MAKING THE TRANSITION FROM PLAN TO MARKET: EXPEREINCE AND LESSONS

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The following is a revised and abridged-for-posting version of Dr. Johannes F. Linn's keynote speech given at the International Symposium on "North Korean Development and International Cooperation," held in Seoul, Korea on July 6-7, 2005.

The Econometric Evidence

A plan for North Korean economic transition should start with a review of the findings of the many economists who have tried to explain with quantitative rigor the different transition experiences in Central Europe and the Former Soviet Union. Central Europe suffered a much shorter and shallower recession and a more rapid recovery than the Commonwealth of Independent States (or CIS). Economists have run increasingly sophisticated regressions with observations for the countries in the region, trying to isolate the factors explaining the different country performances. The common format of their analysis is to relate differing initial conditions and market reforms to economic growth.

Initial conditions consist of country characteristics at the start of the transition. They include three broad sets of variables: first, a country's economic structure, such as the extent of industrialization and urbanization and the endowments of natural resources and human capital; second, the macroeconomic situation, including the extent of an overhang of monetary balances held by the population, fiscal deficits and indebtedness; and third, the institutions required for an effective market economy, including well-developed goods and factor markets, a price system that reflects economic costs, an effective legal and judicial system, and the like.

Market reforms are usually separated into two sets of variables: "Stage 1" reforms consist of macroeconomic stabilization, price liberalization, the opening up to trade and the privatization of small and medium-sized enterprises. These measures can generally be taken relatively quickly early in the transition process. In contrast, "stage 2" reforms take much longer, since they generally

require the creation of new institutional capacity with complex transactions or politically difficult measures. They include the introduction of enforceable property rights, the creation of an effective legal and judicial system and public administration, the development of competitive and robust enterprise and financial sectors, the privatization of large and strategic companies, and the creation of social safety nets. Additional factors judged relevant by various analysts include such variables as progress with political reform, the prevalence of conflict, the extent of external financial support and the existence of a "political umbrella" (such as the prospect of EU accession), and variables reflecting distance from Western markets, such as the simple measure of "distance from Düsseldorf."

What have been the results of these quantitative econometric analyses? Broadly speaking, they conclude that initial conditions matter -- that is, the greater the starting hurdles, the deeper and longer the economic recession and the slower the recovery -- but that they matter less and less as time passes. Most analysts also agree that the extent and speed of market reforms matter -- generally, the more and the faster the reforms, the quicker and stronger is ultimately the recovery, even if the initial recession may be deepened by a "shock therapy" approach to reform. But not all analysts agree about the appropriate speed and sequencing of reforms. Some argue that early reforms in Central Europe and the Former Soviet Union erred by rushing too quickly into wholesale "stage 1" reforms while neglecting "stage 2" reforms. They see China as the prototype of a successful gradual reformer who judiciously liberalized her economy while building the needed institutional infrastructure. A related argument is around the political economy of reform, with some advocating "shock therapy" as a way to lock in political and economic reforms against opposing interests, while others argue that gradual reform permits a less painful and ultimately more sustainable gradual build-up of economic and democratic institutions.

Three Transitions in One

The econometric analyses have by now largely exhausted the scope for quantitative cross-country research. Their conclusion that market reforms work overall is welcome, but the econometric analysis fails to do justice to the dynamics, politics and complexity of country experience. It does not reflect that the transition in Europe and Central Asia was really three transitions rolled into one: 1) a transition in the economic system -- from a centrally planned command economy to a decentralized market economy -- is what the econometric evidence mostly captures; 2) a transition in the political system -- from the authoritarianism of communism to various forms of more pluralist democratic governance; and 3) a transition in the spatial dimension -- which started with a disintegration of the highly integrated system of economic links across the vast Soviet bloc economy, and was followed in turn by an integration into the world economy.

Given the complexity of interactions between these three dimensions, which seems to go beyond the capacity of econometric evidence alone, it is useful to compare the experience of specific countries and country groups to sort out how these various dimensions of transition have interacted, together with different initial conditions, in producing the actual transition experience we have observed and to draw lessons from it.

