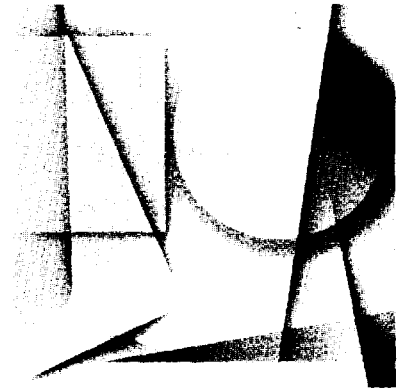


Liberalization, Stabilization, and Growth



Across the transition economies, extensive liberalization and determined stabilization have both been vital for improving economic performance. Liberalization involves freeing prices, trade, and entry from state controls; stabilization means reducing inflation and containing domestic and external imbalances. The two are intricately linked and can and should be initiated early. In the longer term, institutional reforms—establishing clear property rights, sound legal and financial infrastructure, and effective government—will be needed to make markets work efficiently and support growth. But liberalization and stabilization are essential first steps, and they can achieve a great deal even when other key features of an effective market are lacking.

Why is liberalization so important? It decentralizes production and trading decisions to enterprises and households and directly addresses the two fundamental weaknesses of central planning: poor incentives and poor information. Liberalization exposes firms to customer demand, the profit motive, and competition, and it lets relative prices adjust in line with true scarcities. Liberalized markets process information better than central planners, and when goods and services are traded freely, the price mechanism—Adam Smith's invisible hand—matches demand and supply. In most cases the outcome is efficient (market failure is discussed in Chapter 7). Combined with supporting institutions, competitive markets unleash powerful processes to force technological and organizational change. Whereas planned economies experienced low or negative overall productivity growth despite high capital accumulation, at least half of output growth in advanced market economies since World War II has resulted from productivity gains. Creating markets is an investment in a

more dynamic system of economic coordination that fosters long-run productivity and output growth. Finally, liberalization, by depoliticizing resource allocation, helps governments cut subsidies to firms and thus facilitates economic stabilization.

Stabilization policy is vital for transition because macroeconomic imbalance denies countries the gains of market reforms. Evidence from a wide range of market economies shows that once annual inflation rises above a threshold level around 40 percent, growth deteriorates dramatically. High inflation obscures relative price incentives and creates uncertainty, inhibiting saving and investment. Therefore price stabilization always complements liberalization as a basis for growth; as shown below, some transition countries have liberalized faster than others, but none has registered sustained growth without containing inflation at moderate levels.

There are some important parallels between Asian and European transition economies in the relationships between liberalization, stabilization, and growth. In all regions growth has largely resulted from the lifting of restrictions on new entry and a surge of previously repressed activities, especially services and export industries (and agriculture in Asia). Freeing prices and trade, reducing subsidies, and containing credit can also revitalize growth in previously dominant sectors, by increasing the competitive and financial pressure on firms to restructure.

However, as outlined in Chapter 1, there are also major differences between countries—in initial conditions, in approaches to macroeconomic reforms, and in outcomes. In China the initial economic structure combined with strong macroeconomic control has so far allowed large growth gains from partial liberalization to translate into

high saving and a rapid buildup of financial assets by households. This has helped cushion a state sector that remains a drag on the economy—even though its efficiency may be improving and its relative size is shrinking—and has underwritten the reform process itself. Gradual, partial reforms were not an option for most CEE countries and NIS. There only broad-based liberalization has allowed governments to cut their links with firms enough to bring inflation down to levels that would permit economic recovery. These countries all suffered a large decline at first. But those that liberalized early and comprehensively were able to stabilize the economy sooner and enjoy an earlier, stronger resumption of growth.

Liberalization and growth: A close link

In market economies liberalization usually means eliminating price controls and relaxing trade protection in a few heavily regulated or protected sectors. Liberalizers in transition economies face an unprecedented and more daunting task, that of freeing not only the terms of market transactions but the transactions themselves: abolishing state orders and procurement, state production and trading monopolies, and the centralized allocation of foreign exchange. Liberalization also means freeing entry into production, services, and trade, including the freedom to open a new business, to expand or break up an existing business, and to change product mix, suppliers, customers, or geographical base.

The starting point, speed, and scope of free market reforms have varied greatly among transition economies, as initial conditions and political developments have constrained governments' economic policies and influenced their reform choices (see Chapter 1). Hungary and China began liberalizing gradually in the 1960s and the 1970s, respectively. Vietnam accelerated its liberalization in 1989 after partial reforms had failed to raise growth rates or to stabilize the economy sufficiently. Poland liberalized with one "big bang," freeing 90 percent of prices, eliminating most trade barriers, abolishing state trading monopolies, and making its currency convertible for current transactions all at once in January 1990. Albania, the Baltic countries, the former Czechoslovakia, and the Kyrgyz Republic followed this model of rapid and comprehensive liberalization. Bulgaria initially did the same, but strong interest group pressures for continued protection and state support to enterprises later brought something of a reversal. In Romania price reforms advanced fitfully for three years after half of all prices were freed in 1990, but liberalization has recently accelerated. Russia substantially liberalized prices and imports in January 1992, but extensive export restrictions remained in place until 1995 (remaining export duties are set to be eliminated by mid-1996), and many consumer prices are still subject to local gov-

ernment intervention. Countries have usually been slower to adjust or liberalize housing rents and utility and public transport prices (Box 2.1).

Countries' 1989–95 averages on the liberalization index introduced in Chapter 1 (the purple bar segments in Figure 1.2) provide an aggregate indicator of the combined duration and intensity of liberalization. They assess the medium exposure of each country during 1989–95 to free market forces, including domestic price and trade liberalization, foreign trade liberalization and currency convertibility, and new entry and private sector development. It is worth focusing on liberalization over a period of time, rather than just in 1995, because both past and present reforms influence the behavior of enterprises and households and economic performance today. Of course, progress as measured by this index depends on countries' initial conditions as well as their reform efforts, and countries such as Hungary and Poland have followed different paths but achieved a similar degree of overall liberalization by 1995. Country comparisons reveal that domestic and foreign liberalization usually advance together, with liberalization of entry lagging somewhat. Advanced reformers, however, have proceeded faster on all three fronts: the Visegrad and Baltic countries, which have undertaken the most radical price reforms, have also opened the most to external trade and entry.

East Asia: Partial liberalization succeeds under special circumstances

Apart from small, diamond-rich Botswana, China has been the world's fastest-growing economy since its free market reforms began in 1978. Vietnam, too, has grown rapidly since abandoning pure central planning in 1986, especially after accelerating reforms in 1989. Both have liberalized substantially, but not (particularly China) on a scale or at a speed comparable to the radically reforming CEE countries. As described in Chapter 1, China has been "feeling the stones to cross the river." In contrast to the single bold leap of the CEE reformers, China went through several stages of "combining plan with market" before adopting its current goal: the "socialist market economy" announced in 1992 is the first to contain no reference to either plan or regulation. A specifically Chinese dual-track approach was used for liberalizing prices, external trade, foreign exchange, and the enterprise sector (Box 2.2). This has worked well, on balance, especially in agriculture. But it has not been without significant costs, including forgone benefits from a faster integration into world trade, rampant corruption and rent seeking, and, more recently, growing regional disparities. Partly in recognition of these costs, the government is proposing to unify the country's trade and tax regimes in the near future. Liberalization in Vietnam was broader and faster (Box 1.4). But as in China, significant restrictions remain, especially on trade and entry, and

Box 2.1 Pricing energy and other household essentials—a case for phased liberalization?

In most of CEE and the NIS, as well as in urban China, household energy, rents, and public transport remain the principal products whose prices have not been liberalized and are still far below cost. Rents are often below even maintenance costs. Housing and household energy subsidies amounted to 5 percent of GDP in Russia and 5 to 6 percent in Ukraine in 1995. Although these subsidies have played the role of social buffers, blunting households' sudden exposure to market forces, the potential economy-wide gains from efficient energy pricing are huge. In the NIS they could, according to one estimate, rise over ten years to more than 10 percent of GDP annually.

What combination of energy pricing and compensatory social policies provides the best mix of efficiency and protection for poor households? Efficient energy pricing would require raising household prices sharply. Relative to other prices, for example, household electricity prices would have to rise roughly threefold in Bulgaria, the Czech Republic, and Russia from levels of mid- to late 1995. In Hungary they almost cover economic cost already, and they will be raised further by the end of 1996, to permit foreign investors in the privatized electricity distribution companies an 8 percent return on capital. This example shows that full-cost pricing is

indeed possible, although Hungary's circumstances differ from those in most other countries. A study of energy pricing in Poland suggests that an 80 percent price increase for heat, gas, and electricity—roughly to their economic cost—would, in the short term, cost the average household around 8 percent of its budget.

Ideally, reforms would accelerate price increases in parallel with compensatory payments targeted to the poor, administered through the existing social assistance system. But this may not be feasible in all countries. Lifeline pricing is then often the most practical approach. This involves charging a low, subsidized price for a fixed, modest energy quota and full price for consumption above that level. Lifeline pricing is not perfect, because all consumers (not just the poor) get the subsidy, and because those who use less than the quota have little incentive to reduce consumption. At the margin, however, the bulk of consumers pay a price close to economic cost. Lifeline pricing with a large increase in the above-quota price therefore tends to be more efficient than a smaller, across-the-board increase. Simulations for Poland show that it may also have better distributional effects, even though a modest, fiscally affordable lifeline may still leave some of the poor insufficiently protected.

Box 2.2 China's dual-track price reforms

China's price reforms began in late 1978, implementing a dual-track system in which the share of production subject to state procurement continuously declined, and more and more prices were subjected to varying degrees of market guidance. The reforms began in agriculture and spread slowly, first to consumer goods and later to intermediate goods industries. In each case a free market developed in parallel with the controlled market, where state supply was kept unchanged at the (lower) plan price. Supply in the free market track grew rapidly, so its share in total output rose steadily. Meanwhile the planned price was raised incrementally until it approached the market price. By the end of 1994 this dual-track system had led to the decontrol of more than 90 percent of retail prices and between 80 and 90 percent of agricultural and intermediate product prices, all of which are now market determined. Only a few prices remain fixed or negotiable within a band set by the state.

Although liberalization remained incomplete, dual-track price reforms did improve efficiency, because the price of the marginal unit reflected economic cost and correctly signaled relative scarcity, and because the share of sales at planned prices declined over time. Also, the eventual full liberalization of the small share of output remaining subject to controls proceeded smoothly. Less than 20 percent of food products were still sold at fixed official prices when the last food price controls were removed in 1992, so the final convergence of the two tracks caused minimal disruption to the economy as a whole. But dual-track reforms also were costly to implement—a vast number of people were needed, for example, to administer the rationing and distribution system associated with dual food prices—and required strict enforcement to limit the diversion of price-controlled products to the free market and to rein in corruption, with severe penalties for noncompliance.

difficult reforms of state enterprises and the financial sector have yet to be undertaken (Chapters 3 and 6).

