The Post-Communist Transition

Patterns and Prospects

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Most formerly centrally planned economies have laid the foundations for a market economy. Their future development will depend on how they respond to the challenges of the next phase of transition: developing the public and private institutions—in particular, a strong financial sector—needed in a healthy market economy.

ALTHOUGH the transition from a command to a market economy began in the late 1980s in some Eastern European economies, political developments following the fall of the Berlin Wall in late 1989 and the breakup of the Soviet Union two years later sharply accelerated this process. The collapse of the previous economic systems and relationships, and the ensuing large-scale reorientation and reorganization of production initially sent output and trade into a steep decline and triggered rampant inflation. Since then, however, the countries of Central and Eastern Europe and the Baltics, Russia, and other countries of the former Soviet Union have made significant progress in transition and in stabilizing output and prices (see "Ten Years of Transition: A Progress Report" by Patrick Lenain, in this issue).

Transition has so far comprised two distinct phases. The first, which is largely complete in most (but not all) countries, consisted of the liberalization of markets and trade, privatization of state enterprises, and withdrawal of government from many activities. In the second phase, now under way in some countries, the key challenges are to develop the public and private institutions that underpin an effective market economy, to strengthen the state's capacity to raise revenues and provide the public services that are essential to a market economy, and to ensure that sound business practices become more firmly established. The response to these challenges will ultimately determine the extent of competition, quality of corporate governance, climate for investment, and prospects for longer-term growth. A major challenge faced by all these countries is the need to strengthen their financial sectors—the recent turmoil in East Asia provides a stark reminder of the danger of not doing so. And, for some transition economies, the process of economic reform and institutional change will be shaped by the prospect of accession to the European Union.

Progress in transition

A few former Soviet Union countries have yet to meet the challenges of the first phase of transition—market liberalization and privatization (Chart 1). While particularly difficult legacies from the era of central planning may be partly responsible, the fact that some countries have made far less progress than others with which they share many common features (for example, Belarus and Russia) points to the influence of political factors. Moreover, how well the transition economies are functioning today and the paths their future development will follow are, to a great extent, a consequence of decisions they made in the early days of reform, especially with respect to the method of privatization, which can have a significant impact on corporate governance and enterprise restructuring over the longer term.

Market liberalization. By 1994, the first year in which the European Bank for Reconstruction and Development (EBRD) compiled transition indicators (see box), most countries had made rapid progress in liberalizing markets—for example, removing price controls and restrictions on trade and access to foreign exchange (Chart 2). The

Monitoring the transition process

In 1991, the European Bank for Reconstruction and Development (EBRD), a multilateral financial institution headquartered in London, was established for the purpose of fostering the transition in Central and Eastern Europe and the former Soviet Union countries. To help it fulfill this mandate, the EBRD has monitored and analyzed the progress that these countries have made toward establishing market economies. Since 1994, it has published an annual *Transition Report*, which assesses the progress of member countries in all of the many complex dimensions of transition—including price and trade liberalization, competition policy and demonopolization, privatization, enterprise restructuring and corporate governance, reform and expansion of the financial sector, and establishment of the necessary legal framework—and analyzes this process from a cross-country perspective. Each country is awarded a score for the cumulative progress it has made. Scores range from a low of 1 to a high of 4+, which is regarded as the standard achieved by most market economies.

main benefit of liberalization was the adjustment in relative prices; prices began to reflect production costs and market demand, and were thus able to provide clear, market-based signals to producers. The liberalization of markets has been largely completed in most transition economies, with the exception of a few former Soviet Union countries and some sensitive sectors such as infrastructure and housing.

Privatization. There has been steady progress in privatizing both small and large enterprises over the past four years, and, in 1997, privatization registered the largest increase of all the EBRD indicators. Many countries quickly privatized small-scale enterprises (shops and restaurants, for example) in the early years of transition, and most small businesses in the transition countries are now privately owned.

Experience with the privatization of medium-sized and large enterprises has been very diverse, mainly because countries have employed a variety of privatization methods. A number of countries introduced voucher schemes to effect the rapid transfer of shares under mass privatization programs, although these schemes were vastly dissimilar. For example, the Czech Republic distributed vouchers to the general population, either directly or through investment funds, whereas in Russia, workers and managers (enterprise insiders) received a large proportion of the vouchers. Other countries, such as Estonia and Hungary, favored direct sales to strategic investors. The different methods reflected, in large part, complex trade-offs between economic and political considerations. The use of vouchers to distribute shares in enterprises has been justified on grounds of equity, speed, and the low absolute level of savings in the general population. Governments that sold shares directly to strategic investors were, in general, seeking assistance with the rationalization and restructuring of certain enterprises or trying to raise revenues.

There is, perhaps, a greater awareness now than in the early days of transition of the costs of delaying the privatization of strategic or sensitive industries—such as steel, shipbuilding, mining, and agriculture—which can represent a drain on budgetary resources, and of forgoing the substantial revenues that can be raised by selling off such industries. Thus, the governments of Poland, Russia, and Ukraine have recently announced plans to accelerate sales of a significant portion of their shares in many of the largest enterprises in these sectors. Those countries seeking to join the European Union will need considerable investment to bring much of their infrastructure and municipal services up to the latter's standards and thus have an additional incentive for privatizing or commercializing infrastructure services.

