Economy and Governmental Policy In the Postsocialist Countries

Final Report For the NATO Research Fellowsip

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Introduction

The transition economies became a major research object during the last few years. The most prominent western researchers and IMF experts tried to give an insight in the transition turbulence and give recommendation for successful economic policy. Cross-country researches along with special case studies and broad theoretical discussions provided new topics in transition economics.

Still successful systemic transformation was not altogether often in Eastern Europe and the former USSR and even ‘success’ is a very relative term as income still lies far below the pre-reform level, social injustice and unemployment is soaring. The past years have been crucial in the sense of new developments in the area of transition economics. Basing on comparative economics, transition economics has caught up with the ongoing transformation.

A bundle of questions all of them aiming at successful transformation formula troubled a wide circle of economists all over the world. Nevertheless the point of finding successful economic policy seems to be crucial in this discussion. The state that dominated over each particular sphere of economic activities all over years faced a problem of retaining its regulatory mechanism, liberalising various branches of economic activities, creating convenient infrastructure for business growth and stabilising macro-economic indicators as soon as possible. And even if such a perfect transition pattern existed, it was highly dubious that the governments in the postsocialist countries would follow it (for this thesis sees the argumentation below). Nevertheless, the initial positioning of transition economies was so diverse that it is impossible to find policy recommendations proper and general enough for a broad range of them.

Most of transition research papers in the last few years have tried to depict transformation experience, explain the reasons for their success/fail and show the advantages and disadvantages of two prevailing concepts in the transition policy making (gradualism vs. shock therapy). Numerous attempts were made to overview cross-country experience. Regretfully, research of 'eastern' economists were rare and did not acquire the importance they should as concluding from their unique standpoint.

As we consider issues of governmental policy during the transition period, we have to assume first of all that the initial situation in the Central and Eastern Europe (CEU), Baltics and the Commonwealth of Independent States (FSU) differed drastically:

1. Some of the CEU countries possessed good preconditions for reforming their economies such as private land ownership and more liberal economic system and had a relatively shorter experience of living under communism;
2. The dissolution of the Soviet Union left a vacuum of effective power since local republican governments were not able and ready to overtake the functions of central government bodies;
3. Soviet economy was based on the so-called geographical division of labour. This means that oversized plants were placed seemingly arbitrarily in one of the 15 Soviet republics what made them

economically highly interdependent. Although later model estimates (see Murrel,1990; Lücke,1992; Gros and Dauterbande,1992) have consistently proved that trade pattern in the former Soviet Union principally corresponded to the gravity model (trade volume estimates based on the volume of GDP and distance between the countries) and existing relative advantages, the erection of the state borders and considerable shifts in the relative price structure along with the other reasons discussed further below brought the intra-regional trade down (whereas it initially contributed an extremely high percentage of GDP).

As we see so far, the CEE countries possessed several considerable advantages compared with the reform countries in the FSU and most of them also reformed their economies earlier.

This paper tries to analyse nature of economic transformation and the role of government in the implementation of economic reforms. Therefor we consider first of all the genesis of the socialist economy and show the reasons why did it malfunction over the years. Second part of the first chapter deals with reform goals, namely what did the reform programmes envisaged. This is closely related to the nature of the socialist economy, since the reforms were implemented to eliminate the distortions caused by the plan regulation of economic activities. The third part of the first chapter deals closer with the controversial issue of the policy choice between shock therapy and gradualism. It is tried to explain why the policy makers tend to choose this or that kind of policy.

Second chapter overviews the policy steps common for the reform programmes, shows the necessity of each of them and their complementarity. Besides, the issue of correct reform timing and sequencing acquires special attention, because it also determines the later reform success.

The final chapter shows what are the results of reform programmes, what determines their success or failure and tries to outline common experience.

1. Government and its Challenges During Systemic Transformation

1.1. Genesis of the Socialist-type Economy.

One can easily be wondered of why the systemic transformation became at once so necessary whereas the soviet economy for example has for decades shown strong performance. Are the political reforms and economic transition so consistent that political changes could not succeed without support through economic liberalisation.

A socialist-type economy is a plan-oriented economy, this means that production pattern is dictated by the central plan figures, not by the incentive to maximise profit. Money was only important as wage equivalent paid to population. As concerning price making, market did not play any significant role in the socialist economy: prices were built based on the production costs basis.

So-called soft-budget constraints provided no efficient incentives for the producers to become efficient, therefore prices were often built on the exaggerated cost basis. As to the notion of soft budget constraints (sbc), first introduced by J. Kornai sbc mean unwillingness of enterprises to act in a profit maximising (most efficient) way, because no budget constraints really existed (state enterprises were provided with subsidies enough to cover their financial losses). Furthermore, if even producers acted profit-maximising under a distorted system of relative prices, this does not mean their behaviour would be socially optimal.

On the consumer side, behaviour was utility maximising. As in any market economy, consumer tries to choose optimal bundle given his monetary budget restriction. In a socialist-type economy consumer faces fixed prices under which fixed commodity quantities are plan-prescribed produced. The prices for consumer goods lied typically below optimal levels so that large commodity deficits followed with rising importance of black markets where goods were sold to their shadow prices. As wages were the only real cash flows in the economy, a considerable monetary overhang existed. This becomes evident as we consider that even in the late 80s soviet economy was featured by high saving rates on the consumer side, most of the placed on commodity bond issues.

Another proof of the formerly mentioned supposition about vast negative effects of the soft budget constraints on the enterprise efficiency is the investment/GDP ratio. In the years 1977-88 it was an average of 32%, whereas in the advanced industrial economies accounted for mere 21% of GDP. Thanks to direct control over enterprise reinvestments, the soviet government managed to hold investments high, but the growth rates were still far below than those achieved by the advanced industrial countries in the same period. So, the socialist economies were unable to transform plan-induced high investment rates into growth.

