International Monetary Fund

25 Years of Transition

Post-Communist Europe and the IMF

Regional Economic Issues

Special Report

James Roaf, Ruben Atoyan, Bikas Joshi, Krzysztof Krogulski

and an IMF Staff Team

OCT 14

Cataloging-in-Publication Data

25 years of transition : post-communist Europe and the IMF / James Roaf, Ruben Atoyan, Bikas Joshi, Krzysztof Krogulski and an IMF staff team. – Washington, D.C. : International Monetary Fund, 2014.

p. ; cm. – (Regional economic issues special report)

Includes bibliographical references.

1. Former communist countries – Economic policy. 2. Former communist countries – Economic conditions. 3. International Monetary Fund. I. Roaf, James. II. Atoyan, Ruben (Ruben V.) III. Joshi, Bikas. IV. Krogulski, Krzysztof. V. International Monetary Fund. VI. Series: Regional economic issues special report.

HC244.A15 2014

ISSN: 2071-4157

ISBN: 978-1-49830-563-1 (paper)

ISBN: 978-1-49834-201-8 (web PDF)

ISBN: 978-1-49833-218-7 (ePub)

ISBN: 978-1-49835-212-3 (MobiPocket)

Publication orders may be placed online, by fax, or through the mail:

International Monetary Fund, Publication Services

P.O. Box 92780, Washington, D.C. 20090, U.S.A.

Tel.: (202) 623-7430 Fax: (202) 623-7201

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25 Years of Transition: Post-Communist Europe and the IMF

October 24, 2014

EXECUTIVE SUMMARY

The past 25 years have seen a dramatic transformation in Europe's former communist countries, resulting in their reintegration into the global economy, and, in most cases, major improvements in living standards. But the task of building full market economies has been difficult and protracted. Liberalization of trade and prices came quickly, but institutional reforms—in areas such as governance, competition policy, labor markets, privatization and enterprise restructuring—often faced opposition from vested interests.

The results of the first years of transition were uneven. All countries suffered high inflation and major recessions as prices were freed and old economic linkages broke down. But the scale of output losses and the time taken for growth to return and inflation to be brought under control varied widely. Initial conditions and external factors played a role, but policies were critical too. Countries that undertook more front-loaded and bold reforms were rewarded with faster recovery and income convergence. Others were more vulnerable to the crises that swept the region in the wake of the 1997 Asia crisis.

In contrast to the turbulence of the first decade of transition, the early and mid-2000s saw uniformly strong growth. With macroeconomic stability established and key market-based frameworks largely in place, the region experienced large capital inflows, supported by a benign global environment and increasing confidence in rapid convergence with Western Europe—especially for those countries that joined the EU during this period. Widespread foreign bank ownership brought much-needed credibility and technical know-how, and facilitated the provision of financing to the region—indeed to excess, causing growth to become increasingly imbalanced. The resulting vulnerabilities were exposed when the global and euro zone crises struck at the end of the decade, hitting the region harder than any other.

In the wake of these crises, countries embarked on significant consolidation, although some continue to struggle to restore competitiveness and fiscal sustainability against the backdrop of slow growth and lingering structural weaknesses. New analysis shows the effect of widening disparities within the region: the more advanced countries now have more in common with Western European economies than they do with some other former communist countries. But even in the better-performing economies, the pace of convergence has slowed substantially. And reform momentum has generally slowed over the years, with a risk of reversals emerging in a few countries.

To revitalize the convergence process—and, for some countries, to reduce the risk of falling back into crisis—stronger commitment to market-based policies is needed. Two broad priorities stand out. First, a renewed focus on macroeconomic and financial stability in some countries, to rein in persistent deficits and increasing debt, and to address rising levels of bad loans in banks. Second, to raise the pace and depth of structural reforms in areas such as the business and investment climate, access to credit, public expenditure prioritization and tax administration, and labor markets.

The influx of new member countries at the start of transition was a huge challenge to the IMF both operationally and intellectually. The IMF has been closely involved with the region ever since, providing a mix of policy advice, program lending and specialized training and technical support as country needs have evolved.

Country coverage and codes

The report covers the European transition economies up to Belarus, Moldova, Russia, and Ukraine among the former Soviet republics. The full set of transition countries is broader, including the Caucasus and Central Asian republics and even countries such as Mongolia and Vietnam. But in order to have reasonably consistent country groupings for analytic purposes, the report follows the division of countries used within the IMF's internal organizational structure. And it does not cover the experience of former East Germany, which has naturally followed a different path than the other transition economies, and with which the IMF has only had indirect involvement via its surveillance of unified Germany.

The following regional aggregates, country codes and flag markers are used in the report:

- Baltics (shown in **blue**): Estonia (EST), Latvia (LVA), Lithuania (LTU)
- Central Europe (CE5, **green**): Czech Republic (CZE), Hungary (HUN), Poland (POL), Slovak Republic (SVK), Slovenia (SVN)
- CIS (**purple**): Belarus (BLR), Moldova (MDA), Russian Federation (RUS), Ukraine (UKR)
- Southeast Europe EU members (SEE EU, **red**): Bulgaria (BGR), Croatia (HRV), Romania (ROU)
- Non-EU Southeast Europe, or Western Balkans (SEE xEU, **orange**): Albania (ALB), Bosnia and Herzegovina (BIH), Kosovo (UVK), FYR Macedonia (MKD), Montenegro (MNE), Serbia (SRB)

Central and Eastern Europe (CEE) refers to the full set of countries listed above. CEB refers to CE5 plus the Baltics. SEE refers to SEE EU plus SEE xEU. Averages are unweighted unless stated.

Structure and focus of the report

This report sets out the main features of the transition in chronological chapters that alternate with chapters on the main thematic issues from a macroeconomic perspective. The final chapter examines whether it is still relevant to consider the transition economies as a group, and points to key policy challenges going forward.

The main focus is on macroeconomic developments, this being the IMF's principal area of operations and expertise. At the same time, the report tries to summarize progress at the micro level, recognizing that the transition to a market economy is at heart a transformation of legal and economic institutions, and of individual firms and households' incentives and behaviors. In compressing the experience of more than 20 countries over 25 very eventful years, the report inevitably focuses on broad themes, and cannot do justice to the nuance and diversity of individual country narratives.

The report highlights the IMF's role during the transition. But the IMF was only one of a number of agencies that have supported these countries over the past 25 years. While the IMF took a lead role in the early phases of transition, for many countries the process of accession to the European Union (EU) has been the most important catalyst for reform in later phases, and European integration remains today a main driver of structural change. Other key players include the European Bank for Reconstruction and Development (EBRD), European Central Bank (ECB), European Investment Bank (EIB), and World Bank, as well as bilateral country donors and private and voluntary sector institutions. But whether from the IMF or others, the impact of external assistance pales in significance to domestically-driven reform and development—which is the principal subject of the report.

The report was prepared by a team drawn mainly from the IMF's offices in the region. The views presented are those of the authors.

FOREWORD

David Lipton, IMF First Deputy Managing Director

Nearly a generation has passed since Central and Eastern Europe embarked on its historic transition from communism to capitalism and democracy. Many people both in the region and beyond have little or no memory of the old systems, nor the remarkable transformation path that brought the people and countries in the region to where they are today. So, the twenty-fifth anniversary of the launching of reform is a fitting time to remind ourselves what was done, recall the people who did it, and ponder the lessons learned. The IMF, which was called upon by incoming governments in the region for advice and financing, played an important supporting role in this transition, and thus we have a unique vantage point.

Having myself been involved in the early days of reforms in Poland and a couple of other countries in the region, I have a personal perspective on what happened. Looking backward at history, as we must, there is often a temptation to conclude that what happened was natural, even inevitable. In the case of the transition in Central and Eastern Europe, that would be a mistake, and a mistake that diminishes the scope and scale of the accomplishment, and that obscures efforts to discern what worked and why. I know from my experience that looking forward during the inception of reforms, the prospects for transition were daunting. In fact at first, most observers thought the effort would not succeed.

Economies were weighed down by state ownership and relative prices deliberately distorted to favor the buildup of heavy industry. Fiscal and monetary policies, which had aimed at supporting industrial growth rather than achieving macroeconomic balance, had produced chronic excess demand and widespread shortages of goods. By the end, that chronic excess demand had also led to unsustainable external debt and high or hyperinflation. Unfortunately, only a small number of economists or policymakers in these countries at the time had much education or experience that prepared them for the complex tasks ahead. In reality, neither modern macroeconomics, nor for that matter the history of the IMF itself, offered much guidance on such a novel transition. The IMF had helped countries overcome debt and inflation, but had no experience in designing and executing the sweeping changes needed to convert economies from the communist system to capitalism.

So, how did it all succeed? I think four key factors played important roles.

Great people. Courageous politicians and reformers stepped forward and took on the challenge of designing reforms and explaining their consequences to a wary public. Those reformers understood the historic nature of their task and boldly embraced the challenge of transition.

Smart strategies. Reform strategies were developed to address the key imperatives of transition, the need to liberalize prices to reflect scarcity and facilitate resource allocation, stabilize finances to end chronic shortages and inflation, and privatize state companies and assets to begin a process of improved governance over companies and their capital. The countries that most fully addressed all three of these challenges made the quickest and most complete progress.

Magnet Europe. After years of isolation from the Western economic system, and after the distortions and deprivations of the communist system, most citizens just wanted to live in a normal country with a normal economy, and, given their history and geography, that vision was captured in the allure of reintegrating with Western Europe. The historic offer from the European Union to countries in the region provided a gravitational pull that helped policymakers justify and implement difficult reform steps. As reform fatigue brought down governments and new ones took their place, the litmus test for any new policy was "will it lead us back to Europe?" a test that foreclosed much undesirable experimentation.

External support. Debt and balance of payments pressures imposed harsh conditions on governments setting out to make structural reforms while coping with financial destabilization. Financing from the IMF, World Bank, EBRD and bilateral creditors, and in some key cases debt relief from official and commercial bank creditors, helped relieve those constraints. In time, support for privatization efforts, in particular of state owned commercial banks, helped smooth the way for improvements in resource mobilization and efficient resource allocation.

Over the past quarter century, countries in the region have continued the transition, through elections, changes in governments, recessions, and more recently the global financial crisis. Some have upgraded laws, financial systems, and infrastructure sufficiently to become integral to powerful, emerging supply chains linked to advanced economies in the European Union. Others have more to do to complete their transitions, and create the prospects for convergence of living standards toward those in Western Europe. But even in the more successful countries, convergence is far from complete. At the outset of reforms, per capita GDP, on a purchasing power parity basis, in Poland was a third of that in Germany. Last year it was a little over a half. That is progress, but also a reminder that there is more to do.

This volume provides a detailed assessment of twenty-five years of transition in Central and Eastern Europe. By assessing the past, we hope to recognize the remarkable accomplishments to date and contribute to the bright future that lies ahead.

I. OVERVIEW

A transformation in pictures

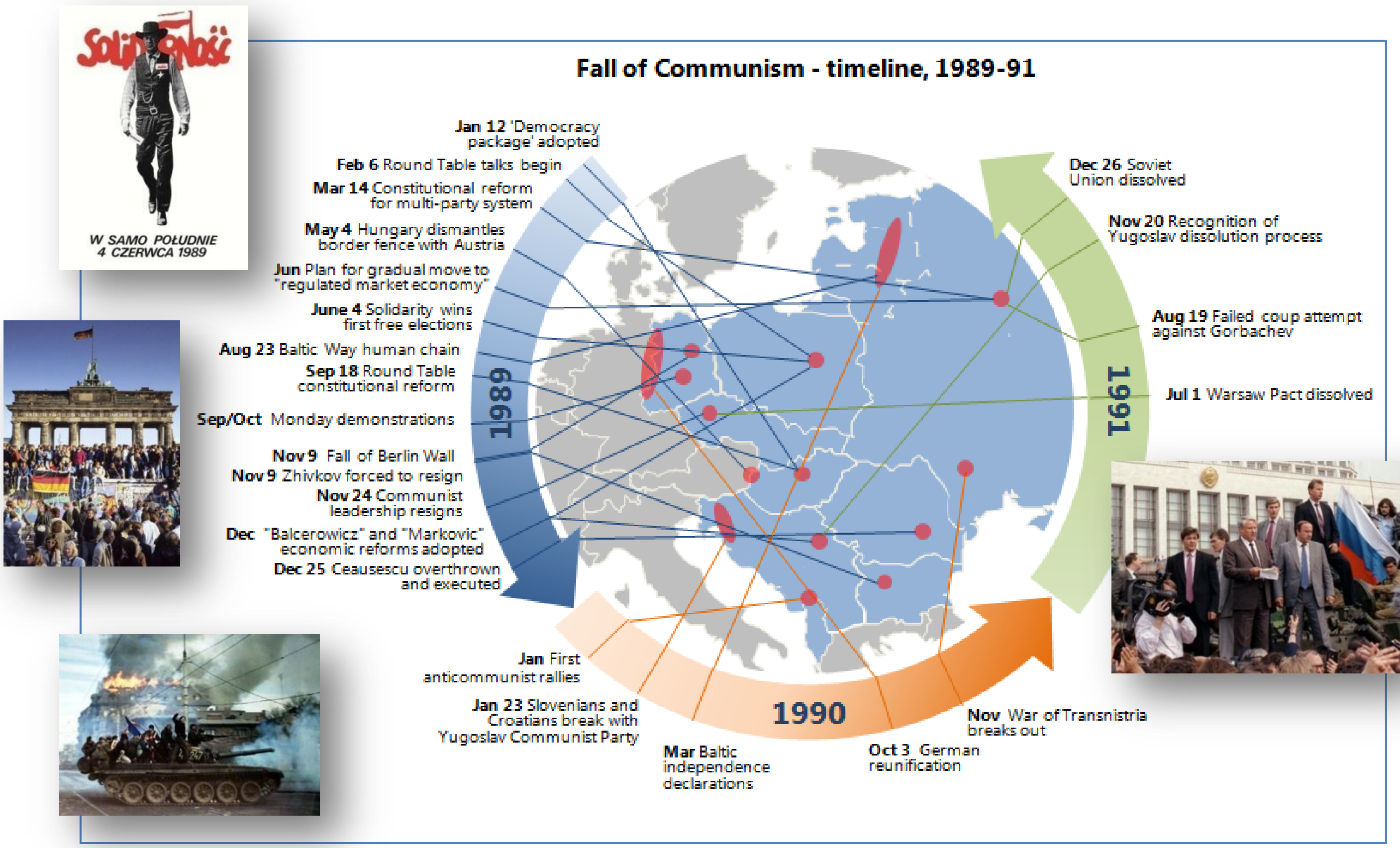
In 1989, the Stalin-era Palace of Culture stood almost alone on the Warsaw skyline. Now it is joined by a host of modern skyscrapers

Public transport in Romania in the late 1980s...and now

Shopping in Bulgaria, early 1990 and today

A. Political Transformation

In the mid-1980s, few would have imagined the dramatic changes that were about to engulf Central and Eastern Europe, notwithstanding the initial steps towards modernization introduced in the Soviet Union by the programs of *glasnost* (openness) and *perestroika* (restructuring). Nor would they have guessed the speed of these changes: by the end of 1991 the political landscape was unrecognizable from just three years earlier.



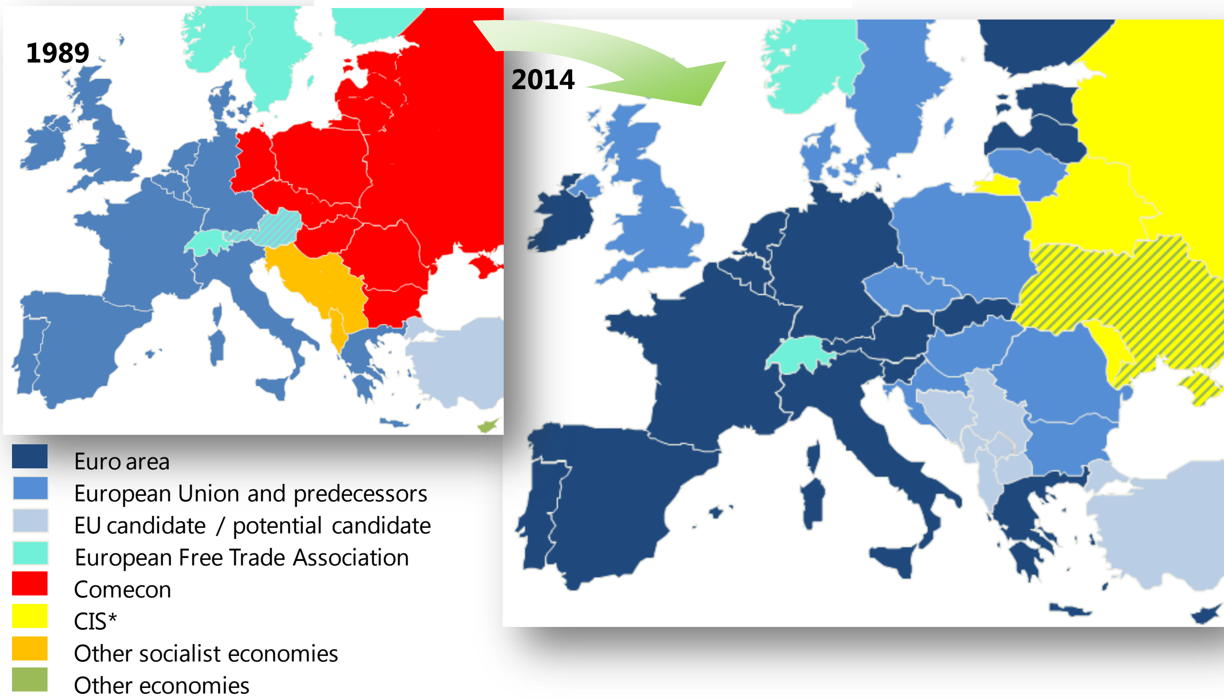
In some cases, the fall of communism broke the bonds that had held countries together, with the dissolution of the Soviet Union and Yugoslavia followed in 1993 by the "velvet divorce" of the Czech and Slovak republics. Conversely, less than a year after the Berlin Wall came down, East and West Germany were reunified. Eventually more than 20 countries emerged from the process. The violence that took place in parts of the former Yugoslavia, and also in Romania and Moldova, stood in marked contrast to the major achievement in almost all other cases, that a transformation of such momentous scale was effected peacefully.

Rapid political changes have continued throughout the quarter-century since 1989. Most notable has been the reintegration with Western Europe. Partnerships with the EU strengthened through the 1990s, culminating with the accession of eight former socialist economies in 2004, followed by Bulgaria and Romania in 2007 and Croatia in 2013. Four of these have joined the euro area, with Lithuania also set to join in 2015. Looking forward, the remaining countries of the Western Balkans all have EU candidate or potential candidate status.

Prepared by James Roaf.

Political and economic integration has not only involved the EU. When the Soviet Union was dissolved at the end of 1991, the Commonwealth of Independent States (CIS) was established, comprising most of the former Soviet republics. Recently this region too has moved towards closer integration through the development of the Eurasian Economic Union, to become operational in 2015 with initial members Belarus, Kazakhstan, and Russia.

European integration

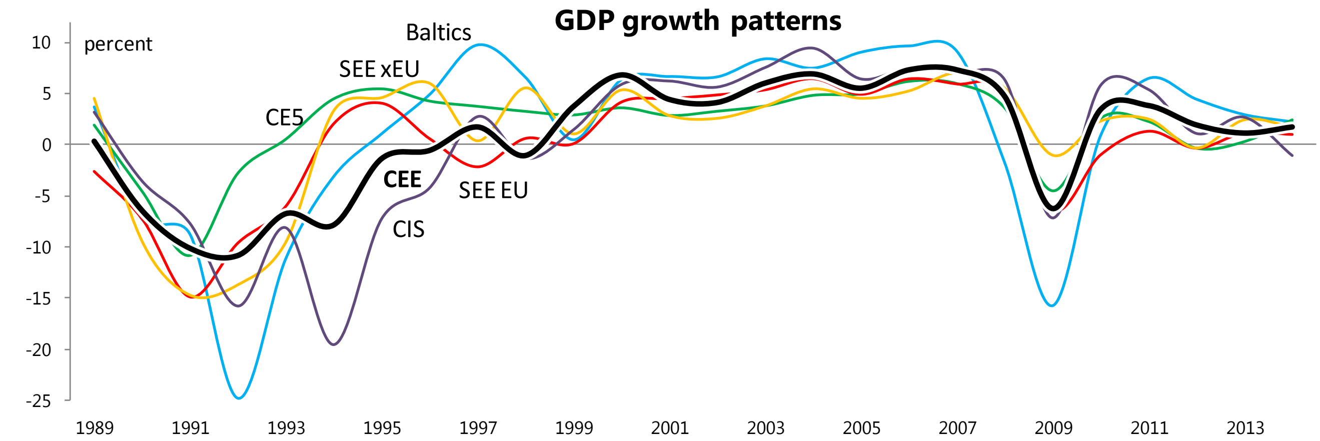


*Ukraine has declared its intention to leave the CIS

B. Economic Transformation

Macroeconomic development

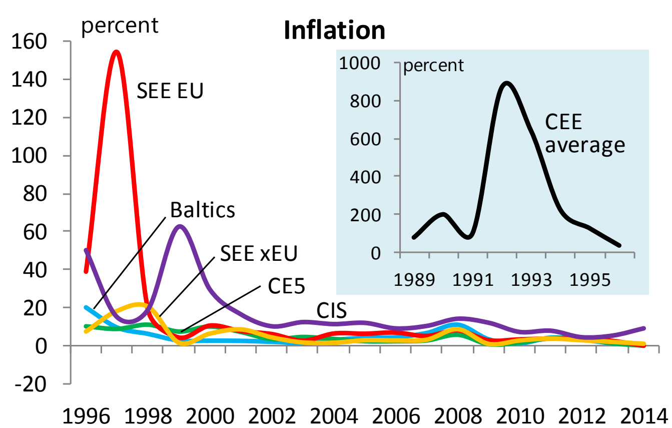
All the transition countries went through recessions with the initial economic dislocation and trade disruption stemming from the collapse of the Soviet-era Council for Mutual Economic Assistance (Comecon). The scale of these recessions varied across countries but were extremely deep and prolonged in some cases—even if the official statistics available at the time tended to overstate the output losses. The 1990s saw diverging growth rates as countries struggled to achieve macroeconomic stabilization and lay the foundations of a market economy. Initial conditions were important to how countries fared in this period: some countries, especially in Central Europe and Yugoslavia, had already experimented with market reforms in the 1980s, while others entered the transition with central planning still fully intact and little familiarity with market systems. External factors mattered too, with countries most dependent on trade with or within the former USSR most affected by its collapse, and countries closest to Western European markets benefiting most from new investment and trade. But after taking account of these factors, policies were critical to outcomes. Countries that took bolder and more front-loaded reforms—notably in Central Europe and then the Baltics—were rewarded with a faster return to growth and stability, including avoiding the series of crises that hit the region in 1997 and 1998.

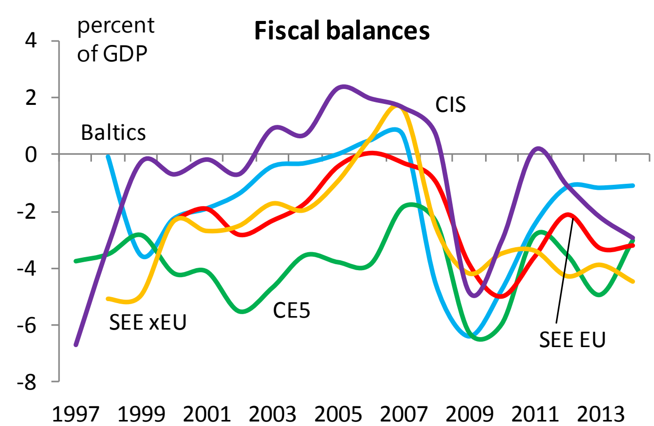


Source: WEO; various sources for some countries in early years.
Note: See country codes box for composition of regional averages. CEE average weighted by GDP, others unweighted.

The initial transition recessions were accompanied by high or hyper-inflation in most countries, as prices moved to market levels and as governments resorted to monetary financing of gaping fiscal deficits. But through the 1990s countries successively brought fiscal deficits and inflation under control, albeit only after false starts in some cases.

In contrast to the turbulence and divergence of the 1990s, growth patterns in the early and mid-2000s were uniformly strong. With favorable global conditions and increasing confidence in rapid convergence with Western Europe, average growth for the region was 6 percent, with no country growing at less than 3 percent annually—a faster rate than most countries have consistently managed before or since. However, while soundly based at the start, growth in this period became increasingly imbalanced, driven in many countries by large-scale borrowing for consumption and construction. The resulting vulnerabilities combined with the effects of the global financial crisis with devastating effect: output declines in 2009 averaged 6 percent and ranged up to 18 percent, a more severe impact than in any other region of the world. The ensuing euro zone crisis and slow global recovery have weighed on growth since—and rising geopolitical tensions further cloud the outlook looking forward.

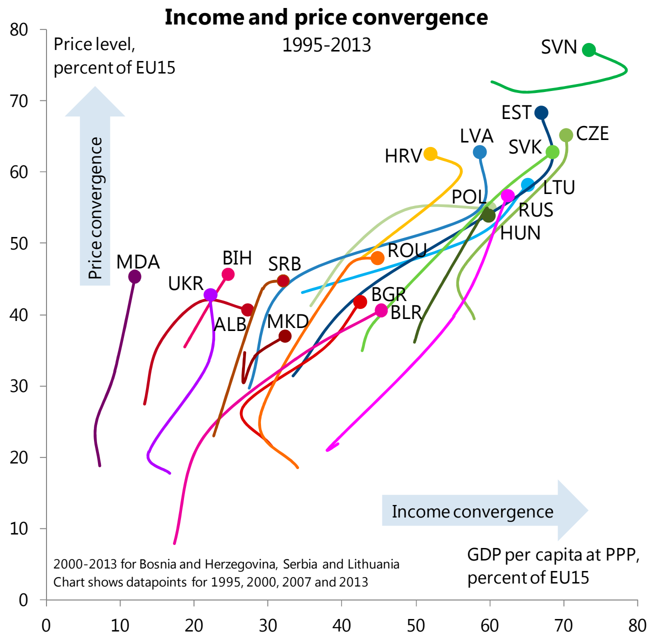




Source: WEO.

Through the 2000s, fiscal positions improved markedly, with revenues boosted by the unsustainably rapid growth. The boom also pushed inflation up somewhat, but demand pressures showed mostly in ballooning external deficits. The underlying fiscal problems were exposed when the global financial crisis hit, with major deteriorations in budget deficits. Most countries have since embarked on significant consolidation, although many have struggled against the backdrop of slow growth.

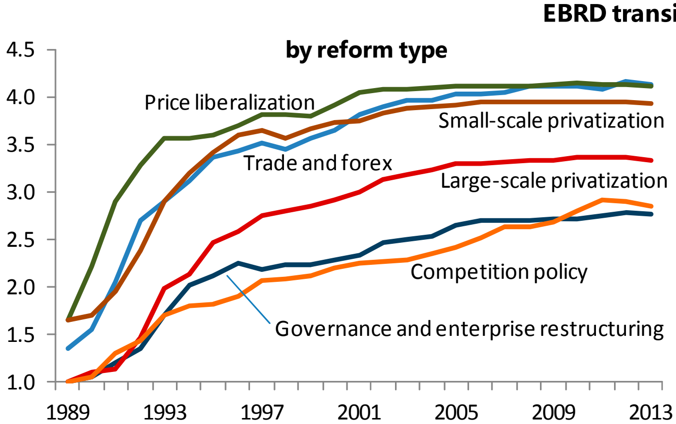
Despite the ups and downs, overall the transition period has been one of strong convergence with Western Europe. On average, income per capita has risen from about 30 percent of EU15 levels in the mid-1990s to around 50 percent today. This average conceals large differences between countries, with some, such as the Baltics, making huge advances; and others, such as Bosnia and Herzegovina, Moldova, and Ukraine, getting increasingly left behind. Price levels—along with wages—have also risen as part of the convergence process. To the extent that price and wage increases have reflected productivity increases from investment and better labor skills, these developments are not a cause for concern. But countries where costs are rising faster than productivity risk losing competitiveness.

