CHAPTER III TRANSITION: EXPERIENCE AND POLICY ISSUES

The rise and subsequent failure of central planning ranks among the most significant events in the twentieth century, posing major challenges to both economic theory and policy from Prague to Beijing.[1] By the late 1980s the limitations of central planning had become very clear, and, since the fall of the Berlin Wall, countries that had maintained centrally planned economies have been—with the assistance of the major international institutions (including the IMF; Box 3.1)—engaged in a historic transition process to market economies.[2] As a result, both the economic structure and the behavior of consumers and producers have undergone major changes, although progress has been very uneven among the participating countries. While much has been achieved, the process has turned out to be much more difficult than anticipated at the outset, and in retrospect it is clear that policies pursued in transition have not always been ideal. In particular, although the need for an institutional infrastructure to support the nascent market economies was recognized from the beginning, in practice such institution building was not always given adequate attention.

This chapter summarizes the results of the transition process to date, including the reasons why results have varied widely between the different transition countries. While it is still too early to pass a final judgment on many aspects of the transition process, the chapter also reviews the main policy lessons that can be drawn from the experience to date and the policies required to move the transition process forward. Specific attention is paid to the political economy aspects of the transition process and how they help to explain intercountry differences in reform efforts and results. Given the scope of the topic, the chapter is necessarily selective. The issues chosen for discussion and the lessons highlighted are those that, from the perspective of the *World Economic Outlook*, seem most striking and relevant.

Among the many legacies of the now defunct systems of central planning, one of the most detrimental was the absence of an institutional and legal infrastructure underpinning the operation of market-oriented economies.[3] There was an absence of well-defined property rights, commercial legislation regulating the entry and exit of private enterprises, financial markets, a commercial banking system, open labor markets, and a market-oriented system of taxation. By definition, central planning implied massive direct government involvement in economic decision making. The absence of market-generated signals about the relative scarcities of outputs and inputs led to highly distorted relative prices and output structures, while ideological suppression of the profit motive reduced innovation, entailing a growing technology gap between the centrally planned and the advanced market economies. The policy bias toward autarky within the Council of Mutual Economic Assistance (CMEA) disregarded potential gains from global international trade, and, in any case, the absence of a domestic price system that signaled relative scarcity made it difficult for countries to identify their "true" international comparative advan-

[1]See Chapter V, "The World Economy in the Twentieth Century: Striking Events and Policy Lessons," in the May 2000 *World Economic Outlook*.

[2]In China and some other east Asian countries with centrally planned economies, the transition began much earlier, although initially with the prime objective of improving rather than abolishing the planned economy.

[3]The only countries currently holding on to central planning and the predominant state ownership of means of production are North Korea and Cuba.

Box 3.1. The IMF and the Transition Economies[1]

When the 25 countries of central Europe, the Baltics, and the Commonwealth of Independent States (CIS) embarked on the transition process, they sought external assistance from a variety of sources, including the IMF.[2] By the early 1990s, all 25 countries had officially become members of the IMF. Soon thereafter, virtually all requested and received financial assistance from the IMF. Based on the necessarily limited experience of countries confronting similar issues, the appropriate transition strategy was hotly debated within and outside the transition economies, including at the IMF. In the international financial community a general consensus was reached on the desirability of a comprehensive approach to deal simultaneously with the liberalization, stabilization, and structural transformation of the economies. To assist the initial stages of the transition, a new IMF lending facility called the Systemic Transformation Facility (STF) was established for a limited period (1993–95). The STF, which had lower conditionality and access than the more traditional IMF facilities, was designed as a stepping stone to the latter.

Throughout the transition years, international institutions, including the World Bank and the IMF, as well as bilateral donors, extended considerable technical assistance, principally in support of national authorities' efforts to build the economic institutions needed for a well-functioning market economy. The IMF helped to draft legislation and provided technical assistance principally in three areas. In the financial sector, the IMF helped to transform the former monobank into a central bank and a commercial banking system and to introduce new payment systems. It also advised countries on banking supervision and prudential regulations, foreign exchange management, and market-oriented monetary policy tools. In the fiscal area, the IMF helped to set up new treasury and new tax systems and provided guidance on improving tax administration and public expenditure management. In the statistical area, the IMF helped to set up new statistical systems for national accounts and prices, balance of payments, money and banking, and public finance accounts. Over time, the emphasis shifted to improving the quality and reliability of data and its timely dissemination. As the Table shows, all three regions received technical assistance at a fairly early stage of the transition. Among the regions, the CIS countries (which had the weakest institutions) have been the largest beneficiaries, with assistance continuing at a fairly intense pace in the later years.

Economic policy advice was also provided by the IMF from the start of the transition process. In the early years of transition, 18 transition economies received financial assistance from the STF. With the exception of some central and eastern European countries, financial access to the more common IMF facilities came later—for example, programs in more than half the CIS countries began only in 1995. Delays typically occurred because it took time to reach agreement on a common policy framework with the authorities or to ensure that basic elements of a market framework existed before programs were implemented.[3] For these reasons, and to assure the commitment and capacity of the authorities to deliver, IMF programs often had a number of "prior actions" (a standard element of most IMF-supported programs), mainly structural reform measures or enactment of necessary legislation that were expected to be undertaken before disbursements began on an IMF-supported program.

[1]For further reading, see Stanley Fischer and Ratna Sahay, "The Transition Economies After Ten Years," IMF Working Paper 00/30 (Washington: International Monetary Fund, 2000); and Charles Wyplosz, "Ten Years of Transformation: Macroeconomic Lessons," a paper prepared for the Annual World Bank Conference on Development Economics, April 28–30, 1999 (unpublished; Washington: The World Bank, 1999).

[2]This box primarily discusses the role of the IMF in the transition economies of central and eastern Europe and the CIS. It should be noted, however, that the IMF has also provided substantial financial and technical assistance to other transition economies in east Asia.

[3]Other reasons were that, in many countries, new currencies were not introduced until late 1993 or 1994, while in some others civil conflicts precluded stabilization and reform.

Box 3.1 *(continued)*

IMF Assistance in 25 Transition Economies

	Central Europe (10)[1]			Baltics (3)[1]			CIS Countries (12)[1]		
	1989–91	1992–95	1996–99	1989–91	1992–95	1996–99	1989–91	1992–95	1996–99
IMF-supported programs[2]	40	73	60	—	100	83	—	35	71
IMF financial assistance									
In percent of IMF Quota	64.1	27.9	35.7	—	58.9	—	—	47.6	57.4
Billions of U.S. dollars (net basis)[3]	2.4	–0.7	–0.1	—	0.5	–0.2	—	12.6	8.8
Technical assistance (person-years)									
Fiscal area	7.1	20.7	13.1	—	7.6	2.8	2.9	57.0	53.9
Financial sector	11.6	25.2	20.1	0.3	9.6	7.6	0.6	66.3	51.5
Statistics	1.2	4.9	4.5	—	5.7	—	0.8	22.1	21.6

Source: International Monetary Fund.
[1]Number of countries in parenthesis.
[2]The percentage of the period during which countries in the group had an IMF-supported program in at least part of the calendar year. Excludes the STF, extended to 18 countries during 1993–95, with a maximum access of 25 percent of their quota.
[3]On a cumulative basis over the indicated period.

The design of IMF-supported programs in the region typically had several common elements, reflecting the fact that all economies were going through similar systemic changes, but at the same time were flexibly designed to suit local conditions. The common elements included the large-scale freeing of price and exchange regimes in tandem with firmer monetary policies, internal and external trade liberalization, demonopolization of large enterprises, rapid privatization of retail trade, encouragement of small businesses, social safety net provisions in the budget, and an overhaul of the tax system. The programs also differed in many important ways, depending on the countries' specific circumstances and the desires of domestic policymakers. For example, "heterodox" programs with wage controls were implemented where wage pressures were a concern. Many countries pegged their exchange rates, while others floated. Privatization programs ranged from voucher schemes to direct sales of enterprises. Subsidies were removed at varying speeds; for example, in the relatively low income countries, energy prices and utility charges were raised more slowly. Occasionally, as in the Baltic countries, fiscal deficits were designed to widen temporarily to accommodate the financing of growth-enhancing reform measures.

As discussed in the main text, there has been considerable heterogeneity in the reform efforts and economic performances of the transition countries during the past decade. Several key factors mainly explain this heterogeneity, especially substantial differences in initial conditions, in the external environment facing different transition countries, and, perhaps most important, in the willingness and ability of national authorities to implement and maintain political support for consistent and sensible policies of economic stabilization and structural reforms—with or without support from the IMF or from the international community more generally. Because these factors were the dominant determinants of the relative success of the transition process in different countries, assessing the contribution of the IMF-supported programs and policy advice is necessarily a difficult and delicate undertaking and one unlikely to lead to consensus or unambiguous conclusions.

Nevertheless, it should be recognized that, operating under IMF-supported programs, virtually all transition countries were able to reduce inflation from three- or four- digit levels fairly rapidly, and this disinflation was generally associated with reductions of fiscal deficits to manageable proportions. These achievements in the area of macroeconomic stability were important in their

own right and were at the core of the IMF's areas of responsibility. They were also a critical foundation for broader efforts at structural reform and institution building that are central to the transformation process. Although, among the international financial institutions, the lead in providing advice and assistance in several key areas of structural reform (including the form and sequencing of privatization, enterprise restructuring, design of social safety nets, and reforms of the legal system) was taken by the World Bank and other institutions, IMF-supported programs embodied important elements of structural reform. The structural reforms in IMF-supported programs generally had a longer time horizon for full implementation than the initial efforts targeted at macroeconomic stabilization.

Where reasonable fiscal discipline was maintained and meaningful structural reforms were pursued—generally under the aegis of IMF-supported programs—inflation typically remained well contained, and output recovered more rapidly than in countries where stabilization and reform efforts were less consistent and vigorous. In line with the principles of IMF conditionality, financial support was generally provided with fewer program delays and interruptions to those countries that implemented their stabilization and reform policies with greater consistency and vigor. As discussed in the main text, this group of relatively successful transition countries was primarily (but not exclusively) in central and eastern Europe and the Baltics, where relatively strong domestic commitment to reform was reinforced by prospects of EU accession, and where initial conditions typically were somewhat more favorable. Thus, the relative success of these transition countries cannot be uniquely or mainly attributed specifically to their adherence to IMF-supported programs; but in general terms, if not necessarily in all of their particular elements, these programs would seem to deserve some credit for that relative success.

The case of most of the CIS countries (excluding the Baltics) is more complex. The disintegration of the Soviet state and the associated collapse of trade and of demand for the products of key industries (especially in the military and industrial complex), termination of large implicit transfers from energy rich to energy poor regions, and the outbreak of armed conflicts occurring in some cases made for particularly unfavorable initial conditions. Understanding of the institutions and practices of a market economy was typically quite poor, and political support for implementation of serious policies of stabilization and structural reform—either rapidly or gradually—was usually weak. Perhaps the domestic political balance could have been shifted toward greater support for sensible and sustainable reform and the losses suffered by the general population could have been eased if, as some suggested, massive foreign financial assistance—a new Marshall Plan—had been made available under appropriate conditionality. Such large-scale external assistance, however, was simply not available. IMF lending to most CIS countries was significant, both as a share of countries' quotas in the IMF and in relation to other official creditors. But the potential scale of IMF lending (together with other external assistance) was never such as to be likely to change substantially the domestic political balance or to help countries absorb a major part of the cost of transition.

In the countries where the transition has been less successful, the IMF's role has tended to be more controversial. This is especially so for Russia because of its size and geopolitical importance and because the progress of IMF-supported programs was a subject of intense interest for many key players in the international community. For Russia, IMF-supported programs were associated with some significant successes, especially the reduction of inflation and the enforcement of meaningful fiscal discipline under the 1995 Stand-By Arrangement. In contrast, the Extended Fund Facility agreed in early 1996 was not a success; little progress was made in most key areas of structural reform and the erosion of fiscal discipline culminated in the devaluation and default of August 1998. Aside from these general observations, an assessment of the IMF's role in this critically

Box 3.1 *(concluded)*

important and highly complex case is beyond the scope of this Box.

For countries (including Russia) that have been less successful in the transition process, it is notable that most IMF-supported programs were subject to significant delays and interruptions. This reflected the normal IMF procedure of insisting on prior actions in key policy areas to demonstrate the commitment of the authorities before initiating IMF lending, and of interrupting a program's disbursements if the authorities fail to put forward reasonable efforts to meet a program's agreed objectives. In several cases (e.g., Bulgaria and the Kyrgyz Republic since 1995), this strategy proved effective in reinvigorating the stabilization and reform process. In other cases, success has remained elusive.

Arguably, in these difficult cases, a different approach by the IMF might have worked better. Perhaps the IMF should have been more sensitive both to constraints on the practical administrative capacity and to limits on the willingness or political ability of some national authorities to push through and sustain rigorous stabilization and reform programs, and should have been more accommodating when programs went off track. But in some of these difficult cases where political support for reforms was typically quite weak, it might have been better for the IMF to stand back from financing and wait for a more auspicious environment for meaningful reform. Judgment on these delicate questions is mainly a matter of political economy rather than of the technical economic content of IMF-supported programs. In the end, it is clear that domestic political support and the development of a viable institutional framework are essential to ensure that IMF-supported programs are effective—in the transition economies, as well as in other countries.

tage.[4] After having initially narrowed the gap with advanced market economies through forced industrialization, the relative performance of the centrally planned economies in terms of income per capita and international competitiveness deteriorated increasingly in the postwar period.[5] And incomplete or failed reform efforts aimed at stalling this relative decline led to unsustainable fiscal deficits and a large monetary overhang in many centrally planned economies in the late 1980s.

There was, however, a positive legacy of state socialism as well. Human capital endowment with respect to both health standards and levels of education was and still is relatively high in these countries compared with market-oriented economies at comparable levels of per capita income. And although comparisons in this area are fraught with statistical difficulties, incomes were apparently more evenly distributed than in the capitalist economies. In addition, the social safety net was both comprehensive and universal, guaranteeing work and thus income for everybody. These favorable aspects reflected policy priorities under state socialism. Their implications for successful transition are probably quite dissimilar. High levels of human capital should facilitate transition, but the comprehensive social safety net left people with little experience in dealing with economic uncertainty and adversity (e.g., unemployment), thereby making the transition more difficult. This is especially so in many countries of the Commonwealth of Independent States (CIS), where a lack of reform of enterprise-provided social services and benefits ties workers to chronically loss-making firms.

[4]The international specialization that did develop within the CMEA was predominantly based on a central-plan determined division of labor rather than on market-driven comparative advantage.

[5]Apart from entailing large private costs and inefficiencies due to the supression of market mechanisms, the system also led to major environmental problems by neglecting social costs in pursuit of policy priorities with regard to military buildup and energy sector development.

Table 3.1. Selected Characteristics of Transition Countries

Transition Country/Group[1]	Year Transition Began[2]	Starting Date of Stabilization Program[2]	Real Output Ratio 1999/1989	Average Inflation 1989–99	1999 EBRD Average Transition Indicator[3]	PPP GDP per Capita 1999
EU accession countries (excluding Baltics)	**1991**	**Mar–91**	**0.95**	**35.5**	**3.3**	**10,009**
Bulgaria	1991	Feb–91	0.67	68.4	2.9	4,812
Czech Republic	1991	Jan–91	0.94	7.8	3.4	13,408
Hungary	1990	Mar–90	0.99	19.7	3.7	11,273
Poland	1990	Jan–90	1.28	49.2	3.5	8,832
Romania	1991	Jan–93	0.74	76.1	2.8	5,798
Slovak Republic	1991	Jan–91	1.01	14.3	3.3	10,255
Slovenia	1990	Feb–92	1.05	12.9	3.3	15,685
Baltic countries	**1992**	**Jun–92**	**0.68**	**33.5**	**3.2**	**6,850**
Estonia	1992	Jun–92	0.78	24.3	3.5	7,909
Latvia	1992	Jun–92	0.56	35.1	3.1	5,893
Lithuania	1992	Jun–92	0.70	41.0	3.1	6,750
Other southeastern European countries	**1990**	**Jun–93**	**0.77**	**3,331.8**	**2.5**	**3,651**
Albania	1991	Aug–92	0.93	33.4	2.5	2,897
Bosnia and Herzegovina[4]	. . .	. . .	0.93	13,118.0	1.8	1,014
Croatia	1990	Oct–93	0.80	100.0	3.0	6,793
Macedonia, FYR	1990	Jan–94	0.59	75.6	2.8	3,903
Commonwealth of Independent States[5]	**1992**	**Aug–94**	**0.53**	**149.1**	**2.3**	**3,337**
Armenia	1992	Dec–94	0.48	106.5	2.7	2,469
Azerbaijan	1992	Jan–95	0.47	233.2	2.2	2,404
Belarus	1992	Nov–94	0.81	162.4	1.5	6,485
Georgia	1992	Sept–94	0.31	17.9	2.5	3,950
Kazakhstan	1992	Jan–94	0.61	77.3	2.7	4,351
Kyrgyz Republic	1992	May–93	0.61	22.3	2.8	2,419
Moldova	1992	Sept–93	0.31	16.5	2.8	1,847
Mongolia	1990	. . .	0.93	46.5	2.8	1,573
Russia	1992	Apr–95	0.55	88.0	2.5	6,815
Tajikistan	1992	Feb–95	0.29	688.5	2.0	1,045
Turkmenistan	1992	. . .	0.61	4.9	1.4	4,589
Ukraine	1992	Nov–94	0.35	169.4	2.4	3,276
Uzbekistan	1992	Nov–94	0.97	304.5	2.1	2,157
East Asia	**1986**	. . .	**1.78**	**17.1**	**2.1**	**2,042**
Cambodia	1990	. . .	1.62	6.3	2.5	1,261
China	1978	. . .	2.52	8.1	2.1	3,709
Lao P.D.R.	1986	. . .	1.85	28.6	1.8	1,385
Vietnam	1986	. . .	1.97	25.4	1.9	1,815

Source: European Bank for Reconstruction and Development, *Transition Report 1999;* IMF staff estimates unless otherwise noted.
[1]Data for country groups are simple averages of group member data.
[2]From Fischer and Sahay, "The Transition Economies After Ten Years," IMF Working Paper 00/30 (Washington: International Monetary Fund, 2000).
[3]Indicator of progress in structural reforms; see the Appendix.
[4]For Bosnia and Herzegovina, inflation over the period 1991–99 for the Federation is used for "Average Inflation 1989–99," and 1999 GDP per capita in U.S. dollars is used for "PPP GDP per Capita 1999."
[5]Data include Mongolia.

The Transition Experience to Date

The countries referred to as "transition economies" and discussed in this chapter comprise 31 countries in Europe and Asia, including all former members of the CMEA (excluding Cuba) and a number of additional countries in east Asia and the Balkan region comprising close to 30 percent of the world's population.[6] They are listed in Table 3.1, together with relevant sta-

[6]Others might spread the net still wider, including countries in Africa and Latin America that embraced some form of central planning at some time. As the impact of socialism on their underlying institutions was, however, quite limited, these countries are not included.

Table 3.2. Transition Economies: Alternative Geographic, Political, and Reform-Effort Groupings[1]
(Boldface denotes radical reformers; italics denotes moderate reformers; all others are slow reformers)

	Countries on the European Union Accession Track			
Southeastern Europe	Baltic countries	Others	Commonwealth of Independent States (CIS)	East Asia
Albania	**Estonia**	*Bulgaria*	*Armenia*	*Cambodia*
Bosnia and Herzegovina	**Latvia**	**Czech Republic**	*Azerbaijan*	*China*
Croatia	**Lithuania**	**Hungary**	Belarus	Lao P.D.R.
Macedonia, FYR		**Poland**	*Georgia*	*Mongolia*
Yugoslavia, Fed. Rep. of		*Romania*	*Kazakhstan*	Vietnam
		Slovak Republic	*Kyrgyz Republic*	
		Slovenia	*Moldova*	
			Russia	
			Tajikistan	
			Turkmenistan	
			Ukraine	
			Uzbekistan	

[1]The reform-effort classification takes as criterion the average level of EBRD transition indicator in 1999, choosing the following thresholds: radical reformers (in bold) with an indicator above 3; intermediate reformers (in italics) with an indicator between 2 and 3; and slow reformers (in plain type) with an indicator below 2. See the Appendix to this chapter for further description of the transition indicator.

tistics characterizing each country's transition process, and can be classified according to a number of geographical, political, and reform-effort criteria that tend to be highly correlated. The most common classification, which will be extensively used in this chapter, partitions the transition countries into five groups, highlighted in Table 3.2: the EU accession countries (which include the Baltic countries);[7] the countries of the CIS; the east Asian transition economies;[8] and the other countries in southeastern Europe (excluding the EU accession countries located in the Balkan region). Some important differences, however, remain between members within groups. In particular, among the EU accession candidates, the three Baltic countries and Romania and Bulgaria differ in important ways from the remaining five central European members of this group, an issue that is addressed in more detail in Chapter IV of this *World Economic Outlook*.[9]

The defining characteristic of the transition countries is their decision to abandon central planning as the principal mode of organizing their economies and to move to market-oriented economies with significant private ownership of the means of production. In most of these countries, the "transition" coincided with major political transformations, and some, but not all, observers include the shift from a one-party autocratic system to a multiparty democracy in their definition of "transition." In China, Vietnam, and the Lao People's Democratic Republic, however, the political system has not been modified significantly during the transition process.[10] In addition to these political differences, transition economies display an enormous diversity in terms of physical and population size, level of development (as measured by GDP per capita), natural resource endowment, and cultural and historical background, greatly complicating intercountry comparison.

The key economic objectives of the transition are to raise economic efficiency and promote

[7]Given the unique position of the three Baltic countries as members of both the former Soviet Union and the EU accession group, they will be presented as a separate group in most tables and figures in this chapter.

[8]Mongolia, which formally belongs in the non-CIS Asia group, will normally be attached to the CIS group, given its former close political and economic association with the Soviet Union, which has heavily influenced its transition experience.

