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How to Improve Transition Process in Next Decade

Prof. Nebojša Savić
ECONOMICS INSTITUTE
Srpskih vladara 16
11000 Beograd, Yugoslavia
Phone and fax: (+381 11) 686-345 and 361-2716
e-mail: nebojsas@Eunet.yu

Abstract

Last ten years countries in transition (CIT) have gained tremendous attention, in part owing to their transforming to market economies, especially when we talk about Central European CIT, but also owing to the needs to improve output recovery in them. The main focus of the paper is (i) on the achieved results in the first ten years of transition, especially in the field of macroeconomic stability and ending moderate inflation, (ii) on the possible exchange rate regimes and dilemas over Washington Consensus and (iii) on the necessary institutional requirements, especially financial, for better development in the future.

Key words: Transition Economies, Stabilization, Output Growth, Institutions

JEL Classification Numbers: E31, E52, E65, H62, O16

Paper prepared for **The Twelfth World Congress of International Economic Association**,
Buenos Aires, 23-27 August, 1999.

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Nebojša Savič[1/]

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The ten-year experience of the advanced reformers among countries in transition (CIT), such as the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia, in transitioning to a market economy has already contributed to the accumulation of knowledge and experience, on the basis of which it is possible to speak about the basic elements of transition economics.

The aim of this paper is, first, to present the hitherto results achieved by the European CIT (ECIT) with respect to growth recovery and the curbing of inflation; second, to point to the significance of savings for growth recovery, linking it to a fiscal deficit and the current account balance: third, to point to different exchange rate regimes and their significance for stabilization and the inflow of foreign capital; and, fourth, to point to the significance of institutional changes as the basis for further transition processes in the ECIT.

1. THE SURVEY OF THE TEN-YEAR DEVELOPMENT OF THE EUROPEAN CIT

For the CIT as a whole, the year 1997 was the first year in which they recorded a positive growth rate (about 1%). For the Central and East European (CEE) CIT, this was the fourth consecutive year in which they could record positive growth rates. This analysis also comprises Sought-Eastern European (SEE) CIT and former Soviet Union (FSU) CIT.

The rate of imports into CIT exceeds the rate of their exports, whereby both imports and exports are increasing at a faster pace than the world economy, or the world imports and exports. As for the inflation rate, the advanced reformers among CIT succeeded in bringing it down to less than 17% in the course of 1997.

1.1. Transition crisis, recovery and growth

Experiences of the initial stabilization. - The transition process aroused numerous controversies over the pace at which the new market economies can be developed.

The so-called Washington Consensus, which will be analyzed in further text, was based on the previous experience of stabilization and structural adjustment on other continents and specifically in Latin America during the debt crisis in the 1980s, and it seemed to be a good guidance as to how transition should be carried out as well. According to this Consensus, it was necessary to do the following. **First,** it was necessary to carry out economic policy measures to establish the appropriate fundamentals, this achieving fiscal and external solvency. **Second**, the multiple nominal anchors should be used to coordinate expectations during the initial disinflation. If fiscal policy is properly set, the need for inflationary taxation will be very moderate. The major nominal anchor should be the fixed exchange rate; should it be decided to use some monetary aggregate as the nominal anchor, the exchange rate should be flexible. **Third,** efforts at structural adjustment should not be delayed, although the expectations concerning their effects should be more modest.[3/] Good microeconomic foundations are necessary for achieving macroeconomic stability; macroeconomic stability helps create such a climate as will enable better microeconomic incentives.

Our attention will now be focused on the way in which all this was achieved in the ECIT (see Tables 1 and 2). During this ten-year period (1989-98), numerous analyses were devoted to the problems of transition crisis and the initial fall in output in CIT.[4/] Although the views were widely varied, it is still possible to distinguish two subperiods:

- output reduction subperiod (1990-1993) during which advanced CIT began their recovery and
- recovery subperiod (1994-98) during which a half of CIT experienced 4-5 years of growth.

[1/] The author is senior research fellow at the Economics Institute, Belgrade, and professor of economics at BK University, Faculty of Management, Belgrade.

