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Explaining Economic Performance During Transition: What Do We Know?

While after the collapse of the communist bloc virtually all of its former member countries embarked on market-oriented reforms, the individual countries followed different routes and experienced different outcomes. In all cases, however, output declined steeply during the early years of transition. What were the main causes behind the severe contraction of output? Why have some countries managed to overcome the transformation crisis far better than others?

The transformation from centrally planned systems to market economies in Central and Eastern Europe and in the former Soviet Union began almost 10 years ago.[1] Following the breakdown of the communist bloc in 1989 virtually all post-communist countries undertook market-oriented reforms. Perhaps no other geographical area and no other period in history experienced a comparably radical change of economic policies. On the one hand, a number of reforming countries progressed impressively towards establishing a market order. Notably Poland, Hungary, the Czech Republic, the Slovak Republic, Slovenia and Estonia launched ambitious reform programmes and can be expected to accede to the European Union in the near future. On the other hand, Russia and the non-Baltic successor states of the USSR still have a very long way to go on the rocky road of reforms. In some of these countries market-friendly reforms are still in their infancy.

During the transformation from plan to market the nations followed various routes to reform and experienced different outcomes. A common pattern, though, is that reforming countries in their entirety witnessed a serious output decline during the early years of transition. Poland, for example, returned to positive growth rates in 1992, after 2 years of contracting output. In contrast, Ukraine has faced 8 years of permanent negative growth since 1991, without any sign of recovery. Of course, no serious economist expected the post-socialist economies to enjoy an immediate recovery or even that they would rapidly catch up with the Western nations. However, the mere depth of the recession and the persistence of negative growth rates in a number of countries remain somewhat puzzling. Hence, two central questions for economic theorists arise:

- what are the main causes of the severe output contractions during transition, and
- why have some reforming countries managed to overcome the transformation crisis far better than others?

Reform Areas and Reform Progress

In the 1960s the model of socialist planned economies appeared to be very successful. Output growth typically reached more than 5 per cent, average investment equalled about 30 per cent or more of GDP and open unemployment was virtually unknown. Central planning was often expected to lead to a fast catching up with Western market economies' standards. During the next two decades the socialist economic system lost much of its seeming attractiveness, however. As predicted by Hayek and Mises forty years earlier, socialist planning proved to be increasingly incapable of solving the coordination problems of a modern economy. An oversized state industrial sector was unable to overcome serious shortages and black market activities became progressively more important. The quality of both consumer and investment goods was very low and so was productivity in all sectors. In short, the static and dynamic inefficiencies of socialist planning caused the visible poor performance of the

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[1] Though one could argue that remarkable experiments with market-friendlier policies in Yugoslavia and Hungary had been observed earlier during the 1950s and 1960s, the beginning of the reforms can be dated to 1990 in Poland, Hungary, and countries of former Yugoslavia, 1992 in the former Soviet Union states, including the Baltic countries, and 1991 for the remaining transition economies.

official economic system. Moreover, economic deterioration in the 1980s contributed a great deal to the breakdown of the established one-party political systems in the communist states.

The events of 1989/90 set the stage for a comprehensive revision of the previous economic systems. Reform-minded politicians faced enormous challenges in transforming the centrally planned economies. In the light of the nearly complete absence of a private sector in most of the countries – in 1990 only Poland had a private sector share of GDP of more than 20 per cent – establishing a market-based system required at least 6 key policy measures to put the countries on a path of sustainable long-term growth.[2] These are, in no particular order:

- ☐ macroeconomic stabilisation,
- ☐ internal liberalisation,
- ☐ removal of restrictions on trade and foreign direct investment (external liberalisation),
- ☐ privatisation of state-owned enterprises,
- ☐ development of a new private sector, and
- ☐ establishment of a market-supportive legal framework.

The list of required policy changes can easily be expanded to further topics such as the creation of a new system of social security, the establishment of a market-friendly tax system and many more issues. Various policy measures of market-oriented reforms can be classified into two broad categories.[3] The macro-level consists of different policies aimed at restoring macroeconomic stability. This implies reducing the public sector deficit as well as the liberalisation of financial markets and exchange rates. Structural reforms are more concerned with the elimination of the price distortions caused by inappropriate government policies at the micro-level. For that reason, they are associated with all forms of deregulation and a removal of the entire set of interventionist policies. Additionally, as economic incentives are supposed to be stronger in private enterprises, 'getting the property rights right' leads to the proposition of a broad privatisation of firms. The most important task of micro-level reforms is getting the institutions right. Enhancing the quality of the legal framework and making property rights safer in a well-designed legal environment is consequently a central element of systemic transformation.

