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ABSTRACT

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While China shared many systemic, initial conditions with the transition economies of Central-East Europe (CEE) and the Commonwealth of Independent States (CIS), it had a more agricultural economy and a more stable political-economic system than many CEE and CIS countries. Unlike most of the CEE and CIS economies, China adopted a strategy of gradual economic transformation that maintained the existing system and created new economic activities on top of it. This enabled China to avoid the transformation depression observed in CEE and CIS, and allowed it to generate high rates of economic growth that have now lasted for almost three decades. At the time of this study, the CEE and CIS economies have also completed a decade or more of respectable economic growth, demonstrating that numerous forms of the transition process can generate long term economic growth. In retrospect, the tradeoff for avoiding an initial depression appears to be the willingness to maintain most of the existing economic and political system rather than embarking on a rapid but incomplete economic and political transformation. With a rising economic instability and political pressure, countries such as Poland and the Soviet Union (CIS) had little choice but to proceed relatively fast. Others, such as East Germany and Czechoslovakia, could have retained the centrally planned system, but they abandoned it and communism rapidly for political reasons. Looking forward, the current situation is an optimistic one, with China, CIS and CEE belonging to the fastest growing regions of the world. It will be interesting to see whether all or only some of these models will turn out to be successful in the long run.

JEL Classification: O1, P2, N1

Keywords: China, transition economies, economic performance

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1. Introduction

China's post 1978 economic reforms and the post 1989 economic transition in the former Soviet bloc and Yugoslavia provide a unique setting for comparing two paths of transformation of a communist economic system into a market economy. In both cases, the transition followed years of increasingly unsuccessful economic performance. Yet, the transition itself was very different in the two settings. In the case of China, economic growth has from the start exceeded most expectations. In the case of Central and East Europe (CEE) and the Commonwealth of Independent States (CIS), there was a precipitous and unexpected economic decline in the first three to eight years, with impressive growth thereafter. While China adopted a gradual approach and appears to have benefited from sensible policies and relative absence of adverse shocks, the CEE and CIS policy makers underestimated economic problems associated with a rapid transformation and made a number of questionable choices in the first few years of the transition.

In this chapter, I compare China's performance and future challenges to those of the CEE and CIS countries. In presenting data and examples from the CEE and CIS regions, I refer to all 27 transition economies but I focus primarily on comparing China's experience with that of the five Central European countries (Czech Republic, Hungary, Poland, Slovakia, and Slovenia), three Baltic countries (Estonia, Latvia and Lithuania), three Balkan countries (Bulgaria, Croatia and Romania), and two CIS countries (Russia and Ukraine). The first eleven countries account for most of the CEE region and have a

combined population of over 100 million people. Russia (population of 145 million) and Ukraine (population of 47 million) are the two principal economies of the former Soviet Union and now the CIS.

The Soviet-style centrally planned system, adopted to some extent also by China, was relatively well suited to mobilizing resources for expanding existing productive activities, such as during World War II and the post-war reconstruction. The Soviet bloc countries started with an impressive 4.5 percent annual growth rate in per capita GNP during the 1950s, exceeding the 3.7 percent rate of growth of a comparison group of market economies (Gregory and Stuart, 1997).[1] However, the rigidities of the command economy made it much less suitable for invention, innovation and efficient allocation of resources, resulting in a long-term slowdown in the entire Soviet bloc since about 1960. While the comparison group of market economies averaged rates of growth of GNP per capita of 4.5 percent in the 1960s, 2.8 percent in the 1970s and 2 percent in the 1980s, the growth of per capita GNP of the Soviet bloc countries is estimated to have fallen to 3.6 percent in the 1960s, 2.8 percent in the 1970s, and 0.8 percent in the 1980s. China followed a somewhat different pattern of growth from the Soviet bloc, in that it achieved a relatively fast rate of GDP growth (6.5 percent) in the 1952-57 period, slower growth (2.4 percent) in 1957-65, but faster growth (4.9 percent) again in the later 1965-78 period before the major reforms were launched (Perkins and Rawski, Chapter 20). Since starting the reforms, China achieved remarkable long run rate of growth (9.5 percent during 1978-2005).

[1] In Gregory and Stuart (1997), the Soviet bloc includes all the states of the Soviet Union plus Bulgaria, Czechoslovakia, East Germany, Hungary, Poland, and Romania. The market economies in the sample include Austria, Belgium, Canada, Denmark, France, Greece, India, Italy, Japan, Netherlands, Norway, Spain, Sweden, Turkey, United Kingdom, the United States, and West Germany.

The long term economic slowdown in the Soviet bloc relative to the western economies and the rapid economic growth in China in the late 1970s and 1980s created expectations that after the fall of Soviet and Yugoslav communism the CEE and CIS economies would generate fast economic growth and gradually catch up with the developed countries.

2. Strategies for Transition

In the early phase, China's policymakers emphasized dual track reforms that had relatively few visible losers, maintained existing production by permitting only gradual relaxation of central controls in the existing state sector and allowed the large scale expansion of township and village enterprises (TVEs) that greatly expanded economic activity (Byrd and Lin, 1990, Qian, Lau and Roland, 2000, and Naughton, 2002). The reform was especially radical in agriculture, especially in terms of a return to household farming, and it generated unexpectedly fast economic growth there. The gradualist strategy changed somewhat around 1993 as the central government reasserted itself, increased the share of budgetary and extra budgetary revenues in GDP (Wong, 2002), invested more in infrastructure, and permitted losers to appear, especially in form of laid off SOE workers (Naughton, 2002). This shift also reflected increased competition within the economy and rising influence of market forces.

The policymakers in the former Soviet bloc developed transition strategies that focused on abandoning the centrally planned system and substituting it with a market system in the context of macroeconomic stabilization and microeconomic restructuring, along with institutional and political reforms. While China adopted a relatively gradual

and unified overall approach, albeit with much experimentation at the local level, the implementation of transition strategies in CEE and CIS was relatively fast, although it varied across countries in speed and emphasis.