[2/] The author expresses his gratitude to professors Dragoslav Avramović, Željko Bogetić, Ljubomir Madžar, Boško Mijatović and Boško Živković for very useful comments on the previous version of this paper. All responsibility for the views expressed in the paper lies solely with the author.

[3/] See: Bruno, M., **Crisis, Stabilization, and Economic Reform: Therapy by Consensus**, Clarendon Press, Oxford, 1993, and Bruno, M., "Stabilization and the Macroeconomics of Transition: How Different is Eastern Europe?", **Economics of Transition**, EBRD, Vol. 1, January 1993, pp. 5-19.

[4/] On the initial concepts of transition see: Savić, N., "Yugoslavia: Transition to Market Economy with Stabilization and Privatization", in: D. Avramović and Nj. Ostojić, **International Economic Trends and Policies - Their Effects on Eastern European Countries**, ECPD, 1995, pp. 263-78.

Table 1. Annual rates of growth of GDP

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998*	1999†
Central Europe	**0.4**	**-5.4**	**-10.8**	**-3.2**	**0.6**	**4.3**	**5.2**	**4.2**	**4.5**	**3.6**	**4.2**
Czech	1.4	-1.2	-11.5	-3.3	0.6	3.2	6.4	3.9	1.0	-1.0	2.5
Hungary	0.7	-3.5	-11.9	-3.1	-0.6	2.9	1.5	1.3	4.4	4.6	4.9
Poland	0.2	-11.6	-7.0	2.6	3.8	5.2	7.0	6.1	6.9	5.2	5.6
Slovakia	1.4	-2.5	-14.6	-6.5	-3.7	4.9	6.9	6.6	6.5	5.0	3.3
Slovenia	-1.8	-8.1	-8.9	-5.5	2.8	5.3	4.1	3.1	3.8	4.0	4.5
Baltic countries	**2.4**	**-3.4**	**-9.9**	**-23.5**	**-13.4**	**-3.7**	**2.3**	**4.0**	**7.9**	**4.0**	**5.3**
Estonia	-1.1	-8.1	-13.6	-14.2	-9.0	-2.0	4.3	4.0	11.4	5.0	5.7
Latvia	6.8	2.9	-10.4	-34.9	-14.9	0.6	0.8	3.3	6.5	4.0	5.2
Lithuania	1.5	-5.0	-5.7	-21.3	-16.2	-9.8	3.3	4.7	5.7	3.0	5.1
SE Europe	**0.6**	**-8.4**	**-17.1**	**-11.2**	**-1.5**	**3.8**	**4.7**	**1.8**	**-2.5**	**3.4**	**4.3**
Albania	9.8	-10.0	-27.7	-7.2	9.6	9.4	8.9	9.1	-7.0	9.0	8.4
Bulgaria	0.5	-9.1	-11.7	-7.3	-1.5	1.8	2.1	-10.9	-6.9	4.0	4.0
Croatia	-1.6	-7.1	-21.1	-11.7	-8.0	5.9	6.8	6.0	6.5	4.2	3.7
Macedonia	0.0	-10.2	-12.1	-21.1	-9.1	-1.8	-1.2	0.8	1.5	5.0	3.8
Romania	-5.8	-5.6	-12.9	-8.8	1.5	3.9	7.1	4.1	-6.6	-5.0	1.7
FSU	**n.a.**	**-3.5**	**-5.9**	**-12.6**	**-10.2**	**-16.1**	**-8.9**	**-3.6**	**2.7**	**0.0**	**-0.2**
Belarus	8.0	-3.0	-1.2	-9.6	-7.6	-12.6	-10.4	2.8	10.4	5.0	0.8
Russia	n.a.	-4.0	-5.0	-14.5	-8.7	-12.7	-4.1	-3.5	0.8	-5.0	-1.3
Ukraine	n.a.	-3.4	-11.6	-13.7	-14.2	-23.0	-12.2	-10.0	-3.2	0.0	-0.1

* - estimation, † - projection; Source: **World Economic Outlook,** IMF and **Transition Report,** EBRD, various volumes.