How much has happened during the transition? According to the latest issue of the 'Transition Report'[4] privatisation progressed significantly in Croatia, the Czech and the Slovak Republics, Poland, Estonia and Hungary. Estimated private sector shares of GDP range from 15 per cent in Belarus to levels of about 75 per cent in Albania and the Czech Republic (1996). Compared to the advanced economies, internal liberalisation in 1998 had not yet reached Western standards. The reforms of financial institutions are not completed in most of the countries; there have been virtually no financial reforms to date in Belarus, Uzbekistan and Tajikistan. With regard to fiscal policies, many countries have failed to introduce and to enforce a market-friendly tax system, while spending remains extensive. As a consequence, most transition economies still suffer from public deficits. Fiscal consolidation efforts were at least partly successful, however. Whereas in 1992 the average ratio of fiscal deficits to GDP was about 13.5 per cent, it declined to 3.5 per cent in 1997. Financing deficits via central bank credits also dropped seriously from an average level of 11 per cent (1992) to less than 1 per cent of GDP (1997).[5] With respect to inflation stabilisation, the majority of reforming countries have been doing reasonably well. Except for Bulgaria and Romania, facing rates of 578 per cent and 152 per cent respectively, inflation fell to two-digit rates in all of the transition economies (1997).

In an attempt to rank the entire package of reform efforts, the EBRD index of policy change in the post-communist countries reports very different progress. In 1997, Hungary, Poland, Estonia and the Czech Republic were considered to be the most liberalised economies in the Central and Eastern European hemisphere, whereas successor countries of the former Soviet Union, such as Tajikistan, Belarus, Turkmenistan, and Uzbekistan lag far behind. These results are in principle confirmed by the 1999 Heritage Index of Economic Freedom. Among 161 nations from all over the world covered by this ranking, Estonia is No. 18 and the Czech Republic ranks as No. 12. Both

[2] Cf. A. Aslund, P. Boone, S. Johnson: How to Stabilize: Lessons from Post-communist Countries, in: Brookings Papers on Economic Activity, No. 1, 1996, pp. 217-313.

[3] O. E. Williamson: The Institutions and Governance of Economic Development and Reform, in: O. E. Williamson (ed.): The Mechanisms of Governance, New York 1996, pp. 322-343.

[4] Cf. European Bank for Reconstruction and Development: Transition Report Update, London 1998.

[5] Cf. C. Cottarelli, P. Doyle: Taming Inflation in the Transition Economies, in: Finance and Development, June 1999, pp. 9-11; V. Tanzi: Transition and the Changing Role of Government, in: Finance and Development, June 1999, pp. 20-23.

nations therefore offer more economic liberties than, say, Germany or Sweden. In contrast, Russia ranks as No. 106 and Turkmenistan is No. 149, indicating that a lot is still to be done until they can be labelled free market economies.[6]

Economic Outcomes of Transition

The challenge of transformation proved to be eminently tough, as the patterns of GDP growth, employment and inflation development shown in Table 1 illustrate. After implementing the first reform steps all countries witnessed sharp output losses.

Even if serious problems concerning data quality cannot be neglected, there is no doubt that a temporary collapse of GDP is a typical pattern in the transition process.[7] It took at least 2 years, as in Poland, to as many as 7 years, as in Tajikistan, for output decline to cease in most countries. Several economies, including Albania, Bulgaria, Romania and the Czech Republic, have experienced several years of recovery, in which GDP did not grow steadily, however. Figure 1 illustrates the average growth performance of former Soviet Union states (FSU) and Central and Eastern Europe (CEE) nations in transition years. The first year of reform, i.e. the year when central planning was officially abandoned, is denoted as 'year 1'.

The fall in output reached an enormous amount. On average, the GDP index for 1997 (1989=100) of the economies in transition was less than 65 – not including the war-torn countries of Bosnia-Herzegowina and Yugoslavia. There are remarkable differences in output performance, though. Until 1997 Russia's GDP collapsed to 57 per cent of its 1989 level, and 8 transition countries witnessed a real GDP of less than half of their 1989 data. In contrast, in 1997 Poland attained an output higher than 1989; and Slovenia and the Czech Republic arrived at GDP levels almost equal to the levels of 1989. While the average output index, compared to the 1989 levels, of FSU nations, including the Baltic states, is only 51.6, the average of CEE countries is about 33 percentage points higher in 1997. Figure 2 shows the pattern of output evolution in FSU countries and CEE countries during transition. The pre-transition year is denoted 'year 0'.

With respect to the labour market, the intensively reforming economies of Central Europe showed a distinct rise in official unemployment rates, with the exception of the Czech Republic where rates stayed below 5 per cent until 1996. Despite their enormous fall in GDP, reported unemployment in the slow FSU reformers Uzbekistan, Ukraine and Moldova remained less than 2 per cent. This obviously points more to the flaws of official data than to a successful labour