While a major debate took place about the merits of fast or "big bang" reform vs. gradual reform, almost all the CEE and CIS governments went ahead rapidly with what I have called Type I reforms (Svejnar, 2002, 2007). These reforms typically focused on macro stabilization, price liberalization and abandoning central planning. The macroeconomic strategy emphasized restrictive fiscal and monetary policies, incomes policies (wage controls), and often also a fixed exchange rate. The micro strategy consisted of price liberalization, dismantling the Soviet bloc trading area, the Council for Mutual Economic Assistance (CMEA), opening up to varying degrees to international trade (thus inducing a more efficient allocation of resources based on world prices), reducing direct subsidies to state-owned enterprises (SOEs), and allowing the SOEs to restructure. The strategy also aimed at removing barriers to the creation of new firms and banks, carrying out small-scale privatization, breaking up the "monobank" system, whereby a single state bank system functioned as a country's central bank as well as a nationwide commercial and investment bank, and allowing the creation of new independent banks. Finally, the strategy aimed at developing a social safety net. The Type I reforms proved relatively sustainable.

Significant policy differences ensued in what I call Type II reforms, which involved the privatization of large and medium-sized SOEs, establishment and enforcement of a market-oriented legal system and accompanying institutions, further in-depth development of a commercial banking sector and the appropriate regulatory

infrastructure, labor market regulations, and institutions related to public unemployment and retirement systems. Many CEE and CIS governments carried out these reforms slowly and incompletely, in part because of political resistance and in part because they were more demanding in terms of know-how and logistics.[2]

I will use the key dimensions of the two sets of reforms in the CEE and CIS economies to provide a perspective on China's transformation that is documented in the various chapters of this book.

Privatization

While China proceeded relatively fast with the introduction of local public ownership through TVEs and assigning cultivation rights to individual farm households, it proceeded slowly with privatization. Indeed, significant privatization of TVEs occurred only after about 15 years after their founding, and substantial privatization of larger firms commenced only about two decades after the start of China's transition. In CEE and CIS, remarkable differences exist across countries in the strategy of privatizing large and medium-sized firms, but all countries proceeded fast relative to China.

For example, Poland and Slovenia moved most slowly in privatizing state-owned enterprises, relying instead on "commercialization" (where firms remained state-owned but were run by somewhat independent appointed supervisory boards) and on the creation of new private firms. Yet they took only ten years to privatize the majority of their industrial firms. Estonia and Hungary proceeded assiduously and surprisingly effectively with privatization of individual state-owned enterprises by selling them one-by-one to outside owners.

2 My reading of the Chinese evidence is that China proceeded gradually even with respect to Type I reforms, an aspect that may have helped it avoid the initial depression experienced by the CEE and CIS

This method of privatization was originally viewed by many strategists as being too slow. Yet it provided much-needed managerial skills and external funds for investment in the privatized firms, it generated government revenue and effective corporate governance, and it turned out to be relatively fast, taking about 6-7 years. Russia and Ukraine opted for rapid mass privatization and relied primarily on subsidized management-employee buyouts of firms. This method had the advantage of speed (2-5 years), but it led to poor corporate governance in that existing management usually was not able to improve efficiency. The method also did not generate new investment funds and skills, and it provided little revenue for the government.

Finally, countries such as the Czech Republic, Lithuania and to a lesser extent Slovakia carried out voucher privatization, whereby a majority of shares of most firms were distributed to citizens at large. While this approach was fair and one of the best in terms of speed (2-5 years), it did not generate new funds for investment, nor did it bring revenue to the government. Instead, it resulted in dispersed ownership of shares and, together with a weak legal framework, it resulted in poor corporate governance. The poor corporate governance often permitted managers or majority shareholders to appropriate profit or even assets of the firms at the expense of minority shareholders.

Banking System

In the development of a banking system, China first only gradually supplemented the traditional Soviet-style monobank system with new banks and financial institutions. However, in the last ten years it has permitted the rise of new institutions, mostly on the periphery of the financial sector, and welcomed foreign financial institutions taking

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economies.

minority stakes in virtually all the major core financial institutions (banks, insurance companies, etc.) other than the central bank.

In contrast, virtually all CEE and CIS countries rapidly abolished the monobank system as part of Type I reforms. Some countries, such as Russia, allowed spontaneous growth of new banks from the bottom up, resulting in the creation of hundreds of banks virtually overnight. In CEE, the process was much more government-controlled, but even there dozens of small private banks rapidly emerged in countries like Czech Republic and Poland. While the banking systems in CEE and CIS differed in various ways, they shared numerous weaknesses. Many of the small banks quickly collapsed. The large banks started the transition with a sizable portfolio of non-performing enterprise loans and, upon restructuring, they rapidly accumulated new non-performing loans. The need for repeated bailouts of the large banks led Hungary, Czech Republic, and Poland to privatize virtually all domestic banks to large western banks in the late 1990s. This was followed by similar privatizations in Slovakia, Bulgaria, Romania, Croatia and other countries, with the CEE region becoming a laboratory for observing the introduction of a western banking system with few if any locally owned banks.

Both China and the CEE and CIS economies have experienced problems associated with soft budget constraints in state-owned banks and failures of new private financial institutions. The CEE countries have opted for a banking system dominated by foreign banks, while China and the CIS have so far given western banks and financial institutions only limited presence.

Labor and Social Institutions

For almost two decades, China maintained much of its original labor and social system that was administered through the SOEs, with urban workers enjoying considerable protection and job security and the rural population receiving only limited social transfers from the central government. The CEE and CIS countries have differed in the nature and speed of the development of labor and social regulations and institutions, but most proceeded relatively fast in comparison to China. By the end of 1991, all the CEE countries developed relatively well-functioning unemployment compensation and social security benefit schemes, with the originally generous benefits becoming somewhat more modest over time (Ham, Svejnar and Terrell, 1998). In Russia and the other countries of the CIS, the official benefits were low to start with and decreased dramatically in real terms over time -- and in the 1990s even the low official benefits were often not paid.

Hence, by proceeding with limited social transfers China has resembled more the CIS than the CEE countries. An important difference is that the population in China is much more rural than that in the CIS, and the benefits provided by the government to the urban Chinese (while small relative to urban incomes) are huge relative to the incomes and benefits available to China's rural residents. The Chinese system hence induces greater urban-rural income inequality.

