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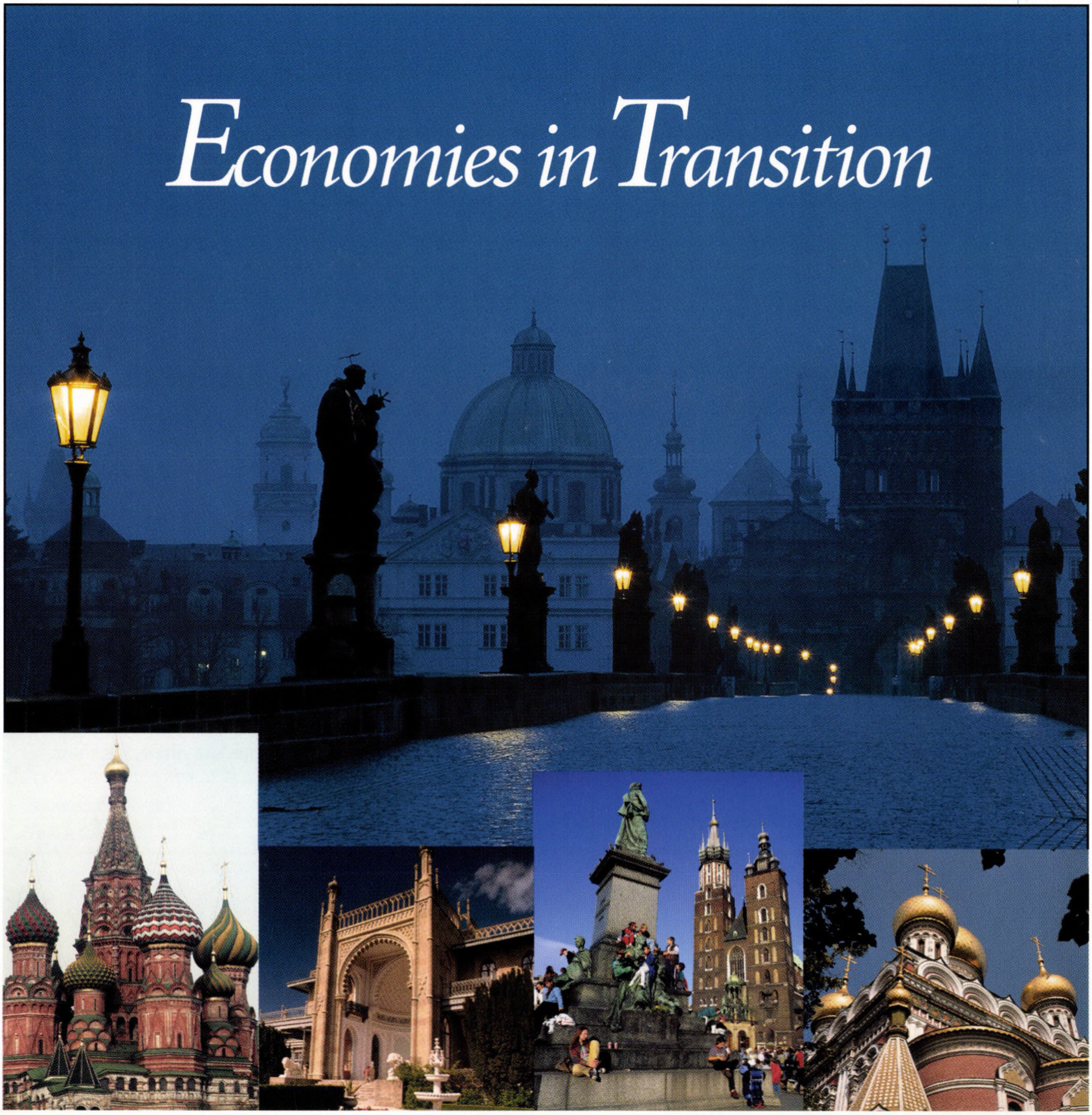
Economies in Transition



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from the editor

IT IS more than a decade since the dramatic process of transforming the former socialist societies into market economies began. The outcome so far has been mixed. Some of these countries, mainly those in Central and Eastern Europe and the Baltics, are now close to becoming full market systems. Others, particularly those farther east and in southeastern Europe, are still struggling to develop their private sectors and establish market institutions.

This issue of *Finance & Development* reviews what has been achieved to date. In the opening article, Stanley Fischer and Ratna Sahay discuss the varied economic progress the different transition economies have made and find that the countries that have performed the best were those that were most committed to reform at the outset. Oleh Havrylyshyn and John Odling-Smee analyze the barriers raised by vested interests in many countries but argue that, despite these, reforms should continue.