So, we were confronted with two phenomena typical exclusively for the socialist-type economies: soft budget constraints and deficits. Both phenomena have created a so-called supply instead of demand-driven economy. Supply-driven economy under soft-budget constraints is devastating not only in the viewpoint of economic development but also in resource exploiting as well. Overexploitation and inefficient utilisation of natural resources (see also below on the issue of relative prices) in the socialist economies was common.

As already mentioned above, price-making in the socialist-type economy was cost-based. Given a rigid (plan-induced)supply, demand did not play any significant role in price-making. This caused not only vast market distortions (such as commodity deficits) but also considerable inter-sectoral disequilibriums. In the former Soviet Union the prices for fuels and raw materials were held far below the world market prices and services were mostly state-subsidised. There are several explanations of why did the soviet authorities hold the raw material prices low:

1. socialist economies had a closed trading system in the frames of the CMEA (Council on Mutual Economic Assistance)and they had a very limited access to the western high-tech technology markets through COCOM regulations. Soviet Union really possessed considerable comparative advantages in the natural resources mining industry. In the closed socialist market the raw materials were relatively abundant and should also be cheaper than on the world markets;
2. cheap raw materials allowed a large number of enterprises to produce extremely inefficient but still remain in the profit-zone. This policy

seems to have been in line with industrialisation efforts, as it granted numerous branches considerable advantages.

3. Russia was and it still actually remains the biggest oil supplier in the former CMEA. Low fuel prices seemed to serve as an additional pressure on the partner socialist governments.

Beginning from the 70s these disequilibriums became particular acute in the former Soviet Union: after achieving extraordinary high growth rates in the pre- and post-war years, socialist economies began to stagnate facing periodical deficits, rising black markets and general inefficiency.

Additional to the wide variety of economic problems, political system of communism was not any longer viable by the end of 80s. In spite of hard efforts to preserve the political system by gradual reforming, first the CEE countries demanded succession from the Warsaw pact and than the former soviet republics strove for their independence.

1.2. Reform Goals

Postsocialist countries have faced an important dilemma: whether to preserve old socialist economic system possibly granting more autonomous rights to state enterprises (as Gorbatschow tried it in the Perestrojka era) or to pursue reform policy, restructure the whole economy and liberalise economic activities. And if one should choose the policy of liberalisation, then why so? Why should be reforming the economy and actually loosing most of government control brackets be so lucrative?

After the breakdown of political system of communism following economic distortions existed in the postsocialist economies:

1. distorted production structure;
2. bad enterprise performance;
3. low labour efficiency;
4. high level of producer and consumer subsidisation;
5. market disequilibriums and commodity deficits;
6. monetary overhang.

To deal with all these problems, government needed to introduce far-reaching liberalisation in the economy thereby inducing systemic transformation. There existed the possibility of retaining soft budget constraints and administrative prices, continuing enterprise subsidisation, but the governments facing large fiscal problems during the breakdown of political system could not sustain this kind of policy in the long run. Nearly every attempt to retain administrative command system of ruling economic behaviour ended either in hyperinflation since the government was unable to preserve low command prices without a large fiscal expansion or the government was re-elected or forced to go on with liberalisation. So, passiveness of the government or attempts to preserve economic status-quo seem to be inefficient.

By choosing active transition policy, the government undertakes several commitments:

1. to impose hard budget constraints on enterprises. This can be conducted either through privatisation or through so-called commercialisation (removal of the most state control mechanism over enterprises with the aim to retain them in the profit area). The meaning of removing soft-budget constraints is to raise enterprise efficiency,

make them competitive, improve financial performance of enterprises. Simultaneously this eases up financial burden on the state budget through removal of the most of subsidies.

2. to liberalise prices and bring the structure of relative prices in consistence with the world market. This makes enterprises to reorient their production structure and leads to the establishment of the consumer-led economy. Though the price liberalisation market equilibrium settles the price-making and commodity deficits and monetary overhang are efficiently removed.
3. to liberalise ownership rights and utilise private ownership as the principal incentive for economic counterparts. Liberalisation of economic activities serves as a rule to introduce economic freedom along with the political one. Market economy without private ownership fails to provide direct incentives for economically active population to behave optimally.
4. external liberalisation and integration into the world market is an extremely important is an extremely important governmental commitment . The XX century was marked by rising economic globalisation, whereas the socialist countries were left behind the iron curtain with a very restricted access to the western markets. With political system being changed and economy being liberalised, the most of the former plan economies get preferential access on the world markets.
5. to create legal and institutional infrastructure compatible with the market economy demands. The ability of government to react fast enough and facilitate transformation by creating sustainable infrastructure determines the success of reforms.
6. to be firm in its reform commitment. Public attitude towards reform depends on whether shows that reforms are irreversible and whether it

is successful in assuring the public. Simultaneously, government has to retain political stability so that economic deregulation and political freedom is accompanied by uncertain business atmosphere. Economic deregulation often leads to a weaker financial discipline, since new private enterprises are eager to escape tax-paying where possible with low risk-costs.

But in fact, governments in the postsocialist countries often chose passiveness and tried to preserve the socialist-type economy. Following reasons clarify their conservative behaviour:

1. Government circles are orthodox communist and try to popularise their policy by preserving high employment through soft-budget constraints and subsidising consumer prices for basic commodities;
2. Government elite is a part or is easily influenced by a interest group choosing postponement of reforms (directorate of state enterprises or oth.).
3. Seigniorage opportunity with low costs for officials who pursue this policy. Inflation tax (seigniorage) means additional issue of baseless money and enriching of government officials through devaluation of real money.

Furthermore, government has a choice either to reform gradually or to pursue so-called shock therapy policy. This differentiation between ‘shock therapy’ and gradualist approach first appeared as some of the transition countries chose to follow IMF-WB recommendations and tried to restructure as soon as possible and some of them, on the other side chose to introduce reforms gradually to let enterprises enough time for conforming with new market rules. Both of approaches have a fundamental theoretical background: gradualism is based on researches by political economy theorists, whilst shock therapy or the big bang approach is mostly a viewpoint of neo-classical economists.