The opinion prevails that macroeconomic stabilization and structural reforms are crucial for the sustained growth of CIT. It can be said that those CIT in which stabilization was achieved very early and structural reforms were carried out at a faster pace, produced better results in the field of output recovery. In addition, it has also been concluded that the correct combination of measures is of utmost significance for growth recovery and that the essential component of a reform package should be the downsizing of government administration and a decrease in government expenditure.[5/] It has also been concluded that output growth in CIT was accompanied by a high increase in exports.[6/]

In his analysis of stabilization programs and reforms in CIT, M. Bruno points out that growth recovery in CIT was achieved thanks to an increased share of the private sector's output in addition to exercising extreme caution in the enforcement of the bankruptcy law.[7/] A stylized presentation of entering a crisis and the transition process until growth recovery, in Bruno's interpretation, is shown in Figure 1. The basic strategy relies on the hitherto experiences in transitioning and can be formulated in the following six points:[8/]

(1) **achieving macroeconomic stability,** primarily by bringing fiscal expenditures and fiscal revenues into balance and by pursuing a tight monetary and credit policy;

(2) **price liberalization by lifting price controls** and creating conditions for the functioning of the market and prices as allocation mechanisms;

[5/] Havrylyshyn, O., I. Izvorski and R. van Rooden, “Recovery and Growth in Transition Economies 1990-97: A Stylized Regression Analysis”, **IMF Working Paper No. WP/98/141**, September 1998, IMF, Washington, D.C.

[6/] Christoffersen, P. and P. Doyle, “From Inflation to Growth: Eight Years of Transition”**, IMF Working Paper No. 98/100**, July 1998, IMF, Washington, D.C.

[7/] Bruno, M., "Stabilization and the Macroeconomics of Transition - How Different is Eastern Europe?", **Economics of Transition**, Vol. 1, No. 1, 1993, pp. 5-19.

[8/] See: Bruno, M., "Symposium on Economic Transition in the Soviet Union and Eastern Europe", **Journal of Economic Perspectives**, Fall 1991.

Table 2. GDP level (1989=100)

	1990	1991	1992	1993	1994	1995	1996	1997	1998*	1999†
Central Europe	**95.3**	**85.0**	**82.3**	**82.8**	**86.3**	**90.8**	**94.7**	**98.9**	**102.5**	**106.8**
Czech	98.8	87.4	84.6	85.1	87.8	93.4	97.0	98.0	97.0	99.5
Hungary	96.5	85.0	82.4	81.9	84.3	85.5	86.6	90.4	94.6	99.2
Poland	88.4	82.2	84.3	87.6	92.1	98.6	104.6	111.8	117.6	124.2
Slovakia	97.5	83.3	77.9	75.0	78.6	84.1	89.6	95.4	100.2	103.5
Slovenia	95.4	86.9	82.1	84.4	88.9	92.5	95.4	99.0	103.0	107.6
Baltic countries	**96.6**	**87.1**	**66.2**	**57.4**	**55.1**	**56.5**	**58.7**	**63.5**	**66.1**	**69.6**
Estonia	91.9	79.4	68.1	62.0	60.8	63.4	65.9	73.4	77.1	81.5
Latvia	102.9	92.2	60.0	51.1	51.4	51.0	52.7	56.1	58.3	61.4
Lithuania	95.0	89.6	70.5	59.1	53.3	55.1	57.6	60.9	62.8	66.0
SE Europe	**91.6**	**76.0**	**67.4**	**66.3**	**68.9**	**72.4**	**73.8**	**71.6**	**73.9**	**77.2**
Albania	90.0	65.1	60.4	66.2	72.4	78.8	86.0	80.0	87.2	94.5
Bulgaria	90.9	80.3	74.4	73.3	74.6	76.2	67.9	63.2	65.7	68.3
Croatia	92.9	73.3	64.7	59.5	63.1	67.3	71.4	76.0	79.2	82.2
Macedonia	89.8	78.9	62.3	56.6	55.6	54.9	55.4	56.2	59.0	61.2
Romania	94.4	82.2	75.0	76.1	79.1	84.7	88.2	82.3	78.2	79.6
FSU	**96.5**	**90.8**	**79.4**	**71.5**	**60.3**	**55.0**	**53.5**	**55.5**	**55.7**	**55.6**
Belarus	97.0	95.8	86.6	80.1	70.0	62.7	64.4	71.1	74.7	75.3
Russia	96.0	91.2	78.0	71.2	62.2	59.6	57.5	58.0	55.1	54.4
Ukraine	96.6	85.4	73.7	63.2	48.7	42.7	38.5	37.2	37.2	37.2