How have free market reforms succeeded in promoting rapid growth in China and Vietnam? Some argue that, in China, gradualism contributed to the reforms' success, as remaining partial controls—based on the continued authority of the Communist Party and enforced through a dense web of local compliance mechanisms—continued to serve a coordinating function, limiting disruptions to production and trade during the phased buildup of market institutions. But the key, in both countries, was the reforms themselves, which spurred growth directly by improving productivity, and indirectly by raising the incomes of large parts of the population and translating them into high saving and investment. The design and sequencing of reforms fit the two countries' economic and political structure and other initial conditions. They began by liberalizing agriculture (land tenure, prices, and procurement), which had previously been heavily taxed. Because most of the work force was in agriculture, better incentives—at the margin prices were flexible, output could be sold freely, and profits accrued to farmers—generated large productivity, output, and income gains, lifting many out of poverty (see Chapter 4). Labor-intensive technology permitted an easy shift to more efficient, family-based production. This in turn freed up a significant share of the labor force to transfer into higher-productivity sectors, especially the new non-state industrial and service sectors that were next in line to be liberalized. The labor force in rural Chinese enterprises increased by 100 million between 1978 and 1994.

China achieved overall (total factor) productivity growth of more than 3 percent a year during 1985–94, exceptional by international standards. An upward bias in recorded GDP growth may exaggerate this figure somewhat, but this high growth in productivity signals that China's growth is relatively intensive—driven by more efficient use of inputs rather than simply more of them—although lower productivity in the still sizable state enterprise sector raises concerns for the future (see below and Chapter 3). Overall, up to one-third of the increase in Chinese output since 1985 can be attributed to greater efficiency. The bulk of the remainder has been due to an unparalleled, growth-promoting investment boom, fueled by income growth which has translated into high rates of household and enterprise saving. Total saving and total investment both averaged close to 40 percent of GDP during 1985–94. This would not have been possible had the government not been able to stabilize the economy by directly curtailing demand during boom periods. In Vietnam, where productivity has grown at comparable rates, increased efficiency accounts for an even larger share of output growth, because investment rates are considerably

lower than in China. Vietnamese output growth has averaged more than 7 percent a year since 1989 and close to 9 percent in 1994 and 1995. In the mid-1980s domestic saving was negative and investment negligible, but both have since increased dramatically.

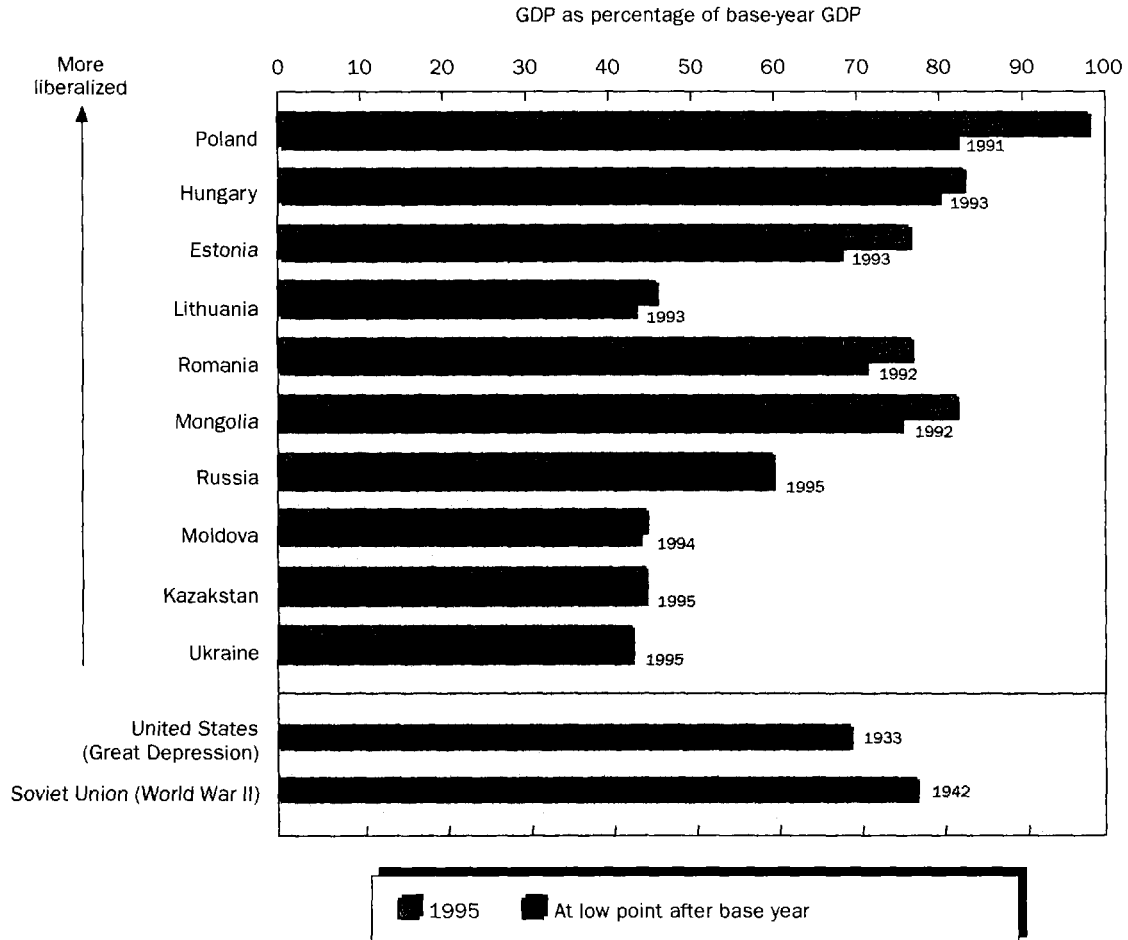
As noted in Chapter 1, state industries employ only a moderate share of China's labor force. Also, China's overall production structure has never been as distorted as it was in the former Soviet Union, and the defense sector has never been as big. This has allowed China to delay deep state industrial reforms—employment in its state sector grew by 20 million during 1978–94—and still record substantial productivity and output growth. Subsidizing unprofitable state enterprises with increasing amounts of cheap credit has had significant costs in terms of lost efficiency. But thanks to its high national saving, China has so far been able to absorb this cost without fundamentally destabilizing the economy (see below). Without comparable levels of saving, and with Soviet aid drying up in the late 1980s, Vietnam was forced to cut subsidies to enterprises as part of its stabilization program. This triggered cuts in the industrial labor force by one-third during 1988–92 and a brief recession in the state sector, followed by adjustment and improved performance. But industrial restructuring took place without economic and social upheaval. One reason was that Vietnam's enterprises, unlike China's, did not provide extensive social benefits, but another was that the newly liberalized agricultural and private manufacturing and service sectors, which account for 60 percent of GDP and 85 percent of employment, grew rapidly and were able to absorb laid-off public sector workers.

CEE and the NIS: Liberalization boosts recovery from initial output losses

Output has fallen dramatically in European and Central Asian transition economies. Some of the official estimates shown in Figure 2.1 overstate the decline because of statistical weaknesses (see Box 1.3), not least, in many countries, the exclusion of a large and growing unofficial economy (Box 2.3). But the data show a substantial decline even after adjusting for these biases; in Russia, for example, output fell by about 40 percent during 1990–95. Estimates based on electricity demand are also problematic but provide perhaps a lower bound to the output decline; they suggest that GDP fell, on average, by around 16 percent in five CEE countries between 1989 and 1994, and by around 30 percent in eleven NIS. Because of sharp falls in investment, consumption has declined less than output, but there is little doubt that living standards fell in the early stages of reform in most countries, notwithstanding improvements in product quality and the elimination of queues (see Chapter 4).

Output has fallen dramatically across CEE and the NIS.

Figure 2.1 Decline and recovery in GDP in selected transition economies and in comparable historical episodes



Note: The base year for the transition economies is 1989; historical base years are 1929 for the United States and 1940 for the Soviet Union. Transition economies are listed according to their average liberalization index scores for 1989–95 (see Figure 1.2). Source: Official data.

Total registered employment has also fallen in CEE and the NIS, although there has not been a clear relationship between employment and output declines. Employment has generally fallen more, and unemployment risen faster, in CEE than in the NIS, because in CEE the labor market adjustment has largely come through layoffs and early retirement, whereas in the NIS the response has generally been to cut working hours (see Chapter 4). Between 1989–90 and 1994, for example, registered employment

fell 20 to 25 percent in Bulgaria, Hungary, and Slovenia, but only 7 to 8 percent in Russia and Ukraine.

WHY DID OUTPUT FALL? Some early studies, focusing mainly on CEE, blamed overzealous stabilization for the initial output decline. But the evidence now suggests that it was mainly driven by three factors: demand shifts due to liberalization, the collapse of the CMEA and the Soviet Union, and supply disruptions due to vanishing or absent institutions and distorted incentives.

Box 2.3 Notes from underground: The growth and costs of unofficial economies

Transition has brought marked growth in countries' unofficial economies. Many commercial and even many productive activities go underground to evade high and volatile taxes, circumvent restrictive and often unpredictably changing government controls, and employ workers flexibly and cheaply. Estimates based on electricity consumption suggest that, between 1989 and 1994, the share of unofficial activity in the economy grew, on average, from 18 to 22 percent in a sample of CEE countries and from 12 to 37 percent in a sample of NIS. Surveys in Ukraine confirm a very large unofficial economy.

Unofficial economies tend to be large where political controls have weakened, economic liberalization is lagging, and burdensome regulations and high taxes make the formal environment hostile for the newly developing private sector. Where the informal economy has grown significantly, it has cushioned the output decline and provided an outlet for entrepreneurial talent. But it is mostly a "survival" economy that focuses on short-term objectives, invests little, and loots state assets. Firms waste time and money in their efforts to get around controls and taxes. These efficiency losses, and the difficulty of conducting certain transactions

unofficially, limit its growth. Informalization also lowers government revenues and encourages capital flight. And by its very nature it breeds corruption and undermines the credibility of formal market and government institutions. Thus, a growing informal economy is no substitute for a formal, open private sector, but in fact eventually impedes its development.

Latin America presents striking parallels. There, too, unofficial activities account for between roughly one-fifth and two-thirds of total output. They thrive where political freedoms are many and economic freedoms few. And where informalization has been most extensive (Bolivia, Peru), growth has been slowest. Measures that have helped in Latin America to bring the informal sector back into the economic mainstream are likely to work in the transition economies as well. These include extensive price, trade, and foreign exchange liberalization; tight macroeconomic policies; a sharp reduction of regulatory constraints; and more professional government administration (see Chapters 5 and 7). A combination of carrot and stick—possibly including a one-time, partial tax amnesty—can help reduce the costs of returning to the formal economy.

Liberalization, combined with stabilization, meant the end of the supply-constrained shortage economy, in which even the shoddiest products could always be sold. Now unwanted goods remained on the shelves. Firms and consumers drew down their supply stocks as hoarding became unnecessary—falling inventories contributed about one-third to the output drop in Poland in 1990–91 and over half of the 11 percent drop in the Baltic countries in 1993. In Russia military procurement was cut by 70 percent. Of course, the elimination of unwanted production and excess inventories did not reduce welfare. But all initial cuts in output had second-round effects on spending and demand, which may have doubled the overall effect on output.