[9]Similarly, Croatia differs significantly from the other countries in the southeastern Europe region.

[10]Whether countries can make a full transition to a market economy without a political transition to a representative democracy remains a bone of contention among social scientists; see European Bank for Reconstruction and Development, *Transition Report 1999* (London: EBRD, 1999), Chapter 5.

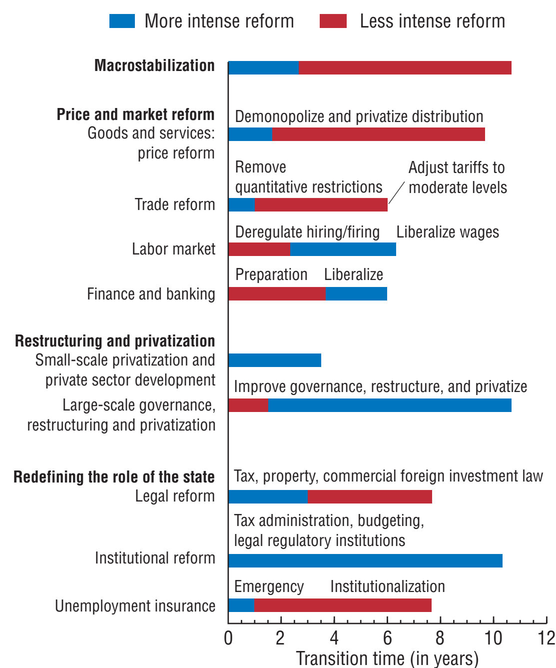
growth. The major elements of the transition process comprise macrostabilization, price and market liberalization (including international trade), restructuring and privatizing state enterprises, and redefining the role of the state. As can be seen from Figure 3.1, these elements—and their possible sequencing—were clearly identified early in the transition process, although views on the relative importance of individual components have changed significantly in some instances (Box 3.2).[11] However, despite the similarity of ultimate objectives and basic direction of changes required, countries' actual transition experience has differed enormously, with respect to both policies implemented and results achieved to date. The reasons for the differences include the country's initial conditions, the external environment (notably external shocks), and the specific policies pursued during the transition.

With regard to each of these factors, the situation in the EU accession countries has been more favorable than that in the CIS countries. Proximity to western Europe was associated with more favorable initial conditions, as the imprint of central planning was more limited, while rapid reorientation of trade to the more stable western European markets reduced these countries' exposure to external shocks largely caused by declining trade within the CMEA. The resulting more favorable output performance was generally associated with more ambitious structural and institutional reforms, which in turn seems to have been partly a result of the external anchor provided by potential accession to the European Union. The close correlation among geographic location, initial conditions, and policies complicates the assessment of the role each of these factors played in determining outcomes.

The transition process consists largely of changes in institutions and modes of business conduct—in both the government and private

Figure 3.1. Key Elements of Reform in Transition

The transition comprises reform in many key areas of the economy, with differing duration and changing intensity over time.



Source: Based on Stanley Fischer and Alan Gelb, "The Process of Socialist Economic Transformation," *Journal of Economic Perspectives*, Vol. 5, No. 4 (Fall 1991), pp.91–105.

[11]The figure is drawn from Stanley Fischer and Alan Gelb, "The Process of Socialist Economic Transformation," *Journal of Economic Perspectives*, Vol. 5, No. 4 (Fall 1991), pp. 91–105.

Box 3.2. Transition Controversies

While the overall objective of transition—creating functioning market economies—is generally agreed, there has been a vigorous debate on how best to accomplish this goal. The conclusions in the main text are not necessarily shared by all observers, and this box presents alternative views on some of the key issues. Most such discussions take as a reference point the "market-fundamentalism" reform strategy that was followed by most of the transition countries of central and eastern Europe, the Baltics, and the CIS, which reflected the thinking of the majority of political leaders in these countries and was supported by many prominent academic advisers and the international financial institutions, including the IMF. This approach, broadly summarized in Figure 3.1, involved simultaneously initiating and implementing macrostabilization, price and market reform, enterprise restructuring and privatization, and institutional reorganization—the so-called "big bang" approach.[1] The decision to start along many fronts simultaneously reflected a belief that the components of reform were interlinked and complementary, so that partial reforms would lead to unsatisfactory outcomes, and that it was important to make the market reform process irreversable by rapidly initiating a comprehensive transition program in the immediate aftermath of the breakdown of the existing political regime.

The debate over transition strategies has been between four groups. One group consists of the protagonists of the reform strategy actually pursued, who consider that the strategy was essentially sound and generally successful where it was vigorously implemented, and that problems arose primarily as a result of shortfalls in implementation. The other three are: those who agree in principle with the market-fundamentalism reform strategy, but disagree with some of the specifics of its implementation; those who believe that the proposed sequencing and speed of reforms were ill-advised; and those who think that the overall strategy was misguided in emphasizing radical reform over gradual institutional development. This debate has intensified recently, fueled by a number of papers that revisit these issues in view of the cumulative evidence from the first decade of transition.[2]

Apart from privatization, dealt with in Box 3.4, the discussion of reform implementation based on market fundamentalism has focused on macroeconomic stabilization. This debate has centered on the adoption of tight fiscal and monetary policies, which, according to the critics, exacerbated the initial output decline and contributed to problems of barter and arrears (Box 3.3).[3] Others argue that the decline in out-

[1]For more details see Alan Gelb and Cheryl Gray, "The Transformation of Economies in Central and Eastern Europe," World Bank Policy and Research Series No. 17 (Washington: The World Bank, 1991), and Stanley Fischer and Alan Gelb, "The Process of Socialist Economic Transformation," *Journal of Economic Perspectives,* Vol. 5, No. 4 (Fall 1991), pp. 91–105.

[2]For an overview of the debate see Gérard Roland, *Transition and Economics. Politics, Markets and Firms* (Cambridge, Mass.: The MIT Press, 2000) and also Grzegorz Kolodko, *From Shock to Therapy: The Political Economy of Postsocialist Transformation* (Oxford: Oxford University Press, 2000). A survey sympathetic to the market fundamentalist strategy is contained in Marek Dabrowski, Stanislaw Gomulka, and Jacek Rustowski, "Whence Reform? A Critique of the Stiglitz Perspective," CASE Working Paper (Warsaw: Center for Social and Economic Research, 2000). A more critical review can be found in János Kornai, "Ten Years After the Road to a Free Economy: The Author's Self-Evaluation," a paper presented at the World Bank Annual Conference on Development Economics, April 2000, Washington. An even more critical approach, with an institutionalist flavor, can be found in Joseph Stiglitz, "Whither Reform?" a paper presented at the World Bank Annual Conference on Development Economics, April 1999, Washington, and Joseph Stiglitz, "Quis Custodiet Ipsos Custodies?" paper presented at the World Bank Annual Conference on Development Economics—Europe, June 1999, Paris.

[3]An earlier body of literature argued that tight macroeconomic policies were needed, but that stabilization could have been accomplished sooner through alternative exchange-rate management policies, more international financial support, and greater efforts toward nonmonetary financing of the budget deficit; see Jeffrey Sachs, "Transition at Mid-Decade," *American Economic Review,* Vol. 86, No. 2 (May 1996), pp. 128–133.

put largely reflected initial conditions and external shocks, and that tight macroeconomic policies laid the basis for a faster and more robust recovery subsequently. This argument applies especially to CIS countries, where incipient hyperinflation made stabilization an urgent priority, and external resources were limited. In the event, tight macroeconomic policies—when applied—did succeed in stabilizing the economies concerned, thus meeting a necessary condition for proceeding with the transition process.

The debate on optimal sequencing and speed of reforms has moved beyond the initial emphasis on "gradualism" versus "shock therapy." Critics of the "big bang" approach argue that the emphasis on speed destroyed still-valuable organizational arrangements among existing enterprises and that the resulting "disorganization" contributed significantly to the output collapse. This collapse, when combined with price liberalization and deep cuts in government spending, in turn led to sharp increases in poverty and income inequality. Also, given the uncertainties inherent in transition, some argue that in a number of cases, Russia in particular, badly sequenced reforms led to vested interests becoming entrenched and blocking further reforms. Other researchers, however, dispute these criticisms, noting that output was already beginning to fall before the transition began, that the organizational arrangements inherited from central planning were unsuited to the market, and that privatized firms have in many cases restructured more rapidly than those left in the hands of the state. They also note that the most unequal allocations of wealth and pronounced increases in income inequality and poverty occurred largely in countries where reforms were implemented only partially, and could be manipulated by vested interests for their own benefit. Finally, they note that the decision to use early "windows of opportunity" to push reforms through rapidly was successful in central and eastern Europe, while the slower recovery of output and continuing disruption in the CIS reflected a failure to implement the strategy with sufficient vigor.

A more basic criticism of market fundamentalism is that it greatly underestimated both the importance and difficulty of creating the institutional infrastructure needed to underpin the operation of market economies. According to this view, creating effective institutions is a lengthy process requiring much trial and error, implying that reform should occur in an evolutionary manner that adapts existing institutions to new needs pragmatically and gradually, as has occurred in China. In this view, market fundamentalism was flawed because it eliminated institutions that could have been useful in the early stages of transition and because it emphasized financial reform and the adoption of new legal frameworks, while underestimating the more lengthy and difficult process of ensuring enforcement of laws, reforming the organization of government, and developing self-enforcing norms that foster entrepreneurship. In the absence of core market-oriented institutions, some argue, other reform efforts often had unintended and negative consequences. Others, however, argue that an evolutionary approach was both inappropriate for the industrial economies of the CMEA region and infeasible given the collapse of central planning and political upheavals associated with the breakdown of Soviet hegemony.

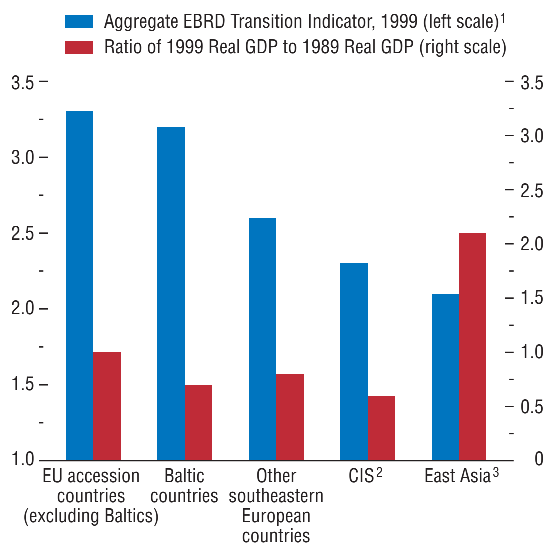
industry—that are difficult to quantify. To facilitate the evaluation and monitoring of progress in transition over time, and to allow a comparison of progress between different countries, analysts have developed quantitative indicators of structural change on the basis of expert judgment, which will be referred to repeatedly in this chapter. The most frequently used and referred to of these so-called transition indicators are those introduced by the European Bank for Reconstruction and Development (EBRD). The EBRD's indicators range from 1 to 4+, with 1 representing conditions unchanged from those prevailing in a centrally planned economy with

dominant state ownership of means of production and 4+ for conditions in an advanced market economy.[12] The indicators cover key areas of structural reform and are presented and explained in more detail in the Appendix to this chapter.[13] Key differences among the five groups of transition countries defined above are summarized in Figure 3.2, which juxtaposes average transition indicator scores for each group, as well as real output in 1999 as a multiple of real output in 1989.

Figure 3.2. Progress in Structural Reform and Output Performance

(Simple country averages for each group)

The extent of structural reform and output performance since the start of transition has differed greatly among countries.



Sources: European Bank for Reconstruction and Development, *Transition Report 1999* (EBRD: London, 1999); and IMF staff estimates for east Asian countries and Mongolia.

[1]Aggregate of eight EBRD transition indicators. For an explanation of these indicators, see the Appendix.

[2]Data include Mongolia, whose EBRD transition indicator is estimated by IMF staff.

[3]EBRD transition indicator estimated by IMF staff.

Macroeconomic Developments

Macroeconomic developments during the transition process, as reflected in output levels and rates of inflation, are summarized in Figure 3.3 for five country groups.[14] The outstanding feature of this diagram is the difference in output growth across these groups. Even though assessing the precise path of output, including relative performance among countries, is complicated by numerous data weaknesses, the broad features shown in Figure 3.3 are undisputed, including relative performance among country groups.[15] The European and CIS transition economies suffered a substantial output contraction at the start of the transition. The de-

[12]Analysts often linearize the scores by assigning a value of ⅓ to a "+" sign and –⅓ to a "–" sign attached to the integer scores 1 to 4, a practice also followed in this chapter.

[13]Transition indicators for Mongolia and the east Asian countries reported in this chapter are IMF staff estimates.

[14]In this, and all other figures of this type, the data are adjusted for the east Asian countries whose transition began prior to 1989. The first 11 years of transition for these countries cover the following periods: China (1978–89), Lao P.D.R. (1986–97), and Vietnam (1986–97).

[15]For further discussion of data (un)reliability see Mark De Broeck and Vincent Koen, "The Great Contractions in Russia, the Baltics and the Other Countries of the Former Soviet Union: A View from the Supply Side," IMF Working Paper 00/32 (Washington: International Monetary Fund, March 2000); and Simon Johnson, Daniel Kaufman, and Andre Schleifer, "The Unofficial Economy in Transition," *Brookings Papers on Economic Activity: 2*, Brookings Institution, 1997, pp. 159–239.

cline was particularly severe in the CIS countries, where the recovery process also started later and was less vigorous. The Baltic countries' output performance was initially similar to that of the CIS countries, but subsequently started to converge to that of other EU accession countries. Performance in the other countries of southeastern Europe has been erratic, heavily influenced by civil strife and war during much of the transition period. Armed conflict also affected developments in some CIS countries in central Asia and the Caucasus. More generally, almost 10 years after the transition process took off in Europe, only a handful of countries are estimated to have returned to output levels at—or slightly above—those prevailing at the start of transition. In contrast, output growth remained very strong in the transition countries of east Asia following the onset of reforms; it continued throughout the transition period, and output levels now substantially exceed starting point levels in these countries (Figure 3.4).

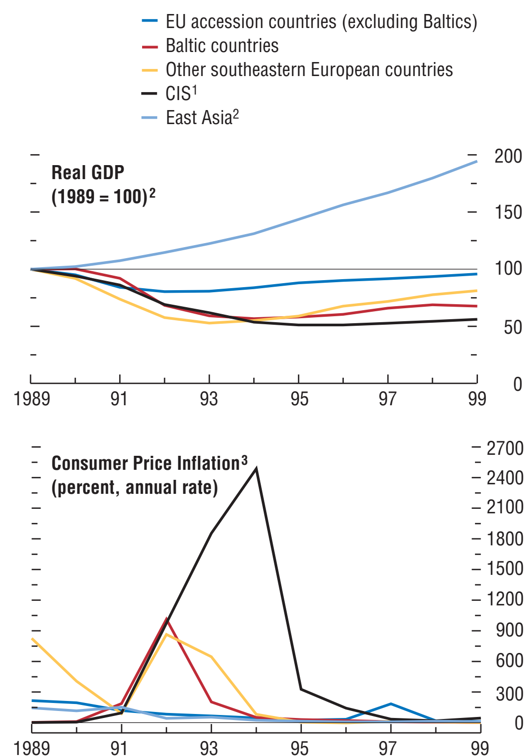
Except in the east Asian transition countries, employment fell in the early years of the transition, but by much less than output, although both output and employment data are likely to be affected by considerable margins of error. In central and eastern Europe, the return to robust growth in the second half of the 1990s has led to some net employment creation.

Nevertheless, total employment at the end of the decade was still more than 10 percent below its 1989 level because the growth stemmed mainly from efficiency gains. In the CIS countries, where the recovery did not take hold until 1999, employment has continued to decline gradually in recent years. In these countries, the labor hoarding inherited from central planning has intensified during the transition, as the cumulative decline in output has far exceeded that in employment, resulting in widespread involuntary temporary layoffs and part-time work.

In most transition countries prices increased substantially in the initial stage of the transition, as a result of price liberalization and the large monetary overhang inherited from the period under central planning (Figure 3.3, lower

Figure 3.3. Output and Inflation Performance During Transition

The evolution of output and inflation during the transition has differed considerably among countries.



[1]Data include Mongolia.

[2]Chart is adjusted for three east Asian countries whose transitions began prior to 1989. The first 11 years of transition for the following countries are as follows: China (1978–89), Lao P.D.R. (1986–97), and Vietnam (1986–97).

[3]The increase in the EU accession group's inflation, in 1997, is largely accounted for by the hyperinflation experienced in Bulgaria that year.

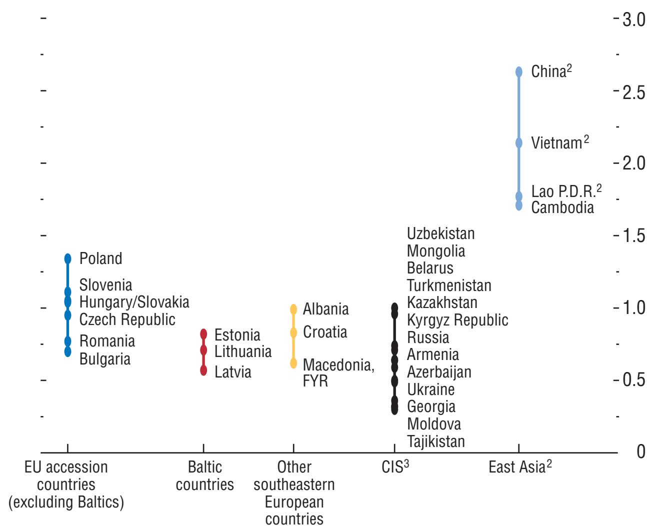
panel). The monetization of large budget deficits, arising from output contraction and fiscal restructuring, fueled inflation, which reached four-digit rates in the mid-1990s in a number of CIS countries. As in the case of output, the southeast European countries had an intermediate inflation performance falling between the CIS and the EU accession group. The resulting macroeconomic instability was much more virulent and persistent in the CIS than in east Asian and European countries. As of 2000, however, significant macroeconomic imbalances persisted in only five countries, with either the inflation rate projected to exceed 40 percent annually, or the budget deficit expected to be 5 percent of GDP or more (Figure 3.5); all of these countries belonged to the group of slow or intermediate reformers in the CIS and other southeastern Europe regions.

A serious problem related to fiscal consolidation and macrostability is the persistence of tax arrears and the proliferation of barter trade, a phenomenon particularly prevalent in several CIS countries (Box 3.3 discusses the origins, extent, and implications of this problem in Russia). The persistence of tax arrears and barter trade reflects the failure to carry out or to complete structural reform in several interlocking areas—most importantly enterprise restructuring; the creation of a financial sector that operates on a commercial basis; and public sector reform, especially the collection of tax revenues.

Countries adopted a variety of exchange rate regimes at the start of the transition or at the time when national currencies were introduced. Estonia instituted a currency board, a number of central and eastern European countries (Croatia, the Czech Republic, the former Yugoslav Republic of Macedonia, Hungary, Poland, and the Slovak Republic) introduced a pegged exchange rate regime, and the other central and eastern European and Baltic countries and all CIS countries chose a flexible exchange rate regime. The choice of a flexible regime was often motivated by a lack of sufficient foreign exchange reserves to back a peg, low initial credibility of policies, and severe un-

Figure 3.4. Real GDP Ratio, 2000 to 1989[1]

Only in the east Asian transition economies does the current level of output greatly exceed the level recorded at the start of transition.



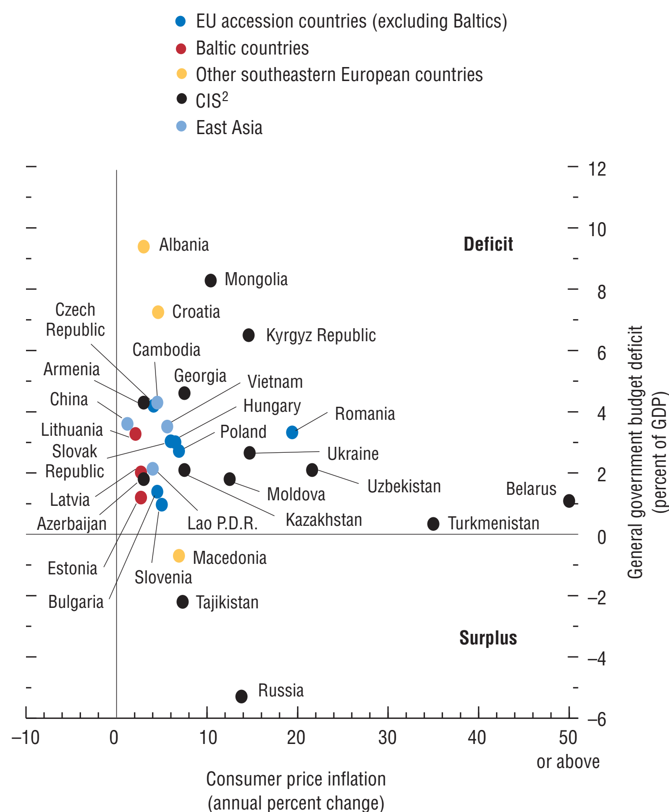
[1]Output projections for 2000 are IMF staff estimates.
[2]Chart is adjusted for three east Asian countries whose transitions began prior to 1989. The first 11 years of transition for the following countries are as follows: China (1978–89), Lao P.D.R. (1986–97), and Vietnam (1986–97).
[3]Data include Mongolia.

certainty regarding the rate at which the currency should be pegged. Many of the nominally flexible regimes were, however, heavily managed in practice as stabilization programs were implemented. The initial choice of exchange rate regime was often modified in the course of the transition. Flexible exchange rate regimes gave way to a peg in Latvia and to currency boards in Bulgaria and Lithuania. Pegged regimes were replaced by more flexible arrangements in the Czech Republic, Poland, and the Slovak Republic, prompted in part by concerns about potentially destabilizing effects of large capital inflows.