Figure 1
Average Growth Performance of CEE and FSU Countries during Transition

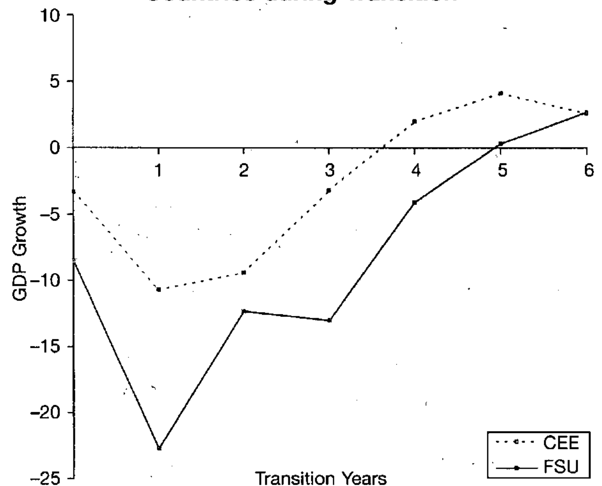
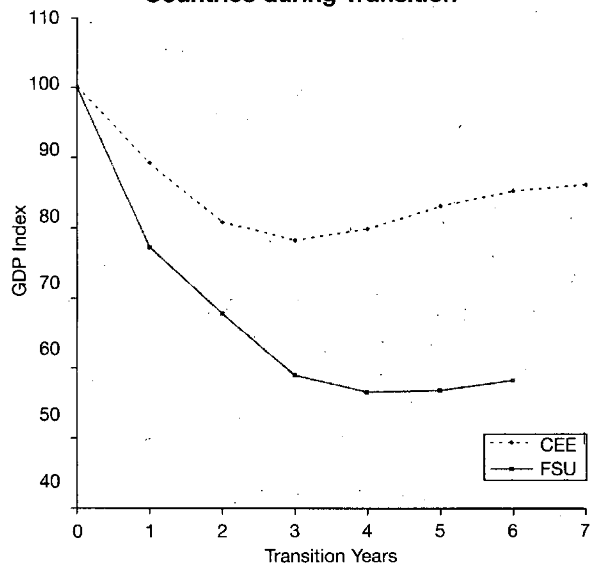


Figure 2
Average output of CEE and FSU Countries during Transition



[6] Both the EBRD index and the Heritage index capture reform progress at the macro-level and the micro-level broadly. For the construction of the indices, cf. European Bank for Reconstruction and Development, op. cit.; Heritage Foundation: Index of Economic Freedom, Washington 1999.

[7] Several reasons indicate that the problem of GDP shrinkage is overstated by the available data. (1) In the socialist system there was a tendency for official statistics to over-report production. (2) The emerging private sector is not captured accurately by official statistics, whereas the shrinking state sector is.

