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# Different Strategies of Transition to a Market Economy

## How Do They Work in Practice?

*Marek Dabrowski*

The government's ability to act fast and with determination is more important to radical economic reform than technical perfection in designing new policy instruments. Political consent to reform measures lasts a short time, so it should be used in full. If the window of opportunity is ignored, the next one may be a long time coming.

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## Summary findings

In 1989, the former communist countries embarked on a transition from centrally planned command economies to market economies (and from repressive dictatorships to Western-style democracies).

In addressing the question, "What is the optimal strategy for this transformation?" Dabrowski revisits the controversy about how quickly and radically the new market rules and their components should be adopted in the former communist countries and discusses the economic and political problems associated with different strategies. Among his conclusions:

- Generally, the faster and more comprehensive the economic reform, the more chance there is to minimize its economic, social, and political costs, and to avoid chronic macroeconomic mismanagement. A more radical and disciplined path of transition is all the more important when initial conditions are less favorable and negative external shocks are greater. Only countries such as Hungary — which had made some progress in market-oriented reform before communism's collapse and which experienced less macroeconomic disequilibrium — could go more slowly.
- Political liberalization and democratization helps the economic transition succeed mainly because it helps weaken the political positions of the traditional communist oligarchy *(nomenclatura)*, which is interested mainly in rent-seeking.
- Unless stabilization and liberalization are achieved quickly, microeconomic restructuring cannot be expected to progress quickly, even if privatization does (as it has in Russia). Other aspects of the transition may take more time. For privatization to succeed, for example, a legal base and organizational infrastructure must be created. But even with privatization, a rapid transition is less risky for restructuring and for complex institutional reform than a slow transition.
- There is no way to avoid a relatively large decline in output, especially of industrial production in the state sector.
- Granting concessions to, and bargaining with, various pressure groups does not produce the expected political results or increase social acceptance of reform.
- Governments should not be afraid of "aiming too high" in embarking on a stabilization program or any other component of transformation. Most post-communist governments do the opposite: dilute the program so much it becomes ineffective.

This paper — a product of the Transition Economics Division, Policy Research Department — is part of a larger effort in the department to look at progress on macroeconomic reforms in former communist countries as they move to a market economy. Copies of the paper are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Chris Rollison, room N9-054, telephone 202-458-4768, fax 202-522-1151, Internet address crollison@worldbank.org. March 1996. (47 pages)



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# DIFFERENT STRATEGIES OF TRANSITION TO A MARKET ECONOMY: HOW DO THEY WORK IN PRACTICE?

Marek Dabrowski

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# I. Introduction

In 1989, the former communist countries (FCC) embarked on the transition from a command, centrally planned economy to a market economy. At the same time, they began to transform their political systems from repressive dictatorships into Western-style democratic regimes. The transition to democracy and the market economy in Central and Eastern Europe (CEE) and in the former Soviet Union (FSU) may be the most important political and economic event in the world history of the last decade of the 20th century.

This paper deals mainly with the problem of the optimal transformation strategy. The intention is to revisit the controversy of how quickly and radically the new market rules (and their individual components) should be adopted in the FCC and the economic and political consequences of different strategies.

The topic and issues presented in this working paper are a continuation of my research and resulting papers from 1990 and 1991 [see Dabrowski, 1992b]. These analyses were based primarily on Polish and a few CEE early transition cases. Hence, this study can benefit from the longer transition history in CEE and from the experience of FSU countries which entered the transformation process in 1992. Although some hypotheses and conclusions are less controversial than they were two or three years ago, it is still too early to elaborate any comprehensive and stable theory of post-communist economic transition. This is too difficult a task for one person. Therefore, this paper is a preliminary sketch of specific problems rather than a comprehensive and closed monograph.

The paper is organized in the following way:

Chapter II gives a short description of the specific features of post-communist economic transition in comparison with policy reforms adopted after World War II in many Western and developing countries. The identification of the real transition strategies is the subject of Chapter III. In the first section of this chapter, I propose a more developed classification of the transition strategies adopted in different countries in the period 1989-94. In Sections 2 and 3, I try to evaluate different strategies from the economic and political points of view. Section 4 analyzes separately the question of output decline under transition. In Chapter IV, I return to the transition strategy debate. Section 1 summarizes the controversy about shock therapy versus gradualism. Section 2 tries to demonstrate which specific components of transition must be done quickly and which of them can be done more gradually. Section 3 is devoted to the sequencing issue, and Section 4 describes the advantages and disadvantages of slow transition. Section 5 analyzes to what extent the different starting conditions influence the transition strategy, and Section 6 discusses the issue of democracy and market reform. In Chapter V some practical recommendations are formulated. Finally, in the postscript, I try to mention some recent developments during 1995.

The **main** conclusion of this paper is related to the question of speed and sequencing of the post-communist transition. Generally, the more fast and comprehensive the economic reform is, the more chance there is to minimize the economic, social and political costs of this process and avoid chronic macroeconomic mismanagement. Less favorable initial conditions and bigger negative external shocks are also arguments in favor of a more radical and disciplined path of transition. Only countries such as Hungary, that achieved some progress in market oriented reform earlier (before communist regime collapsed) and had less macroeconomic disequilibrium, could go more slowly. **Second,** a general conclusion is connected with the crucial role of the initial stabilization and liberalization package. Without success in this sphere, it is hardly expected that quick progress will take place in microeconomic restructuring even if the privatization process is going very fast (as in Russia). **Third**, political liberalization and democratization helps successful economic transition mainly because it contributes to weakening the political positions of traditional communist oligarchy (*nomenlatura*), interested mainly in parasite rent-seeking.

## II. The Specific Features of Post-Communist Transition

### 1. Economic specifics

The agenda of post-communist transition differs very much from the policy reforms adopted in the last ten to fifteen years by many middle-income, developing countries, such as Chile, Mexico, Argentina, Peru, Bolivia, Egypt, and India and after World War II by some of the developed countries, such as Germany and Japan.

The comprehensive and complex reconstruction program undertaken in post-war Germany under Minister of Economy Ludwig Erhard involved only the reintroduction of a stable currency and market regulation after some ten years of a fascist command economy and war. The economy was never nationalized, and all basic legal market institutions survived the war.

The Japanese economy, though less developed than the German one, was also mostly privately owned and severely damaged by the war. Its market mechanism was partly suspended by war and by command-type regulations [see Sachs, 1995].

Most of the developing countries seeking to change their economic systems had to contend with high inflation or hyperinflation and with economies that were overregulated and closed to external competition. Some of them had accumulated a lot of structural distortions. However, these distortions were not as dramatic as those inherited by the FCC, especially those in the FSU. Some developing countries also had to privatize their economies, but all of them, including Chile after Allende, undertook their reforms in a private economy. Chile's transition was probably the most comprehensive and radical outside the former communist block. But even the Chilean transformation of the 1970s and 1980s seems less difficult and dramatic than that of Eastern Europe and the FSU [Edwards and Edwards, 1991].

I fully agree with Stanley Fisher and Alan Gelb [Marer and Zecchini, 1991, p. 184] who wrote four years ago:

> *"In fact most of the individual requirements for socialist economy reform have been faced before, in China, and in Latin American and African countries where the combination of a weak private sector, political monopoly, heavy policy induced distortions and macroeconomic imbalance is not uncommon. Nonetheless the challenge is unique, in its system-wide scope, in its political and historical context, and in the speed of desired reform."*

A similar view was expressed by Leszek Balcerowicz [1994, p. 80] three years later:

> *"[Under communist rule [...] capitalism was destroyed and not merely suspended (as in Germany before 1948) or distorted (as in Latin America and India before their respective rounds of economic liberalization)."*

The new democratic governments in the FCC inherited a range of serious economic problems which determined the agenda of the transition. The four chief problems are as follows:

1. Total or almost total nationalization of the economy left a very limited role for private savings and implied either explicit prohibition of or serious restrictions on private economic activity. To make matters worse, the official systems of education and propaganda in all the FCC tried to convince people of the superiority of state control (sometimes referred to as "social" or "all-national") over private ownership. This indoctrination lasted more than 40 years in CEE, including the Baltic countries, and more than 70 years in the other parts of the FSU.

2. Huge structural distortions stemmed from the monopolization, economic autarky, administrative price regulation, and centralized investment decisions. The former communist economies were strongly oriented to domestic and regional markets (the latter through the Council for Mutual Economic Assistance - CMEA) and were separated from other markets by currency inconvertibility, price controls, trade restrictions, and the state monopoly in foreign trade.

3. The state undertook a high level of social spending relative to the level of economic development [see Sachs, 1995]. This part of the communist heritage is a relatively young one, because the first decades of the communist regime were characterized by austere policies in social spending. This situation started to change some time after the death of Stalin and the round of social and political unrest (GDR in 1953, Poland in 1956 and 1970, Hungary in 1956, Czechoslovakia in 1968). Less repressive (in comparison with the Stalinist period) mutations of communist regimes looked for some form of social support and legitimization. This was the case of Hungary under Janos Kadar (so-called goulash socialism), Poland under Edward Gierek, the GDR under Erich Honecker, or the Soviet Union under Leonid Brezhnev. In some cases, social spending was an attempt to neutralize the expected social unrest coming from political tightening (Czechoslovakia under Gustav Husak and Poland under Wojciech Jaruzelski).

4. Domestic and external macroeconomic disequilibrium prevailed and was especially strong during the final years of the communist regimes, when they lost their capacity to control economic and social life. Partly it resulted from factors described in points 2 and 3. Only the former Czechoslovakia, Hungary, and the former GDR avoided dramatic macroeconomic crises, but even in these countries (and especially in Hungary) the degree of macroeconomic stability was far from Western standards. Domestic disequilibrium manifested itself in the form of a rising budget deficit and monetary expansion, difficulties in controlling wages, and other serious problems leading to high inflation either in repressed (a "shortage economy", to use Janos Kornai's terminology) or in open form. The external imbalances usually led to growing foreign debt.

These four characteristics show the differences of East European and post-Soviet transition in comparison with communist countries in East or South East Asia, such as China, Vietnam, or Laos. They inherited less structural distortions mainly because they were far less industrialized than the FSU or CEE [Sachs and Woo, 1994]. Asian communist countries offered their people far less social support than did the FSU and CEE [Sachs, 1995], and they succeeded in keeping more macroeconomic equilibrium (especially China) in comparison with most of FCC.

In short, the post-communist transformation is a complex undertaking concerning almost all aspects of the economic system and many aspects of the political system. This makes it difficult to single out the most important elements of that process. For the requirements of this paper, I will operate with a simplified scheme which names three basic elements of the transformation process: (a) macroeconomic stabilization, (b) liberalization (deregulation) connected with the change in the system of economic institutions, and (c) privatization and restructuring.

## 2. Political issues

Along with changes in the economic system, the political transition from an authoritarian and highly repressive system to a democratic one has taken place. Here also the 20th century history of the discussed region has not been helpful to achieve this goal. If we look back at the inter-war period only Czechoslovakia had Western European type democracy all that time. Other Eastern European countries (including Baltic states) enjoyed only a limited period of rather unstable democracy with frequent attempts of authoritarian coup d' etats. Some of them were successful leading to semi-dictatorial regimes (examples of Poland, Lithuania, and Hungary). Russia and other nations of former Russian (later Soviet) empire did not have any democratic tradition in their history. Additionally, many of them did not have any experience with their own independent state. Thus in 1990s most of the FSU countries[1] had to build the basic institutions of an independent state from scratch.