The choice of that or another kind of policy is always multifactoral. The government responds to different external pressures while choosing the kind of policy optimal for it. The most important pressures which the transitional governments suffered during the last years were:

1. public pressure. Although the real size and direction of this pressure is different from country to country, public generally supports high employment, opposes cuts in consumer subsidies and social benefits, high inflation rates. General attitude towards reforms depends mostly on the degree of political liberalisation and success of previous reform steps. Successful reform implementation needs also positive public attitude, because given insecure business atmosphere and indefinite future prospects, reforms are destined to fail. Generally, public attitude towards reforms is friendlier at the very beginning when political freedom and the first signs of economic liberalisation are still lucrative for the broad masses. On the other side, the countries which were passive in introducing reforms and this economic policy failed have the friendliest attitude towards introducing reforms.
2. pressure by interest groups. During the transition period, several influential interest groups become active. The interest group mostly blamed for being conservative and trying to sabotage reforms is the group of directors of state enterprises. The directorate tries to preserve soft budget constraints to avoid enterprise restructuring, it opposes privatisation or even tries to become official owner of state enterprises, it is very rigid as concerning the reactions to market signals and it is eager to introduce high import barriers. Especially often in the Former Soviet Union have the state enterprise managers been for years

successful in hindering reforms. Under the collective lobbying pressure of loss-making enterprises, coal mines and military industry heavy financial losses were made as governments pumped a big share of national income trying to preserve them. This led often to soaring inflation, as the real interest rate for the government credits was negative and government simply redistributed the national income.

3. pressure by international organisations. IMF and WB played a very special role in providing financial assistance with binding conditions for national economic policy. During the first years of transition most of the former plan economies sufficed with humanitarian aid to finance their vital imports. Still after 1992, with the decreasing availability of humanitarian aid, transformation economies had to reorient their borrowing towards international financial institutions. These were firm in their intention to grant credits only when economic stabilisation and comprehensive reform programmes were underway. Backing shock therapy theorists, IMF programmes often caused dissatisfaction in the transition countries
4. pressure from neighbour countries. The FSU countries have experienced particular difficulties in the first years of independence, where the rouble zone and direct inter-enterprise contacts were still active. Later on, with the introduction of independent monetary zones and establishment of non-state trading system, only interstate obligations are legally binding for the CIS countries. Nevertheless, some resource-rich countries, Russia in particular, are being blamed to use their economic power as the means of achieving certain political objectives.

A phenomena of rent-seeking, especially thoroughly discussed by Äslund and oth., is another important aspect of governmental economic policy in the transition economies. The phenomena of rent-seeking and seigniorage was particularly acute in the FSU republics, were established political elite subsidised their supporters and most influential interest groups. The rent-seeking behaviour is more common when there is no established political system and no effective public checks and controls mechanism. We consider rent-seeking not only as a common monetary expansion but imposing of export restrictions as well. Resource-rich countries provided enough incentives for the government official to make profit on export licensing and credit issues.

1.3. Economic Policy Choice in the Postsocialist Countries: Liberal Reforms vs. Gradualism

As already mentioned above, the reform programmes in the ex-communist countries can be roughly divided into liberal and gradual ones. The last years were spectacular regarding the vast experience the transition countries made in pursuing the both extremities.

Poland was actually first to pursue liberal transition policy and stabilise early its economy with the help of tight economic and monetary policy. Balczerowicz's government managed to stabilise economy within 2 years (GDP decrease of 11,6% in 1190 and 7% in 1991)although at the cost of extremely high unemployment (16% in 1994)and massive enterprise bankruptcies. Czech Republic was also among those, which decided to reform earlier and set financial stabilisation as one of the priority goals. The reforms in the Czech Republic in spite of a somewhat larger output reduction seemed even more successful and socially-oriented than those in Poland, since no major enterprise shutdowns were implemented and unemployment remained low even for western standards. This means nevertheless that no major efforts to raise drastically enterprise efficiency have been made.

Estonia, Latvia and Albania were also among those countries, which introduced relatively radical reforms. A group of countries including Hungary, Romania and Kyrgyzstan tried to reform more gradually but they were still persistent in their economic reform programmes. Russia and Bulgaria, on the contrary, tried radical reforms but later on liberal governments turned politically weak and left their offices for more socialist-oriented ones. Central Asian republics of the Former Soviet Union (especially Turkmenistan and Uzbekistan) did not even attempt to introduce any consistent reform programme. This becomes evident since former communist elite were still in power trying to preserve old game rules and were not very eager to implement comprehensive reforms.

A number of countries suffered from continuous armed tensions and military conflicts. In spite of different governmental approaches to the reform implementation these countries (Armenia, Azerbaijan, Georgia, Tajikistan) suffered deep economic crises and did not really possess an opportunity to reform their economies.

As it can be easily extracted from the latest experience, ex-communist governments are mostly unwilling to introduce effective reforms or they proceed with so-called gradual reforms. Non-socialist governments are on the contrary more persistent with the transition policy although policies vary greatly from country to country. Once reforms have begun, no possibility of stopping them seems acceptable. Belarus tried to reverse reform as President Lukashenko has entered his office, but such kind of policy can not achieve big positive results. At the same time, pro-reform governments lost several times elections to socialist parties in Eastern Europe (Poland, 1993; Russia, 1993; Hungary, 194; Bulgaria, 1994; Estonia, 1995; Latvia, 1995), but this did not led to any major reversal from the reform track except the case of Bulgaria. On the contrary, reform policies were further pursued with considerable success in most of these countries.

Those countries which remained under the rule of ex-communist governments have always attempted to avoid introducing radical reforms. Either they tried to reform gradually or to preserve most elements of socialist economy. Nevertheless, after years of hyperinflation and financial instability, all of the have recognised the necessity to stabilise. Moreover, inflation tax policies, where whey were pursued on the side of the government can not last forever. Public pressure becomes greater as people begin to recognise the relationship between loan issues and hyperinflation and the elite itself desire financial stability after reaping large amounts of national income. Most transition countries that suffered hyperinflation, managed to get it under control by 1997 and to stabilise currency exchange rates. A general conclusion can be made that governmental policy tends eventually to support monetary stabilisation even if earlier financial policies were followed by hyperinflation and seigniorage.