Table 1
Economic Performance of Economies in Transition

	1989	1990	1991	1992	1993	1994	1995	1996	1997
Albania									
Real GDP growth rate	9.8	-10.0	-17.7	-7.2	9.6	9.4	8.9	9.1	-8.0
Inflation rate[1]	0.0	0.0	104.1	236.6	30.9	15.8	6.0	17.4	42.0
Unemployment rate[2]	...	7.6	8.3	24.4	24.8	10.1	13.9	...	...
Armenia									
Real GDP growth rate	14.2	-7.4	-17.1	-52.6	-14.8	5.4	6.9	5.8	3.3
Inflation rate[1]	...	...	25.0	1341.0	1089.6	1885.0	32.0	5.8	21.9
Unemployment rate[2]	...	...	...	...	5.2	6.6	6.7	9.3	...
Azerbaijan									
Real GDP growth rate	-4.4	-11.7	-0.7	-22.6	-23.1	-18.1	-11.0	1.3	5.0
Inflation rate[1]	...	...	126.0	1395.0	1293.8	1788.0	84.5	6.7	0.5
Unemployment rate[2]	...	...	...	15.0	16.0	15.0	17.0	20.0	...
Belarus									
Real GDP growth rate	8.0	-3.0	-0.7	-22.6	-23.1	-18.1	-11.0	1.3	5.0
Inflation rate[1]	...	...	93.0	1559.0	1996.0	1960.0	244.0	39.2	63.1
Unemployment rate[2]	...	...	0.0	0.5	1.4	2.1	2.7	3.9	...
Bulgaria									
Real GDP growth rate	-0.5	-9.1	-11.7	-7.3	-1.5	1.8	2.1	-10.9	-7.4
Inflation rate[1]	10.0	72.5	338.9	79.4	63.8	121.9	32.9	310.8	578.6
Unemployment rate[2]	0.0	1.5	11.1	15.3	16.4	12.4	11.1	...	...
Croatia									
Real GDP growth rate	-1.6	-6.6	-20.6	-11.7	-0.9	0.6	1.6	4.3	5.5
Inflation rate[1]	...	136.0	149.0	938.2	1149.0	-0.3	3.8	3.4	3.8
Unemployment rate[2]	...	...	13.2	13.2	14.8	14.5	14.5	16.4	16.8
Czech Republic									
Real GDP growth rate	1.4	-0.4	-11.5	-3.3	0.6	3.2	6.4	3.9	1.0
Inflation rate[1]	1.5	18.4	52.0	12.7	18.2	9.7	7.9	8.6	10.0
Unemployment rate[2]	0.0	0.8	4.1	2.6	3.5	3.2	2.9	3.5	5.2
Estonia									
Real GDP growth rate	-1.1	-3.6	-7.9	-14.2	-8.5	-1.8	4.3	4.0	10.0
Inflation rate[1]	...	...	303.8	935.5	35.6	42.0	29.0	15.0	12.0
Unemployment rate[2]	0.0	0.0	0.1	5.0	5.1	5.1	5.6	5.4	...
Georgia									
Real GDP growth rate	-4.8	-12.4	-20.6	-44.8	-25.4	-11.4	2.4	10.5	10.0
Inflation rate[1]	...	3.3	131.0	1177.0	7488.0	6474.4	57.4	13.8	8.1
Unemployment rate[2]	...	...	...	5.4	8.4	...	...	...	...
Hungary									
Real GDP growth rate	0.7	-3.5	-11.9	-3.1	-0.6	2.9	1.5	1.3	4.3
Inflation rate[1]	18.9	33.4	32.2	21.6	21.1	21.2	28.3	19.8	18.4
Unemployment rate[2]	0.3	2.5	7.5	12.3	12.1	10.4	10.4	10.5	10.4
Kazakhstan									
Real GDP growth rate	-0.4	-0.4	-5.0	-2.9	-10.4	-17.8	-8.9	1.1	1.8
Inflation rate[1]	...	...	170.0	2984.1	2169.0	1160.0	60.4	28.6	11.3
Unemployment rate[2]	0.0	0.0	0.0	0.5	0.6	0.8	1.7	3.6	4.2
Kyrgyz Republic									
Real GDP growth rate	4.0	3.0	-5.0	-19.0	-16.0	-20.0	-5.4	5.6	10.4
Inflation rate[1]	...	...	170.0	1259.0	1363.0	95.7	31.9	35.0	14.8
Unemployment rate[2]	...	...	0.0	0.1	0.2	0.7	3.0	4.5	3.2
Latvia									
Real GDP growth rate	6.8	2.9	-10.4	-34.9	-14.9	0.6	-0.8	2.8	6.0
Inflation rate[1]	...	...	262.4	959.0	35.0	26.0	23.0	19.8	18.4
Unemployment rate[2]	0.0	0.0	0.1	2.3	5.8	6.4	6.3	7.0	...
Lithuania									
Real GDP growth rate	1.5	-5.0	-13.4	-37.7	-17.1	-11.3	2.3	5.1	5.7
Inflation rate[1]	...	...	345.0	1161.1	188.8	45.0	35.5	13.1	8.5
Unemployment rate[2]	0.0	0.0	0.3	1.3	4.4	3.6	6.1	7.1	5.9
Macedonia									
Real GDP growth rate	...	-9.9	-12.1	-21.1	-8.4	-4.0	-1.4	1.1	1.0
Inflation rate[1]	...	...	229.7	1925.2	229.6	55.4	9.3	0.2	4.6
Unemployment rate[2]	...	...	19.2	19.8	18.7	20.7	23.7	24.9	30.0
Moldova									
Real GDP growth rate	8.8	-2.4	-17.5	-29.1	-1.2	-31.2	-3.0	-8.0	1.3
Inflation rate[1]	...	...	151.0	2198.0	837.0	116.0	23.8	15.1	11.2
Unemployment rate[2]	0.0	0.0	0.0	0.1	0.7	1.1	1.4	1.6	1.6
Poland									
Real GDP growth rate	0.2	-11.6	-7.0	2.6	3.8	5.2	7.0	6.1	6.8
Inflation rate[1]	639.5	249.0	60.4	44.3	37.6	29.4	21.6	18.5	13.2
Unemployment rate[2]	0.1	6.1	11.8	13.6	15.0	16.5	15.2	14.3	11.5
Romania									
Real GDP growth rate	-5.8	-6.5	-12.9	-8.7	1.5	3.9	7.1	4.1	-6.6
Inflation rate[1]	0.6	37.7	222.8	199.2	295.5	61.7	27.8	58.9	151.6
Unemployment rate[2]	0.0	0.0	3.0	6.2	9.5	9.5	7.4	6.1	7.0
Russia									
Real GDP growth rate	3.0	-2.0	-5.0	-14.5	-8.7	-12.6	-4.0	-4.9	0.4
Inflation rate[1]	...	...	143.9	2508.8	840.1	204.7	131.3	21.8	11.1
Unemployment rate[2]	0.0	0.0	0.0	4.8	5.7	7.5	8.8	9.3	...
Slovak Republic									
Real GDP growth rate	4.5	-0.4	-14.6	-6.5	-3.7	4.9	6.8	6.9	6.5
Inflation rate[1]	1.5	18.4	58.3	9.1	25.1	11.7	7.2	5.4	6.4
Unemployment rate[2]	0.0	1.5	11.8	10.4	12.2	13.7	13.2	11.1	11.6
Slovenia									
Real GDP growth rate	-2.7	-4.7	-8.9	-5.5	2.8	5.3	4.1	3.1	3.3
Inflation rate[1]	272.0	105.0	247.1	92.9	22.9	18.3	8.6	8.8	9.4
Unemployment rate[2]	2.9	4.7	8.2	11.5	14.4	14.4	13.9	13.9	14.4
Tajikistan									
Real GDP growth rate	-2.9	-1.6	-7.1	-29.0	-11.0	-18.9	-12.5	-4.4	2.2
Inflation rate[1]	...	...	204.0	1384.0	7344.0	1.1	2133.0	40.5	165.0
Unemployment rate[2]	...	...	...	0.3	1.2	1.7	2.0	2.6	2.9
Turkmenistan									
Real GDP growth rate	-6.9	2.0	-4.7	-5.3	-10.0	-18.8	-8.2	-8.0	-25.0
Inflation rate[1]	...	...	155.0	644.0	9750.0	1328.0	1262.0	446.0	21.5
Unemployment rate[2]	...	...	2.0	...	...	...	3.0	...	...
Ukraine									
Real GDP growth rate	4.1	-3.6	-11.6	-13.7	-14.2	-23.0	-12.2	-10.0	-3.2
Inflation rate[1]	...	...	161.0	2730.0	1015.5	401.0	182.0	39.7	10.1
Unemployment rate[2]	0.0	0.0	0.0	0.3	0.4	0.4	0.5	1.3	2.3
Uzbekistan									
Real GDP growth rate	3.7	1.6	-0.5	-11.1	-2.3	-4.2	-0.9	1.6	2.4
Inflation rate[1]	...	...	169.0	910.0	885.0	1281.0	117.0	64.0	28.0
Unemployment rate[2]	0.0	0.0	0.0	0.1	0.3	0.4	0.4	0.4	0.5