In these circumstances, a young parliamentary democracy often is connected with political instability (e.g., Bulgaria, Romania, Russia and Poland) that complicates an economic transition. On the other hand, the socially painful and politically difficult agenda of economic transition contributes to political turbulence.

There are many historical cases when a transition from "suspended" or "distorted" capitalism (using Balcerowicz's terminology) to its more liberal and macroeconomically more stable version was accompanied by the political changes from an authoritarian regime to a democratic one. It happened not only in Germany, Austria, and Japan after World War II but also in many developing countries during the last 20 years (especially in Latin America). In many cases, e.g., in Germany and Austria, however, democracy was restored rather than

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[1] The same also concerns most of the former Yugoslav republics.

created for the first time. In some other countries, economic reforms were implemented by authoritarian regimes (as in Chile, South Korea, Taiwan, and Singapore). In China and Vietnam, extensive economic reforms have been implemented without any substantial changes in the political system. Leszek Balcerowicz [1994] classifies these two cases as a peculiarly Asian kind of post-communist transition, as opposed to the Central and Eastern European one. For this reason and because of different economic specifics (see Section 1), these countries are not included in this analysis.

## III. Transition Strategies and Results

### 1. Attempt to identify transformation strategies

After five years of transformation in the former CMEA countries and after more than two years of a similar process on FSU territory,[2] much empirical experience is available for both researchers and policymakers. A very diversified and complicated picture is seen.

More than 30 countries in Europe and Asia are involved in the transition from communism. With the exception of Cuba and North Korea, there are no classic communist economies left. Not all the transition countries, however, have already completed the journey—or even most of it—from a socialist economic system to a market economy. Indeed, in the Fall of 1994 some of the post-Soviet states, such as Ukraine, Belarus, and some of the Central Asia countries, have not yet made an unequivocal decision to move toward a market economy. They are either looking for a third way or trying to preserve what remains of the communist system in politics and in the economy (e.g., partial price controls, export controls, and a central role for state ownership).

There are three basic parameters for classifying the transition strategies:

1. The speed of actions in the main fields of transition: macroeconomic stabilization, liberalization and institutional changes, privatization and restructuring.

2. The comprehensiveness and internal consistency of implemented policies, creating the so-called critical mass of reform and avoiding both macroeconomic mismanagement and a more serious systemic vacuum on the microlevel.

3. The cumulative progress in transition achieved so far.

With respect to all three factors, the countries of Central and Eastern Europe and the FSU[3] may be classified into six broad categories. They are defined mainly along the third criterion, i.e., the cumulative progress in the transition process, although the two other criteria also play an important role. The proposed categories are:

1. One country (the former GDR in mid-1990) embarked on an **extremely radical**, once-and-for-all transformation of the economic system, made possible through the rapid "importation" of a stable currency and of most economic institutions from West Germany.

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[2] Analysis in this paper covers generally the period 1989-1994 only. Some recent updating will be presented in last section ("Post scriptum").

[3] China and Vietnam are excluded from this classification for the earlier mentioned reasons. Macedonia and Mongolia are not analyzed because I do not have the necessary information about these countries.

2. A group of countries (Poland, the Czech Republic, Slovakia,[4] Albania, Estonia, and Latvia) embarked on a **radical** path of transformation (in terms of the speed and consistency) containing the initial macroeconomic stabilization and an extensive domestic and external liberalization of the economy. These programs were followed by the launching of privatization. (Some delays in privatization came from the need to draft appropriate legislation and set up monitoring institutions). By the end of 1994, these countries accomplished the critical mass of reforms and completed the first stage of the transition process.

3. By the end of 1994, Hungary and Slovenia achieved a level of progress in the transition process similar to the second group of countries. They moved, however, **much slower** but in a rather well coordinated way. They had a better starting point, especially in terms of the earlier liberalization of the economy and institutional reforms.

   In the case of Slovenia, the notion about a slow path of transition concerns the large privatization. The macroeconomic adjustment after separation from the Yugoslav federation in 1991 was really radical. Slovenia did not need to take any dramatic measures about the domestic and external liberalization because the former Yugoslavia had a far more deregulated and open economy than other FCCs. Hungary moved gradually on all three transition dimensions. Its liberalization program lasted at least three years [Gacs, 1994], and macroeconomic policy never adopted any dramatic measures. Hungary also has not adopted any spectacular mass privatization policy like the Czech, Russian, or German ones.

4. Countries in the **middle of the process** implemented a number of significant changes (an example is the Russian voucher privatization) but did not finish until the end of 1994 a comprehensive package to transform their economies. This diverse group is made up of three types:

   a/ Lithuania, Kyrgyzstan, and Moldova failed to do radical stabilization and liberalization at the beginning of transition. Now, they are doing more to stabilize and liberalize their economies successfully, and they have a chance to catch up with the second and third groups in the near future. Lithuania and Kyrgyzstan are doing quite well in the privatization sphere.

   b/ Romania and Russia engaged in important reforms but have not had well coordinated transition policies (especially in the macroeconomic sphere) and have suffered macroeconomic mismanagement.

   c/ In 1991, Bulgaria started a very radical liberalization and stabilization program similar to Polish and Czecho-Slovak ones, and it makes up this category. But

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[4] After the dissolution of the Czecho-Slovak federation, this country slowed down the transition process in comparison with the Czech Republic, especially in the sphere of privatization.

later, it slowed down the transition process and did not achieve the critical mass of changes. Moreover, the inability to start large-scale privatization has led to the return of a policy of soft budget constraints in relation to state owned enterprises and to the significant erosion of macroeconomic policy in 1993-94.

5. A few countries undertook **no** significant systemic **changes** and made little progress towards liberalization and privatization of the economy until the end of 1994. This lead sooner (Ukraine) or later (Belarus, some Central Asian states) to economic destabilization and high inflation or hyperinflation.

6. Countries **at war** (Bosnia and Herzegovina, Serbia and Montenegro, Georgia, Armenia, Azerbeijan, Tadjikistan, and Croatia) where economic reforms were never launched or were halted and where war-related expenditures and the destruction and disorganization of the economy have led to hyperinflation make up this group. Like the fourth category, this one is made up of countries with important differences among themselves in the level of economic development, intended economic strategies, and the size of real war damages. For example, Armenia, Croatia, and Serbia started reforms but stopped them. The inability to implement a comprehensive transformation package could be seen, however, as the common denominator of this group.

The categorization proposed here differs significantly from the standard dichotomy between **shock therapy** and **a gradual approach** that will be discussed later in this paper. Yet the real picture is much more complicated than described. In practice, there is more than one variant both of the radical (*shock*) scenario and of gradualism. Some cases escape neat classification. For example, in the beginning of 1994, the new Yugoslavia[5] and Croatia had taken ambitious anti-inflationary measures. At the end of 1994, large transition packages were discussed in Ukraine, Georgia, Armenia, and Belarus.

## 2. Economic effectiveness of different strategies

Tables 1-3 present three basic economic indicators—GDP growth or decline, the annual rate of inflation, and the unemployment rate—of 24 countries in transition. (See Tables 1, 2, and 3 at the end of this paper.) These countries represent all the categories characterized in the previous section except East Germany. To interpret those data, one must remember, of course, that the quality of transition statistics is often problematic. For example, before the transition started, the GDP level was very often overestimated; after the beginning of transition, GDP has usually been underestimated for many methodological reasons [see Bratkowski, 1993a]. The inflation statistics in the FSU before 1992 were very poor. Even now their quality remains problematic in some FSU countries, in part because persistent market shortages (i.e. repressed form of inflation) remain in some transition economies.

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[5] The new Yugoslavia is Serbia and Macedonia.

With all these methodological reservations, the available statistical data seem to show an advantage to countries which belong to the second and third group in comparison with the groups 4, 5 and 6. Also countries from group 4 generally look better than countries from groups 5 and 6. This statement relates both to the inflation figures and to the cumulative output decline. The latter is also influenced by at least two other, and to some extent, interrelated factors: inherited macroeconomic and structural distortions, and the size of adverse external shocks (see Section 4). Slovenia, for example, has not depended on CMEA trade (however, it suffered, to some extent, from the collapse of the Yugoslav market). The Hungarian economy before 1989 was more open to the West than other Comecon countries. On the other hand, Bulgaria heavily depended on CMEA trade and additionally suffered very much from the Gulf Crisis in 1990-91 as well as from the UN sanctions against new Yugoslavia.

The same type of differentiation can be observed in the former USSR. On the one hand, Ukraine, Belarus, and the Baltic states lost very much from the collapse of the FSU market and from energy price adjustments. On the other hand, Russia, Turkmenistan, and Uzbekistan, as net exporters of energy resources and other raw materials, could probably gain something from trade reorientation and changes in the price structure.

The advantage of the first three groups (including the GDR) would be even greater if our analysis included fiscal balances, balance of payments statistics, stability of the exchange rate, or factors such as quality of consumer and producer markets. Also the microeconomic restructuring seems to be more advanced in the first three groups than in the others. The unemployment statistics presented in Table 3 seem to support this hypothesis indirectly.

Of course, one can propose a completely opposite interpretation of Table 3. Countries that adopted quicker and more radical strategies experienced generally higher unemployment than did countries that either went slower (group 4 with the exceptions of Bulgaria and Romania) or have not start the real transition yet (group 5). Perhaps the superiority of gradualism and softer macroeconomic policy might be seen as socially less painful and politically less risky. Such an interpretation, however, would be very short-sighted. **First**, the increase of unemployment seems to be unavoidable, and the soft macroeconomic policy and the blockade of privatization may only delay this phenomenon. Prospects of microeconomic restructuring and economic recovery are delayed by these policies. **Second**, very high inflation or hyperinflation, an unavoidable product of the soft fiscal and monetary policies supporting employment, may do more political damage than high unemployment. **Third**, hoarding labor in SOEs without any production tasks (because output has declined) creates no fewer social tensions than does open unemployment.

Slow and inconsistent changes also make the transition difficult. Macroeconomic instability and the lack of sufficient competition create greater income and wealth differentiation and often encourage criminal practices.

Comparing the strategies used by the second and third groups is extremely interesting. Both groups of countries achieved about the same level of progress in the transition process, completing *de facto* the first stage and making it irreversible. However, the third group reformed more slowly than both the first and second groups. The same final result was possible because the third group started from a better initial position than the second group in sophistication in creating market institutions, in having smaller structural distortion, and in possessing more business experience of SOEs competing on the international market. This explains why the gradualist policy could give any positive results at all—contrary to other Eastern European countries (Romania or Bulgaria) and the FSU.

However, whether the Hungarian or Slovenian gradualism is seen as a real success story remains a question. **First**, the macroeconomic situation and the prospects for the economic growth of Hungary at the end of 1994 seem to be worse than that of other Central European countries. **Second**, one can argue that by implementing more radical strategies, both Hungary and Slovenia could achieve more.