Country Experience

I start with a look at the transition experience of the Central European countries as compared with the CIS as a group. The dramatic differences in economic trajectories post-1990 were due to several factors. First of all, Central Europe benefited from better initial conditions and suffered much less from the disintegration of the economic space of the former Soviet bloc. It also faced a much easier task of integrating with the rest of the world, and in particular with Western Europe. Central Europe also generally went through relatively quick and effective "stage 1" reforms, followed by more gradual and sustained "stage 2" reforms. Political reform, which established quickly a democratic, pluralistic, transparent, and accountable government, allowed for a broad-based alliance of winners from reform and integration and thus supported progress with "stage 2" reforms. Intensive financial and technical support from the international financial institutions (or IFIs) in the early years, and then increasingly the political and financial umbrella of EU accession, were major drivers of sustained reform. Two special features are worth noting: first, substantial debt relief was granted early on in the case of Poland, but not so in the case of Hungary; second, Central European countries made great progress with enterprise and financial sector reform. Some countries in Central Europe were able to raise the share of small and medium-sized enterprises in total employment. Another aspect of their success has been their ability to attract large amounts of direct foreign investment.

The countries of the CIS, in addition to worse initial conditions, faced a much stronger negative impact of disintegration. The small new countries of the CIS were hit hardest. Their industries and agriculture were cut off from supplies and markets. They suffered from interruptions of transport links and their subsidies from Moscow were cut off. They had to introduce new currencies and new governmental structures and in many cases they experienced civil war or cross-border conflict. In addition, with their land-locked location and distance from markets, the small CIS countries faced the greatest challenge of subsequent integration into the world economy. The large CIS countries, Russia and Ukraine, also encountered substantial problems of disintegration and subsequent integration, but less so than their small neighbors, given their size and access to external markets.

The CIS as a group also implemented slower or less effective "stage 1" reforms, including poorer macroeconomic management, and less effective and sustained "stage 2" reforms. Weak enterprise and financial sector reform is reflected in the persistently low share of small and medium-sized enterprises in the CIS, in high capital flight -- on the order of $20 billion per year for Russia in the 1990s -- and in low per capita foreign investment. By assuming all the Soviet debt, Russia provided effective debt relief to all the other CIS countries; but in many cases they incurred new debt quickly due to depth of their recessions and poor macroeconomic management. As a result, some of the poor republics in Central Asia and the South Caucasus ended the first decade of transition with high levels of external debt.

The weaker economic reform performance in the CIS can be explained by the lack of an external political "umbrella" -- although international financial institutions helped shore up the momentum of reform -- and by weak domestic political institutions. The demise of Communist Party control in the late 1980s had been a key factor driving the disintegration of the Soviet Union. But then, powerful special interests -- oligarchs, state enterprise managers, or holdovers from the Communist "nomenclatura" -- managed to undermine both the emergence of democratic institutions and progress with economic reforms.

It is also necessary, then, to dig a little deeper into country-specific experiences, beginning with the case of East Germany, which may be of special relevance for the Korean situation. On the positive side, East Germany was very quickly integrated with the West German and European economies, following the disappearance of the old borders and the immediate and wholesale adoption of Western market institutions. It also received huge financial transfers from the West -- about 50 billion dollars a year -- and benefited from intensive technical and institutional support. On the negative side, East Germany started from mediocre initial conditions and was hurt by the separation from the Soviet economic bloc, followed by the adoption of a joint currency at unfavorable rates, an inflexible labor market and a poorly adapted labor force, all of which created serious price and wage distortions. As a result, East German economy experienced a relatively steep initial decline, and the persistent distortions left the East German economy not performing better than the average Central European countries to the East, and less well than the more successful among them, such as Poland. The unification and transition process also left substantial psychological scars on both sides of the former divide, which time has yet to heal.

Consider then the experience of the Western Balkans, and in particular the countries of the former Yugoslavia. Despite relatively favorable initial conditions, they, too, faced a deep recession, due to the conflict-ridden disintegration of the Federal Republic of Yugoslavia. The recovery which started already after 1993 was fitful and slow however, because of the continuing conflicts and the blockade of Serbia. The Balkan countries were also burdened by high debts and by lingering

difficulties with implementing market reforms and institution building. The intensive engagement by the EU and international financial organizations after the Dayton Agreement in late-1995 was a factor that helped the recovery. The prospects for an eventual membership in the EU also have become an anchor for more intensive progress with reforms.