János Kornai of Harvard University provides his personal perspective of transition as an organic, often trial-and-error, process that should not be rushed. Two of the architects of transition in their countries provide their own distinct perspectives. Leszek Balcerowicz discusses the Polish experience and Einars Repše, that of Latvia. The daunting challenges facing President Putin of Russia are discussed by Andrei Nesterenko of the Russian Academy of Sciences. Other articles on the general theme of transition describe how some transition economies are preparing for accession to the European Union, how transition economies should adapt their institutions to the new financial architecture, the challenge of building treasury systems in such economies, and the distinct situations of the Central Asian economies and Mongolia.

Enzo Croce and Mohsin Khan take a look, in their article, at how developing countries may often benefit from using inflation targeting as a basis for their monetary policy—an approach that has had considerable success in industrial countries. Paul Hilbers, Russell Krueger, and Marina Moretti explain how what are called macroprudential indicators may be used to measure the vulnerability of banking systems to crisis and how they relate to ongoing work on strengthening the international financial architecture.

In the final article of this issue, Mary Locke takes a look at the lively debate in the U.S. Congress in 1997–98 over funding the IMF and asks how it was that, despite the very vocal opposition, full funding was finally approved.

* * *

As an innovation, we are including in the center of this issue a special supplement of topical material and items relating to the work of the IMF. This includes an overview of recent economic developments in the Czech Republic, which is the setting for this year's Annual Meetings of the IMF and World Bank; highlights of the forthcoming *World Economic Outlook* and *International Capital Markets* reports; and an outline of some of the items on the agenda for the Annual Meetings.

Ian S. McDonald
Editor-in-Chief

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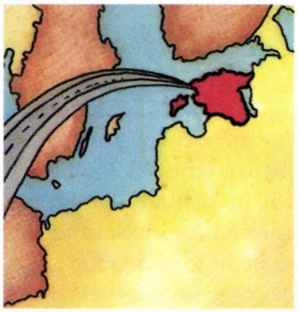

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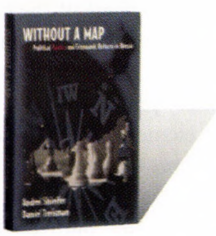

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ECONOMIES IN TRANSITION

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GUEST ARTICLE

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SUPPLEMENT *(between pages 30 and 31)*

Making the Transition to Private Ownership

János Kornai

János Kornai is Professor of Economics at Harvard University and Permanent Fellow of Collegium Budapest. He also sits on the board of the National Bank of Hungary and is associated with the Institute of Economics of the Hungarian Academy of Sciences. He has been a visiting professor at the London School of Economics; Stanford, Yale, Princeton, and Stockholm Universities; and Fellow at the Princeton Institute for Advanced Study. An officer of the Ordre national de la Légion d'Honneur, he has received a number of honorary doctorates and awards.

WHEN the former centrally planned economies began the transition to a market economy one decade ago, I advocated the creation of an economic system based on private ownership, as did many economists. But there was strong disagreement on the best way to carry out ownership reform. Most of the detailed, practical proposals that emerged at the outset of transition revolved around two opposing strategies. In retrospect, I would call them the strategy of organic development (strategy A) and the strategy of accelerated privatization (strategy B).

Supporters of strategy A envisioned the private sector's share of output growing as new private firms appeared and the state sector shrank with the sale or liquidation of state-owned companies. They emphasized the creation of favorable conditions for bottom-up development of the private sector: encouraging the launch of new firms by eliminating barriers to entry, guaranteeing the security of private ownership, enforcing private contracts, and applying affirmative action—cautiously—for example, through tax and credit policies.

Strategy A called for the privatization of state-owned companies through the sale (at fair prices) of state assets, preferably to outsiders able to invest in the companies. State property would not be given away—insiders would also have to pay a fair price. After sale, ownership would be concentrated in the hands of a dominant owner.

Strategy A also stressed the importance of hard budget constraints and consistent enforcement of bankruptcy and accounting laws. Hard budget constraints introduce a process of natural selection: profitable companies are bought by investors while chronic loss makers are forced into bankruptcy and liquidation.

In contrast, strategy B's emphasis was on the rapid elimination of state ownership. It called for privatization primarily through some form of giveaway—for example, voucher schemes. The goals were dispersed ownership—the equal distribution to all citizens of state assets—and the development of "people's capitalism."

In the early 1990s, only a small minority of Western academic economists supported strategy A; the vast majority favored the rapid elimination of the state sector. Now, 10 years into transition, experience has proved that strategy A was superior to strategy B.

Although privatization in Hungary, which has followed strategy A, has not been absolutely free of abuses, Hungary's economic achievement has been impressive. Hundreds of thousands of new small and medium-sized firms have come into being. Tightening budget constraints in the early 1990s weeded out loss-making enterprises and strengthened financial discipline. The chains of mutual indebtedness among companies were broken and the standing of private contracts improved. Consolidation of the banking sector began. Thanks to these achievements, Hungary has attracted considerable inflows of foreign capital.

Although Poland has flirted with strategy B on occasion, its policies are closer to strategy A. Its economic successes have been due not only to its successful macro stabilization but also to the numerous new businesses that have sprung up, the vigorous growth of the private sector, and sizable capital inflows.