Legal System and Institutions

China initially maintained and gradually reformed its legal and institutional system as it proceeded with its gradual economic reform. The major systemic transformation in the CEE and CIS countries required completely new laws and institutions, yet virtually none of these countries succeeded in rapidly developing a legal

system and institutions that would be highly conducive to the preservation of private property and to the functioning of a market economy, although some countries did better than others. This inability to develop a functioning, market-oriented legal structure has been the Achilles heel of the first decade of transition in the former Soviet bloc countries. Many policymakers underestimated the importance of a well-functioning legal system. In addition, many newly rich individuals contributed to the corruption of public officials and did not want a functioning legal system.

In carrying out the legal and institutional transformations, the more western transition economies benefited from the pre-World War II legacy of a functioning legal system. In the late 1990s and early-to-mid 2000s, an important impetus for carrying out legal and institutional reforms in the CEE countries was the need to develop a system that conforms to that of the European Union (EU) as a prerequisite for accession to the EU. In China, a major impetus for legal and institutional change was the entry into the World Trade Organization (WTO), a factor that has also been playing a part in Russia. In China as well as the CEE and CIS countries, foreign investment has also contributed to legal and institutional changes as foreign investors press governments to enact legislation creating a more predictable business climate.

In this context, it is useful to consider the implication of the experience of China and the CEE and CIS economies for an important school of thought that attributes the failure of many countries to grow and develop to corruption. Corruption has been present in China throughout the three decades of rapid growth, and it has been an important phenomenon in the former Soviet bloc economies, including Russia, both during the economic decline in the 1990s and the subsequent period of rapid growth. For instance,

according to the Transparency International (2005) annual report, China ranks #85, behind Poland (#70), Czech Republic (#47), Lithuania (#44), Hungary (#40), Slovenia (#31), and Lithuania (#27), but above Russia (#107) and Ukraine (#126). Since China has been growing faster than any of the other economies, the record indicates that corruption alone is not an adequate explanatory factor for the presence or absence of economic development and growth.

2. Performance of China and the CEE and CIS Economies

China has generally performed very well, although economic performance has varied across provinces and regions. Economic performance has also varied widely across the CEE and CIS countries and over time. The Central European countries of Poland, Slovenia, Hungary, Slovakia, and the Czech Republic initially performed better than the Baltic states of Estonia, Latvia and Lithuania and the Balkan states of Bulgaria and Romania, which in turn performed better than Russia, Ukraine, and other countries in the Commonwealth of Independent States. The situation has changed, however, and as I discuss presently, since the late 1990s the fastest growing economies have been in the Baltic and CIS regions. In what follows, I start with a comparison of macroeconomic indicators and then turn to more microeconomic measures of restructuring and performance.

Gross Domestic Product

Calculating the evolution of GDP is difficult for the early phases of the transition because the communist countries used gross material product, a measure which ignored the production of services. Moreover, the dramatic entry and growth of small firms

during the transition was not well-captured in the official statistics. Statistical offices and the international organizations have devoted significant resources to estimating GDP for the pre-transition years and tracing out GDP accurately thereafter, but the early data obviously have to be interpreted with caution (see e.g., Ren, 1997, Filer and Hanousek, 2000 and 2002, and Brada, King and Kutan, 2000).

With the above caveats in mind, one may carry out a number of comparisons. In 1990, at the start of the transition in CEE and CIS, the sectoral structure China's economy resembled most that of Ukraine and Kazakhstan. In all three economies agriculture accounted for a bit over 25 percent and industry, including mining and construction, for 41-45 percent of GDP (Russia's shares were 17 and 48 percent, respectively). Since then, China reduced the share of agriculture in the same proportion as Ukraine and some other countries, but it deviated from the other countries in that it increased rather than decreased the share of industry. In particular, between 1990 and 2003 China's share of industry in GDP increased from 41 to 46 percent (China Statistical Yearbook, 2006, p. 58), while Ukraine's share declined from 45 to 40 percent (EBRD Transition Report, various issues). In general, the CEE and CIS economies moved from agriculture and industry to services, while China moved from agriculture to both industry and services.

In terms of GDP growth, China's performance since 1978 has been unexpectedly strong, while that of the CEE and CIS was disappointing to disastrous in the early-to-mid 1990s and fairly strong thereafter. Figure 3.1 provides indices of GDP growth for selected CEE and CIS economies. Unlike China, which grew fast continuously since the start of the reforms, all the transition economies experienced large declines in output at

the start of the transition. The decline varied from 13 to 25 percent in the Central European countries; over 40 percent in the Baltic countries; and as much as 45 percent or more in Russia and almost 65 percent in Ukraine. While the CEE countries reversed the decline after 3-4 years, in Russia and most of the CIS no turnaround was visible through most of the 1990s. Almost all the CEE countries have generated sustained economic growth since the early to mid-1990s and the CIS countries have done so since the late 1990s. In fact, since the late 1990s, the Baltic and CIS countries have grown considerably faster than the countries in Central Europe (Figure 3.2). The engine of growth has shifted east and the current debate is whether this represents real sustainable growth or a temporary surge driven in key economies by high natural resource prices.

The strength and persistence of growth in China and the depth and length of the early transition depression in the CEE and CIS countries were both unexpected. A number of explanations have been offered for both. The various chapters in this book present the most recent set of analytical explanations for China. For CEE and CIS, the arguments for the initial decline (transformation recession), discussed in Roland (2000), include tight macroeconomic policies (Bhaduri et al., 1993, and Rosati, 1994); a credit crunch stemming from the reduction of state subsidies to firms and rise in real interest rates (Calvo and Coricelli, 1992); disorganization among suppliers, producers and consumers associated with the collapse of central planning (Blanchard and Kremer, 1997, and Roland and Verdier, 1999); a switch from a controlled to insufficiently regulated monopolistic structure (Li, 1999, and Blanchard, 1997); problems with implementing sectoral shifts in the presence of labor market imperfections (Atkeson and Kehoe, 1996); and the dissolution in 1990 of the CMEA. In my view, most of these explanations

contain an element of truth, but none is in itself completely convincing. All the CEE and CIS countries have gone through the decline, yet cross-country differences in initial conditions and the nature of reform are substantial enough to make one question the universal applicability of any single explanation. Interestingly, China avoided or delayed all of the above phenomena.

