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GROWTH IN TRANSITION ECONOMIES

A REVIEW OF THE LITERATURE

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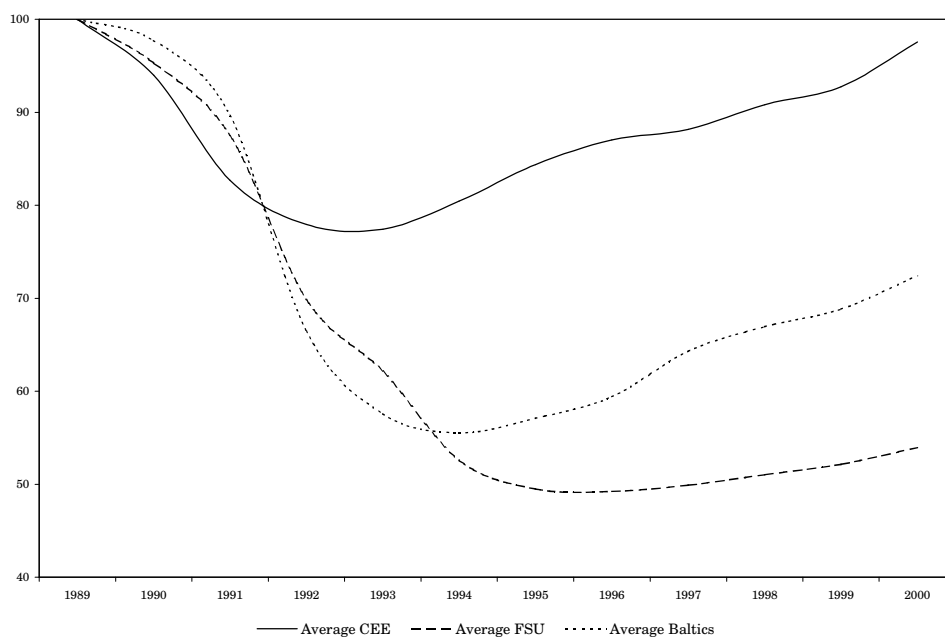
ABSTRACT

The abandonment of central planning led to considerable output declines in countries of the former Soviet-bloc. The magnitude and length of the output declines, as well as recovery experiences have been very diverse. This paper describes and examines the impact of various determinants of output growth, put to the fore in the literature. The central element in the transitional phase is the evolution to a market system. The closer to a market system, the more beneficial effects on growth are expected. Especially government policy -in a wide range of areas- is important in explaining both the time and cross-sectional dimension of output paths during the transitional phase. Government policies can be subdivided in macroeconomic stabilization and structural reform (including the creation of market-enhancing institutions). Macroeconomic stabilization is found to be a necessary, though not sufficient, condition for growth recovery. It is also necessary to put reform into force. This has a contemporary, disruptive effect on growth, but the stock of reform has an offsetting positive effect that starts to dominate at higher levels. Initial conditions are identified as another important determinant of macroeconomic performance at the start of transition. More unfavorable initial conditions lead to larger output declines. However, the effect fades out over time and can be overcome by stabilization and reform policies.

1. Introduction

In the early 1990s the Central and Eastern European countries (CEE), the Baltic States and the other former member states of the Soviet Union (OFSU), abandoned the communist rule. This paper focuses on the economic aspects of the transition from a centrally planned to a market economy. Obviously repercussions of the simultaneous social and political evolution should not be neglected. Figure 1 characterizes the economic evolution (in terms of real GDP): output drops enormously in the early years of transition and the recovery -if any- is slow. Individual country experiences have been diverse, but on average CEE-countries performed 'better' than the OFSU-countries; the Baltic states are in general more associated with CEE-countries. Note that about ten years after the start of transition the output level has on average not yet reached its 1989 level.

Figure 1: Real GDP paths in calendar time (domestic currency, 1989 = 100)



Source: World Economic Outlook Database, September 1999 (IMF)

Several studies empirically analyzed these common large output declines at the start of transition, followed by different recovery patterns across countries (see e.g. De Melo *et al.* (1996), Havrylyshyn *et al.* (1998) and Berg *et al.* (1999)). The period of transition from a planned to a market economy proved to be too specific to be captured within the traditional growth theory framework, which will probably be applicable after the transition period. The literature points to three important 'groups' of determinants of economic performance: reform, macroeconomic stabilization and initial conditions. Overall the best performing countries are those most committed to reform and most consistently pursuing their reform agenda. In this paper we review the theory and intuition behind these results, without going into country-specific details. Section 2 discusses stabilization, which can be thought of as policies aimed at inflation and fiscal balance adjustment. Stabilization is found to be a necessary condition for output growth to resume. Section 3 deals more extensively with reform, 'the process of *installing* a market economy' (e.g. price liberalization, privatization); in addition, market-enhancing institutions are developed to *sustain* the functioning of the market. Differences in macroeconomic, institutional and natural resource conditions prevailing at the start of transition, often argued to be an important determinant of output performance are the subject of section 4. Adverse initial conditions can nevertheless be overcome by anti-inflationary policies and committed reform. Section 5 concludes by briefly sketching a picture of the transitional experience.

2. Macroeconomic Stabilization

The collapse of the central planning system caused nearly all countries to experience three-digit inflation rates (see figure 2a). The upshot of inflation is due to the price jump following initial price liberalization. This eliminated the existing repressed inflation¹ from previous years. However, in most countries (particularly in the OFSU) inflation remained at very high levels because of

monetary financing of fiscal deficits. The latter arose because the loss of government revenues was not accompanied by a cut in government expenditures. The fall of revenues is due to an erosion of the tax base (~ output drop) and inadequate 'tax-coverage' of (privatized) firms. Since debt markets were underdeveloped or did not yet exist, governments had to resort to monetary financing (Budina and van Wijnbergen (1997)). The pressure for monetary expansion was further exacerbated by off-balance expenditures². The monetization of (quasi-)deficits put additionally upward pressure on nominal wages in order to maintain real wages at their purchasing power level.

Loungani and Sheets (1997) present empirical evidence on the negative impact of inflation upon subsequent GDP growth for a panel of 25 transition countries. For a larger sample of inflation crises Bruno and Easterly (1998) find that growth becomes negative during inflation crises (>40% annual inflation) and positive afterwards. Following Fischer *et al.* (1996), figure 2a shows the profile of real GDP growth and inflation (averaged over 24 transition countries) in 'stabilization' timing³. Real GDP growth starts to recover during the year of stabilization and becomes positive two years after stabilization, inflation comes down drastically when stabilization is started and remains relatively low thereafter.

¹ Fixed quotas of goods were delivered at state-managed prices. Given the shortage of goods and since prices did not rise, cash paid wages rising beyond GDP growth implied an accumulation of financial assets. (De Melo *et al.* (1996))

² E.g. subsidies taking the form of loans granted by state-owned commercial banks, wage and pension arrears. This is often referred to as the quasi-fiscal deficit, since sooner or later this will come back to the budget. Direct credit from the central bank to state enterprises (under government pressure) also increased inflationary pressures.