The disintegration of the CMEA and the Soviet Union, coupled with trade liberalization, led to a collapse in trade among CEE countries and the NIS. Buyers substituted imports, including consumer durables, from outside the CMEA, while the shift toward world market prices and trade in convertible currencies entailed huge price rises for previously subsidized energy and raw material imports, especially from Russia. According to one rough estimate, Russia's price subsidies to other countries were worth \$58 billion in 1990, of which \$40 billion

went to the rest of the Soviet Union and \$18 billion to other CMEA countries. Ending these subsidies raised the cost of imported production inputs, reducing aggregate supply and output. Many non-NIS countries suffered overall terms-of-trade losses of more than 10 percent of GDP, and even as high as 15 to 20 percent in the case of some highly import-dependent countries. For its part Russia was unable to exploit fully the improvement in its terms of trade because of collapsing trade volumes and its own continued export restraints. The collapse in trade was compounded by the stupendous inefficiency of the initial interstate payment system, which usually took about three months to process transactions.

Finally, in CEE and the NIS, unlike in China, planning institutions had vanished before new market institutions could develop. For example, many countries have discarded the old systems for allocating agricultural credit and distributing farm output, but new wholesale and retail networks and market-based credit systems are not yet in place. The lack of market institutions caused coordination failures throughout the production and trading system—many of them related to limited information and to uncertainty. Inadequate incentives, often linked to deficient property rights, compounded the shortage of modern

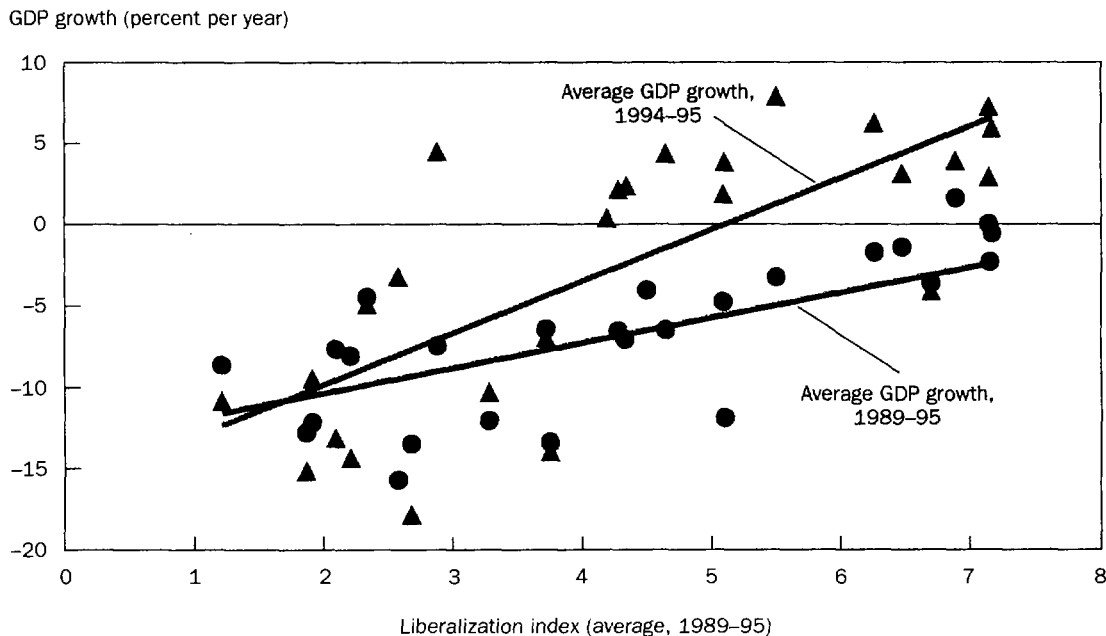
technology and skills and created formidable obstacles to swiftly redeploying factors of production to emerging sectors. Uncertainty encouraged capital flight by firms and households alike, and many firms became survival-oriented, waiting and hoping for better times rather than restructuring actively. To some extent, such problems are an inevitable result of these countries' dramatic break with the past. But they were exacerbated, in many countries, by inconsistent reform policies—including a lack of policy coordination in the ruble zone (see below). Coordination failures, uncertainty, and distorted incentives constrain the start-up or expansion of profitable activities—even as unprofitable or overbuilt sectors collapse. For example, livestock herds shrank dramatically across the NIS in response to steep increases in fodder prices relative to prices for animal products. But Russian oil production has also fallen—by almost half since 1988—despite a steep increase in the relative price of energy. The main reasons

are an acute shortage of maintenance and upgrade investments and an inadequate legal, institutional, and fiscal framework that discourages management improvements, foreign investors, and new technology.

HOW HAS LIBERALIZATION SPURRED RECOVERY? Across CEE and the NIS liberalization has been positively associated with growth. In countries where liberalization has been stronger (as measured by average liberalization scores), output losses have on average been smaller (Figure 2.2). And the difference increases over time: relatively stronger liberalization boosted average growth during 1989–95, but it boosted average growth in 1994–95 even more. Two other factors have had a strong impact on recent growth. First, output has tended to increase further since 1989, or decline less, in poorer, more agricultural countries than in richer countries with more overbuilt industrial sectors. Second, each year a country has been adversely affected by regional tensions has added 6.5

Stronger, more sustained liberalization spells a smaller output decline—and a stronger recovery.

Figure 2.2 Liberalization and growth of GDP



Note: Data are for all twenty-six CEE countries and NIS; results are even stronger if China and Vietnam are included. See Figure 1.2 for details of the liberalization index. Average GDP growth is adjusted to control for the impact of regional tensions in some countries and differences in initial income per capita. Source: De Melo, Denizer, and Gelb, background paper; official data; World Bank staff calculations.

percentage points of GDP, on average, to the annual decline in output since 1989.

Countries have typically returned to growth after three years of sustained liberalization (Figure 2.3). Countries in Groups 1 and 2—those in which liberalization has been more rapid and comprehensive (see Figure 1.2)—experienced an earlier output decline but also an earlier and stronger recovery. Output in countries in the other groups was still falling in 1994–95, but recent reforms have brought a number of them to the threshold of recovery. Ongoing research provides evidence that these patterns of decline and recovery continue to hold even if one controls for differences in countries' initial conditions such as geography, sector structure, or initial macroeconomic imbalance (see Chapter 1).

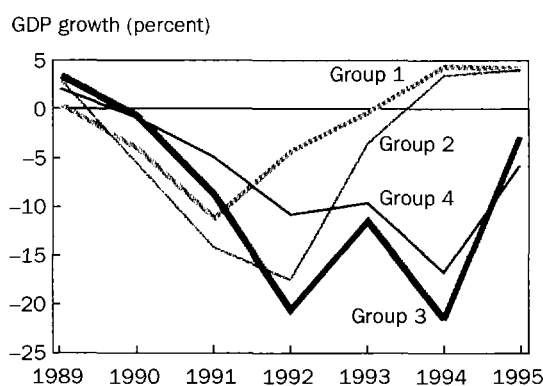
How can countries judge whether market reforms have paid off overall, given that earlier and more vigorous liberalization has led to an earlier decline but faster medium-term growth? One way is to regard the market system as an asset in which countries invest by liberalizing. Countries have invested different amounts at different times, and these investments have generated initial income (GDP) losses and subsequent income gains of different magnitudes. The value of countries' investments as of the end of 1995 is their total GDP accumulated since 1989 (and discounted back to 1989 to allow for the fact that people value income today more than income tomorrow). Figure 2.4 shows that, on average, liberalization has indeed been a good investment. The least liberalized countries have fared slightly better than moderate reformers. More advanced liberalizers, however, whose cumulative market reforms have now reached a critical mass, have come out far ahead, at least in terms of national income. This does not imply that rapid, all-out liberalization is always possible—or preferable. When choosing how much and how fast to liberalize, governments are constrained by initial conditions, and often the effects of different strategies will be highly uncertain. But as noted in Chapter 1, initial conditions still leave policymakers a fair amount of choice—they influence but by no means predetermine economic performance. The fact that, when these factors are controlled for, liberalization tends to pay off suggests that, on average, policymakers will maximize people's incomes by liberalizing as much as possible within the range left open by country-specific constraints.

New growth comes from letting exports and services expand . . .

Exports and services, two previously repressed activities, have been the major engines of growth in transition economies. Overall, the European transition countries have been strikingly successful at opening their economies and reorienting their exports toward world markets (Table 2.1). Despite early skepticism, many have been able to

Countries that liberalize rapidly and extensively turn around more quickly.

Figure 2.3 Time profiles of output decline and recovery by country group



Note: Countries in CEE and the NIS are grouped by their average liberalization index scores for 1989–95 (see Figure 1.2). Countries severely affected by regional tensions are excluded. Annual growth rates are simple averages for each group. Source: Official data; World Bank staff calculations.

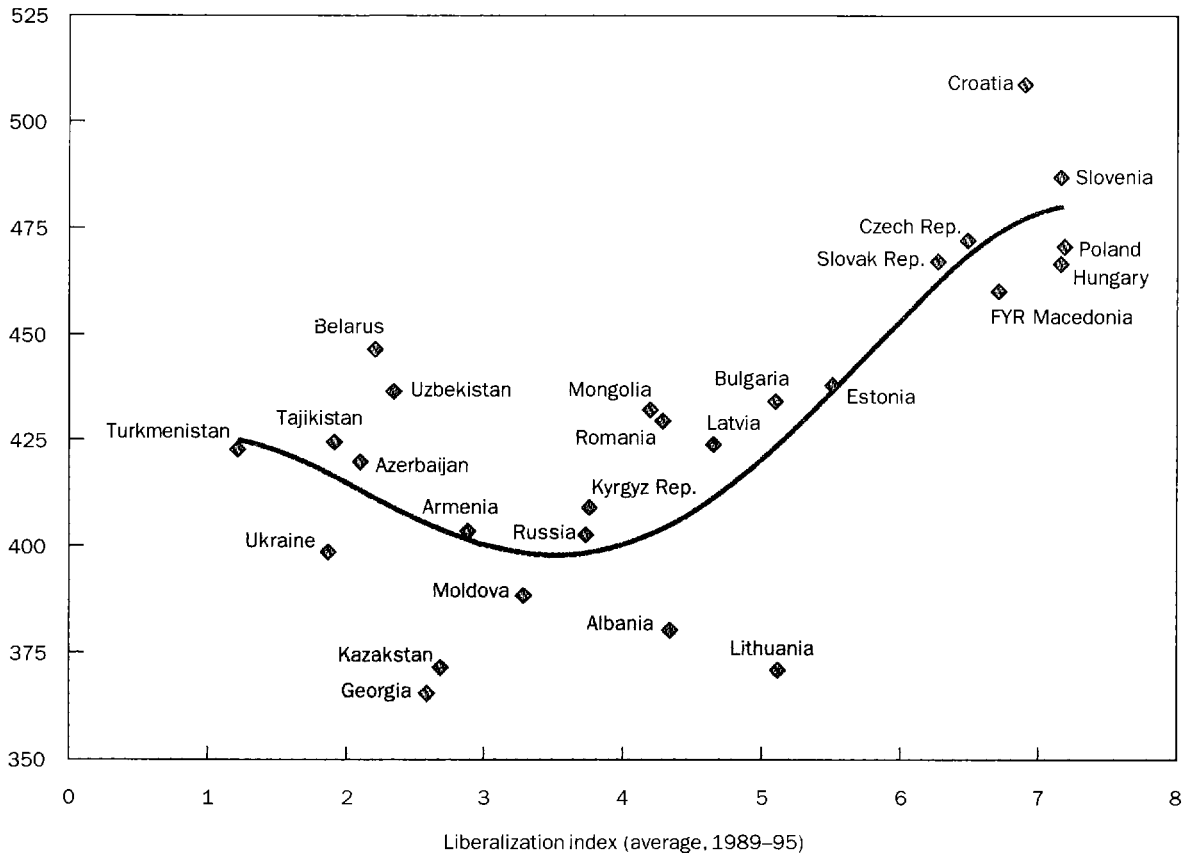
penetrate the “quality barrier” to expanding exports to the West (trade relations with the European Union and integration into world trade institutions are discussed in Chapter 9). Countries have rapidly diversified their exports, and some have begun to reverse the trend of falling unit value for machinery exports—a sign of rising quality. Exports from countries with more open trade regimes, mostly in CEE and the Baltics, declined less with the initial disintegration of the Soviet Union and the CMEA and recovered faster, contributing more to overall output growth (see Table 2.1 and Box 2.4). By contrast, in most NIS, which stuck with state trading arrangements and still impose significant export controls, OECD-oriented exports of manufactures have remained marginal and the contribution of exports to growth has been negligible.