Still their remains the question whether it is less harmful to introduce reforms rapidly or gradually or is it even better to conserve the socialist-type economy. A few studies dealt intensively with the issue of output performance under different economic policy scenarios (liberalisation index), rate of inflation and political stability. Studies by Cata (1997), de Melo, Denizer and Gelb (1996), de Melo and Gelb (1996), Äslund, Boone and Johnson (1996), Fischer, Sahay and Vegh (1996), Havrylyshin (1995) examine cross-country experience and provide empirical analysis of economic performance under shock therapy/gradualism. These studies have shown that there indeed exists a strong relationship between the pace of transition, rate of inflation and output performance. There is particularly intense relationship between output and inflation and medium-term positive correlation between liberalisation and output performance. The studies have also shown that civil and military conflicts additional reduce welfare. Although, the reform experience has shown that the output reduction was somewhat higher in the radical reforming countries in the first years of transition, further years have overbalanced that effect and by 1995 slow reformers had markedly worse economic performance than the fast reformers and most of the gradualist countries still suffered negative growth rates.

In spite of this, many economists suppose that gradual reforms possess several advantages compared to shock therapy. The idea behind this supposition is that social adjustment costs exceed private adjustment costs. Theoretical studies have often arrived to the conclusion that output reduction would be greater under fast reform track as sector-specific inputs take time to adjust to restructuring factor demand. This means for example that as new commercial banks take time to be established, it is hard to get credit for the emerging private sector. It is argued that input restructuring takes time and reforms have to be slowed down so that they become relatively painless. In spite of vast theoretical argumentation, ‘slow reformers’ have as a rule performed worse in the terms of output than the ‘shock therapists’.

There is also a strong belief that radical reforms cause higher unemployment. This supposition is logically true: fast reformers try to push the sectoral adjustment forward, to elevate soft budget constraints, thus to raise labour efficiency by cutting so many jobs as possible. The countries that followed this kind of policy (Poland with unemployment rate of 16,0% in 1994 and Albania with 19,5% in 1994) had really enjoyed higher unemployment. Czech Republic made good progress in reforming its economy but tried to preserve high employment (3,2%). In the former Soviet Union countries unemployment rates are astoundingly low compared to the GDP decreases. This lies partially on negligible unemployment benefits which do not provide enough incentives to get registered as unemployed, but still unemployment is far lower than one would suppose considering output decline. So, higher unemployment as a negative externality of radical reforms really exists as the result of more liberal economic policy.

Fairness of wealth distribution and enterprise privatisation is also a reason why the reforms should be postponed until institutional framework for the reforms is existent. Even representatives of liberal economic school such as Lipton and Sachs argue the necessity of postponing privatisation until the macroeconomic stabilisation is achieved and enterprises are sold to their real prices. At the early stage of reforms privatisation led to the former enterprise managers reaping off the control over their enterprises or the government officials buying state enterprises at negligible prices. But this does not mean that radical reforms necessarily cause such negative externalities. It was mostly gradual transition where the enterprise managers gained more influence as the result of privatisation. Shock therapists tried on the contrary to implement controlled privatisation and sell the enterprises to the highest possible prices.

The sped of institutional development is another argument put forward by Murrell (1992) in favour of gradual reforms. Market economy needs new institutions to be developed and legal infrastructure to be introduced. Gradual reforms supposedly provide enough time to put this into place. The latest years have shown that only radical reform-oriented governments are eager to pursue institutional reforms. In fact, it is macroeconomic transition that needs following institutional reforms. Without any reforms being implemented, no need for new legacy and institutions is there.

Additionally, reform measures which are thoroughly discussed in the following chapter are mostly complementary to each other, i.e. partial reforms have no sense, since their positive effect is suboptimal if not negative when some of the reform steps are not followed by the complementary ones. So, it is more beneficial to conduct reforms in package, than to postpone or to hurry up some especial reform steps.

Gradualist reforms provide also big opportunities for seigniorage and rent-seeking, which are also important reasons for a government to stop its choice on it.

2. Reform Steps

Reforming Eastern European economies turned our to be a task considerably more complicated as it was initially awaited. Temporary structural unemployment, equalisation of the relative prices to the world ones, structural budget problems were anticipated. The reality was truly distressing and exaggerated even the most pessimistic prognoses: extremely high unemployment, hyperinflation and financial collapses were as severe as never before. A big part of transformation difficulties is truly unavoidable and is well justified encountered for the efficiency benefits of systemic transformation and restructuring, but this part seems to be less severe compared to the policy failures, false decision-making, legislative postponements and numerous political crises.

Even in the cases where reforms completely failed, government tried to work out a sort of a reform programme, which was more or less consistently implemented. Transition to a free market-type economy requires following steps to be implemented through governmental economic policy: institutional reforms, fiscal and monetary liberalisation (stabilisation), trade and capital account liberalisation and privatisation. A couple of years ago a dispute was underway whether political liberalisation is a necessary precondition of successful economic reforms or not. It is being argued that economic reforms can be successful with little political liberalisation (as in China or Vietnam). In Eastern Europe it was political liberalisation, that pushed forward intensive economic reforms. Several different studies have empirically proved that the degree of political and economic liberalisation in the CEE are mutually dependent. The success of reforms under communist party rule in China and Vietnam is explainable through relatively low level of industrialisation (consequently less need for industrial restructuring than in the CEE), low level of prior integration into CMEA trade structures and no serious trade interdependence (as in the FSU).