The pace of privatization has varied from country to country, depending on the method chosen. A number of the countries that have used voucher schemes have completed their mass privatization programs. In others, privatization has been held up for various reasons, including the desire of governments to retain control, doubts over the appropriate valuation of an enterprise, or concerns about the social and employment consequences of selling enterprises to strategic investors, who might restructure them.

Corporate governance and restructuring. Corporate governance refers to the extent to which an enterprise's owners can establish control over its management to ensure that the enterprise is run in a commercial manner and that the shareholders receive fair value from its operations. One of the most important lessons to be gleaned from the diverse approaches to privatization is the strong influence the method of privatization has on the creation of ownership structures. These structures have important implications for corporate governance in the post-privatization phase and, in turn, for the pace and extent of restructuring, enterprise performance, and growth of output. Ownership that is concentrated in the hands of a few outsiders appears to result in more effective governance and restructuring, particularly in a legal and regulatory environment that offers little protection of shareholder and creditor rights. In such an environment, widely dispersed outside ownership or insider ownership that is reluctant to dilute its control can adversely affect corporate governance.

Developments over the past year suggest that patterns of corporate governance may change over time. For example, large financial and industrial groups in Russia, on occasion with the support of foreign investors, have purchased shares of enterprises in an attempt to limit the influence of insiders. In the Czech Republic, there have been longstanding concerns that the close links between the main banks, the investment funds they manage, and certain enterprises have contributed to the relatively slow pace of restructuring. The proposed sale of the state's shares in the major banks and other legislative changes that will affect the operations of the investment funds are intended to loosen the ties between the financial and industrial sectors.

Governments need to provide the appropriate incentives for companies by establishing a favorable climate for investment. In general, the former Soviet Union countries have a difficult business and investment climate that tends either to constrain the growth of the private sector or to encourage

Chart 1

Some economies have made considerable progress in transition

Average transition scores, 1997 [1]

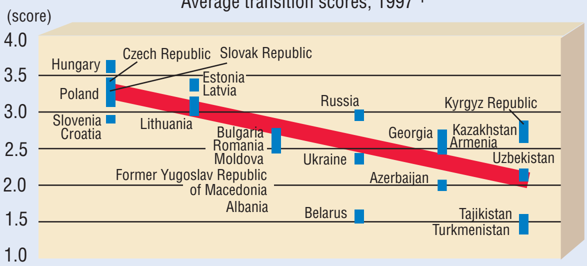


Chart 2

Progress toward creating a market economy [2]

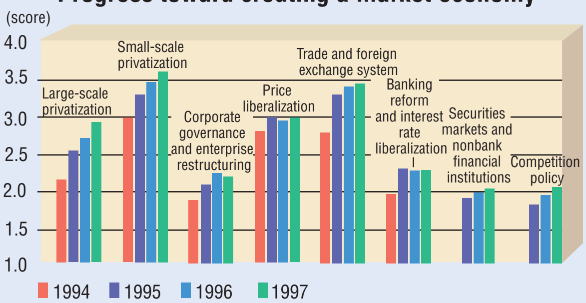
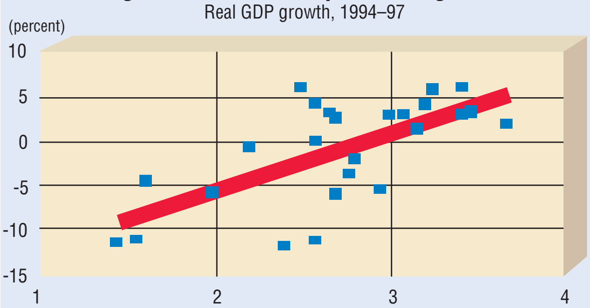


Chart 3

Progress in transition promotes growth [3]

Real GDP growth, 1994–97



Source: European Bank for Reconstruction and Development (EBRD), 1997, *Transition Report* (London).

Note: Transition scores awarded by the EBRD range from a low of 1 to 4+, the standard achieved by most market economies.

[1] Vertical scale shows each country's average transition score on the 1997 indicators.

[2] The average scores across all countries for transition indicators in each year shown.

[3] Horizontal scale represents the average score on transition indicators in 1997.

the growth of the informal economy. Countries can build a healthy environment in which the private sector can flourish by adopting policies that foster competition, breaking up monopolies, eliminating unnecessary licenses that hinder the establishment of new private businesses, and creating transparent and predictable tax systems.

Although there has been considerable progress in developing commercially oriented enterprises, some problems remain. Most countries have phased out directed credits and budgetary subsidies—the main forms of soft budget constraints. However, some countries continue to provide off-budget support to the enterprise sector by allowing tax or energy arrears to accumulate. Most countries have passed bankruptcy laws, although, initially, bankruptcies were difficult to process because of the cost and complexity of procedures and the inexperience of the courts in this area. The number of liquidations is now increasing in some countries, however.