* - estimation, † - projection; Source: author's estimation based on: **World Economic Outlook,** IMF and **Transition Report,** EBRD, various volumes.

(3) **privatization** based on sales or transfer to the citizens;

(4) **trade liberalization,** thus enabling domestic firms and consumers to gain access to the world market, as well as the opening of the domestic market;

(5) **provision of the social safety net,** with a view to taking care of the poor and

(6) **the fastest possible development of legal infrastructure** so as to ensure the smooth functioning of a market economy and, above all, the observance of contracts and the adoption of bankruptcy related legislation.

On the basis of experience gained so far, it is possible to draw the following conclusions: (i) the faster and more thoroughgoing economic reforms, the greater the prospects for minimizing their costs; (ii) political democratization contributes to the success of transition; (iii) it is difficult to avoid a relatively significant fall in output at the beginning of transition, especially in the state-owned industrial sector; and (iv) the government should not be afraid of the highly set aims when opting for a stabilization program and transition.[9/]

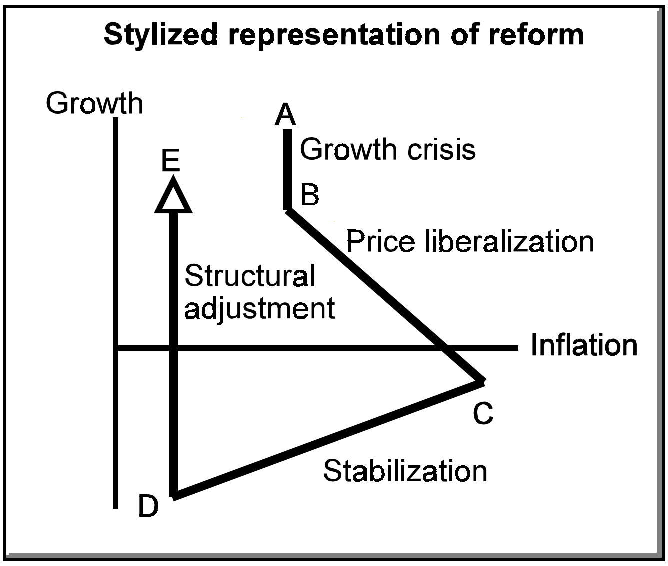

Figure 1

[9/] Dabrowski, M., "Different Strategies of Transition to a Market Economy: How Do They Work", **Wold Bank Working Papers No. 1579**, March 1996, The World Bank, Washington, D.C.

This points to the beneficial influence of a well conceived transition process. In their development efforts, the advanced CIT have so far achieved the following:

- relatively stable growth,
- moderate inflation and
- considerable progress towards institutional reforms and integration into the world economy.

Stability in CIT can be achieved by implementing stabilization programs, by trade liberalization and by setting the institutional framework that will create a sound basis for growth recovery, whereby the maintenance of this stabilization will call for the improvement of other economic indicators. This will require broader reforms as a precondition for sustained growth.

The experience of slow reformers, such as: Russia, Belarus, Ukraine and, to a great extent, Albania, Romania and Bulgaria (up to 1997) points to the significance of the rounded-off reform packages. Reluctance to carry out reforms, "stop-go" policy and partial liberalization without other measures were driving these economies to failure and high inflation ending, in some episodes, in hyperinflation.

1.2. The theory of endogenous growth as a new synthesis in growth theory

Of special significance for CIT is a new synthesis in growth theory, which is known as the theory of endogenous growth. The essential elements of this synthesis are presented in the following four points.