2.1. Institutional Reforms

Institutional reforms are mostly a core of reform programmes. Because has to change the way of influencing economic activities, its new role can be described as that of securing market infrastructure and legal support. This serves to ensure economic agents of safety of their private property and introduce new 'game rules'. The reform credibility depends largely on the ability of the government to introduce basic institutional reforms , make new legislation popular and not too complicated and show that government is still active. Along with guaranteeing private ownership and granting economic freedom, institutional reforms foresee securing fair competition, establishing new financial institutions, social and unemployment offices.

Competition policy is a problematic issue for the transition countries. Oversized socialist enterprises are until now monopolists in most of the CEU. In some case government does not even tries to split these 'natural monopolies' and even greets the creation of new financial-industrial groupings and cartels. The biggest enterprises are often set back on the privatisation list because of 'national economic security'. So, enhancing competition policy remains a challenge throughout the CEE. As mentioned above, establishing new institutions or reforming the old ones belongs to the essential institutional reforms.

Banking sector remains up-to-date a considerable trouble for the CEU. Credits for market interest rates are unavailable for the most entrepreneurs, the transition economies are all in all 'underbanked'. Anyway, CEE countries have introduced a so-called 'two-level' banking system with central (national) bank on the top of it and commercial banks (although in some FSU the former sectoral banks are still state-controlled). Systemic payments problems hamper, in Russia particularly, the further development of banking sector, bad debts common in the transition economies have troubled a lot of banking institutions.

Getting new social and unemployment security systems functioning is utmost important as much of the structural unemployment can be avoided if the labour markets function well and the wages are flexible. Cutting social expenditures and reforming social security system is a necessity because the communist-type social security can not be afforded any more. Simultaneously, new system of unemployment and pension security, medical care has to be introduced.

For many western companies is the activity in the CEE much too risky because there is no legal infrastructure. Not only economic laws are absent but sometimes the new constitution is underway and basic issues as land ownership rights or taxation are not clear. The task of the government is to clarify the basic legal issues, make the new laws comprehensive and available, sustain co-operation between law-making, judicial and executive authorities. Political freedom is another aspect of institutional reforms, since it delivers opportunities for the public to influence governmental decision-making and control its activity. Free mass media when present is a perfect instrument of public pressure on the executive authorities.

As we see, institutional reforms are essential for successful systemic transformation. It is argued that institutional reforms take plenty of time , what is really indisputable but basic institutional changes laying fundamental milestones of market economy are a matter of several weeks.

2.2. Fiscal and Monetary Stabilisation

Fiscal and monetary stabilisation has been a focal point for a number of IMF-sponsored programmes in the developing countries. The necessity of rapid fiscal and monetary stabilisation through tight monetary economic policy has been heavily disputed by political economy followers. Initial price raise in the CEE came through price distortions in the socialist economy. Relative prices had to equalise the world ones and monetary overhang common under the socialist economies should have been eliminated. So far the first inflation impulses can be explained through initial price liberalisation. Nevertheless, some CEE countries tries to preserve certain prices under state control to limit inflation. This led automatically to growing commodity deficits and exaggerated black market prices, not mentioned aggravating fiscal deficits.

Full price liberalisation is not necessarily followed by immediate monetary stabilisation, but the countries with full-scale price liberalisation had mostly moderate inflation rates. Tight monetary policy is a necessary pre-condition for monetary stabilisation. Supporters of gradualist economic reforms have put several arguments against the tight monetary policy such as higher unemployment, necessity of credit issue on enterprises and output decline. These arguments are mostly true in the short run, but monetary expansion-caused inflation leads to some more severe disincentives for the entrepreneurs than the lack of credits. Hyperinflation economies are often marked with dollarisation of real transactions, followed by currency devastation. This was common in those FSU countries which tried to subsidise consumers with low prices and producers with soft budget constraints. Monetary expansions in these countries had multiple negative effects on the economic performance, including hyperinflation, steeply falling currency exchange rates, periodical commodity deficits and oth. These countries were eventually forced to leave their economic policy and liberalise completely. Unlike this, Bulgaria and Belarus liberalised a wide variety of prices at the start of reforms, but reversed this later on and re-expanded administrative control over price-making, which led to soaring inflation and reappearing commodity deficits. Net energy exporters were a special case in the CIS, since they maintained domestic price controls and export-restricting regulations on energy materials until giving the policy up in 1994 (Russia, Kazakhstan), or have been pursuing it till recent (Turkmenistan). Tight monetary policy has all in all been more efficient than the liberal subsidising.

Fiscal deficits remain a considerable problem for the most of the CEE countries. Even the countries which tightened state expenditures still suffer from insufficient budget incomes. Tax-raising is more complicated because new private entries unlike old socialist-type enterprises try to hide their incomes. Financial discipline becomes a very important policy target, as in most CEE countries central bank emissions are the only possible way of covering budget deficits. The most important reason, which says out for price liberalisation and following monetary stabilisation is that distorted prices as they existed in the former socialist countries provide false price signals to the enterprises. False price signals cause distorted resource allocation as output choice differs widely from the socially optimal one.

Besides, delay of monetary and fiscal stabilisation damages government credibility. It becomes ever harder to obtain monetary stability as government loses its popularity and financial system is insecure.

2.3.Trade and Capital Account Liberalisation

Liberalisation towards the rest of the world seems to particularly painful for special interest groups. Trade barriers are a convenient tool of supporting inefficient domestic producers where no direct financial transfers are affordable. As already mentioned, at the beginning of reforms enterprise directors constitute the most influential interest group, which opposes the trade liberalisation. At the same time, integration in the world markets is absolutely necessary for sustainable economic development and as the recent experience of DCs have shown, growing export potential is what pushed the fast growing eastern tigers forward. Simultaneously, as foreign trade is liberalised, interest groups of commodity exporters become stronger, so that once liberalised, barrier-free foreign trade gets ever more supporters.

The trade liberalisation is complementary to the price liberalisation, so the countries which decided to liberalise prices were also eager to open foreign trade. Comprehensive trade liberalisation as it is with price liberalisation is necessary to ensure that prices reflect the commodity scarcity and gives incentives to enterprises to specialise on their comparative advantages.

