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A DECADE OF TRANSITION

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1. This year of 1999 provides an excellent opportunity to review the experiences of a decade of transition from plan to market economies, to ask:

- What did we expect to happen?
- What has happened?
- Why? How does what happened compare to what was expected? Here the answers must include both economic and non-economic factors;
- What lessons have we learned?
- What comes next?

2. What did we expect?

- Fundamentally, that after a period of output decline and disorganization, the economies would begin growing, and that income levels would, over a long period, tend to catch up to those of the industrialized countries. On further consideration, based on the analysis of economic convergence, we could also anticipate that some of the less advanced countries might not catch up;

On the policy prescriptions:

- It soon became the conventional wisdom that successful transition would require macrostabilization; price liberalization; liberalization of trade and current account transactions; privatization and enterprise restructuring; creation of a social safety net; and the development of the legal and institutional frameworks for a market economy;
- Most argued that stabilization would be necessary for the resumption of growth, and many supported a speedy stabilization and reform process — the view that in simplified form supported "shock treatment" over "gradualism. This approach was based on both

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economics and the political economy argument that unless growth recovered quickly, the reform process would be difficult to sustain politically;

- An alternative view was that inflation could not be reduced quickly because of the monopolistic structure of transition economies, and in the absence of key strutural reforms bringing inflation down would have inordinate output costs;

3. What has happened?

- Show a chart of per capita GDP relative to 1989 (from the *Economist*);
- Divide the countries up into four groups and show the output charts in transition time; the output costs have been large, and probably larger than expected by most; however output declines generally came to a halt by 1996-97 and even the turmoil following the crisis in Russia in August 1998 seems to be having a smaller than envisaged impact;
- Show inflation data by country groupings; inflation rates were extremely high at the outset of the transition process — in fact several countries suffered from hyperinflation at the start of transition, but inflation was in the low double digits and less in most countries by 1997, often with the help of a fixed exchange rate;
- Show budget data by country groupings; the pattern of inflation is highly correlated with the behavior of the fiscal deficit — the high inflation periods are characterized by large fiscal deficits, there is a significant improvement in the year or two leading to stabilization, and typically continued improvement thereafter;
- In many cases, price and trade liberalization were indeed quickly achieved. Also, there was substantial progress in privatization, i.e. in the sense of putting ownership out of the hands of the official sector. (Present the data on share of private sector in output, if possible country by country.) But deeper enterprise restructuring has been harder to come by;
- Show the chart on FDI.

4. Why?

- Explain the results of the standard regressions. Emphasize also insitutional variables, including legal framework and property rights; how about the shock treatment versus gradualism debate? This is pretty much what we expected on the economics. But almost certainly we expected growth to be much faster. What accounts for the setbacks in so many countries?

- The regressions explain much of what happened. But there is also room for a dummy variable:

  Distance from Dusseldorf;
  Time under communism;
  Initial income in 1917;
  Political consensus on reform;
  The prospect of joining the EU.

5. Lessons?

- The economics works;
- The politics is very difficult to influence from the outside;
- Does aid work? Yes, but only where policies are right.
- Can aid be used to influence policies? To some extent, but you also have to know when to stop.

6. How do these general findings apply to the Russian experience?

- The August 1998 collapse was due proximately to an inability to service domestic and external public debt obligations, in the face of an unfriendly external environment, in terms of both investor sentiment to emerging markets in general, and weak oil and other commodity prices;
- More fundamentally, this debt situation reflected continued high fiscal deficits, partly due in turn to the lack of progress in structural reforms. This led to continued high spending and inability to collect taxes at the federal level, particularly in cash.
- Russia's experience validates the general results. The collapse last year was due to too little, not too much, reform — and that in turn is in large part a result of a lack of internal consensus on the desirability of the reform process. This has led to poor and incomplete implementation of critical policy reforms.
- The Russian case also illustrates the limitations of the aid process, although it has to be recognized that the amount of aid provided to Russia over the entire period is probably well less than was anticipated at the start of the transition process.

7. What next?

- The countries of CEE that have the prospect of joining Europe in the near future will continue to grow at good rates; the countries of CEE and the Baltics for which membership in the EU is a realistic possibility will likewise grow, albeit at differing rates;

- In BRO, much depends on Russia. Here the long-run prospects are good, but the road could be rocky until a clear political and economic orientation is established.