Figure 2a: (Unweighted) Average of inflation (LHS) and real GDP growth (RHS) in 24 transition countries

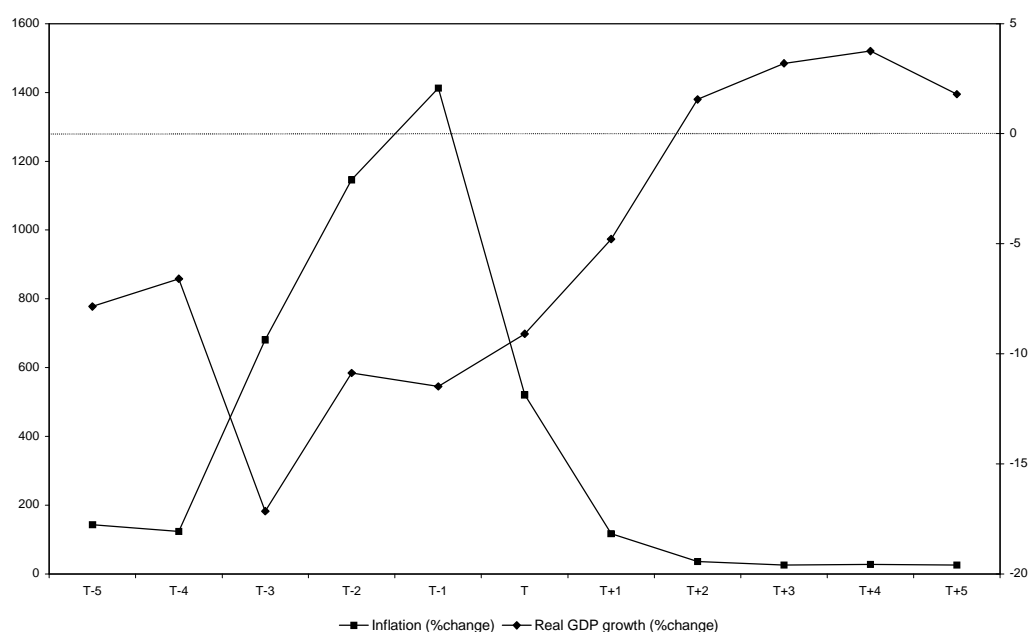
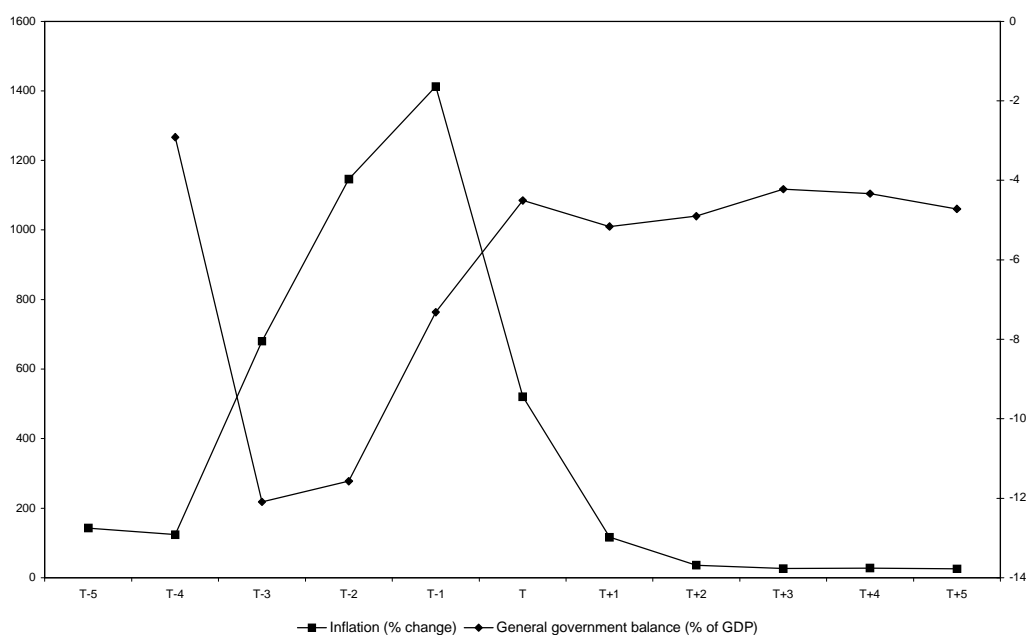


Figure 2b: (Unweighted) Average of inflation (LHS) and general government balance (RHS) in 24 transition economies



Source: Data: *World Economic Outlook Database September 1999 (IMF)*
Transition Report 1999 (EBRD) (General government balances)
 Stabilization dates: *Fischer et al. (1996)*; (Year T is then the year in which inflation stabilization is implemented, T+i are then preceding and following years.)

³ Year T is then the year in which inflation stabilization is implemented, T+i are then preceding and following years.

Two, often mentioned, accompanying measures for inflation stabilization are the reduction of fiscal deficits and a proper exchange rate regime. Without a reduction of the fiscal deficit, high interest rates -needed to fight inflation- would take government debt to higher (unsustainable) levels. In the absence of well functioning debt markets this would necessitate monetary financing (or a default on government debt). Figure 2b shows the profile of government balances and inflation. Government balances start improving the year before stabilization and remain stable afterwards, thereby enabling inflation stabilization. Marked improvements in government balances are associated with the reductions in inflation. Traditionally it is also argued that a fixed exchange rate allows using the credibility of the anchor to bring inflation down. Evidence on the role of a nominal exchange rate anchor in stabilization is not clear, however. Budina and van Wijnbergen (1997) find that both floaters and peggers succeeded in stabilization. On the other hand Fischer *et al.* (1996) find a fixed exchange rate to be an important component of successful inflation stabilization in addition to improvements in the fiscal balance. The problem at the empirical level is that a whole range of exchange rate arrangements is classified either as fixed or floating in order to create a dummy variable. E.g. Poland switched from a pure fixed exchange rate to a pre-announced crawling peg in 1991 to secure its international competitiveness (Papazoglou (1999)), but both are classified as 'fixed'. Some countries also announced a flexible regime, while the exchange rate was *de-facto* pegged to the dollar.

On a more disaggregated level differences between CEE- (including the Baltic States) and FSU-countries have been stressed. FSU countries had -on average- a much higher inflation, a lower growth rate and a worse fiscal balance than CEE countries. At the individual country level Armenia, Bulgaria, Mongolia, Romania and later Belarus and Uzbekistan recorded positive growth rates while inflation was still above 40%. In the case of Bulgaria and Romania positive growth preceded the reduction of inflation. After a few years growth rates became negative again in these two countries, confirming inflation stabilization

as a necessary condition for output recovery. In the other four countries inflation was only slightly above 40%.