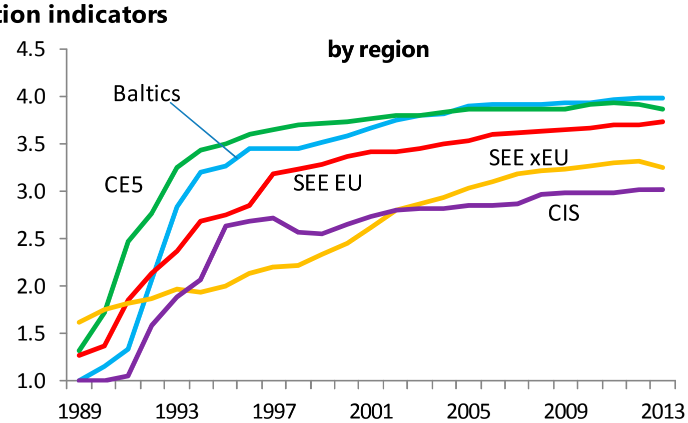


Structural reform

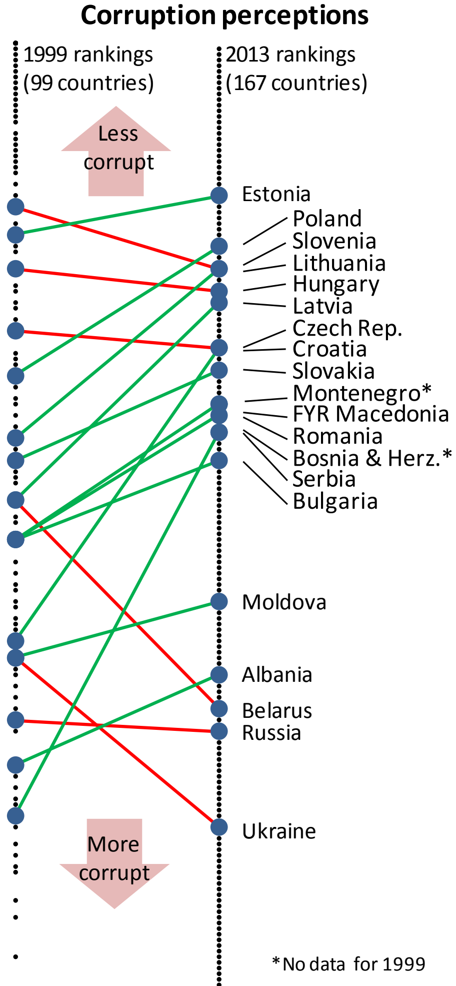
The process of building market economies has been harder than many expected 25 years ago. While reforms have proceeded at very different speeds across the different countries, the sequencing has tended to follow the same pattern. Liberalization of prices, trade, and foreign exchange could be implemented quickly, through legal and regulatory changes. Similarly, privatization of small businesses did not encounter major opposition. Reforms in these areas are mostly complete in all countries except Belarus. But other crucial areas of reform and institution-building have proven much more difficult, chiefly because they involve challenges to vested interests. Large-scale privatization was largely completed in the first decade of transition in central Europe and the Baltics, but remains to be finished in many other countries, especially in the Western Balkans and the CIS. Competition policy, governance reform, and enterprise restructuring have been even more difficult to advance in the face of opposition from insiders benefiting from existing arrangements. Reform momentum has also tended to slow over the years. Countries mostly made rapid progress in the 1990s, but for most, the last decade has seen less change, even in cases where the transition process is still far from complete.

EBRD transition indicators





Source: EBRD.

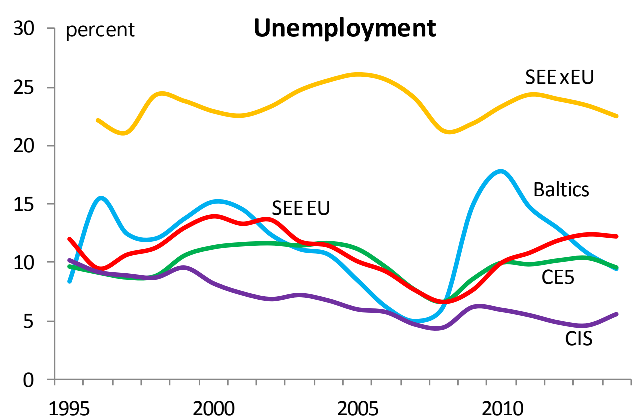


Source: Transparency International.
Note: For comparability of rankings, new countries in 2013 sample shown as gaps in 1999.

A critical element of the reform process has been to build a sound business environment in which firms can start, invest and expand, and, where necessary, die. Creating these conditions requires far-reaching legal, administrative, and institutional reforms across a broad front. At the start of the transition, these were not in place in any of the countries. Business activity was governed instead by central planning, political decisions, and often corruption. Twenty-five years later, this is an area in which the transition countries differ the most from each other, with important implications for their future growth prospects. In the World Bank survey of ease of doing business, they range from 17th place to 131st out of 189 countries worldwide. The range is just as broad in the latest Transparency International survey of investors' perceptions of corruption. But in general, there has been a strong improvement: the large majority of transition countries have raised their rankings relative to the rest of the world over the past 15 years, some very markedly, with only a handful falling back.

The development of the financial sector has been important in strengthening conditions for business. Across the region, Western European banks made strategic investments to establish subsidiaries, to the extent that foreign bank ownership dominates most countries' banking systems. This has facilitated the provision of financing to firms and households (albeit too much, in the mid-2000s boom), but importantly also much needed expertise and technical know-how, and the benefit of arms-length relationships between banks and their customers.

The social impact of the transition has been profound. In moving from a system of guaranteed employment to labor markets governed by supply and demand, and with the closure of unviable firms and industries, unemployment inevitably increased sharply at the start of transition. For most countries, labor market reform and economic growth helped reduce unemployment over time, subject to a continued legacy of long-term unemployment, and the job losses associated with the global crisis. The notable exception has been the Western Balkan countries, which have struggled with extremely high unemployment throughout the transition period. Another stark indicator of the social costs of early transition is life expectancy, which in many countries stagnated or fell for a number of years, most notably in CIS countries.

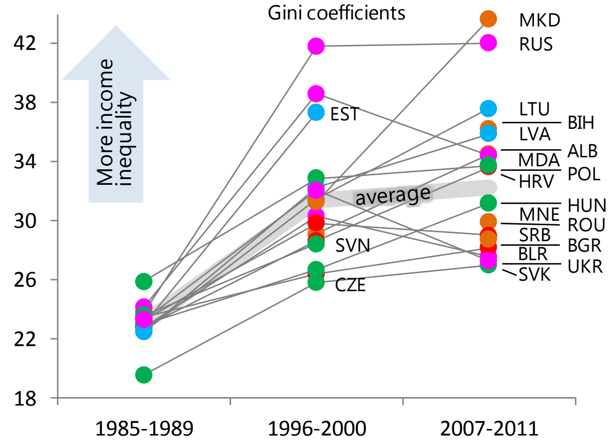


Source: WEO.

Governments also found themselves unable to maintain the generous universal benefits of the socialist era, especially given adverse demographic trends. In general, pension entitlements have been scaled back to more fiscally sustainable levels, and other social benefits better targeted towards the needy. But progress in implementing these reforms has varied widely across countries. Inequality has also risen across the board. As with unemployment, in most countries the main increase took place in the initial stages of transition, with smaller rises (or in some cases reductions) in inequality indicators since. On average, inequality in the CEE region is now on a par with that of the EU15 countries—but in both cases there are wide ranges around the average.

Inequality indicators

Gini coefficients



Note: CEE average calculated for 12 countries where data is available for all three periods.
Source: World Bank.

C. Involvement of the IMF

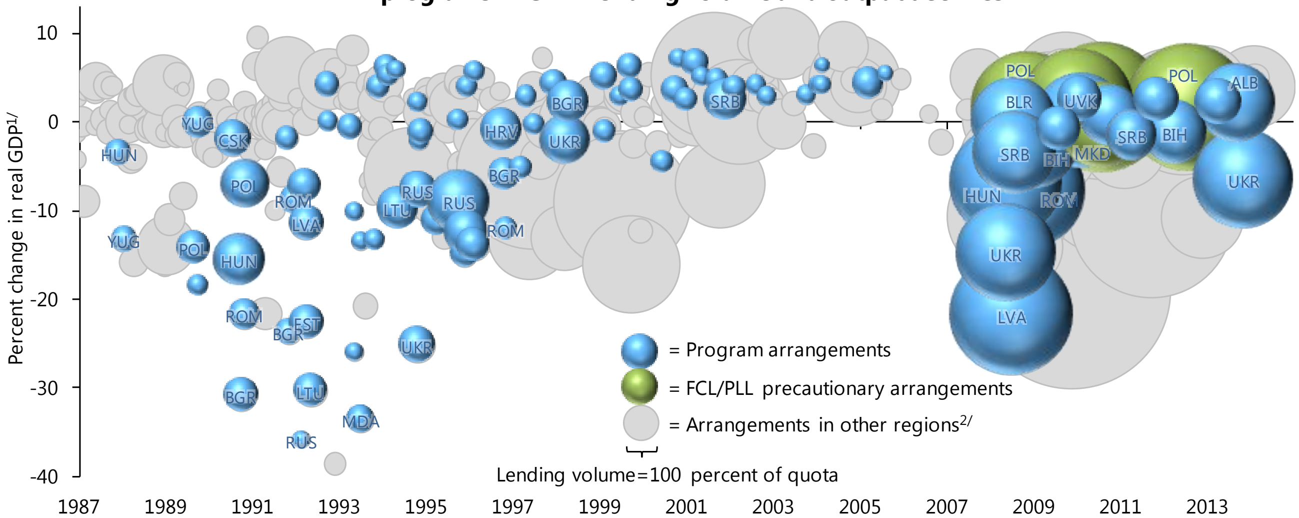
The IMF has been closely involved with the transition process from the start. In fact, some of the countries had joined the IMF well before 1989, with the Fund providing financial and technical support to early reform steps in Hungary, Romania, and Yugoslavia in the 1980s. But it was after the collapse of communism in 1989 that the main expansion of the Fund's membership and activities took place, with 25 new members from the ex-socialist bloc joining by the end of 1993. These countries were almost all in parlous economic conditions and in desperate need of foreign financing and advice.

The arrival of the new members was the most significant development in the Fund's history since the ending of the Bretton Woods exchange rates system two decades earlier. It required a major expansion of all three of the main areas of IMF activity:

- Surveillance, meaning advice on both individual country policies and multilateral issues such as the dismantling of the ruble zone;
- Program lending, by which the IMF provided financing to support countries' economic stabilization programs, with disbursements conditioned on implementation of key policy measures; and
- Training and technical assistance, whereby teams of experts in a particular field worked closely with the country authorities to help design and implement specific reforms such as the adoption of a value-added tax, establishing new monetary policy frameworks, or strengthening expenditure controls.

IMF staffing was upgraded accordingly, along with expertise in economic and legal issues relating to transition. At least, to the extent that such expertise existed. The problem was that the countries were in uncharted territory; no-one at the Fund, or elsewhere, knew for sure how to create a market economy from scratch after decades of distortions under central planning. Thus, the early programs involved a significant element of "learning by doing," jointly between the country authorities, IMF staff and other international advisors.

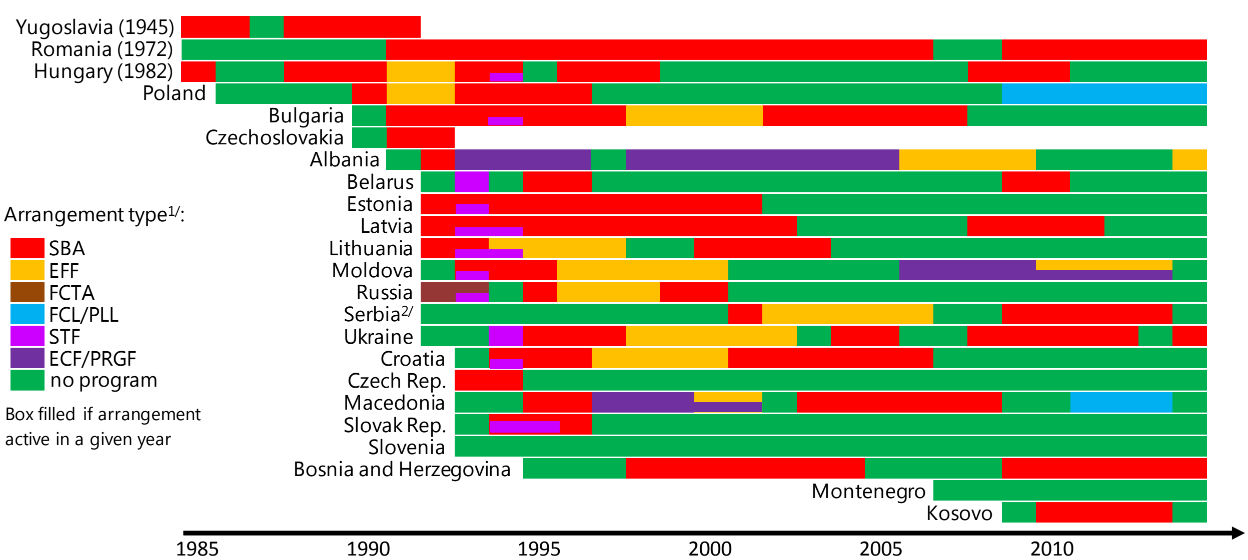
IMF programs in CEE - lending volume and output declines



1/ Maximum cumulutive decline in three years from program inception (or lowest growth if no decline).
2/ Only non-concessional arrangements.

The first of these programs was for Poland in February 1990, only months after the Berlin Wall fell, in support of the "Balcerowicz Plan" for radical, front-loaded reform. This was quickly followed by programs for Hungary and Yugoslavia that same year, with programs for Bulgaria, Czechoslovakia and Romania coming in 1991. With the slew of new countries joining in 1992 after the dissolution of the Soviet Union, the IMF faced a problem: most of the new states lacked the institutional capacity to meet the Fund's normal lending standards. The Systemic Transformation Facility (STF) was set up in 1993 to provide support to countries as they built up sufficient capacity and policy credibility to move to a full-fledged IMF program. More than half the transition countries used the STF in 1993–94. Financing under the STF was strictly limited, reflecting the risks involved and limited repayment capacity. Indeed the early transition programs were generally not very large, at least in comparison with what came later in the Asian, global and euro zone capital account crises. But many of them contended with output losses of unprecedented scale.

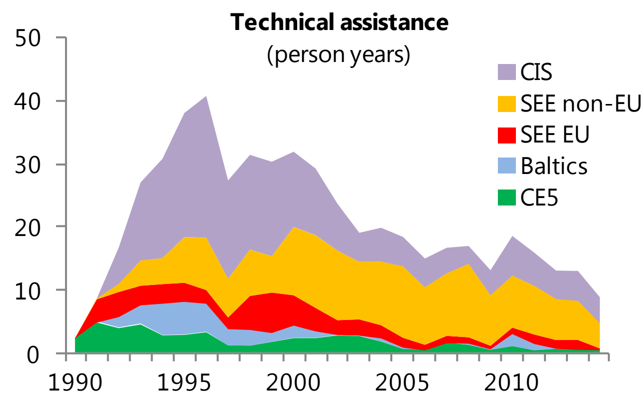
Timeline of IMF membership and programs

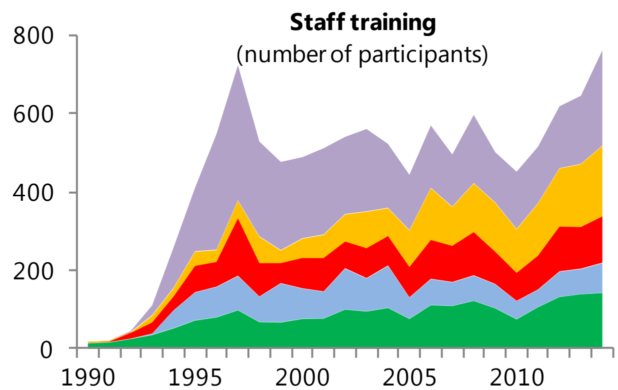


1/ See http://www.imf.org/external/np/exr/facts/howlend.htm for definitions of arrangement types.
2/ Serbia and Montenegro before 2007.

The volume of transition programs remained high through the 1990s. But in the 2000s, the benign global environment and ready availability of market financing meant very few countries were turning to the IMF for financing. This changed dramatically with the onset of the global financial crisis in 2008–09, which saw eight countries in the region returning to the IMF for support. The scale of the turnaround in private capital flows resulted in extremely high financing needs and very deep recessions in some cases—although the programs helped avoid even worse contractions of demand. This period also saw the introduction of new precautionary credit lines from the IMF for countries with sound policies but facing heightened risks, which were used in different forms by Poland and FYR Macedonia.

By 2014 the crisis programs had concluded, generally successfully. But the legacy of slow growth in the aftermath of the global and euro zone crises contributed to persistent fiscal and competitiveness problems in some cases, especially in the CIS and Western Balkans. More broadly, countries continue to face external vulnerabilities. These issues are being addressed by IMF-supported programs in Albania, Bosnia and Herzegovina, Romania, and Ukraine.



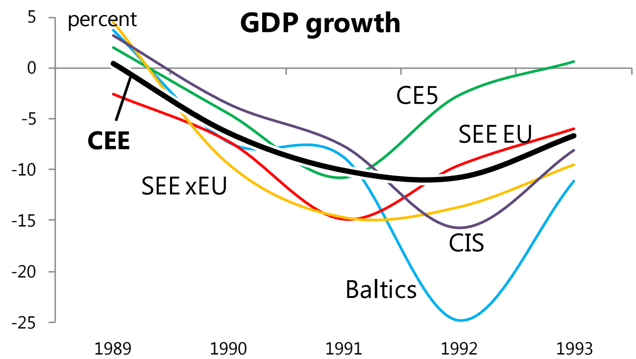


Source: Institute for Capacity Development.

Over the full period since 1989, the IMF has provided a total of some 530 person-years in technical assistance to the transition countries. The bulk of this has been for fiscal policy and the financial and monetary sectors, peaking in Russia and the other CIS countries in the mid-1990s. The IMF has provided training in all aspects of macroeconomic and financial sector policy, statistics, and other areas of relevance to the transition to almost 12,000 individuals from the CEE region, mostly via the Joint Vienna Institute.

II. 1990–1993: INITIAL STABILIZATION AND REFORM

Most countries faced extreme difficulties during the first years of transition. Output fell dramatically across the board as trade links and internal economic relationships were broken. Inflation skyrocketed as price and foreign exchange controls were removed. The countries with better initial conditions and more aggressive approaches to reform reached stabilization faster. In several other countries, however, conflict or institutional obstacles to market reforms exacerbated the transition challenges.



Source: WEO; various sources for some countries in early years.
Note: CEE average weighted by GDP, others unweighted.

By the end of the 1980s, imbalances in socialist economies had reached critical levels. Falling world oil prices undercut the Soviet Union's export revenues and diminished its ability to support other socialist-bloc countries. Budget deficits ranging from about 7 percent of GDP (Poland, 1989) to over 20 percent of GDP (USSR, 1991) were covered mostly by printing money. At the same time, consumer prices remained fixed or heavily regulated, while all basic social services were provided for free. These policies overloaded economies with money that could not be redeemed for goods or services (the "monetary overhang"). In the USSR and other countries, supply deficits that were common for centrally planned economies turned into acute shortages of basic staples like sugar and soap. The contrast between these realities and the perceived wellbeing of Western economies inspired daring reforms that had seemed impossible just a few years before.

"Shock therapy" vs. gradualism

Across Eastern Europe, groups of economists debated blueprints for reforms. Many policymakers and members of the general public believed that sweeping transformation of economies and society could be accomplished within a couple of years, if not months. In Poland, a commission led by Leszek Balcerowicz finalized plans for market reforms in late 1989 (see Box 1). Implemented from early 1990, these reforms became known as "shock therapy", a term coined by Jeffrey Sachs—an adviser to the Polish reformers—in the mid-1980s for reforms in Latin America.[1]

Meanwhile in Yugoslavia, the new prime minister Ante Markovic initiated a planned transformation to a market economy over the medium term. The stabilization and disinflation program formally launched in December 1989 involved abandoning socially owned, worker-managed companies and liberalizing exchange and import regimes. The aim was to correct economic, structural and institutional weaknesses of the economy in the context of a fixed exchange rate. The reforms were supported by an IMF arrangement approved in February 1990. The program initially achieved a large decline in inflation, at a relatively low cost in terms of output loss.[2] However, it foundered in late 1990, in part because of the diverging interests of the Yugoslav republics.

Prepared by Michael Gorbanyov.

[1] See Lipton and Sachs (1990) and Sachs (1993).

[2] See Coricelli and Rocha (1991).

In the USSR in 1990, a group led by Grigory Yavlinsky and Stanislav Shatalin came up with a plan for urgent reforms named "500 days". It proposed extensive privatization of state property in the first 100 days, then price liberalization and removal of administrative controls in the next 150 days. The following 150 days would witness market stabilization after the initial price shock, and the last 100 days a renewal of economic growth. The newly elected Russian parliament supported the program. However, the Soviet parliament and government considered it overly ambitions. Fearing social consequences, President Gorbachev opted for a gradual transition instead. But this proved insufficient to address mounting problems or meet people's desire for change.

Box 1. The "Balcerowicz Plan" in Poland

In late 1989 the new Polish government took advantage of the first window of opportunity to embark on a front-loaded stabilization and reform program. It was a bold approach with many risks, and many observers—including some at the IMF—were not confident of its success. Initial conditions were highly unfavorable:

- Most prices were administered. Initial liberalization in an environment of cheap credit, open-ended subsidies, and fiscal deficits financed by the central bank had led to near-hyperinflation.
- Foreign exchange was rationed, with the official rate fixed at a much more appreciated rate than the market rate; the current account deficit widened and Poland defaulted on external debt.
- The labor market was not functioning, with high levels of over-employment. The capital stock was obsolete. Outside of agriculture, ownership was dominated by state firms.

The reform package was built around three mutually reinforcing pillars:

Tightening financial policies. The zloty was devalued and fixed to the dollar, supported by a stabilization fund and credits from the IMF and other international financial institutions. Interest rates were sharply increased. Tax-based incomes policy applied to all state firms, with penalties on wage increases above the norm. Fiscal tightening involved elimination of income tax exemptions and most subsidies.

Liberalizing the economy. Most price controls were removed, and energy prices were adjusted to reflect cost. Import restrictions and foreign trade monopolies were replaced by tariffs. Foreign exchange became freely available for most current transactions.

Building market infrastructure. Structural changes were launched to set up capital markets to facilitate ownership changes; to modernize and strengthen the banks; to improve regulatory and accounting standards; and to modernize the tax system based on income tax and VAT.

Results were positive, though mixed :

Nominal anchors held and financial conditions improved. The exchange rate peg held for more than a year, much longer than the targeted three months. Real wages declined during 1990–91. Initial inflation targets were exceeded, but disinflation resumed in the face of lower demand and import competition. Monetary aggregates remained under control and real interest rates were mostly positive. External performance was initially robust but real appreciation and the collapse of Comecon subsequently eroded competitiveness. Fiscal accounts over-performed in 1990, on the back of windfall corporate profits.

The output loss was deeper than expected. A sharp contraction in state firms was partly offset by private sector expansion. Employment declined less than assumed, as state firms hoarded labor in the hope of a policy reversal. While open unemployment surfaced, many laid-off workers found jobs in the private sector or took advantage of early retirement and disability provisions. Social safety nets based on product subsidies and employment guarantees were replaced by programs focused on unemployment, pensions, family benefits, and social assistance, but the generosity of some programs—such as unlimited unemployment benefits or liberal disability assessment—invited abuses.

In retrospect, the reforms were successful in stabilizing the economy and setting a sound foundation for a market economy. By end-1991, the corporate and financial sectors were reacting to market incentives and there were early signs of recovery; privatization was gaining grounds; and the credibility of market policies was well established. But as with the experience of many early reform efforts, there was a political cost: the government lost the 1991 elections.

Prepared by Robert Sierhej.

After the Soviet Union collapsed in 1991, worsening economic imbalances emboldened the new Russian President Boris Yeltsin to give a mandate for radical reforms to the government led by Yegor Gaidar. Largely following the "shock therapy" in Poland, the reforms in Russia started with removal of price and exchange rate restrictions in 1992, liberalization of external trade, and lifting of administrative controls at the enterprise level. However, the reforms quickly met with resistance. Vested interests successfully pushed for public financing to loss-making enterprises, and large-scale monetization of public sector deficits continued for several years.

The rapid reforms undertaken in Poland set an example for other countries in the region. They were followed most closely by Czechoslovakia in 1990 and, two years later, by the Baltic countries. Hungary, Croatia and Slovenia trod more cautiously, in part because they had more liberalized economies at the start of the transition and less of a need for rapid change. Albania, Bulgaria and FYR Macedonia tried to implement quick reforms and made some initial progress. But the transition pace in these countries subsequently slowed, because of rising economic and social challenges. Eyeing this experience, Ukraine, Romania and Belarus adopted a gradualist approach, delaying or avoiding reforms.[3] Meanwhile, intensification of conflict in the former Yugoslavia hampered economic transformation, despite its initially more market-oriented economy.

Sequencing of reform

Closely related to the question of speed of reform was sequencing, with some suggesting that liberalization, and especially privatization, should have waited until adequate legal and institutional frameworks were in place in which the private sector would operate—and taking China's transition as a model. Like many of the early reformers, the IMF's view was clear, with the approach towards Russia's first program in mid-1992 characterizing most of the early programs: "…[I]t was important to move as quickly as possible with all the key changes, especially macroeconomic stabilization, liberalization, and privatization. The IMF recognized that many [structural] reforms would take years to complete… But this was not seen as a reason for postponing the main stabilization and liberalization measures."[4] The approach reflects the reality that a China-style sequencing and gradualism was neither feasible nor desirable for the European transition countries. Unlike in China, the collapse of industrial and trade structures meant economies were mostly already in sharp decline and the new governments (of new countries, in many cases) were struggling to establish credibility, stability and control. Liberalization, hard budget constraints on state firms, and (inevitably far from perfect) privatization were preferable to allowing private interests to move into the vacuum left by the collapse of central planning and administrative control, by stripping assets of public companies and extracting rents from price and trade distortions. And importantly, where pursued vigorously, the broad-based reform agenda allowed the emergence of brand-new firms, which became the engine of growth as recovery took hold. [5]

Early reform outcomes

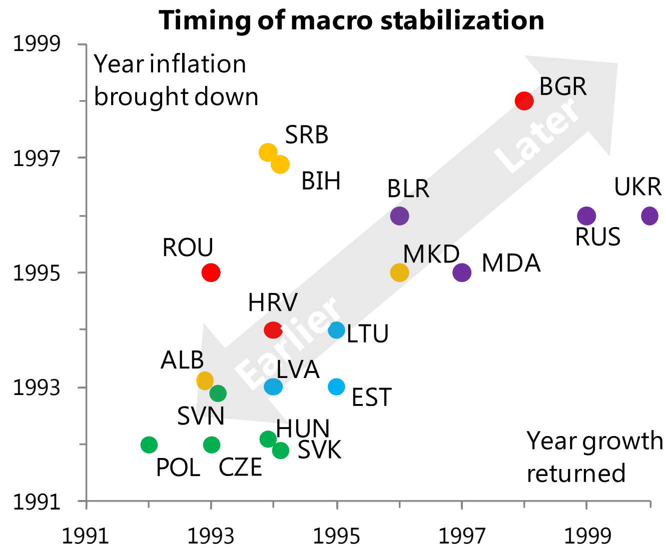
The full scope of transition challenges and related trade-offs became apparent only when the actual reforms commenced, albeit half-heartedly in many countries. Broadly as expected, the centrally planned systems ground to a halt in nearly all economies. However, the new market-based mechanisms were slow to emerge. Many

[3] See Havrylyshyn (2007).