... not available. [1] CPI end of year. [2] end of year.

Sources: European Bank for Reconstruction and Development; International Monetary Fund.

market policy during the reforms. At the beginning of the transformation, inflation in some countries exploded to rates of more than 1,000 per cent, although Table 1 documents that inflation experience varied considerably. Hungary, for example, never had an inflation rate of above 40 per cent. In the vast majority of the transition economies inflation dropped to less than 50 per cent in 1997. The cases of Bulgaria and Romania reveal however that inflation rates often remain highly volatile.

The stylised facts show that all transition economies exhibited a worsening of macroeconomic conditions during the first years. Policy reforms were accompanied by a serious deterioration of growth and a rise in official registered unemployment. Even for successful reformers it took years to recover. Whereas a number of countries managed to overcome the recession very quickly, some other countries – especially the non-Baltic successor states of the Soviet Union – are still far from reaching an acceptable level of economic prosperity. And it is by no means clear that they will recover in a reasonable time. These experiences have led economists to suggest the existence of a U-shaped adjustment path to reforms.[8] The magnitude of the transitional recession and the persistence of the decline in some countries came as a surprise, however. The key theoretical question is why the move to a more efficient regime was accompanied by such a severe initial decline in GDP. Several explanations come into mind immediately.

The Role of Structural Reform Policies

Central planning led to a serious misallocation of resources, but removing distorting policies opened up new opportunities for individuals. Private actors were now free to shift their privately controlled resources to more advantageous purposes. Structural reforms implied a massive reallocation to previously discriminated employment or to newly discovered uses. Factors of production formerly employed in an over-industrialised state sector shifted toward the emerging private sector. Nonetheless, the process of reallocation can in fact lead to a temporary decline in output and an increase in unemployment.[9] Standard neoclassical approaches assume that resources can be shifted between sectors immediately at no cost. But the transfer of factors between different uses is far from being without cost. The removal of various subsidies devalued the stock of human and physical capital, which were industry-specific to a large extent. Shifting resources to the emerging private sector carried with it specific investments. Hence, structural reforms are associated with an economy-wide output loss if creation effects are weaker than destruction effects. During the adjustment response, a reforming economy's production possibility frontier is said to shift inwards, as resources are tied up in the process of reallocation between the state and the private sector.[10] Furthermore, factor prices have proved to be imperfectly flexible downwards. Price rigidities caused increasing unemployment of labour and capital and contributed to the output decline. To be sure, a vast number of inflexibilities impeding faster adjustment were the consequence of still unfinished economic liberalisation. Output decline can thus in part be identified as a policy mistake.

A further explanation of the breakdown of real output during transition is disorganisation.[11] Under the previous system central agencies acted as supervising authorities managing highly specific relations between firms in order to enforce the production and the delivery of goods. The abolition of central planning eliminated the supervising function, leading to increasing uncertainty regarding opportune behaviour in transaction-specific relations. As new market participants could not enter the stage immediately, contractual failures concerning long-term economic relations led to a sharp output decline. The disorganisation problem seems to have been the more important, the longer the chains of production relations between state enterprises were in the planned economies. Disorganisation may then also help to explain shortages in the transition countries despite internal and external liberalisation.