Based on these findings stabilization of high inflation to relatively low and stable levels has been argued to be a prerequisite for growth to resume. It is tempting to conclude that stabilization is a sufficient condition. Fischer *et al.* (1996) warn however that, unless key structural reforms (specifically price liberalization and de-monopolization) have been implemented, inflation cannot be reduced to very low levels without adversely affecting growth because firms need access to easy credit. Papazoglou (1999) also stresses the importance of accompanying structural measures for successful stabilization. The analysis of Bruno and Easterly (1998) suggests that, once below 40% a further reduction of inflation no longer affects growth (no negative effect either though). Johnson *et al.* (1997) show that stabilization cannot lead to growth without depoliticization and institution building.

In sum, the literature shows that inflation reduction to a level below $\pm 40\%$ is a necessary condition for the recovery of growth, further reduction does not seem to yield any effects. A sustainable government balance (particularly when debt markets are underdeveloped) typically facilitates a successful inflation stabilization. The evidence of an inflation reducing effect of a fixed exchange rate regime is moderate. Inflation stabilization is by no means a sufficient condition for output growth to resume. It is also necessary to implement structural reforms.

3. Reform

Kornai (1994) identifies two key elements of the transition to a market economy: the move from a sellers' to a buyers' market (by price liberalization in order to install adequate incentives, trade and foreign exchange liberalization) and the enforcement of a hard budget constraint (by means of privatization, elimination of subsidy programs and creation and liberalization of a financial market).

Blanchard (1997) offers two more essential elements of the process of change: restructuring within surviving firms in search for cost and productive efficiency (via new investment and labor rationalization) and reallocation of resources from old to new activities (via closures and bankruptcies combined with the establishment of new enterprises). The ability of transition countries to reallocate resources toward their best use and to establish institutions to that end has been a major determinant of transition patterns (De Melo *et al.* (1997)). The idea is that the closer a country is to a market economy, the more it benefits from the market's growth generating (allocational) efficiency. Empirically it is found that new reform is costly in terms of growth because of adjustment costs. Eventually these costs are offset by the positive impact of the stock of reform.

Throughout this section we will provide measures of progress in different reform areas as prepared by the European Bank for Reconstruction and Development (EBRD). On average, CEE-countries (including the Baltic States) have made much more progress than OFSU-countries. Across areas there is considerable variation. Most advanced is small-scale privatization and foreign exchange and trade liberalization. Progress in competition policy, non-banking financial institution reform and enterprise reform is somewhat weaker. In what follows we will deal more explicitly with these different categories.

3.1 reform and democracy - gradualism vs. big bang

Economic transition coincided with the move from an authoritarian political regime to a democratic one. This raises the question, which of the two regimes is more favorable for transition. From a theoretical point of view arguments can be raised favoring either regime. Given the difficulty of reform, an authoritarian government might be needed to implement it. On the other hand, a democratic government does have more legitimacy. Certainly in the case of transition economies, where democracy and civil liberties were among the most important aspirations of people, legitimacy is an important element. Moreover institutional changes that support democracy are also likely to be beneficial for economic transition. Dethier *et al.* (1999) find that democracy has facilitated

economic reform. Political stability (measured by government turnovers) has no significant impact upon reform, indicating the irrevocability of the reform process. Once again there are marked differences between CEE- and OFSU-countries. In OFSU-countries civil society was weaker and the old elite battled with reformers over power, slowing down political and economic reform. In CEE countries civil society developed more rapidly, resulting in a smoother process of market-oriented reform.

A debate emerged whether the implementation of reform should be gradual or whether it should take the form of a 'big bang'.⁴ This relates both to the approach within a specific area and across different areas. Advocates of a 'big bang' approach stress the complementarity of reforms in different areas. Another obvious argument in favor of a big bang is that governments may want to use the euphoria induced by the fall of communism to implement painful reforms. The higher reversal costs compared to a gradual approach make a reversal less likely. In turn this would lead to better investment (and consequently output) performance. However, Dewatripont and Roland (1995) note that the outcome of transition will not necessarily be a version of the West German miracle, which is too often assumed. Taking into account this uncertainty, the possibility of an unfavorable outcome makes a big bang approach with its high reversal costs *ex ante* less interesting. Gradualism on the contrary, makes it easier to start and (if necessary) slow down or adapt reform. Moreover successful initial reform will bring people to accept more painful reforms in a next stage. Clearly, the sequence of reforms then becomes very important. Bruno (1992) warns for an intertemporal political trade-off: costly programs might lead to political reversal at a later stage. Two facts support this view: when going through the democratic process big bang programs have been substantially modified and in general reformers have been voted away and have been replaced by more conservative governments (even former communists). Reform has nevertheless been continued, be it at a more gradual pace. The classification into two opposites is useful to illustrate the debate, but it is much too strict. Reform turned out to be a highly complex

package of 'big bang' measures in some fields and gradual movements in others, depending on the specific situation and choices of each country.

3.2 price liberalization and foreign exchange and trade liberalization

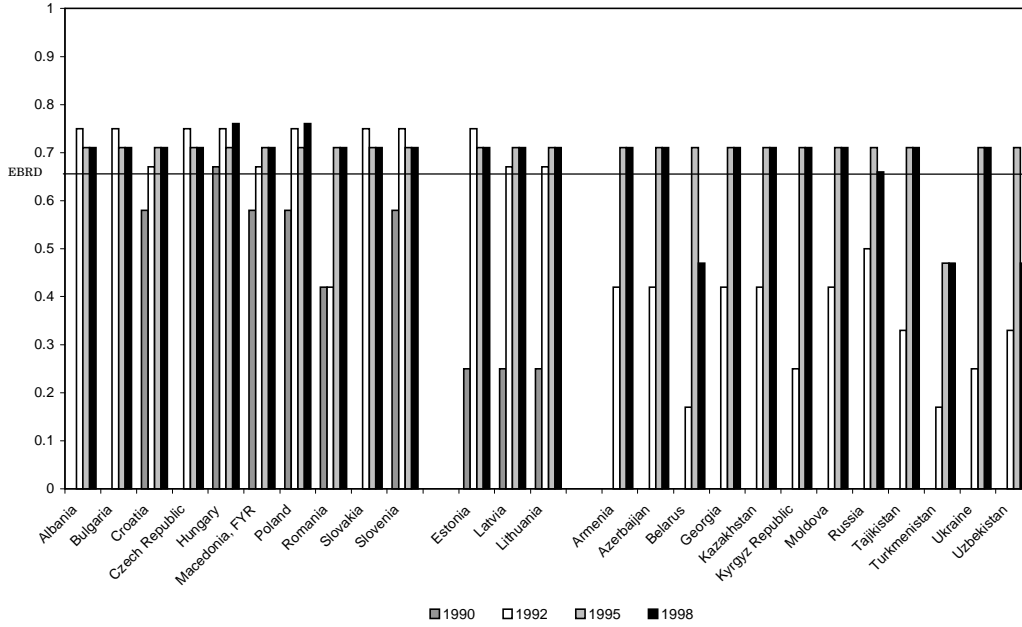
In a market-based economy, prices serve as a mechanism for efficient allocation of resources. Under central planning the government controlled both prices and production, excluding any signaling function. Price liberalization is thus an essential step towards a market economy. Benefits of international trade are widely known (e.g. impact on technological change and productivity). During the communist era trade in Eastern Europe and the Soviet Union was highly inward oriented towards trade with each other. This trade dramatically fell because of the disintegration of the inter-republic payment system and trade links (e.g. the collapse of the Council for Mutual Economic Assistance (CMEA)) and the fall in incomes and demand (Havrylyshyn and Al-Atrash (1998)). Integration in the world economy requires considerable changes in the 'communist' trade regulation. Existing tariffs, import (export) restrictions and other regulation can be large impediments to trade and FDI flows and consequently growth. E.g. the experiences in SouthEast Asia suggest that an export-oriented strategy can be a successful development promoter. The move to current (and/or capital) account convertibility is another crucial issue: international trade requires access to foreign currency (for current account transactions). Under communism legitimate access to foreign exchange was extremely limited and in most cases incoming foreign exchange from exports was immediately converted in domestic currency.