## 3. Political effectiveness of different strategies

Politicians often perceive radical moves toward a market economy as a greater risk and a concentration of difficulties and material sacrifices. Thus radical restructuring may cause more social resistance to changes. Numerous politicians, particularly those who do not feel strong social support, prefer the strategy of gradual, slow transformations; put off the most painful moves; and look for "theoretical" arguments to justify such an approach.

The election defeat of democratic, pro-reform forces and success of populist, anti-reformers[6] are another argument against radical economic transition. However, there is a danger of misinterpretation of these election results.

In countries where anti-reform[7] parties won elections, only Poland presents a case of the radical strategy. However, non-economic factors, such as the so-called 'war on the top' in the Solidarity camp or a conflict around the role of the Catholic Church in political life, played important roles. The Lithuanian pro-democratic movement Sajudis failed to implement a radical economic transition (contrary to Estonia and Latvia) and managed a rather weak, pro-inflationary macroeconomic policy. The Hungarian right-wing government ruling from 1990 to 1994 was very reluctant to implement a radical transition scenario. The partial election failure of democratic forces in Russia in December 1993 can also be seen as the result of their inability to control very high inflation. Only the first success of Slovakian HZDS (Movement for Democratic Slovakia, Vladimir Mechiar's party) can be partly attributed to the resistance against Vaclav Klaus' radical transition policy (including the idea of coupon privatization).

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[6] I have in mind the left wing political parties, having a post-communist origin, which won in Lithuania, Slovenia, Poland, Hungary, Bulgaria, and in part of Russia, and other populist or nationalistic formations (Slovakia, Russia).

[7] The main criterion for classifying a party as anti-reform is its program and slogans proposed to the electorate.

However, nationalistic arguments may have played a more important role here than economic ones.

Other political stories in Eastern Europe showed that gradual transition strategies and populist macroeconomic policies were not political assets. The election defeats of the Ukrainian President Leonid Kravchuk and the Belarusian Prime Minister Vyacheslav Kebich in 1994 were good examples.

A rapid rotation of political elites is likely with a deep economic crisis and a young, unstable democratic regime. But cyclical changes of political sympathies occur in every democratic society. In a young democratic environment with very weak political parties and very unstable public opinion, such a cycle may be much shorter. Some analysts forecast that the recent election trend favoring the social-democratic parties of post-communist origin will be quickly reversed as the public learns that economic problems cannot be solved by painless methods as had been promised during election campaigns (see Samonis [1995] in relation to Lithuania).

There are lessons for political leaders in transition countries based on experience. They should focus more on exploiting the political window of opportunity (which usually occurred at the very beginning of the transition process)[8] for making as many reforms as possible for benefit of the country rather than on short term personal political survival. A stable personal career cannot be expected in so unstable a political environment. A sound and responsible transition policy involves a risk of political failure in the short run but may result in long-term credibility and popularity.[9]

## 4. Output decline under transition

As Table 1 shows, a deep output decline has been a common phenomenon for all the transition economies. This decline occurred regardless of the transition strategy used. However, the size of this decline, discussed in the Section 2 of this chapter, varied according to what strategy the country adopted, conditions at the beginning of the transition, or external shocks.

Although real output declines were smaller than officially registered, they occurred and they were important. These declines posed a significant intellectual and political challenge for most of the economists and politicians in the FCC who had been educated in the communist

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[8] L. Balcerowicz [1994] names this specific window of opportunity after a collapse of communism as the period of "extraordinary politics."

[9] Recent Polish history gives a good example of this. The former Deputy Prime Minister and Minister of Finance Leszek Balcerowicz left office at the end of 1991 unpopular and attacked by most of the political parties. Three years later, when the positive results of the radical transition policy became evident, his popularity is steadily rising while most of his critics have disappeared politically.

fascination of material output and quantity indicators of growth. But even for many Western economists, the size and the length of the post-communist output decline was surprising. A number of misinterpretations were made in both the East and West about what had happened in the FCC. One misinterpretation compares the post-communist output decline with the Great Depression 1929-1933 [Laski, Bhaduri and Levcik, 1993]. Another one sees the roots of decline in the operation of great destruction of the former economic system which was supposedly planned by the radical reformers or advocates of *shock therapy* [Kolodko, 1991; Kolodko, 1992]. The first one has involved a critique of stabilization policy in the FCC as too restrictive and a proposal to reactivate the economy as quickly as possible using the global demand management measures. The second one has led to advocating a more gradual approach to transition and to suggesting more government intervention. Both misinterpretations and conclusions have not been in conflict with each other and often have been presented jointly.

A general look at economic events of the last five years undermines the relevance of both theories. It is very hard to interpret the post-communist output decline as a cyclical, demand-type contraction. I prefer to use a notion of "output decline" rather than "recession," "depression," or "contraction." The collapse of the regulating and resource mobilizing capacities of the command economic system happened in most countries before the economic transition started. Rather, political liberalization and democratization have made further use of the command system impossible.

Post-communist output decline seems to be affected by the combination of different macroeconomic and microeconomic factors. Of course, the composition of these factors differs across the countries. Individual characteristics of each country would need more detailed statistical examination that is beyond the purview of this paper. I want to concentrate on drafting some general hypotheses.

On the **macroeconomic side**, the output decline is caused by the reduction of aggregate demand coming from two factors:

1. Elimination of the speculative demand connected with a shortage economy.[10] It is one shot factor but influencing the initial output decline (decreasing demand for the period of decumulation of inventories).

2. The excess demand coming from the current (flow) macroeconomic imbalances as a result of stabilization policy was eliminated (such an effect is connected with every stabilization program, not only those in the FCC).

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[10] Let me quote the interesting statement of Jan Winiecki [1990, pp.781-783]: '*There is a share of output in an STE* (Soviet-Type Economy - M.D.) *that simply would not have existed in a less wasteful economic system. No less importatantly, this output, although it contributes to economic growth of every STE, does not contribute to economic warfare./.../ the fall of output occured in all areas of the economy without in any way reducing the welfare of the household sector.*' See also - Gomulka [1991, p.6].

In addition to the above two factors, some countries lose output as result of permanent high inflation or hyperinflation. These kinds of losses do not prevent further losses of output when a stabilization program finally is implemented.

Macroeconomic factors, though obvious, are probably not the most important. **Microeconomic factors** are far more influential.

The first group of microeconomic factors is connected with the **shift in the relative demand** which has both external and domestic origins. On the **external** side, some important export markets collapsed: first, CMEA (1990-91), the Iraq market (1990-91), and the Soviet interrepublican market (1992-93). Also, the collapse of Yugoslav (1991) and Czecho-Slovak (1992-93) federations had some effect on their former member countries. Finally, the UN sanctions against the new Yugoslavia hurt the economies of the FY states and Bulgaria and to a lesser extent, Romania and Hungary. Trade liberalization leads usually to an increasing share of both import and export in GDP. New import opportunities decrease demand for some domestic products while new export opportunities give a chance to increase production of other goods. However, because the elasticity of supply response is usually limited (see below), a shift in relative demand coming from import liberalization must be connected with a temporary decrease of output.[11]

Several **domestic** factors contributed to the shift in the relative demand and affected seriously the activity of some sectors: demilitarization (a substantial factor in the FSU and Slovakia), decreasing investment rate and change in the structure of investment demand, rationalization of inter-regional links (especially in Russia), elimination of forced substitution,[12] more consumer freedom coming from elimination of the rationing system and from privatization of part of collective consumption (e.g., housing).

The second group of microeconomic factors has been connected with a dramatic change in the **cost level and structure**. In analyzing the **domestic sources** of cost shock to some industries, the elimination of explicit and implicit subsidies[13] must be mentioned. In some extreme cases, production has been maintained despite value subtracting (i.e., with negative value added) [Hare and Hughes, 1991; McKinnon, 1991]. This means the non-personal costs of production, converted to world prices, are higher than the value of production sold

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[11] This hypothesis seems to be especially relevant to industrial and other material production. Import liberalization can contribute to the parallel expansion of the trade and service sector, underdeveloped in the communist economy [see Berg and Sachs, 1991] and presenting a far greater elasticity (in terms of potential supply response) than the sector of material production. The development of trade and services (including financial services) can very quickly offset the decline in material production as happened in Poland in 1990-93.

[12] In the past it was a standart by-product of the shortage economy.

[13] The most frequent form of hidden subsidies has had a form of underpricing energy and transport services as well as enviromental costs.

according to world prices. The elimination of this production means a real gain for the national economy even though some enterprises or industries must be closed down.[14]

Similar developments have come with an **external price shock**, partly as a result of the unification of the exchange rate (elimination of implicit subsidies connected with a multiple exchange rate regime) and partly with the elimination of special price arrangements inside the CMEA or the FSU. If a government wants to isolate enterprises from the external price shock, maintaining explicit or implicit subsidies (as happened in the Ukraine in 1993-94), leads to a serious balance of payments crisis and to a physical shortage of critical inputs such as energy. Both factors depress the level of production.[15]

Finally, the <u>third</u> group of microeconomic factors has been related to the broad category of motivation and information problems:

1. The command system's mobilization role and its incentives collapsed. This has happened in most countries as a result of political liberalization and democratization, before the economic transition started.

2. Expectations and incentives were created by the privatization process including the insider-outsider game of who will take over the enterprise as a private owner, outflow of the best personnel and management to the new private sector, so-called "end game" [Blanchard and Dabrowski, 1993] or privatization death [Mertlik, 1993].

3. The massive bailout of state enterprises by the government ("government will not allow to close down the biggest state-owned enterprises") was expected. This belief was based on past experience when even the most radical variants of economic reforms (such as Yugoslav, Hungarian, or Polish ones) were not able to make the soft budget constraints for SOEs harder. It has been a reason why the SOEs' adjustment to the new environment was relatively slow and why a big inter-enterprise debt exploded in some countries [see Rostowski, 1993]. Further developments have depended on the credibility of government policy (see Chapter 4, Section 4).

The transition economy is a two-sector economy in the following sense: one part of the economy (mainly SOEs in heavy and military industries, big industrialized construction, and often socialized agriculture) is declining sharply because of the above-mentioned factors. The second one (mainly the new private and privatized sectors in trade and services) is growing dynamically. The decline of the first part frees resources, such as labor, energy and other

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[14] To be precise, the elimination of value-detracting production should contribute to increase of GDP. However, it makes a gross industrial (or agriculture) output lower what creates some problems in the sphere of politics and social perception of the transition process because of traditional using gross output indicators. Beside it, elimination of value-detracting production change very often the structure of intermediary demand what can lead to output decline in the earlier phases of production chain.

[15] I do not mention here a serious fiscal crisis.

inputs, building and real estate, and enables the rapid development of the second part. The speed of development of the "new economy" depends very much on the real economic freedom (i.e., the comprehensiveness and transparency of liberalization process), the presence of hard budget constraints, a stable macroeconomic environment (important for the investment climate), and progress in privatization and restructuring of SOEs.

## IV. Speed, Comprehensiveness, and Sequencing of the Transition

### 1. Historical controversy around transition strategy

The most relevant strategy of economic transition from a centrally planned economy to a market economy is controversial and has dominated the political and intellectual debates of the past six years. The choice of relevant transition strategy is more difficult than designing the final economic model, i.e., a private market economy with a stable currency. Perhaps a useful lesson for the FCC in elaborating adequate transition policy is the experience (mainly negative) of those countries which tried to reform the socialist economy during last 30 years of the communist regime. For latecomers like some of the FSU countries, the experience of transformation pioneers can be of great importance.