The first element of this theory is that **even a long-term equilibrium growth rate of GDP depends on the saving rate**, as contrasted to the Solow-Swan and Cass-Koopmans neoclassical growth models developed in the 1950s and 1960s, in which it was absolutely independent of the saving rate and only the growth path level was considered to be dependent on the saving rate.

The second element of this synthesis is derived from the prevailing doctrine of economic growth in the past periods and is primarily linked to the already mentioned neoclassical models, which **attributed growth to the expansion of capital and labor** or, in other words, to the expansion of factor inputs, augmented through exogenous technological progress.

The third element of this synthesis is linked to the growth models developed in the mid-1980s, in which the role of factor inputs was retained, while **at the same time including technological progress based on increasing returns, R&D and imperfect competition, human capital and government policy**.[10/] At the beginning, the role of policies was confined to economic measures, such as: macroeconomic stability, openness of the economy and the degree of distortions in the major price signals.

The fourth element of this synthesis was taken over from the political economy model and is linked to property rights, the rule of law, institutions and corruption.[11/] Olson argues that the previous models proceeded from an assumption that the resources and available technologies are used in the most efficient way which, in his opinion, is not correct. In refuting this thesis, he advances a counterthesis that many countries are poor just because they waste their resources. The wastage of resources is especially evident in those countries in which the institutional framework for property rights and law were less developed, thus giving rise to corruption.

Numerous studies devoted to growth in the 1990s proceeded from the following determinants in defining differences in the pace and structure of development: (i) factor inputs (investments, human capital); (ii) government policy (monetary and fiscal policy and price distortions) and (iii) indicators of property rights security (tax burden and its fairness, corruption, transparency, political stability).

It has been shown that investments depend not only on the interest rate and that the concept of investments should be extended to include investments in R&D, human capital, learning by doing, the improvement of management, as well as in other elements of total factor productivity (TFP), to which due attention has been devoted only in the more recent theories of endogenous economic growth.[12/]

The basic conclusions given in more recent literature devoted to growth can be summarized in the following theses:

- **initial conditions are significant for the explanation of cross-country differences in the growth rate,** i.e. poorer countries tend to grow faster than richer ones, whereby the abundance of available resources does not ensure growth by itself;

[10/] These models have been synthesized in: Roamer, P., "Endogenous Technological Change", **Journal of Political Economy**, Vol. 98, No. 5, 1990, pp. S71-S102 and: Barro, R. and X. Sala-i-Martin, **Economic Growth**, 1995, McGraw Hill, New York.

[11/] Olson, M., "Distinguished Lecture on Economics in Government "Big Bills Left on Sidewalk: Why Some Nations Are Rich And Others Poor"", **Journal of Economic Perspectives**, Vol. 10, 1997, pp. 3-24.

[12/] See: Lucas, R., "On the Mechanics of Economic Development", **Journal of Monetary Economics**, July 1988. and already mentioned Roamer's paper (1990).

- **a good economic policy (macroeconomic stability and not distortive government interventions) generates a strong effect on growth;** therefore, reducing the annual inflation rate to less than 30-40% is a vital prerequisite for sustainable growth recovery[13/] and
- **legal, political and institutional frameworks** exert a great influence on growth.

On the basis of all this, it is possible to identify the following determinants of grow recovery in CIT:[14/]

- **at the beginning, a fall in output is inevitable** for the following two reasons:
  - **the emergence of a new market** and this is the buyers' market which was not sufficiently developed in the former socialist economies and
  - **the imposition of hard budget constraints,** because the piling of goods which cannot be sold on stock was a clear signal that output should be reduced and changed;
- **growth will not be recovered until a new, credible system of incentives is introduced;** the faster the reform is effected by imposing hard budget constraints and creating the environment with liberal prices, the faster will be the reallocation and restructuring of old outputs and the beginning of creating new ones, and
- the initial recovery is probably linked more to the improvement of efficiency than to the expansion of factor inputs (investments and/or labor).