Macroeconomic stabilization was not a smooth process in all countries. Most transition economies succeeded in bringing down the high inflation rates that characterized the start of transition, reaching reasonable price stability by the mid-1990s, but several countries experienced a resurgence of inflation in the second half of the decade. Belarus, Bulgaria, Romania, Russia, and Tajikistan are the countries where this "U-shaped" stabilization pattern has been most conspicuous. While external shocks (e.g., regional war in the Balkan area) played a role in some cases, an important common factor seems to have been the failure to pursue the reform agenda consistently and vigorously. The resulting buildup of bad loans in the banking sector and of government debt eventually led to a loss of confidence among both domestic and external creditors, entailing currency and banking crises in the countries concerned. Among the stabilization setbacks experienced by various countries, the Russian crisis of 1998 was the most serious, caused by a fiscal policy stance that turned unsustainable—especially when combined with an exchange rate policy aimed at nominal exchange rate stability—and exacerbated by the lack of prudence among international lenders.[16]

Figure 3.5. Macrostabilization: Budget Deficit and Inflation, 2000[1]

Several transition countries have not yet gained macrostability as of 2000.



[1]Data for 2000 are IMF staff projections. Belarus, whose annual inflation in 2000 is expected to be 83 percent, appears on the far right side of the graph.
[2]Data include Mongolia.

[16]Causes and consequences of this crisis, which affected several other countries in the area, and—in combination with the Asian financial crisis preceding it—the world economy, have been analyzed in detail in the December 1998 Interim Assessment of the *World Economic Outlook* (Washington: International Monetary Fund, 1998).

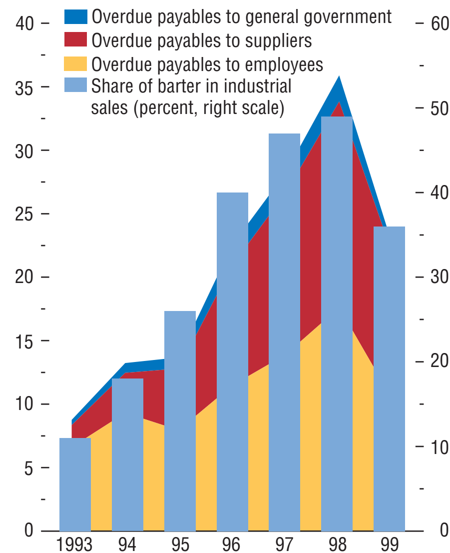
Box 3.3. Addressing Barter Trade and Arrears in Russia

Widespread enterprise arrears and barter transactions are symptoms of the deep-rooted structural problems affecting the transition process in Russia. The non-monetary share in industrial sector revenues rose from about 10 percent in 1993 to almost 50 percent in 1998, while overdue payables by enterprises rose from below 10 percent to over 35 percent of GDP (see the Figure). Despite a significant decline following the August 1998 crisis, barter and arrears remain prevalent in both state-owned and privatized enterprises and in most subsectors of industry and construction. Many firms that now earn cash on exports still make use of barter trade in their domestic transactions.

The reasons behind the proliferation of barter and arrears are complex, but recent studies provide some tentative explanations.[1] Following the liberalization of prices and trade, industrial firms experienced growing liquidity problems as demand fell and directed credit and subsidies were reduced. Many enterprises responded by resorting to nonpayment and barter to keep afloat rather than embarking on market-oriented restructuring. Crucially, the state sanctioned this attitude by tolerating an increase in non-monetary and late payments for both tax and utility bills and a lax approach to bankruptcy. As noncash tax payments, so-called "tax offsets," tend to overvalue the goods delivered to the state, this practice amounted to a significant infusion of implicit subsidies, which became the key reason for the growth of barter and arrears until 1998. The state, especially subnational governments and public utilities, remains a central participant in complex chains of late payments and offsets.[2]

Evolution of Arrears and Barter in Russia

(Percent of GDP unless otherwise noted)



Source: Data communicated by Russian European Center for Economic Policy, Moscow.

Barter and arrears have imposed severe costs on the Russian economy and continue to delay enterprise restructuring. Tax arrears and offsets erode fiscal revenues, and the lack of transparency associated with non-monetary transactions creates opportunities for corruption and fraud. Barter locks firms into trading patterns and networks that tend to discourage innovation and competition. The common practice of mispricing goods in barter and offset transactions obscures financial accounts of enterprises, thus reducing their access to potential outside credi-

[1]See, for example, Simon Commander and Christian Mumssen, "Understanding Barter in Russia," European Bank for Reconstruction and Development Working Paper 37 (London: EBRD, 1999); Clifford G. Gaddy and Barry W. Ickes, "Beyond a Bailout: Time to Face Reality About Russia's 'Virtual Economy,'" *Foreign Affairs,* Vol. 77, pp. 53–67; Brian Pinto, Vladimir Drebentsov, and Alexander Morozov, "Give Growth and Macro-Stability in Russia a Chance: Harden Budgets by Dismantling Nonpayments," World Bank Policy Research Working Paper No. 2324 (Washington: World Bank, 2000).

[2]While barter trade is common in other CIS countries as well, transition countries outside the CIS have largely avoided high levels of barter, mainly because firms have generally maintained monetary payments to the state and public utilities. Arrears, however, have also been a problem in several central and eastern European countries.

tors and investors alike. Perhaps the most damaging aspect of the noncash economy is the ad hoc allocation of implicit subsidies, which provides a cushion against market discipline. As large loss makers tend to run up higher arrears and pay more frequently with overvalued output than profitable small and medium-sized enterprises, this amounts to an implicit cross-subsidy from more productive to less productive segments of the economy.

Barter and arrears ultimately reflect a failure of economic policy to promote the restructuring of the ailing industrial sector. Outdated technology, oversized plants, environmental liabilities, high levels of industry concentration, rigid supplier links, and high transport costs are among the many problems inherited from central planning in Russia. The initial market reforms—price liberalization, privatization, and macroeconomic stabilization—were meant to introduce competitive market forces that would kick-start the restructuring process. However, the competitive effects of these reforms were partly offset by the new implicit subsidies channeled through barter and arrears. This has led to a vicious circle of nonpayment and lack of restructuring.

The persistent failure to impose "hard budget constraints" on nonviable enterprises is partly rooted in social considerations, given the importance of large enterprises for the local economy and the absence of an effective national social safety net. However, it also reflects institutional weaknesses, including the absence of clear property rights and the complex nature of the fiscal relations between the federal, regional, and local governments.[3] In addition, the corporate governance structures resulting from Russian privatization tend to inhibit restructuring, and vested interests continue to dominate relations between the state and the large enterprises.

A credible solution to the nonpayment problem in Russia would have to involve a fundamental reform of public finances, including more stringent enforcement of tax and utility payments, a more effective fiscal transfer system, as well as measures to ensure that budgetary entities pay their own bills in time and in cash. Whereas tax offsets have been virtually eliminated at the federal level and tax arrears reduced, the public utilities and local governments remain important sources of implicit subsidies. The federal government has recently made efforts to improve the fiscal transfer system in a way that provides more incentives to subnational government to collect taxes in cash. In addition, recent initiatives to reform the tax code may facilitate tighter enforcement if they succeed in simplifying the tax system and lowering the overall tax burden on enterprises. The large public utilities have also tried to raise cash collection ratios, but so far with only limited success. Part of the problem is the absence of clear rules on when to cut off nonpayers from the utility service, but there are also corporate governance problems in these utilities, including an unclear separation of commercial and state interests.

While measures to improve payments to the tax authorities and public utilities are necessary to phase out the noncash economy, they may not yield a sustainable solution unless complementary efforts are made to promote enterprise restructuring. An important element would be to establish an effective social safety net for workers who lose their jobs in the process of restructuring. Moreover, the state should use the resources freed by a reduction of tax arrears and offset-based subsidies for explicit support of the restructuring process, by financing redundancy packages for workers, lump-sum grants for municipalities that take on the social responsibilities of large enterprises, and environmental rehabilitation. What is perhaps even more important is to stimulate the creation and growth of new private firms by removing bureaucratic hurdles and addressing corruption. This would help to create employment and shift labor to more productive sectors, thus strengthening domestic product market competition. Combined with more stringent enforcement of tax and utility payments, competition could force loss-making enterprises to restructure more rapidly and thereby reduce barter and arrears, or to go out of business altogether.

[3]See Box 3.5 in this chapter and OECD, *OECD Economic Surveys—Russian Federation* (Paris: Organization for Economic Cooperation and Development, 2000).

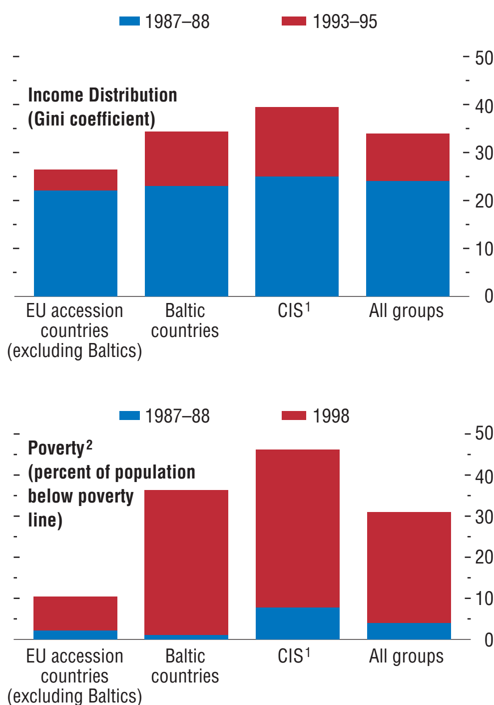
The transition process had a major impact on poverty and income inequality (as conventionally measured), which—as noted earlier—under central planning had been generally less pronounced than in other countries at similar levels of income (Figure 3.6). Once again, a full assessment is complicated by data weaknesses. Under central planning, real income was significantly influenced by privileged access to certain goods and services; and given pervasive shortages before the transition, the data in Figure 3.6 are also likely to exaggerate the actual increase in poverty. Also, some increase in inequality could be expected as a result of introducing market incentives and adjustment of relative prices to reflect scarcities. Nevertheless, there is little doubt that inequality has risen substantially and the economic situation for a substantial number of people, particularly those at the lower end of the income scale or whose savings were wiped out by high inflation at the start of transition, has worsened, while in some cases small groups have reaped substantial material benefits from rent-seeking activities.[17]

The deterioration was most pronounced in the countries of the former Soviet Union (particularly the western CIS), where the share of the population living in poverty rose to 60 percent in some instances. It was more limited, but still significant, in some central and eastern European countries, and poverty was still a persistent phenomenon in most transition economies as of 1998. The recorded increases in poverty were sharpest in those countries where the reform process has stalled, stultifying entrepreneurship and new growth opportunities, and where privatization favoring insiders and poor

Figure 3.6. Change in Poverty and Income Distribution

(Simple country averages for each group)

Except for the east Asian transition economies, the incidence of poverty rose in all countries during transition, and income distribution became more uneven.



Source: Branko Milanovic, *Income, Inequality and Poverty during the Transition from Planned to Market Economy,* The World Bank Regional and Sectoral Series (Washington: World Bank, 1998).

[1]Data exclude Armenia, Azerbaijan, Georgia, and Tajikistan.

[2]Poverty is defined as having an income of less than four U.S. dollars per day in purchasing-power-parity terms.

[17]In the present context, poverty is defined as a daily income of $4 measured at purchasing power parity; income inequality is measured using the Gini coefficient of the distribution of income. For a more comprehensive analysis of social conditions and related indicators in transition economies outside east Asia, see Annex 1.1 in EBRD, *Transition Report 1999*, and Branko Milanovic, *Income, Inequality, and Poverty during the Transition from Planned to Market Economy,* The World Bank Regional and Sectoral Studies (Washington: World Bank, 1998).

targeting of social safety nets have permitted a lopsided accumulation of wealth. Income inequality also increased in the transition economies of Asia, but since output increased rapidly, these countries were still able to achieve impressive reductions in their poverty rates during the transition process.

Structural Reform and Institutional Change

There are two dimensions to the massive changes in the structure of the transition economies witnessed since the start of transition: the wide range of structural and institutional reforms implemented by governments and the resulting changes in economic behavior and institutions. Although considerable progress has been achieved overall, as of 1999 the structural reform process was far from complete, and progress differed greatly across reform areas (Figure 3.7). Reform is most advanced in privatization of small-scale enterprises. The other areas in which reforms are relatively advanced are the liberalization of foreign trade and exchange (although some CIS countries have not started reforms in this area at all) and the elimination of price controls. Structural reforms are least advanced in the regulation and supervision of the banking and financial sector, the development and enforcement of competition policy, the restructuring of large-scale enterprises, and the reform of governance in both the private and the public sector.

Reform progress has also been uneven across countries. Only nine out of the 31 countries listed in Table 3.1 achieved an average transition indicator score above 3, with all but one (Croatia) of these advanced reformers belonging to the EU accession countries (Figure 3.8).[18] The six lowest scores (below 2) are all found outside the group of EU accession countries: three of these slow reformers are members of the CIS (Belarus, Tajikistan, and Turkmenistan),

Figure 3.7. Progress in Reform by Area, 1999[1]
(Simple average of all transition economies for each indicator)

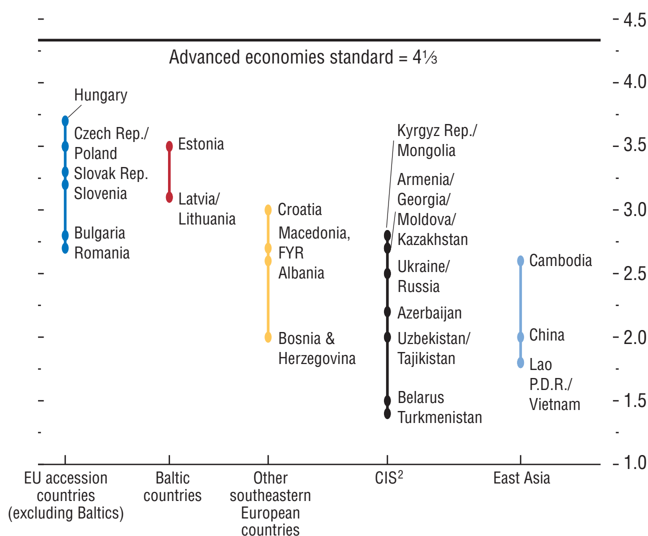
Progress in structural reform, measured on a scale from 1 to 4⅓, differs greatly between different reform areas.

Sources: European Bank for Reconstruction and Development, *Transition Report 1999* (EBRD: London, 1999); and IMF staff estimates.
[1]For an explanation of the indicators, see the Appendix.

[18]The only EU accession countries scoring below the threshold (i.e., a score of 3) separating advanced from intermediate reformers are Bulgaria and Romania.

Figure 3.8. Aggregate EBRD Transition Indicator, 1999[1]

The extent of structural reforms undertaken during transition, measured on a scale from 1 to 4⅓, differs considerably among countries.



Source: European Bank for Reconstruction and Development, *Transition Report 1999* (London: EBRD, 1999).

[1]Average of eight EBRD indicators. For an explanation of the indicators, see the Appendix.
[2]Data include Mongolia.

and two are located in east Asia (Lao P.D.R. and Vietnam).[19] The bulk of the transition countries (including Russia and China) fall into the group of "intermediate" reformers, with scores ranging from 2 to 3, underlining the need to continue with intensive reform efforts.

The ranking of transition economies according to their aggregate transition indicator score closely matches their ranking in terms of perceived institutional quality, as measured by standardized sample surveys or ratings by commercial agencies. The overall indicator of institutional quality in Figure 3.9 is an aggregate of five component indicators, comprising government effectiveness, extent of regulation, rule of law, the extent of democracy, and graft.[20] At a more detailed level, some interesting differences emerge among countries with respect to the component indicators. CIS countries have excessive regulatory burdens and face significant governance problems, while the EU accession countries are favored by a higher degree of democratization and a more limited degree of public regulation and control (see Table 3.11 in the Appendix).

In response to structural reforms and efforts to stabilize the economy, several important characteristics of the transition countries have changed drastically (Figure 3.10).[21] Most prices are now market determined: in 1997 only three

[19]The slow reformer group also includes Bosnia and Herzegovina, where the situation is complicated by a continuing *de facto* split of the country into two separate administrative entities, which impedes effective policymaking at a central government level.

[20]A paper prepared for the *World Economic Outlook* by Beatrice Weder, "Institutional Reform in Transition Economies: How Far Have They Come?" (unpublished; Washington: International Monetary Fund, 2000), provides an extensive survey of the institutional quality of transition economies, using indicators developed by Daniel Kaufmann, Aart Kraay, and Pablo Zoido-Lobatón in "Governance Matters," World Bank Policy Research Working Paper No. 2196 (Washington: World Bank, 1999) and "Aggregating Governance Indicators," World Bank Policy Research Working Paper No. 2195 (Washington: World Bank, 1999). These indicators are explained in more detail in the Appendix.

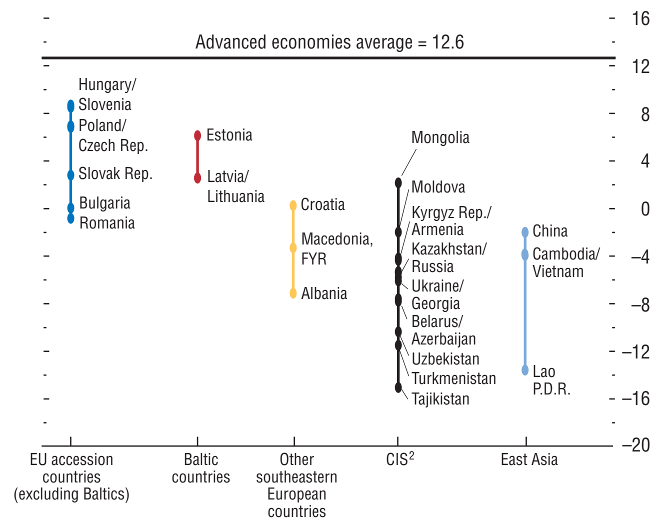
[21]See EBRD, *Transition Report 1999*, Chapter 4, for a more detailed overview of progress in structural adjustment.

transition countries (all members of the CIS) administered more than 30 percent of the prices of basic goods. The excessive industrialization that characterized all but the transition countries of east Asia has also been reduced, as is evident from the falling share of industry in total employment in all but the east Asian transition economies.[22] This was partly a result of a rapid expansion—in both absolute and relative terms—of the service sector, which had been severely neglected under central planning. And the public sector dominance in economic activity was replaced by a remarkable pickup in private sector activity: the private sector share of GDP rose to an average of 70 percent in the EU accession countries in 1998 and to 50 percent in CIS countries. This adjustment was achieved via both the privatization of old state-owned enterprises and the emergence of new private firms and activities. Although privatization generally boosted firms' productivity, especially when hard budget constraints were imposed, there is some evidence that productivity in both new domestic firms and foreign-owned firms exceeds that in domestic privatized or public firms, suggesting that the process of enterprise restructuring remains incomplete.[23]

An area in which progress differed significantly among transition countries, with important implications for the transition process overall, is the privatization and restructuring of large-scale public enterprises. The transition countries of east Asia, where privatization of large public enterprises is just starting, are at one end of the spectrum, and restructuring of the enterprises concerned still looms large on

Figure 3.9. Index of Institutional Quality, 1997–98[1]

The differences in "institutional quality" among countries, measured on a scale from –20 to 12.6, are very similar to differences in the extent of structural reform.



Source: Beatrice Weder, "Institutional Reform in Transition Economies: How Far Have They Come?" (unpublished; Washington: International Monetary Fund, 2000).

[1]For an explanation of the indicators, see the Appendix.

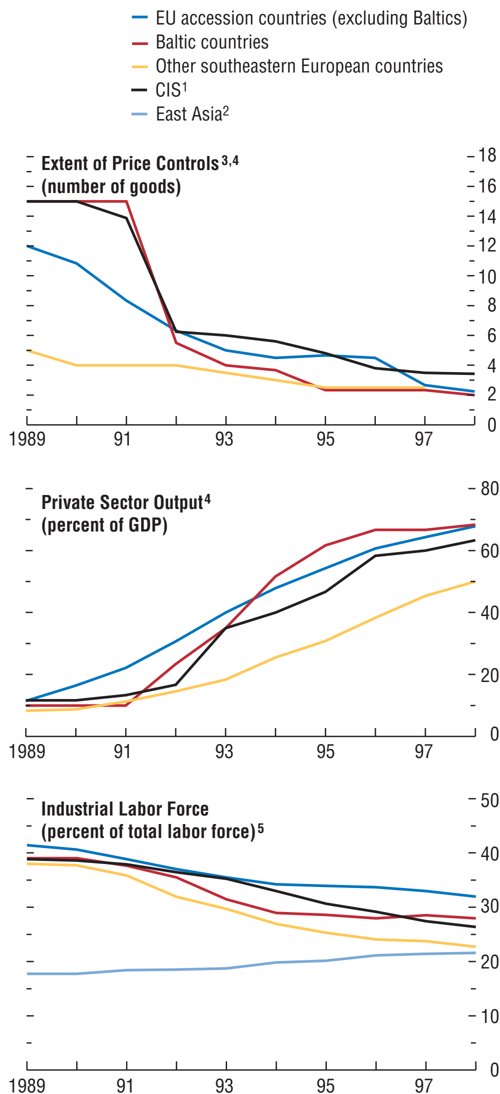
[2]Data include Mongolia.

[22]In terms of output shares, which combine both price and output effects, by 1998 only three countries recorded an industrial share of GDP above 40 percent, as opposed to 12 countries in 1990.