Another source of a supply-side caused transitional recession is restructuring.[12] With regard to state firms, restructuring implied a change of ownership and an alteration of organisational procedures and production techniques to enhance productivity. In the short run, restructuring was clearly accompanied by a production decline in those state firms which were reorganising. Labour demand decreased unambiguously since labour hoarding was a main feature of socialist economies. Whether successful restructuring contributes to a rise or a fall in unemployment in the longer run, depends on the value of the elasticity of substitution between capital and labour. Only factor

[8] Cf. A. Przeworski: Democracy and the Market. Political and Economic Reforms in Eastern Europe and Latin America, Cambridge 1991; N. van Long, H. Siebert: A Model of the Socialist Firm in Transition to a Market Economy, Kiel Working Papers, No. 479, 1991; J. C. Brada, A. E. King: Is There a J-Curve for the Economic Transition from Socialism to Capitalism?, in: Economics of Planning, Vol. 25, 1992, pp. 37-53; O. Blanchard: The Economics of Post-Communist Transition, Cambridge 1997.

[9] Cf. E. Hernandez-Cata: Liberalization and the Behavior of Output During the Transition from Plan to Market, in: IMF Staff Papers, Vol. 44, 1997, pp. 405-429; O. Blanchard, op. cit.

[10] Cf. the contribution by M. Mussa: Government Policy and the Adjustment Process, in: J. Bhagwati (ed.): Import Competition and Response, Chicago, London 1982, pp. 73-120.

[11] Cf. O. Blanchard, M. Kremer: Disorganization, in: Quarterly Journal of Economics, Vol. 112, 1997, pp. 1091-1126.

[12] Cf. O. Blanchard, op. cit.

productivity which rises over time due to restructuring will create new jobs.

To summarise, structural reforms appeared to have a harmful effect on output and employment in the short run. Reallocation and restructuring affected the shrinking state sector and the expanding private sector in opposite ways. The net effect on output behaviour in post-communist countries is therefore unclear, because it depends on the relative magnitude of state sector decline and private sector expansion. Economic recovery will set in if the creation effects of structural reforms outweigh their destruction effects. In this respect, the credibility of policy reforms seems to play the key role.[13] The main argument is that reallocation and restructuring are essentially investment decisions. If a policy change lacks credibility from the viewpoint of private actors, new investments will be withheld. The lack of credibility then has a harmful impact on investment response. The key problem is that a disappointing reallocation of resources in turn enhances the probability of policy reversals. Rodrik demonstrates that these effects can lead to multiple equilibria, which are either conducive or detrimental to the success of a market-friendly policy change. Reforms can collapse, even if a government which is reform-minded but lacking in credibility follows a correct economic recipe. The sharp initial decline in production in a number of transition countries and even the failure of reforms may thus be the result of a self-fulfilling prophecy.

Stabilisation Policies

A central feature of economic transition is severe efforts to stabilise prices from a situation of high inflation. As noted above, some nations suffered from price instability due to excessive public deficits, financed by monetary expansion. The sudden increase of inflation in Central and Eastern Europe and in the former Soviet Union during the first years of economic reforms, however, had additional causes.[14] First, the elimination of subsidies and price ceilings led to an initial explosion of prices. Second, nearly all of the post-communist states faced a serious monetary overhang caused by previously repressed inflation.

Disinflation policies are usually composed of three standard ingredients:

- a tight monetary policy,
- an exchange rate based stabilisation, and
- a fiscal contraction.

With regard to its short-run costs, economic theory is still dominated by the Keynesian view that disinflation is inevitably accompanied by a decline in aggregate demand and output. The primary reason is that fiscal adjustment and a tight monetary policy lead to contractions in domestic demand. Furthermore, rapid disinflation is said to give rise to hysteresis effects on the labour market, and may contribute to an enduring high rate of unemployment. Calvo and Corricelli see evidence for a credit crunch hypothesis during the transition of former socialist economies.[15] Strict monetary policies and high interest rates in combination with seriously underdeveloped financial sectors caused extreme shortages of available credit for firms under reconstruction. Firms were thus forced to sell their physical capital stock, to slow down production, and to cease paying employees and suppliers. Moreover, some authors consider the breakdown of the CMEA in 1991 to be a central cause of initial GDP decline.[16] Since the trade relations of the previous regimes predominantly concentrated on the socialist partners in the communist bloc, the CMEA demand shock undoubtedly played a major role. According to this view, the transition countries' anti-inflation efforts contributed to short-run output losses, or, to put it differently, macro-policies were excessively contractionary.

Recent theoretical developments, however, put some doubts on the conventional wisdom. High and volatile inflation rates are detrimental to a smooth functioning of the market system. Disinflation policies in that case may even have short-term expansionary effects, especially when they are aimed at taming hyperinflation. The sacrifice ratio of a disinflation to one digit rates, however, depends to a much higher degree on supply-side conditions in the reforming countries. In line with that reasoning, Aslund, Boone, and Johnson report that transition economies which undertook both rigid liberalisation and stabilisation

[13] Cf. in general D. Rodrik: Policy Uncertainty and Private Investment in Developing Countries, in: Journal of Development Economics, Vol. 36, 1991, pp. 229-242; N. Funke: Credibility of Government Policy: Lessons for Economies in Transition, in: INTERECONOMICS, Vol. 28, 1993, pp. 73-78.

