1. Introduction

What do we mean by the transition from central planning to a market economy? What is the starting point and where is the destination? Should we look at some kind of model centrally planned economy (CPE) and analyse the process of changing it to an unregulated market economy, or should we be concerned with the variety of CPEs which actually existed and with the even greater variety of regulated market-based economies, both actual and potential, into which they might evolve?

The answer must be a balance. The economics of transition became an issue of significance when many CPEs collapsed between 1989 and 1991, even though reform of CPEs had long been on the agenda and major Asian CPEs had set out on the path to system reform in the late 1970s and mid-1980s.[1] It would be too artificial to analyse transition without reference to the specific historical situation. At the same time we do not want to become too bogged down in the individual circumstances of economies where in many cases economic change was occurring in a context of idiosyncratic political turmoil.

1.1 WHAT IS TRANSITION?

The key elements of transition are the replacement of physical allocation of a nation's resources by allocation in response to price signals, which requires both price liberalization and enterprise reform. These are complementary, because without enterprise reform there is unlikely to be the desired response to relative price changes and with artificial prices reformed enterprises' decisions will not be socially optimal. Even in the leading market economies, however, many allocation decisions are not in response to market-determined prices (for example, intra-firm transactions or the provision of services by the public sector) and many market-determined prices are not socially optimal (for example, when suppliers have monopoly power or when there are environmental or other externalities). The shift from an enterprise sector dominated by state-owned entities can take place by infinite combinations of privatization of the existing enterprises (which can take many forms and cover varying proportions of the total state-owned sector), entry of new domestic firms and foreign investment.

A successful transition does not have a unique well-defined outcome. It does require establishment of the policy framework needed to facilitate a well-functioning market economy, such as the provision of legal, physical and other infrastructure. Again, however, a range of institutional arrangements can underpin successful market economies; contrast, for example, Canada, France and Japan. Trade policy and financial sector reform are also often crucial (because exchange rates and interest rates are critical prices), and macroeconomic stabilization may be required because relative price signals are obliterated by high inflation. On the other hand many high inflation countries (or countries with restrictive trade policies or repressed financial sectors) are indubitably market economies, albeit poorly functioning ones.

Thinking on transition issues has been strongly affected by the consensus view on development economics in the 1980s and 1990s – just as thinking on the emerging subject of development economics in the 1940s and 1950s was strongly influenced by the Soviet industrialization debates and practical experience. Developing countries adopting economic reforms in the 1980s and 1990s bore some similarity to the CPEs due to their reliance on heavily interventionist import-substituting industrialization policies, but the CPEs have undertaken far more drastic reforms, especially in the areas of reforming state-owned enterprises and in establishing financial sectors. The situation also differs in that most CPEs were middle-income countries with large industrial sectors and, except for China and the South-East Asian CPEs, have faced large declines in living standards.

Still, there are lessons to be learned from the experience of economic reform elsewhere, especially about the importance of the real exchange rate and interest rate structure, the interconnections and sequencing issues, and how long reform can take to deliver benefits (over 15 years in Chile or New Zealand – among the earliest and most rapid reformers) and the threat to reform from vested interests (reflected in the stop–go reform process in many South American countries). On specific policies, such as pensions, the transition economies can draw directly on substantive debates and occasional experience (for example, in replacing pay-as-you-go pensions by fully funded schemes) to accelerate processes that have evolved over decades in established market economies.

1.2 THE HISTORICAL BACKGROUND AND GOALS OF TRANSITION

The practice of central planning was overwhelmingly determined by Stalin's resolution of the industrialization debates in the USSR in the late 1920s (Erlich, 1960). The Soviet planning system became not only important in itself but the blueprint for almost all other CPEs, which adopted the Soviet model either by choice or by compunction. The spread of Soviet-style planning occurred mainly in the 1940s, when the Baltic states were absorbed by the USSR, the European countries east of the iron curtain became subordinate to the USSR and adopted central planning (as did the Mongolian People's Republic in the late 1940s), and the People's Republic of China was established. Subsequently some other Third World countries adopted Soviet-style planning; apart from Vietnam they do not feature prominently in my story, and a few (Cuba and the Democratic People's Republic of Korea) are the last bastions of central planning.