Reform and expansion of the financial sector. The development of stable, market-oriented financial systems is one of the most challenging aspects of transition. Financial institutions were lacking in the command economies, especially in the area of capital markets, and it will take time to develop the skills and capital base banks need to become effective financial intermediaries.

Most governments have stressed the importance of developing a sound banking system and taken steps to strengthen their supervisory capabilities. Many have adopted the Basle Committee on Banking Supervision's guidelines on capital adequacy. However, because of the high-risk environment and numerous banking problems in many countries, a capital requirement of 8 percent of risk-weighted assets is a bare minimum, and emphasis should be on further strengthening the capital base. Moreover, since banking regulators adopted international accounting standards and loan classification and provisioning requirements, it has become clear that loan-loss provisions, in particular, need to be increased.

Many transition countries, particularly those in Central and Eastern Europe, have had to deal with the problem of nonperforming loans inherited from the past. In some cases, this problem was exacerbated in the early years of transition when banks continued to make bad loans—the result, in part, of lax licensing policies for the creation of new banks and poorly designed recapitalization programs for state banks. While many failed smaller banks have been liquidated, governments have usually sought to recapitalize and then privatize troubled state banks. In some countries, the recapitalization of banks was accompanied by programs to work out the nonperforming loans to enterprises, either by establishing workout departments in the banks or separating nonperforming loans out into a "hospital" bank. The importance of resolving the issue of nonperforming loans has been demonstrated in some recent bank privatizations when a lack of agreement on the quality of the banks' loan portfolios made it difficult to determine the appropriate share prices for the institutions.

The structure of the banking sector has begun to change in the transition countries. The typical pattern is one where a few big banks with a large share of the banking sector's total capital and assets coexist with many small, often undercapitalized banks. This pattern is likely to become even more pronounced with the closure or merger of many of the weaker banks. The entry of more foreign banks into the region has acted as a spur to competition. Further change is also inevitable in those countries negotiating to join the European Union, which will be forced to strengthen their banking sectors in order to comply with European Union banking directives, to harmonize their regulations with those of other countries, and to complete the privatization of major banks to make their banking sectors more competitive.

The development of capital markets has been slower than that of the banking sector. Although stock markets were established (or reestablished) at an early stage of transition in many countries—especially those where privatization was implemented using a voucher system, which led to initial share trading—the necessary regulatory structures and penalty enforcement mechanisms have been slower to develop. As a result, liquidity tends to be low and dealings are often not transparent, with much of the trading done off-exchange.

Successful development of capital markets is partly dependent on the establishment of independent regulatory institutions, such as securities commissions, and adequate standards for accounting and financial disclosure. It will also require the creation of institutions with the resources to invest, such as pension and insurance funds. In many of the transition countries, where eligibility criteria for drawing pensions are very generous and relaxed, the current pension burden on budgets is quite high (even though inflation has eroded the purchasing power of pensions in many countries). A number of countries—including Estonia, Hungary, Kazakhstan, and Poland—have passed legislation to reform their pay-as-you-go public pension schemes and plan to develop privately managed, fully funded schemes.

Private sector share of output

One indicator of the outcome of market-oriented reforms is the share of the private sector in the economy. This share has grown steadily in most transition countries; the EBRD estimates that, by mid-1997, the private sector accounted for more than 50 percent of GDP in 19 of the 26 countries where the EBRD operates.

In some countries—Poland, for example—the response of entrepreneurs and new private business to market opportunities has been a driving force in the sharp improvement in enterprise performance and growth. The private sector's share in the economies of the Czech and Slovak Republics, Estonia, and Hungary—countries that have privatized most state enterprises—is so extensive that any further expansion of the private sector will require faster growth relative to the public sector and rapid creation of new companies. In contrast, in many of the former Soviet Union countries, a combination of unpredictable taxation, bureaucracy, and corruption have slowed the pace of private sector development. One result has been that much private sector growth has been in the informal economy, so that the share of the private sector is often understated in the official data.

Prospects for medium-term growth

In the early years of reform, output fell sharply in all of the transition economies; there is some evidence that the extent of the decline was partly related to the degree of economic distortion under the previous system. The timing and speed of the recovery in output in these economies have been linked to two factors—the successful implementation of macroeconomic stabilization programs and market liberalization—indicating a positive relationship between reform and growth (Chart 3).

Higher output can also be the result of increased investment, a skilled workforce, and better use of existing resources in production. Given that much past investment was misdirected and that these countries had highly educated populations before transition began, it is likely that some of the growth of the past decade reflects an improvement in the organization of production in response to market incentives. For some countries, especially those in Eastern Europe, the introduction of reforms has unleashed market forces. The results are already evident, as there has been a shift away from industrial production and toward services. With the expansion of the private sector in these countries, the breaking up of monopolies, and the growth of imports, competition has increased, leading to significant gains in productivity. In the longer term, however, it is more likely that growth will depend on increasing the rate of private investment, developing and diffusing new technologies, and acquiring the skills needed in a more advanced market economy. F&D

This article draws on the EBRD's annual Transition Reports, *as well the* Transition Report Update *published in April 1998. The next* Transition Report *will be published in November 1998.*

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