Inflation

While China experienced a 15-25 percent annual inflation in the 1993-95 period, for most of the 1980s, 1990s and 2000s it kept inflation below 10 percent. In fact, since 1997 China appears to have achieved considerable price stability. The picture is very different in the CEE and CIS countries. A number of these economies experienced high or hyperinflation as the command system faltered. Poland, Slovenia, Albania, Bulgaria and Romania all experienced at least one year from 1990 to 1993 when consumer price inflation exceeded 200 percent; Estonia, Latvia and Lithuania all had one year with inflation around 1000 percent; and Russia, Ukraine, and Kazakhstan experienced at least one year when inflation was above 2000 percent. Sometimes these bouts of inflation arose after lifting price controls, in other cases the inflation grew out of financial sector crises. However, by the late 1990s policy makers had shown that they could reduce inflation rates with considerable effectiveness.

Table 3.1 shows the rates of inflation for a selected group of transition countries. As may be seen from the table, by the beginning of the 2000s inflation rates in many transition economies were in single digits. Even countries that experienced very high rates of inflation during the 1990s -- Russia, Ukraine and Bulgaria, for example -- had inflation rates in the range of 8-10 percent by 2006.

From the comparative perspective, it is notable that unlike a number of the CEE and CIS economies, China never experienced hyperinflation or major monetary overhang, and hence did not have to impose highly restrictive macroeconomic policies that might choke off its rapid and steady rate of economic growth. It also achieved a rapid rate of growth while for the most part avoiding high rates of inflation.

Exchange Rates, Current Account and Exports

During the last three decades, China has increasingly opened up its economy (its trade ratio at 60 percent is higher than that of any large economy), kept a relatively fixed exchange rate, and maintained first balance and then surplus on its current account. Domestic demand has been an important engine of growth but exports have increasingly provided an outlet for China's production.

Most CEE and CIS economies strongly devalued their currency as a means of ensuring global competitiveness and adopted a fixed exchange rate as part of macroeconomic stabilization. The CEE countries also significantly reoriented their foreign trade away from the old CMEA region and toward market economies – primarily Western Europe. However, with inflation in the 1990s the fixed exchange rates of many countries became overvalued, leading in some cases to substantial current account deficits. Most countries responded by devaluing their currencies again and adopting flexible exchange rates, although some countries (e.g., Bulgaria, Estonia and Lithuania) adopted currency boards as a means of long-term economic stabilization. Recently, Slovenia went furthest in fixing its currency to its principal trading partners by joining the Eurozone at the start of 2007. Most of the CEE economies became very open economies, while the CIS economies have on average remained relatively more closed.

Both China and the large CIS economies have thus remained relatively closed, but China's manufacturing exports and CIS resource exports have been increasingly gaining in importance.

External Debt and Financial Crises

China launched its transformation without foreign debt and gradually became a major creditor to the rest of the world, accumulating sizable foreign exchange reserves. It has also avoided the worst effects of the Asian financial crisis because it was sufficiently insulated from the global financial markets and substituted domestic public investment for falling external demand.

Many, but not all, transition countries started the 1990s with high foreign indebtedness. In Bulgaria, Hungary, and Poland, external debt exceeded 50 percent of GDP in 1990. In Russia, external debt in 1990 was 148 percent of GDP. However, other transition economies, such as Romania, Slovenia, Czech Republic, and Slovakia, had conservative regimes and foreign debt was less than 20 percent of GDP in 1990.

By the mid-1990s, many of the highly indebted countries reduced their debt/GDP ratio, while a number of the less indebted countries increased theirs. But since about 1996, foreign indebtedness has risen in the relatively more indebted countries and in 1988 Russia defaulted on its sovereign debt. Interestingly, while the Russian financial crisis had a major impact on the CIS countries that still had close trading relations with Russia, it had relatively little impact on the CEE countries which had already reoriented most of their trade to western Europe.

Hence, both China and the CEE economies managed to avoid the financial crises of the late 1990s, albeit for different reasons.

Budget and Taxes

China has proceeded gradually in reforming its tax system and ensured adequate budgetary revenues from the rapidly growing economy. The seemingly favorable picture may hide significant off-budget expenditures and revenues and potential unfunded future liabilities. However, until now China's fiscal system has not been a major obstacle to rapid growth (see Bird and Wong in this volume).

In contrast, as the transition unfolded, CEE and CIS governments had to develop a number of new fiscal institutions for collecting taxes. This institutional development was one of the hardest Type II reforms to achieve. While tax collection was relatively effective even at the start of the transition in the CEE region, Russia and some other countries of the CIS initially struggled with declines in tax revenues as many producers avoided paying taxes either by operating through barter or by accumulating tax arrears. The situation was particularly difficult as the governments were facing demands for new public expenditures, including infrastructure and the new social safety net. The relative inability of Russia and other CIS nations to collect taxes was one reason why their social safety nets were from the start weaker than those in CEE.

While Russia and some other CIS economies have successfully reduced tax rates and simplified the tax system dramatically to improve tax collection, many of the CEE economies have higher tax rates than other countries at a similar level of GDP per capita. Yet, the relatively high ratios of taxes to GDP in these transition economies have not prevented many of their governments from running budget deficits. Russia and other natural resource exporting countries, however, have been running budget surpluses throughout the 2000s.

An especially problematic aspect of the public finances in the CEE economies has been the increasing strain from the pension system. These countries started the transition with publicly-funded pensions that covered most of the population, low retirement ages (on average 60 for men and 55 for women), a high and rising ratio of retirees to workers, and high levels of promised benefits relative to recently earned pre-retirement wages (World Bank, 1994; Svejnar, 1997). Moreover, most of these systems had a perverse redistribution of benefits from lower- to higher-income workers. The systems were largely pay-as-you-go and not sustainable. Several countries, including Hungary, Poland, Latvia and Kazakhstan, have already moved to raise the retirement age and to supplement the public retirement system by a multi-pillar public/private retirement system with a funded component. Russia and other CIS countries face less of a public sector burden with regard to retirement costs, because the level of government-promised retirement benefits is lower.

As the discussion indicates, the gradual transformation and rapidly growing economy has enabled China to avoid (at least on surface) the various budgetary problems encountered in the CEE and CIS economies. For different reasons, China and the resource rich CIS countries (Russia in particular) enjoy a relatively favorable budgetary situation. As mentioned above, however, China may face off budget unfunded liabilities in the future.