The initial policy dilemma seemed to be the **radical** strategy of fast and comprehensive changes (very often called *shock therapy*) on the one hand and the **evolutionary** way of *gradual* (step by step) changes on the other. During the last five years, this controversy was widely discussed and various arguments came from the following:

- the theoretical foundation of economic science [Ees and Garretsen, 1994],
- political economy and political dynamics of the transition process [Åslund, 1994; Dabrowski, 1992b; Balcerowicz, 1994],
- inertial nature of human behavior [Murrell, 1992],
- the gradual nature of institutional changes [ECE, 1993],
- consistency of the new economic system and necessity to break down the inertia of the old system [Balcerowicz, 1993; Dabrowski, 1992b],
- nature of the macroeconomic stabilization and the role of expectation [Sachs, 1994; Balcerowicz, 1989; Balcerowicz and Gelb, 1994],
- negative experience of the reforms of the socialist economy in the past [Sachs and Lipton, 1990; Dabrowski, 1992b],
- economic and social costs of transformation (output decline and unemployment) [Nuti and Portes, 1993; Laski, Bhaduri and Levcik, 1993; Roland, 1994],
- fiscal consequences of adopted transition strategy [Kolodko, 1992; Aghion and Blanchard, 1993], and
- the environment for private sector development [Johnson and Loveman, 1995].

Important weaknesses of the transformation strategy debate of the last five years are as follows:

**First**, neither *shock therapy* nor *gradualism* was defined precisely in terms of the speed of transition process and the types of policy instruments relevant to each alternative strategy.

**Second**, this debate had very a strong emotional component coming from the term *shock therapy* (nobody likes shock and wants to be treated in this way).

**Third**, some commentators and analysts thought the official policy statements and documents identified the kind of strategy adopted by specific countries. However, the official policy declarations were often misleading.

An example is the Russian transformation in 1992-93 which was seen by many observers as a case of shock therapy similar to the Balcerowicz's program in Poland in 1989-91. At the end of 1991, some government documents and interviews of government officials could give limited reasons for such an assessment. Also, the political and intellectual opposition accused Gaidar's and Fiodorov's team of using shock therapy. This accusation was meant to discredit the most radical reformers in the public's eyes. In practice, however, it would be very difficult to classify Russian transformation policy as radical[16] [see Dabrowski, et al, 1993; Dabrowski and Kozarzewski (eds.), 1995; Sachs, 1994; Åslund, 1994].

**Fourth**, the length of the observation period also played a significant role. In 1990, Hungary and Poland were seen as representing completely different approaches to the transformation strategy. Poland was viewed as a leading case of *shock therapy*, and Hungary was treated as an example of the *gradual* approach. This difference was determined, to a significant extent, by the different starting points of each country, especially in respect to macroeconomic equilibrium and the level of domestic and external liberalization. Differences in the official rhetoric of each government played a role here. Now, after five years of economic and political transformation, the real differences between these countries are not very important. Both Hungary and Poland have made comprehensive and radical reforms and have been successful implementing the "critical mass" of systemic changes. Both face similar problems in their current economic policies (fiscal crises, big public debt, unfinished privatization process, difficulties with inflation, etc.).

**Fifth**, the dichotomy, *shock therapy* versus *gradualism,* does not pay enough attention to the nature of the individual components of the transition policy (see next section).

General debate on *shock therapy* versus *gradualism* is oversimplified and of small practical usefulness with the specific transition agenda and timetable. If an argument is made for the radical (shock) approach, it should be defined precisely. On the other hand, if one argues in favor of gradualism, the specific measures and their speed of implementation should be explained.

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16 Apart from the privatization program which was for more comprehensive, quick and radical than in many other post-communist countries [see - Jermakowicz, Panków, and Abramov, 1994].

The discussion about general speed and consistency of transition policy has more merit concerning political strategy. This relates to the earlier mentioned problem of a political window of opportunity (or period of extraordinary politics using Balcerowicz's terminology).

## 2. What must be done quickly, what can be done gradually?

Table 4 presents a general picture of the possible and recommended speed of the individual components of transition process. (See Table 4 at the end of this paper.)

### 2.1. Macroeconomic stabilization

Macroeconomic stabilization, especially in the case of very high inflation or hyperinflation episodes, must be a one time, comprehensive, and radical operation. It is hard to expect that gradual macroeconomic stabilization can work in the specific conditions of a transition economy. The empirical evidence from Romania and Russia supports this view.

The transition economies need a tough stabilization policy at the very beginning of the transition process. At least three factors are important here:

1. A big monetary overhang (stock of suppressed inflation) which is a product of price control, shortage economy[17]and compulsory savings, and forced substitutions usually exist. The size of this overhang has differed between countries—the biggest one was probably in the FSU[18] but Poland, Romania, Bulgaria and Albania had large ones too; far smaller ones occurred in the three most balanced socialist economies, the former GDR, Czecho-Slovakia, and Hungary. However, even in Hungary, an overhang existed and complicated the process of domestic and external liberalization. It was only liberalization, especially domestic price liberalization and unification of the exchange rate, that "unfroze" accumulated monetary overhang and caused so-called corrective inflation. A tough macroeconomic policy is necessary to impede the conversion of one-time corrective inflation into permanent high inflation or even hyperinflation.

2. The price deregulation and unification of the exchange rate (usually connected with substantial devaluation) have created strong inflationary expectations, i.e., have contributed to decreasing demand for domestic money. If price liberalization is implemented gradually and preceded by a long public discussion (as happened in Poland in 1987-89 and in the FSU in 1990-91), inflationary expectations are relatively stronger and the flow from domestic money more dramatic. The deregulation of the domestic market and financial system of SOEs—other important components of a liberalization package—also have contributed to increasing money velocity (because

[17] The idea of shortage economy was introduced to the economic literature by Janos Kornai [1980].

[18] For the estimation of monetary overhang in the FSU, see Cottarelli and Blejer [1991].

they have unfrozen money balances of SOEs which were very strictly controlled by central planning authorities[19] [see McKinnon, 1992]). The last process is sometimes called the increase of the level of the internal currency convertibility.

3. In the last stages of communist regimes, many governments failed to maintain elementary macroeconomic discipline. They lost control over credit and wage policies, accepted huge increases of subsidies and social spending, and created many tax exemptions. All that contributed to an explosion of the budget deficit and monetary expansion. The "softness" of monetary, fiscal, and income policy was caused by the lack of political legitimization of the government who wanted to "buy" social peace in exchange for economic concessions. Poland in the late 1980s (under its last two pre-democratic governments) and the Soviet Union during last years of Gorbachev *perestroika* are examples. On the microeconomic level, state control over SOEs became very weak and created a system vacuum. The traditional plan targets did not act any more, and the pressure of domestic and foreign competition and the barriers of demand were still insufficient. SOE managers were no longer subject to communist party or state administration control. Moreover, as a result of political liberalization and the democratization progress, they could influence the government macroeconomic policy (of course, further relaxing it) through parliament, lobbying structures, trade unions, etc.

Partial, inconsequential, and inconsistent economic reforms can be seen as another source of macroeconomic, especially fiscal, problems. Socialist market reforms in Yugoslavia, Hungary, Poland, and the Gorbachev reforms in the Soviet Union are examples. Greater autonomy of enterprises did not permit confiscation of their whole financial surplus by the budget which formed a significant source of budget incomes in the classical model of a planned economy. Economies under reform were not always able to replace this income with a sufficiently effective tax system [McKinnon, 1992]. Selective price control, coupled with inflation, lead to increasing burdens for the state budget by way of subsidies (or decreasing the revenues from the turnover tax). The inflation also caused increasing pressure on the increases of wages (including salaries financed by the budget) and social benefits.

In addition to these three general problems, some countries have had other ones. Military conflict damages the production process, trade relations, and revenue collection and makes big budget spending unavoidable. Uncertainty about future currency arrangements (in

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[19] In the typical command economy monetary overhang was neutralized not only by price control but also by various planning and administrative restrictions and general regulation, limiting the possibility of its effective spending. Excessive money supply was neutralized by making part of money balances "void" in some sense. SOEs that had cash or other liquid financial assets could not use them freely to purchase goods and services, to pay salaries, to invest, etc. Financial assets were fragmented into different specific accounts, e.g., investment spending, wages. Additionally, many basic goods, services, or convertible currency were subject to administrative rationing, i.e., having money was not enough to obtain such goods. The increase of economic autonomy of enterprises and limitation of administrative distribution of physical resources brought an increased flow of existing financial resources.

some FSU and former Yugoslavia [FY] countries) has devastated savings. And the list of problems goes on.

The size of the macroeconomic challenge has varied from country to country. The first two factors were present in all the transition economies. The third one was avoided in Czecho-Slovakia, the GDR, and Hungary. These countries also had smaller monetary overhang and smaller inflationary expectations due to macroeconomic discipline.

The above characteristics have determined the agenda of macroeconomic policy in the first stage of transition. All the countries have had to eliminate monetary overhang and to neutralize inflationary expectations and declining demand for money connected with liberalization. Most of these countries must solve the problem of current flow imbalances in fiscal and monetary policies.

### 2.2. Liberalization

Theoretically, domestic and external liberalization can be implemented either in one radical package or gradually, step by step. Successful examples of both approaches are apparent [see e.g., Dornbusch and Helmers (eds.), 1988]. However, the specific features of post-communist transformation present arguments in favor of a more radical liberalization scenario. It is connected, among others, with negative fiscal implications of price control, difficulty in privatizing an overregulated economy, and the necessity of building a competitive environment for state-owned enterprises.

The complex price liberalization and unification of the exchange rate (as one of the crucial price parameters) is the most urgent issue in the transition agenda.

**First**, price liberalization is necessary to allow the market allocation mechanism to work. It concerns not only current allocation decisions but also investment decisions. Liberalization is important for elimination of price distortions inherited from the command economy. Many years of `socialist market' reforms show that any government decision is not able to eliminate those distortions in the administrative way. A gradual liberalization of prices is not a rational solution. The appearance of price distortions and selective shortages (goods at still controlled prices disappear from the market very fast) is the negative aspect of this variant. Besides, increasing inflationary expectations and money velocity are the standard by-products of such a policy [see Dabrowski, 1992b].

**Second**, price liberalization is fundamental for the reduction of subsidies and tax exemptions which are necessary conditions of budget adjustment and contribute to the success of the stabilization effort. Without that step, eliminating the budget deficit is more difficult.

**Third**, without free price setting, real demonopolization and privatization with the development of new private sector cannot be expected.

**Fourth** and most important, price deregulation is crucial for the elimination of market shortages.

The transition experience shows that the successful elimination of the shortage economy needs to fulfil at least four conditions:

1. price liberalization (the most important one);

2. efficient monetary control;

3. external liberalization (i.e., decreasing tariff and non-tariff barriers and free access to foreign currency);

4. allowing free private entrepreneurship, at least in the area of domestic and foreign trade.