[4] Odling-Smee (2004), p6.

[5] See, for example, Stiglitz (1999) and Dąbrowski et al (2000), while Husain and Sahay (1992) discuss the impact of sequencing in privatization.

economic and trade linkages within the former communist bloc collapsed, aggravated by the painful dissolution of the former USSR and Yugoslavia, and individual producers faced a long road towards re-integrating into local and global supply chains. Many plants and factories ceased production, as their output met no demand under the new conditions. In turn, they stopped paying wages, or, in some cases, paid them in kind with their own products. As a result, output collapsed or shifted into the informal "gray" economy.



Source: WEO; various sources for some countries in early years.
Note: Colors reflect regional groupings.

Cumulative GDP contractions in the first three years of transition ranged from about 13 percent in Poland and Czechoslovakia to about 25 percent in Bulgaria and Romania, 30–40 percent in the Baltics, Russia and Ukraine, and 50 percent in Moldova.[6] Moreover, in a few countries the output contraction extended long beyond the first years of transition. At the same time, there are reasons to believe that the imperfect Soviet-style statistics (focused on "material product") exaggerated the scale of early output losses. On the production side, much of the decline came from falling output of heavy equipment that was of questionable value outside the communist trade and output system, while emerging goods and services sectors were not fully captured in the statistics. Falls in living standards were overstated from the consumption side too: prices went up (so measured real incomes fell) but little or nothing had been available at the low prices and a lot was available at the new higher prices. In addition, queuing and other costly resource-using, rent-seeking activities from before the reforms had never been counted.[7]

Budget revenues collapsed as well, as old revenue channels splintered and new taxation systems were not yet established. Delays in restructuring state-owned enterprises (SOEs) implied a need to cover their losses as well. In nearly all countries, the resulting large public sector deficits were financed by printing money. Adding to the inherited "monetary overhang", this stoked hyperinflation in many countries. In the first year after the controls were removed, prices jumped by about 7 times over in Poland, 26 times in Russia and over 100 times in Ukraine. Hyperinflation and the bankruptcy of government-owned banks, like Sberbank and its branches in Russia and other former Soviet countries, wiped out the life savings of ordinary people. Many workers of defunct state-owned companies lost their jobs and faced extreme difficulties adjusting to the new realities.

For many countries, the economic contraction and accompanying currency devaluation made external debt service unbearable. Over 1990–92, Poland and Bulgaria successfully restructured their external debts under the Paris Club framework, in the context of IMF-supported programs. For the former Soviet republics, the solution came as a deal brokered with Russia and the Paris Club. As a result, Russia assumed responsibility for all debts of the former USSR to official creditors, and negotiated their restructuring with the Paris Club. In exchange, it took all

[6] Estimates refer to cumulative output declines over 1990-92 except for Baltics and CIS, where the comparable transition period is 1992–94.

[7] Lipton and Sachs (1990) model some of these effects (including pre-transition repressed inflation). Blanchard (1997) uses alternative measures such as industrial production. See also Åslund (2007).

former USSR property abroad, as well as its claims on other countries (mostly hard-to-recover claims on developing countries that had received economic and military assistance from the USSR). Along with its assets, debt of the former Yugoslavia was apportioned to the states resulting from its dissolution, paving the way for the countries to reach debt restructuring agreements with the Paris and London Clubs.

IMF support for early transition

At the outset, the IMF assumed the lead role in channeling international assistance to the former communist countries, with other institutions—including the EBRD, created in 1991 primarily to support the nascent private sector—playing increasing roles as transition advanced.[8] During this period, the IMF provided advice and technical assistance in areas such as upgrading taxation systems, establishing modern central banks, and adopting international standards for statistics and for fiscal and monetary data reporting. Progress in implementing recommendations varied considerably, very much depending on the authorities' program "ownership" and commitment to reforms. In addition, the IMF helped meet the urgent early needs to strengthen institutional capacity and develop understanding of the market economy via a wide range of training courses, provided both at headquarters and at the new Joint Vienna Institute.[9]

Divergent transition paths

The results of the first years of transition were very uneven. Poland, the Baltics and the other countries that embraced "shock therapy" reforms went through the transition faster. But there were still high initial social costs. In Poland, for example, the unemployment rate reached 16 percent, as over a million people lost their jobs. Bold reforms set these countries firmly on the path to economic restructuring and recovery. By 1992, the Polish economy stabilized, and then began to grow. The other Central European economies and the Baltics followed closely, with reversals of their output declines already in sight.

The situation was different in countries such as Belarus and Ukraine, which had stayed longer in the Soviet system and gone deeper in suppressing private sector initiative. These countries often preferred a gradualist approach to reforms and sought to maintain features of the old system. They could not escape the initial sharp economic contraction but lagged behind in the post-transformation recovery. In these countries, the initial stabilization attempts—including those supported by the IMF—did not produce the intended results, and economic slump extended well beyond the early 1990s. And in the former Yugoslavia and Moldova, policy challenges were aggravated by conflict and civil wars.

[8] "By far the most important actor in providing assistance during the early stages of the transition is the IMF… Apart from macroeconomic significance, its programs provided a strong boost to genuinely-committed reformers in transition economies. Once the goals of economic stabilization are achieved, other actors have the potential to play in institution-developing and sectoral problems." Dąbrowski (1995), p4.

[9] The JVI was established in 1992 in cooperation with the Austrian authorities and other international partners. Examples of critical areas of support included the creation, from scratch, of monetary authorities in the former Soviet republics and the development of national treasury systems to enable budgetary planning and control.

III. MONETARY AND EXCHANGE RATE POLICY

After the fall of communism, monetary policy had to take on a more active role, requiring policy and institutional changes, including the establishment of independent central banks. A key choice was whether to use monetary aggregates or fixed exchange rates as the basis for the initial stabilization following price liberalization. Most countries later moved away from their initial choice of nominal anchor, eventually tending towards inflation targeting, hard exchange rate pegs, or euro adoption, with a diminishing number of intermediate regimes.

Establishing monetary policy frameworks

Centrally planned economies had long experienced enormous price distortions, with prices detached from market forces. Trading was confined mostly among Comecon members, with limited trade with the rest of the world. The integration of these economies into the international monetary and trading systems urgently required liberalization of prices (with the monetary overhang leading to large inflationary pressures) and establishment of currencies as units of exchange (which depreciated considerably in the initial phase).

An immediate priority was to establish functioning central banks. The communist "monobanks" encompassed functions of monetary emission and foreign exchange management, commercial banking—in the sense of passively providing financing for transactions arranged by the planning agencies—and even deposit-taking in some cases. These functions needed to be separated into policy-based responsibilities of the central bank, and business activities devolved to commercial banks. Beyond this, instituting central bank independence became one of the most important achievements of the early transition. Studies have shown the success that increased central bank autonomy had in lowering inflation, with that in turn correlated with subsequent real GDP growth.[1]

Central bank autonomy and accountability required strong legislation. From similar starting points, countries varied widely in the degree of independence attained. In many cases, central bank laws were not specific about the monetary policy goal under the given monetary regime or the degree of instrument autonomy in the context of monetary policy implementation.[2] Some countries were already taking important steps at the start of the transition. For example, Poland's new central bank law in early 1989 established the independence of the governor, passed previous commercial banking activities to nine commercial banks and set a main objective of "strengthening of the Polish currency". Similar reforms were put in place in Czechoslovakia in early 1990. In the case of countries created from the dissolution of Yugoslavia, asserting monetary sovereignty and departing from the Yugoslav dinar was seen as an important act of legislative independence. Countries that were not able to establish these practices during the initial attempts of stabilization (such as Bulgaria, Romania, Russia and Ukraine) were mostly forced to undergo second rounds of stabilization. IMF technical assistance was used in many cases to adopt and revise central bank laws, with the credibility of monetary policy bolstered by the presence of an IMF-supported program.

For the states emerging from the collapse of the Soviet Union in late 1991 the immediate question was whether to continue using the ruble as a common currency (the "ruble zone") or to issue separate national currencies. At the start, they all retained the use of the ruble. However, when the new Central Bank of Russia (CBR) took official control over issuance from the communist-era Gosbank in January 1992, it encountered severe difficulties in controlling the money

Prepared by Armine Khachatryan.

[1] See Loungani and Sheets (1997) and Lybek (1999).

[2] See Fischer et al. (1998), Siklos (1994).

supply. Previous branches of Gosbank became central banks of emerging states and had the right to issue non-cash rubles, but with little incentive to coordinate or limit the emission. The CBR imposed limits on inter-republic lending, which led to further separation of cash and non-cash rubles. The different republics' non-cash rubles "traded" at varying discounts to Russian non-cash rubles. At the same time, cash rubles issued by the CBR continued to circulate as if a separate currency. Given these conditions, countries—starting with the Baltics—took the lead in leaving the zone and introducing their own currencies. In mid-1993 the CBR suddenly withdrew pre-1993 ruble notes from circulation, prompting more countries to exit the zone, with most issuing their own currency within the year.

The IMF was active in these policy discussions, seeking to balance the interests of its new member countries and encourage their productive cooperation, in line with its mandate. Recognizing the lack of preparedness of many of the new countries to pursue independent monetary policies, the IMF engaged in discussions on how to ensure the effective functioning of the ruble zone. However, as it became apparent that the divergence of political and economic interests was too great—a realization the Fund has been criticized as reaching late—it assisted in the orderly dissolution of the ruble zone and introduction of the new national currencies.[3]

Nominal anchors: exchange rate or monetary targets?

The extent of monetary overhang dictated the size of the initial price jump. Subsequently, many transition countries experienced price volatility and increases linked to the phasing out of enterprise subsidies and further freeing of prices. As discussed in Chapter II, the transition countries did manage to rein in inflation within the first decade, though for some it took much longer than others. Inflation stabilized first in the countries of Central Europe followed by some of the Balkan countries and the Baltics, given their rapid departure from the ruble zone and the launch of relevant reforms. In Bulgaria and Romania, the first attempts at stabilization failed. CIS states progressed more slowly given their efforts to liberalize initially within the ruble zone, resulting in imported Russian inflation. In many countries, efforts to achieve price stability were hampered by the slow progress of reforms and liberalization.

The choice of a nominal anchor played a large role in determining stabilization paths.

- An exchange rate peg seemed clear to the population and technically easy to implement, and in most cases could help end a hyperinflationary spiral, engender confidence and induce greater commitment to fiscal adjustment. However the stringent fiscal discipline needed to maintain a peg in the face of countries' precarious external positions was challenging both economically and politically. In general, fixed exchange rates were seen as more beneficial for smaller, very open economies. Further, pegged rates required sufficient foreign exchange reserves to defend the currency and accommodate shifts in money demand. There was also a lack of adequate data to gauge the "right" exchange rate level to target.
- Money-based stabilization was the alternative. Targeting a monetary aggregate could help maintain low inflation, while external and real shocks could be much better absorbed given the flexible exchange rate. But the arrangement was less easily understood and was susceptible to sharp fluctuations in money demand.

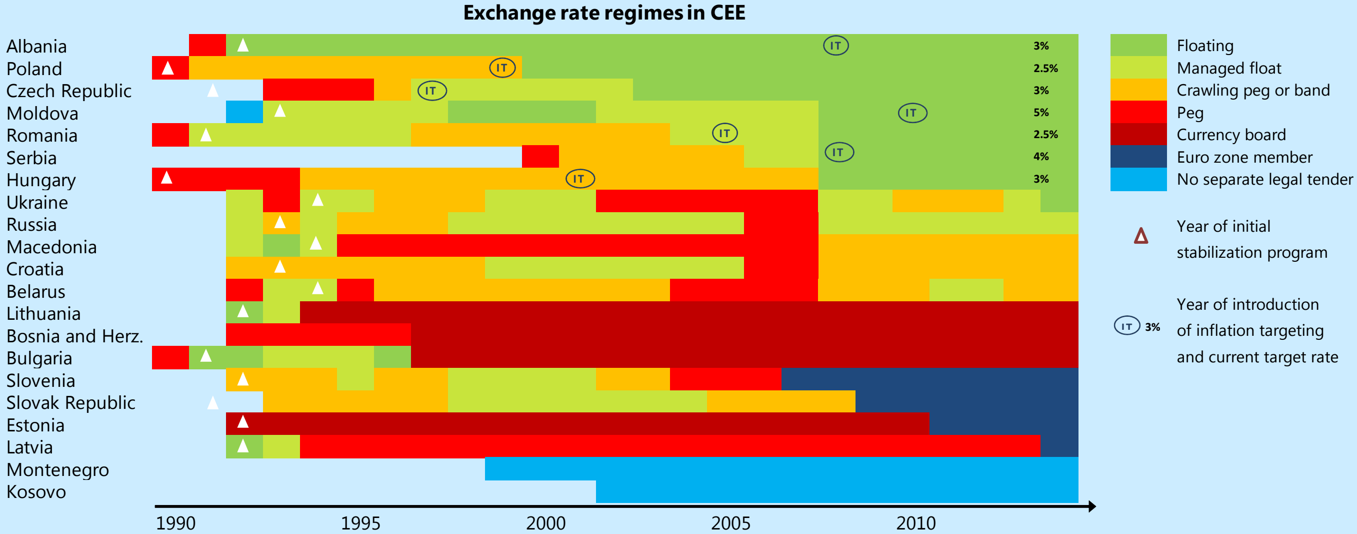
The IMF also provided advice on these choices, taking into account individual country characteristics such as the strength of macroeconomic fundamentals, the types of shocks that countries faced, the level of reserves, degree of market liberalization, openness of the economy and capital mobility.

[3] See Odling-Smee and Pastor (2001) and Boughton (2012).

Country experience with both types of nominal anchors has been mixed.

- Exchange rate anchors seem to have been effective so long as the supporting adjustment measures and institutions were adequate. In some countries they were generally effective in stabilizing prices (Poland, Czechoslovakia), inducing fiscal discipline and contributing to large capital inflows (Estonia). In others the experience was mixed, partly because of lack of credibility of the exchange rate anchor. Hungary's adjustable peg and frequent revisions to the framework (especially before 1995) failed to manage inflationary expectations.
- Money-based stabilizations had a mixed record, with a number of countries either abandoning the approach at an early stage, or revising it right after the initial stabilization. The initial choice of Latvia and Lithuania for money-based stabilization was driven by low international reserves. Latvia's new central bank law established a strong, independent institution that signaled tight monetary policies. In Lithuania, central bank independence was weaker and so was the initial commitment to stabilization, before the country eventually adopted a currency board in 1994. In both cases inflation was brought under control, albeit while the countries suffered severe output losses. In Belarus and Russia, the initial money-based programs appear to have been the only practical option to combat high inflation given fiscal and other policy weaknesses, but both subsequently moved to exchange rate pegs. Moldova had a relatively strong and independent central bank, but was exposed to external shocks.

Exchange rate regimes in CEE



Source: AREAER database to 2012 updated by author.

By the late 1990s, more transition countries were fixing or managing their exchange rates than using free-floating regimes. Many countries, including in the CIS, had a "fear of floating," inclining them towards a more fixed framework. For some, integration with the EU was the motivation for a more fixed exchange rate, as an anchor to ensure stability, maintain competitiveness, promote structural reforms, and help meet inflation targets. In 1997, both Bosnia and Herzegovina and Bulgaria chose hard pegs in the form of currency boards (see Box 2 on Bulgaria's experience, and the mechanics of the arrangement). For Bosnia and Herzegovina the choice was driven by political considerations as much as economics. After the negative experience preceding the breakup of Yugoslavia, when states had been unable to agree on allocation of central bank credit—with some enjoying preferential access—it was determined that the transparency and automaticity of a currency board would best meet the needs of a country emerging from the complex process of post-war nation building. The credibility of the arrangement was helped by the one-to-one link to the deutschmark, which was widely used and trusted across the country. As in Bulgaria, the Bosnian currency board has stood the test of time, and serves as the principal anchor of the country's financial stability.[4]

[4] See Kovacevic (2003).

No fewer than nine countries moved to more flexibility with the onset of the global financial crisis in 2008; since then countries' choices seem to support the "bipolar" view of opting either for floating or for a fixed peg, with fewer intermediate regimes. By the time of Lithuania's entry in 2015, five countries in the region will have joined the euro area. For some the move has provided a natural "exit strategy" from hard pegs to the euro, losing little in monetary policy flexibility while reducing vulnerabilities, including through access to ECB facilities.

Box 2. Introducing the Bulgarian Currency Board

In the early years Bulgaria faced significant setbacks in its transition to a market economy. Fiscal slippages repeatedly undermined attempts at money-based stabilization. By mid-1996, the slow and incomplete transformation of state-owned enterprises left the government with mounting debt, a collapsing financial system, a free falling currency, and by the end of the year hyperinflation.

A currency board-based stabilization was proposed in late 1996, following the successful experience in the Baltics. Under such arrangements, the stock of base money is backed fully with foreign exchange, to give confidence in the exchange rate (which is fixed to foreign currency by law) and to provide an automatic adjustment mechanism for external shocks. The idea was initially greeted with skepticism. Obvious concerns were the lack of foreign currency to back such a system, as well as the fragile state of the financial system. However, as monetary and political instability mounted, the idea of a currency board to instill discipline and restore credibility gained appeal. At the same time it became more feasible as hyperinflation reduced the real value of government debt and real monetary balances, and improved banks' net asset positions (because they had significant foreign currency assets following early recapitalization, and liabilities mostly in leva). These factors both eased financial sector pressures and also reduced the foreign reserves required to back a currency board. The decisive political shift came with the election of a new government in April 1997 vowing to implement an economic stabilization plan based on a currency board. The currency board was enshrined in a new central bank law passed by parliament in June that year.

Along with other important policy changes—notably a newfound fiscal discipline—the currency board contributed to a rapid return of monetary stability and growth. From mid-1997 on, inflation came down rapidly and interest rates started moving close to German levels, while growth resumed in 1998. During the initial years the system weathered a number of challenges, including the 1998 Russian crisis and the closure of a number of smaller banks. Bulgaria joined the EU in 2007. At this time, potential disadvantages of the arrangement were demonstrated by huge swings in capital flows leading up to and during the 2008–09 crisis: as discussed in Chapter X, these swings, and their growth impact, were generally larger for fixed-rate than floating-rate economies. However, the authorities were able to use policy buffers built up prior to the crisis to ameliorate its impact. The currency board is expected to remain in place until eventual euro adoption.

Prepared by Anne-Marie Gulde-Wolf.

Inflation targeting

As their economies stabilized, many transition countries faced new challenges. The more advanced fixed-rate economies experienced increased capital inflows, putting pressure on domestic demand and making it harder to maintain low inflation. Less developed countries like Moldova also faced challenges such as shifts in money demand due to large remittances, making it hard to choose a credible nominal anchor.

Reflecting global trends, a number of transition countries have adopted inflation targeting (IT), with Russia and Ukraine set to join them in 2015. The literature identifies key pre-requisites for successful IT, among them central bank instrument autonomy; lack of fiscal dominance; developed debt and securities markets; established frameworks for transparency and accountability; and sufficiently advanced modeling and forecasting capacity.[5] Some of the seven countries that have adopted IT are still missing a number of these, but have still found it an important policy anchor to adopt. IMF technical assistance in this area has focused on institutional and technical changes, building research and forecasting capacity,

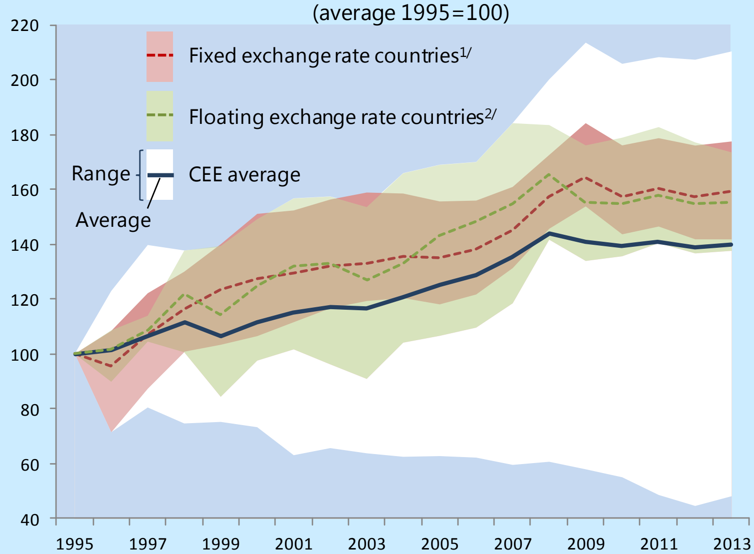
[5] See Masson et al. (1997), Batini and Laxton (2007).

improving database management, and communications policies, in order to help maximize the benefits from an inflation targeting framework.

Real exchange rate developments

Real exchange rates have moved in dramatically different ways across the region, but on average there has been real appreciation, mirroring relative productivity improvements as the countries have developed.[6] Appreciation was particularly pronounced during the mid-2000s boom, with little if any further increase since the crisis that followed. Within this overall pattern, there seems to have been little difference between subsets of countries with predominantly fixed, or predominantly floating, exchange rates: average real appreciation since 1995 has been strikingly similar for the two groups. It does appear though that the floating rate countries had somewhat faster appreciation during the boom, and significant depreciation in the bust, suggesting that flexible rates helped cushion the effects—and possibly also the scale—of capital inflows and their subsequent reversal. In contrast, the fixed rate countries all faced further real appreciation in 2009, likely adding to difficulties in the crisis, before seeing relative prices ease in 2010.

Real effective exchange rate
(average 1995=100)

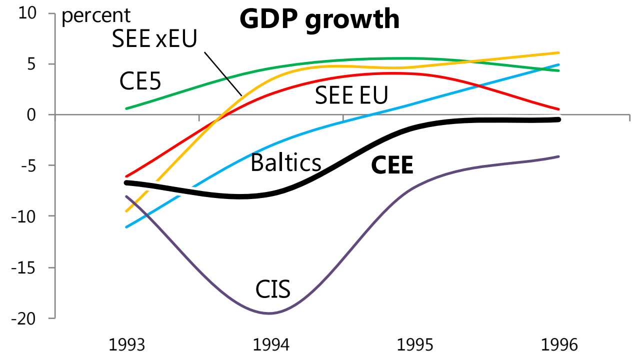


1/ BGR, EST, LVA, LTU.
2/ ALB, CZE, MDA, POL, ROU.
Source: IMF staff estimates.

[6] See, for example, Mihaljek and Klau (2008).

IV. 1994–1996: MARKET REFORMS

The mid-1990s saw continued rapid economic changes in the region, often amid considerable political uncertainty. For some countries, macro stabilization came earlier, and the main challenge was structural reform to improve the workings of the economy. For others, the task of developing market structures took much longer, and was carried out in a more difficult macro environment with inflation and fiscal deficits not yet firmly under control. This period saw considerable advances in both policies and economic outcomes in all transition countries, albeit with a lot of variance. Successful program implementation during these years proved to be a key determinant in sustaining economic growth and helping weather challenges in the years to come.

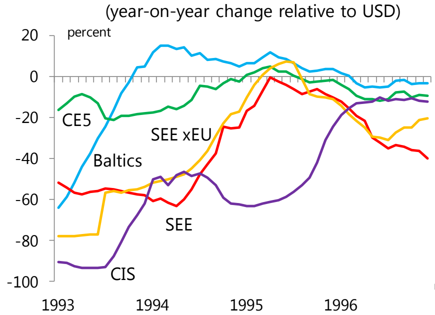


Source: WEO; various sources for some countries in early years.
Note: CEE average weighted by GDP, others unweighted.

Globally, the mid-1990s was a period of integration, with the North American Free Trade Agreement coming into force in January 1994 and the World Trade Organization (WTO) being established a year later. Market reforms in many CEE countries enabled them to integrate into the global economy, with increased trade and capital flows. As a concrete indicator of progress, some became OECD members during this period—the Czech Republic in 1995, followed by Hungary and Poland in 1996.

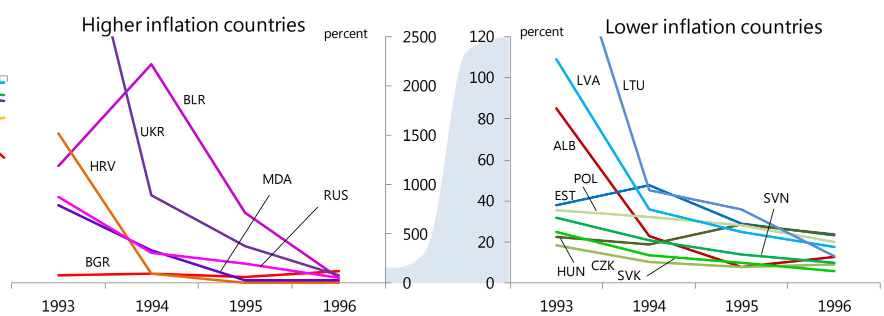
At the same time, the region was overshadowed by war in the Balkans. After four years of the worst violence Europe had seen since 1945, costing well over 100,000 lives, the wars in Bosnia and Herzegovina and Croatia ended in 1995, although other conflicts in the region continued to take place through the rest of the decade. The Dayton peace agreement laid the grounds for governance in the new state of Bosnia and Herzegovina, a key element of which was an independent central bank and a currency board linking the exchange rate by law to the deutschmark. In the CIS, Belarus took (in hindsight, at least) a decisive turn away from the path of market reforms in the 1994 presidential elections, while in Russia, politics also greatly influenced economic policy in the lead-up to the Presidential elections in mid-1996.

Nominal exchange rate dynamics
(year-on-year change relative to USD)



Source: WEO, IFS.

Inflation

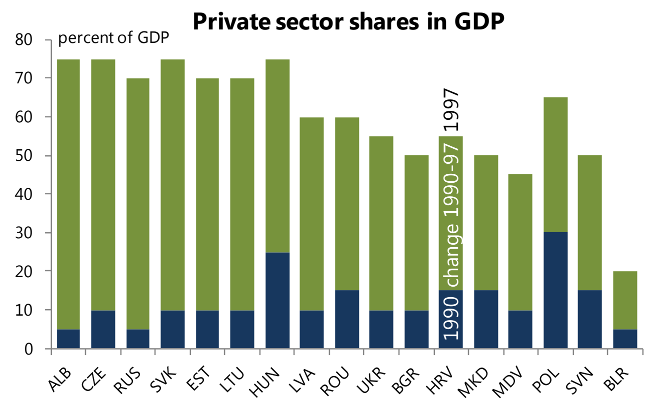


Prepared by Bikas Joshi, Marko Paunovic and Joanna Swirszcz.