Trade policies in China and Vietnam have combined substantial, although partial, liberalization with active export promotion, with Vietnam relying more on the former and China on the latter. State trading now covers

After seven years, aggressive liberalizers in CEE and the NIS have come out ahead.

Figure 2.4 Liberalization and cumulative GDP

Cumulative GDP, 1989–95 (percentage of 1989 GDP)



Note: Data are for all twenty-six CEE countries and NIS. See Figure 1.2 for details of the liberalization index. Cumulative GDP is the normalized net present value of total GDP over 1989–95, discounted at 10 percent per year. It is adjusted to control for the impact of regional tensions in some countries and differences in initial income per capita and the abundance of natural energy resources. Results are robust to changes in the discount rate and to the inclusion of China and Vietnam. Source: Official data; World Bank staff calculations.

only a few important products and represents a shrinking share of trade in both countries. Many exports are liberalized completely, and most remaining export controls are not binding, but imports remain subject to significant restrictions, especially in China. Both countries have exempted exporters from import duties on their inputs and created favorable conditions for export-oriented foreign investment—Vietnam mainly through deregulation,

China through the creation of special economic zones, the opening of coastal areas, and preferential tax treatment and access to foreign exchange for exporters.

Although China and Vietnam have liberalized trade less than have the Visegrad and Baltic countries, their overall trade performance has been at least as spectacular. China has sustained export growth of more than 15 percent per year on average since 1978; Vietnamese export

Table 2.1 Trade policy and export performance in CEE and the NIS

Country group	Trade policy			Export performance				
	State trading, 1994	Quantitative restrictions, 1994	Years of current account convertibility by end-1995	Change in share of CMEA or Soviet exports (percent) ^a	Mfg. exports to OECD, 1994 (percent of GDP) ^b	Average annual contribution of export growth to GDP (percentage points) ^c		
						Exports to OECD only, last year before transition to 1994	Total exports, last year before transition to 1994	Total exports, first year of transition to 1994
Group 1	Very small	No	4	-57.2	24.5	2.3	2.1	3.0
Group 2	Very small ^d	No ^d	2	-43.9	18.1	1.4	-3.1	3.7
Group 3	Moderate ^e	Yes ^e	1	-13.6	3.3	0.2	-11.2	0.5
Group 4	Extensive	Yes	0	-14.2	4.4	-0.1	-14.4	0.3
Rg. tensions	Extensive	Yes	0	-20.8	3.7

.. Not available. Mfg., manufacturing. Rg. tensions, group of countries severely affected by regional tensions (see Figure 1.2).

Note: Data are simple averages for each country group (see Figure 1.2).

a. For CEE countries, data are for 1989–94 CMEA exports; for NIS they are for 1990–94 Soviet exports.

b. For Albania, Mongolia, and Slovenia, data are for total exports.

c. The last year before transition was 1989 for Poland, 1990 for the other CEE countries, and 1991 for the NIS.

d. Mongolia was the only Group 2 country with significant state trading and quantitative export controls in 1994.

e. The Kyrgyz Republic was the only Group 3 country that had essentially eliminated export restrictions by 1994.

Source: Kaminski, Wang, and Winters 1996; IMF 1995a; EBRD 1995; World Bank staff calculations.

Box 2.4 Trade policy and performance: Estonia and Ukraine illustrate how close the link

Estonia and Ukraine have pursued diametrically different trade policies. Their trade performance has varied accordingly.

Rapid trade liberalization pays off. Estonia removed virtually all export barriers, eliminated all quantitative import restrictions, kept only a few low import tariffs, and made its new currency fully convertible for current account transactions, all by the end of 1992. Import liberalization introduced world relative prices for tradables. And radical export liberalization—a policy that distinguished Estonia from most other NIS—allowed a rapid reorientation of trade, accelerated adjustment to Western quality standards, and boosted hard-currency export revenues. More than half of Estonia's exports now go to Western Europe, and close to two-thirds of its imports come from there. Export growth contributed 11 percentage points a year to GDP growth during 1992–94. Even if one corrects for Estonia's special advantages—close ties with Finland, proximity to Western Europe, and Baltic Sea ports that have boosted legal and illegal trade—its export performance has been phenomenal.

Slow trade liberalization imposes high costs. Ukraine maintained many price and trade controls until the fall of 1994. State trade—including state procurement and an extensive network of bilateral trade agreements

with other NIS and ex-CMEA countries—remained intact. Administrative controls kept domestic prices below world prices. Tight export controls (including licenses and quotas) sought to prevent producers from selling subsidized goods abroad. Exporters had to surrender foreign exchange earnings at below-market exchange rates. The import regime remained liberal, but domestic buyers lacked foreign exchange to pay for imports. Ukraine's policies proved counterproductive. The intergovernmental agreements failed to stem the trade decline with the other NIS and blocked trade diversification: Western Europe accounted for less than 20 percent of Ukraine's total trade in 1994. Isolation from world markets delayed enterprise adjustment and perpetuated inefficiencies. Exports fell, contributing negatively to output growth during 1992–94, and large trade deficits contributed to a spiraling depreciation of the currency and economic destabilization. Ukraine's reforms in late 1994 included considerable price liberalization and the elimination of most direct export controls, and exports grew in 1995. A nontransparent reference price system continues de facto to restrain exports below a minimum price, encouraging rent seeking and corruption, but as of early 1996 its coverage is limited to a small and declining share of exports.

growth in the shorter period since 1986 has exceeded 25 percent per year. Initial conditions played a significant role in these achievements. China did not suffer a trade shock from dissolution of the CMEA, of which it was not a member, and it was able to draw on its Hong Kong connection and a large expatriate community to help develop its export industries. Vietnam enjoyed an oil export bonanza that partly offset the loss of CMEA markets and cushioned the withdrawal of Soviet transfers and an initial decline in nonoil industries. In addition, both countries were able to exploit their strong comparative advantage in labor-intensive manufactures. Within China and Vietnam (just as across CEE and the NIS), exports have grown faster in those industries and regions with more open trade and foreign investment regimes, and higher exports have been associated with faster output growth. A World Bank study of options for reforming China's trade regime has shown that the remaining export and import restrictions carry high efficiency and welfare costs. These would be reduced by the further liberalization measures proposed in support of China's bid to join the World Trade Organization (WTO).

Some have argued that, whatever the overall speed of liberalization, foreign trade and exchange transactions should be liberalized more slowly than internal markets, to lessen the initial decline in domestic employment and output. Yet there is powerful evidence from transition economies that the benefits of early external liberalization—in parallel with domestic liberalization and stabilization—far outweigh the potential costs. Establishing essentially free trade (except, possibly, a modest and uniform import tariff) early on yields a particularly large return in these countries, for several reasons. First, the legacies of central planning—especially the bias toward autarky and large firms—magnify the efficiency and output gains from competing in world markets, and comparisons of countries' aggregate trade performance bear this out (see above). Firm-level evidence from Bulgaria, Poland, and Russia also shows that trade liberalization has indeed spurred enterprise restructuring and helped make markets competitive. Second, in the early stages of liberalization, producers in most countries have been shielded from foreign competition by heavily undervalued currencies, whether exchange rates are fixed or floating (see below). Undervaluation also created a strong incentive to seek export markets.

By contrast, continued trade controls are likely to yield few benefits for transition countries. Import protection is at best a blunt instrument for alleviating the pain of adjustment, since it cushions entire industries, not just the weakest firms. Entry promotion, retraining programs, and targeted social assistance are likely to be much more effective. Furthermore, unlike these measures, trade controls

need to be enforced against strong incentives for both partners in a voluntary transaction to circumvent them. In transition economies, whose institutional capacity is especially weak, trade controls therefore tend to be relatively ineffective at protecting firms or raising tariff revenues, and instead breed corruption (see Chapters 5 and 7). Finally, worldwide experience has shown that "temporary" protection measures all too often become permanent, and that frequent changes in trade policy are bad for firms that are expanding and developing foreign ties. Both problems have particular relevance to those of the transition countries where political conditions are volatile.

Services have been the second major source of growth in transition economies. One study estimated that reversing the past repression of services in the NIS could increase national income by more than 10 percent and generate around 6 million additional jobs, substantially compensating for declines in other sectors. Service sector output has indeed soared during transition, especially where liberalization is more advanced (Table 2.2). In the leading reformers the initial "service gap" (the shortfall in the service sector share of GDP relative to that in established market economies) has essentially been closed. Spirited entrepreneurs have responded vigorously to improved incentives, often despite serious obstacles, including numerous and frequently changing regulations, slow and often corrupt bureaucracies, and crime, in addition to high taxes and lack of credit. Services have grown less in countries such as Belarus, where reforms are not as advanced.

The adjustment from industry toward services has meant huge shifts in relative prices. In Russia the price of paid services relative to that of goods in the average consumer basket rose fivefold between 1990 and 1994. In parallel, the share of industry in GDP fell 7 percentage points and that of agriculture 9 percentage points, while the share of services increased by 16 percentage points. Industry's share has declined even more sharply in the advanced reformers. This has contributed to an improved environmental record across CEE countries and the NIS, whereas rapid industrial growth has led to deteriorating environmental conditions in the East Asian transition economies (Box 2.5).

Agriculture's share in GDP has fallen somewhat in most transition economies. In CEE and the NIS, agriculture was highly inefficient and, in contrast to East Asia, sustained by subsidies on inputs, credit, and retail prices. The sector has suffered an unnecessarily severe relative price shock—input prices, especially fuels, rose four times as much as output prices—because supply and processing are not yet fully competitive, and governments still intervene to hold down food prices. Further liberalization should allow agricultural producers to retrace some of their lost ground.