Capital account liberalisation is more controversial than the trade one, because large capital outflows can follow monetary instability when the capital accounts are liberalised. This would provoke undesirable currency devaluation. Analogue to this, overwhelming capital inflows can be followed by currency revaluation and decreasing competitiveness. Capital account liberalisation means not only higher instability on the currency markets, but foreign investments as well, which are essential for economic development. Foreign investments are mostly innovative and are more efficient than domestic savings since foreign firms possess more experience of dealing with market environment than the former socialist enterprises. Moreover, foreign investments constitute in some countries an essential part of gross investments. It’s necessary to mention that capital account liberalisation is easier and faster to implement than the trade liberalisation, so that optimal timing requires trade liberalisation to be followed by capital account liberalisation

2.4. Privatisation

Private property is a milestone of the market economy and privatisation is the focal point of reforms in the postsocialist countries. The macroeconomic importance of privatisation comes mainly through higher enterprise efficiency, whereas big-scale privatisation does not necessarily induce increased efficiency and better financial performance. If the large scale privatisation does not influence managerial behaviour, it can leave an enterprise without any major efficiency changes. So, enterprise sell on ‘outsiders’ should be generally preferred as they possess more incentives and opportunities to impose pressures. Most CEE countries preferred to implement so-called voucher mass privatisation programmes. In some countries the design of mass privatisation has been oriented to the enterprise sell on the ‘insiders’ (Lithuania, Russia, Uzbekistan). In some other countries voucher privatisation has foreseen dispersed outsider ownership.

The countries, which have completed their mass privatisation programmes, proceeded with enterprise stake cash sales on strategic investors. Privatisation of the sensitive sectors has enjoyed little progress over the last years. Energy, communal services, telecommunications are dealt as strategic sectors and their privatisation has been delayed.

Contrary to the large-scale one, small-scale privatisation has been easier to implement and in spite of considerable differences in start-up timing and liberality of reforms, the most of formerly of formerly state small-scale enterprises have been privatised. Privatisation of agricultural land has been hindered by discussions over land ownership as some of the CEE countries were unwilling to introduce private land ownership and preferred to introduce long-term leasing contract system.

Although privatisation is a progressive step towards market economy, considerable doubts have been expressed whether privatisation should not be initially postponed. This point of view is justified through the supposition that at the initial stage of reforms enterprise managers and government officials are the ones who probably gain control over existing enterprises. This leads not only to greater social injustice but makes it highly dubious that the enterprises gain in efficiency. Another argument supported even by orthodox economists is the necessity of prior financial and monetary stabilisation before the privatisation is underway. Only stable macroeconomic environment ensures that the enterprises are sold to their real prices. Concluding from these arguments, gradualist economists suggest commercialisation to interchange the privatisation process. Commercialisation aims also at better enterprise efficiency but without any changes in the enterprise property rights. As the experience of the late 80s in the former Soviet Union has shown, commercialisation does not imply any major changes in enterprise behaviour, since it does not influence the managerial behaviour and is thus a way of delaying privatisation.

2.5. Sequencing of reform steps

As well as to the contest of each reform step, gradualists and shock therapists possess completely different views of optimal reform sequencing.

Orthodox economists suggest that price and wage liberalisation should initiate reforms. This would deliver enterprises with new price signals necessary for restructuring their output decisions. Foreign trade liberalisation is also complementary to the price liberalisation. Simultaneously small-scale privatisation is envisaged to open way for internal enterprise restructuring. Price liberalisation should be followed by strict monetary and financial policy securing rapid financial stabilisation. This also means imposing hard budget constraints on enterprises. Large-scale privatisation seems more efficient when financial stabilisation is attained. Such institutional reforms as establishing new market institutions, developing basic laws and introducing private property are of prior importance and should be implemented at the very start of reforms. Nevertheless, development of financial and security markets needs time and should be preceded by monetary stabilisation. Capital account liberalisation needs a certain currency stability, which was often achieved through direct currency binding and currency board activities.

An alternative gradualist approach supposes preservation of price and enterprise subsidising and postponement of large-scale privatisation would help to avoid enterprise bankruptcies and thus contain high unemployment

Eventually both approaches possess following advantages and disadvantages:

	Slow Pace Transition	Shock Therapy
High inflation risk	X	
Change in relative price structure	X	X
Higher unemployment (short run)		X
Less social benefits		X
Enterprise bankruptcies		X
Efficient resource re-allocation		X
Higher unemployment (long run)	X	
Currency devaluation	X	

3. Results of Reform Programmes

As already mentioned, the reform programmes in the CEE were extremely different, but still there are a scope of points where their experience seems similar.

3.1. Role of non-State Sector

Role of private (non-state sector) is the major indicator when the progress of the reforms is being discussed. Enterprises in the private sector are anyway more efficient and respond better to the market signals than the state-owned ones. Official data shows drastic rise in private sector share of GDP, whereas there is a big difference between the countries, which implemented comprehensive privatisation programmes and those which postponed the enterprise privatisation (Kazakhstan, Belarus, Ukraine). Hereby one has to estimate the volume of hidden economy which has sharply gained its importance over the last years. As the hidden economy lies mostly in the private sector and constitutes temporarily 20-35% of GDP, the data for the private sector can be considered as underestimated. Simultaneously, rise in the GDP share does not necessarily mean any rise in the size of the private sector. It was the case in Georgia, for example, that enormous GDP decline (especially beg in the state sector) together with stagnating private sector and privatisation caused its share in GDP to rise from 17,8 to 60%.

3.2. Changes in the Sectoral Breakdown of Economy.

As already mentioned in the first chapter, price liberalisation have caused a major change in the relative price structure. Service sector prices have risen faster than those in any other sector. In the sectoral breakdown, industrial intermediates (fuel and raw materials in particular) left the final product prices far beyond them. As shown in the Table 4, dramatic changes in the sectoral breakdown of GDP happened.