Most countries had started growing by the mid-1990s, with the notable exceptions of the CIS and Bulgaria. Inflation declined in most countries, and to relatively low levels in Central Europe, the Baltics and some of Southeast Europe. This disinflation was reflected in exchange rates as well; whether fixed or floating regimes were followed, most exchange rates achieved some form of stability by 1995-96. In fiscal policy too, deficits were being brought under control, albeit more slowly in the CIS countries than in others.

Countries' economic reform programs

By 1994, almost all transition countries had in place stabilization programs supported by the IMF, with objectives of advancing market reforms. The latter objectives were also supported by policy advice and financing from the World Bank, with the EBRD focusing on helping develop the private sector and encourage foreign investment. Country authorities faced major challenges in reducing state influence in economic activities, and increasing the role of the market. The reforms had to navigate shifting balances of power and interests, as old economic and political interests ceded (sometimes reluctantly) to new emerging players. The blank slate that transition economics presented also implied experimentation with different approaches.



Source: EBRD.
Note: Countries ordered by size of changes in 1990-1997.

Broadly speaking, the mid-1990s programs had five main objectives: (i) macroeconomic stabilization, (ii) price liberalization and current account convertibility, (iii) enterprise reform (principally, privatization—see Box 3), (iv) creation and strengthening of social safety nets, and (v) development of institutional and legal frameworks for a market economy. But the composition of the programs—as set out in their stated objectives—depended on country circumstances and political priorities:

- In Poland, structural and institutional changes formed the core of programs in the period—in particular privatization—and elements to encourage investment, strengthen financial discipline, improve competitiveness, and reform the pension system. The second wave of privatization formed the major market-reform component of the program for the Czech Republic.

- The Baltics had started transition later than Central Europe, but moved very quickly. Measures in early programs included expediting the sale of public properties and extending privatization to medium- and large-scale enterprises. Subsequent programs involved further financial reforms (including privatizing banks and legal initiatives on bankruptcy, foreclosure, supervision and regulation) and privatization of natural monopolies. Measures were also included to overhaul pension systems, social tax laws, and unemployment compensation.

- The pace was slightly slower in Hungary. The 1993 program emphasized strengthening governance of SOEs and improving the bankruptcy process, while the 1996 program went further, with emphasis on restructuring and privatizing SOEs (including banks), continuing liberalization of international transactions, and strengthening the social security system. At the same time, Hungary took decisive action to address its growing fiscal imbalances with the "Bokros Package" in 1995.[2] In Bulgaria, a plan for mass privatization of 500 medium- and large-scale SOEs was drawn up; since implementation stalled, however, this comprised one of the objectives of their 1996 program as well. Romania's program contemplated removing subsidies, accelerating privatization, and strengthening the financial discipline of SOEs.

Box 3. Privatization

Privatization was a key element of market reform programs in the region. Both in scale and approach it differed greatly from the occasional sales of large SOEs in the West that had popularized the term in the previous decade. Most transition countries had no private sector to speak of during the centrally planned years. Even those that did, such as Hungary and Poland, had private ownership mostly in the non-industrial sector, especially agriculture and small firms. Yugoslavia was unique in having a large cooperative sector with worker ownership of firms, but it posed similar challenges. After the collapse of communism, SOEs were ill-equipped to participate in new market mechanisms, and withdrawing the state from production was intended to increase efficiency and to harden the "soft budget constraints" that SOEs had enjoyed. With an unprecedented scale of privatization across countries, along with new enterprise creation, and "greenfield" foreign direct investment (FDI) in many cases, the share of the private sector in GDP rose rapidly over the 1990s.[1]

In most cases, small-scale privatization was achieved fairly quickly, generally by auction (often at low prices, with the objective of transfer of ownership rather than revenue) or, especially for property and land, via restitution. However, privatizing medium- and large-scale enterprises was more difficult, particularly when those enterprises were connected to sensitive industries and government revenue. For these enterprises, countries chose a range of different options:

- The most common means of disposing of state assets was through management-employee buyouts, used as the primary method in Albania, Croatia, Estonia, Poland, Slovenia, and Ukraine (and to some degree in Belarus). Such purchases were quite common early on, perhaps signaling insiders' knowledge about the companies' prospects.
- Another form of mass privatization was through the use of vouchers or certificates. Bosnia and Herzegovina, the Czech Republic, Lithuania, Moldova, and Russia used this as the primary method, and additional countries used it as a secondary method. In many countries, distribution of vouchers for the purchase of shares was used as a means of generating support for the privatization process. While this approach had egalitarian benefits, the fact that vouchers could be traded in secondary markets in some countries led to an emergence of insider privatization (especially in countries like Russia, where insiders had already gained significant concessions, and in the Czech Republic, where assets ended up being sold and consolidated in investment funds).
- Direct sales were used in other countries, including sales to foreign investors in some cases.

Nontransparent transactions in some countries raised questions about the fairness of the process. The "loan for shares" scheme in Russia—devised in advance of the 1996 presidential elections, whereby select oligarchs managed to gain control of many large enterprises for a fraction of their underlying values—engendered great hostility towards the privatization program, and the reform agenda in general.

What did privatization achieve? One question is whether privatization in the region resulted in enterprises being put in the hands of those who could use them efficiently and productively. A literature survey by Djankov and Murrell (2002) suggests that privatized enterprises did restructure more quickly and perform better, but only when supporting legal and regulatory institutions were in place. Clear property rights, hard budget constraints, and adequate competition seem to have been necessary conditions to ensure a growth dividend. At the same time, privatization was not a choice for most countries in early transition: central governments were very weak, and de facto control of enterprises was rapidly migrating to private interests. The best policymakers could do was to try to steer this process to better outcomes through the approaches to privatization chosen.

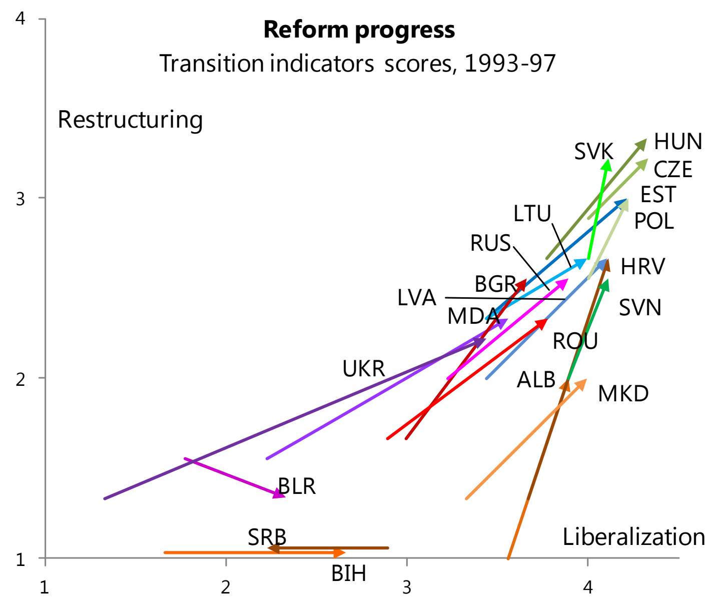
[1] Husain (1994), for example, considers the impact of the withdrawing role of SOEs in the economy on private sector growth.

[2] Named for the incoming finance minister Lajos Bokros. See Žídek (2014).

- Where initial conditions were weaker—such as in Albania and Moldova—early programs focused on reforming state enterprises and reducing direct state interventions in economic activity. Subsequent programs in Moldova, from 1995 on, slowly advanced this agenda, including revising bankruptcy procedures for SOEs, facilitating entry of private banks, furthering privatization and establishing a market-based agricultural sector. The program with FYR Macedonia in 1995 was intended to accelerate privatization and improve competitiveness, though it required normalizing relations with official bilateral and multilateral creditors.

- In Ukraine, the first full program in 1995 envisaged privatization, elimination of export quotas on most goods, reduction of price controls, and adjustments in prices for subsidized goods. The subsequent program focused on sale of state enterprises. Similar themes were seen in Russia, where liberalizing trade structures and accelerating privatization remained among program objectives, given shortfalls in implementation in earlier programs.

Program design tended to be ambitious, and in many cases implementation fell short of program objectives and targets. Generally, though, this was a period when most countries made progress in market reforms—which in turn was reflected in growth outcomes (Box 4). The change in EBRD transition indicators between 1993 and 1997 paints a useful picture in two dimensions: (i) "liberalization" indicators on prices, trade and foreign exchange, plus small-scale privatization; and (ii) "restructuring" indicators on competition policy, large-scale privatization, governance and enterprise restructuring. As discussed in Chapter I, liberalization was typically politically easier, and implemented ahead of the more controversial restructuring reforms. Almost all countries made progress in both dimensions. The CE5 and Baltic countries started ahead and stayed ahead—but many Southeastern European countries also made great strides. Despite the late start, most CIS economies moved forward significantly, especially in liberalization. But for many the progress would not be enough: most of the countries that ended this period with restructuring still far from complete ran into difficulties in the subsequent period, as described in Chapter VI. Conflict accounts for the lack of reform progress seen in Bosnia and Herzegovina and Serbia.



Source: EBRD.

Box 4. Reforms and Recovery

The initial stage of transition was marked by large drops in output. When countries did recover, they did so at markedly different speeds. What determined the pace of recoveries?

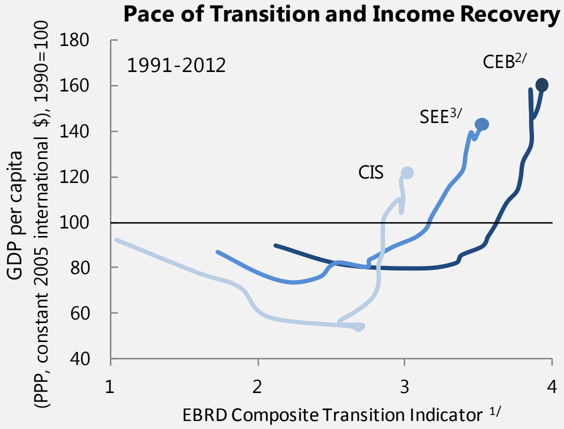
Early diagnoses of transition analyzed this issue using a cross-country approach:

- Havrylyshyn et al. (1998) looked at determinants of growth in transition economies over 1990–97. They found that macroeconomic stabilization (including fiscal restraints) and structural reforms helped achieve sustainable growth. While reforms might have depressed output initially, long-term growth was associated with sustained reform performance. They found the role of adverse initial conditions —where countries began the transition process—to be negative but small.
- Similarly, Fischer et al. (1998) found that more successful stabilization measures (resulting in lower inflation and more stable exchange rates), higher assistance, and faster and more comprehensive structural reforms were associated with better growth outcomes during this period. While initial conditions seem to have mattered at the start, this effect wore off over time.
- De Melo et al. (2001, p. 1) stressed that: "economic liberalization is the most important factor determining differences in growth." But Campos and Coricelli (2002, p. 825) go further: summarizing various studies, they noted that price liberalization and tight macroeconomic policies are not sufficient to foster growth. They note: "institutions enabling the functioning of a market economy are a fundamental precondition, particularly relating to financial markets and social safety nets."

Is the speed of reform important? Indeed, analysis of recoveries in transition suggests that the pace of reforms was a significant determining factor. The "shock-therapy" transition in Poland, and front-loaded reforms pursued by most other Central European and Baltic (CEB) countries—albeit initiated from a better initial position—appear to be associated with quicker macroeconomic stabilization and lower transition-related losses in per capita incomes.

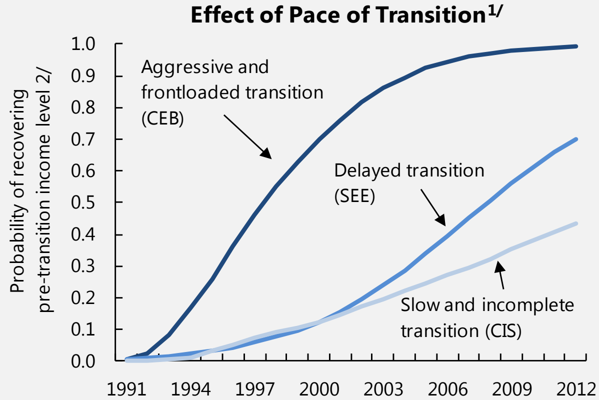
Also, strong reformers appear to recover their pre-transition levels of per capita incomes much faster than those that followed a more gradual reform strategy. Durational analysis performed for 16 emerging European economies highlights a strong empirical link between the probability of a country reaching its pre-transition per capita income level and its overall progress measured by EBRD transition indicators. Indeed, the probability of closing the transition-related slump in per capita incomes increased much faster in countries that front-loaded the reform effort (CEB countries) than in those countries that left their transition agenda partial and incomplete (SEE and CIS countries).

Pace of Transition and Income Recovery



1/ Average of the six EBRD transition indicators.
2/ Central Europe and Baltics.
3/ Limited to ALB, BGR, MKD, ROU, SRB due to data availability.

Effect of Pace of Transition[1/]



1/ Probabilities are based on regression estimates and historical series of EBRD transition indicators.
2/ Probability of reaching pre-transition (1990) level of GDP per capita (PPP, constant 2005 international dollars).

Source: World Bank; EBRD Transition Report; IMF staff estimates.

Prepared by Ruben Atoyan and Bikas Joshi.

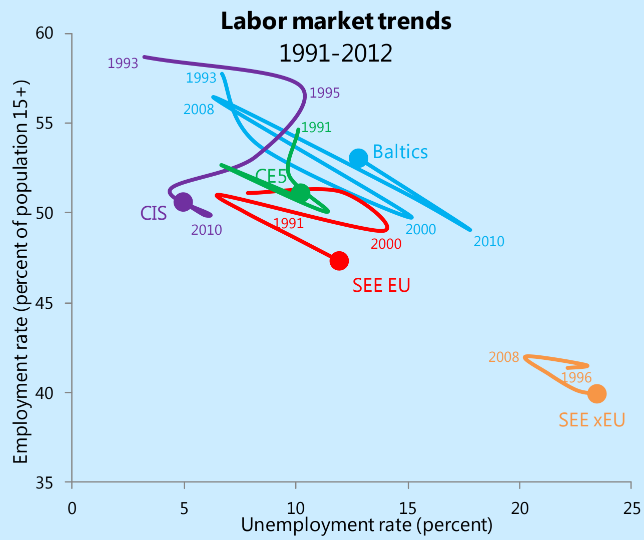
V. LABOR MARKETS

Starting from a common base of full but unproductive employment under communism, reform of labor market policies and institutions has varied widely across countries. While labor market outcomes also depend on factors well beyond the labor market itself, these policy differences are associated with very different results in terms of employment and unemployment. Institutional reforms to improve the working of the labor market, while protecting vulnerable groups, thus remain a key priority for many countries of the region.

The transition from central planning to market-based economies was initially accompanied by severe effects on output and employment. At the beginning, unemployment was low (outside the Western Balkans), but the headline numbers masked unproductive employment in inefficient state-owned enterprises and the public sector. Inevitably, the early reforms of deregulation and privatization—along with the collapse of trade and supply links—resulted in large job shedding from the restructuring of enterprises, which outweighed new job creation. Job shedding, however, was important for transition. By forcing the acquisition of new skills by workers, it facilitated job matching in the context of the radical enterprise restructuring and the emergence of the private sector, particularly in countries where appropriate labor market institutions were quickly established. It also helped establish a balance between the bargaining powers of workers and managers, putting a check on real wages dynamics.

Deep recessions with weak systems of support led to long-term unemployment and politically irrevocable commitments to support affected individuals. Throughout the region, workers laid off from declining industries had difficulty finding jobs in new industries due to skill mismatches, and many ended up locked in informal employment.[1] Thus, labor market institutions had to be established to manage labor relations and mediate job shedding. Countries had to decide on proper levels of unemployment benefits and severance protection; approaches to trade union representation and collective bargaining; active labor market programs for the unemployed (for example public employment services, training schemes, and employment subsidies), and how these programs could be financed in the face of severe fiscal constraints. Many countries have struggled in the face of these challenges.

The pace of labor market reforms differed across countries. Central European countries were fairly aggressive in upfront deregulation and large-scale enterprise restructuring. This led to large job losses, but by the late 1990s these reforms started to pay off as unemployment declined and employment rates started to recover. Similar trends were witnessed in the Baltics, which saw large cyclical swings between employment and unemployment through the transition, and SEE EU countries. In contrast, postponing layoffs in CIS countries may have helped to reduce labor market congestion, but at a cost of less job creation in the higher productivity private sector. As a result, employment creation was modest and employment rates continued to fall. In the Western Balkans, high rates of unemployment and low rates of employment persisted throughout the transition, pointing to deep structural factors.

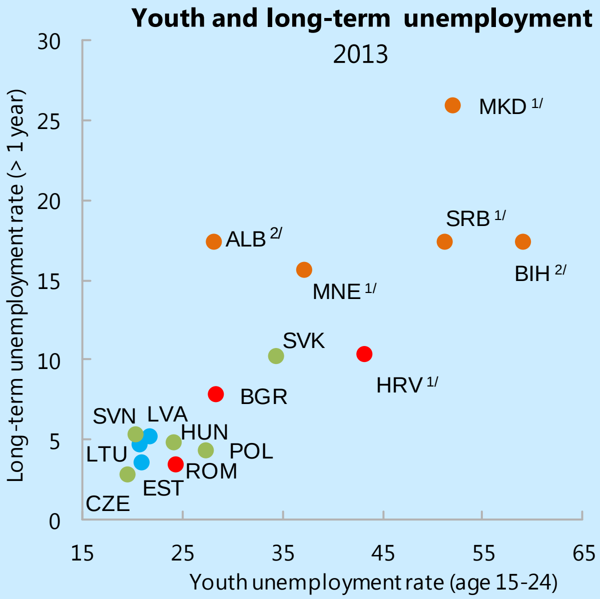


Source:WEO, World Bank, IMF staff calculations.

Prepared by Ruben Atoyan and Irena Jankulov.

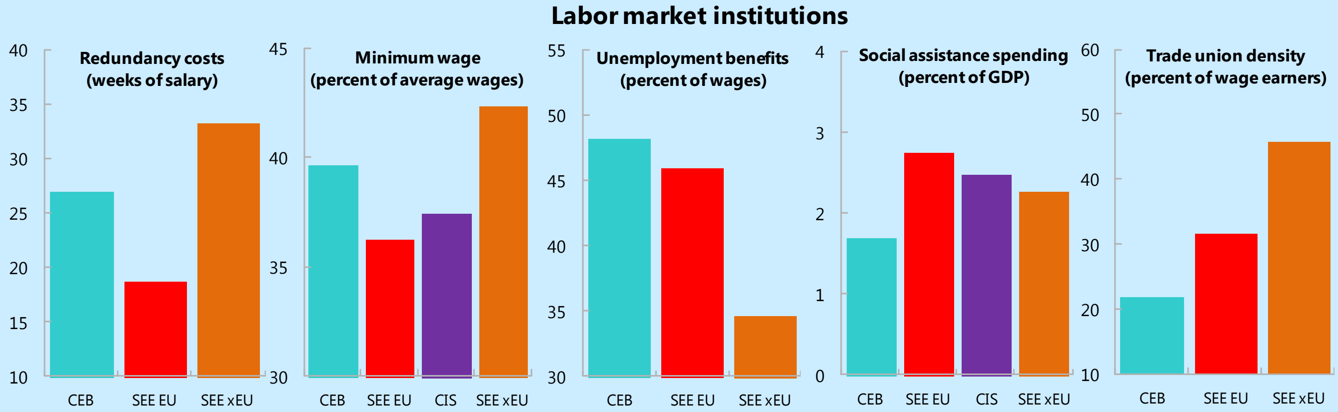
[1] See Lehmann (2014), and Slonimczyk (2014).

In transforming labor market institutions, the region has moved a long way towards Western European norms. Nevertheless, there are significant differences across countries in cost rigidities, unemployment benefit systems, collective bargaining, and active labor market policies. Equally important are differences in labor taxation and the design of social protection programs, as these are likely to have a significant bearing on incentives to formal work and may discourage employment among low-wage earners. Other barriers, some outside the labor market—lack of child and elderly care options, limited flexible work arrangements, imperfect access to information, or adverse social norms—can effectively exclude some groups from labor markets, especially women, youths, older workers, and ethnic minorities. These factors are important for understanding the significant variations in labor market indicators. Indeed, activity rates vary drastically across the region, from about 70 percent in the Baltics and the Czech Republic to around 40 percent in the Western Balkan countries. The latter also report the highest youth and long-term unemployment rates in Europe.



Sources: Country authorities; OECD; Haver; Eurostat; CEA: and IMF staff calculations.
1/ 2012
2/ Balkan average used for long-term unemployment rate. due to missing data.

Cross-country differences in labor market institutions

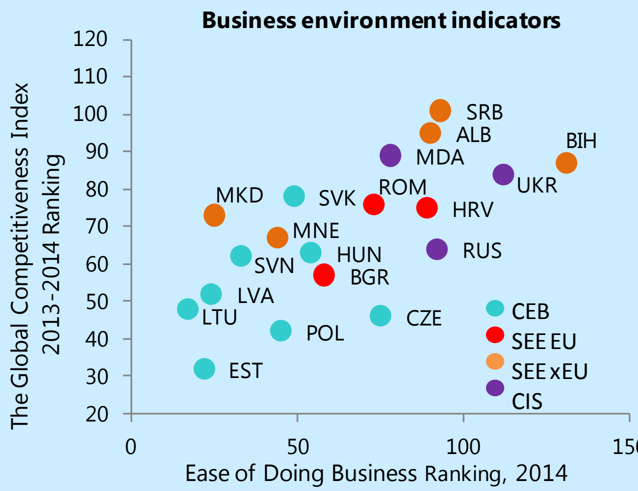


Source: European Commission; Kovtun and others (2014); IMF staff calculations.
Note: Data as of 2009-12, depending on availability; data for trade union as of 2004. Data are not available for CIS countries for all presented categories.

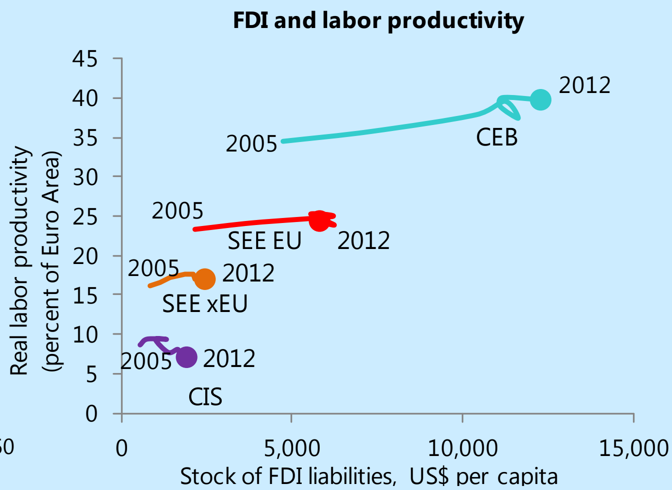
The legacy of centrally planned economies and their self-management system of enterprises—leading to "over-protecting the insiders"—is still weighing on labor market outcomes in a number of countries in the region. In the course of the transition, different political balances were drawn between the protection of jobs (with generous severance payments making dismissals very costly) and the protection of transition (by strengthening unemployment benefit systems and active labor market policies):

- Cost rigidities appear to be high in SEE non-EU countries, likely contributing to the overall labor market rigidity. Similarly, minimum wages are high relative to the average wages in most of these countries, further aggravating unemployment problems (Hamermesh, 2014).
- Relatively generous social assistance programs could have also contributed to the rigidity of labor markets in many countries in the region. Notable exceptions are the Central European and Baltic countries (CEB, grouped together reflecting generally fairly similar labor market characteristics), where lower social assistance spending coincides with more generous unemployment benefit programs. In contrast, a fairly low level of unemployment benefits in SEE non-EU countries coincides with higher severance benefits, likely reflecting the public choice of placing the burden of income support of the unemployed on employers.
- While trade union membership has dropped throughout the region, SEE countries—especially non-EU members—are also those where trade unions played a stronger role. Powerful unions in an environment of overly rigid employment protection legislation often contributed to labor market duality, a division into "insiders" (with higher incomes, job security, and prospects for upward mobility) and "outsiders" (with lower incomes and security, and little training).
- Dramatic emigration and diminishing of human capital due to the "brain drain" played a role in all transition countries. But high rates of emigration from the Balkans, which increased dramatically during the devastating conflicts of 1990s, were critical in shaping labor markets and institutions of this region. High emigration rates also resulted in the high level of remittances inflows—averaging over 8 percent of GDP annually—which provided a steady stream of nonwork-related income and probably therefore significantly relaxed budget constraints and affected labor-leisure decisions of households. Internal migration of better skilled labor from rural to urban areas likely also fueled structural unemployment in a number of countries (Ebeke and Everaert, 2014).

Role of the (un-)finished transition



Source: World Bank; World Economic Forum; IMF staff calculations.



Source: WEO; Haver; IMF IIP Database; IMF staff calculations.

Differences in labor market outcomes reflect factors broader than the labor market itself. In CEB countries (and to a lesser extent SEE EU countries) that advanced transition quickly, comprehensive structural reforms helped to develop a vibrant private sector. The reforms are also reflected in a strong link between better standings in international competitiveness and business indicators, and greater responsiveness of labor markets to economic cycles. In these countries, a large number of younger and smaller firms fueled much of the job creation during the pre-crisis boom years. Furthermore, the earlier push for reforms also helped lower investors' risk perceptions and strengthen the overall competiveness of the economy. Foreign capital—especially greenfield foreign direct investment (FDI)—played a key role in developing new sectors that could reabsorb the dismissed employees from the declining sectors. By facilitating transfers of technology, managerial skills, and international marketing networks, deepening pools of FDI appeared to have opened a self-enforcing cycle of fast productivity convergence and job creation.

Challenges going forward

Completing successful transition in the labor market is far from simple. Policy priorities vary according to individual country circumstances, with the Balkan countries having the most pressing and far-reaching needs, reflecting weaker labor market institutions and the legacy of worker-managed firms in the former Yugoslavia. However, there are also common themes. First, there is a need to address remaining structural impediments to growth. Maintaining macro-financial and political stability is a key pre-condition, but robust economic growth will ultimately hinge on cultivating more competitive product and factor markets and deeper trade integration, both within the region and more globally. Improving the business and investment climate will stimulate entrepreneurship, improve productivity, and create more and—importantly—better jobs, including for younger workers and women.

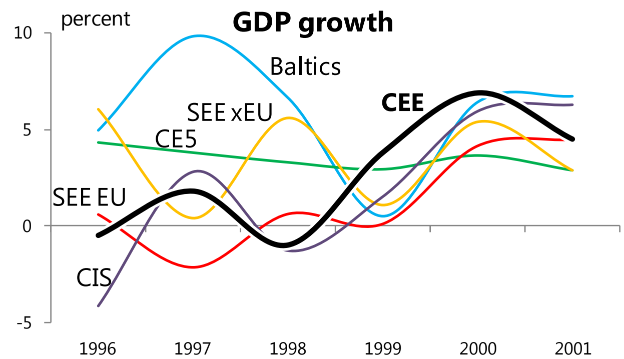
Second, strong labor market institutions are key to generating productive employment. But these institutions are equally important for providing support to those for whom labor market reforms may result in a reduction in benefits, and addressing duality between "insiders" and "outsiders" in the labor market. This balance is difficult to achieve, but there are roles to be played by active labor market policies, as well as appropriate levels of employment protection and unemployment benefits (along the lines of the "flexicurity" model of the Nordic countries), coupled with revamped collective bargaining institutions. Welfare reforms aimed at better targeting of social assistance and incentivizing labor market participation for all groups are needed, as is boosting skills and adaptability of workers through improved training and education.