Figure 3a shows the progress made in price liberalization, figure 4b offers an overview of progress with respect to foreign exchange and trade liberalization. Following EBRD (1999) a score of about 0.85 for foreign exchange and trade liberalization (full current account convertibility) and a score of 0.65 for price liberalization (most prices free except for housing rents and infrastructure tariffs) indicates a 'liberal' policy stance. CEE-countries and the Baltic States

⁴ See the introduction to Dewatripont and Roland (1995) for a list of references favoring either 'gradualism' or 'big bang'.

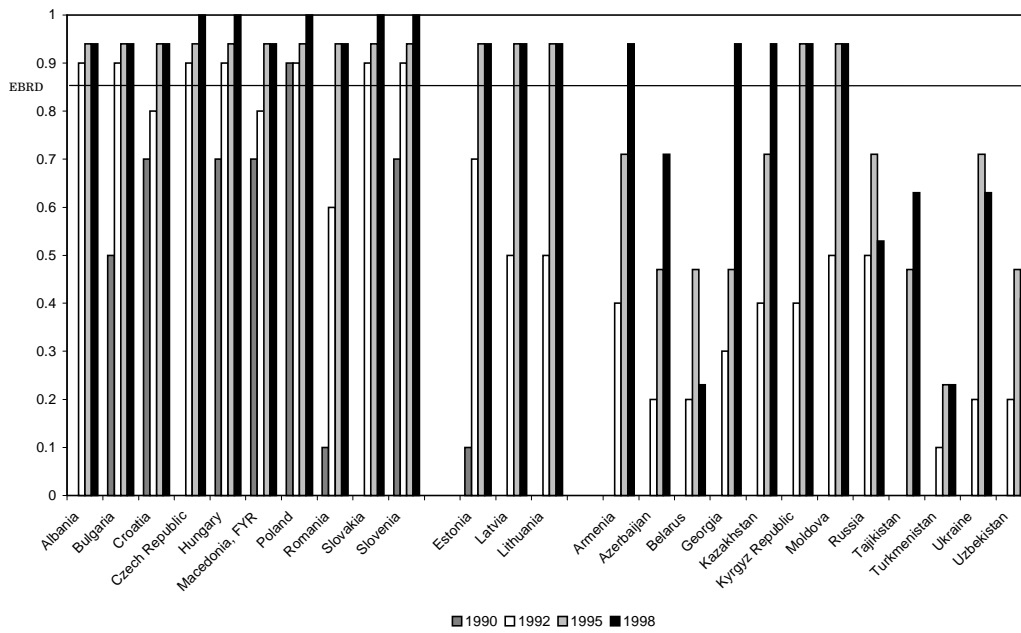
satisfy both criteria, several OFSU-countries still need to improve foreign exchange and trade liberalization.

Figure 3a: Price liberalization



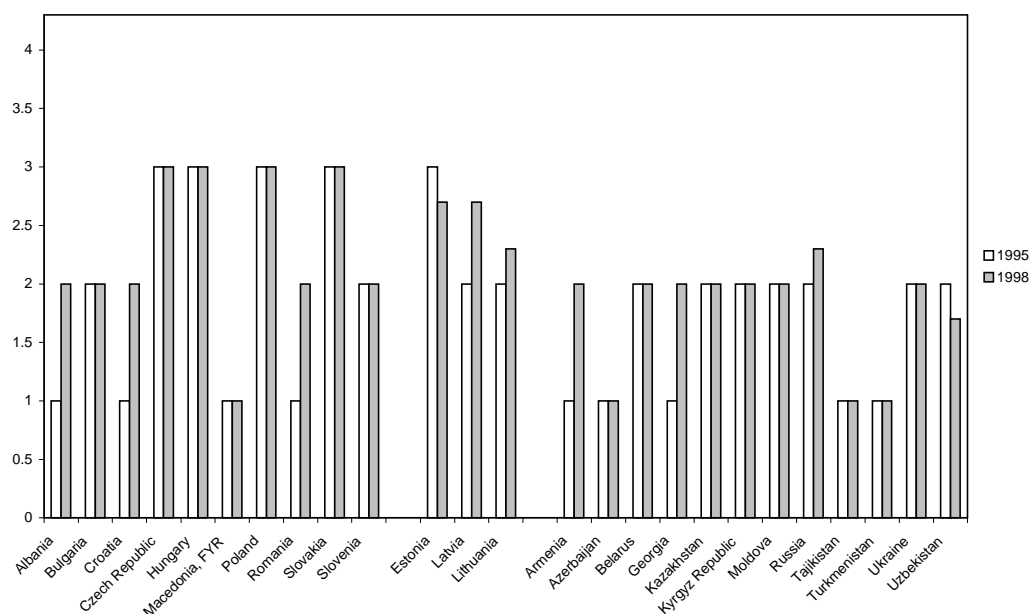
Source: EBRD Transition Report 1999

Figure 3b: Foreign exchange and trade liberalization



Source: EBRD Transition Report 1999

Figure 4: Competition Policy



Source: EBRD Transition Report 1999

3.3 privatization and restructuring

In most countries private ownership was almost non-existing, even a large part of the housing stock and the small shops were state property. As a unit of production, state-owned enterprises (SOEs) were a failure (Brada (1996)) because private ownership of productive assets is needed for agents to receive and respond to market signals. Privatization is thus another crucial step in the reform process. Although the importance of privatization was acknowledged at the start of transition and the private sector share in GDP is well over 50% in most countries now, privatization turned out to be a cumbersome process. In general small firms have been privatized fast, comprehensively and relatively successfully; the privatization of large SOEs proved to be much more cumbersome (see table 1). E.g. in the Czech Republic the state still has a majority stake in major utilities and 40 large firms and banks, designed as 'strategic' (Havrylyshyn and McGettigan (1999)). Inside opposition from managers and workers, fearing the loss of income and social benefits (e.g. housing and health care were provided by SOEs), and the fear of reformist governments to be swept away are the main sources of reluctance to privatize.