The demise of central planning in the USSR is usually dated to the 1987 Law of Enterprises, which abolished output targets. Enterprises were supposed to become self-financing, but state orders still accounted for most of industrial output and enterprises continued to want (and often obtained) guaranteed input supply. State orders diminished after 1989, but markets functioned poorly and tax rates or arbitrary confiscations by central or local government were unpredictable. With the dissolution of the USSR in December 1991 the reality of transition became stronger as Russia adopted a sweeping price liberalization in January 1992 and other successor states were either unwilling or incapable of maintaining anything like the detailed physical planning of earlier decades.

In the Soviet satellites the abandonment of central planning became associated with political liberation. In 1989 and 1990 economic liberalization progressed rapidly in East Germany, Poland, Czechoslovakia, Hungary and Mongolia, and more erratically in south-eastern Europe. Despite the variations in historical, political and cultural conditions the destination, at least as initially perceived, was a shared one: towards a market economy which would deliver material prosperity, while the government would mitigate the worst social effects of a market economy. The Scandinavian model was often invoked in eastern Europe and the Baltic states. For all of the European transition economies the political goal of accession to the European Union was important, and provided added incentive to transform their economies into ones which would fit into the EU.

China's experience contrasts sharply to that of the European transition economies, or Russia or Mongolia. China introduced its economic reforms in the late 1970s, yet retained substantial elements of central planning. Even in the 1990s plan prices continued to play a significant role, especially in maintaining the viability of state-owned enterprises. The Chinese authorities were insistent in refusing to include their country among the category of transition economies during the early 1990s, instead describing theirs as a social market economy. In Vietnam too, despite sweeping reforms introduced during the second half of the 1980s under the slogan *doi moi*, there was some resistance to categorizing adoption of a market economy as the ultimate goal. In both

China and Vietnam the Communist Party remained in power and permitted no political pluralism.

The contrasting paths of China (and Vietnam) on the one hand and of the European transition economies and Russia on the other hand has spawned a large literature on Asian versus European transition models. On the usual economic criteria of output growth and inflation the Asian performance has been far superior, but there is much debate over whether this is attributable to differing policies or initial conditions or targets. There is always a temptation to consider the two groups as so diverse as to be incomparable, but from an economic systems perspective their starting points were sufficiently similar that there ought to be lessons to be drawn from including both groups in the countries to be studied. Thus, I will include in the sample all of the countries listed in Table 1.1, although some will feature more than others due to their size, the demonstration effect of their policies or performance, or a particular policy innovation.[2]

1.3 THE CHANGING FIELD OF TRANSITION ECONOMICS

Studying economies in transition has been a field in transition. The pressing need for practical guidelines encouraged quick clear judgements about appropriate policies, and such judgements would inevitably be simplistic and sometimes wrong. The policymakers, who came to power in 1989 and the early 1990s, had substantial room for manoeuvre and the policies adopted in the name of establishing a market economy varied hugely. For people living through the transition, the scale of the economic shocks could be traumatic, and often led to feelings that the staid old planned economy had not been so bad after all.[3] For analysts, the magnitude of the differences in policies and performance was a boon.

Initially, transition economics was dominated by the Big Bang debate. Should reforms be introduced altogether and as quickly as possible, or was gradualism more desirable and, if so, what was the appropriate sequencing? The early emphasis was macroeconomic rather than microeconomic. Prices were freed, but the focus in the early 1990s was on monetary policy and inflation rather than on relative prices, although sweeping foreign trade and exchange rate liberalization brought appropriate relative prices quickly to Poland and East Germany. Microeconomic reforms, including enterprise reform, were on the back burner, even though many blueprints for mass privatization circulated. Policy debates were clouded by uncertainty about the political constraints. Did governments face a one-time window of opportunity in which wide-ranging reforms could be introduced, with modifications and fine-tuning coming later, or did the collapse of Communism herald a new era in which gradual change was possible and where implementing the right policies was more important than speed and irreversibility?