[23]See "Enterprise Response to Reforms," Part III in EBRD, *Transition Report 1999;* Simeon Djiankov and Peter Murrell, "Enterprise Restructuring in Transition: A Quantitative Survey," (unpublished; Washington: World Bank, 2000); and Simon Commander, Mark Dutz, and Nicholas Stern, "Restructuring in Transition Economies: Ownership, Competition, and Regulation" (unpublished; Washington: World Bank, 1999).

Figure 3.10. Progress in Structural Adjustment

In response to wide-ranging structural reforms, all transition economies have undergone significant structural change.



Sources: For the extent of price controls: European Bank for Reconstruction and Development, *Transition Report, 1999* (London: EBRD, 2000); for private sector share in GDP, World Bank, *World Development Indicators*; for industrial labor force, national authorities; and IMF staff estimates.

[1]Data include Mongolia.

[2]Chart is adjusted for three east Asian countries whose transitions began prior to 1989. The first 11 years of transition for the following countries are as follows: China (1978–89), Lao P.D.R. (1986–97), and Vietnam (1986–97).

[3]Number of goods with administered prices in the basket of 15 basic goods constructed by the EBRD.

[4]Simple average.

[5]Countries within group weighted by their total labor force.

the policy agenda. At the opposite end of the spectrum are the majority of the advanced EU accession countries, where most large-scale public enterprises have been privatized and where restructuring is proceeding apace. Most CIS countries occupy an intermediate position: many large public enterprises have been privatized, but restructuring has made little progress for a number of reasons (see Box 3.4, which also reviews the policy debate regarding the speed and sequencing of privatization and restructuring public enterprises).

The development of the financial sector has been marked by the elimination of the central bank monopoly in credit allocation, as virtually all transition countries have by now established a two-tier banking system. However, in many countries, the extent of intermediation by the banking sector—especially in terms of credit extended to the private sector and deposit taking from households—has remained limited. Banks often have made little progress in developing a capacity for prudent lending and sound risk management, and they continue to lend to affiliated enterprises or, under official pressure, to loss-making, state-owned enterprises. As a result, these banks are burdened by large amounts of nonperforming loans and they remain vulnerable to systemic crises. Although the core elements of a proper legal and regulatory framework for the banking sector have been put in place in most countries, implementation and enforcement problems remain widespread, in part owing to the weakness and lack of independence of the regulatory authorities. Development of the nonbank financial institutions, including insurance companies and securities markets, is even more limited than that of the banking sector.

Transition in the External Sector

The process of reintegrating the transition economies into the world economy through trade flows has made major progress. Before the transition, most transition economies were locked in excessive and inefficient trade relations with other CMEA members, often due to

Box 3.4. Privatization in Transition Economies

The privatization of state-owned companies has been a central element of the transition in central and eastern Europe, the Baltics, and the CIS. A larger private sector, which would harness profit motives, was expected to result in better allocation of resources and improved economic efficiency. The scale and pace of private sector development—both in terms of privatization and establishment of new enterprises—have been remarkable. The EBRD estimates that in 1999 the private sector produced over half of GDP in 20 of the 26 transition countries monitored.[1] Small-scale privatization is virtually complete in all but five countries, while the privatization of medium-sized and large enterprises is nearing completion in about 10 countries.

Has privatization yielded the expected benefits? A number of empirical studies have examined the impact of privatization at the enterprise level, using various measures of enterprise performance and restructuring, such as changes in the workforce, revenue growth, profitability, and productivity.[2] Although it is difficult to assess to what extent this research is affected by selection bias (i.e., good firms are privatized before bad firms), a number of fairly robust conclusions have emerged:

- In central and eastern Europe and the Baltic countries, privatized firms have generally restructured more quickly and performed better than comparable firms that remained in state ownership; partly this is due to extensive involvement of foreign investors in the privatization process and a relatively sound business environment.
- Privatization has often failed to boost restructuring and better performance of enterprises in most of the CIS countries, partly as a result of the poor corporate governance structures in many privatized firms and partly because of the persistence of "soft budget constraints," including implicit subsidies from the state.
- Post-privatization ownership is an important determinant of firm-level restructuring and performance. Across the whole region, the best performers have been firms that were acquired by foreign strategic investors. Similarly, firms with concentrated ownership (insider and outsider) have generally performed better than firms with dispersed ownership.
- The method of privatization has been important for the speed and perceived equity of the process. However, since many countries applied a combination of methods (vouchers, management-employee buyouts, and direct sales), there has not been a clear relationship between privatization method and post-privatization ownership and restructuring.

These stylized facts suggest that privatization has not always been effective in bringing about enterprise restructuring. Although private ownership activates profit motives, private ownership alone is not sufficient to make firms efficient—complementary conditions are required to make privatization lead to effective restructuring.[3] This has significant policy implications:

- Privatization risks producing perverse results in the absence of hard budget constraints and competition. When privatized firms continue to receive subsidies, especially implicit support in the form of soft credit and tax arrears, they tend to focus their efforts on rent seeking rather than on restructuring. When barriers to international trade and entry of new firms remain high, incumbent large firms continue to operate as quasi-monopolists, with little incentive to restructure. These factors are among the reasons why privatization in cen-

[1]See European Bank for Reconstruction and Development, *Transition Report 1999* (London: EBRD, 1999). The east Asian transition countries are excluded from this sample.

[2]For a review of this research, see Oleh Havrylyshyn and Donal McGettigan, "Privatization in Transition Countries: A Sampling of the Literature," forthcoming in *Post-Soviet Affairs*, as well as Simeon Djankov and Peter Murrell, "Enterprise Restructuring in Transition: A Quantitative Survey" (unpublished; Washington: World Bank, April 2000).

[3]See, for example, Jeffrey Sachs, Clifford Zinnes, and Yair Eilat, "The Gains from Privatization in Transition Economies: Is 'Change of Ownership' Enough?" CAER Discussion Paper No. 63 (Cambridge, Mass.: Harvard Institute for International Development, Consulting Assistance on Economic Reform, 2000).

Box 3.4 *(concluded)*

tral and eastern Europe and the Baltics has worked much better than in the CIS.

- Privatization that results in widely dispersed ownership structures can work well only in countries with effective standards of corporate governance. In many transition countries, managers with relatively small ownership stakes wield considerable power without being effectively controlled by shareholders, which provides incentives for asset stripping and self-dealing. Concentrated ownership, such as in firms owned by foreign strategic investors or in small and medium enterprises fully owned by managers, has generally yielded the best results.
- The benefits of privatization are larger in countries with an effective legal framework and secure property rights. In many transition economies, especially those in the CIS, the business environment remains marred by corruption, weak courts, and overbearing bureaucracy, as well as by complex and unfair tax systems. These conditions generally undermine enterprise efficiency and long-term investment incentives.

The first decade of transition thus suggests that privatization does not work equally well in all circumstances. Indeed, there is a view that privatization should have been implemented much more gradually, with enterprise restructuring and improvements in the institutional framework preceding privatization.[4] Yet, building effective legal institutions and good corporate governance generally takes a long time and there is no guarantee that in the meantime state firms are run any better than privatized firms, especially if the general business environment remains influenced by vested interests.[5] On balance, it is clear that strong emphasis on financial discipline and competition early on in the reform process (as was the case in Poland, but not Russia) is an important complement to privatization.

Looking ahead, the question is what can be done with the large number of dysfunctional privatized firms, especially in the CIS countries. Strengthening the effectiveness of legal, regulatory, and fiscal institutions is without doubt desirable. However, this process takes time, and the existing shortcomings in corporate governance may require more immediate action.

Some observers have suggested that re-nationalization may be a way to prevent continuing abuses by rogue managers.[6] In countries with widespread corruption, however, reversion to state ownership may make matters even worse. Moreover, a process of re-nationalization and subsequent re-privatization is likely to be hijacked by precisely those vested interests that have undermined the initial privatization process. A more promising route would be to dilute the ownership stake of managers in those firms that have failed to restructure and have run up large arrears, with creditors converting the firm's debts and arrears into new stock and selling the company to strategic investors. This is essentially a case-by-case approach, however, especially considering the limited number of willing investors.

Perhaps the most effective way to promote restructuring at this stage of transition is to foster competition and hard budget constraints to force even badly run enterprises to adapt or go out of business. This would require further opening up of international trade, reducing bureaucratic hurdles to entry, tightening payment discipline, improving bankruptcy procedures, promoting a healthy financial sector, and phasing out implicit subsidies. "Starting all over" by re-nationalization and re-privatization is unlikely to be a realistic or desirable option. Accelerating reform to foster competition and hard budget constraints seems a more effective, if difficult, way forward.

[4]See, for instance, Joseph Stiglitz, "Whither Reform? Ten Years of the Transition," paper presented at The World Bank Annual Conference on Development Economics, April 1999, Washington.

[5]This point is made, for example, by John Nellis, "Time to Rethink Privatization in Transition Economies?" *Finance and Development,* Vol. 36, No. 2 (June 1999), pp 16–19.

[6]This may come about automatically if the original privatization is legally challenged. However, instances of revoking privatization have been very rare despite frequent complaints about cronyism and corrupt privatization practices in the past.

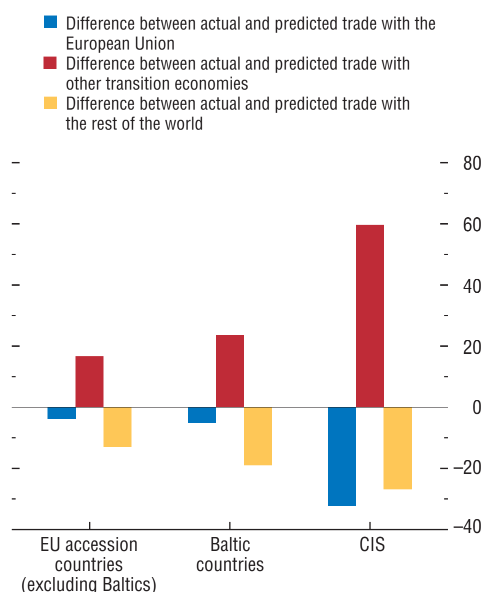
political and strategic considerations rather than economic criteria. But extensive trade liberalization has helped to bring the geographical and commodity composition of trade more in line with countries' comparative advantage. The central and eastern European countries in particular have reallocated trade flows away from other centrally planned economies toward the European Union, while transition countries in east Asia, especially China, strongly penetrated world markets. As of 1997, more than 70 percent of exports from the EU accession and other southeastern European countries were directed to non-transition economies, but this share rose only to 30 percent in CIS countries, partly reflecting geographic location. Despite these gains, reintegration into the world economy has not been completed. According to EBRD calculations, intraregional trade among transition economies (excluding east Asia) in 1997 remained well above normal levels as computed by a gravity model (Figure 3.11). This legacy of excess intraregional trade is still particularly prevalent in CIS countries.

With the exception of China and Russia, a major commodity exporter, the opening to external trade has been accompanied by rising current account deficits. In central Europe, current account deficits remained moderate as a share of GDP in the first years of the transition, reflecting contractions in domestic demand, real exchange rate undervaluations that occurred at the beginning of the transition, and external financing constraints. Current account deficits in central Europe have widened since 1996, however, as the regional pickup in growth and investment has been associated with rapidly rising imports of both consumption and investment goods. In the Baltics and the CIS countries other than Russia, current account balances, measured as a percentage of GDP, increased considerably between 1992 and 1998. Several factors contributed to this development. Many of these countries experienced large terms of trade losses, as prices for energy imports from former CMEA trade partners moved to market-determined levels. Moreover, these countries ran high

Figure 3.11. Adjustment Gap of Regional Export Structure[1]

(Percentage point deviation from "norm")

Although the foreign trade of most transition countries has been largely liberalized, the regional structure of exports is still affected by the legacy of directed trade under central planning.

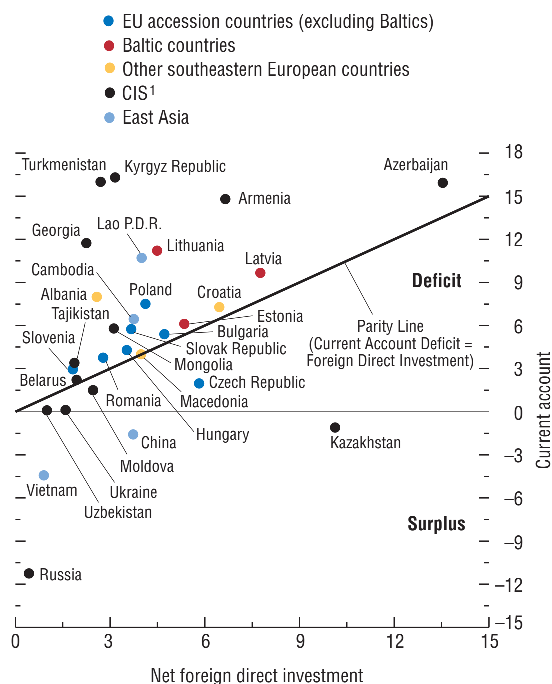


Source: European Bank for Reconstruction and Development, *Transition Report 1999* (London: EBRD, 1999).

[1]The "norm" is the hypothetical share of regional exports in total exports, computed from a gravity model of export structure.

Figure 3.12. Current Account Deficit and Foreign Direct Investment, 1999
(Percent of GDP)

In most transition countries the current account deficit greatly exceeds foreign direct investment, increasing these countries' external vulnerability.



[1]Data include Mongolia.

fiscal deficits, as the authorities tried to absorb the revenue and expenditure pressures associated with sharp falls in national income and fiscal restructuring. Finally, as a result of slow progress in building a competitive and diversified export sector, trade liberalization early on mainly stimulated imports of consumer goods and services. External adjustment policies introduced in the wake of the Russian crisis have narrowed the current account deficits in this group of countries, but in many cases the deficits still remain high—sometimes above 10 percent of GDP (Figure 3.12).

In part prompted by the need to cover sizable current account deficits, the transition countries have required substantial external financing since the early 1990s. The amounts and composition of such financing have varied markedly (Figure 3.13). In the EU accession countries official flows, which accounted for most of the financing in the initial transition years have been replaced by private inflows as the main financing source. Foreign direct investment to these countries increased sharply from the mid-1990s in response to improved economic performance, deeper policy reforms, and prospects of EU membership. In most of these countries short-term capital inflows have also picked up. These flows have at times complicated the conduct of monetary policy. Foreign direct investment in China and Vietnam rose very rapidly in recent years, aided by—in the case of China—the establishment of free trade zones in coastal areas. China has also gained increasing access to other private financing flows, foreign bank loans in particular.

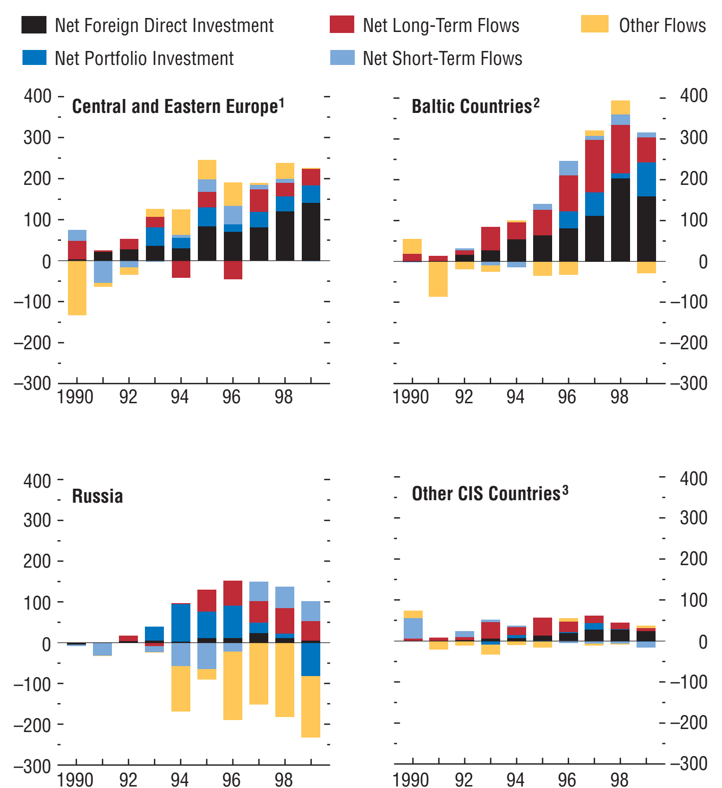
In contrast, the CIS countries have had relatively little access to private capital flows. During the early 1990s, their financing needs were often met in a disorderly manner. In the framework of the common ruble zone, which existed until the middle of 1993, the Central Bank of Russia was an important source of financing, as was the accumulation of arrears on payments for energy imports. Following the breakdown of the ruble zone, Russia continued to provide financing to other CIS countries on commercial terms, but in

several cases the resulting debt was not serviced and arrears on payments for energy imports continued.[24] Since the mid-1990s, however, the role of such exceptional financing has diminished, and most CIS countries with current account deficits have relied increasingly on multilateral loans as the main financing source. During 1996–97, some CIS countries, including Kazakhstan, Moldova, and Ukraine, also turned increasingly to private market financing, but these efforts suffered a major setback following the 1998 Russian crisis. Also, with the exception of oil-rich Azerbaijan and Kazakhstan, the CIS countries have received little foreign direct investment.

The high current account deficits registered throughout the transition in a number of CIS countries have led to rapid increases in external debt and debt service. The initial debt position in the CIS countries other than Russia was favorable, as they concluded agreements under which Russia inherited all external debt obligations for the entire former Soviet Union to official and private creditors.[25] Following the breakdown of the ruble zone in the course of 1993, arrears and obligations to the Central Bank of Russia incurred by other CIS countries were converted into government debt at commercial terms. As the public sector in many of these countries, including subnational governments and state enterprises, continued to resort to external borrowing to cushion the impact of the transitional recession, the median external debt to GDP ratio increased further, to around 45 percent by 1999, reflecting both the rise in debt and the decline in output. Most of the external debt is owed to or guaranteed by the government, and

Figure 3.13. Composition of Net Capital Flows
(U.S. dollars per capita)

Net capital flows to transition economies varied considerably between different countries and over time.



¹Central and eastern Europe excluding Belarus, Estonia, Latvia, Lithuania, and Moldova.
²Estonia, Latvia, and Lithuania.
³Commonwealth of Independent States excluding Russia.

[24]For an analysis of how the disorderly financing of substantial external imbalances contributed to the macroeconomic instability and high inflation in the CIS countries during 1992–94, see Patrick Conway, *Crisis, Stabilization and Growth: Economic Adjustment in Transition Economies* (Boston: Kluwer Academic Publishers, forthcoming).

[25]Russia, in return for taking over the debt of the former Soviet Union, inherited the Union's external assets. It also received a debt relief package from official creditors under the auspices of the Paris Club and debt referrals by commercial bank creditors.

Table 3.3. Foreign Indebtedness, 1999
(In percent)

Country Group[1]	Ratio of Debt to GDP	Ratio of Debt to Exports	Ratio of Short-Term Debt to Total Debt	Ratio of Debt Service to Exports
EU accession countries (excluding Baltics)	46.3	110.3	13.5	13.2
Baltic countries[2]	29.8	56.9	26.2	14.4
Commonwealth of Independent States[3]	62.7	150.3	12.8	15.5
High-debt CIS countries[4]	86.8	192.5	10.4	20.9
Low-debt CIS countries[5]	34.5	101.0	15.5	9.2
Other southeastern European countries	38.8	149.0	17.1	43.2
East Asia[6]	76.3	212.9	4.8	8.3

Sources: European Bank for Reconstruction and Development; and IMF staff estimates.
[1]Data for country groups are simple averages of group member data.
[2]Baltic countries data are from the European Bank for Reconstruction and Development.
[3]Data include Mongolia.
[4]Countries with debt to GDP ratios above 60 percent.
[5]Countries with debt to GDP ratios below 60 percent.
[6]Excluding Lao P.D.R. and Vietnam, which are Heavily Indebted Poor Countries, the debt to GDP ratio would drop to 43.2 percent and the debt to exports ratio would fall to 143.9 percent.

therefore it constitutes a future budget obligation. Moreover, a high proportion of the debt—including most borrowing from multilateral sources—has been contracted on market (or near market) terms, and poor debt management practices have exacerbated the debt burden. In some cases, key debt indicators, including fiscal indicators, are approaching levels that may be difficult to sustain, similar to those in many of the economies currently defined as Heavily Indebted Poor Countries in the late 1980s. With the exception of these CIS countries, and also of Bulgaria—which continues to carry a heavy debt legacy from the central planning era—the external debt burdens of the transition countries remain moderate (Table 3.3).

Comparing Transition Economies with the Rest of the World

With the transition process now under way for over 10 years, it is legitimate to ask how far the reform process has advanced and whether transition economies are still distinct from other countries. Across a range of characteristics, the answer appears to be that the transition countries as a group are difficult to distinguish from other countries with similar levels of per capita income, although the CIS countries continue to exhibit some significant differences.[26] The quality of institutions actually appears to be higher in the advanced EU accession countries than in upper-middle income developing countries, but lower in the CIS and some Balkan countries than in lower-middle income developing countries; for most Balkan and east Asian countries the quality of institutions is comparable with that of countries at similar income levels (Table 3.4).[27]

The overall comparison gives essentially similar results when the attractiveness and the competitiveness of the business environment is evaluated on the basis not only of institutions, but also by using indicators of openness, governance, financial sector development, infrastructure quality, state of technology, and labor market flexibility.[28] The EU accession countries are

[26]For an international comparison of the status of institutional development, see Weder, "Institutional Reform," and Daniel Gros and Marc Suhrcke, "Ten Years After: What Is Special About Transition Countries," Hamburg Institute of International Economics Discussion Paper No. 86 (Hamburg: HWWA, 2000).

[27]Table 3.4 ranks the countries on the basis of the overall index of institutional quality and provides a quintile allocation of countries. The table is meant to provide a rough comparison rather than a precise ranking, given the lack of precision of the underlying data.

[28]See Jeffrey Sachs, Clifford Zines, and Yair Eilat, "Benchmarking Competitiveness in Transition Economies," CAER II Discussion Paper 62 (Cambridge, Massachusetts: Harvard Institute for International Development, February 2000).