Privatization and Creation of New Firms

While experimenting with private ownership, the Chinese authorities decided to delay for over two decades substantial privatization of state-owned enterprises. However, from the early 1980s they eased access to critical inputs through the dual track system

and permitted a major expansion of the township and village enterprises (TVEs). The TVEs filled niches, supplied the SOEs and many eventually started competing head on with the SOEs. The TVEs generated considerable economic activity and provided industrial and service employment in rural areas. In the last decade, most have turned into private firms and thus constituted a gradual process of de-etatizing China's economy.

The CEE and CIS transition economies proceeded relatively quickly and directly with creating private firms. In the early 1990s, most transition economies privatized small enterprises, primarily through local auctions. The small scale privatization was instrumental in creating small and medium-sized enterprises in countries where most firms were, by ideological and practical design, either large or very large. This shift in ownership rapidly increased efficiency and quality of production.

Parallel developments were the breakups of SOEs, restructuring of firms and management, and increased competition. Breakups of small, average and somewhat above-average size appear to have increased efficiency of both the remaining master enterprises and the spun-off units (Lizal, Singer and Svejnar, 2001). Most of the broken-up firms were subsequently privatized.

A large number of new (mostly small) firms were founded in most transition economies. Like the TVEs, these firms filled niches in demand and started to compete with existing state-owned enterprises. Since many of the transition economies became relatively open economies, the new private firms were also competing with imports. The growth of new firms has varied across countries. In general, it proceeded faster and smoother in the CEE countries than in the CIS.

Finally, in most countries, a large part of private assets were generated through large-scale privatization, which differed in its method across countries. What is remarkable, however, is how quickly most countries generated private ownership, irrespective of the particular privatization methods used. In 1989, only Poland and Romania had more than 10 pecent of GDP produced by private sector firms, and in most countries private sector share was around 5 percent of GDP (Table 3.3.2). But these figures increased very quickly. As early as 1994, the private sector accounted for more than 30 percent of GDP in most of the transition economies and represented half or more of GDP in many countries, including Russia. Table 3.3.2 shows that by 2000 the private sector share of GDP was at or above 60 percent in all of the transition economies and in most of them it constituted 70-80 percent. Except for Russia, which has recently backtracked and nationalized some (especially energy) firms, the private sector share has been maintained or has grown steadily since 2000.

The estimated effects of privatization on economic performance have in many respects been disappointing, given the optimistic expectations. At the country level, some of the fastest growing economies (Poland, Slovenia and also China) have been among the slowest to privatize. At the micro level, surveys from the late 1990s and early 2000s make assessments that range from finding no systematically significant effect of privatization on performance (Bevan, Estrin and Schaffer, 1999), to concluding (some cautiously) that privatization improves firm performance (Shirley and Walsh, 2000, Megginson and Netter, 2001, and Djankov and Murrell, 2002). The recent survey by Estrin, Hanousek, Kocenda, and Svejnar (2007) finds that privatization to foreign owners has by and large increased efficiency and scale of operations, while the effects of

privatization to domestic owners have been mostly insignificant. Many of the early microeconometric studies suffer from serious problems: small and unrepresentative samples of firms; misreported or mismeasured data; limited controls for other major shocks that occurred at the same time as privatization; a short period of observations after privatization; and above all, not controlling adequately for selectivity bias. Selectivity bias is likely to be a particularly serious problem since better performing firms tend to be privatized first (Gupta, Ham and Svejnar, 2001). Thus, comparing the post-privatization performance of privatized firms to the performance of the remaining state-owned firms without controlling for selectivity bias, as many studies do, erroneously attributes some of the superior performance of the privatized firms to privatization.

Studies of China provide a similar picture though less bleak picture (Estrin et al., 2007). For instance, studies of total factor productivity find diverse results, with the effect of non-state ownership being mostly positive but sometimes statistically insignificant. As in the studies of CEE and CIS, in the studies of China the effect of foreign ownership is more positive than that of other forms of non-state ownership. In China, a particularly important part has been played by joint ventures whose contribution to industrial output has grown rapidly over time. Together with foreign firms, the joint ventures generate about one-half of china's exports. Overall, the findings of somewhat limited effects of privatization to domestic owners in the transition economies (and to a lesser extent in China) provide sobering evidence since the general expectation was that there would be much improvement in the efficiency of firms as a result of privatization.

Domestic and Foreign Investment

Throughout the 1980s, 1990s and 2000s, China maintained a high rate of investment. In this sense, China has joined the East Asian tigers. China has also generated a significant inflow of foreign direct investment that has had a positive effect on the modernization of China's economy. In recent years, one observes also a reverse flow in the form of Chinese FDI to other countries.

The Soviet bloc countries and former Yugoslavia, like the East Asian tigers, were known for high rates of investment, often exceeding 30 percent of GDP. Investment rates declined to about 20 percent of GDP in the 1990s in a number of transition economies (EBRD, 1996), although some countries, such as the Czech and Slovak Republics, maintained relatively high levels of investment throughout. Unfortunately, in the first decade of the transition, much of this investment appears to have been allocated inefficiently by the inexperienced and often politicized or corrupt commercial banks (e.g., Lizal and Svejnar, 2002).

As may be seen from Table 3.3, until 1996 Hungary was the only transition economy receiving a significant inflow of foreign direct investment (FDI). This was in part because early on Hungary created a more hospitable business climate than other transition countries and also established well-defined rules and regulations for FDI. But starting in 1998, major foreign investments went to the Czech Republic, Poland, Slovakia, and the Baltic countries. Overall, with one-tenth of the population of China, the CEE economies have been receiving roughly one-half of the annual FDI inflows going to China. These sizable FDI inflows have had a major effect on GDP growth and export competitiveness of the CEE countries, with some having foreign owned firms accounting for two-thirds to three-quarters of exports.

Employment Adjustment, Wage Setting, Unemployment, and Income Distribution

China's employment and more generally labor market adjustments have been different from those observed in the CEE and CIS transition economies, although the limited system of social transfers made some features similar to those in the CIS. While the CEE and CIS economies adjusted employment considerably already in the first decade of the transition, China's SOEs started adjusting employment on a major scale only in the second decade of reforms. China's SOEs have hence been adjusting employment but at a slower pace than their counterparts in the CEE and to a lesser extent CIS countries. A big employment adjustment occurred in China through the formation of the TVEs, which generated sizable employment for the rural labor force. More recently, China's private firms have been creating employment on a significant scale. Open unemployment is a significant phenomenon in the urban areas but less in the countryside. With declining administrative limitations on migration, Chinese workers move substantially in search of lucrative employment opportunities. Finally, with the rapid economic growth, China's income distribution has become quite unequal, with the Gini coefficient being estimated to be around 50.