Interesting conclusions can be drawn from the comparison of the transition in three small, poor countries: Albania, Georgia and the Kyrgyz Republic. Albania experienced a brief and relatively shallow recession, followed by a sustained recovery, while Georgia especially, but also the Kyrgyz Republic, lost large shares of their economies and recovered only slowly. What explains these differences?

First, Albania: Although the country had very poor initial conditions in terms of its extreme communist heritage, it did not have to go through a disintegration. On the contrary, from a highly isolated command economy the country quickly opened up and transformed itself into an entrepreneurial, private sector-driven market economy, albeit somewhat chaotic and with weak governance and institutions. The country received a lot of support from the international financial institutions and from the EU, but mostly it benefited from its ability to integrate quickly with the European economy. As a result of a low initial debt, rapid growth and reasonable macroeconomic management, Albania retained a relatively low level of external debt throughout.

Georgia and the Kyrgyz Republic, like other CIS countries, also started with relatively poor initial conditions, but probably somewhat better than those of Albania. What really hurt both countries severely were the economic disintegration of the Soviet Union, the severe civil conflict in the case of Georgia, and the extraordinary difficulties of gaining access to markets in the case of Kyrgyz Republic, due to its land-locked situation. Both countries had a reasonable reform record and benefited from substantial IFI support, but neither enjoyed the political anchor of the hope of one day joining the EU. Add to that weak institutions and initially poor macroeconomic management and these two countries became mired in debt, although they started out with no debt to speak of.

Finally, I should briefly compare the experience of Russia and China. Joseph Stiglitz compared the two in a well-known article from 1999, in which he compared the rapid economic growth of China with the seemingly inexorable decline of Russia from 1989 through 1997. Stiglitz attributed the dramatic difference between the two trajectories basically to the failures of Russian reformers and their external advisers. He particularly blamed an excessive speed of liberalization and privatization and a neglect of the need to build the necessary institutional capacities of a market economy. Leaving aside the eventual strong recovery of Russia, I believe the reasons for the early and protracted decline are more complex than Stiglitz allows.

First, Russia was characterized by bad initial conditions, including a strict command economy, a large state-owned enterprise sector, little agriculture, and a huge military-industrial complex. Second, it was severely hit by the political and economic disintegration of the Soviet Union, which not only created many disruptions in the traditional economic links across the Soviet economic space, but also made it impossible to consider a gradual process of liberalization, a process that would have required continued strict political control. Third, Russia was hit by a severe oil price collapse with global oil prices reaching a long-time nadir in 1998. Finally, rather than being the poster child of "shock therapy," Russia actually was not able to carry through aggressive and systematic reforms during the 1990s. Its reforms were halting and partial and were undermined by sustained fiscal deficits and rising debts, all of which culminated in the financial crisis of 1998.

China, in contrast, had better initial conditions, including a less strict command economy, a smaller state-owned enterprise sector, and a large agricultural sector. Moreover, it was able to retain political control over its entire territory and its reform process. This meant that China could avoid the disintegration process that so badly hurt the countries of the former Soviet Union and was able to pursue a gradual, but deliberate reform course. This course included prudent macroeconomic policy, the use of a two-tier pricing system, effective agricultural liberalization, and the unleashing of its entrepreneurial potential through the system of semi-private township and village enterprises. In addition, China rapidly integrated itself into the world economy with an export oriented strategy and welcoming the large inflow of expatriate capital from its overseas Chinese communities.

Lesson 1

Initial conditions matter, especially in the early years of transition, but they do not determine the ultimate success or failure. Among the key initial conditions are the following: 1) the depth of the command system and the institutional "memory" of prior experience with the market system -- the more extreme the command system and the less "memory," the more difficult will be the transition; 2) the economic structure at the start of the transition -- a large state-owned industrial sector, a small agricultural reserve, and a large military complex will make the transition more painful; 3) the distance to major world markets -- ease of access to world markets will facilitate integration into the world economy, which is a key to successful transition; 4) natural and human resource endowments -- oil and gas wealth can help or hurt, depending on their prices and on how the resources are used, and a highly educated and healthy population makes the transition easier; 5) the macroeconomic situation -- high initial macro-imbalances and debt can be serious burdens.

Initial conditions can help or harm, but they do not condemn to failure, as the Albania case has demonstrated; nor do they ensure success, as the case of the former Yugoslavia has shown. Much depends on what happens as the transition process unfolds, which brings us to Lesson 2.