In the early 1990s, the Czech Republic (then Czechoslovakia) was the first country to pursue strategy B. Václav Klaus, prime minister at the time, championed voucher schemes. During the first phase of privatization, state assets were dispersed among millions of voucher holders—only to end up later concentrated in investment funds. Unfortunately, these funds lacked the capital to develop, or invest in, the companies. Moreover, they were intertwined with large commercial banks, which were principally or entirely state owned. With this type of ownership structure, corporate governance remained weak and enterprise restructuring dragged on. Despite the country's strident free-enterprise rhetoric, budget constraints remained soft. Although there have also been serious mistakes in macroeconomic policy, strategy B seems to have been one of the major causes of the Czech Republic's poor economic performance.

The saddest example of the failure of strategy B may be Russia, which pursued an extreme form of the strategy: a voucher scheme coupled with mass, manipulated transfers of property to managers and privileged bureaucrats. In this environment, a historically unprecedented "ownership reform" occurred in which the ownership of natural resources, especially oil and gas, was expropriated by "oligarchs." The soft budget constraint infiltrates every cell of Russia's economy and body politic. Companies do not pay their suppliers, any more than employers pay their employees or debtors their creditor banks. The state itself is often behind in paying wages and pensions.

Arguments behind the strategies

The advocates of strategy B cited *ethical* considerations: every citizen must be given an equal share of the former property of the state for reasons of fairness. However, the "fair distribution" of property was short lived; ownership was quickly concentrated in the hands of a few. The sale of state assets (at fair prices) does not redistribute wealth or income, nor does it reduce the wealth of the state. But the revenues can be invested wisely, as in Hungary, which used a significant part of its receipts to pay off foreign debt. The consequent reduction in interest payments and marked improvement in the country's credit rating brought real benefits to all the country's citizens.

The advocates of strategy A emphasized *sociological* considerations: the development of a solid, property-owning middle class is essential to the consolidation of capitalism. The emergence of institutional investors is not a substitute for a radical social transformation, as has been demonstrated by the close correlation between economic success and the restratification of society in some transition countries.

The arguments that most interested economists, of course, concerned *economic efficiency*. Here, strategy A is clearly the winner. The new companies that have sprung up in the transition countries are generally more productive than those that have remained under state ownership or been privatized. The Schumpeterian spirit of enterprise, sweeping aside inefficient, nonviable companies; new, real owners intent on establishing order; and foreign capital flowing into large, modern investments—these together have boosted productivity and enhanced export performance.

Finally, the advocates of strategy B advanced *political* arguments. There is no question that the voucher program was crucial to the victory of the governing party in the second free Czech elections. The Czech government was the only one in Eastern Europe to serve two consecutive terms during the 1990s. By contrast, the coalitions in power during the first parliamentary cycles in Hungary and Poland lost the second general elections held in those countries. Their successors also pursued strategy A, however, and four years later they too were defeated, after refusing to resort to a giveaway privatization to win votes. (Incumbents who want to be reelected are definitely better off following strategy B!)

The advocates of strategy B repeatedly cited the argument that, if the "window of opportunity" opens for privatization, the opportunity has to be seized and the privatization carried out *rapidly,* while the state bureaucracy is still too confused and weak to resist. Changes of ownership have to be irreversible, or opportunities may be lost forever. This argument can be neither confirmed nor denied. Although, with the benefit of hindsight, it is clear that Czech democracy, for example, was unlikely to succumb to a new communist takeover or the reappearance of Soviet tanks, it was not so clear in 1991.

With respect to Russia, we often hear that mass privatization had to be carried out swiftly before the communist party was voted back into power. I believe, however, that if privatization in Russia had followed a different course, with fewer abuses and adverse social consequences, Russians would be less nostalgic for the communist system. The emergence of a broad middle class, the protection of property rights and enforcement of contracts, and the introduction of democratic institutions ensure more popular support for capitalism and provide a more solid foundation on which to build a market economy.

Conclusion

In the early 1990s, a subject often discussed in economics classes was "gradualism versus shock therapy." In my view, the question was badly put because it implied that speed was a yardstick. I am convinced that speed, while important, is not the primary measure of success. The transformation of society is not a horse race.

The transition from socialism to capitalism has to be an organic process. It is a curious amalgam of revolution and evolution, a trial-and-error process in which some old companies survive while others vanish, and new firms are tested before being accepted or rejected. Some developments are rapid, others slow. Some call for a one-stroke intervention, while many others come about through incremental changes.

I start from the conviction that the capitalist system is superior to the socialist system. From that premise, it follows that the firmer capitalism's foundations are, the better the medium- and long-term performances of the system will be. The emphasis has to be on consolidation, stability, and sustainability, not on breaking speed records. F&D

The author of numerous articles and books, Professor Kornai published The Road to a Free Economy: Shifting from a Socialist System—The Example of Hungary *(New York: W. W. Norton) in 1990. The book has appeared in 16 languages.*