Table 2.2 Liberalization and sectoral restructuring

Country group ^a	Average liberalization index, 1989–95 ^a	Change in share of GDP, 1989–94 (percentage points)			Share of services in GDP (percent)			Percentage of 1989 services gap filled in 1994
		Agriculture	Industry	Services	Actual, 1989	Normal share ^b	Gap in 1989 ^b	
CEE and NIS								
Group 1	6.9	-4	-12	16	42	51	9	173
Group 2	4.7	1	-11	10	35	51	15	68
Group 3	3.4	0	-4	4	33	49	16	25
Group 4	2.0	-2	3	-1	34	49	15	-7
Rg. tensions	3.9	14	-7	-7	41	50	9	-80
China and Vietnam	5.5	-10	5	6	32	41	8	66
Average of all transition economies	4.4	2	-6	5	37	49	13	38

Rg. tensions, group of countries severely affected by regional tensions (see Figure 1.2).

a. See Figure 1.2 for details of the liberalization index and the countries in each group.

b. The "normal" services shares of countries are shares predicted from a regression of sectoral shares on income per capita and population size in a sample of 108 developing and industrial economies. The services "gap" is the difference between the actual and the normal share of services in GDP.

Source: Syrquin and Chenery 1989; official data; World Bank staff calculations.

... And from forcing old firms to restructure

Price and trade liberalization and sharp cuts in fiscal and credit subsidies are crucial to forcing firms to adjust and turning the enterprise sector around. Indeed, industrial restructuring has turned out to be highly decentralized in transition economies. Output shifts between subsectors have followed no obvious pattern. Heavy industry, assumed to be the most overbuilt, has not contracted relative to light industry. Branches have not systematically expanded or contracted as their relative competitiveness has improved or

deteriorated with the move toward international prices. Instead, industrial restructuring has involved large changes in output and employment at the firm level. Studies show that enterprise performance varies greatly within an industry, and past profitability often provides little clue as to which firms will thrive and which succumb.

Industries are in flux, with new entry, breakups and mergers, a sharp rise in the number and share of small firms, and new products and processes. Price and trade controls, which affect entire industries, impede this kind

Box 2.5 Transition can help the environment—with the right policies

Transition has reduced environmental damage in most CEE countries and NIS, with pollution dropping as a consequence of the fall in economic activity, especially in industry. There are signs that the recovery in industrial output may not be accompanied by equivalent increases in pollution, because of more effective environmental regulation and improved enforcement. China, in contrast, has grown rapidly. This has resulted in higher pollution and worsening environmental conditions. The environmental performance of most heavy industrial enterprises remains poor, and many new light industries generate water pollution and hazardous wastes, which pose a serious threat. In the most polluted large cities a combination of stricter environmental policies and economic changes seems to have stabilized levels of air pollution—the most immediate environmental threat to human health.

In all transition economies a combination of further market reforms and sound environmental policies can improve environmental performance. First, changes in relative prices should promote more efficient use of energy and natural resources. Second, privatization and reduced state interference in industrial decisions will encourage management to improve the operating performance of existing plant, while replacing old equipment with new plants incorporating cleaner production technologies. Well-designed environmental regulation and investments can contribute to this process. Third, a clear institutional separation of enterprise ownership from environmental regulatory authority should help ensure realistic environmental standards. Fourth, foreign direct investment and international cooperation—such as through the Baltic Sea cleanup programs—can bring in best environmental practices from around the world.

of decentralized enterprise adjustment and market-led differentiation of enterprises by performance. Governments worldwide have tried to pick winners and target support only to viable firms. This is risky business at the best of times; in the volatile environment of transition it is impossible. Even firm-specific, performance-linked credits and subsidies will inevitably assist many nonviable firms. Such support wastes resources and discourages viable firms from adjusting. Moreover, subsidies tend to go to state enterprises. This tilts the playing field against new private entrants, the main source of new jobs.

Experience across CEE and the NIS supports these arguments. Hungary and Poland have sustained strong liberalization and reduced enterprise subsidies, from 7 to 10 percent of GDP in the late 1980s to 2 to 3 percent in the early 1990s. Enterprises there have adjusted, and their performance has improved much more than that of their counterparts in Bulgaria and Russia, where liberalization has been less consistent and budgetary and central bank subsidies to enterprises still averaged 6 to 7 percent of GDP in 1993–94. Chinese state enterprise reforms included decentralized, although partial, liberalization from the beginning; not coincidentally, enterprise productivity and output growth have been higher in the more liberalized regions and sectors, where competition has been stronger, and in the less regulated nonstate segments of the economy (see Chapter 3).

Restructuring of production and output has involved extensive adjustment in labor markets. Although registered unemployment has remained low in some countries, especially in the NIS (see Chapter 4), analysis of economy-wide and sectoral labor flows reveals that total turnover rates (hires plus fires) probably averaged around 20 to 25 percent in the NIS during 1991–93. Such high turnover rates are comparable to those in middle-income developing countries such as Chile and Colombia and exceed those in Canada and the United States. Between 70 and 80 percent of hired and fired workers moved within the same sector rather than to other sectors.

Stabilization: A vital ingredient in transition

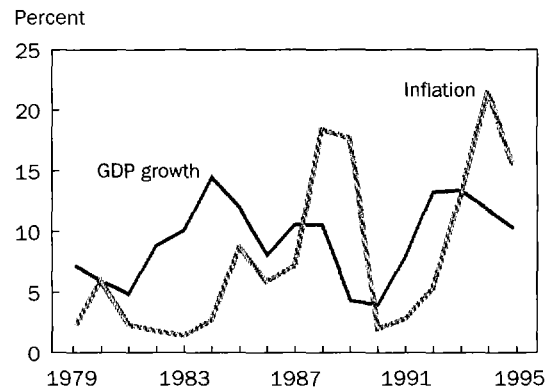
Stabilization policy is an essential complement to liberalization in transition. Policies to contain inflation and impose hard budget constraints on firms are necessary for market economies to grow and firms to restructure. But the interaction between macroeconomic policies and other reforms, including liberalization, is greatly affected by initial conditions. In this respect, China is a distinctive case.

China: A cyclical pattern of moderate inflation

Throughout its reform period China has experienced moderate inflation, with boom-and-bust cycles in prices and output (Figure 2.5). Each boom has featured rapid credit

China has oscillated between boom and bust.

Figure 2.5 GDP growth and inflation in China



Source: World Bank 1995e, 1996a.

expansion (mainly to finance investment projects) and a sharp rise in inflation. This has been followed by a strengthening of financial policies, especially through direct administrative controls, including ceilings on bank lending, direct prohibitions on investment, and price reregulation. Macroeconomic imbalances widened when reform began in 1978 but were effectively controlled by government policy. The boom cycles have been triggered by reform initiatives. In 1984 enterprise and trade reforms gave increased freedom and expansionary incentives to firms. After a cooling-off period in 1986–87 a new round of trade, price, and wage reforms and the introduction of the contract responsibility system for enterprises (under which multiyear contracts specify the profits and output to be turned over to the state) gave another boost to demand. And in January 1992 reforms designed to encourage investment and enterprise autonomy through locally driven incentives set off another round of inflationary pressures.

This pattern largely reflects the incompleteness of Chinese reforms, especially in the enterprise and financial sectors. With soft budget constraints and with interest rates on bank loans frequently set below inflation, enterprises and powerful local governments have sought to capture the benefits of increased credit in the form of higher local investment, incomes, and employment, expecting that any inflationary costs would be dissipated through the entire economy. Partial price reforms have increased the need for government subsidies, to cover the losses of

enterprises whose prices remained fixed at artificially low levels. Meanwhile, fiscal decentralization and difficulties in developing effective tax administration have contributed to large declines in government revenues (Chapter 7). As a result, the government shifted more and more of its fiscal responsibilities to the banking system. The net flow of resources from banks to enterprises has been large, amounting to 7 to 8 percent of GDP in the late 1980s and early 1990s. About half of this was refinanced by the central bank through quasi-fiscal operations. Moreover, bank loans to enterprises and central bank loans to banks have both involved large implicit subsidies (equivalent to around 3 to 4 percent of GDP), in the form of negative real lending rates and noncollection of bad debts (bad enterprise debts are now estimated to account for at least 20 percent of banks' portfolios).

In most other countries such conditions would have led to high inflation. But China has not been like most other countries. This rapidly growing economy has avoided high inflation because of a seemingly insatiable demand for cash and bank deposits by enterprises and households, whose bank deposits increased more than threefold in real terms between 1984 and 1993. The resources raised through money creation—seigniorage—have been exceptional, peaking at almost 11 percent of GDP in 1993 (1 to 2 percent is typical in market economies). In this environment China's central authorities have so far been able to contain inflation by periodically stepping in with administrative controls; these will become less effective as reforms progress.

Demand for money is likely to grow more slowly in China in the future, for three reasons: money balances are already high, close to GDP in 1994; alternatives to bank deposits—equities, enterprise bonds, foreign currency, and real assets—are increasingly available; and capital movements are becoming de facto more open. Bank financing of public sector deficits will then more readily translate into inflation. This adds to the urgency of reducing these deficits—not by administrative fiat but by addressing their structural roots—and expanding the scope for noninflationary deficit financing through domestic bond issues.

Administrative controls still played their part in cooling off an overheated economy in 1994–95. But at the same time central bank credit to the banking system was reduced, and the consolidated public sector deficit has begun falling. To consolidate these gains, China will need to accelerate reforms in the state sector. Improving the effectiveness of indirect instruments of monetary policy requires hardening budget constraints on both enterprises (to increase their interest rate sensitivity) and banks (to strengthen risk considerations in loan decisions and pricing). This will entail deepening reforms in a number of difficult areas that governments in CEE and the NIS have been grappling with,

such as bankruptcy and liquidation, layoffs, state bank restructuring, social assets of enterprises, and a social safety net for urban employees (Chapters 3, 4, and 6).

CEE and the NIS: A tortuous path of inflation

Inflation in CEE and the NIS has broadly followed three stages, each corresponding to a phase of reform. The first, during the early months of liberalization, involved the release of the monetary overhang (excess money supply) that had accumulated under central planning. The second, spanning years two and three of liberalization (in some cases longer), has been linked mostly to the speed with which subsidies to enterprises were phased out and prices not previously freed were decontrolled. The third stage, usually reached once inflation has fallen below 40 percent a year, concerns mainly the more advanced reformers and involves exchange rate policy and capital flows. The essence of the inflation story in most CEE countries and NIS is that free market reforms first turned high, repressed inflation into high, open inflation, and then further liberalization and tight financial policies brought inflation down by containing persistent domestic subsidy pressures. This is in stark contrast with the story in China, and somewhat different from that in Vietnam, which experienced high, open inflation already under central planning but since then has sustained sharp cuts in subsidies to enterprises (see Box 1.4).