In the CEE and CIS economies, SOEs responded to the negative output shock by decreasing employment and/or real wages in the early 1990s (Svejnar, 1999). At one extreme, Hungary experienced a more than 20 percent initial reduction in industrial employment with real wages rising almost 20 percent. At the other extreme, Czech industrial wages declined almost 25 percent with employment falling less than 10 percent (Basu, Estrin and Svejnar, 2005). In Russia and the rest of CIS, the adjustment brought a mixture of wage and employment adjustment (Desai and Idson, 2000) and the wage

decline was more pronounced than in the CEE region (Boeri and Terrell, 2002). In Central Europe, labor demand elasticities with respect to output and wages rose rapidly to western levels as the transition was launched, indicating that firms started behaving as cost minimizing entities. Depending on the institutional setting in a given country, the sharp decline in output at the start of the transition was hence absorbed more by employment or wage decreases.

The GDP and employment data suggest that restructuring in the transition economies involved an initial decline in labor productivity as output fell faster than employment. Productivity has risen since then, however, as output growth has exceeded that of employment. In fact, this recent pattern has given rise to a concern among some analysts and policy makers that the CEE and CIS economies are suffering from "jobless growth".

Unemployment was basically an unknown phenomenon before the transition, but it emerged rapidly in most CEE countries. Within two years after the start of the transition, the unemployment rate rose into double digits in most CEE economies. The high unemployment rates reflected high rates of inflow into unemployment as firms laid off workers, and relatively low outflow rates as the unemployed found it hard to find new jobs. The Czech labor market was an ideal model of a transition labor market, characterized by high inflows as well as outflows, with unemployment representing a transitory state between old and new jobs (Ham, Svejnar and Terrell, 1998, 1999). Unemployment as a serious problem emerged more slowly in the CIS, where firms were somewhat slower in laying off workers and used wage declines and arrears as mechanisms to keep workers with low reservation wages attached to firms.

Over time, the patterns and dynamics of unemployment became more diverse. The Czech Republic was the only central European country to enter recession in the second half of the 1990s and its unemployment rate correspondingly rose to 8-10 percent. The fast-growing economies of Poland, Hungary, Slovenia, and to a lesser extent Slovakia managed to reduce their unemployment rates in the late 1990s. Conversely, the CIS and Baltic countries experienced gradual increases in unemployment as their transition proceeded. By 1997, unemployment rates in Russia and Estonia were near 10 percent. By 1999-2000, the unemployment rate rose again in Bulgaria, the Czech Republic, Poland, Slovakia and Slovenia, and at present many transition economies have unemployment rates that are at least as high, and often significantly higher than, those observed in the European Union.

While real wages in CEE have increased steadily after their initial decline in the 1989-91 period, in Russia and a number of other CIS countries real wages declined until 1993 and stagnated or increased only gradually thereafter (EBRD, 2000). The trajectory of real incomes has thus been different in the more and less advanced transition economies.

The reduction in employment in the old SOEs, rise in unemployment and establishment of new firms have brought about considerable destruction and creation of jobs, as well as mobility of labor. Contrary to the main models of the transition process, however, Jurajda and Terrell (2001) show that job creation in new firms has not been necessarily tightly linked to job destruction in the old firms since many new jobs have been created even in economies that experienced low rates of job destruction. Sabirianova (2000) provides a related structural insight, namely that much of the labor

mobility in Russia consists of occupational rather than geographic change, with individuals moving from one occupation to another within regions, as jobs in old occupations are destroyed and opportunities in new occupations are created. Compared to the U.S. and China's labor markets, where individuals move geographically, the transition in CEE and CIS has led to more occupational rather than geographic mobility.

Data on the Gini coefficient, measuring the extent of inequality in income distribution, are given in Table 3.4. The communist countries had highly egalitarian income distributions but inequality increased in the CEE and CIS economies during the 1990s and 2000s. Between the late 1980s/early 1990s and late 1990s/early 2000s, the Gini coefficient rose from 20-25 to 24-32 in Central Europe, low 20s to low 30s in Bulgaria and Romania, 23 to 30 in Ukraine, and 26 to 40 in Russia. Income inequality in the transition economies has hence become comparable to that in advanced capitalist economies and developing countries such as India. However, the official Russian and Ukrainian data in Table 3.4 probably underestimate the extent of income inequality. In particular, the data from the Russian Statistical Office (Goskomstat) are based on contractual wages, but in the 1990s many Russian firms were not fully paying these contractual wages (Desai and Idson, 2000). Inequality calculations based on survey data from the Russian Longitudinal Monitoring Survey of households suggest that income inequality in Russia has reached much higher levels – a Gini coefficient of 52 – resembling the level of inequality found in China and developing economies with relatively inegalitarian distribution of income. It is to be noted that the relatively egalitarian income distribution in the CEE countries has been generated the social safety nets, which offset the inequality that was brought about by market forces (Garner and

Terrell, 1998). In Russia the social safety net was regressive, making the distribution of income more unequal than it would have been without it (Commander, Tolstopiatenko and Yemtsov, 1999).

Overall, existing studies indicate that income and consumption inequality has increased during the transition and that the increase has been greater in the east and has depended on the relative importance of changes in the distribution of wages, employment, entrepreneurial incomes, and social safety nets. In Russia in particular, there has been a rapid rise in wage inequality, which has in turn had a strong effect on income inequality dynamics (Mitra and Yemtsov, 2007). The dominant common cause of inequality in all the transition economies appears to be wage decompression, resulting from the attenuation of the centralized wage setting and the high return to skills associated with globalization (Munich, Svejnar and Terrell, 2005, and Mitra and Yemtsov, 2007).