Table 3.4. Countries´ Institutional Quality: Quintiles, 1997–98

Highest Quintile	Second Quintile	Third Quintile	Fourth Quintile	Lowest Quintile
Switzerland	Costa Rica	Fiji	Senegal	Albania
Netherlands	Poland	Western Samoa	Ecuador	Korea, Dem. People's Rep. of
Finland	Malawi	Comoros	Macedonia, FYR	Cameroon
New Zealand	Czech Republic	Bahrain	Turkey	Syrian Arab Republic
Denmark	Israel	Croatia	Uganda	Chad
Norway	Bahamas, The	Cape Verde	Venezuela	Belarus
Sweden	Greece	Bolivia	Cuba	Indonesia
United Kingdom	Estonia	Bulgaria	Papua New Guinea	Azerbaijan
Luxembourg	Trinidad and Tobago	India	Sri Lanka	Kenya
Singapore	Uruguay	Brazil	Madagascar	Mauritania
Canada	Botswana	El Salvador	Vietnam	Yemen, Republic of
Australia	Qatar	Jamaica	Bangladesh	Guinea-Bissau
Ireland	Belize	Gambia, The	Cambodia	Maldives
Austria	Oman	Mexico	Central African Republic	Sierra Leone
Germany	Namibia	Romania	Colombia	Bosnia and Herzegovina
Iceland	Korea, Republic of	Lebanon	Nicaragua	Nigeria
United States	New Caledonia	Mali	Kyrgyz Republic	Burundi
Portugal	Kuwait	Dominican Republic	Honduras	Niger
Solomon Islands	Jordan	Ethiopia	Armenia	Congo
Spain	Argentina	Tanzania	Swaziland	Uzbekistan
France	Tunisia	Ghana	Djibouti	Liberia
Cyprus	Slovak Republic	Egypt	Mozambique	Yugoslavia, Fed. Rep. of
Hong Kong SAR	Brunei	Malaysia	Guatemala	Haiti
Puerto Rico	Latvia	Peru	Zimbabwe	Turkmenistan
Japan	Lithuania	Côte d'Ivoire	Kazakhstan	Angola
Italy	United Arab Emirates	Moldova	Gabon	Rwanda
Belgium	West Bank and Gaza	China	Iran, Islamic Republic of	Bhutan
Taiwan Province of China	Mongolia	Zambia	Russian Federation	Equatorial Guinea
Chile	Philippines	Suriname	Guinea	Algeria
Hungary	Morocco	Saudi Arabia	Paraguay	Sudan
Malta	Thailand	Lesotho	Ukraine	Lao P.D.R.
	Guyana	Burkina Faso	Pakistan	Tajikistan
Barbados	Panama	Benin	Georgia	Somalia
São Tomé and Príncipe	South Africa	Nepal	Togo	Zaire

Group Identification

EU accession (excluding Baltics)	Baltic countries	Other southeastern European countries	CIS[1]	East Asia

Source: Beatrice Weder, "Institutional Reform in Transition Economies: How Far Have They Come?," (unpublished; Washington: International Monetary Fund, 2000).
[1]Data include Mongolia.

the most "competitive," but could gain by increasing their openness. The Baltic countries had even lower tariff barriers than the advanced economies (on average) in 1998–99, but are still afflicted by poor quality of physical infrastructure and low labor market flexibility. The CIS countries were the least competitive, with the western member countries scoring higher than those in central Asia on almost all fronts.

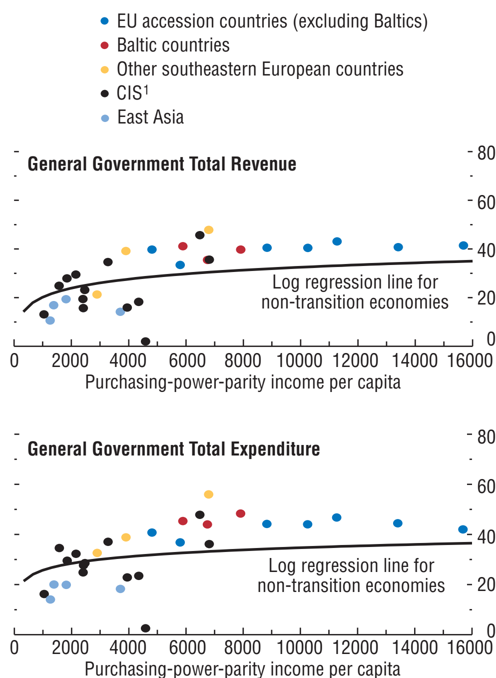
Some structural distortions inherited from central planning are still present in the economic structure of the transition countries, while some positive legacies also persist. On the one hand, government size (as measured by revenue and expenditure ratios to GDP) in transition economies of middle income levels is generally larger than in market economies at similar levels of income (Figure 3.14). Also, even after controlling for income and other pertinent economic indicators, the extent of trade among the former CMEA countries (excluding Vietnam) and the size of the industrial sector

are generally still larger than market economy benchmarks.[29] On the other hand, human capital endowment was and remains high by international standards in the transition economies, even though its skill mix may not always correspond optimally to the requirements of a market economy. Despite a temporary negative effect of the transition process—particularly in western CIS countries, where indicators of life expectancy and adult mortality have worsened since the onset of transition—health and education conditions are generally still favorable compared with other countries at similar levels of income (Table 3.5).

The financial system is still underdeveloped by international standards, based on measures of financial maturity that have recently been developed and appear to be linked to growth and development.[30] On the one hand, the provision of credit by private banks relative to that by the central bank is by now close to the norms observed in market economies at comparable levels of income (Figure 3.15, upper panel).[31] The east Asian transition countries and the EU accession countries are somewhat above this benchmark, and most CIS countries are below it. On the other hand, the depth of the financial system and the degree of financial intermediation to the private sector are still more limited than in traditional market economies. For most transition economies (with the notable exception of

Figure 3.14. Government Revenue and Expenditure, 1999
(Percent of GDP)

Transition economies with per capita incomes above $5,000 still have a relatively large public sector; their ratios of government revenue and expenditure to GDP systematically exceed the average ratios in non-transition economies.



[1]Data include Mongolia.

[29]Jarko Fidrmuc and Jan Fidrmuc, "Integration, Disintegration and Trade in Europe: Evolution of Trade Relations During the 1990s," paper presented at the fifth Dubrovnik conference on Transition Economies, Croatia, June 23–25, 1999, published as Working Paper B3 (Bonn: Center for European Integration Studies, 2000), and Gros and Suhrcke, "Ten Years After."

[30]For the link between financial intermediation and growth, see Ross Levine, Norman Loyaza, and Thorsten Beck, "Financial Intermediation and Growth: Causality and Causes," World Bank Policy Research Working Paper No. 2059 (Washington: World Bank, February 1999).

[31]The data in Figure 3.15 on financial markets in transition countries were specially constructed for the *World Economic Outlook*; see William Branson and Ben Sutton, "Financial Maturity in Transition Economies" (unpublished; Washington: International Monetary Fund, 2000).

Table 3.5. Proxy Measures of Human Capital
(Average across years)

Country Group[1]	Primary School Enrollment (gross) 1995–99	Life Expectancy at Birth (years) 1998–99	Infant Mortality Rate per 1,000 Live Births 1998–99	Adult Illiteracy (percent of people aged 15 and over) 1998–99	*Memorandum* Purchasing Power Parity GDP per Capita 1998–99
EU accession countries (excluding Baltics)	99.9	72.2	10.4	1.1	9,837
Baltic countries	94.0	70.3	11.1	0.4	6,737
Other southeastern European countries	92.9	72.4	16.5	9.3	4,514
Commonwealth of Independent States[2]	93.8	68.4	21.8	7.0	3,278
East Asia	115.6	61.5	65.5	35.2	1,987
Other Economies					
Advanced economies	101.9	77.5	5.2	4.8	23,278
Developing countries[3]	93.7	60.5	61.3	30.2	4,435
Low income	78.0	52.3	89.1	45.0	1,401
Lower middle income	101.2	66.9	42.2	19.9	4,305
Upper middle income	102.8	69.4	26.6	13.3	9,287

Sources: World Bank; IMF staff estimates.
[1]Data for country groups are simple averages of group member data.
[2]Data include Mongolia.
[3]Data exclude Cambodia, China, Lao P.D.R., Mongolia, and Vietnam.

China), indicators such as the ratio of private credit to GDP and liquid bank liabilities to GDP are well below the average of other countries with similar levels of income, with the EU accession countries being generally closer to the benchmark than the CIS countries (Figure 3.15, middle and lower panels).

Explaining Differences in Performance and Resulting Policy Lessons

Among the major differences in performance among transition economies are the evolution of output and inflation following the start of the transition process (Figure 3.3). Empirical research suggests that this divergent performance can be explained in terms of four main factors: differences in inherited economic structures; political developments—including civil strife and war in some countries in southeastern Europe and the CIS; reform strategies; and macroeconomic policies.[32] In particular, the much larger output contraction experienced initially by the CIS and Baltic countries compared to the central European transition economies owed much to worse initial conditions in terms of larger price and trade distortions (Table 3.6), as these implied a more extensive reorganization of resources and structural adjustments.[33] In contrast, some countries in southeastern and central Europe (especially the successor states to the former Republic of Yugoslavia, but also Hungary and Poland) had made significant progress with reform before, particularly in terms of public controls of prices, ownership of small firms, and the structure of external trade.[34] Given the dis-

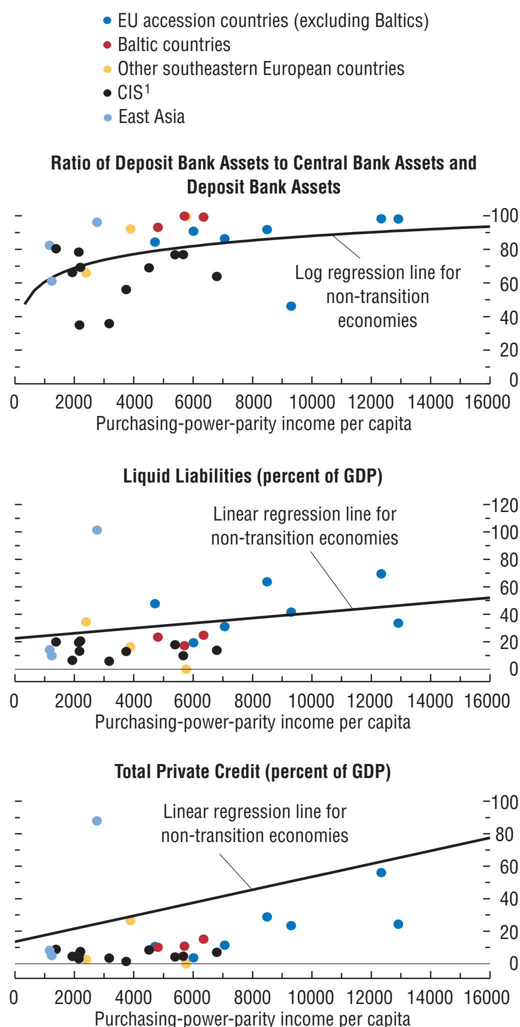
[32]Stanley Fischer and Ratna Sahay, "The Transition Economies After Ten Years," IMF Working Paper 00/30 (Washington: International Monetary Fund, 2000); Charles Wyplosz, "Ten Years of Transformation: Macroeconomic Lessons," CEPR Discussion Paper No. 2254 (London: Centre for Economic Policy Research, 2000); Jànos Kornai, "Ten Years After The Road to a Free Economy: The Author's Self-Evaluation," paper presented at the World Bank Annual Bank Conference on Development Economics held in Washington, D.C. on April 18–20, 2000.

[33]Martha De Melo, Cevdet Denizer, Alan Gelb, and Stoyan Tenev, "Circumstances and Choices: The Role of Initial Conditions and Policies in Transition Economies," World Bank Policy Research Working Paper No. 1866 (Washington: World Bank, 1997), and Peter Murrell, "How Far Has The Transition Progressed?" *Journal of Economic Perspectives*, Vol. 10, 1996, pp. 25–44.

[34]The liberalization index for the transition economies of east Asia for the year 1989 is also relatively high, as these countries started the reform process earlier.

Figure 3.15. Financial Maturity Indicators, 1994–99
(Simple country averages)

Two-tier banking systems have been established in almost all transition countries, but the extent of financial intermediation is generally still limited when compared with other economies.



[1]Data include Mongolia.

torted structure of industry and trade, the collapse of the CMEA in 1991 resulted in a severe demand shock, particularly for countries of the former Soviet Union and Mongolia (Figure 3.16), where—with the exception of Russia, which had a somewhat more diversified geographic composition of trade—intra-CMEA trade accounted for as much as 80–90 percent of total trade (some 30–40 percent of GDP). In addition, many of the CIS countries were severely affected by the loss of fiscal transfers through the former Union budget, by 16 price increases on energy deliveries from Russia, and by the large output falls in Russia—their principal trading partner.[35] However, recent empirical evidence shows that the impact of initial conditions faded gradually over time: the macroeconomic performance at the beginning of the transition process was heavily influenced by the initial conditions, but the subsequent path of recovery was closely associated with the strength of the reform efforts.[36]

The slower output recovery in CIS countries, compared to the EU accession countries, has been mostly associated with less vigorous and more limited structural and institutional reforms, as well as less successful stabilization policies, entailing greater macroeconomic instability following the onset of transition. A wide body of research suggests that countries with deeper and wider reforms experienced an earlier resumption of output growth and a faster reduction in inflation, while delaying key structural reforms or stabilization measures did not prevent output declines. The countries that implemented more ambitious structural reform programs were also the ones that were more successful in achieving macroeconomic stabili-

[35]See Robert A. Mundell, “The Great Contractions in Transition Economies,” in *Macroeconomic Stabilization in Transition Economies,* ed. by Mario I. Blejer and Marko Skreb (Cambridge: Cambridge University Press, 1997).

[36]See de Melo and others, “Circumstances and Choices,” and Elisabetta Falcetti, Martin Raiser, and Peter Sanfey, “Defying the Odds: Initial Conditions, Reforms, and Growth in the First Decade of Transition” (unpublished; London: EBRD, 2000).

Table 3.6. Initial Conditions

Transition Country/Group[1]	Share of Industry in GDP 1990	Liberalization Index 1989	Repressed Inflation 1987–90[2]	Black Market Premium 1990 (%)	Years Under Central Planning[3]	Purchasing Power Parity Income per Capita (U.S. Dollars) 1989	Council of Mutual Economic Assistance Trade (percent of GDP) 1990	Natural Resource Endowment
EU accession countries (excluding Baltics)	**0.52**	**0.16**	**5.5**	**339**	**43**	**6,547**	**8.3**	
Bulgaria	0.59	0.13	18.0	921	43	5,000	16.1	poor
Czech Republic	0.58	0.00	–7.1	185	42	8,600	6.0	poor
Hungary	0.36	0.34	–7.7	47	42	6,810	13.7	poor
Poland	0.52	0.24	13.6	277	41	5,150	8.4	moderate
Romania	0.59	0.00	16.8	728	42	3,470	3.7	moderate
Slovak Republic	0.59	0.00	–7.1	185	42	7,600	6.0	poor
Slovenia	0.44	0.41	12.0	27	46	9,200	4.0	poor
Baltic countries	**0.45**	**0.05**	**25.7**	**1,828**	**51**	**7,973**	**35.9**	
Estonia	0.44	0.07	25.7	1,828	51	8,900	30.2	poor
Latvia	0.45	0.04	25.7	1,828	51	8,590	36.7	poor
Lithuania	0.45	0.04	25.7	1,828	51	6,430	40.9	poor
Other southeastern European countries	**0.38**	**0.27**	**9.4**	**163**	**47**	**3,655**	**6.2**	
Albania	0.37	0.00	4.3	434	47	1,400	6.6	poor
Croatia	0.35	0.41	12.0	27	46	6,171	6.0	poor
Macedonia, Former Yugoslav Rep. of	0.43	0.41	12.0	27	47	3,394	6.0	poor
Commonwealth of Independent States[4]	**0.41**	**0.04**	**24.3**	**1,795**	**70**	**4,755**	**27.2**	
Armenia	0.55	0.04	25.7	1,828	71	5,530	25.6	poor
Azerbaijan	0.44	0.04	25.7	1,828	70	4,620	29.8	rich
Belarus	0.49	0.04	25.7	1,828	72	7,010	41.0	poor
Georgia	0.43	0.04	25.7	1,828	70	5,590	24.8	moderate
Kazakhstan	0.34	0.04	25.7	1,828	71	5,130	20.8	rich
Kyrgyz Republic	0.40	0.04	25.7	1,828	71	3,180	27.7	poor
Moldova	0.37	0.04	25.7	1,828	51	4,670	28.9	poor
Mongolia	0.41	0.00	7.6	1,400	70	2,100	31.0	moderate
Russia	0.48	0.04	25.7	1,828	74	7,720	11.1	rich
Tajikistan	0.34	0.04	25.7	1,828	71	3,610	31.0	poor
Turkmenistan	0.34	0.04	25.7	1,828	71	4,230	33.0	rich
Ukraine	0.44	0.04	25.7	1,828	74	5,680	23.8	moderate
Uzbekistan	0.33	0.04	25.7	1,828	71	2,740	25.5	moderate
East Asia[5]	**0.36**	**0.50**	**8.7**	**336**	**19**	**882**	**4.1**	**. . .**
Cambodia	. . .	. . .	. . .	. . .	15	894	. . .	. . .
China[5]	0.49	0.46	2.3	208	29[6]	800	1.0	moderate
Lao People's Democratic Republic[5]	. . .	. . .	. . .	. . .	11	736	. . .	. . .
Vietnam[5]	0.23	0.53	15.0	464	11/32[7]	1,100	7.2	moderate

Sources: Martha De Melo, Cevdet Denizer, Alan Gelb, and Stoyan Tenev, "Circumstances and Choices: The Role of Initial Conditions and Policies in Transition Economics" (Washington: World Bank, 1997); Data for Cambodia and Lao P.D.R. are IMF staff calculations.

[1]Data for country groups are simple averages of group member data.

[2] Repressed inflation is calculated as the percent change in the average real wage less the percent change in real GDP over 1987–90.

[3]Until beginning of transition.

[4]Data include Mongolia.

[5]Table is adjusted for three east Asian countries whose transitions began prior to 1989 (China, 1978; Lao P.D.R, 1986; Vietnam, 1986), except for the "Liberalization Index", 1989, which refers to 1989 for all countries.

[6]Data is IMF staff evaluation and different from original source.

[7]South and North Vietnam respectively. IMF staff evaluation, different from original source.

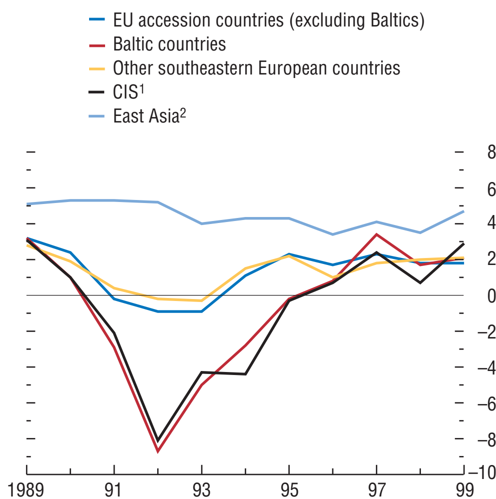
zation.[37] (The special case of east Asian transition economies will be reviewed in the following paragraphs.).

The initial surge in prices in most transition countries was a result of repressed inflation preceding reform, but the subsequent explosion into hyperinflation in several CIS countries was due to ongoing policies failing to maintain macroeconomic stability. In the last years of central planning, most countries allowed a monetary overhang to build up: wages paid to workers exceeded the value of goods produced by state-owned enterprises (whose prices were set artificially low), the excess being financed by money creation. When prices were liberalized, this inflationary pressure generated a one-off jump in prices. A rapid deterioration of the fiscal accounts, coupled with monetary financing of budget deficits in the context of the ruble zone, subsequently generated rapid inflation.[38] The reasons why these adverse developments were so

Figure 3.16. Trade-Weighted Real GDP Growth of Trading Partners

(Annual percent change)

Strong trade links among members of the defunct Council for Mutual Economic Assistance (CMEA) at the start of transition led to the transmission of output shocks within this area, which were largest for the member states of the former Soviet Union.



Source: IMF staff estimates.

[1]Data include Mongolia.

[2]Chart is adjusted for three east Asian countries whose transitions began prior to 1989. The first 11 years of transition for the following countries are as follows: China (1978–89), Lao P.D.R. (1986–97), and Vietnam (1986–97).

[37]For the role of structural reforms, see Falcetti, Raiser, and Sanfey, "Defying the Odds"; Oleh Havrylyshyn and others, "Growth Experience in Transition Countries, 1990–98," Occasional Paper No. 184 (Washington: International Monetary Fund, 1999); Andrew Berg and others, "The Evolution of Output in Transition Economies: Explaining the Differences," IMF Working Paper 99/73 (Washington: International Monetary Fund, 1999); Holger Wolf, "Transition Strategies: Choices and Outcomes," *Princeton Studies in International Finance No. 85* (Princeton, New Jersey: Princeton University, June 1999); Peter Christoffersen and Peter Doyle, "From Inflation to Growth: Eight Years of Transition," IMF Working Paper 98/100 (Washington: International Monetary Fund, July 1998); Martha De Melo, Cevdet Denizer, and Alan Gelb, "Patterns of Transition from Plan to Market," *The World Bank Economic Review*, Vol. 10, No. 3., pp. 397–424, and references cited therein. The importance of institutions for growth in transition economies has been documented, among others, by Aymo Brunetti, Gregory Kisunko, and Beatrice Weder, "Institutions in Transition: Reliability of Rules and Economic Performance in Former Socialist Countries," World Bank Policy Research Working Paper No. 1809 (Washington: World Bank, 1997); and Oleh Havrylyshyn and Ron van Rooden, "Institutions Matter, But So Do Policies," IMF Working Paper 00/70 (Washington: International Monetary Fund, 2000).