Price liberalization is absolutely necessary in the very beginning of the transition process. The lack of full liberalization will undermine the stabilization effort not only because of negative fiscal implications of the price control. If the economy has a heavily distorted price structure (the case of most of the FCC), the postponed liberalization must bring a price jump. It can create inflationary expectations and hurt achieved stabilization (as it happened in Ukraine in the end of 1994).

Demonopolizing the economy first and liberalizing prices second seems unrealistic. Usually, liberalization of prices is necessary much faster than is significant progress in demonopolization. In addition, real development of the private sector (the most significant factor of internal demonopolization) will be unlikely with the omnipresent control of prices. So there is no practical possibility of avoiding deregulation of prices before completing the demonopolization of the domestic market.

Liberalization of foreign trade and introduction of a convertible currency become inseparable elements accompanying the liberalization of the domestic market and deregulation of domestic prices. Foreign competition should be allowed into the monopolized domestic market, and the structure of domestic prices should be adjusted to the structure of prices in the international market. Thus, the real reallocation of resources based upon the criteria of the world market can be initiated, and comparative advantages for the economy from international trade may be achieved.

If the necessity of external liberalization is recognized, the speed and the sequencing of this process is controversial in the post-communist countries and elsewhere [Bruno, 1988, pp. 223-247]. Numerous goods, so far beyond the reach of the importers, can now flow freely into the country and compete successfully with domestic products. Also, the adjustment of domestic prices to world prices forms the real test of truth. It shows that a certain part of economy is extremely ineffective—not only because it does not bring profit but also because its value added is negative (see Chapter 3, Section 4).

The radical opening of the economy (the reunification of Germany was an extreme example) in such a situation means the probability of sudden bankruptcy of a large number of enterprises with all the political and social consequences. Some industries and enterprises must be eliminated after opening up a post-communist economy.

Such a danger makes many politicians propose that external opening should be carefully "dosed." But the possibilities of demonopolization of the domestic market (the only fast means in case of small and medium size countries) are lost. Putting off the opening delays only the test of truth for ineffective factories and businesses. The general technological backwardness of post-communist economies does not provide, in principle, chances for significant reconstruction during the transition period. In the meantime, further investment decisions based on a falsified price system can be taken. Lobbies interested in the protection of specific industries usually become seriously weakened in the beginning of transition but after some time start to rebuild their political influence [see Gacs, 1994]. The idea of 'fine tuning' policy in respect to external liberalization is hardly feasible from the political point of view. The experience of Russia and some other FSU countries, where the political opportunity for radical export liberalization were lost in 1992 and never came back, can be an important warning for advocates of the gradualist approach to external liberalization.

Although the liberal approach is more painful during the initial stage of transformation, it presents greater chances for overcoming economic backwardness over the long term. The Russian experience from 1992, with price liberalization in a still closed economy, seems to support this latter thesis.

## 2.3. Institutional changes

More comprehensive institutional changes usually cannot be introduced overnight, especially in the new democratic regimes where the legislative process needs some time. The former German Democratic Republic is the only exception because it imported all the market institutions from the West Germany.[20] The speed of institutional change is of great importance. The sooner institutional progress can be achieved, the better the results that can be expected in both macro- and microeconomic policy spheres. Some examples of needed institutional reform are the tax system and tax administration, banking sector reform and restructuring, insurance law, civil and commercial law, bankruptcy law, justice administration, and budgetary law.

## 2.4. Privatization

Privatization by its nature is a gradual process. However, it can be implemented faster or slower, in a more or less market oriented way.[21] Whether speed and political attractiveness

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[20] They were automatically extended on the former GDR territory according to the Treaty on Monetary, Economic and Social Union and on the basis of the Unification Treaty.

[21] Among less market-oriented methods of privatization, one can distinguish different experiments with collective or quasi-collective ownership as well as insiders-oriented privatization. These forms are especially popular in some FSU and FY countries.

or quality (in sense of quick real restructuring) should have priority is probably the biggest dilemma of privatization policy.

Arguments in favor of rapid privatization have a fundamental character. The starting point of the transformation in the Central and Eastern Europe countries was characterized by exclusive state and pseudo-cooperative form of ownership (Czecho-Slovakia, Romania, Bulgaria) or their significant domination (Poland, Hungary). Quick market reform demands quick ownership changes. Progress in other aspects of the transformation process depend on the speed of privatization. In the same way, the possibility of coming out of a transition output decline depends on the progress in ownership changes. The Polish experience of economic growth generated mainly by new private and privatized enterprises is the best example here.

That, in turn, directly and indirectly influences the durability of achieved macroeconomic stabilization. Bulgaria is another good example which should be treated as a real warning to other countries in transition. Early in 1991, this country started with radical and quite successful liberalization and stabilization programs. However, the privatization process was seriously delayed. Only small privatization, based mainly on physical restitution, was done. The non-reformed sector of large, state-owned enterprises quickly increased pressure on state budget and monetary policies, leading to significant erosion of the macroeconomic situation in the end of 1993 and 1994. The politically powerful groups involved in profit shifting and asset stripping from non-reformed SOEs to private sector emerged. These groups have not been interested to support progress in real privatization and liberalization parasitizing on the unclear status quo and political uncertainty [see Bogetic and Hillman, 1995]. A similar phenomenon can be observed in some FSU countries where privatization is delayed.

In the political sense, quick privatization was expected to encourage reconstruction of the middle class who would form the social base for the democratic system and for the market economy. This expectation did not materialize yet. Although some important changes in social stratification are seen in countries which are the most advanced in the transition process (including the formation a new entrepreneurial class), it is too early to expect quick changes in the economic and political mentality inherited from the communist era.

However, the mass privatization program is putting attention on the distribution of property rights among the population. This can give real political gains to some politicians. The election success of Vaclav Klaus and his Citizen Democratic Party in the Czech Republic in 1992 is the one example. The neutralization of a very strong communist and nationalist opposition against privatization in Russia by Anatolii Chubais in 1992-93 was possible only because of the distributional aspect of the voucher program which gave significant concessions to managers and employees. On the other hand, the lack of a clear and socially attractive distributive component of the National Investment Fund (NFI) program in Poland did not allow a mobilization of social support for the mass privatization idea.

Like stabilization and liberalization measures, privatization needs political momentum. If the best political time is lost, privatizers must work in far less comfortable conditions. The history of Polish privatization is a good example here [see Earle, Frydman, and Rapaczyński, 1993]. Although Poland was the first post-communist country in which privatization was discussed publicly in 1986, the start of large privatization came only at the end of 1990 [see Blaszczyk and Dabrowski, 1993]. (Privatization was also talked about in Hungary in 1986.) The best political time for privatization (in 1990) was lost. Even the idea of mass privatization, invented and popularized in all the Eastern Europe[22] by Janusz Lewandowski[23] and Jan Szomburg [Lewandowski & Szomburg, 1989] met substantial political resistance in Poland and was implemented only at the end of 1995.[24] Although the Polish economy is now mostly privately owned and presents good progress in restructuring, the development of the new private sector as well as small and medium size privatization made this possible. Most of the large enterprises, especially in heavy industry, remain in state ownership and create serious economic and political tensions.

Slovenia and Bulgaria are other good examples of countries where long lasting intellectual and political debates on optimal privatization strategy either slowed down (Slovenia) or almost completely stopped (Bulgaria) real ownership transformation.

All that was said above shows that speed is a crucial economic and political parameter of the privatization process and is far more important than its excellence or fiscal revenues. An important question: is it necessary to sacrifice the quality of the privatization process (especially the possibility to create private owners who have majority control over an enterprise) in favor of speed and distribution/political effect?

Of the three rapid privatization stories among the FCC available now, i.e., East Germany, the Czech Republic, and Russia, only the first one was achieved using "classical" methods elaborated in highly developed countries, that is, through the sale of state enterprises on commercial principles, careful market valuation of offered property, earlier partial restructuring of the firms, etc. A massive inflow of investments and managerial cadres from West Germany and huge financial transfers from the federal budget made this possible. Even in such favorable circumstances (not available at any other FCC), privatization and the restructuring process were not free from strong social conflicts and political frustration of a significant part of the former GDR society. The Czech Republic and Russia had to rely on

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[22] This idea was introduced in the Soviet Union in 1985 by the independent economist Vitalii A. Naishul [1985] and published in *samizdat*. Only a small circle of dissidents in the former USSR knew about it. Lewandowski and Szomburg proposed it independently during the conference on 'The Proposals of Transformations of the Polish Economy,' organized by The Central School of Planning and Statistics in Warsaw, on 17-18 November, 1988, which was the first international academic event in Eastern Europe where the privatization issue could be openly discussed.

[23] He was the Minister of Ownership Transformation in Poland - from January to December 1991 and from July 1992 to October 1993.

[24] The history of the political struggle over the mass privatization program in Poland is described by Lewandowski [1994].

non-equivalent (i.e., almost free of charge)[25] methods of distribution of state-owned assets and gave up temporarily the restructuring targets.

The Czech Republic and Russia did not lose a chance for substantial restructuring as concentration of diluted ownership will progress in the future. Perhaps the investment funds created on a voluntary basis can play a significant role in a restructuring process. As far as mass privatization is based on individual, exclusive, and fully transferable property rights, it does not close prospects for real private ownership control in privatized enterprises. In the case of Russia, the final result of mass privatization will depend on the macroeconomic stability and effective liberalization of its economy (see the next section).

2.5. Restructuring

The purpose of restructuring is to change both the sectoral and branch structure of the national economy, and to change the internal structure and the behavior of an individual firm. It is closely connected with huge structural distortions inherited from the centrally planned economy (see Chapter 2, Section 1).

The restructuring of state-owned enterprises is not a one step process (as price liberalization can be). However, as in the case of privatization, it can be done with varying speed. Faster restructuring (as in East Germany) can give a positive output response sooner than a slower one. In the meantime, however, it threatens a larger output decline, a larger number of bankruptcies, and higher unemployment that may have unpleasant political and fiscal implications. On the other hand, if governments want to slow down this process, open or hidden[26] subsidization often becomes unavoidable.[27] It involves the risk of fiscal crisis and negative pressure on monetary policy, intensive rent-seeking, and slower economic growth in the future. Governments in the FCC will not be able to overcome the informational barrier (who really needs support and for how long) and monitor such a fine tuning policy without losing political credibility and stimulating strong political pressure from different groups.

### 3. Two important sequencing issues

The mutual dependence of stabilization and liberalization, and a few problems within the process of liberalizing an economy have been discussed. Remaining are two important questions about the process of privatization.

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[25] There was a registration fee for the coupon book (in Czecho-Slovakia) or voucher (Russia).

[26] These may take the form of tax exemptions, acceptance of tax arrears or by accumulating non-performing assets in the state-owned banks which eventually may be bailed out by the government.

[27] Wage control may slow the restructuring process without negative implications for the budget (even with a positive impact on the fiscal situation).

### 3.1 Can mass privatization precede stabilization and liberalization?

This first question asks whether widespread privatization ought to precede stabilization and liberalization.

Doing privatization first was a popular approach in the initial stage of the debate over transition. The USSR's Program of 500 Days suggests a different sequence from the Balcerowicz program in Poland. (See 500 Days, 1990). First, begin privatization and absorb the monetary overhang, then balance the budget, and last, liberalize prices. According to this way of thinking, only after privatization has been accomplished can prices be liberalized and economy stabilized.