In relevant literature there is a consensus that investments are the main engine of growth over a medium and long term, whereby investments include not only buildings and equipment; instead, they are understood from a broader aspect and also include investments in human capital. Although net investments do not have to be large so as to promote recovery, it is still necessary to reallocate both the existing investments and part of the capital stock to new sectors and products: this means that old sectors will undergo disinvestment and, thus, will have negative net investments. This view can also be supported by the findings of more recent studies at the corporate level, which point to a high rise in productivity during the hitherto process of transition.[15/]

A recent IMF study also points to the significance of the level of investments in the current phase of development of CIT. Its main conclusion is that, in 17 CIT under consideration, which have achieved sustained growth, the share of investments in GDP declined from 30%, as was recorded in the period of administrative management in those countries, to about 20% of GDP.[16/]

Thanks to all these findings, it is possible to arrive at the following conclusions:

- **stability is the vital yet not sufficient prerequisite for output recovery in CIT;**[17/]
- **liberalization and structural reforms are necessary to provide support to growth,** or, in other words, the greater the number of reforms, the better growth performance;
- **initial conditions in CIT** and, above all, a higher degree of industrialization and other specific features of each country (e.g. war and the like) exert an influence on the development of each CIT[18/] and
- **the more developed the market institutions the better quality and faster output recovery;** this refers, above all, to the rule of law, elimination of the corruptionist climate and equitable taxation.[19/]

[13/] Bruno and Easterly have suggested a higher rate (30-40%), see: Bruno, M. and W. Easterly, "Inflation Crises and Long-Run Growth", **NBER Working Paper No. 5209**, 1995, NBER, Massachusetts, Cambridge, while Fischer, Sarel and Ghosh and Philips suggested lower inflation rates; see: Fischer, S., "The Role of Macroeconomic Factors in Growth", **Journal of Monetary Economics,** Vol. 32, 1993, pp. 458-512, Sarel, M.,"Nonlinear Effects of Inflation on Economic Growth", **IMF Staff Papers,** Vol. 43, 1996, Washington, D.C., pp. 199-215, and: Ghosh, A. and S. Phillips, "Inflation, Disinflation and Growth", **IMF Working Paper No. 98/68**, 1998, IMF, Washington, D.C.

[14/] Havrylyshyn, O., I. Izvorski and R. van Rooden, “Recovery and Growth in Transition Economies 1990-97: A Stylized Regression Analysis”, **IMF Working Paper No. WP/98/141**, September 1998, IMF, Washington, D.C.

[15/] Pohl, G., R. Anderson, S. Classens and D. Djankov, “Privatization and Restructuring in Central and Eastern Europe: Evidence and Policy Options”, **World Bank Technical Paper No. 368**, 1997, The World Bank, Washington, D.C.

[16/] See the recent IMF study: “Growth Experience of Transition Economies”, 1998.

[17/] The exceptions (Bulgaria and Romania in 1997 and Belarus and Ukraine in 1998) only confirm the rule that the transition project should be consistently carried out and that “stop-go” policy, that is, reluctance displayed by those countries, only exposes the economy to the risk of failure and its switch to the old practice of irrational use of resources.

[18/] De Melo, M., C. Denizer, A. Gelb and S. Tenev, “Circumstance and Choice: The Role of Initial Conditions and Policies in Transition Economies”, 1997, **IFC,** Washington, D.C.

[19/] Several studies have shown that growth is higher in those economies in which market institutions are more developed: Brunetti, A., G. Kisunko and B. Weder, “Credibility of Rules and Economic Growth: Evidence From a Worldwide Survey of the Private Sector”, **Policy Research Working Paper No. 1760**, 1997, The World Bank, Washington, D.C.; Johnson, S., D. Kaufmann and A. Shleifer, “The Unofficial Economy in Transition”, **Brookings Papers on Economic Activity No. 2**, 1997, Brookings Institution, Washington, D.C. and: Olson, M., N. Sarna and A. V. Swamy, “Governance and Growth: A Simple Hypothesis Explaining Cross-Country Differences in Productivity Growth”, **USAID**, 1997, mimeo.

1.3. The speed and the sequencing of transition

In transition theory, a significant place is held by two questions which will be now analyzed: the first is what is the speed of transition, and the second is what is the sequencing in transition.