[38]On fiscal developments, see Vito Tanzi and George Tsibouris, "Fiscal Reform over Ten Years of Transition," IMF Working Paper 00/113 (Washington: International Monetary Fund, 2000).

different in scale among transition economies can only be fully understood by discussing the political economy of reform (see next section).

Unlike the macroeconomic developments in the transition countries in Europe and the CIS, the transition countries of east Asia did not experience an initial output contraction following the initiation of the reform process, and output growth actually rose significantly during transition.[39] The rapid growth experienced by China in particular has led a number of observers to argue that a gradual approach to reform may be more effective.[40] Others, however, have argued that this favorable outcome occurred despite gradualism, not because of it, and that a large part of the difference in performance is explained by differing initial conditions and political stability.[41]

A distinguishing feature of the transition process in China and other east Asian countries is that the process was started by the incumbent governments, with the initial objectives of raising income and growth by introducing incentives, modifying the traditional planning system, and opening up the economy to the outside world. The reform process was therefore inevitably gradualist in nature—although in specific areas it was quite far reaching—and evolved over time.[42] Thus, in contrast with the experience in a number of transition countries in other regions, economic reform efforts were initiated and implemented in a relatively stable political climate, without the disruptive effects associated with civil strife or the dissolution of state structures.

While the debate on the causes of the strong growth in the transition countries of east Asia still continues, specific initial conditions clearly also played an important role. Apart from the political aspects noted above, a central distinction is that the east Asian economies were still largely agricultural, with a large pool of surplus labor. Thus, initial reforms—for instance, permitting greater private sector activity in agriculture and relaxing entry into industry in rural areas—could generate large increases in output. In most other transition countries, where most people were securely employed by large, albeit inefficient, public enterprises, there was no alternative to tackling the problems in the state-owned industrial sector up front, which inevitably resulted in a period of substantial economic dislocation.

In addition, macroeconomic conditions were generally more favorable. In particular, China enjoyed a relatively strong fiscal position when initiating its reform efforts and has succeeded in avoiding major macroeconomic crises.[43] Although the other transition economies in east Asia faced large fiscal deficits and experienced a period of very high inflation at the outset of their transitions, they were able to quickly reduce inflation to more moderate levels by drastically tightening fiscal and monetary policies, and any decline in output was modest and short-lived—mainly because of a strong supply response from agricultural reforms. The transition countries in east Asia also were less affected by trade distortions, having begun to diversify and

[39]The transition process in Mongolia is in many ways similar to that of the faster reforming economies in central Europe—see Sanjay Kalra and Torsten Sløk, "Inflation and Growth in Transition: Are the Asian Economies Different?" IMF Working Paper 99/118 (Washington: International Monetary Fund, August 1999).

[40]See Barry Naughton, "What Is Distinctive About China's Economic Transition? State Enterprise Reform and the Overall System Transformation," *Journal of Comparative Economics,* Vol. 18, No. 3, (1994), pp. 470–90; and Thomas Rawski, "Progress without Privatization: The Reform of China's State Industries," in *The Political Economy of Privatization and Public Enterprise in Post-Communist and Reforming Communist States,* ed. by Vedat Milor (Boulder, Colorado: Lynne Rienner, 1994).

[41]See Jeffrey Sachs and Wing Thye Woo, "Structural Factors in the Economic Reforms of China, Eastern Europe, and the Former Soviet Union," *Economic Policy*, Vol. 9 (April 1994), pp. 101–145.

[42]China's present objective of developing a socialist market economy was not formally adopted until 1993, 15 years after the start of the reform process.

[43]However, stabilization in China has taken place in distinct cycles. Typically, reforms led to rising domestic demand and inflationary pressures, which—given the limitations of macroeconomic instruments—prompted the authorities to tighten administrative controls and slow down reforms to maintain macroeconomic stability; see Stefan Erik Oppers, "Macroeconomic Cycles in China," IMF Working Paper 97/135 (Washington: International Monetary Fund, September 1997).

reduce their trade dependency on the CMEA area much earlier; thus when the CMEA collapsed in 1991, the negative external demand shock was less severe.

The strong growth performance in the east Asian transition economies following the onset of the transition may also reflect three key elements of the reform strategies adopted in the region. First, while reforms in the east Asian transition countries have indeed been partial, leaving the large state-owned enterprises and the financial sector until late in the process, they have nevertheless been quite radical in the areas in which growth has been most dynamic, such as agriculture, foreign enterprise entry, and creation of new rural enterprises. Second, the reform process facilitated and encouraged the development of new small and medium-scale enterprises (even though property rights were never well defined). In China, the so-called township and village enterprises grew rapidly, accounting for an increasing share of industrial output and especially exports. However, this approach of allowing small-scale initiatives to thrive while postponing the reform of the large-scale, state-owned industrial enterprises appears to have been possible only where the large-scale, state-owned firms did not constitute a major part of the overall economy. Third, the reform strategy—particularly in China—has been characterized by pragmatism and flexibility, with different reform approaches often allowed to coexist and compete for a period. Given the difficulties of implementing reforms in such a large and diverse country such as China, this approach has helped to build local ownership of reforms, and has yielded important lessons that could then be applied country wide. For example, the development of both the household responsibility system in agriculture, and to some extent of the township and village enterprises, stem from local, rather than central, initiatives and experience.

As noted earlier, the gradual pace of reform in public enterprises and in the financial sector was feasible because of the initial structure of the economy, and it has helped maintain social stability in China and other east Asian transition economies. Such stability has, however, been bought at a price. In China, for example, the lack of reform of state enterprises contributed to a serious deterioration in the firms' financial positions, financed primarily through a substantial buildup of nonperforming loans in the state-owned commercial banks. By the mid-1990s, the situation was no longer sustainable, and since that time financial and enterprise sector reforms have been at the top of the policy agenda. Over the last few years, significant progress has been made—including privatization of the bulk of small-scale enterprises and the reduction of nonperforming loans in state banks—although much remains to be done to restructure large enterprises and to develop a strong and commercially oriented banking system.

Political Economy of Transition

It is tempting to argue that the large differences in stabilization efforts and progress in structural reform are simply a manifestation of different policy objectives and commitment, as revealed by actual reform measures taken and the effectiveness of their implementation. This interpretation, however, begs the important question: why were there such large differences in policy objectives and in countries' success (or failure) in translating the objectives into legislation and then implementing this legislation? To shed more light on this question, it is necessary to complement economic analysis with insights from political economy.[44]

The more successful EU accession countries embarked on vigorous structural reform and dismantled the command economy before the suc-

[44]This section relies heavily on the analysis presented in Oleh Havrylyshyn and John Odling-Smee, "The Political Economy of Reform in Transition Countries," *Finance and Development*, Vol. 37, No. 3, September 2000, pp. 7–10; and Gérard Roland, *Transition and Economics—Politics, Markets and Firms* (Cambridge, Massachusetts: MIT Press, 2000); and "The Politics of Economic Reform," Chapter 5 in the EBRD *Transition Report 1999*.

cessor countries to the former USSR. The reason for this is first of all political: Soviet hegemony in the eastern bloc and the resulting Soviet tutelage of the states in eastern Europe had weakened well before the disintegration of the Soviet Union itself. However, not only the timing but also the depth and vigor of reforms to transform their economies was more pronounced among these countries, which, following the breakup of the Soviet Union, came to include the three Baltic states. The major reason for the greater determination and consistency with which these EU accession countries approached the structural reform process is explained by most observers by their underlying historical affinity to western Europe and—with central planning introduced only in the late 1940s—significant understanding of a market-based economy.[45] Consequently, the political upheavals that shook central and eastern Europe toward the end of the 1980s were perceived by these countries as an opportunity to return to a market economy and adopt the institutions that underpin it. The resulting resolve to embrace necessary structural change, and the positive incentive of joining the European Union, accelerated the reform process and helped to prevent opposing coalitions from forming and obstructing it.

In contrast, most of the CIS countries had no obvious alternative model to follow when the Soviet Union disintegrated, and with central planning having existed for close to 70 years, little knowledge of the operation of a market-based economy remained. In fact, it can be argued that a market-oriented economy has never existed in the majority of the CIS countries. As noted above, little up-front external financing was made available—relative to needs—to support radical reform in most CIS countries, particularly at the beginning of the process.[46] Together with a lack of clear orientation in the reform process, this in many cases led to a situation where reforms moved relatively slowly.[47] The major exception to this pattern was Russia, which obtained considerable outside support and developed a reform plan early on. However, following some initial radical initiatives, reforms were subsequently slowed by internal opposition in a manner similar to the rest of the CIS.

In a situation where reform was only partial, a variety of opportunities for rent seeking by individuals emerged, including many members of the former governing elite. These "vested interests" benefited from a situation of partial and incomplete reforms, because their ability to influence and modify policies enabled them to generate rents from persistent market distortions, unchecked by either the political system or by competitive markets. Since this situation would have been undermined by a more comprehensive reform, these groups used their economic power to distort or stall the reform process.[48] The success of vested interests in appropriating wealth and income, in combination

[45]In corresponding econometric research this explanatory factor is usually proxied by one or more "initial conditions," like time spent under central planning and/or geographical distance from western Europe; for representative examples of such research see Wolf, "Transition Strategies," Fischer and Sahay, "The Transition Economies After Ten Years," and Jeffrey Sachs, Clifford Jinnes, and Yair Eilot "Patterns and Determinants of Economic Reform in Transition Economies: 1990–1998," CAER II Discussion Paper No. 61 (Cambridge, Massachusetts: Harvard Institutue for International Development, February 2000).

[46]A determined comprehensive approach comparable to the Marshall Plan, which supported the reconstruction of western Europe following World War II, never materialized. Much of the financing that did materialize at the early stages of transition was in the form of cumulating arrears, rather than loans or grants dedicated to support an orderly transition process.

[47]In a more nuanced classification, the EBRD distinguishes those CIS countries where the reform process has stalled and another group where little, if any, substantial reform had occurred up to mid-1999 (Belarus, Turkmenistan, and Tajikistan); see "The Politics of Economic Reform," Chapter 5, EBRD, *Transition Report 1999*.

[48]There is a historical parallel between these powerful interest groups (the "oligarchs") in some of today's transition economies and the "robber barons" of early capitalist development in today's market economies; see Mancur Olson, *Power and Prosperity: Outgrowing Communist and Capitalist Dictatorships* (New York: Basic Books, 2000). In Olson's view, overcoming the grip of vested interest groups on the government and the economy in general in either case requires the development of a representative government immune to "capture" by these (or other) interest groups.

with falling aggregate output, led to a significant increase in income inequality and poverty (Figure 3.6). This weakened general public support for the reform process, which often found its expression in the election of parliamentary majorities (or strong minorities) skeptical about the direction of reform, generally resulting in a slowdown in the pace of reform.

Lessons from the Transition Process

The experience accumulated during the last two decades of transition provides important policy lessons not only for the transition countries themselves, but also for reform strategies in other countries—developing and advanced economies alike. The following issues stand out.

Countries that adopted a two-pronged strategy combining macroeconomic stabilization and comprehensive structural reform were, on the whole, more successful in limiting the output losses at the outset of the transition and achieving robust growth subsequently.[49] The two components of the strategy were equally necessary: a measure of macroeconomic stability had to be secured before countries could proceed effectively with enterprise and financial sector reform, and such stability could not be maintained unless the enterprise and banking sectors were subject to financial discipline and competitive pressures.

Delaying certain key structural reforms (price and trade liberalization, and the elimination of soft budget constraints) has typically been associated with higher and more protracted inflation and a less robust recovery from the initial output fall. However, a privatization strategy that starts with a rapid privatization of small-scale enterprises and adopts a more gradual approach for large enterprises, conditional on the introduction of commercial legislation to support viable corporate governance structures and to provide effective competition (or regulation in case of natural monopolies), appears to have been most effective, provided these enterprises were sold in a transparent way (Box 3.4).

The transition strategy pursued by the east Asian economies has been accompanied by a remarkable acceleration of growth, with close to 400 million people lifted out of poverty in China since 1978 according to World Bank estimates. In China, this has owed much to the authorities' ability to develop a reform strategy that took advantage of the specific conditions they faced—such as the large agricultural sector and rural labor surplus—and generated rapid growth without adversely affecting social stability, thereby creating the domestic support for further reforms. However, just as in other countries, the fastest growth seems to have taken place in the sectors where reforms were most comprehensive. Moreover, delays in reforming large enterprises and the financial sector have been costly, and constitute a major challenge for the future.

The importance of institutional reform was recognized at the beginning of the transition, but in practice it was given too little attention relative to macroeconomic developments by both policymakers and advisors alike, probably because the difficulties of implementing these reforms had been underestimated and there was a lack of experienced personnel. The necessary reforms may also have been insufficiently prioritized, especially in view of the limited administrative capacity in many countries. Building an effective institutional and legal infrastructure in support of the market and private sector activity, while essential to the ultimate success of transition, is inevitably time-consuming and complex, as it also requires adjustments in the social practices and behaviors of both government officials and private sector agents. The experience of the EU accession countries strongly suggests that an external political anchor can greatly assist institution building and implementing governance reform.

The extensive trade liberalization measures that were adopted in almost all transition coun-

[49]As the example of the Baltic states demonstrates, such a strategy could be pursued and was successful even in cases where unfavorable initial conditions or the negative impact of external shocks had to be overcome.

tries have helped to redress the distortions inherited from central planning and to bring the geographical and commodity composition of trade more in line with each country's specific resources and comparative advantage. And proximity to the European Union has helped the central and eastern European countries in particular to reallocate trade flows away from other centrally planned economies toward western Europe. The more successful reformers have been able to gain rapid access to foreign capital markets, as well as to attract rising foreign direct investment, thereby quickly reducing reliance on official and multilateral financing. The less successful reformers were less able to do so—and in some cases, such as Russia, faced capital flight—which significantly hindered the reform effort.

The role of exchange rate regimes, which was hotly debated during the initial phase of the transition process, has not turned out to be a crucial determinant of success or failure during the stabilization phase of the transition. Countries at both extremes of the exchange rate regime spectrum (e.g., currency boards in Baltic countries and floating exchange rates in the CIS) were able to bring inflation down rapidly, as long as they kept the money supply and related fundamentals under control. Whenever monetary or fiscal policies were not supportive, however, using exchange rate policies to combat inflation was not successful, as exemplified by the Russian crisis of 1998. Pegging the exchange rate served as a monetary anchor initially for several countries, but most of these have now shifted to a more flexible exchange rate (e.g., Poland) to maintain policy independence in the presence of high capital mobility.

Finally, the political economy argument that policy mistakes in sequencing reform and half-hearted implementation allowed insiders to form coalitions aimed at stalling the reform process has been largely validated in central and eastern Europe and the CIS.[50] In several transition countries, the political decision making process, which determines the nature and pace of structural reforms, has been captured by vested interests that engage in rent-seeking activities and maximize their economic benefits—at least in the short run—at an intermediate stage of reform. Such vested interests, once firmly entrenched, are difficult to dislodge. The costs they inflict can be very high, as such groups may succeed in blocking the development of the institutional infrastructure that underpins the operation of market economies, thus stalling the transition process. This underscores the need for carrying out and sequencing further structural reform in such a way as to minimize the interference of vested interest with the policymaking process.

Policy Agenda for the Future

The transition economies, particularly those that have finally overcome the transition recession, face the key challenge of achieving sustained and robust economic growth and catching up with the living standards in market economies. Further restructuring and elimination of inefficiencies inherited from central planning and the absorption of new technology through trade and financial integration with the advanced economies can help these countries to realize their substantial potential for growth and convergence. Indeed, a number of transition economies in central and eastern Europe and the Baltic countries have already embarked on the path of sustained robust growth. They are expected to gradually close the remaining GDP per capita gap with comparator market economies through more rapid productivity growth, in tandem with the rebuilding of the physical capital stock and the adoption of new technologies and management practices. This convergence process is discussed in more detail in Chapter IV.

To catch up, transition economies need to both pursue sound macroeconomic policies and

[50]Oleh Havrylyshyn and John Odling-Smee, "The Political Economy of Reform in Transition Countries," and EBRD, Chapter 5, *Transition Report 1999*.

to make progress toward completing structural reforms and building the institutions required to underpin a market economy, while recognizing realistic constraints on their implementation capacity. A well-focused policy agenda is especially important for countries that have not yet managed to embark on a path of sustained growth and convergence. In these countries, the challenge is to reinvigorate the reform process in the face of limited institutional capacities, the existence of vested interests, serious governance problems, and, in some cases, widespread arrears and fiscal problems. Unless reform efforts are focused and strengthened, these countries face the prospect of remaining in an incomplete transformation trap, where low domestic saving and investment, a lack of enterprise restructuring and concomitant inefficiencies, pervasive problems with barter and arrears, lack of competition, limited foreign direct investment, and capital outflows create a vicious circle depriving them of the opportunity to achieve higher growth, bring down inflation, and reduce their dependency on official external financing.

Macroeconomic Policy Challenges

Many transition countries now enjoy the benefits of macroeconomic stability, which is needed for successful growth and convergence. This is particularly true in the EU accession countries, whose macroeconomic challenges are discussed in Chapter IV. Elsewhere in the transition economies, however, the legacies of central planning, and of the transition process, have continued to complicate macroeconomic policies. The rudimentary nature of financial systems often have limited the ability to conduct monetary policies. [51] The most important macroeconomic challenges, however, relate to fiscal policy. High levels of government expenditure—both on and off budget—and lack of an effective tax collection system generate pressures for large fiscal deficits. This problem is further complicated by the non-transparent and quasi-fiscal nature of much government spending, often associated with implicit subsidies for existing enterprises. The transition process has itself created fiscal pressures, as both output declines and tax system reform led to revenue reductions, and structural reform measures generated additional spending, which, when combined, exceeded revenues from privatization.[52]

The legacies of central planning are particularly important for those countries least advanced in structural and institutional reform—Belarus, Tajikistan, Turkmenistan, and Uzbekistan—that continue to maintain large subsidies for enterprises, extensive price controls, and restrictive capital controls. In these countries, central bank support for the budget, banking system, and enterprises continues to fuel rapid growth in the money supply and high inflation. The resulting macroeconomic instability is unlikely to disappear without fundamental structural reform.

Many of the low-income transition economies in the CIS and other countries of southeastern Europe also face significant structural budget deficits, often associated with the desire to cushion the impact of steep falls in output that were deeper and have lasted for longer than originally anticipated. The counterpart to these fiscal deficits has generally been foreign borrowing. The need to service the resulting external debt is putting pressure on fiscal positions, and, in some cases, the limited capacity to raise revenue is a significant constraint on external debt serv-

[51]However, many transition countries, particularly those starting central banks from scratch, have in the meantime moved to establish independent monetary authorities, and the quality of their institutional arrangements are now often comparable with those in advanced economies. See Helmut Wagner, "Central Banking in Transition Countries," IMF Working Paper 98/126 (Washington: International Monetary Fund, 1998); and Tonny Lybek, "Central Bank Autonomy, and Inflation and Output Performance in the Baltic States, Russia, and Other Countries of the Former Soviet Union, 1995–97," IMF Working Paper 99/4 (Washington: International Monetary Fund, 1999).

[52]Such spending is associated with restructuring enterprises, recapitalizing banks, creating government social insurance for the unemployed, and replacing social services provided by state enterprises under central planning.

ice (Table 3.3). Further fiscal adjustment is needed to avoid exacerbating these unfavorable debt dynamics, while the international community should consider whether in some cases, as in other low-income countries with high levels of debt, the negative effects of the existing debt overhang require additional measures.[53]

In many transition economies, including Russia, macroeconomic policies are complicated by a variety of structural impediments. Limited spending and revenue management capacities, arrears, and, in some cases, a lack of coordination between central and local governments mean that it is difficult for fiscal policy to respond to shocks, such as large changes in commodity prices, in a discretionary manner. Monetary policy is constrained in many cases by the absence of well-functioning financial institutions and interbank and treasury bill markets. Additional challenges facing the monetary authorities include entrenched inflationary expectations that reflect uneven macroeconomic policy performance in the past, and—most notably in Russia—substantial capital outflows.[54] More generally, the need to import foreign capital to support stronger growth entails the risk of sudden reversals of inflows, while financial imbalances in the enterprise sector and weak financial systems engender a relatively high vulnerability to macroeconomic instability and financial crises.

The central macroeconomic challenge in China and Vietnam, given their rapid growth and low level of inflation, largely relates to the fiscal costs associated with losses in state-owned enterprises and banks, accrued pension liabilities, and the costs of structural reforms. Such liabilities, which also exist in a number of CIS countries, have significant implications for medium-term fiscal sustainability.[55] This underscores the importance of continuing current efforts to strengthen revenue mobilization and further improve budgetary management, combined with comprehensive reform of state-owned enterprises and the banking system.

The Structural Reform Agenda

All transition countries, including those that have advanced most toward meeting the requirements of a well-functioning market economy, continue to face challenges in structural reform and institution building in a broad range of areas (Table 3.7). The need for structural reform and institution building is particularly pressing in those transition economies, including virtually all CIS and some east Asian countries, where reforms have been partial or slow and are in some cases obstructed by special interest groups. The specific reform agenda varies in individual countries, and in most cases reforms will need to be carefully prioritized and sequenced in line with the available administrative and institutional capacity. Three areas that appear particularly critical—and in which countries face common challenges—are restructuring enterprises, building a market-based financial sector, and transforming the role of the state.

Enterprise Restructuring

In most countries outside the EU accession group, continuing inefficiencies and loss-making activities in large-scale enterprises—often the only employer in a single company town—remain a serious drag on the economy. In Russia and other CIS countries, the problem primarily

[53]The impact of high levels of debt on low-income developing countries is discussed in "How Can the Poorest Countries Catch Up?" Chapter IV, May 2000 *World Economic Outlook*.