THE FIRST STAGE: AN INFLATION THAT CAME IN FROM THE COLD. In CEE and the NIS inflation came into the open—suddenly in most countries—and prices soared when they were freed. Money in circulation and in banks exceeded the value of goods and services that firms and households wanted to buy, and this monetary overhang flooded the market, driving up prices. The price stability of the planning system had become untenable, because inflation had been repressed. By late 1991 many black market prices in Russia were five times higher than official prices, the black market exchange rate reached more than forty times the official level, and grain hoarding had become so widespread that supplies for large urban areas were in jeopardy.

This burst of inflation in the first year of liberalization was associated with huge currency depreciations in many economies in CEE and the NIS, regardless of the exchange rate regime. Equilibrium exchange rates are difficult to determine, especially in transition economies, and, in general, when economies with deep inefficiencies open up to world trade some initial depreciation is to be expected. But the data suggest that the initial devaluations in Poland and the former Czechoslovakia were four times larger than what would have been necessary to maintain purchasing power parity for Polish and Czech goods; the Bulgarian lev fell to one-seventh its purchasing power

parity (PPP) value, and the Russian ruble to about one-tenth a "normal" level. Capital flight and long-repressed demand for foreign goods placed continued pressure on exchange rates, and this accelerated domestic inflation through rising import prices.

In the NIS the lack of monetary policy coordination in the ruble zone (the common currency area on the territory of the Soviet Union after its disintegration) exacerbated inflation and created severe payments problems for interstate trade. At the start of 1992 fifteen national banks, acting as new central banks, tried to outbid each other in emitting credit, because the proceeds would accrue domestically while the costs, in higher inflation, would be dispersed throughout the ruble zone. The National Bank of Ukraine was especially active in this. In June 1992 the Russian central bank stopped the automatic clearing between bank deposits in other NIS and those in Russia, but then it began to issue large amounts of "technical" credits to many NIS to be used to purchase Russian goods. In Uzbekistan such credits amounted to 60 percent of GDP in 1992. These problems set the stage for the introduction of new currencies throughout the NIS.

THE SECOND STAGE: THE STRUGGLE TO REGAIN CONTROL. The main culprit in prolonging high inflation was rapid monetary expansion (Table 2.3). Slow reformers permitted rapid growth in the money supply and thereby ended up with the highest inflation rates; the more advanced reformers, by contrast, posted the smallest money supply growth on the way to recording the lowest rates of inflation. In the NIS inflation followed growth in broadly defined money with a rather short lag of four months. In contrast to developments in China, demand for real money balances in the NIS declined, further raising inflation. Households and firms began to adjust to high inflation; in Belarus, for example, the real money stock fell by half in a two-year period.

Generous central bank credits were the main cause of inflationary money supply growth in this stage. Over the three years 1992–94 net domestic credit in Poland roughly tripled in nominal terms, and the money supply roughly tripled in parallel. By contrast, in Russia both grew roughly 150-fold during the same period. Much domestic credit went to support the budget, in response to severe fiscal problems associated with the onset of reforms. For the NIS in particular, transition meant a precipitous fall in government revenues. Receipts from the state enterprise sector fell sharply, and the new tax administrations proved unable to tax the emerging sectors (Chapter 7). At the same time pressures grew to maintain expenditure at high levels, especially for social purposes. Price liberalization also exposed the extensive systems of cross-subsidies inherent in the planned economy, shifting all or most of the cost onto the budget. Fiscal deficits were fairly large during 1990–94, averaging 6 to 7 percent of GDP in Bulgaria, Hungary (which had substantial interest payments), and Uzbekistan. They were even higher in Russia, averaging 12 percent of GDP.

To ease budget pressures, many governments mandated that the banking system undertake quasi-fiscal activities, most often by extending highly subsidized credits to state enterprises to shore up past patterns of production and employment. Many enterprises found that their cash balances had been severely devalued, and they demanded additional credits. They received the backing of officials who believed that a shortage of real money balances was largely responsible for the output drop. For example, in Russia in mid-1992 these officials argued that the money supply had to "catch up" with the price increases that had occurred since the beginning of the year. Among slower reformers in CEE and the NIS, credit subsidies from the central bank were often around three times the size of the fiscal deficit.

Table 2.3 Inflation and money supply growth
(percentages per year)

Country group	Average inflation			Growth in money supply, broadly defined ^a		
	1992	1993	1994	1992	1993	1994
CEE and NIS ^b						
Group 1	58	27	19	60	31	28
Group 2	554	169	78	..	110	65
Group 3	1,273	1,163	723	473	276	170
Group 4	829	2,390	1,547	..	1,171	1,112
China and Vietnam	11	9	15	33	25	28

.. Not available.

Note: Data are simple averages for the countries in each group (see Figure 1.2).

a. The definition of the money supply used for each country is the one that most closely approximates M2; its growth is measured from end-year to end-year.

b. Countries severely affected by regional tensions have been excluded.

Source: IMF and World Bank data.

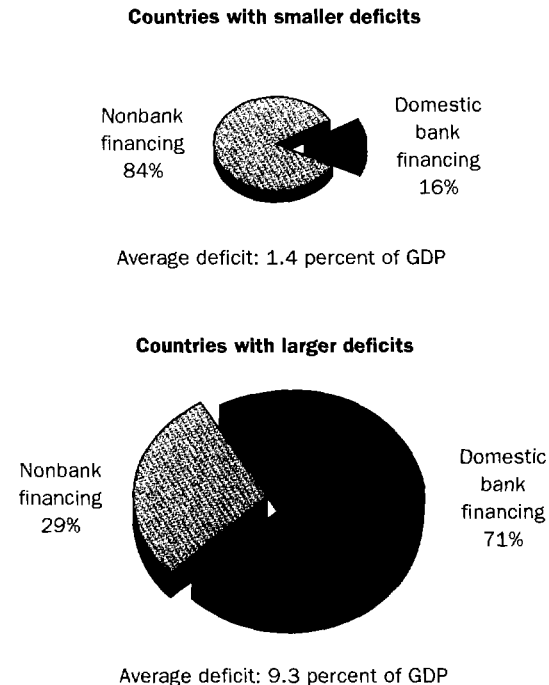
Financing these fiscal and quasi-fiscal deficits in a non-inflationary manner was not easy, and most ended up being funded through seigniorage—put simply, by printing money (Figure 2.6). Inflation, fueled by excessive money supply growth, levied an implicit “inflation tax” on individuals by reducing the real value of their money holdings. This caused huge transfers of income and wealth among households, enterprises, and banks (Box 2.6). Seigniorage averaged more than 16 percent of GDP in Russia during 1992–93, about the same as total central government revenues. In CEE it was more modest, averaging 5 to 6 percent of GDP in Poland and Hungary in 1990–92. Seigniorage in leading reformers has since stabilized at “normal” levels—about 1.5 percent of GDP.

Bringing inflation under control required a sustained reduction in money supply growth. Especially in the NIS, the combination of tightening monetary policy and shrinking money demand meant that, in stark contrast to the Chinese situation, banks could not make net resource transfers to the enterprise sector for any length of time. Monetary rigor had to be supported by sharp cuts in subsidies, especially those provided to enterprises through cheap central bank credits. This, in turn, required sustained liberalization to eliminate the losses due to price controls and other government interventions and to break the close link between enterprises and governments. The experience of successful stabilizers also suggests that positive real interest rates contributed to remonetizing the economy (by raising the demand for money) and stemming currency depreciation. These developments, together with greater central bank independence, bolstered confidence in stabilization programs. By 1993–94 reformers in Group 1—the Czech and Slovak Republics, Hungary, Poland, and Slovenia (see Figure 1.2)—had achieved moderate rates of inflation, averaging 23 percent a year. Annual inflation averaged roughly 120 percent in the Group 2 countries, about 930 percent in Group 3, and almost 2,000 percent in Group 4 (Figure 2.7). Even late or hesitant reformers had begun substantial monetary and fiscal adjustment (for example, Bulgaria’s budget deficit was cut by 7 percentage points in 1994). Inflation has now started to come down in all the CEE countries and NIS and remains extreme only in Tajikistan and Turkmenistan, where liberalization was least advanced.

THE THIRD STAGE: INFLATION AS A PRICE OF SUCCESS? Cross-country studies of market and transition economies alike suggest that bringing inflation down from high to moderate levels (around 40 percent a year) is unambiguously good for growth; the direct effects of reducing it further are less clear. Growth resumed in the Czech Republic and Latvia at annual inflation rates of 10 percent and 26 percent, respectively, and in Poland, Estonia, and Lithuania at rates of 42 to 45 percent. However, transition economies have good reasons to try to reduce infla-

Governments running larger deficits rely more on the printing press.

Figure 2.6 Bank and nonbank financing of fiscal deficits



Note: Data are simple averages for six transition countries with deficit-GDP ratios smaller than 5 percent (Croatia, Estonia, Latvia, Lithuania, Poland, and Slovenia) and eight with ratios greater than 5 percent (Albania, Belarus, Bulgaria, Hungary, Kazakhstan, Moldova, Russia, and Slovak Republic). The ratio for each country is the annual average for 1992–94. Source: IMF and World Bank data.

tion below 40 percent. Governments need to build confidence in their currencies (in many cases new ones) and credibility for their policies. Relatively high levels of inflation make this more difficult, by raising the probability that inflation will spiral out of control in the future. Countries should also note that the seigniorage revenues they can now earn at moderate rates of inflation are likely to evaporate as financial systems adjust.

One major obstacle to bringing inflation down further is incomplete price reform. In many transition economies

Box 2.6 Redistribution through inflation: The Russian experience

Inflation in the presence of low nominal interest rates redistributes wealth from savers to borrowers by eroding the real value of savings and debt. In 1992 an enormous inflation tax of 30 percent of GDP was levied on financial assets in Russia (see table). Households lost the equivalent of 12 percent of GDP. Some enterprises also lost, but others gained, as did the financial sector (including the central bank). Large enterprises and financial conglomerates were the main winners.

The inflation tax took a quarter of household income, further depressing consumption. It was also probably regressive, falling on the poor more than on the rich. Moving into dollars or real assets usually involves a transaction of a certain minimum size, which lower-income households can seldom muster—a phenomenon that is well documented in Latin America. Surveys of Russian households confirm that those with higher incomes hold most foreign exchange, and that those with lower incomes *in particular express great concern about inflation.*

Because inflation wiped out personal savings, it disproportionately affected those who had saved the most. The elderly, increasingly seen selling flowers or family heirlooms on the street, are one such group. But there are others. Under the Soviet system, generous wage and pension benefits had been used to encourage people to move to remote locations—the hope being that after a few years' work they would have enough money to buy a house in central or southern Russia. Most Russians who now live in Vorkuta, in the extreme north, went there to work in the coal mines for exactly that purpose. Now, however, their supposed retirement savings will not even buy airfare back to central Russia, and the people of the city find themselves stranded just when the coal mines are about to close.

Gainers and losers from inflation in Russia
(percentages of GDP)

Category	Losses	Gains	Net gain
Households	12	0	-12
Enterprises	18	16	-2
Financial sector	0	8	+8
Government	0	4	+4
Other NIS	0	2	+2
Total	30	30	0

Note: Data are for the period from February 1992 to January 1993.