Third, sustained employment growth requires improving cost competitiveness. The mix between improving competitiveness through greater exchange rate flexibility and reductions in business and labor costs will vary across countries. In many cases, legislation governing minimum wages and redundancy costs would need to be revisited. Broadening the tax base by addressing tax evasion is also needed to create fiscal space to lower the tax burden on labor and reduce the shadow economy.

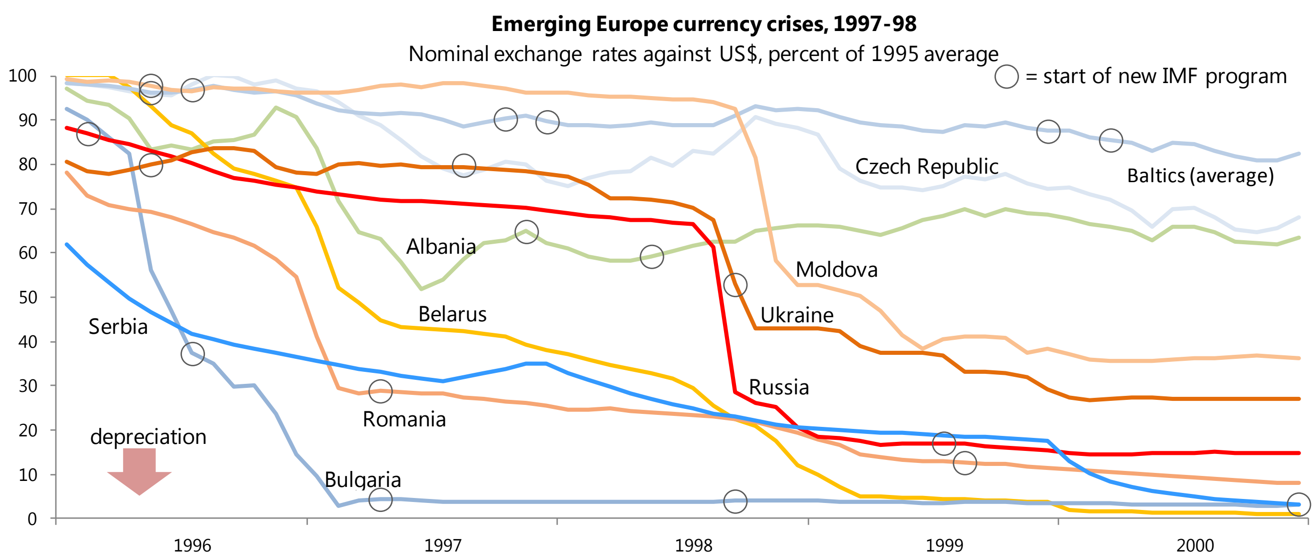
Finally, completing the labor market transition in an environment of slow post-crisis recovery will inevitably have wide-ranging social consequences. Social cohesion should be achieved through extensive consultation between all social parties. The adjustment must be seen as fair, and as involving labor not just in the production sector, but also in the services and financial sectors. It is also important to have a well-targeted social safety net in place to protect the most vulnerable and make fiscal space for critical social and infrastructure spending.

VI. 1997–2001: TURMOIL AND RECOVERY

The latter part of the 1990s was a period of major crises in emerging markets, from Mexico in 1994–95, through Asia in 1997, and leading to Argentina in 2001. The emerging European economies were highly vulnerable in this environment, with macroeconomic stability not fully secured, nascent market institutions, and fragile financial systems. And indeed many of the countries that had progressed less in establishing robust market-based frameworks succumbed, first in a number of individual crises, and then in the wake of the systematic case of Russia in 1998. However, these crises (several of which involved calls on the IMF for financial assistance) resulted in most countries learning from the experience, and exiting the period determined to follow policies that would reduce their exposure to such risk—laying the ground for the period of growth that followed.



Source: WEO; various sources for some countries in early years.
Note: CEE average weighted by GDP, others unweighted.



1997: Idiosyncratic crises

The costs and risks of incomplete reform became increasingly apparent through 1997. By early in the year, Bulgaria was already in a full-fledged banking and currency crisis, which cost 14 percent of GDP in output loss and left the lev worth just a few cents of its value of a year before. Only after April 1997 was stabilization achieved, through a new program in support of a currency board arrangement (see Box 2).

Neighboring Romania suffered high inflation in early 1997 triggered by recent price liberalization, a rapidly depreciating exchange rate and a deep recession, following years of delayed reforms. The authorities managed to temporarily reduce inflation by managing the exchange rate, but the strategy was undermined by fiscal slippages

Prepared by James Roaf.

and delivered considerable real exchange rate appreciation and a ballooning current account deficit—subsequently leading to a renewed currency crisis following Russia's default a year later.

Meanwhile Albania suffered a unique crisis in 1997. In light of its earlier isolation, the country had made major progress towards a market economy. However, financial sector development had been limited, and the official banking system was moribund. Instead, an informal credit market had built up, financed via remittances. Deposit-taking companies developed in this environment, but instead of making loans to the real economy, the companies morphed into pyramid schemes, paying very high returns to depositors based on ever-increasing flows of new deposits into the scheme. By late 1996, more than two-thirds of Albanians had invested in the schemes, many selling their homes or livestock to do so. But soon the schemes started to unravel, and depositors' accounts were frozen, leading to mass riots. By March 1997 Albania was in chaos: the government fell and some 2,000 people were killed in the violence. GDP fell by about 10 percent in 1997, the currency collapsed and inflation spiraled. However, the recovery was relatively swift, with a strong rebound in growth in 1998—due in part to the new government's budget discipline in refusing to compensate depositors and allowing inflation to cut real public wages.[1]

Belarus too suffered a crisis going into 1997, though (in contrast to Albania) of a recurrent nature. The combination of inconsistent macroeconomic policies—including expansionary monetary and credit policies while trying to maintain an artificially high exchange rate—along with a reluctance to allow market forces to operate at the enterprise level, inevitably led to severe balance of payments difficulties. By the end of 1997 the exchange rate had fallen to half its level of a year earlier.

Finally the Czech Republic, under pressure from a widening current account deficit and contagion from the Asia crisis, and buffeted by a recent series of bank failures and revelations of fraud in the mass privatization scheme, was forced in May 1997 to abandon the exchange rate peg that had anchored monetary policy since early in the transition. But the impact was relatively mild compared to other cases: the exchange rate depreciated by around 10 percent, while for 1997 as a whole, GDP fell by 1 percent.

1998: The Russia crisis and its aftermath[2]

At the beginning of 1998, few would have guessed that the Russian economy would end the year in political and economic collapse. The general view was that macroeconomic stability had largely been achieved—with growth returning and inflation conquered—but that Russia still faced major challenges in fiscal policy, and across a broad swath of structural policies.[3] What was not understood at the time was the extent and speed with which these latter shortcomings could undermine the fragile stability that was in place, and their inconsistency with maintaining Russia's sliding peg exchange rate.

But in hindsight there were a number of warning signals already. Spillovers from Asia had raised borrowing costs, and precipitated sharp declines in oil and other commodity prices, hitting Russia's exports and budget revenue.

[1] See Jarvis (2000).

[2] This section draws on IMF (1999). See also Box 5.

[3] See, for example, Fischer (1998).

Maintaining the exchange rate required increasing short-term and foreign currency-denominated borrowing, and, in late 1997, heavy intervention. And the hoped-for improvement in tax collection failed to materialize.

Adverse developments piled up through 1998. Foreign financing started to dry up amid continued fiscal disappointment and a growing awareness of the exposure of the banking system to the exchange rate and short-term government debt. In May the central bank had to raise interest rates sharply to defend the currency. In July, a voluntary swap of short-term ruble debt for Eurobonds, and agreement with the IMF on a new package of official support, gave some respite. But this proved short-lived, as the parliament rejected key program measures, while the government could not finance its deficit and repay maturing debt without central bank financing. By mid-August, reserves were being rapidly depleted even with overnight rates rising close to 300 percent.

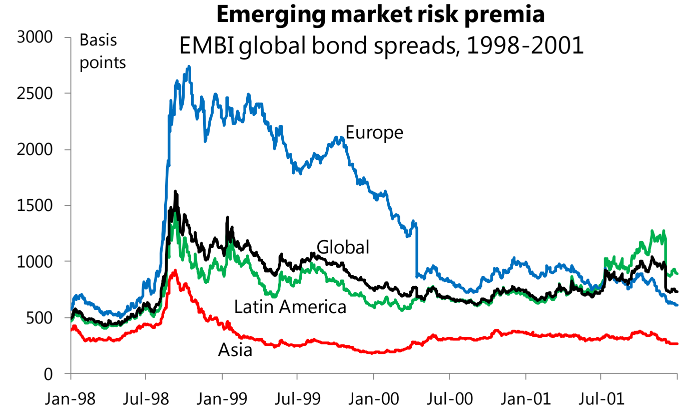
The crisis came to a head on August 17, when the authorities announced the devaluation of the ruble, a unilateral restructuring of ruble-denominated public debt, and a moratorium on private sector external debt payments. In the absence of supporting macroeconomic policies, confidence fell further, and the ruble went into freefall—from 7 to the dollar to 20 by early September. A week after the devaluation, the government was dissolved.

The combination of devaluation and effective default had a devastating impact on the banking sector, paralyzing the payments system for over a month and with bank customers losing large shares of their deposits. Industrial production dropped sharply, and GDP declined over 5 percent for the year. The effect of devaluation on foreign currency liabilities pushed debt to unsustainable levels, requiring a restructuring (completed in 2000) of legacy Soviet-era debt. Vulnerable groups—the poor, pensioners, and many public employees—were hit especially hard as devaluation and inflation wiped out savings and sharply reduced the value of wages, pensions and social benefits.

The shock from the Russia crisis reverberated both regionally and globally. In the region, it was felt most strongly through the effect of the collapse of Russian imports, which halved in the months following the devaluation. The hardest hit were the former Soviet republics, which had export shares to Russia ranging from 20–25 percent in the Baltics through Belarus and Ukraine to Moldova at over 50 percent. The last three were all forced to follow Russia with large exchange rate devaluations, and suffered sharp slowdowns in growth.

Emerging market risk premia

EMBI global bond spreads, 1998-2001



Source: JP Morgan.

The Baltic countries, in contrast, were determined to maintain their new currency board arrangements pegged to hard currencies—notwithstanding, in Latvia's case, significant contagion via banking sector links to Russia. This required sharp increases in interest rates, as well as intervention in the foreign exchange market. All three countries fell into recession at the end of 1998, and unemployment rose significantly. Nevertheless, they succeeded in defending their currencies—a result which added to their resolve, and their credibility, when faced with similar pressures during the global financial crisis a decade later.

Other CEE countries, whose export shares to Russia were mostly in the region of 5 percent, were less exposed through the trade channel. But they were affected through financial markets, with pressure on exchange rates—especially Slovakia, where the crisis contributed to the decision to float the koruna in October 1998 —and increases in real interest rates. Effects on GDP were small compared with the Baltics and other former Soviet republics, however.

Globally, the Russia crisis constituted a major shock to emerging markets, with spreads widening sharply in Latin America and Asia as well as Europe, and contributing to Brazil's currency crisis. One dramatic consequence was the collapse of the prominent US hedge fund, Long Term Capital Management, which lost $5 billion due to interest rate movements in the wake of the Russian crisis, and needed a bailout to avoid a potential market meltdown.

Box 5. IMF-Supported Programs with Russia in the 1990s—a View from the Field

In retrospect it is clear that the IMF-supported programs with the Russian Federation, spanning most of the period from mid-1992 through 2000, had some unique features. In terms of design, as with other programs, the focus was on macroeconomic stabilization with a large dose of structural policies to try to restructure the economy after eight decades of dysfunctional economic management under the Soviet regime.

However, independent Russia's starting conditions at the outset of 1992—notably a bankrupt treasury, the collapse of the command economy, and disrupted economic relations—overshadowed initial efforts at stabilization and growth. Those starting conditions were arguably worse than those that prevailed in most Central and Eastern European countries that emerged from behind the Iron Curtain after 1989. The expectation at the time was, nevertheless, for a sustained rebound in Russia once the monetary overhang and resource misallocation under the Soviet state-control system had been addressed. But it took ten years of under-achieved programs to bear fruit.

There were important advances in structural reform, especially under the early programs. But the state seemed to lack the means to be really effective, at least until after the 1998 default. Perhaps in reaction to living under the centralizing principles of the communist regime, central authority was discredited and weak. Strong disparate forces in the regions and powerful oligarchs further undermined normal state functions. As a result, legislation had little practical effect. The civil service was demoralized, bloated and underpaid. Tax collection was inadequate to finance even a limited government function, much less the wholesale transformation required by the circumstances. Program targets for tax collection were repeatedly thwarted by a tendency first to overestimate the government's capacity to raise revenues and then, when faced with chronic shortfalls, to resort to apparently attractive shortcuts that promised quick fixes to problems that required institution-building.

Despite the underperformance against both macroeconomic targets and the structural reform agenda, the IMF continued to support Russia with financing, with the country becoming (at the time) the largest borrower ever from the Fund. But as policy implementation fell short, internal inconsistencies were building up, which—along with the trigger from the Asia crisis—led inexorably to the 1998 crisis. The crisis was a hard lesson for the IMF, but served as a wake-up call for Russia. It proved to be the fateful tipping point in Russia's prevarication to become a modern, market economy.

Prepared by Martin Gilman, Senior IMF Resident Representative in Moscow, 1996-2001, based on Gilman (2010).

1999–2001: Recovery

In light of the turmoil ensuing from the Russia crisis, the recovery in the region was surprisingly rapid. For the region as whole, GDP rebounded by 4 percent in 1999 and 7 percent in 2000, by which time every country in the region was growing, most of them strongly. Russia's recovery was particularly fast, helped by improved competitiveness due to the devaluations, an improvement in commodity prices, and, once the initial period of chaos had passed, policy actions. Key measures included a much more serious effort to collect taxes than in the past, as well as advances on the labor code, deregulation, pension reform and legal reform. Elsewhere in the region countries put the crises behind them and embarked on consolidation. In hindsight, the late 1990s period overall was one of gains both in terms of macroeconomics and structural reform. By 2001, most countries in the region had current accounts, budget deficits and inflation under control. Average EBRD transition indicators also improved for almost all the countries in the sample, some quite significantly.

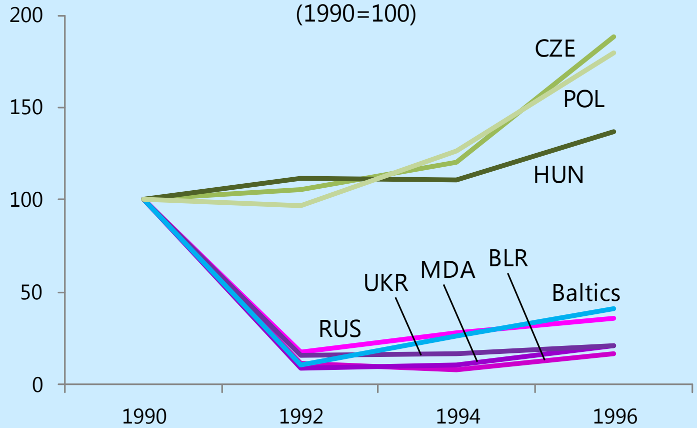
VII. TRADE AND CAPITAL FLOWS

Trade and investment links with Western Europe have been among the most important factors behind the growth of the past 25 years. Some countries have been able to exploit these opportunities much more effectively than others, due to location, initial conditions, and the policy environment. Looking forward, countries that have benefited less so far need to develop a more external orientation and a more conducive environment for foreign investment, while the more successful countries need to focus on building markets globally and advancing to higher value production.

After decades of closed borders, creating an environment of free-flowing goods, services, and capital in post-Communist Europe was key to integration with Western Europe and the rest of the world. Accessing the open markets of Western Europe would result in increased investment and economic growth, greater product choices and quality for consumers, and improved standards of living. All transition countries began their journey to integration with these goals in mind.

Trade in the region had been focused inward during the decades preceding transition. This was particularly the case for the Soviet republics. In 1990, approximately 80 percent of exports from the Baltics and CIS republics went to Russia. Not surprisingly, these countries experienced a dramatic drop in exports with the dissolution of intra-USSR trade links, resulting in large income drops and a shortage of foreign currency in the early 1990s. Some other transition countries had already begun diversifying their trade destinations toward broader Europe in the decade leading to transition. As a result, these countries did not experience a noticeable drop in exports in the early 1990s.

Gross exports of selected CEE countries
(1990=100)



Source: Direction of Trade Statistics and Foreign Trade Statistics in the USSR (World Bank)

Membership in international institutions offered not only new markets and increased movement of goods, but also strong regulatory and political frameworks to build sound market institutions, support sustainable structural reforms, and increase competitiveness across sectors. Central European countries started joining the World Trade Organization as early as 1995, and by 2000 half of the region had joined, lowering tariff rates, harmonizing legislation, and signing up to independent dispute settlement mechanisms. Although full economic integration into the EU would take years for most transition countries, integration through trade and investment began almost immediately. By the mid-1990s, many Central and Southeastern European countries had implemented bilateral trade agreements with the EU as a precursor to actual membership. In contrast, CIS countries signed partnership agreements with the EU that did not include significant trade liberalization components. Six countries are also now members of the OECD, a sign of sustained progress and convergence.

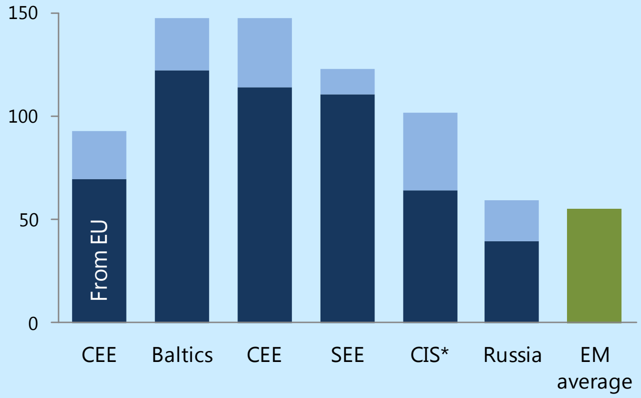
Investment needs were overwhelming, given underdeveloped infrastructure and dilapidated industrial capacity. Capital from Western Europe infused the region, playing a key role in development. Over the transition period, the region moved from relative isolation to become highly financially integrated with the rest of the world, particularly the EU. Total stocks of external capital reached levels significantly higher than the average for emerging markets, and as high as 150

Prepared by Jesmin Rahman and Joanna Swirszcz.

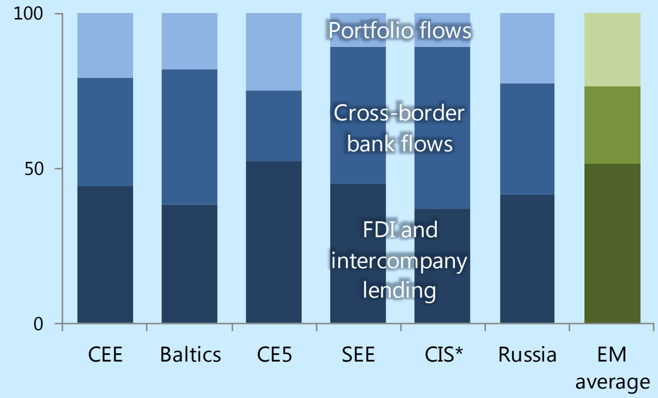
percent of GDP for Central Europe and the Baltics. About three-quarters or more of external capital came from EU member countries, highlighting the overwhelming dependence of the region on the EU.

The bulk of external capital into the region has taken the form of FDI and cross-border bank flows. The dominance of FDI has been partly a result of the large scale privatization that followed transition, but also of greenfield investment, particularly in Central Europe. And as countries opened their financial sectors to privatization, much of the sector became owned by Western parent banks. To take advantage of lending and profit opportunities in these new markets, large shares of cross-border flows were intermediated through subsidiaries. However, countries differed in terms of the relative importance of FDI and cross-border bank flows in external capital composition, ranging from FDI being much more significant than bank flows in Central Europe to the opposite in CIS countries. Portfolio flows, which make up a little more than one-fifth of total inflows to the region, have been significant only in Russia and in some Central European countries with more developed financial markets.

Stock of external funding
(percent of GDP, 2012)



Composition of external funding
(in percent of total, 2012)



* CIS excluding Russia
Source: CESEE Regional Economic Issues Spring 2014.

There are several factors that contributed to the differing dependence on FDI in transition economies. First, the depth of initial reforms mattered. As discussed in Chapter IV, only a few Central European countries made early progress in the "difficult" structural reform areas such as competition policy, governance and enterprise restructuring. The resulting improved business environment helped attract FDI into these countries in significant quantity, making them less reliant on cross-border bank flows. A second factor that favored Central Europe was the state of the manufacturing sector. Countries with a better-functioning manufacturing base that could readily link up to neighboring Western countries' manufacturing sectors drew FDI into the tradable sector. Others drew FDI more in favor of utilities and other non-tradable sectors.

The diverging pattern of capital flows also had a lasting impact on overall export and growth performance in the region.[1] Broadly speaking, countries fall into three groups based on their growth experience and the role of the external sector in growth.

- Export-driven robust growth: The reform progress and manufacturing conditions discussed above, along with geographical proximity, served to strongly link the Central European countries to the German supply chain, granting access to more dynamic markets in Asia and elsewhere (see Box 6). This ushered in an era of export-driven growth,

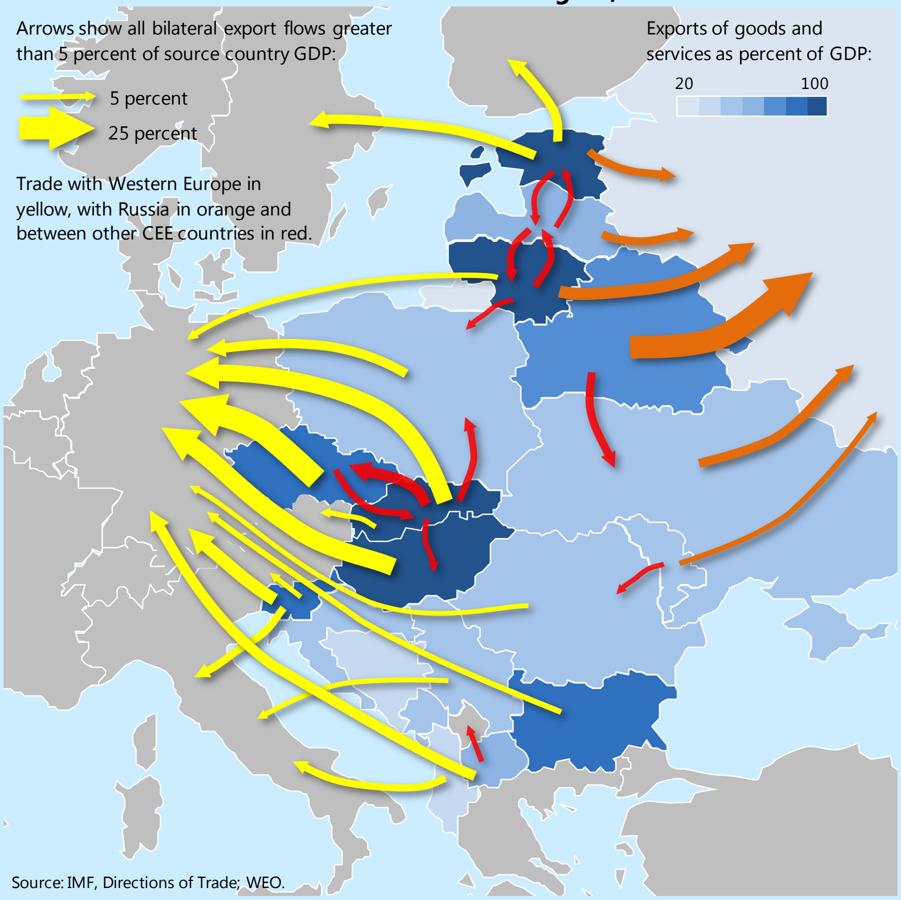
[1] See Atoyan (2010).

particularly of machinery and transport equipment manufacturing. Over time, these countries have not only moved up the production value chain, but also created areas of new comparative advantage.

- Domestic demand-driven high paced growth: The Baltic countries, as some of the early reformers, attracted a lot of external capital. But due to a small manufacturing base and the small size of the economies, a significant part of foreign capital took the form of cross-border bank flows channeled into very high domestic credit growth. Although income convergence in these countries leading up to 2008 financial crisis was the fastest in the region, they also saw by far the largest output declines during the crisis.

- Domestic demand-driven slower growth: Most Southeastern Europe countries had a late start in transition due to political turmoil. The region received significant FDI as well as cross-border flows. But these were mostly concentrated in the non-tradable sector, partly due to lagging reforms. Convergence since the financial crisis has essentially stopped in these countries.

Trade directions in CEE region, 2013



Source: IMF, Directions of Trade; WEO.

Countries vary strongly in their degrees of export orientation, only partly on account of country size, with particularly low shares in the Western Balkans. Trade flows to Western Europe and Russia (important for CIS countries and the Baltics) dominate intra-regional flows, which are strong only within the "German supply chain" countries and among the Baltics. Import demand from EU countries accounts for a significant share of GDP, rising as high as 20–25 percent for countries that have joined the EU.

While trade and financial integration has been a strong source of convergence, it has created vulnerabilities as well. As described in Chapter VIII, several countries in the region ran double-digit current account deficits during the boom years. External debt reached record high levels relative to their emerging market peers in other parts of the world. Although dependence on parent institutions assuaged concerns of sudden withdrawal and roll-over risks, high indebtedness has been a drag on recovery.

The crisis did succeed in correcting the flow imbalances, although in a brutal manner in some cases. Nevertheless most countries in the region are having a hard time returning to robust broad-based growth. From the trade perspective, the exposure to the EU, a region with persistent weaknesses, is creating headwinds. Countries with a more diversified export market, or countries whose exports are linked via Germany to final demand outside Europe, have fared better. And as discussed in Chapter IX, the financial interlinkages to Western European parent banks have been associated with slow credit growth, another factor constraining recovery in the region.

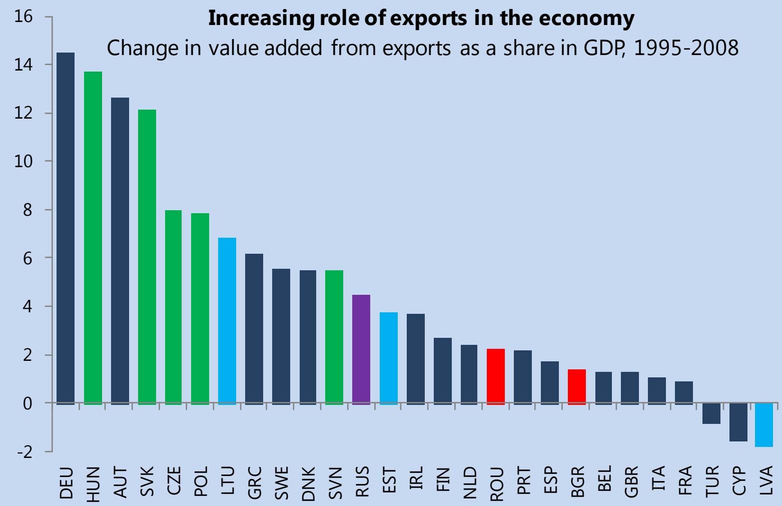
As post-transition countries move forward, the challenge is to take advantage of European integration without building further vulnerabilities. Outside Central Europe, this requires a higher orientation toward the tradable sector. Inside Central Europe, it means moving up the value added chain and creating new areas of comparative advantage. The days of very rapid and indiscriminate capital inflows are most likely over. At the same time, the EU is moving toward greater integration, with banking union and steps towards fiscal union, which pose new challenges for countries outside the euro zone or EU. To navigate in a world of more integration, countries in the region will need to have greater structural flexibility and competitive strength to ensure a durable convergence.