[14] Cf. P. J. J. Welfens: Economic Reforms in Eastern Europe: Basic Problems, Options and Opportunities, in: INTERECONOMICS, Vol. 26, 1991, pp. 214-222.

[15] Cf. G. A. Calvo, F. Coricelli: Output Collapse in Eastern Europe. The Role of Credit, in: IMF Staff Papers, Vol. 40, 1993, pp. 32-52.

[16] Cf. J. C. Brada, A. E. King, op. cit.; E. Borensztein, D. G. Demekas, J. G. Ostry: An Empirical Analysis of the Output Declines in Three Eastern European Countries, in: IMF Staff Papers, Vol. 40, pp. 1-31.

policies recovered faster and experienced less severe output losses than countries in which anti-inflation policies were not that rigorous.[17] Recent empirical investigations concerning fiscal adjustments in OECD countries have also shown that state budget consolidation is not necessarily associated with a recession, due to wealth and expectation effects.[18] Credibility of anti-inflation policies also seems to play a crucial role for the size of the output decline. If, say, a fiscal adjustment is believed to be unsustainable, private sector expenditures will not rise, and contractionary Keynesian effects dominate expansionary non-Keynesian effects. The transitional recession will then be sharp, and it will be increasingly difficult for the government to attain fiscal balance and macroeconomic stabilisation.

Gradualism vs. Shock Therapy

To many observers, the choice of the speed and the comprehensiveness of reforms are the key features of the economic transition. The discussion on an appropriate strategy for reform, however, comes to inconclusive results. On the one hand, proponents of a gradual approach claim that a severe output collapse can be avoided if reform policy measures are not too tight.[19] A step-by-step elimination of subsidies to state firms, or a gradual removal of trade barriers, for instance, leaves enterprises an extended time to adjust to the new economic environment. Consequently, gradualism is said to lead to less sharp output deterioration and moderate initial unemployment. On the contrary, a higher pace of policy changes is supposed to cause an immediate breakdown of state firms while private businesses are not yet capable of absorbing capital outflows and layoffs.[20] As seen from this view, reform policies were too fast and often too tight.

On the other hand, the case for gradualism is less convincing if it is considered that incentives to reallocate resources and to restructure state firms are seriously weakened. The central point is that policies affect incentives in the declining state sector as well as in the newly emerging private sector. If, for example, hard budget constraints for state enterprises are not completely enforced, restructuring will not occur. At the same time private business is affected negatively by the higher taxes needed in order to finance remaining subsidies. Job creation and economic recovery, which depend on the magnitude of adjustment, are depressed. According to the proponents of a big bang, gradual reforms always carry with them the danger of preserving inefficiencies far too long.[21] Slowing down the speed of change is then supposed to be detrimental to growth and employment.

Shock therapy is also often said to be unsuitable for the reform of institutional arrangements. The old institutions are invalidated but new arrangements need time to develop. Murrell points out that fast changes destroy informational networks and capacities of economies.[22] As seen from this viewpoint, the displacement of institutional arrangements is an erroneous strategy because it causes a loss of valuable knowledge, never available to the designers of new institutions. At the beginning of the transition, market-supportive institutions hence work at best imperfectly – radical institutional reforms often create the risk of an institutional vacuum. Advocates of gradualism therefore propose a smooth substitution of previous arrangements by new ones in order to manage the severe problems of discontinuity. The main dilemma of this proposition is that central planning institutions in 1989 lost simply all of their trustworthiness, as sharply increasing shadow market activities indicate. It was even better for people to rely on a highly insecure environment than to trust in a corrupt and incompetent state bureaucracy. In that case a fast and comprehensive change of rules seemed to be superior to moderate reforms.

The controversial debate about the sound strategy is likewise linked to aspects of the credibility of reforms. Some authors claim that the credibility of reforms is enhanced if the government signals its true motives via radical reform measures.[23] The argument rests on the assumption that policy reversals are less

[17] Cf. A. Aslund, P. Boone, S. Johnson, op. cit.

[18] Cf. C. J. McDermott, R. F. Wescott: An Empirical Analysis of Fiscal Adjustments, in: IMF Staff Papers, Vol. 43, 1996, pp. 725-753; A. Alesina, S. Ardagna: Tales of Fiscal Adjustments, in: Economic Policy, Vol. 27, 1998, pp. 487-545.

[19] P. Hare, T. Revesz: Hungary's Transition to a Market Economy: The Case Against a 'Big-Bang', in: Economic Policy, Vol. 14, 1992, pp. 227-264; P. Aghion, O. Blanchard: On the Speed of Transition in Eastern Europe, in: P. Hare, J. R. Davis (eds.): Transition to the Market Economy, Vol. 1, London, New York 1997, pp. 63-98.

[20] Cf. R. J. Caballero, M. L. Hammour: On the Ills of Adjustment, in: Journal of Development Economics, Vol. 51, 1996, pp. 161-192; P. Aghion, O. Blanchard, op. cit.