The speed of transition: "big bang" versus gradualism. - This question was one of the central hot issues at the beginning of transition and was largely confined to the comparison of the Polish and Hungarian road to transition. With the passage of time, however, in time, it was becoming increasingly evident that stabilization, if necessary, should be carried out right away, and that structural reforms, which require a longer period so as to be successfully effected, must not be delayed for this reason.

The origins of this debate should be sought in differences in the initial conditions of Poland and Hungary. In 1990, Poland needed stabilization because it was faced with hyperinflation, goods shortages and a high fiscal deficit, in addition to the debt servicing crisis. Hungary also required stabilization but the need for it was not so pronounced, since the inflation rate was a two-digit one and was much lower than in Poland. In addition, the problem of budget deficit was also less pronounced. However, Hungary's key problem was linked to foreign debt servicing. Very soon, Czechoslovakia was also included in this debate.

The packages implemented in these three countries were basically similar and consisted in the establishment of an external and internal equilibrium, by employing the same instruments (strict monetary and fiscal policy). M. Bruno argues that, although these packages were very similar to the IMF ones, they were the result of the policies pursued by the democratically elected governments which assumed full responsibility for the implementation of these measures, whereby domestic experts were assisted by their colleagues.[20/]

Why has the question of shock therapy versus gradualism has gained such importance in discussions? The answer should be sought in the political sphere. Shock therapy, which is also termed "big bang" and "cold turkey", reflects an intellectual and political commitment to monetarism, a neoclassical vision, coupled with resoluteness to make a radical breakaway with the past. In this sense, shock therapy rules out any possibility of embarking on the so-called third road, i.e. any version of "market socialism". **In fact, opting for shock therapy implies the ruling out of any possibility of reversing one's steps,** coupled with the implementation of drastic measures (which would decrease the standard of living for a moment) and very good prospects for a fast recovery.

On the other side, the situation in Hungary was burdened by divisions over the program to be implemented; confusion was caused by promises given during the election campaign and strong feelings of the citizens that the country was well ahead on its way to a market economy and that no greater sacrifice would be necessary. It should be noted that in that period Hungary already had largely liberalized prices and foreign trade flows while the forint was close to becoming convertible.[21/]

It can be concluded that there is still no rounded-off theory of gradualism. Whereas the concept of shock therapy has been theoretically explained,[22/] there is still no theoretical explanation of gradualism. There is only a recommendation given by the gradualists that the adverse effects of the initial transition shock should be absorbed as much as possible. **The gradualist approach is linked to institutional and microeconomic development and not to macroeconomic policies.**[23/]

The gradualists usually point to the following two arguments. According to the first one, it is evident that shock therapy cannot be applied to structural reforms; thus, privatization cannot be carried out overnight, even in the case of the most radical scheme, i.e. a free distribution, and the same applies to the transformation of the banking system. According to the second one, total costs associated with the implementation of a shock program may be higher than the costs of a gradualist one.

The shock therapists refuted both remarks, arguing that although a structural reform needs time, its efficiency is enhanced by fast stabilization. Further, no one can be certain as to the amount of the social costs of transition, but it is certain that those costs can be substantially cut by means of the appropriate compensation arrangements and social safety net.

A theoretical debate devoted to this issue ended a long time ago in favor of shock therapy to a greater or lesser degree, although the opinion prevails that too great attention was devoted to this issue in the past

[20/] Bruno, M., “Stabilization and Reform in Eastern Europe: A Preliminary Evaluation”, **IMF Staff Papers, Vol. 39, No. 4**, December, 1992, pp. 743.

[21/] For more detail see in: Blanchard, O., K. Froot and J. Sachs, (eds.), **The Transition in Eastern Europe - Volume 1: Country Studies**, NBER, University of Chicago Press, Chicago, 1994.

[22/] See: Sachs, J. and D. Lipton, “‘Shock Therapy’ and Real Incomes”, **Financial Times**, January 29, 1991 and: Winiecki, J., **Post-Soviet-Type Economies in Transition**, Avebury, Aldershot, 1993.