Table 1: Average values of the EBRD indices for small and large scale privatization and enterprise reform (a value of 4.3 denotes a situation comparable to a market economy)

	<i>Privatisation</i>				<i>Enterprise reform</i>	
	<i>Small scale</i>		<i>Large scale</i>		1994	1998
	1994	1998	1994	1998		
Average CEE	3.60	4.01	2.50	3.23	2.50	2.57
Average Baltic States	3.67	4.10	2.67	3.33	2.33	2.80
Average FSU	2.25	3.16	1.75	2.53	1.33	1.87
Total Average	3.00	3.62	2.22	2.94	1.91	2.27

Source: own calculations with data from the EBRD Transition Report 1999

Privatization and the move to the market economy aim at gains in productivity by stimulating productive efficiency and offering greater motivation to managers and workers, which in turn fosters economic growth. The debate on how to achieve this can be divided into two schools (Havrylyshyn and McGettigan (1999)). The first school argued that private owners have greater incentives to improve efficiency since they bear the financial consequences of their actions. Moreover the highly uncertain 'transition' environment also requires more effective entrepreneurial skills. Managers will be chosen on their abilities, not on political or ideological grounds. Therefore faster privatization, implying faster efficiency improvements, is preferred. Actual events have forced advocates of this line of thought to qualify their arguments. Their idea was that good property rights by themselves were sufficient to assure a good functioning of the market; market institutions and a competitive environment were expected to arise following privatization, independent of the manner of privatization or government actions. This overlooks the fact that certain circumstances (in particular the high existing concentration) may yield private firms with monopoly power as the outcome of privatization. It is highly unlikely that exactly these firms would be the strongest advocates of competition. Figure 4 shows that policy makers have also neglected competition policy. The other school defends almost the opposite, namely that the creation of an adequate market environment would be sufficient to separate viable firms, entering in a phase of restructuring and 'bad' firms, going out of business, all without a need for immediate privatization. An appropriate market environment comprises macroeconomic stability, competitive markets, hard budget constraints and property rights. The latter should offer entrepreneurs protection of the rewards from their efforts and risk taking. Hard budget constraints imply the abolition of state subsidies, soft credits and the acceptance of tax or interenterprise arrears.

They prompt managers to restructure their firms, restraining them from lobbying for government support instead.

With respect to the sequence of privatization of different industries the importance of the responsiveness to outside shocks is stressed. Since private firms are more able to interpret market signals, areas where a lot of information is transmitted and where signals are more volatile should be privatized first (Megginson and Netter (1998)). Husain and Sahay (1992) qualify this intuition by noting that the flexibility to respond to price signals of the economy as a whole might be restricted to that of the state sector if sectors are highly interdependent. An optimal sequencing rule then implies maximizing the gains arising from flexibility (adjustment to market signals) and minimizing the distortion arising under oligopoly (result from privatizing a highly concentrated market). The outcome is that “the sector facing relatively less uncertainty and containing the relatively less concentrated industrial structure should be privatized first”.

Firms should also be restructured in search for cost and productive efficiency in order to survive in a competitive market environment. Restructuring took place both in SOEs and privatized firms. Two types of restructuring can be discerned: ‘defensive’ and ‘strategic’ restructuring. Most SOEs engaged in ‘defensive’ restructuring as a response to expected greater competition and possible upcoming privatization. Defensive restructuring mainly consisted of measures to cut costs (labor shedding, energy saving). This is unlikely to be sufficient in order to survive long in a market environment, but it helps to survive in the short run. Strategic restructuring on the other hand comprises -next to cutting costs- substantial (outside) investment in a/o new products, new production techniques, human capital and the introduction of new managerial, ownership and financial structures. Strategic restructuring clearly enhances the chance to survive in the long run. Nevertheless not every privatized firm has opted for strategic restructuring. All this made it difficult to observe a clear association between improvements in performance and privatization. In this respect the privatization technique used has been widely investigated as a possible determinant of subsequent enterprise performance.

Table 2 offers an overview of the most important techniques with their respective pros and cons. Different (combinations of) techniques have been used with varying success (see e.g. Brada (1996)). Governments faced a trade-off between maximizing revenues and targeting sales to preferred investors. In most cases political constraints⁵, rather than economic arguments determined the government's choice. The (consensus) conclusion arising from the empirical literature is that no single method can be shown to be universally better; the ownership structure, financing effects and the skill and resolution of agents involved seem to be more important determinants of the likelihood of a successful privatization and restructuring (Havrylyshyn and McGettigan (1999)).

A stylized fact is that newly established firms always perform better than any type of privatized firm. As with competition, much less attention was paid to the establishment of *new* small and medium-sized firms. Note that privatization and the creation of new firms are possibly interdependent: if privatization leads to restructuring and freeing up of assets and (potential) human capital, this is complementary to the creation of new firms. These new firms then serve as an engine of growth because they foster human capital accumulation, are very dynamic in terms of job creation and do not need to undertake costly restructuring. Moreover the links between the state and the enterprise sector further break down.

⁵ Political considerations required governments to avoid a sell-out to foreign investors, but at the same time little domestic financial savings were available for something considered as a risky investment.

TABLE 2: Different methods of privatization and their pros and cons

Method	Definition	PRO	CONTRA
Restitution	Return of state assets to rightful owners	<ul style="list-style-type: none"> - restore public confidence in legal framework 	<ul style="list-style-type: none"> - complicated claims prolonging the process - disrupt production by splitting up collective ownership in small holdings
Direct asset sales & share issues	Given the underdeveloped domestic capital markets, state assets are sold to outside investors directly or through a public share offering	<ul style="list-style-type: none"> - revenue earnings - flexibility - introduction of outside expertise - promote development of national stock market (in case of share issue) - build reputation through fair issues - need to establish regulatory framework 	<ul style="list-style-type: none"> - lack of domestic capital to invest - complex administration when preparing state assets for sale (e.g. reliable accounting data) - politically infeasible given the resulting unequal distribution of assets - too fast, weak established regulations
Management-employee buyouts (insider privatization)	Sale or donation of shares/assets to some combination of managers and employees (~'inside' investors)	<ul style="list-style-type: none"> - feasible and popular given powerful positions of managers or employees in some countries - easy and fast implementation possible - possibly aligning incentives of workers and owners 	<ul style="list-style-type: none"> - inequitable; employees-managers, not population at large, benefit - opposition to restructuring: excessive wage increases, above optimal employment, insufficient investment - insiders lack 'market skills'
Mass privatization	Government gives away (or sells for a nominal fee) vouchers that can be used to purchase shares in enterprises (possibly with restricted post-sale trading of stocks)	<ul style="list-style-type: none"> - helps to overcome shortage of domestic capital, moreover increased participation may foster the development of capital market institutions, stock markets and corporate governance - fairer and more transparent than other techniques (also avoids difficulties of valuing enterprises) - avoid sellout of national assets to foreigners - form opposition to privatization process 	<ul style="list-style-type: none"> - dispersed ownership structure with negative impact on corporate governance - pooling of ownership in funds to overcome the previous problem gives rise to a new monitoring problem: who monitors the monitor (i.e. the fund management)? - Accompanied by quick establishment of a legal framework, resulting in weak legal framework and poorly defined property rights

Privatization is an ongoing process and it may still take several years to clearly see the effects, but the following consensus picture is emerging. To achieve productivity gains and economic growth privatization as well as an appropriate market environment is necessary; they are even mutually re-enforcing. The method of privatization turns out not to be that important for enterprise performance, since it is only the first step in a longer process of changes in ownership structure. This ownership structure and the skills and resolution of the agents involved are much more important. Finally, newly established firms outperform privatized firms.