Assessment by the Financial Markets

Except for a short period of time after the Russian financial crisis, western capital markets have been increasingly positive in their assessment of China, CEE and CIS. As may be seen from Table 3.5, the transition economies have gradually raised their ratings by international rating agencies such as Standard and Poor's, and the most advanced countries now have ratings that place them among the lower tier developed countries. Because of its long term progress and in part because of its formidable foreign exchange reserves, China is now rated A -- on par with Slovakia and ahead of all the transition economies except for Slovenia, which has a rating of AA. Country financial ratings hence

represent yet another dimension of economic performance where China is a leading transition economy.

3. Concluding observations

While China shared many systemic, initial conditions with the transition economies of Central-East Europe (CEE) and the Commonwealth of Independent States (CIS), it had a more agricultural economy and a more stable political-economic system than many CEE and CIS countries. Unlike most of the CEE and CIS economies, China adopted a strategy of gradual economic transformation that maintained the existing system and created new economic activities on top of it. This enabled China to avoid the transformation depression observed in CEE and CIS, and allowed it to generate high rates of economic growth that have now lasted for almost three decades. At the time of this study, the CEE and CIS economies have also completed a decade or more of respectable economic growth, demonstrating that numerous forms of the transition process can generate long term economic growth. In retrospect, the tradeoff for avoiding an initial depression appears to be the willingness to maintain most of the existing economic and political system rather than embarking on a rapid but incomplete economic and political transformation. With a rising economic instability and political pressure, countries such as Poland and the Soviet Union (CIS) had little choice but to proceed relatively fast. Others, such as East Germany and Czechoslovakia, could have retained the centrally planned system, but they abandoned it and communism rapidly for political reasons. Looking forward, the current situation is an optimistic one, with China, CIS and CEE

belonging to the fastest growing regions of the world. It will be interesting to see whether all or only some of these models will turn out to be successful in the long run.

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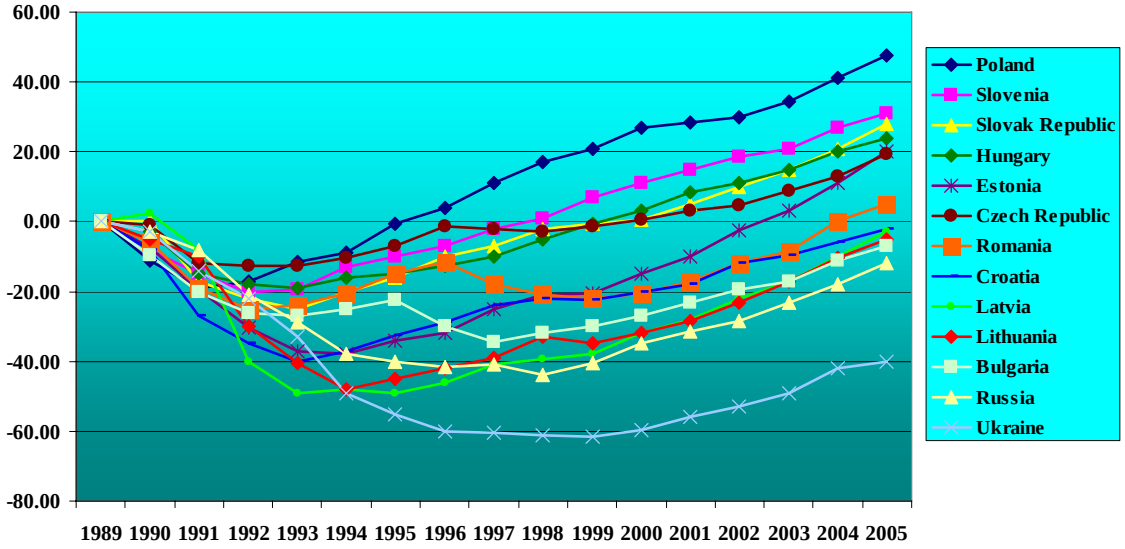
Real GDP Index (Base Year 1989)



Real GDP Index (Base Year 1998)