Box 6. Central Europe: Benefiting from the German Supply Chain

Being part of supply chains has benefited Central Europe (CE) countries enormously. Over time, these countries have increased their domestic value added from exports in line with increase in Germany and much more than in other European countries. While exports increased across all categories during 1995–2008 in CE countries, the increase in knowledge-intensive manufacturing sectors, namely machinery and transport equipment, was spectacular. Between 1995 and 2008, exports from these niche sectors multiplied many times over in these countries.

CE countries have also managed to create new areas of comparative advantage over time. In 1995, the revealed comparative advantage of these countries lay in labor- and capital-intensive manufacturing. By 2008, they managed to create comparative advantage in knowledge-intensive manufacturing. This was largely due to being part of the German supply chain. Cross-country econometric regressions show that factors that helped them to link up include close proximity to Germany, competitive unit labor costs, and a strong trade-enabling environment.[1]

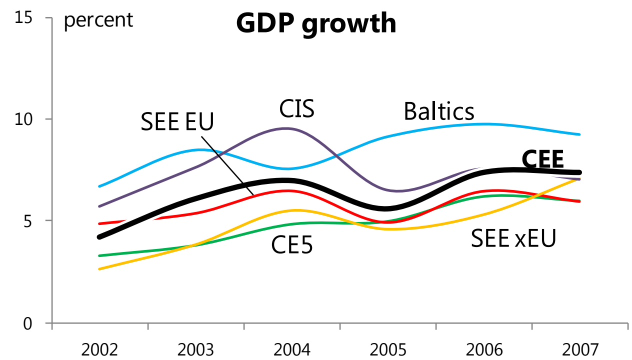
[1] See Rahman and Zhao (2013).



Source: Rahman and Zhao (2013)

VIII. 2002–2007: BOOM

The mid-2000s saw extremely rapid growth across the region, spurred by the benign global environment and ever-increasing confidence in the process of convergence with the EU. However, growth was driven largely by external borrowing for consumption and construction, and became increasingly unsustainable. Even for those countries that heeded the dangers, it was very difficult to devise policies that could push back against the tide of capital flowing into the region.



Source: WEO. CEE average weighted by GDP, others unweighted.

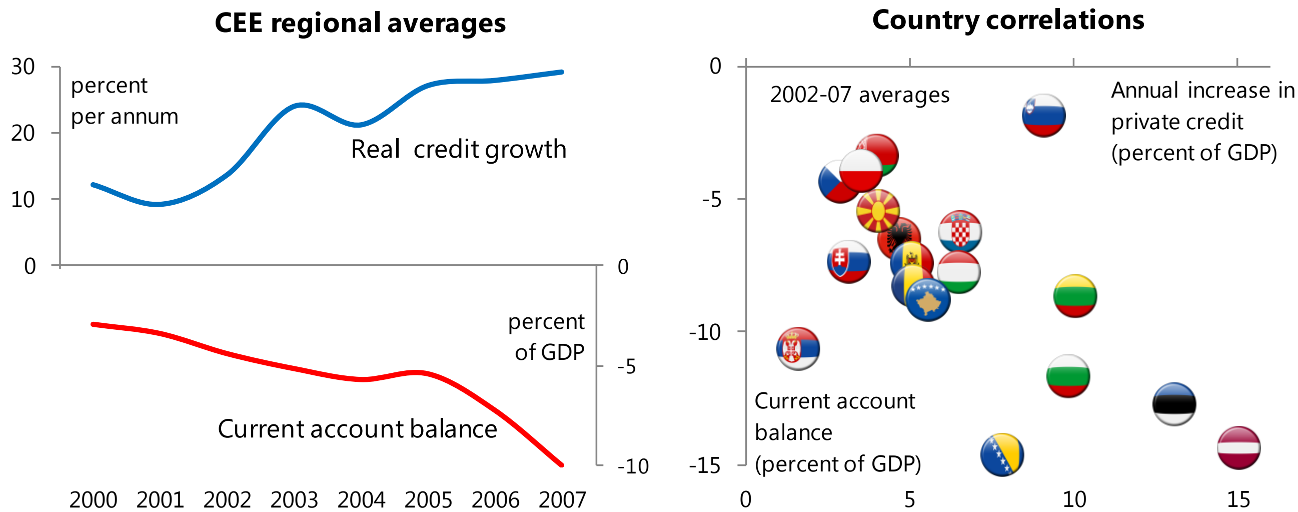
The "Great Moderation" period was marked by strong growth and high optimism across emerging markets globally. But it was particularly marked in the CEE countries, where there was seen to be strong convergence forces driving the economies towards Western European income levels. For the region as a whole, growth averaged almost 6 percent a year over the period—a rate at which incomes would double every 12 years, putting Western livings standards seemingly within the grasp of a generation. A major milestone was passed with the accession of 10 countries from the region to the EU (see Box 7). Financial markets shared in the optimism of the region, with ready access to private financing enabling almost all the transition economies to "graduate" from IMF-supported lending programs during the period: the number of CEE program countries fell from 13 in 2001 to three by mid-2007.

However, in hindsight, the optimism of this period was in part misplaced. The pace of economic reform generally slowed in this period, and the strong growth was based on a rapid increase in domestic demand, with credit booms fueling consumption growth and investment directed towards construction and real estate. The flipside was the emergence of very large external imbalances, as productive capacity struggled to keep up with the pace of demand. When the credit bubbles eventually burst in late 2008, triggered by the global financial crisis, the region suffered devastating losses in output, and also in confidence in the convergence process and prospects.

Across the region as a whole, the average current account deficit increased dramatically, while credit growth rose to extreme rates. The link between the two at the individual country level is clear: over 2002–07, annual average increases in the credit/GDP ratio corresponded closely to the current account deficits in the period. The most extreme cases were the Baltics and Bulgaria, where credit ratios increased by 8–10 percent a year, accounting for most of the huge external imbalances the countries were running. Given that the credit growth was in large part funded by foreign capital, as Western European banks competed for market share, the credit growth also provided the needed financing for countries to run such large external deficits. This ease of financing added to complacency about the risks involved. These risks were compounded by the attractions of borrowing in foreign currency (typically euros or swiss francs): for borrowers used to seeing the local currency appreciate, foreign-currency loans appeared to carry both lower interest rates and the prospect of diminishing principal when measured in local currency. Only when many exchange rates depreciated sharply in the bust did these products show they had a dangerous sting in the tail.

Prepared by James Roaf.

Bank lending and the current account



Note: See country codes box for country flags.
Source: WEO; World Bank.

This is not to say that the unsustainability of the boom period was unnoticed or ignored at the time. Among others, the IMF issued warnings of the risks posed by rapid credit growth and the associated demand booms and external imbalances.[1] However, views differed even within the IMF, and traction of this advice was difficult. Explanations of rapid credit growth as a natural catching-up to Western European levels of financial intermediation were politically attractive. And the naysayers' arguments were also undermined by the fact that the boom itself tended to flatter prudential indicators, by raising bank profitability, reducing bad loan ratios (through the rising denominator) and increasing collateral valuations as asset prices rose.

Even when countries recognized the dangers, it was difficult to identify means to address the problem. The scale of the inflows into the European transition economies tended to overwhelm the policy levers available to the authorities. Monetary policy was constrained either because it had been ceded to fixed exchange rate regimes or because raising interest rates would only attract more inflows. With public debt and deficits mostly appearing to be sound, the kind of fiscal tightening that would be needed to offset the inflows—multiple percentage points of GDP—was politically infeasible.[2] Many countries did tighten prudential policies considerably, including via raised capital and liquidity requirements, but this did little to dampen the appetite for lending. It also led to diversion of flows around the local banking system, either via nonbank lending (notably leasing) or by Western European parent banks—which were beyond the reach of local regulators—lending directly to firms in CEE. Finally, capital controls on inflows were seen as inconsistent with countries' commitments as new or prospective EU members, and also likely to be subject to circumvention.

The experience of Bulgaria provides a case in point. With confidence building in the run-up to expected EU entry in 2007, credit was growing at 30 percent a year or more in real terms, while the current account deficit was

[1] See contemporary individual country reports, as well as staff papers such as Cottarelli et al. (2003) and Duenwald et al. (2005).

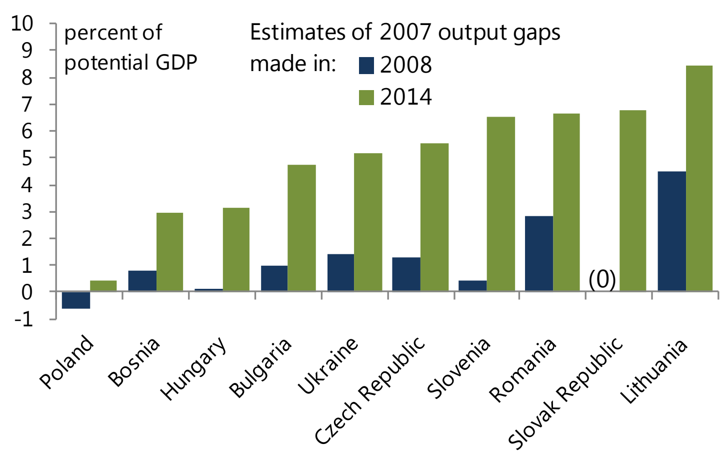
[2] Atoyan et al. (2012) show that a pronounced counter-cyclical fiscal stance would have been effective in leaning against surging capital inflows, but the required magnitude of fiscal tightening for most countries would have been difficult to achieve.

increasing alarmingly into double digits. The currency board arrangement tied monetary policy to that of the euro zone. Budgetary policy was already very tight, with an overall surplus close to 3 percent of GDP in 2005–06. Bank capital ratios were high and measures to drain liquidity from the system seemed to have no impact on lending growth. Bulgaria therefore resorted, with IMF encouragement, to imposing direct lending limits on banks. However, while the limits were observed, the desired macroeconomic impact was not achieved: capital inflows continued via nonbanks and parents, and the current account deficit continued to rise, peaking at no less than 25 percent of GDP in 2007.

At the same time, countries' failure to stem the credit growth did not mean such policy efforts were wasted, since the countries that tightened fiscal and prudential policies were in a better position to weather the storm when the crisis eventually hit: this was an important factor behind the general success in avoiding more severe banking crises in the region in 2008–09.

Whatever the warnings that were made, the sheer scale of the boom and associated imbalances was certainly not adequately appreciated. Estimates made at the time suggested that the cyclical boom was responsible for only a small part of the strong output growth, which was therefore expected to continue at a rapid pace in the future. For the cases where the IMF published estimates, economies were on average thought to be operating at only about 1 percent of GDP above their potential at the peak of the boom in 2007. These estimates have since changed dramatically. Looking back now, the average estimated "output gap" in 2007 has increased to 5 percent, with some countries seeing extremely large revisions. This also had important implications for fiscal policy: as in a number of advanced European countries, the cyclically high tax receipts in the boom masked severe underlying fiscal problems, which were exposed in the aftermath of the crisis.

Revisions to estimates of overheating



Source: WEO, IMF country reports.

Box 7. EU Accession and its Implications

The boom period in the transition countries was closely associated with the accession of 10 of their number to the European Union. Eight were admitted in 2004 and two in 2007, adding 25 percent, or 100 million people, to the population of the union in its most significant expansion since it was founded.[1]

For the new member states, as for the EU itself, the effects of the accession were profound. The most important effects came through three main channels: liberalization of trade, capital and labor flows; institutional and legal development and integration; and access to EU funding. These effects were not felt only at the time of joining, but rather as a process, starting well before accession and continuing well after.

- Joining the single market for trade has brought unambiguous benefit to the new member states, as discussed in Chapter VII. The effects of the other aspects of liberalization have been much more nuanced. In general, advantages of capital account liberalization are much harder to establish than for trade, and the challenges posed by banking inflows to the CEE countries have amply borne this out. Meanwhile the opening of labor markets has been associated with large-scale migration from the new member states to the old—around 2-3 million people by some estimates. The economic benefits of these moves seem to have accrued mainly to the recipient countries, with a negative growth impact in the source countries—though of course benefits to the migrants themselves should not be ignored.[2]

- Raising local institutions and legal frameworks towards EU standards has played a critical role in economic development. Accession required deep and far-reaching improvements to legislation and administration. The actual application of EU norms in practice has been slow in some of the new members, but the process of EU integration remains a key driver of reform.

- Financial flows from the EU increased sharply after accession, from below 1 percent of GDP on average before to almost 2.5 percent of GDP within three years, in the form of structural funds, agricultural support, and other subsidies. Perhaps more important than the volume of funds is the effectiveness with which they have been used, which has varied across countries.

The process of further accessions is expected to be relatively protracted. While membership prospects may therefore not yet provide as strong an impetus for reform and investment as they did for the countries that have already joined, the EU remains closely engaged with candidate and potential candidate countries to help them meet accession requirements.

[1] The Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, the Slovak Republic and Slovenia joined on May 1, 2004. Bulgaria and Romania joined on January 1, 2007. Among the other transition economies, Croatia joined on July 1, 2013, and Albania, Bosnia and Herzegovina, Kosovo, FYR Macedonia, Montenegro, and Serbia have candidate or potential candidate status.
[2] See for example Holland et al. (2011).

IX. FINANCIAL SECTOR

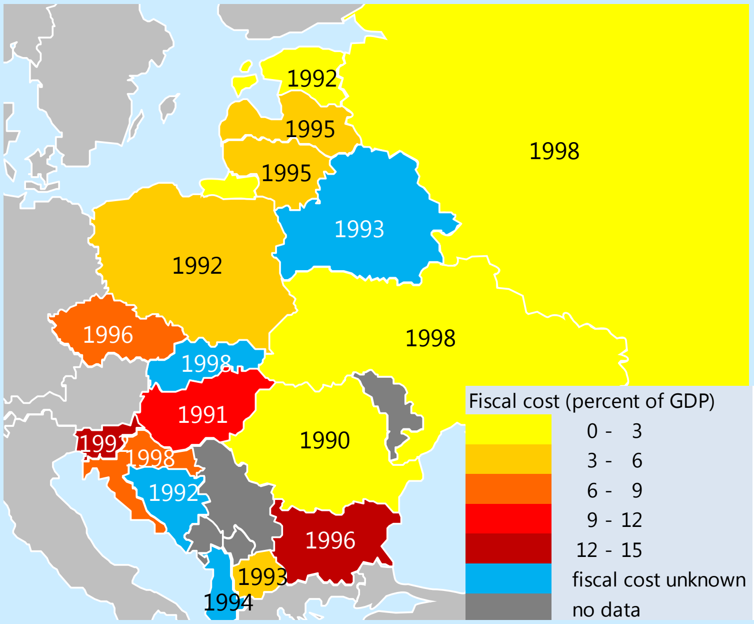
After incomplete reform that led to banking crises across the region in the 1990s, almost all countries adopted a model based on strong bank supervision and high participation in local banking sectors by Western European parent banks. This brought much needed know-how and access to foreign financing—but also contributed to the major credit boom in the 2000s, exacerbating the effects of the global financial crisis at the end of the decade. Current policy priorities include addressing crisis legacies of bad debts and slow credit growth, as well as adapting to the new regulatory environment in the euro zone.

Communist legacy and early banking crises

During the communist era, financial systems in the region had a purely passive role, with "monobanks" administratively channeling resources into politically-selected tasks and projects by state enterprises. Due to this reduced, record-keeping role, these banks did not engage in evaluations or risk assessments of the loans extended, and services provided to the general public were very modest or non-existent.

With the onset of transition, a two-tier banking sector was developed as a crucial element of the market economy, to help allocate resources to productive use. The creation of central banks, and modern financial systems was an unprecedented challenge, involving building from scratch a number of pillars to underpin a functioning system. These included prudential regulation, supervision, and an appropriate framework for competition. In this process, all the transition economies benefited from external technical assistance provided by the IMF, the World Bank and by foreign experts sent from various central banks.[1] Progress in implementing these reforms was mixed across the region, as with other necessary supporting reforms such as improved contract enforcement and sound monetary policy implementation.

Post-transition banking crises



Source: Laeven and Valencia (2008)

As large (and mostly state-owned) enterprises to which banks had lent underwent stress associated with their new exposure to market forces, banks quickly found themselves with serious bad loan problems. These problems quickly escalated as banks were coerced into new lending to keep these companies alive, while interest rates were rising on the back of macroeconomic stabilization programs. Recovery of nonperforming loans turned out to be almost nonexistent, reflecting both the soft budget constraints that provided little incentive to companies to restructure, and also strong political unwillingness to let companies go bankrupt.

Private banks were also allowed to operate, but often featured low capitalization and close connections to businesses, reflecting lenient

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Prepared by Guillermo Tolosa and Krzysztof Krogulski.

[1] See Ingves (2001) for a fuller description of IMF involvement.

supervision requirements. Deep-rooted weaknesses in the sector were addressed by a string of inadequate solutions, including repeated recapitalizations without requiring restructuring, unsuitable privatizations to connected parties with little know-how and expertise, and sales of minority shares that did not significantly reduce strong political influence.

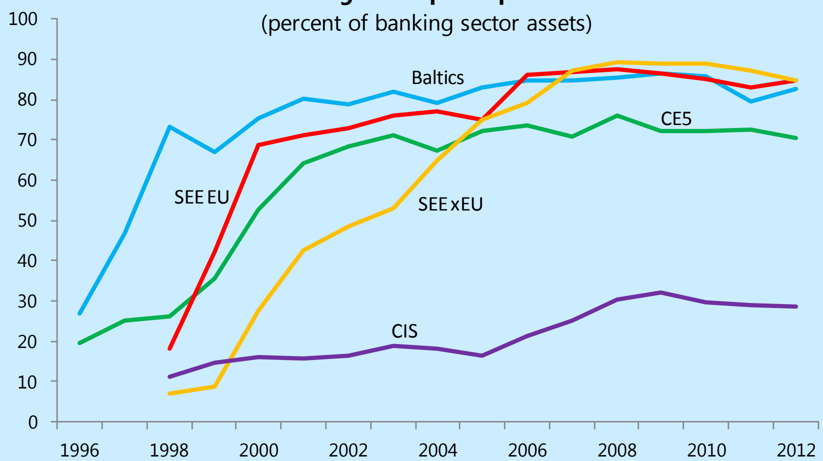
The ineffectively functioning banking sectors created a vacuum in the supply of financial services. This tended to be filled by some legitimate microcredit operations, but also by fraudulent entities which, in the context of still weak regulatory environments abused inexperienced clients and damaged trust in the financial system. Given this background across the financial industry, most countries faced full-fledged financial crises during the 1990s.

Modernization and foreign inflows

In the aftermath of these traumatic crisis episodes, it became clear that deeper reforms were required. While some CIS countries relied more on tighter state oversight, in other countries—especially where the prospect of EU membership served as an institutional anchor—the political will emerged to engage strategic investors in the sector via privatizations. In some cases, like Poland, budget needs also helped make bank privatizations politically feasible. With improving macroeconomic conditions and attractive valuations, investor appetite was strong, and a wave of privatizations took place, usually involving Western European banks. At the same time some banks started operations in the region through greenfield investments.

The completion of the process in the early 2000s saw the creation of modern, market-oriented and independent banking systems. In most CEE countries, banking became the sector with the highest private and foreign participation, and foreign bank ownership was also higher than in other emerging market regions. Foreign parent banks, mostly from mature markets, brought know-how, technology, a new culture of service, high supervision standards, and brand names that instilled confidence among battered depositors. On the other hand, they brought new sources of risks, including exposure to foreign shocks and exposure to specific banks. The pattern of parent banks differed across the region, with Baltic countries benefiting to a disproportionate extent from Swedish investment, while at the other extreme Poland was host to a very diverse group of countries and banks.

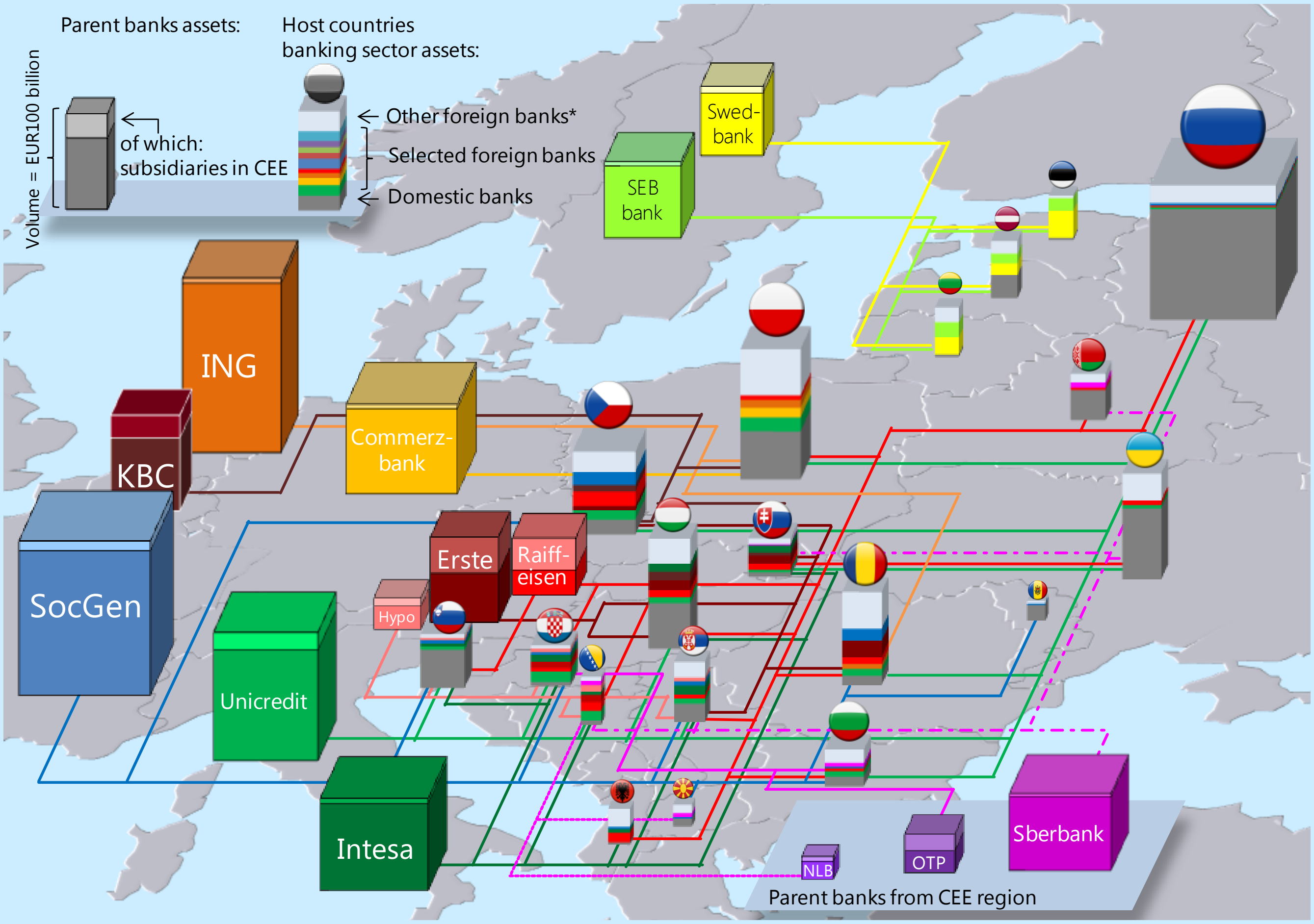
Foreign bank participation
(percent of banking sector assets)



Source: EBRD, Bankscope.

The presence of foreign banks brought easy funding from abroad. They often followed a model of centralized funding, whereby parents shifted large amounts of liquidity to wherever it was deemed to be needed most. At the same time, ample financing on money markets transmitted the tide of capital inflows also to countries where the share of foreign-owned banks was lower. Large European banks were pursuing an aggressive strategy of expansion of cross-border lending, with the EU accession countries appearing especially attractive, leaving CIS countries much less affected. But as discussed in Chapter VIII, the vastly improved access to finance came with considerable drawbacks: large volumes of lending were channeled into consumption and nontradable sectors, contributing to significant imbalances which unwound precipitously in the wake of the 2008 global financial crisis.

Foreign banks operating in CEE



* Other banks include Alpha Bank, Citibank, DNB, Eurobank, GE Money, Millennium BCP, National Bank of Greece, Santander and Sparkasse.
Note: Figure shows ownership structure of CEE banking sectors. Each parent bank is linked to a country, where its subsidiary operates. Volume of each block reflects balance sheet size of parent banks or total assets of host banking sectors.
Source: Raiffeisen Research; Bankscope.

Crisis and retrenchment

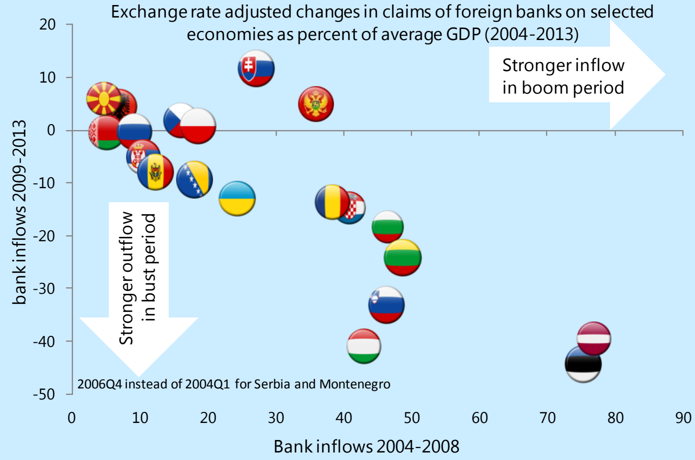
The eruption of the global financial crisis in 2008 triggered high risks of banking instability in the region. It was feared that a potential disruptive adjustment of exchange rates and macroeconomic imbalances, along with the expected unwinding of real estate booms, could wreak havoc on bank balance sheets. But in the event, banking crises were generally avoided, as macroeconomic adjustment proceeded more smoothly than expected and portfolio losses were gradually absorbed by considerable preexisting buffers. Notable exceptions were the collapse of a large bank in Latvia, widespread problems in Ukraine, and relatively small and targeted recapitalization in other countries (such as Slovenia).

A variety of factors were at play to prevent disruptive macroeconomic adjustments. The IMF, together with the EU in member countries, put in place a number of lending arrangements while EBRD, European Investment Bank (EIB) and World Bank provided funds to the banking system. Bank funding flows to the region were initially affected, but not in as destabilizing a way as originally feared, and were subsequently stabilized through 2010. Banking systems benefited from the prevalence of parent-subsidiary relationships, which proved to be a more stable source of flows, in some specific cases aided by coordinated action and more explicit commitments in the form of the Vienna Initiative (see Box 8). As the euro zone crisis heated up in late 2011, parent banks started to experience considerable renewed distress, with several requiring state intervention. Against this backdrop, cross-border exposures to the region came under pressure again, but once again without disruptive macroeconomic effect.