The decade after 1989 clarified some of these issues, and the focus of analysis shifted in consequence. Some macroeconomic variables were crucial and demanded priority, others were less pressing. Without some degree of monetary stability, a market economy functions poorly, and within half a decade or less all governments had learned the need to contain inflation and recognized the monetary causes of inflation. The choice of exchange rate regime was less crucial and, on the whole, countries with monetary stability enjoyed relatively stable exchange rates while countries failing to control inflation through domestic monetary policy failed to achieve stability in forex markets whatever the declared exchange rate regime. Fiscal policy was more complex, but in the absence of domestic bond markets it too was secondary to the needs of monetary policy. If governments could only finance budget deficits by monetary creation, then containing the deficit was a prerequisite for monetary control. Initially at least, with revenues falling, budgets were balanced by expedient cuts in expenditures rather than as a result of careful assessment of the role of government.

The Big Bang debate gradually fizzled out. Some reforms, by their nature, take longer to implement, while macroeconomic stability and the case for or against fine-tuning fiscal and monetary policy are ongoing concerns in a market economy. Advocates of a Big Bang generally had the right menu of reforms, but, apart from on controlling inflation and on trade policy, were skimpy about specifics. By the century's end, the policy debate was about the nature of the desirable policies rather than about the speed of implementation. The need for care over the design of institutions was acknowledged by people who had previously emphasized the need for rapid enterprise reform, the creation of financial markets and so forth, while erstwhile gradualists recognized that delaying the implementation of good policies was rarely justified.

In general, the change has been from simple blueprints and straightforward policy prescriptions towards greater recognition of the complexity of systemic change. This is visible in policy areas, and in theoretical and empirical work on transition.

In the policy arena, polemical debates were loud (where they were allowed) and in the more democratic countries elections led to reactionary swings as radical reformers were replaced by ex-Communists across central and eastern Europe and in Mongolia. Yet, none of the 'second' governments tried to reinstate central planning. Even in Azerbaijan, where the democratically elected radically reformist Popular Front government was ousted and replaced by an autocratic president who had served in Brezhnev's Politburo, commitment to a market economy remained (and implementation was accelerated). The urgency implied by the 'one-time window of opportunity' view dissipated. Nevertheless, initial steps did matter, because they created the parameters within which subsequent developments were framed.

Theoretical debates also became less shrill. Initial writing inevitably had an eye on policymakers. Proponents of a viewpoint were unwilling to acknowledge caveats, and theorists simplified their messages. As in development economics half a century earlier, the pioneers of transition economics were passionate. They were often correct, but simplification of something as complex as a market economy inevitably gets many details wrong – and those details may be critical in affecting people's lives. By the 2000s, theorists were recognizing the need for division of labour to analyse competition policy, labour markets, education and so forth. They also acknowledged path dependence, implying that we need to take a long-term perspective on the consequences of policy decisions or of other institutional change.

Empirical research has followed both political trends and theory. Early attempts to provide evidence on the relative merits of rapid versus gradual reform were plagued by data limitations. By the time a reasonable data set could be compiled, the questions had changed, but the cross-country comparisons remain interesting. Much of the analysis of performance reported in Chapter 4 is set in this framework.

Recent research has, however, moved in diverse directions. Recognition of the importance of institutions and of path dependence has encouraged country case studies, or even more disaggregated local or industry studies. These provide invaluable country-specific background, but by their nature do not yield general results. Another development has been to use the increasingly available survey data. In particular, the household surveys conducted under the aegis of the World Bank's Living Standards Measurement Study (LSMS) program provide a richer picture of living standards than do the usual macroeconomic aggregates such as GDP per capita, and are rich enough for sophisticated analysis of the correlates of poverty or other variables of interest. Surveys of labour markets and of businesses have also proven helpful in analysing actual outcomes, rather than relying on misleading official figures on unemployment or enterprise formation.