[21] Cf. A. Berg, J. Sachs: Structural Adjustment and International Trade in Eastern Europe: The Case of Poland, in: Economic Policy, Vol. 14, 1992, pp. 117-173; K. Murphy, A. Shleifer, R. Vishny: The Transition to a Market Economy: Pitfalls of Partial Reform, in: Quarterly Journal of Economics, Vol 107, 1992, pp. 889-906.

[22] Cf. P. Murrell: Evolutionary and Radical Approaches to Economic Reform, in: Economics of Planning, Vol. 25, pp. 79-95.

likely if shifting back to the old system is more costly. Additional merits of a big bangapproach therefore lie in a credible commitment to policy change. On the other hand, it is also argued that radical reform measures may be harmful to credibility, since the government constrains its future policy options.[24] The crucial point is that no policymaker can escape political pressures when things are really going bad. Announcing a flexible strategy or a less rigid policy may then enhance the credibility of the entire reform package.

Empirical studies suggest that faster and more comprehensively reforming countries like Poland did better in general than slow reformers.[25] Cross-sectional studies show that differences in growth performance after some years of transition are predominantly explained by differences in reform efforts.[26] Output decline was not that harsh and economic recovery set in earlier and proved to be sustainable in countries that launched more ambitious reforms. The performance of intermediate reformers is comparably worst during the early transition years. This group of countries witnessed an even sharper economic collapse than virtually non-reforming countries. After almost a decade of reform, it seems that radical strategies have paid well.

Effect of Initial Conditions

Structural reforms, macroeconomic stabilisation and the choice of the reform strategy affect output and growth performance during transition. It remains unclear, however, to what extent the initial decline is attributable to reform policies or to adverse starting conditions. Moreover, it can be argued that the choice of a sound strategy for reforms depends crucially on the state of economic conditions at the beginning of the transition. The problem is to decompose output dynamics into the separate impacts of policies on the one hand and previous distortions on the other.

There is, of course, some evidence that inherited conditions throw a dark shadow on economic performance in the early transition years. Most empirical investigations confirm the negative impact of unfavourable starting conditions, as measured by the level of macroeconomic and structural distortions, the share of agrarian production, initial GDP per capita and over-industrialisation, on economic performance.[27] De Melo et al. estimate that a more auspicious initial environment in the Central and Eastern European countries served as a growth benefit of 5 per cent per annum on average compared to the successor states of the Soviet Union. Havrylyshyn, Izvorski and van Rooden, on the other hand, report that the effect of initial conditions is rather weak compared to the influence of liberalisation policies during the reform period. They also claim that the impact of starting conditions is declining over time. The legacy of previous policies only seems to be weighty in the short run. This is confirmed by the fact that the more ambitious reforming Baltic successor states of the former Soviet Union managed to overcome the transition crisis far better than other successors, although they faced similar distortions at the beginning of the reforms. Another fact that highlights the importance of initial conditions is that almost all non-reforming countries also experienced GDP losses. Delaying reforms did not prevent output deterioration. Berg et al. find that the main force behind the output decline is adverse initial conditions, whereas output recovery is primarily driven by the extent of the structural reforms.

Concluding Remarks

Almost 10 years after the start of the transition economic theory is beginning to understand the mechanisms that caused the serious output collapse in the post-communist nations. It seems that both supply-side and demand-side responses to the policy changes as well as bad initial conditions contributed to the dramatic output losses during the early years of reform. Countries that initiated comprehensive reforms were able to return to positive growth rates. Delays in policy changes and the failure to continue with reforms after some minor initial steps appear to be the central causes of the ongoing bad performance in a number of transition economies.

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[23] Cf. D. Rodrik: Promises, Promises: Credible Policy Reforms via Signalling, in: Economic Journal, Vol. 99, 1989, pp. 756-772; N. Funke: Timing and Sequencing of Reforms: Competing Views and the Role of Credibility, in: Kyklos, Vol. 46, 1993, pp. 337-362.

[24] Cf. A. Drazen, P. R. Masson: Credibility of Politics versus Credibility of Policymakers, in: Quarterly Journal of Economics, Vol. 109, 1994, pp. 735-754; P. Aghion, O. Blanchard, op. cit.

[25] Cf. M. de Melo et al.: Circumstance and Choice: The Role of Initial Conditions and Policies in Transition Economies, World Bank Working Paper No. 1866, Washington, 1997; O. Havrylyshyn, I. Izvorski, R. van Rooden: Recovery and Growth in Transition Economies 1990-97: A Stylized Regression Analysis, IMF Working Paper No. 141, Washington 1998; A. Berg et al.: The Evolution of Output in Transition Economies: Explaining the Differences, IMF Working Paper No. 73, Washington 1999.

[26] Krueger and Ciolko however claim that a serious measurement bias may overstate the impact of reform policies relative to starting conditions. Cf. G. Krueger, M. Ciolko: A Note on Initial Conditions and Liberalization During Transition, in: Journal of Comparative Economics, Vol. 26, 1998, pp. 718-734.

[27] Cf. footnote 25.