The deleveraging process was concentrated on host countries that had seen the strongest inflows during the boom—including the Baltics, Bulgaria, Hungary and Slovenia—regardless of the share of foreign-owned banks. But there were no large-scale divestments in transition countries, and foreign banks continued to dominate the landscape.[2]

Deleveraging

Exchange rate adjusted changes in claims of foreign banks on selected economies as percent of average GDP (2004-2013)

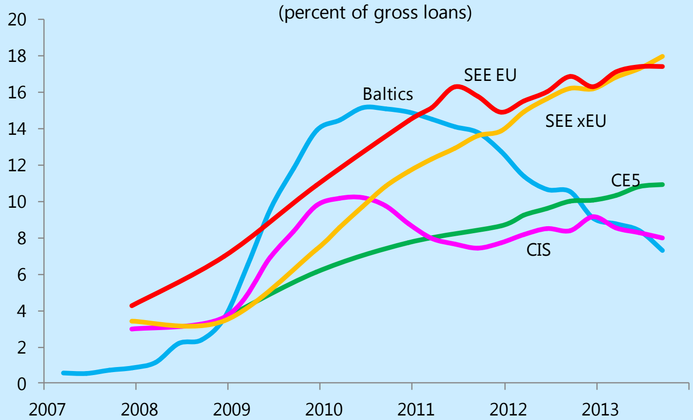


Note: See country code box for country flags.
Source: BIS locational statistics.

Significant exposures to embattled sectors (mainly construction) and the prolonged slump of economic activity translated gradually into an increase in nonperforming loans (NPLs). As banks provisioned for these loans, profitability in the system was hurt. High NPL levels and low profitability have slowly been overcome in some countries—especially the Baltics—but continue to be a very serious problem in others, especially in Southeast Europe.

Nonperforming loans

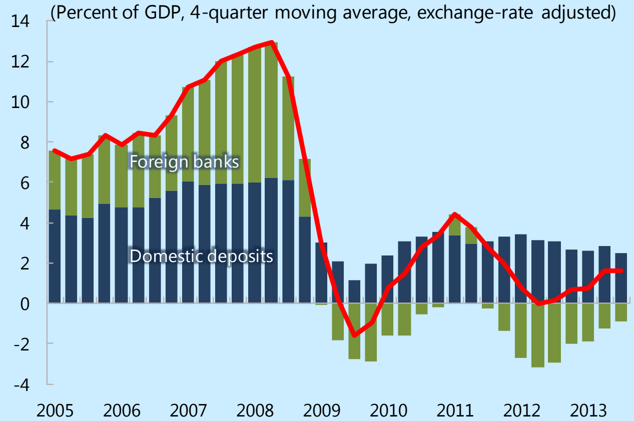
(percent of gross loans)



Source: IMF, Financial Soundness Indicators.

Evolution of principal bank funding sources*

(Percent of GDP, 4-quarter moving average, exchange-rate adjusted)



* Excludes Russia, Montenegro and Kosovo because of data unavailability.
Sources: BIS, Locational Banking Statistics; IMF, International Financial Statistics; IMF, WEO; and IMF staff calculations.

Bank lending growth remained very weak throughout the crisis, with various countries experiencing creditless recoveries. While contracting demand for credit was a major force at play, supply factors were also important.[3] NPLs hampered credit growth by tying up bank funding and managerial resources. Deleveraging also played a role, affecting especially banks with higher initial levels of foreign funding or subsidiaries with a less solid parent, which both saw larger reductions in credit growth.[4] But domestic credit fell significantly less than cross-border credit, because of alternative sources of funding and deposit growth, leading to an emerging model of decentralized banking in which subsidiaries are

[2] See IMF (2013a) and "CESEE Deleveraging and Credit Monitor", Vienna Initiative, various editions.

[3] The relative roles of supply and demand factors in the deleveraging process have been a subject of considerable debate (See Avdjiev et al. 2012).

[4] IMF (2013a), Feyen et al (2012), and Ongena et al (2013). Possibly because foreign banks tend to have larger foreign fund needs, earlier literature also showed more aggressive credit curtailing by foreign banks. De Haas et al. (2013) and Popov and Udell (2012) find that multinational bank subsidiaries in Emerging Europe cut lending more than domestic banks. Cull and Martinez Peria (2012) find that foreign banks lent less during the crisis.

increasingly self-funded. Small and medium enterprises (SMEs) have faced the most difficulties in accessing credit, being seen as riskier, especially in environments of weak property rights and slow collateral enforcement.

A challenge going forward is how to revive credit provision and expand SME access to finance. Quick action to tackle weaknesses in the business environment, as well as making adequate use of guarantee schemes (including from international financial institutions) are natural steps to kick-start demand and expand access. In addition, most banks need to address legacy assets more decisively, in order to focus on opportunities for new lending. In some cases—most urgently in Southeast Europe—governments also need to do more to aid resolution of NPLs, including removing obstacles to developing markets for distressed assets, stronger tax and supervisory incentives, improvements to legal and insolvency systems, and facilitating debt restructuring (including out-of-court procedures).[5] The ongoing adoption of the decentralized banking model is likely to make new lending more sustainable, by reducing funding risks. However, the shift in this direction poses challenges. If done too fast it could hamper the recovery in credit (as alternative sources of funding are unlikely to be developed quickly enough), and if taken too far it could imply a suboptimal allocation of resources at a regional level.

At the EU level, the new banking union and regulatory harmonization are shaping a new landscape of banking. These developments are expected to bring positive spillovers for the transition countries in general, by enhancing financial stability and reducing fragmentation. This in turn raises the possibility of further benefits for EU members that decide to join the banking union, reducing compliance costs for cross-border banks and reducing problems of home-host supervision issues, albeit at the cost of loss of autonomy at the individual country level. Either way, the process of adapting to the new frameworks is likely to bring fresh challenges for transition countries in coming years, including for non-EU members.

[5] See Vienna Initiative (2012) and Liu and Rosenberg (2013).

Box 8. The Vienna Initiative

At the height of the global financial crisis in the fall of 2008, concerns ran high that the CEE economies would suffer a contagious financial meltdown. High external deficits and debt, widespread foreign-currency lending, and foreign-dominated banking raised the specter of an uncoordinated "cut and run" by Western banks, which had extended funding of some US$450 billion to the region—corresponding to over 50 percent of GDP in many countries—thereby triggering a succession of collapsing financial systems and exchange rates throughout the region. Moreover, any multilateral financial assistance granted to CEE countries would prove futile if it merely financed funding withdrawals by Western banks. Another worry was that home country authorities would limit public support schemes for Western cross-border banks groups to their domestic operations, leaving CEE affiliates to fend for themselves.

The Vienna Initiative sought to address the need to coordinate between the major public and private stakeholders for an effective response to these risks. Following informal discussions, the inaugural meeting was held in Vienna in January 2009. It brought together the key Western parent bank groups, home- and host-country authorities (central banks, supervisory agencies, and finance ministries), and multilateral organizations (EBRD, European Commission, EIB, IMF and World Bank). Parent banks committed in letters signed by top management to maintain CEE funding levels and recapitalize their local subsidiaries as needed for five countries with programs supported by the IMF and the EU (Bosnia and Herzegovina, Hungary, Latvia, Romania, and Serbia). Home-country authorities agreed that any public support for parent banks would not discriminate between the groups' domestic and foreign operations, while host-country authorities likewise pledged to treat domestic and foreign banks equally. In the context of the "Joint IFI Initiative," the EBRD, World Bank, and EIB disbursed €33 billion to strengthen banks in the region, complementing the financing provided under IMF- and EU-supported programs. The Vienna Initiative also held annual "full-forum meetings" to facilitate broader policy discussion between representatives across CEE, their Western counterparts, and multilateral organizations.

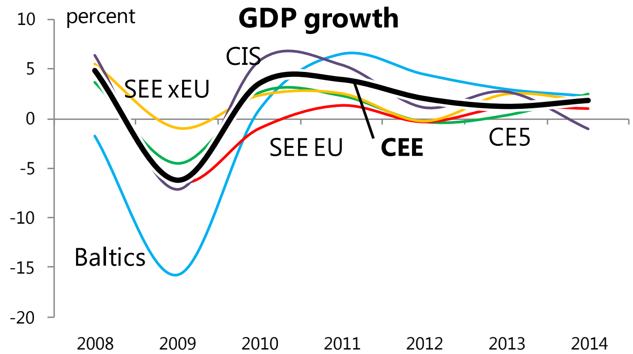
In the event, the feared financial meltdown did not materialize. Banks remained engaged not only in the five countries with explicit exposure maintenance agreements but in the region as a whole. Overall funding by Western banks for CEE declined by less than funding to other emerging market regions at the peak of the crisis. The initiative's activities diminished as the global financial crisis subsided over the course of 2010. Exposure maintenance agreements with banks were often relaxed and some lapsed as IMF and EU-supported programs ended.

The initiative was re-launched as "Vienna 2" in January 2012 in response to renewed risks for the region from the euro area crisis. Its focus shifted to fostering home and host authority coordination in support of stable cross-border banking and guarding against disorderly deleveraging. Western banking groups continued to play an important role in the initiative, both by supporting the coordination efforts and by doing their own part to avoid disorderly deleveraging. The initiative developed numerous inputs for the design of the European banking union with a view to fostering integrated and effective financial sector oversight of banks throughout CEE. For non-EU countries in the region it facilitated "Host Country Cross-Border Banking Forums" to improve practical aspects of cooperation between the authorities of a host country and the authorities of the home countries of its banks. While "Vienna 2" did not involve exposure maintenance arrangements for banks, the evolution of foreign funding for CEE banks and their lending activity was closely monitored, with the main findings published in quarterly "CESEE Deleveraging and Credit Monitors."

Prepared by Christoph Klingen. See www.vienna-initiative.com for further details and publications.

X. 2008–2013: CRISIS

The imbalances that built up in the "Great Moderation" period left the transition economies highly vulnerable. The combination of these initial conditions and external shocks—from Lehman Brothers' collapse in 2008 and the euro-zone crisis in 2010–12—had devastating effects, hitting CEE hardest among the emerging markets regions. The impact still resonates, manifested in continued below-potential growth, high unemployment, and fragile financial markets. Moreover, region-wide economic convergence with Western Europe has stalled since the crisis.



Source: WEO. CEE average weighted by GDP, others unweighted.

Impact of the crisis

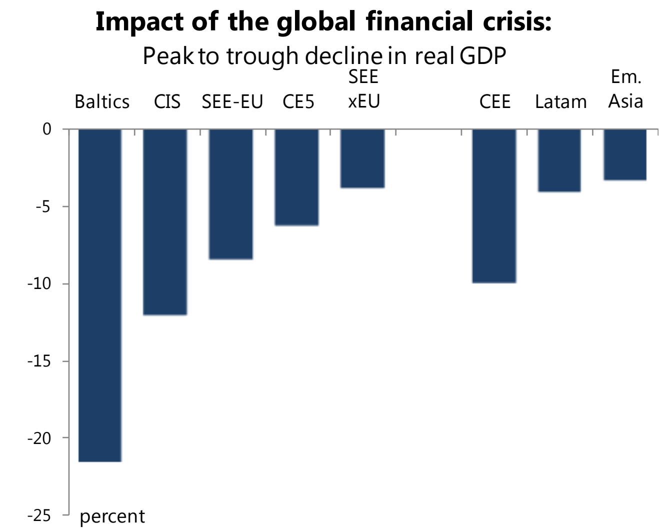
The global financial crisis, which began in advanced economies in the summer of 2007, spread to most emerging markets—including those in the CEE region—with a lag. This initial resilience, when regional growth remained robust, credit growth was still buoyant, and foreign capital continued to flow, led to claims that the region had "decoupled" from developments in advanced economies. However, after the collapse of Lehman Brothers in September 2008 and the ensuing increase in global risk aversion, capital inflows to the CEE region came to a sudden stop and global trade collapsed, placing the region at the epicenter of the emerging market crisis. This "recoupling" with advanced economies continued through the euro area crisis. The growth slowdown in the euro area and deleveraging by Western European banks gave further negative shocks to the region, and have continued to weigh heavily on macroeconomic and financial developments.

Source: JP Morgan, CEIC, Markit, and IMF staff calculations.
1/ TED spread up to end-2009, Euribor - German T-Bill after.

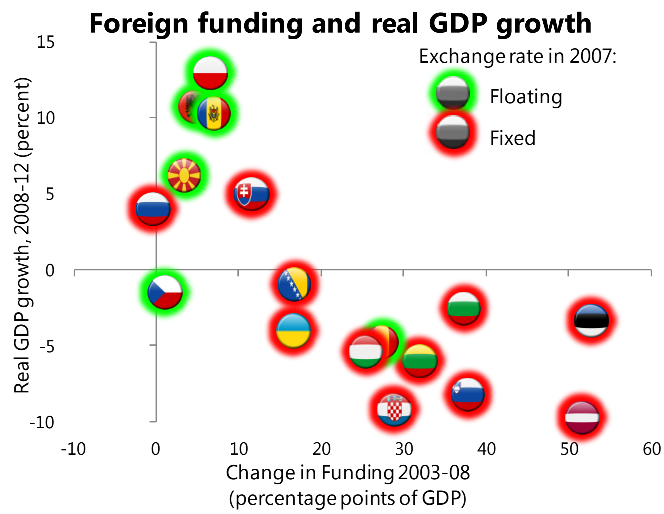
The immediate macroeconomic impact of the global financial crisis varied substantially across the CEE countries, in large part reflecting the degree of imbalances that had built up during the boom. The Baltic countries experienced the greatest peak-to-trough contractions in output, with Latvia contracting by as much as 25 percent of GDP. On average, the non-EU SEE region experienced the smallest output loss, at less than 5 percent, although at the

Prepared by Ricardo Llaudes and Bikas Joshi.

individual country level Poland escaped recession along with Albania and Kosovo. The CEE region as a whole suffered much larger output declines than other emerging market regions.



Source: WEO.



Note: See country code box for country flags.
Source: WEO; BIS.

With the onset of the crisis, the region experienced a protracted reversal of the strong capital inflows that had occurred in the boom: as with the bank flow component covered in Chapter IX, over half of the increase in the ratio of total foreign funding to GDP during the boom was subsequently gradually unwound.[2] This sudden stop in inflows contributed to deep recessions as the lack of new funding triggered declines in credit and domestic demand. In this context, countries with fixed exchange rate regimes typically had greater capital inflows during the pre-crisis years, but also deeper and more protracted slowdowns in the aftermath of the crisis.

Econometric analysis confirms the link between pre-crisis fundamentals and vulnerabilities and the severity of output contractions.[3] In addition to the financial linkages described above, other significant determinants of the impact of the crisis in the region were:

- **External vulnerabilities.** High current account deficits, high external debt, and low levels of reserve coverage were associated with sharper output declines. Excluding Russia's oil-related surplus, the average current account deficit in the CEE region stood at over 12 percent of GDP in 2007, compared to close to balance in Latin America and surpluses in most emerging Asian economies.
- **Trade linkages.** Countries whose exports make up a larger share of aggregate demand saw greater output losses, reflecting the growth slowdown in advanced European trading partners and the increasing interconnectedness and responsiveness through supply chains. Commodity exporting countries such as Russia and Ukraine were also affected by sharp corrections in commodity prices.

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[2] IMF (2013a).

[3] Llaudes, et al. (2010).

Policy responses[4]

Governments responded to the collapse in economic activity with significant fiscal accommodation and monetary stimulus, and quickly adopted emergency measures to stabilize financial sectors. However, their ability to pursue countercyclical policies at the onset of the crisis was limited by the policy space and financing available. Countries that entered the crisis with stronger fundamentals and more buffers—better external and fiscal balances, lower public debt, and lower inflation—were able to respond with greater and more credible countercyclical easing. In cases where policy adjustment needs were large or external financing needs were insurmountable, countries requested IMF program support to smooth the required macroeconomic adjustment and secure additional external financing.

Since the financial sector bore the initial brunt of the crisis in the region, measures to safeguard financial stability and maintain the confidence of depositors and debt holders became the authorities' first line of defense:

- Reserve requirements were relaxed to pump liquidity in the financial sector in Belarus, Bosnia and Herzegovina, Hungary, Latvia, Romania, Serbia, and Ukraine. Similarly, new fixed-term domestic and foreign currency liquidity supply operations were introduced. These operations were often made possible through swap and repo arrangements with Western European central banks: for Hungary and Poland with the ECB and the Swiss National Bank, and for Latvia and Estonia with the Central Bank of Sweden.
- To minimize the risk of disorderly withdrawals of capital, the Vienna Initiative (see Box 8) helped ensure parent bank groups' commitment to maintain their exposures and recapitalize subsidiaries in, the context of macroeconomic support programs with the IMF and EU.
- The countries that had higher foreign reserves going into the crisis made greater use of them when the crisis hit, to avoid sharp depreciations that could have damaged corporate, household, and bank balance sheets. In particular, Russia made substantial use of its very high reserves to create space for corporates and banks to adjust to a revised global outlook with lower oil prices.

The monetary policy response to the crisis had to strike a balance between supporting the economy with easier monetary conditions and preserving financial sector stability by avoiding excessive exchange rate depreciation. As with other emerging markets, monetary responses to the crisis reflected differences in exchange rate regimes, external funding costs, and the level of pre-crisis policy rates:

- Countries where sharp exchange rate overshooting would have led to serious balance sheet effects raised policy rates temporarily (Hungary, Russia, Serbia, and Ukraine) or left them unchanged (Latvia and Romania). In general, countries with pegged exchange rates or those that were perceived by markets to be more risky—as reflected in higher bond spreads—had more limited space for monetary stimulus.
- On the other hand, countries with more credible monetary policy frameworks (such as Poland and the Czech Republic), reflected in low or falling inflation, provided more monetary stimulus.

The extent of fiscal accommodation depended on the available fiscal space in the given country. Higher pre-crisis primary balances and lower public debt levels allowed for greater fiscal accommodation during the crisis. Conversely, countries with limited fiscal space (like Hungary, which had run much larger deficits than other

[4] This section draws on Bakker and Klingen (2012) and IMF (2009).

countries during the boom) or needing to support fixed exchange rate regimes (the Baltics) were forced to adopt fiscal adjustment measures to boost market confidence in their policy frameworks.

Given the scope and magnitude of the crisis, many countries turned to the IMF for financial or policy support. The design and purpose of their IMF-supported programs reflected countries' specific circumstances. Many of them (Belarus, Bosnia and Herzegovina, Hungary, Latvia, Romania and Ukraine) were approved in the immediate aftermath of the global crisis, and took the form of large and front-loaded support packages aimed at avoiding crippling recessions. For EU members states these were joint programs with the EU. An arrangement with Serbia was first treated as precautionary but was quickly augmented and drawn upon. In 2009, Poland qualified for the newly-introduced Flexible Credit Line, a precautionary arrangement with no requirement to take additional measures, underscoring its very sound economic fundamentals and policy frameworks. Additionally, FYR Macedonia adopted a Precautionary Liquidity Line (which it later drew upon), an arrangement that recognized its sound fundamentals with focused and limited conditionality.

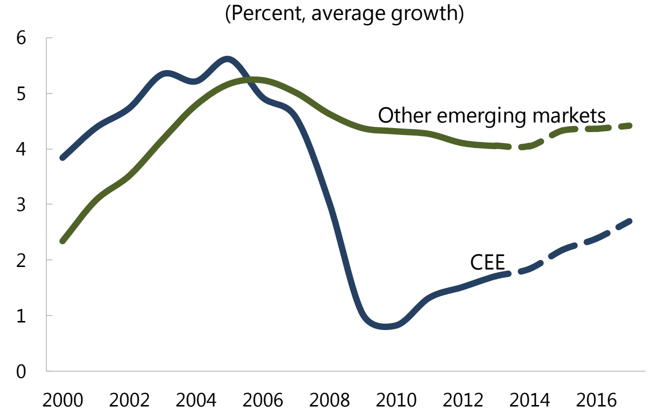
Fragile recovery

Almost all countries in the region saw a return to growth in 2010 and early 2011, with the rebounds tending to be strongest in the countries that had seen the largest output falls in 2009—notably the Baltic and CIS countries.[5] But a range of factors increasingly took their toll. The lingering effects of weak private and public balance sheets, along with the emerging euro area crisis, damaged growth through financial sector retrenchment and withdrawal of fiscal stimulus (as discussed in Chapters IX and XI) as well as effects on confidence, investment and trading partner demand. The result was a marked slowdown in growth in 2012 affecting every country of the region, with nine slipping back into recession.

The easing of the euro zone crisis since mid-2012 has given some respite. But the shocks have left lasting damage to regional growth prospects. While subject to a high degree of uncertainty, IMF estimates suggest that potential output for the region has declined sharply since 2008, and is likely to remain subdued going forward.[6] This contrasts with relatively unchanged estimates of potential output for many other emerging markets. The growth model that yielded increased income levels and economic convergence prior to the crisis is unlikely to be available going forward because the elements underpinning this model—strong trading partner growth and ample foreign bank financing—will probably not return soon. Instead, strengthening global competitiveness through renewed efforts to implement structural reforms, and restoring the capacity of the banking system to supply credit to the economy, are likely to be key prerequisites for raising potential growth in the future.

Potential output slowdown

(Percent, average growth)



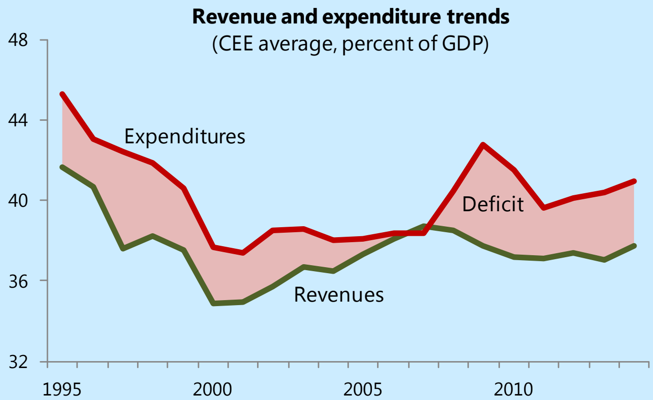
Source: WEO and IMF staff calculations.
Note: "Other Emerging Markets" includes Argentina, Brazil, Chile, India, Indonesia, Malaysia, Mexico, South Africa, and Thailand.

[5] The strength of recovery in Latvia, notwithstanding aggressive fiscal adjustment, has been the subject of considerable debate. Blanchard et al. (2013) set out the discussion and the evidence.

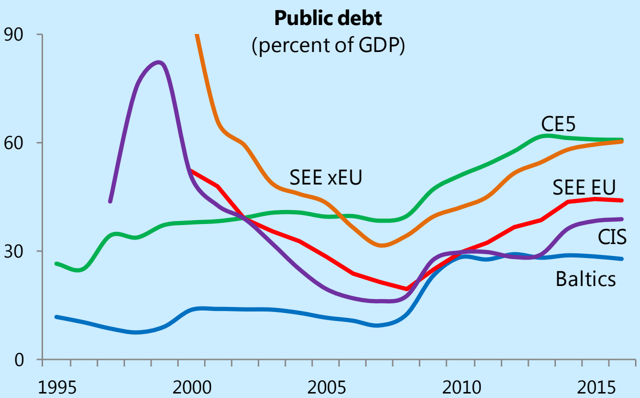
[6] See IMF (2013b).

XI. FISCAL POLICY

During the first decade of transition, amid volatility and weak growth, containing fiscal imbalances was an urgent task to achieve macroeconomic stability. After the initial phase was over, as fiscal institutions were modernized and income levels started to grow, the fiscal positions of most countries in the region improved significantly—especially as revenues benefited in the boom years that preceded the global financial crisis. The crisis prompted governments to take a range of adjustment measures, some in the context of IMF-supported programs. Looking at the region as a whole, a decline in deficits was achieved, but fiscal vulnerabilities remain high in a number of countries.

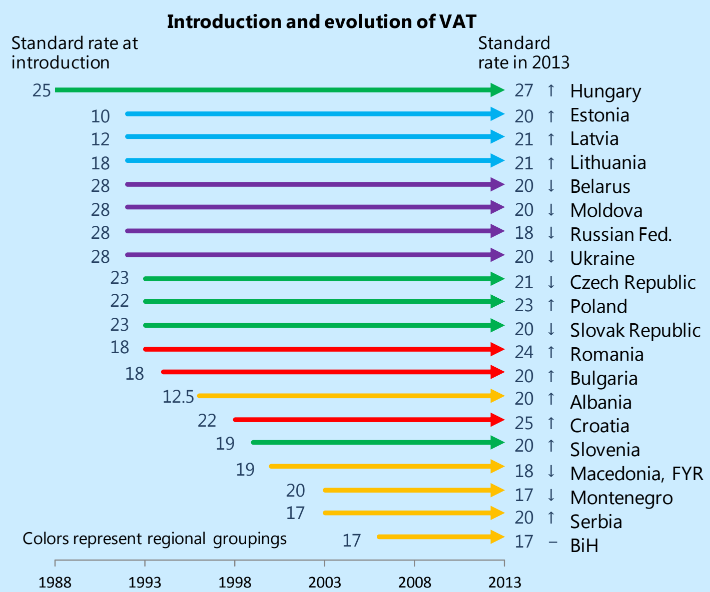


Source: WEO.



Fiscal challenges in the 1990s

At the beginning of transition, most countries experienced a dramatic decline in tax revenues. While output was collapsing, the tax system and administration was not prepared for the needs of a market economy.[1] The old system relied to a large extent on turnover taxes, taxes on enterprises and payroll taxes, and tax administration was largely based on negotiations between enterprises and government officials, rather than on a codified system with tax bases and rates clearly defined in law. With the transition to a market economy, dramatic increases in the number of enterprises put significant pressures on tax administration. Reforms to create new, modern tax authorities were essential, but progress varied across countries, with slower progress in CIS and SEE countries.



Source: IMF Fiscal Affairs Department.

The structure of revenues changed too. While payroll taxes remained a significant source of revenues, the collection of corporate taxes (former profit remittances) declined substantially. And trade liberalization led to a significant reduction in customs revenues. The main innovation in response was the introduction of value-added tax (VAT), which by 2000 had already been adopted in 17 countries. As well as improving resource

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Prepared by Daehaeng Kim, Dasenka Nestrovic and Marko Paunovic.

[1] See, for example, Tanzi and Tsibouris (2000).

allocation by reducing distortions in product and factor markets, this generally led to improved revenue performance, although the VAT share in total revenues varied significantly.[2]

Adjusting public expenditures in line with the sharply declining revenues was essential to maintain fiscal sustainability. As a result of price liberalization, many state companies stopped relying on government subsidies. Also, military expenditures declined significantly across the region, and capital expenditures were cut heavily. Public sector reforms improved control over wages. However, budget spending on social assistance increased, as governments took on more social responsibilities that had been shared with employers under the socialist regime. The transition also called for reforms in expenditure management systems. Under the existing systems, government institutions enjoyed financial autonomy both in collecting own revenues and in spending decisions. The challenge was to establish modern financial systems that enabled centralized budget planning and proper financial accounting for the central government.