This sequence is based on two assumptions. The **first** is that privatization is possible before basic macroeconomic stabilization is achieved and the liberalization process completed. The **second** assumption is that the massive sale of state owned assets can create substantial income for the budget.[28]

Events in Russia partly confirmed the feasibility of the first assumption. A radical, comprehensive privatization package (the Chubais voucher program) was implemented before macroeconomic stabilization and full liberalization (especially external) was achieved. However, privatization without macroeconomic stabilization, adequate liberalization, and the reduction of monopolies creates an unhealthy private sector prone to bargain with the government rather than compete in international markets.

Privatizations in the FCC have not, in fact, created substantial budget revenue. **First,** fiscal and monetary adjustment is necessary very quickly, otherwise the economy will suffer hyperinflation. Starting privatization takes time, even in countries which decided to do it rapidly (such as Germany, the Czech Republic, and Russia). **Second,** if privatization is to be done really quickly, the non-equivalent methods of distribution of state owned assets must be adopted. It means, by definition, zero or almost zero[29] budget revenues and sometimes substantial operational costs. **Third,** in countries which tried not to forget about budget revenues from privatization (Poland and Hungary), they never exceeded 0.5% of GDP.

Although radical privatization is very important for the final success of the transition process, it cannot be treated as a substitute of macroeconomic stabilization and relevant monetary and fiscal adjustment. To be effective from the microeconomic point of view, privatization must be preceded by successful macrostabilization and extensive liberalization of the economy. If these conditions are not met, there is danger of creating a private sector oriented more toward political rent-seeking than effective market competition. A privatization process can create more social tensions than a more stable and open economy.

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[28] This last assumption was made by Stefan Kawalec [1989] in his privatization proposal for the Polish economy.

[29] Sometimes some fees for distributed vouchers (coupons, certificates) are collected.

### 3.2. What should be first: privatization or enterprise restructuring?

Advocates of "commercial" privatization, based on Western (mainly UK) experience, usually propose restructuring prior to privatization in order to make the latter more successful from a business point of view and more profitable for the state budget. Protection of future small shareholders from investment risk also plays an important role here. The 1990 Privatization Law in Poland (at least its "capital" privatization component) was built on this assumption. However, the argument of monitoring the social and political costs of restructuring was also raised in favor of restructuring before privatization [see Roland, 1994].

Those who favored privatization first argued that the state has very limited capacity to deal with enterprise restructuring, especially in post-communist economies where the state apparatus is extremely weak and the size of the state sector is enormous. Moreover, restructuring is a time and money consuming process, very sensitive to political pressure and lobbying. Proponents of quick privatization wanted to use a simplified procedure of selection, valuation, and decision-making or to try voucher privatization schemes. The task of restructuring should be left for future private owners.

Practical experience justified the second approach rather than the first. However, some preparatory measures should be taken by the government administration prior to commercialization and privatization. Breaking up multi-plant enterprises needs special attention. Selling several small pieces is easier than selling big conglomerates with strong inside differentiation. This relates also to the enterprise's technical and social infrastructure.[30] To cut off these activities is not easy from political point of view, but to privatize enterprises and keep all this burden is often impossible.

## 4. Advantages and disadvantages of slow transition

The speed and sequencing of the transition debate continues. Slow and gradual macroeconomic stabilization does not make sense for countries which entered the transition process with a big monetary overhang and substantial fiscal and monetary flow imbalances. The rationality of slow price and trade liberalization applies only in countries which had more open and deregulated economies before the post-communist transition started and inherited less price and structural distortions (Hungary and the former Yugoslavia). The real choices are about the speed of privatization, more sophisticated institutional changes, and the restructuring of state-owned enterprises.

There are two advantages for slower transition in the microsphere and in the institutional sphere. **First**, more gradual changes make accommodation to the new rules of game and institutions easier. It concerns producers, consumers, and the public administration which

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[30] Big socialist enterprises were usually "overloaded" with technical, social, and cultural infrastructures serving not only them but also local areas (power and heating stations, cultural centers, stadiums, sport clubs, clinics, technical schools, infants' nurseries and kindergartens, etc.).

must also pass the complicated period of transition and have time to learn the new system. **Second**, slower restructuring of SOEs can dilute, to some extent, political resistance against change. Too large a number of bankruptcies in a relatively short period of time and too high a level of open unemployment is probably not acceptable politically, even for the most popular government.

Two other potential advantages are more problematic than the previous ones. **First**, the advocates of gradualism stress that a slower path of transition allows for better designed and mutually coordinated institutional changes. This is not always true because it creates a danger of a longer systemic vacuum in the meantime (see below), and it often contributes to the frequent phenomenon of the political instability in the FCC. Taking more time for institutional changes runs the risk that pieces of legislation enacted later may not be consistent with those enacted earlier. **Second**, many authors [e.g. Aghion and Blanchard, 1993] underline negative fiscal implications of microeconomic restructuring too rapidly (with the collapse of budget revenues and the explosion of social expenditures). They call for the optimal speed of transition. This hypothesis needs, however, more detailed verification. Some rough comparisons of FCC fiscal situations show that countries more advanced in transition, which adopted radical transition strategies (groups 2 and 3), are doing better generally in this sphere than other countries [de Melo, Denizer, and Gelb, 1995].

The ineffectiveness of a slow transition has a potentially positive aspect. In some recent cases, the negative effects of the slow transition (mainly macroeconomic disregulation) helped overcome social and political reservations towards a radical strategy. A feeling that things could not be worse and that in reality there is nothing to lose reduced the political risk of urging a faster transition. The macroeconomic chaos, corruption, and criminality of disregulated economic life may push the society and the government toward radical solutions. That is what happened in Poland in 1987-89, in part of the FSU in 1989-91, and in the Ukraine in 1992-94. However, it is a very risky game. The 'positive' way out from the deep economic and social crises is not the only solution. Alternatively, long lasting economic and social crises and repressive dictatorships may be the result of the inability of young democratic regimes to manage the economic transition from planned economies to market economies.

Once the political window of opportunity is lost for radical economic transformation, it may not return. The Latin American experience shows that once vicious circle of macroeconomic populism and dictatorship is started, it is not easy to stop. Sometimes 20 or 30 years was lost for countries like Argentina, Peru, or Brazil before they found a way to economic and political stability.

There are other disadvantages of gradual transition (especially when this process is badly coordinated) apart from the risk of losing the unique political window of opportunity. Table 5 gives a list of traps connected with slow transition. (See Table 5 at the end of the paper.)

The main microeconomic danger concerns a systemic vacuum where old rigors of a command economy no longer act and the influence of the market mechanism is still too small to influence the economic behavior of enterprises. This half-plan and half-market economy, or in extreme cases, a non-plan and non-market economy, does not respond to any influence. Soft budget constraints allow SOEs to continue their excessive demand for various inputs and make them inflexible in relation to market signals. Additionally, an ownership vacuum is created when the state owner, for political and administrative reasons, has lost the capacity to execute its property rights, and the public ownership has not been privatized enough.

The negative macroeconomic consequences of a slow transition manifest themselves mainly through a big budget deficit from continued open and hidden subsidization connected with soft budget constraints and excessive social obligations of the state. The budget deficit, together with a soft credit policy in relation to the SOE sector, results in a big monetary expansion. Excessive demand must lead to serious balance of payments difficulties.

Although some elements of a systemic vacuum during the transition period cannot be avoided, the government should try to shorten this period as much as possible to avoid both macro- and microeconomic mismanagement.

Unfortunately, the experiences of almost all slow (group 4) and very slow (group 5) reformers is very discouraging. Continuing market shortages (due to incomplete price liberalization), inflation or hyperinflation, decreasing output, and balance of payments crises have been the standard economic problems in countries, such as the Ukraine, Belarus, Kazakhstan, and Russia. Only few gradual reformers (Hungary and Slovenia from group 3) avoided these negative consequences because they started transition with more advanced market regulation and with a better macroeconomic equilibrium (see Chapter 3, Section 2).

The necessity of constructing various substitute solutions for the transition period is another weakness of gradual (slow) strategy. Palliative solutions, in general, do not bring the economy closer to final market solutions. These solutions start living their own lives and create an independent logic of behavior of economic agents. Their unexpected side effects make additional intervention and regulation necessary. The energy of government is used not for quick achievement of final, economic solutions but for improving temporary instruments. The transformation period becomes extended in time, and economic policy gets into a vicious cycle of over-regulation.

Post-communist governments that engage in excessive intervention have met immediately informational and administrative barriers. Informational barriers are well known from the centrally planned economy. Central authorities have to rely on information received from the bottom level—from enterprises, associations, etc. This information is, of course, heavily influenced by the micro interests of the economic agents trying to obtain as much as possible from the government. The strong political bargaining and intensive rent-seeking become unavoidable consequences of excessive government intervention [Dabrowski, 1994].

Government administration in the FCC, connected with its political and institutional transformation, is extremely weak [Åslund, 1994; Dabrowski, 1994]. It has tremendous problems fulfilling the elementary functions of any state, such as public security, justice administration, public enforcement of contacts, protection of private property rights, tax and custom duty collection, etc. Overloading the government with additional tasks worsens its performance.

Every government, but especially the post-communist ones, faces the problem of credibility. Faster, more dynamic, and consistent changes increase this credibility in relation to macroeconomic and microeconomic policies. It creates positive expectations, brings inflation down earlier, and pushes SOEs toward quicker restructuring. On the other hand, a slow pace of change, policy compromises, maintaining subsidization (even if proclaimed as temporary), or attempting a bail out (even if it is declared a one time deal) increase illusions that implemented reforms are not definite and can be reversed under political pressure.

The experience of "socialist market reforms" played an important role here. It showed that partial and gradual changes did not often give any perceptible effect. The massive old system swallowed and adapted new instruments and institutions. The changes seemed temporary. Substantial transformations need to be made in the way which makes an easy return to the centralized system impossible and will change expectations of economic agents.

## 5. How do the initial conditions matter?

The differences in the starting conditions of individual countries have varied:

- the level of economic development;
- how long the command system and communist regime lasted;
- the share of the private sector in the national economy;
- the size of structural distortions, including dependence on CMEA or inter-FSU markets and the level of militarization that determines the size of the absorption of adverse shock;
- openness of the economy in relation to the capitalist countries;
- availability of easily tradable natural resources;
- the level of domestic and external macroeconomic equilibrium;
- the experience or lack of experience with market socialism reforms and their results;
- the level of political liberalization and democratization before the communist system collapsed;
- the strength of anti-communist and pro-independence movements in the past;
- ethnic homogeneity or differentiation;

- the quality of state administration and the legal system [see Sachs, 1995]; and
- the presence of militant trade unions [see Balcerowicz and Gelb, 1994].

All these factors have made the conditions of economic and political transformation of each country unique. Very often, it led politicians in each country to emphasize specific problems and use them as an excuse for not implementing necessary reforms on time or for doing them badly in inconsistent ways. The slogan, "we are an unique case and we must look for our own variant of transition" is frequently heard in countries with delayed economic transitions, such as the Ukraine or Belarus. In practice this postulate means rejection of a radical and consistent variant of transformation à la Poland, the Czech Republic, or Estonia in favor of some variant of gradualism with less macroeconomic discipline, gradual liberalization, greater government intervention, and slow privatization (or looking for some "third way" solution).