3.4 development of a financial system

Under communism most financial transactions were part of the planning system (Hermes and Lensink (2000)). The central bank, often nothing more than a central office of book keeping, transferred deposits from state-owned savings bank(s) to lending bank(s). Lending banks granted credits as described in 'central plans'. The only other financial institution in some countries was a state insurance company covering commercial risks for exporting firms (Caprio (1995)).

Surveys by Levine (1997) and Tsuru (2000) indicate that the development of financial markets and institutions is a critical and inextricable part of the growth process in any country. The question arises whether a bank-based system, a market-based system or some combination of both should be adopted in transition economies. Tsuru (2000) argues that transition economies have no alternative but to adopt a relationship-based system, with banks as the most important financiers. The main argument is that the requirement of a high quality legal framework -much more important for a market-based system- cannot be met. Moreover the information value of stock prices, which requires regular trading, is undermined by the existence of capital controls and the limited amount of domestic savings, resulting in thin stock markets. Mass (or voucher) privatizations of SOEs were expected to foster stock market development, but the success was limited.

It is thus not surprising that the development of a private banking sector received a lot of attention. Meyendorff and Snyder (1997) argue that the efficiency and health of a private banking sector is crucial for consolidation of initial reform. Megginson and Netter (1998) indicate that the banking sector should be among the first to be privatized and restructured because of the leading role it can occupy in the further transition process. This can be illustrated following Levine (1997) who defines five basic financial functions: mobilize savings, allocate resources, exert corporate control, facilitate risk management and ease trading of goods, services and contracts. Although savings were to a large extent inflated away (negative real interest rates), banks should be able to pool the remaining (and new) domestic savings in order to grant (longer term) credits for productive investments. Banks should of course assure savers of liquid deposits and rule out bank-runs. In this respect savings banks generally benefited from government deposit insurance⁶. However, given the disintegration of the state and consequently its doubtful position as guarantor and supervisor, greater reliance on basic regulation and incentives to ensure a sound financial system was desirable (Caprio (1995)). Another way to gain the public's confidence is to deliver some proof of expertise in identifying profitable projects. However, incentives for banks to mobilize resources were limited because credit ceilings were installed and simply because it was unprofitable. The latter follows from the high taxation of financial intermediaries and the unattractive lending opportunities (to large SOEs or to new firms). A private banking sector was also expected to guarantee the timely settlement of payments, necessary in the new market environment. Finally an improved financial system was also expected to contribute to more efficient resource allocation. Privatized banks freed from government dictates would then enforce financial discipline and grant loans based on commercial criteria. This implies efficient credit assessment and monitoring of the use of resources, as banks were hoped to become a source of dynamic corporate governance (Brada (1996)). Their involvement would also help to ensure that insiders do not divert resources at the expense of shareholders (Caprio (1995)). Banks would then lead the way in the restructuring of (privatized) SOEs.

⁶ Note that government deposit insurance may lead to moral hazard behavior on behalf of the

Table 3: Overview of some characteristics of the financial sector in selected years

	<i>Bad loans</i> (% of total loans)		<i>Banking sector</i> <i>reform</i>		<i>Non-banking</i> <i>fin. institution</i> <i>reform</i>	
	1994	1998	1994	1998	1995	1998
Albania	34.9 (95)	91.3	2	2	1	1.7
Bulgaria	6.8	12.9 (97)	2	2.7	2	2
Croatia	12.2	14.6	3	2.7	2	2.3
Czech Republic	35.8	26.7	3	3	3	3
Hungary	17.6	5.9	3	4	3	3.3
Macedonia, FYR	42.2 (96)	32.9	2	3	1	1.7
Poland	34.7	11.5	3	3.3	3	3.3
Romania	18.5	34.2	2	2.3	2	2
Slovakia	30.3	44.3	3	2.7	3	2.3
Slovenia	22	11.5	3	3	3	3
Estonia	3.5	4	3	3.3	2	3
Latvia	11	6	3	2.7	2	2.3
Lithuania	27	12.9	2	3	2	2.3
Armenia	34	7.9 (97)	1	2.3	1	2
Azerbaijan	15.7	19.6	1	2	1	1.7
Belarus	8.4	16.5	1	1	2	2
Georgia	23.9	6.5	1	2.3	1	1
Kazakhstan	14.9 (95)	7.3	1	2.3	2	2
Kyrgyz Republic	92.3	1.6	2	2.7	2	2
Moldova	16.3	4.6	2	2.3	2	2
Russia	5.9	4.6	2	2	2	1.7
Tajikistan	-	3.2	1	1	1	1
Turkmenistan	11.2 (95)	2.2	1	1	1	1
Ukraine	-	-	1	2	2	2
Uzbekistan	-	-	1	1.7	2	2

Source: EBRD Transition Report 1999

* Figures between brackets indicate the year if it deviates from the year denoted above

Progress in reform of the financial sector (see table 3) has been much slower than expected due to the lack of the required knowledge, skills and experience. Governments also avoided foreign investment, which could improve efficiency and health of privatized banks by bringing in expertise and capital (Meyendorff and Snyder (1997)). In addition direct competition from foreign banks was restricted. The most important problem is however that domestic banks suffer from 'debt overhang' and from the soft budget constraints prevailing under communism. Under communism banks granted credits without any profitability

banks.

or risk assessment and credits were paid back from the federal budget to the banks. Firms did not have to worry about liquidation, because a bankruptcy law did not exist. The resulting moral hazard behavior among firms and banks led to a massive stock of granted credits, of which a large part became uncertain to be redeemed (*cf.* the percentage of bad loans in table 3). This increased the risk of bank failures and discouraged granting credits for new projects.