The share of the service sector, where the most newly established private entries orient their activity to because of steeply rising demand, has typically enjoyed growth on the GDP share basis. This tendency is general for all transition countries except for the slowest reformers, where agriculture became a net winner. Industry was the sector mostly effected by systemic transformation. Truly, industry became the sector with the biggest idle capacities and highest unemployment. This came through enormous rise in input prices as well as changing demand on the commodity markets.

Generally countries with bigger reform progress have bigger gains in service sector at the expense of industry and to a somewhat less degree of agriculture. Slow reformers have a somewhat less obvious pattern (with big gains either in agriculture or in industry).

3.3. General Macroeconomic Indicators.

GDP figures are most conventional to be considered for macroeconomic performance of a given country. Transformation was accompanied by major GDP reduction all over the region. Countries which pursued more liberal reform programmes were the ones to pick rapidly up with their output performance. Poland was the first country to recover in 1992, whereas all CEE and Baltics had positive growth rates since by 1994. The FSU countries were somewhat slower with Armenia in 1994 with positive growth. Nevertheless, by 1996 a number of countries managed to stabilise their output and had positive growth rates.

Inflation is another indicator which stands simultaneously for financial performance, monetary discipline and relative price shocks. Logically, the first year of transition was the year where the inflation peaked mostly as the result of price liberalisation. The countries with tight monetary policy managed to bring inflation down. In other countries soft-budget constraints and wide seigniorage opportunities conditioned following hyperinflation, but the progress is really astounding as some countries brought their inflation rates down into a lower two-digit zone during a single year.

Another effect of structural reforms on the macroeconomic indicators is the trade re-orientation. The importance of interrepublican trade for the FSU republics was somewhat more thoroughly discussed in the first chapter. Foreign trade volumes in the Former Soviet Union were negligible as compared to the intra-Soviet trade. Market reforms made the FSU countries less dependent on each other and helped to develop trade with the rest of the world

Table 1. Public Opinion about Market Economy, 1990-95, net percentage positive

	1991	1992	1993	1994	1995
Albania	45	51	52	41	59
Armenia		-25	-40	-45	-9
Belarus		-12	-19	-18	-27
Bulgaria	45	36	18	-2	6
Czech Republic	39	24	15	11	6
Estonia	32	19	26	14	20
Georgia				-24	15
Hungary	51	39	21	20	5
Latvia	43	-12	2	-5	1
Lithuania	8	-7	-22	-41	-44
Poland	28	33	29	26	46
Romania	-5	41	29	50	38
Russia	8	-7	-22	-41	-44
Slovakia	29	15	-4	0	0
Slovenia		36	2	14	1
Ukraine		-12	-19	-18	-27

Source: Anders Äslund, Peter Boone, and Simon Johnson. How to Stabilise: Lessons from Post-communist Countries. Brookings Papers on Economic Activity

Table 2. Net Revenue from Credit Issue and Natural Resource Endowments in Post-Communist Countries, 1992

	Value of net credit issue	Exports of major natural resources
Estonia	0.2	0
Hungary	0.2	0
Poland	6.4	0
Romania	6.4	0
Latvia	11.9	0
Albania	14.4	0
Lithuania	19.7	0
Kyrgyz Republic	29.1	0
Moldova	32.6	0
Russia	32.7	24200
Ukraine	34.5	...
Kazakhstan	35.7	1000
Belarus	42.8	0
Turkmenistn	63.2	840
Uzbekistan	...	673

Source: Anders Äslund, Peter Boone, and Simon Johnson. How to Stabilise: Lessons from Post-communist Countries. Brookings Papers on Economic Activity

Table 3. Private Sector Share in GDP (%) in Eastern Europe, Baltics and the CIS, 1989-94

	1989	1990	1991	1992	1993	1994
Bulgaria			16.6	25.3	35.9	40.2
Croatia		18.8	25.2	34.9	41.2	44.9
Czech Republic	11.2	12.3	17.3	27.7	45.1	56.3
Hungary	14.9		33	44	52.4	
Poland	28.6	31.4	45.3	48.2	53.5	56
Romania	12.8	16.4	23.6	26.4	32	35
Slovak Republic				22	24.6	43.8
Slovenia				32.4	39	58.2
Armenia	8.1	11.7	24.2	36.7		
Belarus	5.1	5.5	6.8	8.1		
Estonia			17.7	22		
Georgia	17.8	28.1	27.3	49	56.9	60
Kazakhstan	15	7.2	12.2			20.2
Kyrgyzstan					56.4	58
Latvia						
Lithuania			16	37	57	62.3
Moldova						
Russia	5.3	6	10.1	14	21	25
Ukraine		7.6	7.8	5.6	7.5	
Uzbekistan				38.8	46.7	54.2

Source: European Bank for Reconstruction and Development, Transition Report 1995. Investment and Enterprise Development, London.1995.

Table 4: Changes of Sector Shares in GDP at current prices, 1989-93

	Industry	Agriculture	Services[3]
Albania	-26.4	6.7	19.7

[3] Calculated as a residual for some countries

Armenia	-22.5	47.9	-25.4
Azerbaijan[4]	7.7	0.7	-8.4
Belarus	5.2	-5.5	0.3
Bulgaria	-23.5	1.3	22.2
Croatia[5]	-3.6	2	1.6
Czech Republic	-10	-0.4	10.4
Estonia	-8.4	-9.9	18.3
FYR Macedonia[6]	-7.3	2.6	4.7
Georgia	-21.3	34	-12.7
Hungary	-8	-8	16
Kazakhstan	9.2	-15.1	5.9
Kyrgyzstan	-6.7	4.1	2.6
Latvia	-13.1	-4.3	17.4
Lithuania	-3.3	-6.7	10
Moldova	1.8	-11.9	10.1
Poland	-19.4	-5.9	25.3
Romania	-19.3	6.7	12.6
Russia	-11.1	-5.6	16.7
Slovak Republic	-14.9	-2.7	17.6
Slovenia	-8.9	0.2	8.7
Tajikistan	1.3	6.1	-7.4
Turkmenistan[7]	1.7	-4.3	2.6
Ukraine	-3.5	13.5	-10
Uzbekistan	2.7	-7.8	5.1

Source: European Bank for Reconstruction and Development, Transition Report 1995. Investment and Enterprise Development, London.1995.