Some countries started and implemented their transition policy in relatively better circumstances: they inherited fewer macroeconomic imbalances from the communist system (Czecho-Slovakia, the former GDR, and Hungary to some extent), fewer structural distortions (Hungary, Slovenia, Poland), a partially liberalized economy, and some market institutions (Hungary, the former Yugoslavia, Poland), some enclaves of private economy (Poland, Hungary), some democratic traditions (CEE and the Baltics in comparison with the rest of the FSU and Albania).

The same concerns implementation conditions. As was mentioned earlier, the size of adverse shocks has differed significantly across the region with Bulgaria, and most of the European FSU countries except Russia, bearing the biggest burden. Some countries have suffered war destruction that stopped completely any reforms (Bosnia, the Caucasian countries, Tadjikistan) or delayed them significantly (Moldova, Croatia). On the other hand, Russia, Turkmenistan, Uzbekistan and Kazakhstan, due to presence of rich and easy tradable natural resources, have an easier task of structural adjustment.[31] The size of Western assistance has differed significantly among the countries with Poland, Albania and Baltic states as the relative leaders [see Kaminski and Wang, 1995; Dabrowski, 1995].

Can worse starting and implementation conditions serve as a justification for a slower and less inclusive economic transition? The above analysis gives a negative answer. Moreover, countries beginning transition in less favorable economic and political situations (countries of the FSU, Romania, Bulgaria or Albania), which were more devastated in political, economic, and psychological terms by communist regimes and inherited fewer market institutions than Poland, Hungary, or the former Yugoslavia, had no choice. A strategy of slow or very slow changes meant they risked serious economic and political crises. Gradualism was a feasible option only for countries with a relatively good starting position such as Hungary.

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[31] This factor, however, seems to have a rather demobilizing influence on political elite.

## 6. Does democracy help economic transition?

The turbulence in the transition process created by the unstable political life in the FCC raises some doubts that a young democracy is the best political regime for complicated and socially painful economic reforms. The East Asia experience argues in favor of a more authoritarian solution. South Korea, Taiwan, Singapore, Indonesia and recently China and Vietnam implemented market oriented reforms under totalitarian regimes. Chile is another example of a serious economic transition pushed forward under the umbrella of a military dictatorship.

Is a pragmatic dictatorship a feasible and rational choice for FCC societies and their political elites?

Before answering this question, interrelationships between democracy and market economy should be analyzed. While it is clear that a stable, free market economy can co-exist with a non-democratic political regime, the opposite situation, i.e., a democracy under the domination of state ownership and central planning, can hardly survive. Likewise, a democratic regime will struggle to survive permanent very high inflation or hyperinflation. However, an unhealthy political system can severely damage the economic system and economic policy

The free market can work without democracy, and some people may expect that an authoritarian solution would help to protect the smooth economic transition from the instability connected with young, imperfect democracy. However, this solution is not a realistic alternative for CEE and the FSU. There are some reasons for it:

**First**, democracy and political freedom have autonomous value for many contemporary societies, and they will not be traded for an economic standard of living. Most of CEE and FSU countries which have a relatively high level of education feel this way [see Sachs, 1995]. Moreover, the democratic emancipation became a dominant political trend during last twenty years and is strongly supported and stimulated (both positively and negatively) by the developed countries (G-24). A country which would decide to abandon democracy and choose an authoritarian solution would be a subject of international ostracism.

**Second**, the economic transition in the FCC would not have begun if political liberalization and democratization did not happen. All the experience of pre-transition reforms shows that they never could reach some critical points (like abandoning the monopoly of state ownership) because the communist political regime did not allow it (even in its most liberal version as in Hungary or Poland). Moreover, countries which have achieved the most progress in the economic transition (see Chapter 3, Section 1) are usually the same ones as the leaders in the democratization process [see de Melo, Denizer, and Gelb, 1995; Karatnycky, 1995]. Sound democratization allows the break up of the political and economic domination of the former communist oligarchy (so-called *nomenklatura*) and eliminates economic structures inherited from the communist systems. Countries that have made only partial progress in democratization and political liberalization have serious problems with real demonopolization and deconcentration of domestic market structures, external liberalization, removing subsidies and implementing hard budget constraints, avoiding organized clearing of inter-enterprise arrears, implementing real positive interest rate policy, starting the mass-scale transparent privatization, rotation of SOE managers, etc. The economic policy of these countries is dominated by strong rent-seeking groups of special interests [see Åslund, 1994].

**Third**, for the reasons explained in the previous paragraph, the probability of a free market oriented authoritarian regime in the FCC is very low. Such a regime either would try objectively to protect the economic and political interests of the former communist oligarchy (even using the strong anti-communist rhetoric) and declining, backward sectors of the economy or to promote an openly populist policy.

Political reforms and economic reforms must be promoted actively at the same time. Some of the political troubles of Poland have their roots in the lack of new a constitution and in the serious weakness of the proportional election law in 1991-93. The Belarusian and Ukrainian instability and economic populism can be explained in the weakness of constitutional regulation as well as in the election system. On the other hand, some very limited progress in the political institutions like the party system in Russia after 1993 (in comparison with most other FSU countries but still behind CEE countries) was possible due to the new constitution and a mixed election scheme adopted during the December 1993 general election. Very impressive results of Czech transition were possible due to very close coordination of economic and political reforms.

## V. Conclusions

The empirical experience of the period 1989-94 gives many valuable observations which can contribute to the initial discussion on the speed and sequencing of the transition process. Macroeconomic stabilization and liberalization must be done quickly, but other aspects of transition may take more time. For example, the privatization process needs to have a legal base and organizational infrastructure created. However, even in the case of privatization, a rapid transition seems less risky for restructuring and for more complicated institutional reforms than a slow one.

These conclusion have practical value as well as theoretical importance. Several countries, sometimes large and politically important (e.g., the Ukraine, and Belarus) have not decided definitely what transition strategy they want to choose. The transformation experience accumulated so far by the other countries would help them to make an adequate decision.

Some important conclusions discussed in this paper are worth repeating once more:

**First**, there is no way to avoid a relatively large output decline, especially of industrial production in the state sector. Its degree of inevitability largely depends on the inherited structural distortions. Those countries that were not afraid to undertake a radical transition program geared towards stabilization and liberalization, and that decided to privatize relatively quickly and open the economy to foreign capital (the first three categories from my classification), were the first to arrest the output decline and restore economic growth. Albania, Poland, East Germany,[32] Czech Republic, Slovakia, Slovenia, the Baltic countries, and recently Hungary seem to be on the path of sustainable economic growth.

On the other hand, those countries that attempted to maintain previous production levels through subsidies, credit expansion, and protectionism have already recorded more dramatic GDP decreases than those that chose the radical scenario, with few prospects for a return to economic growth. This decline has been accompanied by high inflation or hyperinflation, with all the attendant social costs, such as more unequal distribution of income and wealth or the deep criminalization of economic activity.

**Second**, the policy of granting concessions to and bargaining with various pressure groups does not produce the expected political results and does not increase social acceptance of the changes under way. Here the experience of Russia, Romania, the Ukraine, and Belarus is the best proof. On the other hand, where a strong institutional foundation of a market economy has been established, even when the political forces of the ancient regime are returned to power in elections, they have had to continue the policy of reform.

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[32] East Germany, where strong economic growth has also returned, can be seen as an exception in that output decline in 1990-1992 was extremely severe. The reason seems to lie in the uncontrolled rise of wages paid by East German enterprises toward the West German level.

**Third**, the comprehensiveness and appropriate sequence of changes play a decisive role. In particular, effective institutional changes cannot be introduced when the economy remains in macroeconomic imbalance and closed to external competition. The example of the radical Russian privatization, performed under conditions of high inflation, "soft" financing of enterprises, and an absence of competition, should be a good lesson to those politicians who would like to postpone the politically difficult tasks of stabilization and deregulation. Formally privatized enterprises that remain dominated by insiders, i.e., under manager and employee ownership and acting in a very "soft" environment, continue to behave like traditional state enterprises. They prefer to bargain with the state rather than to compete on international markets. Bulgaria's experience shows the opposite danger: insufficiently rapid progress in privatization also undermines the positive results of macroeconomic policy and creates political obstacles to further reforms.

**Fourth**, one should not be afraid of "aiming too high" when embarking on a stabilization program or any other component of transformation policy. The practice of post-communist countries shows that this danger is not likely to materialize. What is more likely to happen is diluting the program to a degree that makes it ineffective. The ability to act fast and with determination seems more important than technical perfection in designing policy instruments. Political consent to reform measures does not usually last long, so it should be used in full. If that opportunity is wasted (as it was in Ukraine when that country gained independence in 1991), the next one may a long time in coming.

Except East Germany, countries that can be considered as leaders in the transition (groups 2 and 3) still have a long way to go to finish this process. The most urgent tasks for these seem to be the following:

1. taking inflation down to the level comparable with the West European, US, and Japanese standards of a few percent per year; (Only the Czech Republic is a relatively close to this target.)

2. stopping the increase of public debt (of crucial importance for Hungary and Poland);

3. continuing the large scale privatization; (Even Poland, the Czech Republic and Hungary have ca. 40% GDP contributed by the public sector; the big industrial enterprises, public utilities, and banks seem to be in the most difficult position in the remaining agenda.)

4. deregulation of the housing market;

5. beginning the fundamental reform of a social safety net with the pension system as a top priority; (Progress in this area is critical for the fiscal performance and labor mobility.)

6. deep reforms are also needed in the sphere of social services such as education and health; and

7. most countries need reforms of public administration and strengthening the local self-government.

## Postscript

During the first 10 months of 1995 one could observe an acceleration of the transition process in countries that I classified in the end of 1994 as relatively delayed. Croatia, Lithuania, Kyrgyzstan and Moldova continued fast and comprehensive reforms on all the fronts. Armenia, Kazakhstan and Georgia have become the next generation of the fast post-Soviet reformers. Romania and Russia strengthened substantially their macroeconomic policies. Romania joined the group of countries with moderate inflation (of course, taking into account FCC standards) below 50% per year. Russia has more difficult way because of a big inflationary inertia accumulated during the previous years. The same can be observed in Ukraine which started a complex transition program in the end of 1994 but inflation is still very high and final results uncertain. Belarus and Uzbekistan are two other countries which seem to start in 1995 more serious stabilization effort but they are still delayed with privatization and other institutional reforms.

If progress continues, the classification proposed in Chapter 3 will become very quickly only a historical one. However, the recent developments have delivered additional arguments in favor of quick and radical transition strategy.