Source: Easterly and Vieira da Cunha 1994.

the prices of energy and some services are still far below world levels and will therefore increase substantially in coming years. A recent World Bank study on Russia indicates that prices for housing, transport, and telecommunications (relative to those for manufactured goods) would have to increase roughly sixfold from their 1994 levels just to reach 60 to 75 percent of their relative values in industrial market economies.

Large inflows of foreign capital, including some reversal of capital flight, also frustrate the lowering of inflation, because they add to the money supply and put pressure on prices. This has been a particular problem for more advanced reformers. In a sense it is indeed a price of success, since investors are attracted to the large growth potential and high returns on investment that stem from liberalization and moving to a market economy. But extremely devalued currencies have also been a factor (Latvian prices were around 7 percent of Swedish levels in July 1992). The capital account in CEE went from net outflows of \$8 billion in 1991 to net inflows of \$13 billion in 1993; inflows also rose sharply in Russia and Vietnam in 1995.

Domestic prices will inevitably have to rise relative to foreign prices, in response to these inflows. But opinion differs over whether advanced reformers should allow this to occur through inflation or through nominal currency appreciation. How long should they allow the inflows to feed through to domestic prices, without adjusting the exchange rate? There is no unambiguous answer. Considerations of the size of the current account deficit and the sustainability of capital inflows aside, transition countries can have strong reasons to keep the exchange rate unchanged. In particular, they may fear that an early exchange rate adjustment will tarnish their hard-won credibility with financial markets and, just as important politically, deprive exporters of the partial shelter of an undervalued currency. The trouble is that most of the alternatives to a nominal appreciation carry other costs. Some countries that have put off changing the exchange rate have tried to limit the inflationary impact of inflows through tight fiscal policy, or by requiring commercial banks to increase reserves. Others have issued bonds in an attempt to mop up surplus cash. Yet such sterilization is expensive, especially in transition economies with underdeveloped capital markets, because the central bank pays far more on the bonds than it receives on its foreign reserves. It also puts upward pressure on interest rates, which can hurt domestic borrowers while actually fueling the problem it is trying to address, by attracting yet more foreign capital. Placing controls on foreign capital flows is no solution: experience in Asia and Latin America suggests that such controls increase the cost of capital in the short term and are ineffective in the long term.

Stabilization pegs—and chronic arrears

Like market economies undergoing adjustment, transition economies have faced a variety of issues related to the design of a stabilization program. The experience of different transition countries has afforded tentative answers to at least some of these dilemmas.

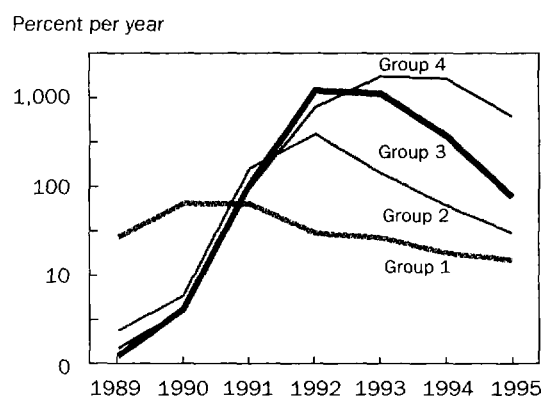
One key question is whether a fixed or a flexible exchange rate is more effective, and less costly, in bringing down inflation. Experience in transition economies shows that inflation has been reduced significantly under both fixed exchange rates (Croatia, the Czech and Slovak Republics, Estonia, Hungary, Poland during most of 1990–91) and flexible arrangements (Albania, Latvia, Moldova, Slovenia, Vietnam). However, studies suggest that although reducing fiscal deficits is crucial for disinflation under both arrangements, a fixed exchange rate can help to bring high inflation down more rapidly and at lower cost to growth. One reason is that the automatic exchange of foreign for local currency by central banks at a fixed rate lets enterprises and households rebuild their real money balances more easily. Also, with flexible rather than fixed exchange rates, domestic authorities have complete discretion over monetary policy, so they have to tighten credit further to make their commitment to stabilization credible. Early in the stabilization process, a fixed rate may thus be a useful policy instrument. Over the medium term the choice of exchange rate regime remains an open question.

Can incomes policies also help restrain inflation? In market economies, incomes policies (for example, penalty taxes on “excess” wages) have a decidedly mixed record at controlling wage increases and promoting price stability. But many analysts consider temporary wage controls an essential component of macroeconomic policy in transition economies, particularly as a substitute for strong owners where unions are powerful, to limit cost-push inflation from rising wages. A study of Poland found that wage controls did inhibit pay increases, although wages beyond the ceiling were paid. By and large, wage controls seem rarely to have been binding during the early stages of price liberalization, and they have not in themselves been sufficient to restrain wages in countries without supporting fiscal and monetary restraint.

When should countries move toward flexible interest rates? As market forces gain strength in transition economies, indirect monetary controls become more effective than direct ones. They do not encourage the growth of informal financial markets, which erodes the share of credit that the authorities control directly, and they help depoliticize the allocation of credit. But the particular problem facing transition economies is that the widespread insolvency of banks and enterprises, together with the legacy of passive creditors and the absence of strong owners, means that a broad spectrum of borrowers will

Progress with liberalization brings down inflation.

Figure 2.7 Time profiles of inflation by country group



Note: Countries in CEE and the NIS are grouped by their average liberalization index scores for 1989–95 (see Figure 1.2). Countries severely affected by regional tensions are excluded. Annual inflation rates are simple averages for each group. Inflation is plotted on a logarithmic scale. Source: IMF and World Bank data.

want to borrow more, not less, when interest rates rise. This distress borrowing can result in an extended period of very high real interest rates followed by financial crisis. Experience indicates some ways to limit the problem. First, the authorities can enhance the pace and scope of interest rate liberalization by taking steps to increase competition in financial markets as well as to deal with insolvent banks and enterprises. Second, they can exclude unsound banks from credit auctions (as most countries already do). And as in the Kyrgyz Republic and Poland, they can prohibit banks from making new loans to firms in severe difficulty before the start of bank and enterprise restructuring (see Chapters 3 and 6).

How should pervasive arrears be handled? Particularly in transition economies, stabilization policy is complicated by the arrears that enterprises run up with one another, with banks, or with government (in the form of tax and social security arrears). But one lesson of the past few years is that growth in arrears to unsustainable levels is not an inevitable by-product of stabilization. Cross-country expe-

rience shows that credible stabilization, including a consistent refusal to inject new credit, is the best way to combat increases in arrears. Where fiscal and monetary policies have been tight—as in the Visegrad countries, the Baltics, and the Kyrgyz Republic—creditors have learned quickly the consequences of not being paid and begin cutting off defaulting debtors. By contrast, irresolute stabilization policies reinforce expectations that government will bail out firms. Complex, centralized programs of netting or clearing arrears tend to fail for precisely this reason, especially when combined with credit injection. Instead of reducing arrears, they weaken financial discipline and encourage more arrears among enterprises, and the resulting high arrears equilibrium further undermines the credibility and effectiveness of macroeconomic stabilization (Box 2.7). Similarly, the secret of Estonia's success in curbing energy arrears (which have plagued many NIS) has been its strictly enforced policy of disconnecting nonpaying enterprises, which has proved a powerful deterrent. By contrast, a reluctance to cut customers off was a key factor behind the buildup of energy arrears in Lithuania,

Moldova, and Ukraine, where energy debts reached between 5 and 8 percent of GDP by early 1995.

As stabilization proceeds and enterprise budgets harden, interenterprise arrears decline and tax arrears rise. Many governments have been unable to enforce tax payment even where legally their claims have top priority, ahead of secured creditors (in Poland and the Czech Republic). Tax arrears (including interest and rescheduled overdue taxes) were estimated at 8 to 10 percent of GDP in Poland and Hungary by the end of 1993 and at almost half that in the Czech and Slovak Republics. In the NIS tax arrears are lower, but rising sharply. To address the problem, government first needs to clear any arrears for which it may itself be responsible. In Russia, for example, two-thirds of the amounts due to enterprises from government were in arrears in mid-1994. Such a stance undermines discipline in the rest of the economy and, as was seen in 1995, can have serious social consequences and fuel political opposition when it prevents workers from being paid. In most transition countries more than 95 percent of taxes due are still being paid, so the integrity

Box 2.7 Government's best response to interenterprise arrears? Strengthen financial discipline

Interenterprise credit typically rises rapidly in the early stages of transition. This partly reflects an adjustment to levels of trade credit common in established market economies. But often interenterprise credit rises further and turns into arrears, as sellers, used to getting paid, continue shipping goods to buyers who have increasing difficulty paying. Afraid that the liquidation of some firms could ripple through the economy in a domino effect and force the liquidation of others, governments often look for measures to reduce exploding interenterprise arrears. But experience shows that interventions can easily backfire and undermine financial discipline.

Kazakhstan, Romania, and Russia all implemented a centralized netting out of arrears between firms. In theory such netting can reduce the stock of gross arrears without changing the net position of firms. In practice, however, netting exercises are technically complex. Some firms owe others more than they are owed themselves. The Kazakh, Romanian, and Russian programs did not differentiate adequately between enterprises with net credit and those with net debt. Firms were issued new credits sufficient to pay off outstanding debts over and beyond what they were owed themselves. The result was an inflationary net expansion of credit, and the message to enterprises was that both

debtors and careless creditors would be bailed out. Enterprises responded with business as usual, and arrears rose further.

Poland's firm stance on stabilization convinced enterprises that they would not be bailed out, and they became cautious before shipping goods to buyers. Changed expectations reinforced hard budget constraints and eventually stopped the growth of arrears. Poland has also experimented with an alternative method for clearing arrears. Creditors can sell their claims on a secondary market. Because the sale is at a discount, the creditor loses value and learns to be more careful. Buyers of claims can use them to pay for goods and services purchased from the debtor firms. In principle, such markets in secondary debt can help impose financial discipline and reduce arrears without direct government involvement. Their volume and effectiveness in Poland, however, have so far been limited by high transaction costs, by difficulties in resolving disputed claims, by banks' hesitation to sell the bad debt of longstanding customers, and by the legal requirement that debtors consent to the use of claims as payment. Thus, in Poland as elsewhere, conventional debt collection methods—reputation, informal cajoling, debt contract enforcement, foreclosure on collateral, and bankruptcy (Chapter 5)—remain the principal recourse for aggrieved creditors.

of the tax system is not in jeopardy. Heroic efforts to collect taxes from severely distressed firms are unlikely to yield much additional revenue. But tax forgiveness across the board should be avoided since it encourages further increases in arrears. Governments should instead handle tax arrears through case-by-case debt workout schemes. These should be accompanied by improved accounting and auditing, the selective use of bankruptcy, and seizure of commercial receivables and other liquid assets to prevent the problem from recurring. The difficult task, which no country has mastered, is to design a support system that credibly targets subsidies to the most difficult cases, such as distressed enterprises in one-company towns, and keeps subsidies limited, temporary, and fiscally affordable (Chapter 3).

Into the future: What is needed to sustain growth and stability?

