; raised interest rates to positive real levels; and—not least—imposed financial discipline on state enterprises and laid off hundreds of thousands of redundant workers (see Chapter 3). These measures stabilized the economy—inflation fell below 10 percent by 1992—and restored growth, which has averaged 8 percent since 1991. Exports and investment are growing at double-digit rates. Vietnam's transition is not complete. Industrial production remains concentrated in state enterprises, and administrative controls remain pervasive. But its liberalization and stabilization measures were closer to those of Eastern Europe than they were to those of China. Not all East Asian reforms have been phased or gradual.

proved incentives. This allowed for the reallocation of surplus agricultural labor to new rural industries, which generated 100 million new jobs between 1978 and 1994 and encouraged further reform. China thus started transition largely as a peasant agrarian economy and with far greater scope for reallocating labor than Russia.

There were also important differences in financial development at the outset of transition. China's financial system was underdeveloped, with the money stock (M2) equal to only 25 percent of GDP. As markets developed and incomes improved, household savings and bank deposits grew rapidly. This financed growth and buffered the state sector through bank lending at interest rates that were often below inflation (Chapter 2). Prudent macroeconomic policies were key, holding inflation to modest levels and helping maintain confidence in the currency. Russia's economy, on the other hand, was already highly monetized in 1990, with M2 equal to GDP. The huge monetary overhang from forced saving represented resources already provided to the planned economy. Liberalization of prices and the monetization of fiscal deficits led to hyperinflation, which rendered these savings worthless. By 1994 the Russian money stock had dwindled to only 16 percent of GDP.

Differences in initial conditions and structural characteristics therefore explain a good deal of the divergence of transition outcomes and policies across countries. They do not explain all—the sustained application of market-oriented reform policies, within a broadly "right" macroeconomic environment, has been a crucial ingredient in success. However, the right reform mix must reflect initial conditions and so cannot simply be transplanted between such starkly different countries as China and Russia.

**Table 1.2** Russia and China: Two very different countries

| | Russia | | China | |
|---|---|---|---|---|
| **Indicator** | **1990** | **1994** | **1978** | **1994** |
| *Sectoral structure of employment (percent of total)* | | | | |
| Industry | 42 | 38 | 15 | 18 |
| Agriculture | 13 | 15 | 71 | 58 |
| Services | 45 | 47 | 14 | 25 |
| Total | 100 | 100 | 100 | 100 |
| Employment in the state sector | 90 | 44 | 19 | 18 |
| *Money and output* | | | | |
| M2 as a percentage of GDP[a] | 100 | 16 | 25 | 89 |
| GDP per capita (dollars) | | | | |
| From *World Bank Atlas* | 4,110 | 2,650 | 404[b] | 530 |
| At PPP | 6,440 | 4,610 | 1,000[b,c] | 2,510 |

a. Data are averages of quarterly ratios.
b. In 1990 dollars.
c. World Bank staff estimate.
Source: IMF, various years (b); World Bank data and staff estimates.

## The agenda

The CEE countries and the NIS have not seen the spectacular growth of China and Vietnam, but many have turned the corner and resumed growth, some vigorously. With continued vigilance to sustain hard-won progress and implement further reforms, these countries can join the ranks of the high-growth economies. Other countries in the region have the potential to follow in their path. China and Vietnam, too, will have to push further in many areas, from property rights to institutional development to social policies, to sustain their rapid growth. In every case what matters is the breadth of the policy reforms attempted and the consistency with which they are maintained. The record to date, the challenges ahead, and the lessons these different groups of countries have to learn from one another are explored in detail in the following chapters.