Acknowledgement of the complexities of systemic change has added to the excitement of studying economies in transition. The heady days of 1989 and the early 1990s when western economists could show that their knowledge might be helpful to politicians concerned with raising their country's economic performance are past, and not without some recognition of the knowledge's limitations. Nevertheless, as we move from propagating simple truths to seeking deeper understanding, economists studying the new market economies can shed light on the fundamentals underpinning successful and unsuccessful market economies. Simplified views of privatization have made

Table 1.1 European and Asian economies in transition

	Population (million) mid-1992	GNP per capita (US$) 1992	Population (million) mid-1999	GNP per capita (US$) 1999
Central Europe				
Slovenia	2	6540	2	9890
Hungary	10	2970	10	4650
Estonia	2	2760	1	3480
Czech Rep.	10	2450	10	5060
Latvia	3	1930	2	2470
Slovak Rep.	5	1930	5	3590
Poland	38	1910	39	3960
Lithuania	4	1910	4	2620
Eastern Europe				
Belarus	10	2930	10	2630
Russia	149	2510	147	2270
Ukraine	52	1820	50	750
Balkan and Caucasus				
Bulgaria	9	1330	8	1380
Moldova	4	1300	4	370
Romania	23	1130	22	1520
Georgia	6	850	5	620
Armenia	4	780	4	490
Azerbaijan	7	740	8	550
Albania	3	LM	3	870
Croatia	5	LM	4	4580
Macedonia FYR	2	LM	2	1690
Serbia	11	LM	11	LM
B & H	4	L	4	LM
Asia				
Kazakhstan	17	1680	15	1230
Turkmenistan	4	1230	5	660
Uzbekistan	22	850	25	720
Kyrgyz Rep.	5	820	5	300
Mongolia	2	LM	3	350
Tajikistan	6	490	6	290
China	1162	470	1250	780
Laos	4	250	5	280
Vietnam	69	L	78	370
Cambodia	9	L	12	260

Table 1.1 European and Asian economies in transition (cont.)

	Population (million) mid-1992	GNP per capita (US$) 1992	Population (million) mid-1999	GNP per capita (US$) 1999
Other				
German Dem. Rep.	17	LM	n.a.	n.a.
North Korea	23	LM	23	L
Afghanistan	22	L	26	L
Myanmar	44	L	45	L

Notes: n.a. = not available in the source; since 1990 the German Democratic Republic forms the eastern Länder of Germany; in 1992 lower income (L) is less than $675 and lower middle income (LM) $676 to $2695; in 1999 L is $755 or less, LM is $756 to $2995.

Source: World Bank data from *World Development Report 1994*, 162–3 and 228, and *World Development Report 2000/2001*, 274–5 and 316.

way for subtler analysis of relations between business and government and of corporate governance. Creating competitive markets appears more important than formal denationalization. The evidence behind such statements is examined in Chapter 5.

NOTES

1. Writing from the 1980s on Chinese economic reforms will be referred to as part of the transition literature. At the time, however, it was generally regarded as idiosyncratic country-specific material, rather than as a generalizable example of systemic change, just as previously research on the Chinese economy seemed to fit neither in the comparative economics nor the development economics sub-fields of economics.
2. Some will be given short shrift because of difficulties in documenting or interpreting the pre- or post-reform economic system. Afghanistan, Bosnia and Herzegovina and other Yugoslav successor states, the Caucasus countries and Tajikistan and Cambodia have suffered from civil war or invasion. In some of these countries, as well as Laos and Myanmar, the nature of their central planning is debatable. The countries listed in this note also tend to have poor data sources. I will omit completely the various African experiments with central planning, most of which were short-lived or conducted under conditions of civil war. The small island nation of Cape Verde is the most comparable in its peaceful transition begun in 1991, but the situation is complicated by large amounts of foreign aid and remittances – perhaps comparable to Mongolia, but Mongolia has over four times the population of Cape Verde and aid per capita was less in Mongolia. Cuba will be mentioned briefly, but it too has been rather idiosyncratic and officially is still committed to the planned economy.
3. Such feelings were often too hard to bear. One of the most distressing phenomena has been the dramatic increase in the suicide rate in some transition countries, especially among males in the western part of the former Soviet Union who suffered large unanticipated income losses (Brainerd, 2001).