Currently, soft budget constraints remain an important problem -be it to varying degrees across countries (Megginson and Netter (1998))- since banks may prefer to refund bad debtors instead of filing their petition in bankruptcy (a procedure has been installed, *cf. infra*). Doing this, they gain the potential repayment of previous debts (Perotti (1993)). If the government is a large shareholder or if it bails out loss-making firms more bad debtors will be refunded because the government considers the welfare of employees next to the pure monetary return. Banks may even try to trigger bailouts if they expect the government to give them a subsidy for it. Low liquidation values also lead to soft budget constraints. Because the liquidation value is related to the level of collateral this is especially problematic in transition economies. Collateral is scarce because of the absence of private wealth and poorly functioning markets for liquidated assets. Berglof and Roland (1998) also identify the poor quality of new projects as a source of soft budget constraints. Poor quality implies small differences in expected returns between new projects and refinancing. Given the sunk costs, this makes it possible that banks prefer refinancing. Hardening the budget constraint implies a credible commitment not to refinance and to liquidate an agent eventually. Given the high interdependence of firms a tough liquidation policy could create a knock-on effect, in the end putting the banks themselves in a difficult position. This 'too many to fail' problem leads to softer budget constraints. If the banks themselves can reasonably expect to be bailed out by the government, this will also lead to creditor passivity and soft budget constraints (Berglof and Roland (1998)). Continued refunding of unprofitable former debtors diverts resources away from new investment projects (bearing a cost in growth terms) and increases the risk of bank failures.

Roland (1994) argues that a screening mechanism is necessary to identify good and bad firms. Viable firms (possibly viable after debt relief) should become independent of the government (through privatization) and face hard budget constraints as client of a privatized bank. Bad firms should either remain under strengthened government control or be liquidated. This boils down to a clean up of banks' balance sheets, releasing them from incentives to concentrate finance on bad firms and enabling them to relocate lending towards the dynamic private sector.

3.5 market-enhancing institutions

The newly created market environment has of course to be backed up with appropriate market-supporting institutions. In this context law enforcement in general, a bankruptcy law and financial stability are often cited as indispensable institutions to ensure a proper functioning market economy.

Johnson, Kaufmann and Schleifer (1997) conclude from their analysis that the government should offer an attractive combination of institutions, public goods (e.g. law enforcement) and taxes, making firms choose to work officially. Regulations and especially excessive taxes, used to finance public goods, are however likely to induce fraud. Moreover the turmoil at start of transition offered a large scope for politicians/civil servants to pursue their own interests. The result was that firms were not established or that entrepreneurs opted to work unofficially, using 'public' goods provided by criminal organizations (e.g. protection). In transition countries these criminal organizations apparently succeeded in supplying an attractive 'taxation-public goods' combination that allowed for a good functioning of the unofficial economy. CEE-governments succeeded in quickly establishing an advantageous institutional framework, thereby keeping the unofficial economy small. OFSU-countries, on the other hand, had more problems putting the right institutions in place. The necessary reduction in government expenditure (because of the low government revenues at the start of transition) proceeded in a rather incoherent manner in the OFSU-countries. The supply of public goods is always among the first to be cut, since

it is easy to do so. But instead of limiting oneself to a few priority programs, OFSU-governments decided to cut expenses for all programs, keeping them half-alive and barely working (Cornia and Popov (1998)).

A bankruptcy law, one of the cornerstones of a market economy, was lacking in most transition countries. Insolvency legislation should enhance all parties' rights in a transparent and equal way; procedures aim at maximizing and protecting the value of the insolvent entity (EBRD (1999)). Ideally a procedure should lead to liquidation of non-viable firms and to restructuring of firms hit by a transitory shock (Tornell (1999)). For transition economies, insolvency legislation may serve as a useful tool in the restructuring of (privatized) firms. Liquidation of non-viable firms does not necessarily entail a loss of valuable investments, as long as the bankruptcy law assigns control over the assets as quickly as possible to new, more efficient users (Aghion *et al.* (1994)). The possibility of bankruptcy also provides incentives to run firms as efficient as possible and to service debts consistently. Especially in transition economies, with powerful management (e.g. oligarchs) and poor corporate governance, a good bankruptcy law can contribute to more effective management.

High and highly variable inflation is one of the biggest threats to a payment system. The fear of negative real income effects reduces the willingness of the public at large to hold domestic currency. In turn, this affects both economic transactions and the holding of financial assets with the domestic financial system. The pressure to monetize large fiscal deficits gives rise to inflationary pressure. The absence of a well functioning government debt market and problems on the revenue side of the budget further exacerbate the problem. One often cited solution to inflationary pressures is the creation of an independent central bank. A more independent central bank is more able to resist the pressure from politically influential managers of state firms to provide subsidized loans to their firms. An independent central bank also can deny cheap credit to the government, thereby providing an incentive to reduce budget deficits. Hermes and Lensink (2000) identify two main tasks of central banks in transition countries: the reform and safeguarding of the payment system and

contributing to a stable banking system by supervising bank behavior and acting as the lender of last resort. Loungani and Sheets (1997) find a negative relationship between inflation and an independence index, obtained by assessing the resemblances with the Bundesbank, with causality running from independence to inflation. Another index -closer to a statutory independence index- is not significant. Statutory independence is apparently no guarantee for actual independence. Results should be interpreted with some caution however, since they only have twelve observations. Hermes and Lensink (2000) conclude that for transition countries independence is useful to reduce inflation from high levels to relatively low levels, but not for a further reduction (<15%).