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**Table 1:**
**GDP Growth (+) or Decline (-) in Selected Transition Economies**

| Category | Country | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 | 1995[a] | Cumulative 1989-1995 |
|---|---|---|---|---|---|---|---|---|---|
| 2 | Poland | +0.2 | -11.5 | -7.6 | +2.6 | +3.8 | +6.0 | +5.5 | -2.4 |
| 2 | Czech Republic | +0.4 | -3.0 | -10.0 | -5.0 | -0.9 | +2.6 | +4.0 | -12.0 |
| 2 | Slovakia | -1.0 | -2.5 | -11.2 | -7.0 | -4.1 | +4.8 | +5.0 | -15.9 |
| 2 | Albania | +9.8 | -10.0 | -27.7 | -9.7 | +9.6 | +9.4 | +7.8 | -16.6 |
| 2 | Estonia | +3.3 | -8.1 | -11.3 | -19.3 | -6.6 | +6.0 | +6.0 | -28.7 |
| 2 | Latvia | +5.7 | -3.4 | -8.3 | -33.8 | -14.8 | +1.9 | +0.4 | -46.0 |
| 3 | Hungary | +0.7 | -3.5 | -11.9 | -4.5 | -0.8 | +2.0 | +1.2 | -16.3 |
| 3 | Slovenia | -3.6 | -2.6 | -9.3 | -6.5 | +1.3 | +5.0 | +4.5 | -11.5 |
| 4a | Lithuania | +1.1 | -6.9 | -13.1 | -37.7 | -24.2 | +1.7 | +5.3 | -58.1 |
| 4a | Kyrgyzstan | +3.8 | +3.2 | -5.0 | -19.1 | -16.0 | -26.5 | +2.0 | -48.2 |
| 4a | Moldova | +8.8 | -1.5 | -18.0 | -21.3 | -8.7 | -22.1 | +1.5 | -50.1 |
| 4b | Romania | -5.8 | -5.6 | -15.1 | -13.5 | +1.3 | +3.5 | +4.5 | -28.4 |
| 4b | Russia | +1.5 | -3.6 | -12.9 | -18.5 | -15.0 | -12.0 | -4.3 | -50.3 |
| 4c | Bulgaria | -1.9 | -9.1 | -11.7 | -5.6 | -2.4 | +1.4 | +2.3 | -24.7 |
| 5 | Belarus | +7.9 | -3.2 | -1.9 | -9.6 | -10.6 | -20.2 | -13.8 | -43.0 |
| 5 | Kazakhstan | -0.3 | -0.8 | -13.0 | -14.0 | -12.0 | -25.0 | -11.0 | -56.5 |
| 5 | Turkmenistan | -7.0 | +1.8 | -4.7 | -5.3 | -10.0 | -20.0 | -1.0 | -39.1 |
| 5 | Ukraine | +4.1 | -3.6 | -11.9 | -17.0 | -16.8 | -23.7 | -10.3 | -58.2 |
| 5 | Uzbekistan | +3.7 | +1.6 | -0.9 | -9.5 | -2.4 | -3.4 | -4.0 | -14.5 |
| 6 | Armenia | +8.0 | -7.2 | -11.8 | -52.0 | -14.1 | +5.3 | +5.1 | -59.7 |
| 6 | Azerbeijan | -6.3 | -11.7 | -0.7 | -26.8 | -23.1 | -22.0 | -8.7 | -67.1 |
| 6 | Croatia | -1.5 | -8.5 | -28.7 | -24.8 | -3.7 | +0.8 | +5.0 | -50.7 |
| 6 | Georgia | +2.6 | -11.1 | -20.6 | -42.7 | -39.2 | -35.0 | -5.0 | -83.4 |
| 6 | Tadjikistan | -2.9 | -1.6 | -8.7 | -30.0 | -11.1 | -21.4 | -19.5 | -65.7 |

Source: The World Bank, IMF and PlanEcon data base; World Economic Outlook, IMF, October 1995, table 4.

[a] Forecast

**Table 2:**
**Inflation in the Selected Transition Economies**
**(CPI - average of the year to average of the previous year)**

| Category | Country | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 |
|---|---|---|---|---|---|---|---|
| 2 | Poland | 251.0 | 586.0 | 70.3 | 43.0 | 35.3 | 32.2 |
| 2 | Czech Republic | 2.3 | 10.8 | 56.7 | 11.1 | 20.8 | 10.2 |
| 2 | Slovakia | 0.0 | 10.8 | 61.2 | 10.1 | 23.0 | 14.0 |
| 2 | Albania | 0.0 | 0.0 | 35.5 | 225.9 | 85.0 | 28.0 |
| 2 | Estonia | 6.1 | 23.1 | 210.6 | 1069.0 | 89.0 | 48.0 |
| 2 | Latvia | 4.7 | 10.5 | 124.4 | 951.2 | 109.0 | 36.0 |
| 3 | Hungary | 17.0 | 29.0 | 34.2 | 22.9 | 22.5 | 19.0 |
| 3 | Slovenia | 1306.0 | 549.7 | 117.7 | 201.2 | 32.0 | 19.8 |
| 4a | Lithuania | 2.1 | 8.4 | 224.7 | 1020.3 | 390.2 | 72.0 |
| 4a | Kyrgyzstan | 0.0 | 3.0 | 85.0 | 854.6 | 1208.7 | 280.0 |
| 4a | Moldova | 0.0 | 4.2 | 98.0 | 1276.0 | 789.0 | 327.0 |
| 4b | Romania | 1.1 | 5.1 | 174.5 | 210.9 | 256.0 | 131.0 |
| 4b | Russia | 2.2 | 5.6 | 92.7 | 1353.0 | 896.0 | 220.0 |
| 4c | Bulgaria | 6.0 | 22.0 | 333.5 | 82.0 | 72.8 | 89.0 |
| 5 | Belarus | 1.7 | 4.5 | 83.5 | 969.0 | 1188.0 | 2200.0 |
| 5 | Kazakhstan | 0.0 | 4.2 | 91.0 | 1610.0 | 1760.0 | 1980.0 |
| 5 | Turkmenistan | 2.1 | 4.6 | 102.5 | 492.9 | 3102.0 | 2400.0 |
| 5 | Ukraine | 2.0 | 4.0 | 91.2 | 1210.0 | 4735.0 | 842.0 |
| 5 | Uzbekistan | 0.7 | 3.1 | 82.2 | 645.0 | 534.0 | 746.0 |
| 6 | Armenia | 0.0 | 10.3 | 100.0 | 825.0 | 3732.0 | 5458.0 |
| 6 | Azerbeijan | 0.0 | 7.8 | 105.6 | 616.0 | 833.0 | 1500.0 |
| 6 | Croatia | 2520.5 | 135.6 | 249.5 | 938.2 | 1516.0 | 98.0 |
| 6 | Georgia | 0.0 | 3.3 | 78.5 | 913.0 | 3126.0 | 18000.0 |
| 6 | Tadjikistan | 0.0 | 4.0 | 111.6 | 1157.0 | 2195.0 | 452.0 |

Sources: de Melo, Denizer, Gelb [1995], table 3.

## Table 3:
## Registered Unemployment Rates as Percentage of Labor Force (end of year)

| Category | Country | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 |
|---|---|---|---|---|---|---|---|
| 2 | Poland | 0.1 | 6.1 | 11.8 | 13.6 | 16.4 | 16.0 |
| 2 | Czech Republic | 0.0 | 0.8 | 4.1 | 2.6 | 3.5 | 3.2 |
| 2 | Slovakia | 0.0 | 1.5 | 11.8 | 10.4 | 14.4 | 14.8 |
| 2 | Albania | 1.9 | 7.7 | 8.6 | 26.9 | 28.9 | 19.5 |
| 2 | Estonia | 0.0 | 0.0 | 0.1 | 4.8 | 8.8 | 8.1 |
| 2 | Latvia | 0.0 | 0.0 | 0.1 | 2.1 | 5.3 | 6.5 |
| 3 | Hungary | 0.3 | 2.5 | 8.0 | 12.3 | 12.1 | 10.9 |
| 3 | Slovenia[a] | 2.9 | 4.7 | 8.2 | 11.1 | 14.5 | 14.5 |
| 4a | Lithuania | 0.0 | 0.0 | 0.3 | 1.3 | 4.4 | 3.8 |
| 4a | Kyrgyzstan | 0.0 | 0.0 | 0.0 | 0.1 | 0.2 | 0.7 |
| 4a | Moldova | 0.0 | 0.0 | 0.0 | 0.7 | 0.8 | 1.2 |
| 4b | Romania | 0.0 | 0.0 | 3.0 | 8.4 | 10.2 | 10.9 |
| 4b | Russia | 0.0 | 0.0 | 0.1 | 0.8 | 1.1 | 2.2 |
| 4c | Bulgaria | 0.0 | 1.5 | 11.1 | 15.3 | 16.4 | 12.8 |
| 5 | Belarus | 1.0 | 1.0 | 1.0 | 0.5 | 1.5 | 2.1 |
| 5 | Kazakhstan | 0.0 | 0.0 | 0.1 | 0.5 | 0.6 | 1.0 |
| 5 | Turkmenistan | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | n.a. |
| 5 | Ukraine | 0.0 | 0.0 | 0.0 | 0.3 | 0.4 | 0.4 |
| 5 | Uzbekistan | 0.0 | 0.0 | 0.0 | 0.1 | 0.2 | 0.3 |
| 6 | Armenia | 1.0 | 1.0 | 3.5 | 3.5 | 6.2 | 5.6 |
| 6 | Azerbeijan | 0.0 | 0.0 | 0.1 | 0.2 | 0.7 | 0.9 |
| 6 | Croatia | n.a. | 9.3 | 15.5 | 17.8 | 17.5 | 18.0 |
| 6 | Georgia | 0.0 | 0.0 | 0.0 | 5.4 | 8.4 | n.a. |
| 6 | Tadjikistan | 0.0 | 0.0 | 0.0 | 0.3 | 1.1 | 1.7 |

Sources: de Melo, Denizer, Gelb [1995], table 10.

[a] Annual average

**Table 4:**
**What Can be Done Gradually?**

| Area | Can be done gradually | If YES, what are the main dangers or negative implications |
|---|---|---|
| Macroeconomic stabilization | NO | |
| Domestic liberalization | NO; YES - In exceptional situations | Price distortions, inflation. expectations, fiscal problems, delayed demonopolization and privatization |
| External liberalization | YES | Price distortions, weaker competition, less pressure for restructuring |
| Privatization | YES | Delayed restructuring, pressure for macropolicy, intensive rent-seeking, informal privatization |
| Restructuring of the state sector (subsidization) | YES | Delayed restructuring, fiscal crisis, other pressure for macropolicy, intensive rent-seeking, the information and political barrier in monitoring, credibility problem |

**Table 5:**
**Traps of Slow Transition**

| | |
|---|---|
| | **TRAPS OF SLOW TRANSITION** |
| 1. | Microeconomic traps - mainly the danger of systemic vacuum<br>• in regulatory sense (central planning does not work already, market competition does not start yet)<br>• the lack of effective property rights |
| 2. | Macroeconomic traps (especially in countries which started with big macroeconomic disbalances)<br>• the danger of a big budget deficit, monetary expansion and hyperinflation<br>• the danger of a balance of payment crisis |
| 3. | Credibility issue (macro and micro aspect) - domestic and external |
| 4. | Information and administrative barriers of monitoring slow transition + problem of transitory solutions (e.g. subsidization, price control, foreign trade control) |
| 5. | Economic costs<br>• greater cumulative decline of GDP<br>• higher inflation, less domestic and external savings<br>• more balance of payments problems |
| 6. | Social costs<br>• unemployment issue<br>• more unequal distribution of income and wealth<br>• more corruption and criminal behavior |
| 7. | Lost political opportunities (limited political patience and acceptance for radical changes) |
| 7a. | Rebuild pressure groups |

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