Lesson 2

Content, pace, and sequencing of market reforms matters. Here, key dimensions need to be borne in mind as one plans for and implements transition reforms. First, macroeconomic stability is essential throughout the transition -- inflation undermines the recovery and high fiscal deficits will create unsustainable debt and financial crisis, as in the case of Russia and the highly indebted poor CIS countries. Second, rapid stage 1 reforms cause short-term disruptions, but permit rapid recovery later, as shown by the case of Poland and the Baltics. Third, gradual stage 1 reforms also can succeed, but they require strong political control, careful design and lasting commitment, as shown in the case of China; the risk is that they can easily lead to corruption and get derailed by countervailing interests, as in the case of Russia and other CIS countries. Fourth, steady and sustained stage 2 reforms are necessary under all circumstances to build market institutions and social infrastructure; these reforms need to start early and take time. Fifth and finally, a systematic misalignment of prices and wages and inflexible market structures can negate the benefits of integration and institutional improvements, as the case of East Germany has demonstrated.

So far these first two are more-or-less standard lessons. I, however, will add three more.

Lesson 3

The process of disintegration and integration matters. The experience demonstrates that it matters whether or not a country disintegrates as part of the transition process, and how it integrates into the world economy during the process of transition. For instance, economic disintegration was a major cause of initial decline in Central Europe and the CIS. In addition, economic integration matters for rapid, and sustained recovery is much more difficult for land-locked countries distant from major markets than for countries with good market access; the transition countries and the international community can help with policies that facilitate the integration process. Furthermore, political disintegration makes gradual economic reform very difficult, as the case of Russia has shown, and it can create conflict, as in the case of the Balkans, the South Caucasus, and Tajikistan.

Lesson 4

The politics of transition are key. Managing the transition is not just a matter of good economic and institutional design. Understanding and managing the politics of transition are as important. This means that reformers must consider explicitly who are the winners and losers from the transition; the presence of social safety nets for those negatively affected helps in managing the politics of transition. Experience also shows that in the short to medium term, political control helps with orderly economic transition and allows gradual reforms, as in the case of China, and in some CIS countries with authoritarian regimes. But in the medium to longer term, concentration of economic and political control risks the emergence of entrenched, non-transparent, unaccountable, special interest-driven political control; this in turn results in poor governance and high corruption, and a great potential for political and economic instability. The recent developments in the Central Asian CIS countries vividly demonstrate this risk.

Lesson 5

External financial and political support can help, but it is no panacea. The transition process brings with it substantial transition costs and uncertainties. External financial and technical support can cushion the costs and can serve as a commitment mechanism, if it is conditioned on effective reform, as was the case in Central Europe, the Baltics, and in Albania. However, external support can also result in uncoordinated assistance and advice, and heavy debt burdens, as has been the case in some of the poorer CIS countries.

It is also important to note that the EU accession "umbrella" has served as an important political commitment mechanism and as a source of financial support, but such can also impose inappropriate rigidities in labor markets, in tax and regulatory systems, and in social security systems. The current efforts by the new Central European EU members to achieve flexible market conditions certainly go in the right direction.

Finally, the German experience shows that the combination of transition and unification is an immensely complex economic, institutional, political and even psychological process that requires much careful planning, as well as patient and sensitive implementation.

Conclusion

The bad news is that there is no blueprint, no single set of necessary and sufficient conditions for success. Much depends on the specific country conditions and on a complex interplay of political and economic variables. Also, political and economic disintegration, if they occur along with the transition, will make the process much more difficult to manage.

The good news is that there are some key common elements to success. In the short to medium term, prevention of conflict, maintaining macro stability, elimination of major price distortions, and creating space for entrepreneurial activity in small and medium-sized firms will help tremendously. Maintaining basic social services and social safety nets and avoiding the concentration of too much political and economic power are important ingredients to create the political underpinning for sustained reforms. In the medium to longer term, it is necessary to develop effective public institutions. This includes effective public administration and judicial systems, a transparent and accountable political system, a sound investment climate and financial sector, and the maintenance of flexible market structures with sound corporate governance.

The international community and the immediate neighbors can play a key role in helping a transition country in the overlapping processes of transition and integration, which ultimately need to go hand in hand for lasting success. It is my hope and optimistic expectation that the Korean people will achieve such a success.

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