Strong liberalization and stabilization help transition economies correct their inherited inefficiencies and macroeconomic imbalances and move to a path of secure and rapid growth. But what can transition economies do to stay on that path?

Lessons from abroad: Get policies right and stick with them . . .

What can transition economies learn from periods of sustained rapid growth elsewhere? One key lesson is that both sound policies and consistency matter. Liberal, pro-competition policies create the potential for enhanced domestic growth, external trade, and access to financing. But countries will only fully exploit this potential by being consistent over time.

Consider postwar Western Europe. Germany's fast recovery and subsequent growth explosion have often been described as an economic miracle—GDP growth averaged 9 percent between 1948 and 1960. Closer examination dispels much of the miracle explanation. Part of the very strong expansion in the initial period was due to catch-up; Germany also benefited from Marshall Plan aid, increased human capital through migration, improvement in the terms of trade, and a strong expansion in foreign markets. But the key to Germany's sustained rapid growth was its consistently market-friendly growth strategy, which included price and trade liberalization, currency reform, tax reductions, and the establishment of strong enabling institutions such as the Bundesbank. Transition economies, like established market economies, benefit from consistent rather than stop-go policies.

Growth averaged 9 percent in Japan during 1948–60, close to 7 percent in Indonesia during 1970–93, and 8 percent (with a rising trend) in the Republic of Korea during 1956–87. In each case growth recovered and surged

after a severe economic crisis. In addition to having large agriculture sectors that could serve as a springboard for growth, these countries owed their success mostly to getting the policy basics right. Consistently good macroeconomic management, banking reforms that promoted saving, and a strong focus on education and a suitable skill mix provided the framework for high and rising private investment. And in all the rapidly growing Asian economies favorable trade policies have allowed exports to be a major engine of growth.

. . . And encourage strong saving and investment

As was shown all too clearly under central planning, high investment alone does not guarantee fast growth. The composition and quality of investment, as well as human capital and technological know-how, are also critical. However, sustained rapid growth has been associated with exceptionally high saving and investment rates worldwide. Saving generally averages at least 25 percent of GDP and investment at least 30 percent in fast-growth periods (Figure 2.8). In CEE and the NIS both the rate of capital accumulation and the efficiency of investment are presently inadequate to sustain rapid long-run growth. In CEE in 1994, saving averaged about 15 percent of GDP and investment 17 to 18 percent; average saving and investment rates in the NIS were close to 20 percent. Capital productivity, historically very low in both regions, has recently begun to recover in the leading reformers, but continued improvements will be critical for sustaining growth.

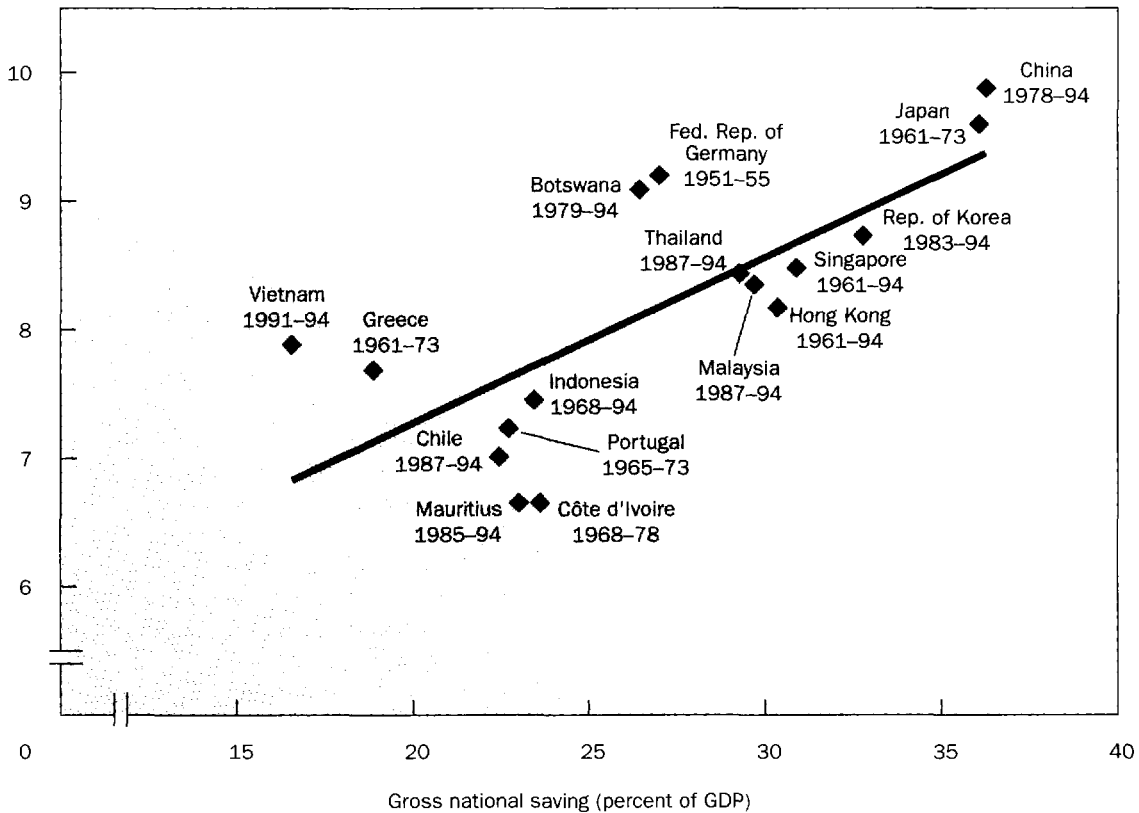
In contrast, saving and investment rates are now approaching a very high plateau in China and are still rising from already respectable levels in Vietnam. Productivity gains will become an increasingly important source of growth in years to come, particularly in China, where saving—and thus investment—rates are likely to decline over the medium term. Given the shrinking scope for improving efficiency through further shifts in resources, achieving these gains will increasingly depend on broadening enterprise and financial sector reforms that boost efficiency at the firm and the industry level. These are likely to include reforms in ownership and allocation of investment. In China, for example, overall productivity in the nonstate sector has been increasing at 4 to 5 percent a year, more than double the rate in the state sector, which continues to absorb the bulk of investment credit. It would be preferable for the government to take the greatest possible advantage of current rapid economic growth to implement difficult but necessary state sector reforms.

What role is there for foreign saving and investment? High investment can be financed externally for some time, but it is funded overwhelmingly by domestic saving in the long run. This is due to a home bias in saving and

Sustained, rapid growth depends on high rates of saving.

Figure 2.8 Saving rates and GDP growth during high-growth periods in selected economies

GDP growth (percent per year)



Note: Data are annual averages for the periods indicated. Source: IMF, various years (c); official data; World Bank staff estimates.

investment decisions, limited international capital mobility, the dominant role of retained earnings in funding corporate investment (accounting for the bulk of private investment in industrial countries), and lending constraints imposed by world capital markets. In transition economies, with their weak domestic capital markets and still generally poor credit ratings, promoting domestic saving is especially important. Foreign investment, despite its many benefits, cannot be a substitute for domestic investment.

How can governments promote domestic saving and effective investment? Mitigating economic uncertainty and

checking capital flight are critical, and both require most of all ensuring macroeconomic stability. Fiscal reform is crucial: higher public saving, through reduced government deficits and spending, directly increases total saving and means less crowding out of private investment. This is particularly important in those transition economies where government is still large (as in the Visegrad countries; see Chapter 7) or has pursued loose fiscal policies (as in Bulgaria and Tajikistan). A liberal foreign exchange regime and market-determined interest rates are also important, as are sound and stable legal, banking, and government institutions. Progress in these directions, particularly the last,

will be difficult for transition economies—even in eastern Germany, where western German institutions have been adopted wholesale, firms single out legal uncertainty and administrative problems as the key obstacles to investment.

Prudent fiscal policies also support growth by preventing the government from running up an unsustainably high debt burden. Most CEE countries and NIS, with the notable exceptions of Bulgaria, Hungary, Poland, and Russia, started with little debt, but many have since run large fiscal deficits, leading to a sharp rise in public indebtedness. The long-term costs of government living beyond its means are well illustrated by Hungary, which has the largest foreign debt per capita among transition countries. Unlike some other heavily indebted reforming countries, Hungary has continued to service its foreign debt without debt reduction or rescheduling. Repayments and interest have largely been financed by more borrowing, both domestically and externally, resulting in rapid growth in the public debt stock. But financing this debt has become hugely expensive. High and rising interest payments increasingly eat into other government spending, because revenues are at a plateau yet budget deficits need to be reduced to keep the debt burden sustainable. The government has therefore decided to use part of the one-off revenues from privatization in 1995 to retire some of its high-interest domestic debt. This may well turn out to be a good investment for the future.

How long will it take to catch up?

Popular wisdom in early postwar Germany was that it would take decades before the average person would own a second pair of shoes. It took five years. When Germany was unified, politicians promised and people hoped that the eastern *Länder* would catch up with their western counterparts in less than five years. By all accounts it will take much longer. So how long might it take for the more advanced CEE and Baltic reformers to reach income levels comparable to those in European market economies? And how long for most of the NIS, China, and Vietnam to join the East Asian newly industrializing economies?

Arithmetic catch-up calculations, with all their limitations, do provide a sobering perspective on the magnitude of the tasks ahead. For China they suggest that it would take five or six years of growth at present rates to reach the current income level in Indonesia and between ten and fif-

teen years to reach that in Thailand. For the Visegrad countries and Slovenia they suggest that it would take about twenty more years at present growth rates to reach the average income level of the EU countries in 1994. Actually catching up with EU average incomes would require much faster growth (around 8 percent a year) or significantly more time (around forty rather than twenty years). Most estimates based on actual conditions in Germany place the catch-up period for eastern Germany at between ten and twenty years; by implication, the catch-up period for the CEE countries and the NIS would be longer, because they lack eastern Germany's favorable initial conditions and rich "big brother." Recent empirical work assesses the prospects for faster CEE catch-up through sustained high growth rates. To make this scenario a reality, CEE countries would need to adopt more market-friendly fiscal policies, including lower marginal tax rates and current government expenditures, an overhaul of government-funded pensions (Chapter 4), and efforts to strengthen government investment—in addition to completing enterprise and financial sector reforms (see Chapters 3 and 6).

The agenda

The clear lesson of transition in both Europe and Asia is that countries that liberalize markets and preserve economic stability are rewarded with resumed or accelerated growth in output and productivity. China's contrasting initial conditions and strong macroeconomic control enabled it to take a more gradual and phased approach to transition. But the main engines of rapid growth in China have been the same as in the successful CEE countries and NIS: rapid entry of new firms, including in the service sector, and growth in exports. China's major challenge for the future is to exploit the large potential efficiency gains from further enterprise and banking reforms and, as the supply of low-cost savings falls with continuing reforms, to enable these funds to be reallocated to more productive sectors. Advanced reformers in CEE and the NIS also have to consolidate their gains, through continued sound macroeconomic policies, and to encourage higher saving and investment by avoiding overregulation and by slimming and reorienting government. Less advanced reformers still face the more urgent task of freeing their economies from the macroeconomic instability and remaining state controls that impede recovery.