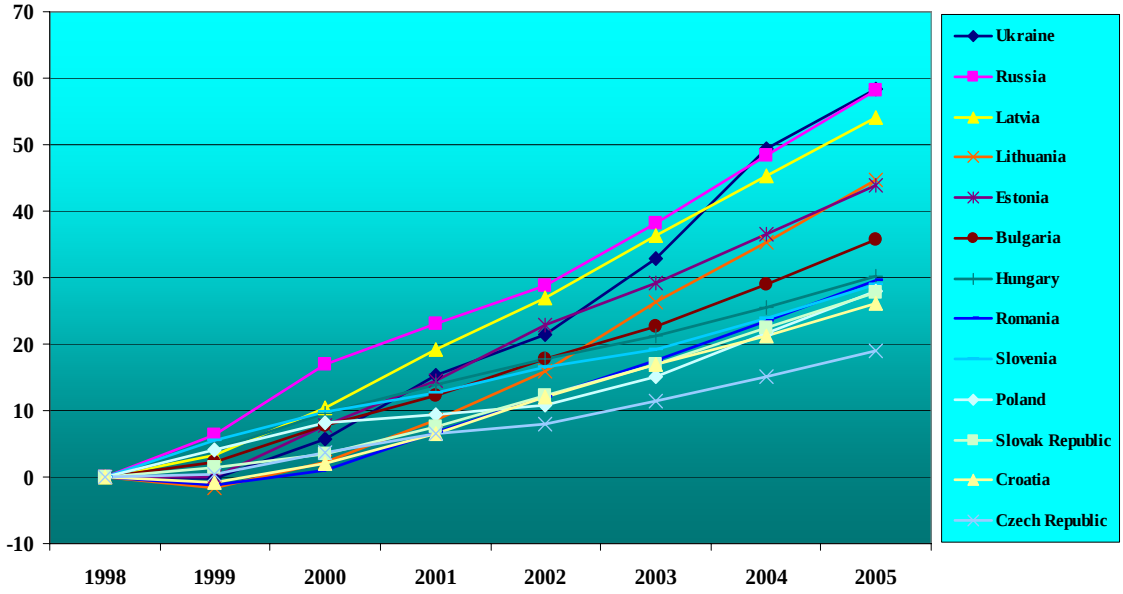


Table 3.1

Consumer Price Inflation

	1990	1992	1994	1996	1998	2000	2002	2003	2004	2005	2006**
Czech Republic	9.7	11.1	9.9	8.8	10.6	4	1.8	0.2	2.8	1.9	2.7
Hungary	28.9	23	18.8	23.6	14.3	9.8	4.8	4.9	6.7	3.6	2.0
Poland	585.8	43	32.2	19.9	11.8	10.1	1.7	0.7	3.5	2.2	1.2
Slovakia	10.8	10	13.4	5.8	6.7	12	3.3	8.5	7.5	2.7	4.2
Slovenia	549.7	207.3	21	9.9	7.9	8.9	7.5	5.6	3.6	2.5	2.5
Estonia	23.1	1076	47.7	23.1	8.1	4	3.6	1.3	3.0	4.1	3.4
Latvia	10.8	951.2	35.9	17.6	4.7	2.6	1.9	3	6.2	6.7	6.0
Lithuania	8.4	1020.5	72.1	24.6	5.1	1	0.3	-1.2	1.2	2.7	3.0
Bulgaria	26.3	82	96.3	123	22.2	9.9	5.9	2.3	6.1	5.0	6.5
Croatia	609.5	665.5	975	3.5	5.7	6.2	2.2	1.8	2.1	3.3	3.2
Romania	127.9	210.4	136.7	38.8	59.1	45.7	22.5	15.4	11.9	9.0	7.7
Russia	5.6	1526	311.4	47.8	27.6	20.8	15.7	13.7	10.9	12.7	10.5
Ukraine	4.2	1210	891	80	10.6	28.2	0.8	5.2	9.0	13.5	10.5

**Projection

Sources:

EBRD Transition Reports, IMF World Economic Outlook.

OECD Economic Outlook Vol. 72, Economist Intelligence Unit.

Table 3.2

Private Sector Share of GDP

	1989	1990	1992	1994	1996	1998	2000	2002	2004	2006
Czech Republic	5	10	30	65	75	75	80	80	80	80
Hungary	5	25	40	55	70	80	80	80	80	80
Poland	30	30	45	55	60	65	70	75	75	75
Slovak Republic	5	10	30	55	70	75	80	80	80	80
Slovenia	10	15	30	45	55	60	65	65	65	65
Estonia	10	10	25	55	70	70	75	80	80	80
Latvia	10	10	25	40	60	65	65	70	70	70
Lithuania	10	10	20	60	70	70	70	75	75	75
Bulgaria	10	10	25	40	55	65	70	70	75	75
Romania	15	15	25	40	55	60	60	65	70	70
Russia	5	5	25	50	60	70	70	70	70	65
Ukraine	10	10	10	40	50	55	60	65	65	65

Source: EBRD Transition Reports

Table 3.3

FDI Net Inflows (mil US$)

	1990	1992	1994	1996	1998	2000	2002	2003	2004*	2005**
Czech Rep.	132	983	749	1276	3591	4943	8276	1895	3917	8500
Hungary	311	1471	1097	2279	3065	2190	2590	874	3653	3500
Poland	0	284	542	2741	6049	9324	3901	3927	5353	6431
Slovak Rep.	24	100	236	199	374	2058	4007	549	1259	1800
Slovenia	-2	113	129	167	221	71	1489	-139	277	346
Estonia	n/a	80	212	111	574	324	153	763	781	2500
Latvia	n/a	29	279	379	303	400	374	328	538	622
Lithuania	n/a	8	31	152	921	375	715	142	510	655
Bulgaria	4	41	105	138	537	1003	876	2070	1232	2697
Croatia	0	13	110	486	835	1085	591	1700	898	1000
Romania	-18	73	341	415	2079	1051	1080	2156	5020	5300
Russia	n/a	1454	409	1657	1492	-463	-72	-1769	2132	5000
Ukraine	n/a	170	151	516	747	594	698	1411	1711	900

*Estimate/**Projection

Source: EBRD Transition Reports, World Bank Development Indicators.

Table 3.4

Income Inequality (GINI coefficients)

	Late 1980s Early 1990s		1990s		Late 1990s – Early 2000s	
	Year	Gini	Year	Gini	Year	Gini
Czech Rep.	1988	20	1992	23	1996	25.4
Croatia	1988	28.6	1998	29.7	2001	29
Hungary	1987	24.4	1992	26	1998	24.4
Poland	1987	25	1993	29.8	1998	31.6
Slovak Rep.	1988	19.5	1993	21.5	1996	25.8
Slovenia	1987	19.8	1993	24.1	1998	28.4
Bulgaria	1989	21.7	1993	33.3	2001	31.9
Romania	1989	23.3	1994	28.6	2000	30.3
Russia (a)	1991	26	1993	39.8	2000	39.9
Russia (b)	1992	54.3	1994	45.5	1996	51.8
Ukraine	1988	23.3	1996	33.4	1999	29

(a) Based on Goskomstat data.
(b) Based on Russian Longitudinal Monitoring Survey.

Sources: World Bank Development Indicators and our own calculations

Table 3.5

Investor Ratings (Long-term Ratings on Foreign Currency-Denominated Sovereign Debts)

	1994	1995	1996	1998	2000	2001	2002	2004	2005	2006
as of	15-Nov	15-Nov	12-Nov	13-Nov	1-Nov	28-Nov	6-Nov	11-Nov	9-Nov	3-Nov
Czech Rep.	BBB+	BBB+	A	A-	A-	A-	A-	A-	A-	A-
Hungary	BB+	BB+	BB+	BBB-	BBB+	A-	A-	A-	A-	BBB+
Poland	na	na	BBB-	BBB-	BBB+	BBB+	BBB+	BBB+	BBB+	BBB+
Slovak Rep.	BB-	BB+	BBB-	BBB-	BB+	BBB-	BBB-	BBB+	BBB+	A
Slovenia	na	na	A	A	A	A	A	AA-	AA-	AA
Latvia	na	na	na	BBB	BBB	BBB	BBB+	A-	A-	A-
Lithuania	na	na	na	BBB-	BBB-	BBB-	BBB	A-	A-	A-
Romania	na	na	BB-	B+	B-	B	B+	BB+	BBB-	BBB-
Russia	na	na	BB-	CCC	SD*	B	BB-	BB+	BBB-	BBB+
China	BBB	BBB	BBB	BBB+	BBB	BBB	BBB	BBB+	A-	A

Source: Our estimates based on Standard and Poor's Rating Handbook