[54]In addition to credibility problems in the conduct of macroeconomic policy, these outflows reflect slow progress in structural reform. Experience in the central and eastern European countries, as well as elsewhere, suggests that sound macroeconomic policies and structural reforms could help eliminate such capital outflows relatively quickly. But, while capital controls can mitigate volatility in short-term flows of external capital, they are largely ineffective at stopping capital flight. See Prakash Loungani and Paolo Mauro, "Capital Flight in Russia," IMF Policy Discussion Paper 2000/05 (Washington: International Monetary Fund, 2000).

[55]See Nicholas R. Lardy, *China's Unfinished Economic Revolution* (Washington: The Brookings Institution, 1998).

Table 3.7. Areas of Remaining Major Reform Backlog[1]

Countries	Large-Scale Privatization	Small-Scale Privatization	Governance & Enterprise Restructuring	Price Liberalization	Trade & Foreign Exchange System	Competition Policy	Banking Reform & Interest Rate Liberalization
EU accession countries (excluding Baltics)							
Bulgaria			■			■	
Czech Republic							
Hungary							
Poland							
Romania			■			■	
Slovak Republic							
Slovenia						■	
Baltic countries							
Estonia							
Latvia							
Lithuania						■	
Other southeastern European countries							
Albania	■		■			■	■
Bosnia & Herzegovina	■	■	■			■	■
Croatia						■	
Macedonia, FYR			■			■	
Commonwealth of Independent States[4]							
Armenia			■			■	■
Azerbaijan	■		■			■	■
Belarus	■	■	■	■	■	■	■
Georgia			■			■	■
Kazakhstan			■			■	■
Kyrgyz Republic			■			■	■
Moldova			■			■	■
Mongolia	■		■			■	■
Russian Federation			■		■	■	■
Tajikistan	■		■			■	■
Turkmenistan	■	■	■	■	■	■	■
Ukraine	■		■			■	■
Uzbekistan			■	■	■	■	■
East Asia							
Cambodia			■			■	
China	■	■	■		■	■	■
Lao P.D.R.	■		■		■	■	■
Vietnam	■	■	■		■	■	■

Source: European Bank for Reconstruction and Development, *Transition Report 1999;* Asian countries not members of the CIS were evaluated by IMF country specialists.
[1]EBRD indicators whose value is less than 2.5 in 1999.
[2]Projected inflation in 2000 exceeds 30 percent.
[3]Projected budget deficit in 2000 exceeds 5 percent of GDP.
[4]Data include Mongolia.

concerns newly privatized enterprises where, due to weak governance structures and persistent soft budget constraints, little restructuring has taken place. In China and Vietnam, in contrast, the problem is centered on state-owned enterprises, which—partly as a result of relatively gradual reforms—are burdened by substantial overcapacity and surplus labor, heavy debt, and a variety of social obligations to employees. In Russia and the CIS, the resulting losses have been financed through rising tax arrears and access to subsidized energy, and in China and Vietnam by borrowing from state-owned banks, resulting in high levels of nonperforming loans.

Securities Markets & Nonbank Financial Institutions	Commercial Law	Financial Regulation Law	*Memorandum* Macrostabilization Not Achieved	
			Inflation[2]	Budget deficit[3]
■				
■				
■				
■				
■	■	■		■
■	■	■		
■				■
■		■		
■				
■		■		
■	■	■	■	
■	■	■		
■				
■		■		■
■				
■				■
■				
■				
■			■	
■	■	■		
■		■		
■	■	■		
■	■			
■	■	■		
■	■	■		

In Russia and the CIS, as discussed in Box 3.3, the most effective way to promote enterprise restructuring now appears to be to foster competition and impose hard budget constraints, through eliminating direct and indirect subsidies from the budget, removing access to subsidized energy, implementing effective bankruptcy laws, and strengthening corporate governance rules (including the rights of minority shareholders and creditors). This is especially important in cases, like Russia, where enterprise control was transferred to insiders, and where the incentive structures to which these insiders respond remain distorted. In China, the authorities are seeking to commercialize and restructure the largest enterprises, most recently by creating four asset management companies to take over nonperforming loans from state banks and to undertake debt equity swaps with qualified enterprises. A key challenge is to ensure that these asset management companies have the necessary legal powers and support to ensure that the enterprises in which they become owners or creditors are appropriately restructured. In both cases, restructuring will need to be accompanied by the development of stronger social safety nets to ease the social costs of adjustment. Since restructuring is necessarily a lengthy process, it is also important to remove obstacles to start up new enterprises, which tend to be the main source of growth and employment creation.

In Russia and the CIS, there is the specific challenge of changing the role of energy and utility companies, which—often under pressure from local authorities or vested interests—are used to support loss-making activities in industry and agriculture, for instance, by charging fees that do not cover costs and accepting barter and arrears (Box 3.3). This practice reflects, in part, lack of progress in corporate restructuring and in providing social safety nets. To reduce the scope for energy and utility companies to be used in this manner, fee collection rates need to be improved and user charges set at levels that reflect costs and eliminate cross-subsidies between different user groups, accompanied by greater competition, privatization, and a general hardening of budget constraints.

Building a Market-Based Financial Sector

The development of a strong and sound banking system that can effectively and efficiently intermediate savings and investment is central to underpin sustainable growth. Once again, the

situation varies widely among transition economies. In the EU accession countries—which are discussed in more detail in Chapter IV—the banking system is in most cases starting to intermediate effectively, although it remains relatively underdeveloped by international standards (Figure 3.15). However, considerable restructuring is still required in a number of these countries, and a few—notably Romania—currently face serious systemic problems. In Russia and the other CIS countries, the banking system is very small and underdeveloped, with a number of banks facing serious financial problems, and plays only a limited role in intermediation, which has declined further due to the failure of many private banks in the 1998 banking crisis. Only a small proportion of household saving is placed with the banking sector, and the bulk of new investment is financed through retained earnings or through informal capital markets. In China, in contrast, the banking system is large and intermediates a substantial proportion of household saving. However, as noted above, the bulk of this lending has been directed to state-owned enterprises, resulting in the accumulation of substantial nonperforming loans, while the much more dynamic private sector lacks financing.

In Russia and the CIS countries, developing an action plan to deal with remaining insolvent banks will be important; thereafter, the primary challenge will be to develop the banking system from the present very low base. This will require efforts to stimulate wider private ownership of banks—through privatization of banks that remain state-owned and through new entry—and to foster competition. However, it will be critical that new private and privatized banks are subject to effective corporate governance, as well as proper regulation and supervision to avoid abuses, including insider lending. In addition, accompanying reforms of the legal and regulatory environment—including the accounting framework, collateral rules, and bankruptcy legislation—will also be required. Since this will clearly take time to accomplish, licensing requirements will need to be relatively restrictive so as to encourage entry only by high-quality and well-capitalized institutions. In practice this means that the banking system can only grow gradually, with initial new entrants likely to be primarily foreign banks.

In China, where the assets of the banking system exceed 100 percent of GDP, the challenge is to reform and restructure the existing banks while maintaining financial stability. While the transfer of a substantial proportion of nonperforming loans to asset management companies will substantially improve the financial position of the four state banks, it will be critical to prevent the reemergence of a new bad loan problem. This will require both successful restructuring of the state enterprises—to eliminate ongoing losses—and the development of a commercial credit culture in the banks themselves. As in Russia and the CIS, this will require sustained efforts to strengthen the regulatory and supervisory systems; strengthen banks' internal governance; and ensure that they are free of political interference, particularly from the provinces. The limited entry of new private banks, and the gradual diversification of ownership of state banks, can also play an important role. China's prospective entry to the World Trade Organization—which will give foreign banks full national treatment by 2005 (Box 1.3)—underscores the importance of moving ahead rapidly with restructuring efforts.

Transforming the Role of the State

A key element of transition is the transformation of the role of the government, from directly intervening in economic activities to establishing and enforcing the "rules of the game" for a market economy, while raising revenues in a transparent manner to finance essential public sector activities.[56] In some areas significant progress has been made in this difficult and complex task,

[56]Vito Tanzi, "Transition and the Changing Role of Government," *Finance and Development*, Vol. 36, No. 2 (June 1999), pp. 20–24.

notably in setting up some of the key macroeconomic institutions necessary for a market economy. However, in many countries excessive government regulation remains a serious problem, engendering corruption, rent seeking, and a large hidden economy. At the same time, much remains to be done to strengthen the rules and regulations needed to allow markets to function in an orderly and transparent way, and to ensure that rules and legislation are fully and fairly enforced. In particular, a market economy requires clear and well-publicized civil and criminal codes that are fully and impartially enforced by an independent judiciary and an effective police force. In the commercial area more specifically, the reinforcement of collateral and bankruptcy laws, creditor and shareholder protection rules, and accounting and reporting requirements remains of key importance.

In many countries, particularly in the CIS and east Asia, there is a need for continued fiscal reform, focusing on the following key areas:[57]

- *Strengthening the tax system and tax administration.* Tax policies have often left room for negotiation or preferential treatment, which has promoted rent seeking and undermined the ability of the government to raise revenues fairly. Moreover, a tolerance for nonpayment of taxes, in combination with disorderly expenditure compression and spending arrears stemming from budget formulation and implementation problems, has—especially in Russia—contributed to more general nonpayment and arrears cycles throughout the economy (Box 3.3).
- *Improving fiscal transparency and proper accounting for government operations,* off-budget expenditures and contingent liabilities in particular. In a number of countries, off-budget and quasi-fiscal expenditures are substantial, undertaken through extra-budgetary funds (China), subsidies provided by energy and utility companies (Russia and the CIS), or through the banking system (China, Vietnam, and Lao P.D.R.). Many countries also need to address substantial contingent fiscal liabilities, especially for pensions.
- *Reforming fiscal federalism arrangements*, including in Russia and China (Box 3.5) in particular, to ensure that they are supportive of macroeconomic adjustment and structural reform.
- *Establishing well-functioning public sector institutions*, including government agencies and ministries, and creating the right incentives for those who run these institutions. Progress in this area of reform has been rather slow, reflecting the complexity of the reform agenda, attempts to rebuild rather than replace the old institutions, and weak and inconsistent political commitment to serious reforms. In many cases, inherited organizational and procedural weaknesses and a lack of coordination at the center of government still need to be addressed. Moreover, public sector management practices and the civil service overall need to be strengthened. The rule of law has to apply to all government activities, and government officials need to be held fully accountable for their actions.
- *Continuing expenditure policy reform*, with a focus on phasing out remaining subsidies and on strengthening social expenditure programs. Introducing effective and transparent social assistance programs, facilitating the reallocation of labor by replacing enterprise-provided social benefits and services, and ensuring the financial viability of pension systems are key priorities. In view of the rise in income inequality during the transition, the redesign of tax and expenditure programs may also take into account distribution objectives.

The increase in poverty and income inequality in many countries since the beginning of the

[57]The early fiscal reform efforts in the countries in transition are discussed in more detail in Chapter V, "Progress with Fiscal Reform in Countries in Transition," of the May 1998 *World Economic Outlook*.

Box 3.5. Fiscal Decentralization in Transition Economies: China and Russia

A number of advanced and developing countries have experimented with fiscal decentralization over the past two decades, and this trend has extended to the transition countries as well. However, persistent macroeconomic instability in some and the entrenched legacy of socialism and central planning in others have generated additional challenges that are complicating the design of effective fiscal federalism.

The argument for fiscal decentralization is founded mainly on the premise that it facilitates a more efficient delivery of public services. At the same time, because of free-rider problems, decentralization can give rise to significant fiscal and macroeconomic risks. And local government debt can spiral out of control if local officials, and their creditors, believe a central government bailout is likely. The interest in fiscal decentralization has prompted a surge in the literature on its economic consequences. This work focuses on the design of a multi-tier fiscal system, including incentive structures and policy implementation, and emphasizes the importance of good governance, transparency, and elimination of corruption.

There is broad agreement that successful fiscal decentralization is generally based on the following four policy principles:[1] (1) clarity of roles between different levels of government to achieve accountability; (2) a measure of autonomy for both the expenditure and revenue function of subnational governments, accompanied by an efficient system of federal equalization grants; (3) institutional procedures to ensure coordination and cooperation between different levels of government; and (4) institution building, including development of the administrative infrastructure needed by local governments to carry out the tasks assigned to them.

Transition countries must also deal with challenges that are part of the legacy of central planning, including inappropriate location of key industries and that, in most transition countries, health care, education, old age and disability pensions, and often housing were provided through the public enterprise sector. Competitive pressures have led firms to eliminate social overhead expenses, which were usually replaced by transfers and service provision by local rather than central governments. Localities were thus left with large social expenditures that were critical in light of the worsening economic situation, but with little in the way of additional taxing power. While this process began early in the transition period in central and eastern Europe and the countries of the former Soviet Union, it has only recently started to take place in China.

As a result of these transition-related pressures, local governments in many countries face large unfunded obligations, and have been driven to tax competition with central authorities. Uncoordinated rivalry for tax revenues has contributed to excessive tax rates and inefficient tax administration, undermining central government revenue collection. In China, for example, payroll tax rates for the pension system vary from 17 to 29 percent, depending on the province, and until recently some industries had special rates as low as 10 percent, while others paid well over 30 percent. Regional equalization transfers have generally been underfinanced, leaving social safety nets weakest in those regions where they are most needed. Yet without adequate income support for individuals displaced by reform, political pressure to block restructuring has often proven insurmountable.

While transition-related fiscal federalism problems have persisted in a number of countries (Georgia, Kazakhstan, and Ukraine), the two largest transition countries—China and Russia—face remarkably similar problems in this area. Both introduced significant reforms in 1993–94. China, while retaining a unitary state structure, carried out a substantial reform of intergovernmental relations in 1994, aimed in part at increasing the "two ratios"—general government revenue to GDP and the central government's share in total revenue—that were

[1]See Era Dabla-Norris, Jorge Martinez-Vasquez, and John Norregaard, "Fiscal Decentralization and Economic Performance: The Case of Russia, Ukraine and Kazakhstan" (unpublished; Washington: International Monetary Fund, July 2000).

judged to be dangerously low in the early 1990s. The central government revenue share has improved modestly, but general government revenues as a percentage of GDP have continued to decline until recently. Similarly, in 1994 Russia introduced a new constitution that created a federal structure, but powerful local governments especially in resource rich regions were often able to divert revenues collected on behalf of the central government for their own purposes. Several Russian oil-producing regions, notably Tatarstan and Bashkirtostan, won favorable exemptions from the statutory revenue-sharing rules. Current revenue-sharing arrangements also have provided incentives to sub-national authorities to use monetary surrogates, in the form of tax and expenditure offsets in particular, exacerbating Russia's barter and arrears problem (see Box 3.3).

Partly as a result of these developments, central governments in both China and Russia have faced persistent revenue shortages. Moreover, a relatively large share of fiscal transfers has been *discretionary* and subject to negotiation, rather than based on objective criteria that reflect revenue capacity and expenditure need. In both countries, but particularly in China, sub-national governments have extremely limited authority to tax, which has led officials to record some revenues off budget. As a result, the use of authorized extra-budgetary "fees and charges" accounts for over a quarter of general government revenue in China.

China and Russia each face large regional discrepancies in their social safety nets, which are generally financed by payroll taxes that provide the least revenue in precisely those regions where the need for social spending is greatest (because of unemployment and high pension system dependency ratios). This imbalance has at times led to pension and other benefit arrears, in both Russia and China, although in the latter the central government has sporadically provided discretionary transfers to clear them. Furthermore, local pension and unemployment administrations in China have driven payroll tax rates to extremely high levels, particularly for foreign-funded enterprises, which may undermine job creation and efforts to attract foreign direct investment.

How to reform these systems? In both China and Russia, major revenue sources are shared between central and local governments, giving local officials an incentive to divert central revenue to local coffers. It is important to clarify the assignment of revenue sources to avoid poaching of central government revenues.[2] And once their tax base has been determined, local authorities should be responsible for determining effective tax rates and tax collection to raise revenue in line with needs arising from assigned tasks. Moreover, adverse distribution effects of the regional transfer mechanism should be eliminated in both countries by greater reliance on transparent formula-based grants that reflect spending needs and revenue capacity. Budget processes and tax administration need to be improved at the local level in both countries, including budget reporting, for without adequate data on local public finances, central governments in both countries may face considerable fiscal and macroeconomic risks. Finally, in Russia and especially in China, the expenditure responsibilities of different levels of government need to be clarified so that local governments can focus public resources on areas of responsibility unambiguously assigned to them, including in particular traditionally local public services like schooling and police protection. In the absence of such reforms, in both Russia and China the regional governments most in need of funds will continue to be least able to obtain them at reasonable tax rates. Hence, if the fiscal transfer mechanism is not reformed to ensure that resources go to those localities most in need, financing enterprise restructuring and other structural reforms, including the creation of social safety nets, will be increasingly difficult and could, in turn, slow down the pace of reform.

[2]In 1994 China created separate tax administrations for local governments, to allow the central authority to concentrate on federal taxes.

transition poses an important policy challenge.[58] The best way to alleviate poverty and income inequality in the transition countries will be through robust private sector growth. The benefits of the associated employment opportunities will be made broadly accessible by policies that upgrade human capital by providing equal access to basic health and education services. Policies also need to address the new poverty risks associated with the transition to a market economy, including those stemming from unemployment. Main priorities are to introduce unemployment assistance schemes that are affordable and easy to administer, to streamline pension benefits and ensure their timely payment, and to better target other social assistance programs and utility price subsidies. More generally, and in view of their high dependency on public service provision, the poor have much to gain from efforts to establish a well-functioning legal and judicial system and professional law enforcement and to strengthen the civil service.

Reinforcing the Momentum of Structural and Institutional Reform

The major challenge still facing the transition economies is to reinforce the existing momentum of structural and institutional reform. Building effective market-economy institutions is central to long-term growth prospects in all countries, but is particularly relevant for the transition economies, given the inadequacy of their pre-transition institutional arrangements. Deeper structural reforms in the EU accession group, including the Baltic states that were initially part of the former Soviet Union, compared to Russia and other members of the CIS have led to a superior macroeconomic performance, providing testimony to the importance of such reforms for longer-term welfare. Maintaining the rapid expansion in the transition economies of east Asia will likewise require continuing efforts to restructure state-owned enterprises and the financial system.

Greater competition—from either domestic or foreign producers—can play a significant role in supporting the reform process. In addition to promoting the efficient use of resources, competition erodes the economic rents associated with particular activities, lowering the benefits to incumbents from the status quo and reducing the resources that they have available to oppose reforms. Domestic competition can be promoted directly by effectively sanctioning anti-competitive behavior, through such actions as banning the formation of cartels and regulating natural monopolies. In addition to promoting competition among existing firms, countries must encourage the entry of new firms, investors, and products that challenge the established market positions of incumbents. This in turn requires providing a favorable business environment for small and medium-size enterprises, removing barriers to foreign direct investment and joint ventures, and developing markets for (re-)sale of equity and control in firms where ownership has been transferred to insiders (incumbent managers and workers).[59]

Another important avenue through which the transition countries can safeguard and nourish the reform momentum is by pursuing further trade and financial integration with the global economy. Among the CIS countries, bilateral trade agreements, cross-border barter, and a tolerance for external payment arrears continue to hamper trade diversification outside the region and should be phased out in favor of most-favored-nation-based trade. Extra-regional trade diversification is not warranted in all cases: restoring and strengthening trade links in regions that in the past have been (and are still prone to be) torn by civil strife

[58]These policy challenges are discussed in more detail in World Bank, *Making Transition Work for Everyone: Poverty and Inequality in Europe and Central Asia* (Washington: World Bank, 2000).

[59]The importance of effective competition, in particular by removing obstacles to the entry of new firms—both domestic and foreign—is a theme developed in more detail in Chapters 7 and 8 of the EBRD *Transition Report 1999*.

and ethnic violence can help promote peace and political stability.[60] Advanced economies also have a role to play. Eliminating trade barriers for products such as textiles, steel, bulk chemicals, agricultural products and food stuffs—areas in which the transition countries have a potential comparative advantage—would help stimulate trade linkages. Instead, transition economies that are not yet members of the WTO continue to be subject to more or less arbitrary regulations imposed by importing countries and frequent invocation of antidumping regulations.

International financial integration can also play a major role as an incentive mechanism. Private capital inflows can help to renew and expand the capital stock and close the technology gap with the advanced economies. Foreign direct investment, in particular, is generally considered a stable and effective way to transfer productive capital and technical know how from the advanced economies, and concentrated foreign ownership has been found to consistently outperform other ownership types in producing active enterprise restructuring in the transition countries. Borrowing in international financial markets and the related need to be concerned about creditworthiness and credit ratings can help signal a commitment to honor financial obligations, reinforce domestic financial discipline, and strengthen external debt management practices.

An additional mechanism providing incentives for further structural and institutional reform is linked to membership in supranational organizations (Table 3.8). By establishing a substantial number of policy goals and conditions on which consensus might be difficult to reach, such an "external anchor" helps to focus policy, thereby functioning as an arbitration mechanism in case of differing internal political opinions.[61] The European Union has played this role for the countries of central and eastern Europe and the Baltics, with EU accession providing an objective that continues to promote rapid structural and institutional reforms (see Chapter IV).[62] Indeed, the lure of closer political and economic ties with western Europe was sufficiently powerful that it had an influence on policies in the EU accession group from the beginning of the transition process, well before they became formal candidates for membership in the Union. In east Asia, membership of ASEAN plays a similar role for Vietnam, the Laos People's Democratic Republic, and Cambodia, although given ASEAN's much less stringent membership requirements, it has been considerably less effective in promoting structural and institutional reforms.[63]

The WTO can act in a similar manner for other transition economies, although the range and depth of entrance requirements is much more limited than for EU membership.[64] In particular, WTO membership has been a major

[60]Overcoming historical antagonism by strengthening intraregional trade was an important objective in the reconstruction of western Europe following World War II, where it succeeded beyond most peoples' expectations. For similar objectives in today's context, see The World Bank, *The Road to Stability and Prosperity in South Eastern Europe—A Regional Strategy Paper* (Washington: The World Bank, 2000).