4. The Role of Initial Conditions

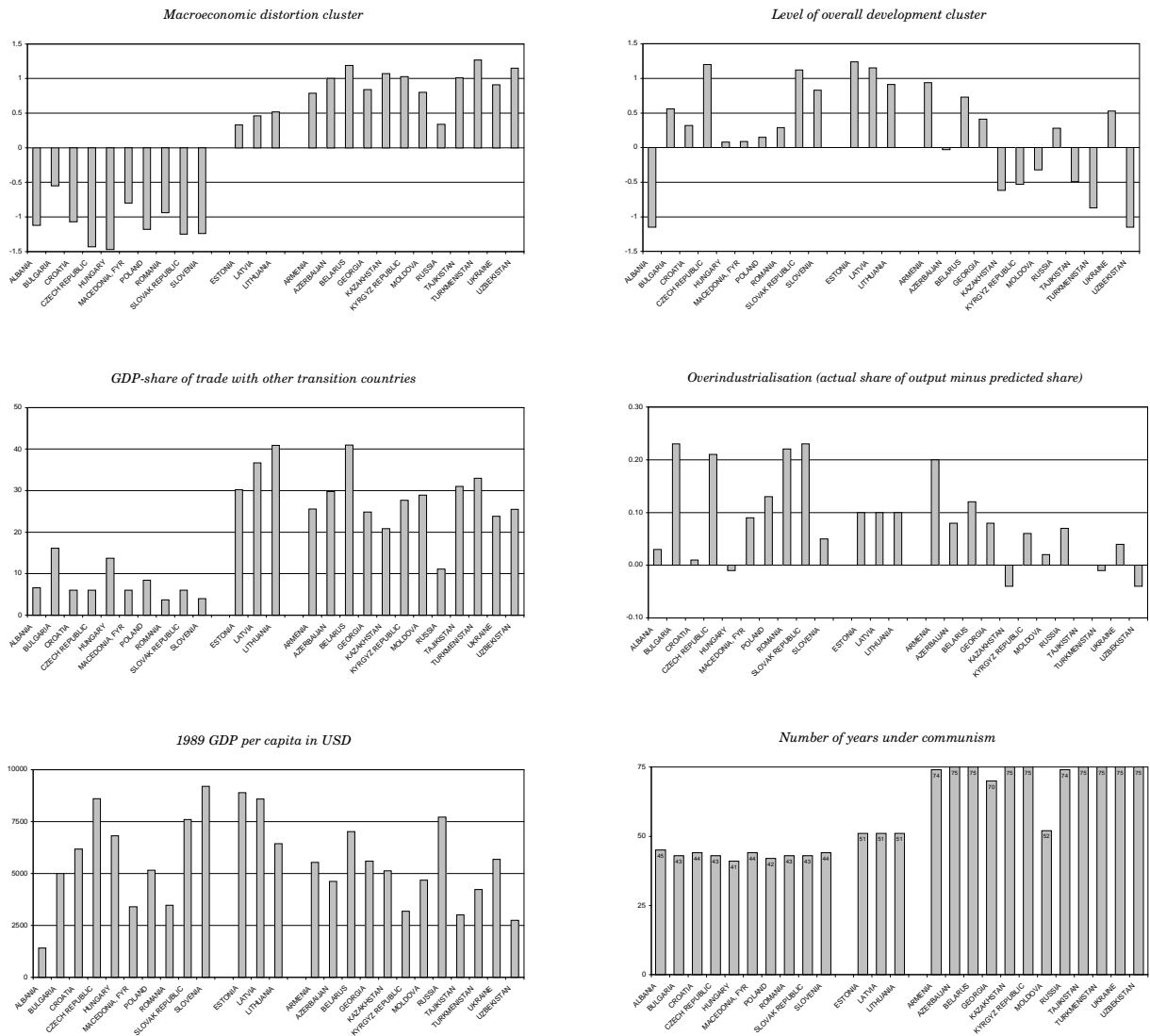
In the context of output performance differences in macroeconomic, institutional and natural resource conditions prevailing at the start of transition, commonly referred to as initial conditions, have received a lot of attention. De Melo *et al.* (1997) were among the first to identify initial conditions and to analyze their impact upon cumulative output growth. By means of a principal component analysis they reduced a set of eleven conditions to two clusters (because of a possible multicollinearity). The first cluster can be interpreted as an index of macroeconomic distortions at the beginning of transition and unfamiliarity with a market environment; the second represents the level of overall development prior to transition. Figure 5 shows next to both clusters, four important conditions. Macroeconomic distortions are obviously much larger in OFSU-countries than in CEE-countries, the picture on overall development is less clear, but again it seems more favorable to CEE-countries. The Baltic States have the highest development levels, confirmed by the relatively high levels of GDP *per capita* in 1989. Macroeconomic distortions are smaller than in OFSU-countries, but a lot higher than in CEE-countries. Especially their high trade integration with other transition countries was very unfavorable. Industrialization is often mentioned as an indicator of development, but a lot of transition countries

suffered from overindustrialization (measured in figure 5 as the actual share of industry in GDP minus the predicted share; see De Melo *et al.* (1997) for prediction). The share of industry was often high because trade and services were typically repressed in socialist countries.⁷ Finally, the number of years a country spent under communism is used as a proxy for a country's 'market memory'. The CEE-countries and the Baltic States were market economies before WWII, while OFSU-countries, under communism since the Russian Revolution in 1917, lack any market experience. This is often mentioned as one of the explanations for the wait-and-see approach to institutional reform in the OFSU-countries as compared to the CEE-countries and the Baltic States.

De Melo *et al.* (1997) show that their clusters have an impact both upon output performance and reform (measured by an aggregate liberalization index). Berg *et al.* (1999) allow for a time varying effects of initial conditions based on the idea that macroeconomic distortions will gradually vanish as liberalization and stabilization continue. They show that the initial output decline is mainly caused by adverse initial conditions; the recovery is overwhelmingly associated with structural reform (cf. *supra*), while macroeconomic stabilization helps but has a smaller quantitative impact (it might be a necessary condition though). In sum, adverse initial conditions lead to output losses that can be overcome by faster structural reform and stabilization policies. Since De Melo *et al.* (1997) showed that the government's reform policy is to some extent determined by initial conditions, one might be worried about multicollinearity problems when including both a reform index and initial conditions in a regression explaining output performance. Favorable starting conditions might generate better results with respect to growth, making it easier to accept the negative effects of reform, resulting in faster and more encompassing reform (see Krueger and Ciolko (1998)). Fisher and Sahay (2000) argue that the extent of reform has been correlated with initial conditions, but that this is not the whole story. It is important to note that unfavorable initial conditions do not reduce the effectiveness of reform, they only discourage reform.

⁷ This is an example of an economic consequence of the socialist ideology, often referred to as the

Figure 5: Initial conditions



Source: De Melo, Denizer, Gelb and Tenev (1997)

'socialist development overhang'.

5. Conclusions

The following picture of the transitional experience arises from the literature. The government has an important impact on macroeconomic performance by macroeconomic stabilization and by structural reform and the creation of market-supporting institutions. In addition to this, macroeconomic and institutional conditions, prevailing at the end of socialism, play an important role. More unfavorable initial conditions lead to larger output declines, but the effect fades out over time and can be offset by stabilization and reform policies. To a large extent more unfavorable conditions and the failure to stabilize and implement structural reform account for the larger output decline in the OFSU-countries compared to the CEE-countries and the Baltic States. Inflation stabilization, which is facilitated by sustainable government balances, is a prerequisite for the recovery of growth. A fixed exchange rate regime was helpful to stabilize inflation, but empirical evidence is moderate. Stabilization is however not a sufficient condition for output recovery. Structural reform is necessary. The closer a country comes to a market economy, the more it benefits from the positive growth effects of the market mechanism. However, putting new reform measures into force is costly in terms of growth because of adjustment costs. At higher levels of reform already achieved, a positive stock effect starts to dominate this negative adjustment effect. Political instability slowed down reform, but the fact that reform is nevertheless continued, stresses its irrevocability. In practice reform was a mix of 'big bang' measures in some fields and a more gradual approach in others. With respect to price liberalization and foreign exchange and trade liberalization, rapid progress has generally been made. Privatization of small firms was also fast and successful, privatization of large firms was, however, more cumbersome. The necessary restructuring of firms advanced with difficulties because of opposition of employees. Employees were often able to block reform because the politically most feasible method of privatization resulted in employees controlling their firm. The creation of a private banking sector was expected to rule out soft budget constraints, one of the most important incentive problems under

socialism. Progress has been much slower than expected, however, in this area.

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