But most countries succeeded in bringing their fiscal deficits under control during the 1990s, albeit some much earlier than others. Recorded general government deficits fell on average by 1¼ percentage points to about 3½ percent of GDP between 1992 and 2000—although the overall adjustment was probably greater, as in the initial years governments often had trouble controlling or even monitoring public enterprises' deficits, which were often financed by central bank credit or arrears. While the size of deficit reductions varied significantly across countries, spending cuts, particularly in current expenditures, have tended be more durable than revenue-based adjustments, contributing to successful fiscal rebalancing to put public finances on a sustainable path.[3]

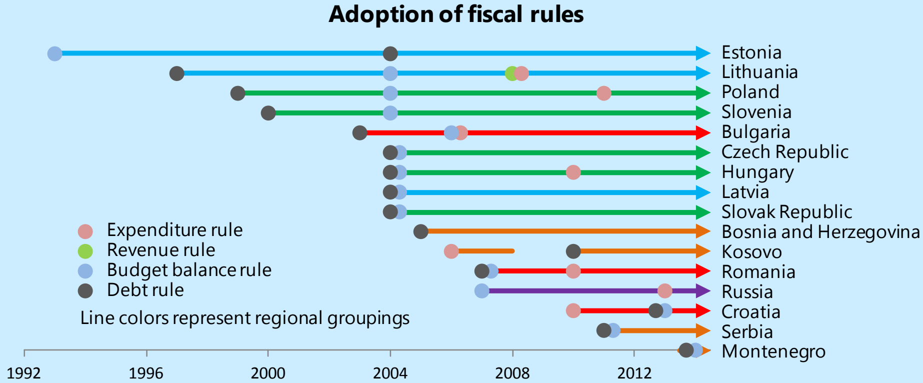
Despite the sizable deficit reductions, public debt increased considerably. The average public debt exceeded 55 percent of GDP in 2000, up from 19 percent in 1992–93. The increase was largely driven by CIS countries, where the recognition of off-budget and quasi-fiscal liabilities, and the more pronounced output decline, contributed to rising public debt. And within the average some countries (such as Bulgaria and Poland) saw decreasing public debt due to the impact of debt restructuring.

Fiscal developments during the boom years

The strong domestic demand-driven growth that characterized the mid-2000s was reflected in fiscal revenues, and the headline fiscal positions of most countries in the region improved significantly. Revenues grew faster than GDP, helped by strong revenues from profit and consumption taxes, while public expenditures grew in line with GDP on average—although within this current expenditures tended to increase as interest burdens fell. For most countries, lower deficits and high growth resulted in large reductions in debt to GDP ratios in this period—by as much as 50 percent of GDP or more over 2000-07 in Bulgaria, Moldova and Russia, the last helped by strong oil prices. Three Central European countries bucked the trend, however, with rising debt: although improving through the period, deficits averaged 4 percent of GDP in the Czech Republic and Poland, while Hungary had consistently large deficits, averaging 7 percent of GDP. Diversion of revenues into funded pension schemes accounted for part of Hungary's underperformance, but the main factor was weak fiscal discipline in the face of easy financing conditions. The Slovak Republic, in contrast, achieved large reductions in both deficits and debt in this period.

[2] For example, the Baltics witnessed large increases in VAT collection in 1992-1995 (from 3½ to 9 percent of GDP in Latvia), while across CIS countries the share of VAT collection in 1995 was well below 4 percent of GDP, even though VAT rates in the Baltics were generally lower. See Stepanyan (2003).

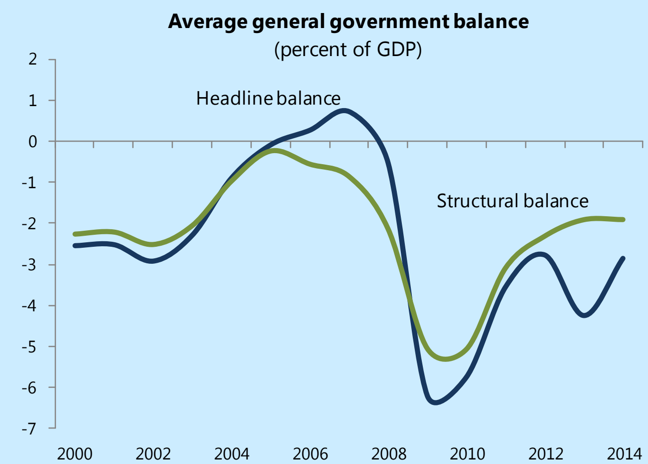
[3] See Purfield (2003).



Source: IMF Fiscal Affairs Department, updated by authors.

In fact, fiscal policy across the board turned out to be less prudent than it appeared at the time. The opportunity to use windfall revenues for more ambitious deficit reduction was forgone in many cases. Many countries adopted fiscal rules, with a view to imposing a durable constraint on fiscal aggregates. Supranational rules were adopted in the context of EU accession, and many countries adopted national rules as well. However, the rules were mostly based on budget balances, without careful consideration of business cycles, potentially resulting in procyclical fiscal policy. Looking back, estimates of structural deficits—that is, correcting for the effect of the unsustainable demand boom on revenues—show that underlying fiscal positions strengthened on average during the early 2000s, but actually deteriorated again from 2005, even though headline balances continued to improve. Weak corrective procedures and the suspension of sanctions for excessive deficits at the EU level contributed to further weakening of financial discipline.

Fiscal impacts of the global financial crisis



Note: Average for: BGR, CZE, LTU, POL, RUS, SVK and SVN.
Source: WEO.

The crisis of 2008–09 had very serious effects on the fiscal situations of the transition countries, with tax revenues dropping sharply as housing bubbles burst and domestic demand shrank. For example, in 2008, fiscal balances in Estonia and Latvia worsened by about 5 and 8 percent of GDP respectively. As discussed in Chapter X, fiscal responses to the crisis varied across countries, depending on their pre-crisis fiscal buffers, exchange rate regimes, and the political cycle. Despite serious fiscal adjustment efforts, the average fiscal balance for the region fell to a deficit of over 6 percent of GDP in 2009, with near-double digit deficits in some countries.

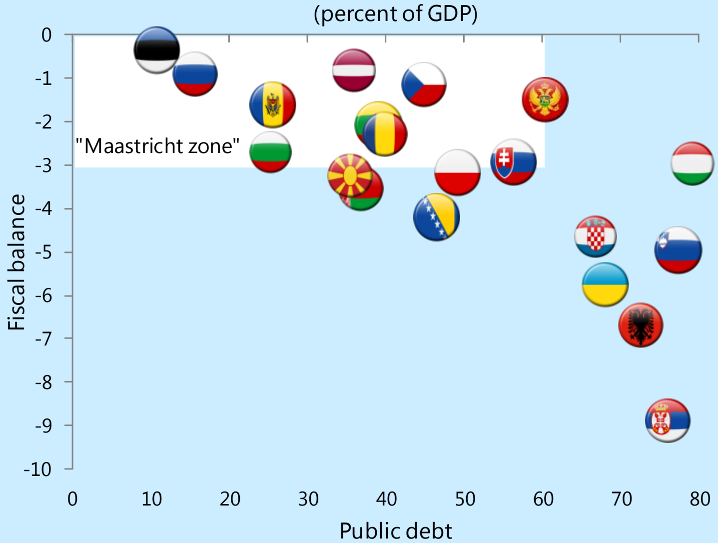
Subsequent significant fiscal consolidation, coupled with economic recovery, reduced deficits to a little over 3 percent of GDP on average by 2013. Fiscal adjustment was most dramatic in Latvia, Lithuania, Romania, Russia and the Slovak Republic, where deficits have declined by 5 percent of GDP or more since 2009. In contrast, many SEE countries saw deficits deteriorate in this period, in large part reflecting the effects of continued recession. The consolidation was mostly achieved through expenditure cuts. Looking at the region as a whole, revenues weakened by nearly 1 percent of GDP on average and were much more than offset by expenditure cuts averaging 2½ percent of GDP. Again, the results differ significantly by country. On one end of the spectrum, the Baltic countries adjusted expenditures by about 8 percent of GDP on average, while in Bulgaria, Croatia and Slovenia expenditures increased in terms of GDP. The successful fiscal consolidations stabilized public debt, but in Southeastern European countries that had less ambitious adjustment programs, public debt remains on an increasing path.

Fiscal challenges looking forward

Despite the declines in regional average deficits, fiscal vulnerabilities remain high in a number of countries. In 2014 deficits are set to remain above 4 percent of GDP in several countries, concentrated in the Western Balkans—some of which, along with Hungary, Slovenia and Ukraine, also have high public debt. In order to bring debt to a sustainable path the high deficits should be addressed promptly, including through growth-friendly fiscal consolidation alongside structural reforms to boost potential growth. Due to already high tax burdens, the focus of the adjustment, for most countries, will have to be on the expenditure side, as well as on strengthened tax administration.

In many countries, even where expenditure levels have adjusted, composition of expenditure remains an issue. Broad expenditure reforms, especially in heath, education, and other social sectors to increase targeted transfers and subsidies would increase the efficiency of public expenditure. Similarly, reducing quasi-fiscal activities while protecting capital spending, and consolidating medium-term budgeting practices would provide predictability, tailoring fiscal policy towards achieving its objectives, including growth and poverty alleviation.

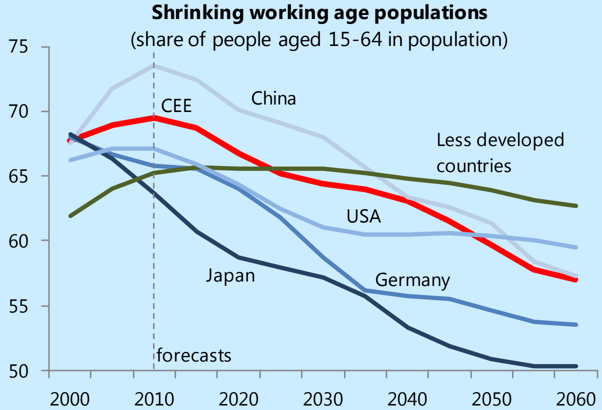
Fiscal projections for 2014
(percent of GDP)



Note: See country code box for country flags.
Source: WEO.

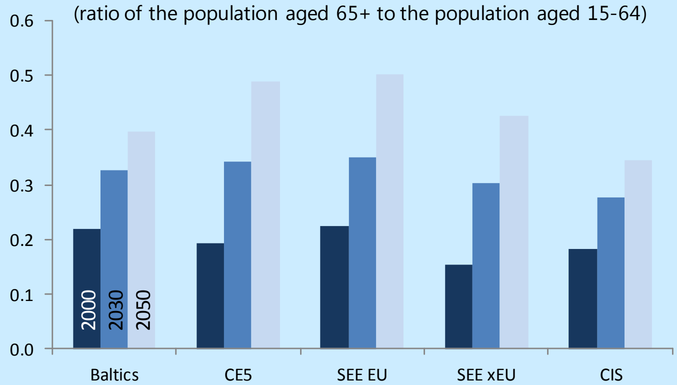
Demographic factors also pose major challenges to fiscal policy, as well as to growth strategies more generally. The working age share of the population is projected to embark on a secular decline from the middle of this decade on. The fact that these projections are no worse than for many other countries does not diminish the problem. As in advanced European economies, the most direct impact of aging populations and shrinking labor forces is on already overstretched state pension schemes: the average old age dependency ratio in the transition countries is projected to more than double in 40 years, from 20 percent of the working age population in 2010 to 43 percent in 2050. Sluggish growth will only add to these pressures. Although countries have adopted a number of reforms through the transition—parametric reforms such as increased pension ages, strengthened contributions collection, and, in several cases, multi-pillar systems with a funded component—these are mostly insufficient for pension systems to sustain adequate benefit levels in the medium term. Raising retirement ages further, encouraging greater labor market participation—including of women, whose participation is quite low across the region—and strengthening incentives for voluntary saving for retirement, would aid the sustainability of pension systems, and boost growth.

Shrinking working age populations
(share of people aged 15-64 in population)



Source: UN, World Population Prospects (medium variant)

Elderly dependancy ratio
(ratio of the population aged 65+ to the population aged 15-64)



XII. 2014 AND BEYOND

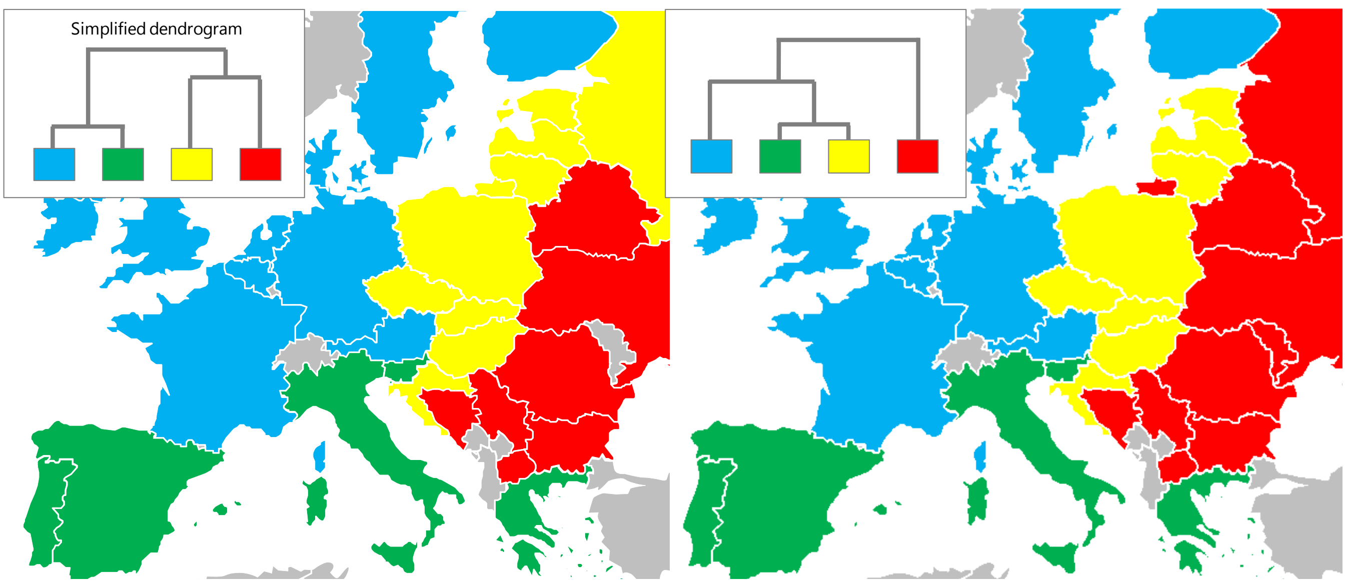
After 25 years, where do the transition countries stand, and where are they headed? Does it still make sense to think about this set of countries as a discrete group, or are the differences between them now greater than the commonalities? And what are the main policy priorities looking forward to the next 25 years?

Country situations in 2014

The transition countries have, for the most part, made remarkable progress in the past quarter century. Most are fully functioning market economies, with stable macroeconomics, strong institutions, and income levels that have converged strongly with the West. Indeed, cluster analysis provides evidence that the relative status of the transition economies within Europe has changed over time. Groupings based on a set of indicators expected to be associated with countries' state of development suggest that in the late 1990s, the continent remained divided along "traditional" west-east lines, with advanced countries on one side and transition countries on the other—albeit with Slovenia already displaying the characteristics of the advanced group.[1] Each of these clusters divided into two principal subgroups, again more or less along predictable lines. These relationships are represented by tree diagrams ("dendrograms") identified by the analysis.

Clusters in Europe

1998-2000 2011-2013



If we fast-forward to the latest data, we see that the continent continues to divide into roughly the same four clusters as before, with only a couple of countries changing groups. However, the relationships between the clusters—again, as shown by the dendrograms—have changed in an important way. The differential development

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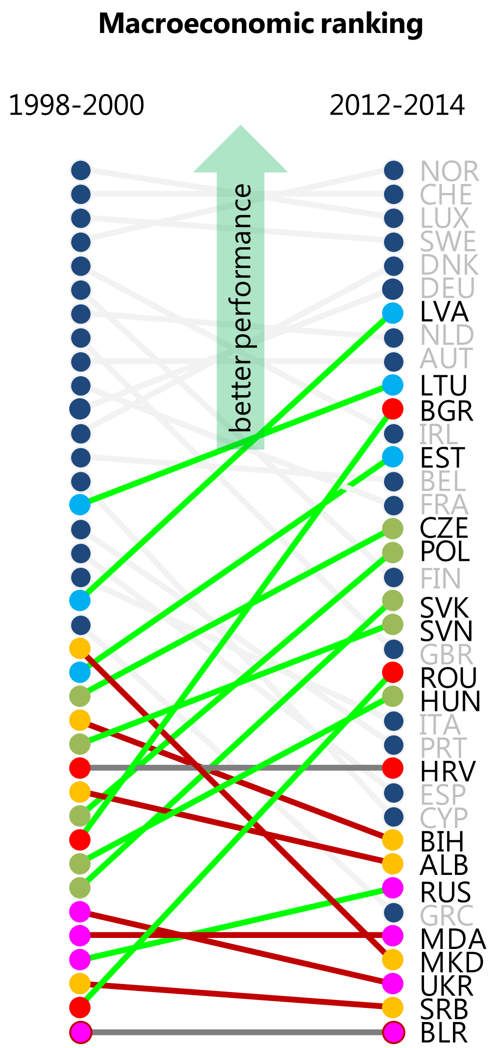
[1] Cluster analysis is a statistical technique that groups observations (countries in this case), by seeking to maximize similarities within clusters while maximizing differences between clusters, across a range of indicators. The exercise uses normalized series for GDP per capita at purchasing power parity (PPP), life expectancy, energy use per unit of GDP, the share of agriculture in GDP, and the Transparency International corruption perceptions indicator to proxy for institutional strength. Clusters were identified using three-year averages. In both time periods, per capita GDP had the strongest discriminatory power of the five indicators in identifying the clusters.

of the transition economies, with more rapid progress in Central Europe and the Baltics than in Southeast Europe and the CIS, has led to greater disparities between the two subgroups. Meanwhile, the effects of the global and euro zone crises have tended to drive the two subgroups apart in Western Europe as well. According to the latest indicators, these two processes have now progressed to the extent that the "advanced" CEE countries have more in common with the EU15 countries (and within them, the "southern" Europe subgroup) than they do with former Comecon partners to the east.



This general picture of a more "commingled" continent is also supported by a different approach based on a simple ranking of macroeconomic performance relative to advanced European country norms.[2] Taking three-year average values up to 2000, there was almost no overlap between "advanced" and "emerging" Europe. A decade and a half later, some of the CEE countries have moved deep into the former advanced territory, and the rankings are now highly interwoven between the two groups. This ranking also illustrates the growing disparities among the transition economies, as with the broader cluster analysis above—although here it is notable that in purely macroeconomic terms, the more "advanced" CEE countries are close to the best performers in Western Europe, and generally far ahead of the "southern" Eurozone countries.

Of course, any of these results can only be illustrative, and should not be overinterpreted, especially at the individual country level. But the general messages chime with other evidence of transition progress discussed in the earlier chapters of this report.

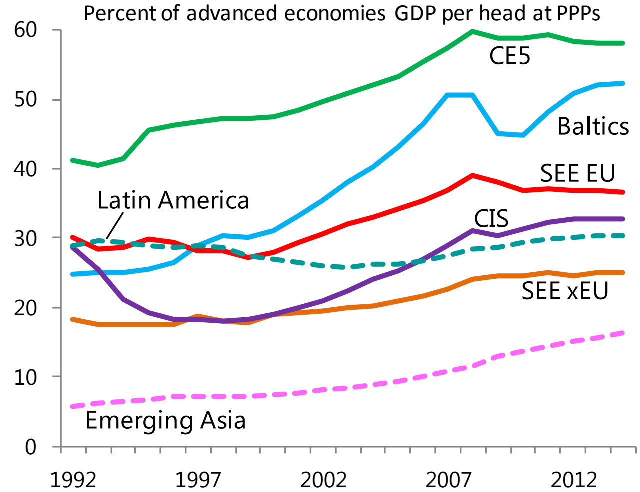
So, much as the overall progress of the transition economies is to be lauded, there are clouds around the picture. First, even after 25 years some countries have failed to make a decisive break with the past, or have seen former state command replaced with control by private interests. Such countries continue to struggle with low growth, high unemployment and uncompetitive industries, and risk getting left further and further behind.

[2] The macroeconomic ranking is based on a weighted average of seven macroeconomic indicators (current account balance, inflation, unemployment, government balance and debt, GDP per capita at PPP and real GDP growth). Weights were generated by principal components analysis of EU14 countries (EU15 excl. Luxembourg) using 2000–14 averages, which yielded results fairly close to equal weighting across the seven variables (with all taking the expected signs). The variables were normalized against 2000-14 EU14 benchmarks.

Second, even in the well-performing economies, the pace of convergence has slowed dramatically in recent years. From 1995 to 2008 the region as a whole was catching up towards average EU incomes at a rate of about 1 percentage point a year, from around 35 percent to nearly to 50 percent. Since the crisis this rate has dropped sharply. Measured against all advanced economies, most countries of the region have been flat or falling back. Relative incomes in Emerging Asia, in contrast, have continued to rise strongly, albeit from a much lower base.[3]

Income levels relative to advanced economies

Percent of advanced economies GDP per head at PPPs



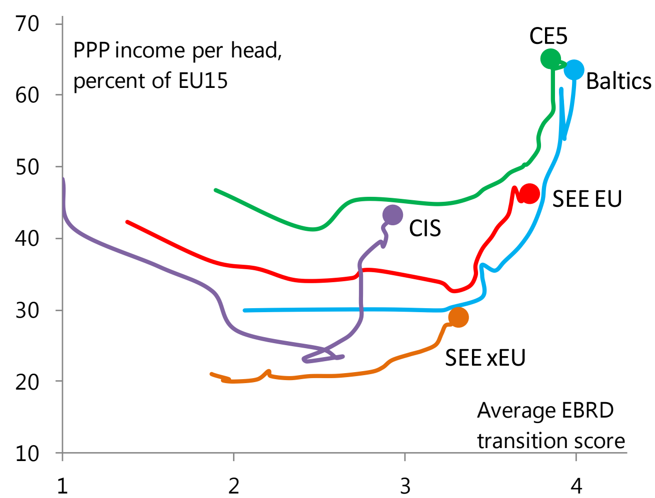
Source: WEO.

Relatedly, as discussed in Chapter X, estimates of growth potential going forward have been revised down drastically since the twin crises hit. If such projections materialize in the medium term, the process of convergence—on which the region still pins strong hopes—will be much slower than in the past, threatening disillusionment and posing risks to fiscal and social policies. The recent increase in geopolitical tensions within the region could also adversely affect prospects, the more so if the tensions are long-lasting. Uncertainty, if left unresolved, could lead to a decline in confidence, reducing investment and consumption across countries—and further depressing long-term prospects.

Policy priorities

What needs to be done to revitalize the convergence mdel and reduce the risk of some transition countries yet again falling back into crisis? The first priority is to ensure that policies are moving ***forwards, and not in reverse***. As noted in Chapter VI, the crises of 1997–98 tended to galvanize countries to pursue sound macro policies and structural reforms more vigorously, contributing to the successes of the subsequent period. In contrast, the recent crises appear to have resulted, in a few countries, in a more fundamental questioning of the direction of market reforms.[4] Perhaps this mirrors the effect the crisis has had in rethinking some of the orthodoxies of macro policies in the advanced countries. But it is important to draw the right lessons from experience. There seems little to suggest that the problems some countries ran

Reform and convergence, 1990-2013



Source: WEO, EBRD.

Note: Baltics, SEE xEU from 1992. Excludes CZE, MDA.

[3] Comparisons across other transition countries—especially those in Asia—are difficult, as they began with very different economic structures and political systems. For a discussion, see Sachs and Woo (1994).

[4] See EBRD (2013) for discussion of reform reversals and political factors associated with success in implementing market-oriented policies.

into during the crisis were due to "too much reform," or that a return to a more activist role of the state in industry or other sectors will help. Instead, as discussed in Box 4, there is good evidence of a strong relationship between reform and convergence, even if the payoffs from reforms sometimes take time to materialize. A better lesson from the crisis might be the importance of establishing strong legal frameworks and adequate macro-prudential controls: generally it was the countries that tried to rein in market excesses during the boom that did better in the bust.

The second priority is a renewed focus on ***macroeconomic and financial stability***. It has come as something of a shock after the "Great Moderation" period, when macroeconomic conditions seemed favorable across the region, that many countries—notably in the Western Balkans—are again facing persistent deficits and rising debt. These countries, which tend also to have high unemployment and high social needs, face a difficult political and economic challenge in restoring sustainability. In 2014 inflation has unexpectedly posed a challenge to macroeconomic policy from below in many countries—turning negative in as many as nine cases—while in some others (mainly in the CIS) it has risen well above target.[5] Finally financial sector stability—an area of strength in most of the region—has come under question in isolated cases, and high and rising NPL levels pose challenges more broadly.

The third priority is to increase the ***pace and depth of structural reforms*** going forwards. A key lesson from the past 25 years is that sound macroeconomic policies on their own are not enough to achieve convergence—which instead depends fundamentally on deep-seated structural and institutional change. Reform momentum has slowed since the early 2000s across almost all the CEE countries. For some this may reflect an element of "coasting" after the efforts to meet EU membership requirements for 2004 or 2007. It may also reflect the benign global conditions of the boom period, when countries could receive plentiful financing with our without needing to "prove" anything to foreign investors, and certainly without needing to satisfy conditionality from the IMF or others. Conversely, in the wake of the global and euro zone crisis, conditions were so difficult as to mean that energies were directed fully to crisis management rather than structural reform.

Consistent with the results of the cluster analysis presented above, the slowdown may simply reflect the fact that many of these economies are now more like "regular" countries, where reforms tend to be incremental, and to advance via deliberate political processes balancing the interests of stable segments of society. From this perspective the early window of opportunity for very rapid and radical change—exploited much more effectively by some than others, as discussed in this report—may now have closed. But just because countries are no longer identified solely as "transition economies" does not diminish the need to pursue ambitious policy agendas. After all, the strongest calls for structural reforms nowadays tend to be made in countries like Japan or in southern Europe, with no history of communism, which are struggling to restore growth prospects.

Specific policy recommendations vary from country to country, with IMF advice provided in regular consultation reports for each member country. Reflecting the diverging patterns of development discussed above, the most urgent and far-reaching reform priorities are concentrated in many of the Western Balkans and CIS countries. But consistent with the priorities put forward in the preceding thematic chapters, and as also spelled out in the IMF's

[5] See IMF (2014a), IMF (2014b) for discussion of inflation developments, as well as the impact of Ukraine/Russia tensions and other conjunctural issues.

October 2013 and April 2014 Regional Economic Issues reports, some common policy themes across the CEE region emerge as elements of pro-growth strategies:

- Strengthening the business environment is a critical factor throughout the region. This requires actions across a broad front, including corporate governance, property rights and contract enforcement, administrative reform and cutting "red tape," insolvency law and competition policy. Attracting FDI, further integration into global supply chains—also looking beyond Europe—and moving within these supply chains to higher value-added activities, will be strong determinants of growth potential. For a number of countries, legal and administrative reforms are needed to improve governance more broadly.
- More balanced composition of fiscal consolidation between expenditure and revenue, and measures to strengthen revenue administration and tax compliance. In many countries demographic pressures point to a need for further reform of pension systems, as well as for broader long-term fiscal consolidation.
- High NPLs highlight the need for strong and independent banking sector supervision, improved insolvency frameworks and judicial reforms. Reviving credit growth and broadening SMEs' access to finance remain critical in many countries.
- Incentives to raise labor market participation and reduce skill mismatches, with use of active labor market policies where appropriate. In some cases institutional reform is needed to reduce duality between formal and informal or temporary employment, while providing support to vulnerable segments of society

The IMF remains closely engaged across the region to help countries advance their policy agendas, continuing to adapt the mix of surveillance, program support and technical assistance as country needs evolve. From the initial urgent search for policy options as central planning collapsed 25 years ago, through good times and bad since, new challenges have constantly arisen compelling the close collaboration between the IMF and its member countries in the region. No doubt such challenges, and such collaboration, will continue through the next 25 years as well.

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