[61]See Erik Berglof and Gerard Roland, "From 'Regatta' to 'Big Bang'?—The Impact of the EU Accession Strategy on Reform in Central and Eastern Europe" (unpublished; Washington: IMF, 2000).

[62]The international financial institutions, among them the IMF, also played, and continue to play, a role as an external anchor, in addition to providing technical assistance and financing. In particular, the IMF will continue to promote sound macroeconomic policies and institutional and structural reform to promote sustained growth and convergence and lower vulnerability to financial crises.

[63]ASEAN's most significant contribution has been to advance the liberalization of intraregional trade through the formation of the Asian Free Trade Area (AFTA) in 1992.

[64]While EU accession requires coordination of commercial practices and law, financial cooperation, and adherence to fiscal policy norms, WTO rules and obligations are limited to international trade. A number of transition economies have already become WTO members, and with a few exceptions the remaining transition countries are at present candidates for WTO accession; see Table 3.8. For more details, see Constantine Michalopoulos, "The Integration of Transition Economies into the World Trading System," World Bank Policy Research Working Paper No. 2182 (Washington: World Bank, 1999).

Table 3.8. Transition Economies' Membership in International Organizations

(X represents full membership; O indicates the country has applied for membership)

	International Organizations and Treaties										
	Global					Regional				Memorandum	
Country	IMF/IBRD	WTO	EBRD	OECD	EU	CEFTA[1]	CIS	AFTA[2]	APEC[3]	CMEA[4]	NATO
Albania	X	O	X							X[5]	
Armenia	X	O	X				X			X[6]	
Azerbaijan	X	O	X				X			X[6]	
Belarus	X	O	X				X			X[6]	
Bosnia and Herzegovina	X	O	X							X[7]	
Bulgaria	X	X	X		O					X	
Cambodia	X	O									
China	X	O						X	X		
Croatia	X	X	X							X[7]	
Czech Republic	X	X[8]	X	X	O	X				X[9]	X
Estonia	X	X	X		O					X[6]	
Georgia	X	X	X				X			X[6]	
Hungary	X	X[8]	X	X	O	X				X	X
Kazakhstan	X	O	X				X			X[6]	
Kyrgyz Republic	X	X	X				X			X[6]	
Lao P.D.R.	X	O						X			
Latvia	X	X	X		O						
Lithuania	X	O	X		O					X[6]	
Macedonia, FYR	X	O	X							X[7]	
Moldova	X	O	X				X			X[6]	
Mongolia	X	X								X	
Poland	X	X[8]	X	X	O	X				X	X
Romania	X	X[8]	X		O					X	
Russia	X	O	X				X		X	X[6]	
Slovak Republic	X	X[8]	X	O	O	X				X[9]	
Slovenia	X	X	X		O	X				X[7]	
Tajikistan	X		X				X			X[6]	
Turkmenistan	X		X				X			X[6]	
Ukraine	X	O	X				X			X[6]	
Uzbekistan	X	O	X				X			X[6]	
Vietnam	X	O						X	X	X	

[1]Central European Free Trade Agreement, concluded in 1992 among five central European EU accession candidates.
[2]Asian Free Trade Association, formed in 1992 by the Association of South East Asian countries (ASEAN).
[3]Asia-Pacific Economic Cooperation.
[4]Council for Mutual Economic Cooperation, dissolved in 1991.
[5]Albania became a CMEA member in 1949 but ceased active participation in 1961.
[6]Automatic membership as member of the Soviet Union.
[7]Associated membership as member of the Republic of Yugoslavia.
[8]Member since creation of the WTO in 1995.
[9]Automatic membership as part of Czechoslovakia.

issue on China's policy agenda, providing a potent symbol of the country's continuing "opening up" to the rest of the world. As an external anchor, WTO membership will help to ensure that China's substantial exports of manufactured goods are not discriminated against in foreign markets and that China's important textile sector will benefit from the elimination of the quotas on textiles and clothing administered under the WTO Agreement on textiles and clothings (previously known as the Multi-Fiber Arrangement) from 2005. Providing external competition for domestic firms will also assist in pushing forward needed restructuring of state-owned enterprises and reforming the financial system.

It is tempting to conclude that the WTO (or a free trade arrangement with the European Union) would provide a similarly effective anchor for other transition countries, in particular

Russia and other members of the CIS, but in practice caution is warranted. Although most members of the CIS are either in negotiations for entry into the WTO or are already members, WTO entry seems to play a smaller role in the policy debate in these countries compared to China. One reason is the difference in commodity composition of their exports. The labor-intensive manufactures that constitute the bulk of Chinese exports to advanced economies are more affected by WTO rules than the primary products that dominate exports from Russia and several other CIS members. If an external anchor is not embraced, the need for purely domestically driven reforms and policies that promote competition, entry, and global integration—which could help develop a more broadly based export sector that would in turn be supportive of reform—is correspondingly the greater.

Appendix: Indicators of Structural Reform and Institutional Quality

This appendix documents two indicators of structural reform and the index of institutional quality referred to in Chapter III.

The aggregate transition indicator is the average of eight component transition indicators of structural reforms published in the EBRD *Transition Report*, which measure the extent of enterprise privatization and restructuring (three indicators), market liberalization and competition (three indicators), and financial sector reform (two indicators) (Table 3.9).[65] Three of these indicators have been calculated since 1989, the others since 1994 or 1995.[66] The EBRD indicators range from 1 to 4+, where 4+ indicates that the country's structural characteristics are comparable to those prevailing on average in the advanced economies, and 1 represents conditions before reform in a centrally planned economy with dominant state ownership of means of production. In this *World Economic Outlook* the transition indicators are linearized by assigning a value of +⅓ to a "+" sign, and a value of –⅓ to a "–" sign. The original indicators are published annually in the EBRD *Transition Report* for all the transition economies discussed in Chapter III, with the exception of the east Asian countries and Mongolia. The transition indicators for these latter transition economies in this *World Economic Outlook* (including in Table 3.9) are IMF staff estimates.

An alternative, widely used indicator of structural reform referred to in Chapter III is the "Liberalization Index", developed by De Melo, Denizer, and Gelb and available yearly from 1989 to 1997 for all countries analyzed in Chapter III, excluding Bosnia and Herzegovina, Cambodia, and the Lao People's Democratic Republic (Table 3.10).[67] The index is a weighted average of three separate indices: domestic market liberalization (weight 0.3), foreign trade liberalization (weight 0.3), and enterprise privatization and banking reform (weight 0.4). The Liberalization Index ranges from 0 to 1, with the boundaries having a similar interpretation to those of the EBRD transition indicators.[68] Given the inherent difficulties in measuring progress made in structural and institutional reforms, the two indices discussed above should be considered only a rough estimate of such progress.

The index of institutional quality used in Chapter III has been developed by Beatrice Weder by aggregating five of the six indicators of

[65]European Bank for Reconstruction and Development, *Transition Report* (London: EBRD, 1999 and previous issues).

[66]Since 1998 the EBRD has also published four legal transition indicators, gauging the extensiveness and effectiveness of commercial law and of financial regulation.

[67]Martha De Melo, Cevdet Denizer, and Alan Gelb, "Patterns of Transition from Plan to Market," *The World Bank Economic Review*, Vol. 10, No. 3, pp. 397–424 (Washington: World Bank, September 1996); the index was subsequently updated to 1997 and is available upon request from these authors.

[68]The cumulative liberalization index (the sum of the annual liberalization indices from 1989 to the year under consideration) has sometimes been used as a combined measure of the extent as well as of the duration of reforms.

Table 3.9. EBRD Transition Indicators, 1999[1]

	Privatization and Restructuring			Market Liberalization and Competition			Financial Markets Reform		
Countries/Transition Groups	Large-scale privatization	Small-scale privatization	Governance & enterprise restructuring	Price liberalization	Trade & foreign exchange system	Competition policy	Banking reform & interest rate liberalization	Securities markets & nonbank financial institutions	Aggregate transition Indicator[2]
EU accession countries (excluding Baltics)									
Bulgaria	3.0	3.3	2.3	3.0	4.3	2.0	2.7	2.0	2.9
Czech Republic	4.0	4.3	3.0	3.0	4.3	3.0	3.3	3.0	3.4
Hungary	4.0	4.3	3.3	3.3	4.3	3.0	4.0	3.3	3.7
Poland	3.3	4.3	3.0	3.3	4.3	3.0	3.3	3.3	3.5
Romania	2.7	3.7	2.0	3.0	4.0	2.0	2.7	2.0	2.8
Slovak Republic	4.0	4.3	3.0	3.0	4.3	3.0	2.7	2.3	3.3
Slovenia	3.3	4.3	2.7	3.0	4.3	2.0	3.3	3.0	3.3
Baltic countries									
Estonia	4.0	4.3	3.0	3.0	4.0	2.7	3.7	3.0	3.5
Latvia	3.0	4.0	2.7	3.0	4.3	2.7	3.0	2.3	3.1
Lithuania	3.0	4.3	2.7	3.0	4.0	2.3	3.0	2.7	3.1
Other southeastern European countries									
Albania	2.0	4.0	2.0	3.0	4.0	2.0	2.0	1.7	2.5
Bosnia & Herzegovina	2.0	2.0	1.7	3.0	2.7	1.0	2.3	1.0	1.8
Croatia	3.0	4.3	2.7	3.0	4.0	2.0	3.0	2.3	3.0
Macedonia, FYR	3.0	4.0	2.0	3.0	4.0	1.0	3.0	1.7	2.8
Commonwealth of Independent States[3]									
Armenia	3.0	3.3	2.0	3.0	4.0	2.0	2.3	2.0	2.7
Azerbaijan	1.7	3.0	2.0	3.0	3.3	1.0	2.0	1.7	2.2
Belarus	1.0	2.0	1.0	1.7	1.0	2.0	1.0	2.0	1.5
Georgia	3.3	4.0	2.0	3.0	4.0	2.0	2.3	1.0	2.5
Kazakhstan	3.0	4.0	2.0	3.0	3.0	2.0	2.3	2.0	2.7
Kyrgyz Republic	3.0	4.0	2.0	3.0	4.0	2.0	2.3	2.0	2.8
Moldova	3.0	3.3	2.0	3.0	4.0	2.0	2.3	2.0	2.8
Mongolia[4]	2.0	4.0	2.3	3.3	4.3	2.0	2.3	2.0	2.8
Russian Federation	3.3	4.0	1.7	2.7	2.3	2.3	1.7	1.7	2.5
Tajikistan	2.3	3.0	1.7	3.0	2.7	1.0	1.0	1.0	2.0
Turkmenistan	1.7	2.0	1.7	2.0	1.0	1.0	1.0	1.0	1.4
Ukraine	2.3	3.3	2.0	3.0	3.0	2.0	2.0	2.0	2.4
Uzbekistan	2.7	3.0	2.0	2.0	1.0	2.0	1.7	2.0	2.1
East Asia[4]									
Cambodia	3.3	3.3	2.0	3.3	4.0	1.0	3.0	1.0	2.5
China	1.0	2.3	2.3	2.7	2.3	2.3	1.3	2.0	2.1
Lao P.D.R.	1.7	3.0	2.0	3.0	2.0	1.0	1.0	1.0	1.8
Vietnam	1.0	1.7	2.0	2.7	1.7	2.3	1.3	1.7	1.9

Source: European Bank for Reconstruction and Development, *Transition Report 1999* (London: EBRD, 1999); IMF staff estimates for east Asian countries and Mongolia.
[1]Analysts often linearize the scores by assigning a value of ⅓ to a "+" sign and –⅓ to a "–" sign attached to the integer scores 1 to 4, a practice also followed in this chapter.
[2]Simple average of eight component indicators.
[3]Data include Mongolia.
[4]EBRD transition indicators estimated by IMF staff.

governance developed by Kaufmann, Kraay, and Zoido-Lobatón (Table 3.11). [69] These five component indicators have been developed for the period 1997–98 for some 150 countries by aggregating more than 300 separate indicators from two types of sources: ratings produced by com-

[69]Beatrice Weder, "Institutional Reform in Transition Economies: How Far Have They Come?" (unpublished; Washington: International Monetary Fund, 2000); Daniel Kaufmann, Aart Kraay, and Pablo Zoido-Lobatón, "Governance

Table 3.10. Liberalization Index

Countries/Transition Groups	1989	1990	1991	1992	1993	1994	1995	1996	1997	Cumulative Liberalization Index 1997
EU accession countries (excluding Baltics)										
Bulgaria	0.13	0.19	0.62	0.66	0.66	0.64	0.58	0.65	0.79	4.92
Czech Republic	0.00	0.16	0.79	0.86	0.90	0.90	0.93	0.93	0.93	6.40
Hungary	0.34	0.57	0.74	0.78	0.82	0.86	0.90	0.90	0.93	6.84
Poland	0.24	0.68	0.72	0.82	0.82	0.86	0.89	0.89	0.89	6.81
Romania	0.00	0.22	0.36	0.45	0.58	0.68	0.71	0.72	0.75	4.47
Slovak Republic	0.00	0.16	0.79	0.86	0.83	0.83	0.86	0.86	0.86	6.05
Slovenia	0.41	0.62	0.71	0.78	0.82	0.82	0.85	0.87	0.89	6.77
Baltic countries										
Estonia	0.07	0.20	0.32	0.64	0.81	0.89	0.93	0.93	0.93	5.72
Latvia	0.04	0.13	0.29	0.51	0.67	0.81	0.81	0.85	0.89	5.00
Lithuania	0.04	0.13	0.33	0.55	0.78	0.89	0.89	0.89	0.89	5.39
Other southeastern European countries										
Albania	0.00	0.00	0.24	0.66	0.70	0.70	0.74	0.74	0.78	4.56
Bosnia & Herzegovina	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Croatia	0.41	0.62	0.62	0.72	0.79	0.82	0.85	0.85	0.85	6.53
Macedonia, FYR	0.41	0.62	0.65	0.68	0.78	0.78	0.78	0.82	0.82	6.34
Commonwealth of Independent States[1]										
Armenia	0.04	0.04	0.13	0.39	0.42	0.42	0.49	0.72	0.72	3.37
Azerbaijan	0.04	0.04	0.04	0.25	0.31	0.35	0.44	0.55	0.62	2.64
Belarus	0.04	0.04	0.10	0.20	0.33	0.36	0.48	0.48	0.51	2.54
Georgia	0.04	0.04	0.22	0.32	0.35	0.39	0.49	0.69	0.72	3.26
Kazakhstan	0.04	0.04	0.04	0.33	0.60	0.76	0.82	0.86	0.86	4.35
Kyrgyz Republic	0.04	0.04	0.14	0.35	0.35	0.39	0.61	0.72	0.75	3.39
Moldova	0.04	0.04	0.10	0.38	0.51	0.55	0.68	0.75	0.75	3.80
Mongolia	0.00	0.00	0.44	0.55	0.61	0.67	0.67	0.67	0.83	4.44
Russia	0.04	0.04	0.10	0.49	0.59	0.66	0.77	0.80	0.83	4.32
Tajikistan	0.04	0.04	0.11	0.20	0.26	0.30	0.39	0.42	0.45	2.21
Turkmenistan	0.04	0.04	0.04	0.13	0.16	0.22	0.22	0.32	0.36	1.53
Ukraine	0.04	0.04	0.10	0.23	0.13	0.26	0.51	0.59	0.65	2.55
Uzbekistan	0.04	0.04	0.04	0.26	0.30	0.43	0.58	0.57	0.57	2.83
East Asia										
Cambodia	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
China	0.46	0.49	0.49	0.49	0.56	0.59	0.59	0.62	0.66	4.95
Lao P.D.R.	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Vietnam	0.53	0.53	0.56	0.59	0.59	0.62	0.65	0.67	0.68	5.42

Source: Martha De Melo, Cevdet Denizer, and Alan Gelb, "Patterns of Transition from Plan to Market," *The World Bank Economic Review*, Vol. 10, No. 3, pp. 397–424 (Washington: World Bank, September 1996), and subsequently updated to 1997 by the authors.

[1]Data include Mongolia.

mercial risk rating agencies and other organizations, reflecting expert opinions; and surveys of firms and households, compiled by international organizations and other institutions.[70] Weder's institutional quality index is an aggregate of five component indicators related to the extent of

Matters," World Bank Policy Research Working Paper No. 2196 (Washington: World Bank, 1999); and Daniel Kaufmann, Aart Kraay, and Pablo Zoido-Lobatón, "Aggregating Governance Indicators," World Bank Policy Research Working Paper No. 2195 (Washington: World Bank, 1999).

[70]The authors who developed the indicators underlying the institutional quality index warn against precise ranking exercises among the countries for which the index is available, given great data uncertainty and differing degrees of coverage and data availability for different countries.

Table 3.11. Index of Institutional Quality, 1997–98

Countries/ Transition Groups	Voice and Accountability	Political Instability and Violence	Government Effectiveness	Regulatory Burden	Rule of Law	Graft	Simple Average: All six Components	Simple Average: Weder[1]
EU accession countries (excluding Baltics)								
Bulgaria	6.0	4.3	–8.1	5.2	–1.5	–5.6	0.1	–0.8
Czech Republic	12.0	8.1	5.9	5.7	5.4	3.8	6.8	6.6
Hungary	12.0	12.5	6.1	8.5	7.1	6.1	8.7	8.0
Poland	10.7	8.4	6.7	5.6	5.4	4.9	7.0	6.7
Romania	4.1	0.2	–5.7	2.0	–0.9	–4.6	–0.8	–1.0
Slovak Republic	7.4	6.5	–0.3	1.7	1.3	0.3	2.8	2.1
Slovenia	10.7	10.9	5.7	5.3	8.3	10.2	8.5	8.0
Baltic countries								
Estonia	7.9	7.9	2.6	7.4	5.1	5.9	6.1	5.8
Latvia	6.2	4.6	0.7	5.1	1.5	–2.6	2.6	2.2
Lithuania	7.7	3.5	1.3	0.9	1.8	0.3	2.6	2.4
Other southeastern European countries								
Albania	–0.1	–10.0	–6.5	–7.0	–9.2	–9.9	–7.1	–6.5
Bosnia & Herzegovina	–9.7	–11.6	–11.1	–12.6	–11.1	–3.5	–9.9	–9.6
Croatia	–3.2	4.1	1.5	2.4	1.5	–4.6	0.3	–0.5
Macedonia, FYR	0.9	–4.0	–5.8	–3.1	–2.6	–5.2	–3.3	–3.2
Commonwealth of Independent States[1]								
Armenia	0.2	–4.5	–6.5	–5.7	–1.5	–8.0	–4.4	–4.3
Azerbaijan	–9.2	–3.6	–8.3	–10.0	–5.6	–10.0	–7.8	–8.6
Belarus	–5.2	–3.7	–6.6	–14.7	–8.8	–6.5	–7.6	–8.3
Georgia	–2.9	–7.6	–5.1	–8.5	–4.9	–7.4	–6.1	–5.8
Kazakhstan	–7.1	2.2	–8.2	–4.0	–5.9	–8.7	–5.3	–6.8
Kyrgyz Republic	–2.5	3.2	–5.8	–7.6	–4.7	–7.6	–4.2	–5.6
Moldova	1.6	–2.0	–4.6	–2.8	–0.2	–3.9	–2.0	–2.0
Mongolia	8.4	3.7	0.2	1.7	0.4	–1.5	2.2	1.8
Russia	–3.1	–6.9	–5.9	–3.0	–7.2	–6.2	–5.4	–5.1
Tajikistan	–15.6	–18.6	–14.2	–15.2	–13.3	–13.2	–15.0	–14.3
Turkmenistan	–14.5	0.0	–12.5	–19.3	–9.7	–12.9	–11.5	–13.8
Ukraine	–0.1	–2.4	–8.9	–7.2	–7.1	–8.9	–5.8	–6.4
Uzbekistan	–13.4	–3.3	–13.0	–14.0	–8.7	–9.6	–10.4	–11.8
East Asia								
Cambodia	–9.1	. . .	. . .	–0.4	–2.3	. . .	–3.9	–2.2
China	–13.0	4.8	0.2	–0.7	–0.4	–2.9	–2.0	–3.4
Lao People's Dem. Rep.	–10.5	. . .	. . .	–18.2	–12.0	. . .	–13.6	–14.6
Vietnam	–14.2	6.5	–3.0	–4.6	–4.4	–3.3	–3.8	–5.9

Source: Beatrice Weder, "Institutional Reform in Transition Economies: How Far Have They Come?" (unpublished; Washington: International Monetary Fund, 2000).
[1]Excludes index of political instability and violence.
[2]Data include Mongolia.

democracy, government effectiveness, extent of regulation, rule of law, and graft, respectively.[71] The index, as well as the component indicators, range from –25 to + 25, and its average value for advanced economies is 12.6.[72] The institutional quality index is estimated for the period 1997/98 only, and no time series for the index is available.

As can be seen from Table 3.12., the three indices are highly correlated. High correlation be-

[71]The component indicator of "Political Instability and Violence" is not included in Weder's institutional quality index.
[72]The original component indicators in Kaufmann and others, "Governance Matters," ranged from –2.5 to +2.5. In Weder's work, these indicators have been multiplied by 10.

Table 3.12. Correlation Among Indices[1]

	EBRD Transition Indicator 1997	Liberalization Index 1997	Institutional Quality Index 1997–98
EBRD Transition Indicator, 1997	1.00	0.95	0.90
Liberalization Index, 1997		1.00	0.85
Institutional Quality Index, 1997–98			1.00

[1]Calculated from a set of 25 transition economies for which all three indices are available.

tween the liberalization index and the aggregate transition indicator reflects the similarity of the concepts measured, while high correlation between these two indicators and the index of institutional quality suggests that countries that have been successful in raising institutional quality were also the ones most successful in implementing structural reforms.