Table 5: Indicators of External Viability for the Former Soviet Union Countries. In per cent of GDP unless otherwise indicated

[4] Chamge over 1989-92
[5] Change over 1990-93
[6] Change over 1989-92
[7] Change over 1989-91

	Central Government Fiscal Balance	Gross Current Acoount	Net Stock of Reserves	External Debt	Debt Service
Armenia	-10	-8	2	17	4
Azerbaijan		-13	1	21	7
Belarus	-2	-2	1	17	4
Estonia		-5	2	5	
Georgia	-6	-8	3		
Kazakhstan	-2	-4	2	20	4
Kyrgyz Republic	-13	-15	2	30	80
Latvia	-5	-4	3	9	2
Lithunia		-2	3	10	3
Moldova		-7	3	80	11
Russian Federation	-5	1	2	31	7
Tajikistan	-5				12
Turkmenistan	-2		6	1	
Ukraine	-5	-4	1	24	9
Uzbekistan		-1	9	10	15

Sources: Various Statistical Bulletins

Table 6: Growth in Real GDP

	1991	1992	1993	1994

Bulgaria	-11.7	-7.3	-2.4	1.4
Czech Republic	-14.2	-6.0	-0.9	2.6
Hungary	-11.9	-3.0	-0.9	2.0
Poland	-7.6	2.6	3.8	5.0
Romania	-12.9	-10.0	1.3	3.4
Slovak Republic	-14.5	-7.0	-4.1	4.8
Estonia	-11.0	-14.2	-6.7	6.0
Latvia	-8.3	-35.0	-15.0	-2.0
Lithuania	-13.1	-37.7	-24.2	1.7
Armenia	-10.8	-52.4	-14.8	5.4
Azerbaijan	-0.7	-22.6	-23.1	-21.9
Belarus	-1.2	-9.6	-11.6	-21.5
Georgia	-13.8	-40.3	-39.0	-35.0
Kazakhstan	-13.0	-13.0	-12.0	-25.0
Moldova	-11.9	-29.0	-9.0	-22.0
Russia	-13.0	-19.0	-12.0	-15.0
Ukraine	-12.0	-17.0	-17.0	-29.0
Uzbekistan	-0.5	-11.1	-2.4	-2.6

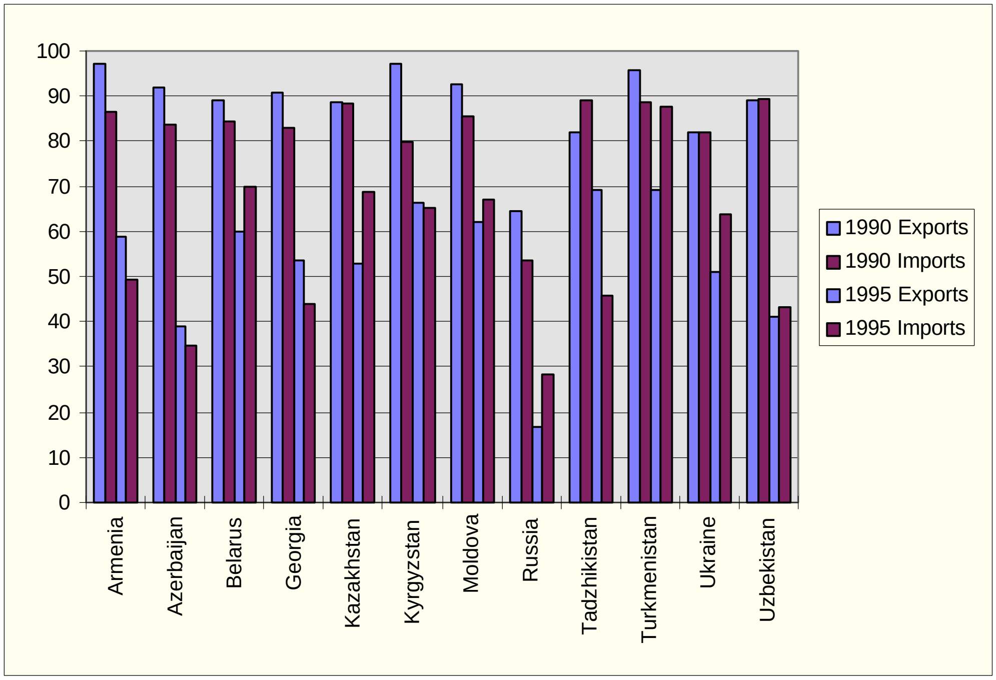
Source: European Bank for Reconstruction and Development, Transition Report 1995. Investment and Enterprise Development, London.1995.

Table 7 Inflation in Eastern Europe, the Baltics and the CIS

	1991	1992	1993	1994
Bulgaria	339	79	64	122
Czech Republic	52	13	18	10
Hungary	32	22	21	21
Poland	60	44	38	30
Romania	223	199	296	62
Slovak Republic	58	9	25	12
Estonia	304	954	36	42
Latvia	262	958	35	26
Lithuania	345	1175	189	45
Armenia	25	1341	10996	1885
Azerbaijan	126	1395	124	1788
Belarus	93	1558	1994	1875
Georgia	131	1463	7492	7380
Kazakhstan	150	2567	2169	1160
Moldova	162	2198	837	98
Russia	144	2318	841	203
Ukraine	161	2000	10155	401
Uzbekistan	169	910	885	423

Source: European Bank for Reconstruction and Development, Transition Report 1995. Investment and Enterprise Development, London.1995.

Figure 1: Intra CIS Trade as percentage of total foreign trade in 1990 and 1995



Source: Data of CIS Interstate Statistical Committee

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