[23/] Murrell, P., “Conservative Political Pholosophy and the Strategy of Economic Transition”, **Eastern European Politics and Societies**, Vol. 6, No. 1, 1992, pp. 3-6.

period, considering the fact that both stability with liberalization and institutional and microeconomic reforms are required if the results of transition are to be successful.

The sequencing of transition. - There is a consensus in today's economic theory that stabilization must precede structural reforms. Stabilization must be accompanied by liberalization. Price liberalization is necessary due to numerous monopolistic positions and the presence of regulated prices, while trade liberalization is a precondition for conducting the strategy of an open economy and the opening of the domestic market. This should be accompanied by the devaluation of domestic currency and the introduction of convertibility. This will provide conditions for the improvement of competitiveness, elimination of price distortions, in addition to a price adjustment to the price structure on the world market; the exchange rate would be used as the nominal anchor after devaluation, which would make imports more expensive, thus eliminating the need for the imposition of high tariffs in the process of opening the economy.

With the progress of the transition process, the discussion about shock therapy versus gradualism, as well as about the sequence of moves shifted to:

- **the question of political credibility,** which means that the central issue for economic policy makers is the consistent implementation of the announced measures; this is where the experts see a difference between the Central European countries, which have succeeded in carrying out the announced economic policies, and Russia, Bulgaria and Romania, in which those measures have been announced but have not been successfully implemented, and
- the view that **economic policy makers should aim at stabilization first, while at the same time initiating structural reforms,** required for the improvement of credibility.[24/]

Long-term growth projections of CIT. - At the end of this survey of the ten-year experience of CIT, we shall deal with the long-term growth projections. During the period 1998-2002, the world economy is expected to grow at the annual rate of 3.5% and CIT and LDC at the annual rate of 5% and 6.5% respectively; the growth of world trade will amount to 6.3% and will be accompanied by an increase in CIT's imports and exports of CIT by 7.1% and 7.5% respectively, coupled with the reduction of the inflation rate to the one-digit level.[25/] The average growth rate in the period 1970-2002 will be 3¾%. As for the rate of exports and imports, it can be observed that they were more intensive than the growth of the world economy. Table 3 gives a survey of the anticipated share of specified groups of countries in the world economy with the projections up to 2020.

Table 3. Share in world output in percent

	1970	1980	1990	1997	2005	2015	2020
Developed	65	59	59	56	49	42	39
LDC	28	33	33	40	47	54	56
CIT	7	8	8	4	4	4	5

Source: **World Economic Outlook,** October 1997, IMF 1997.

In the period up to 2020, the share of CIT in the world economy will be stagnant, i.e. 4-5%, whereby the major change in the share will be observed in LDC: their share will decline from 56% in 1997 to 39% in 2020, in favor of LDC, whose share will increase from 40% to 56% respectively.

2. STABILIZATION, INFLATION, SAVINGS AND FISCAL DEFICIT IN CIT

2.1. Inflation and growth

Of great significance for the economic policy managemet is an answer to the question **whether inflation stimulates growth**? The view that inflation provides incentive to economic growth, which is often put forward for political reasons, **has no theoretical or empirical ground.** It has been unambiguously confirmed that there is a negative correlation between the two-digit or higher inflation rate and growth.[26/] However, there is still some dilemma concerning low inflation rates (below 10% annually). At this level of inflation, Fischer established a negative interdependence with growth, while Barro and Sarel did not detect this negative

[24/] On the role of rents in slowing down the transition process, see: Gelb, A., A. L. Hillman and H. W. Ursprung, “Rents as Distractions: Why the Exit From Transition is Prolonged”, in: N. C. Baltas, G. Demopoulos and J. Hassid, eds., **Economic Inter-dependance and Cooperation in Europe**, Springer Verlag, Berlin- Heidelberg, 1998, pp. 21-38.

[25/] **World Economic Outlook,** October 1997, IMF 1997.

[26/] See: Fischer, S., “The Role of Macroeconomic Factors in Growth”, **Journal of Monetary Economics, Vol. 32, No. 3,** 1993, pp. 485-512 and Bruno, M. and W. Easterly, “Inflation, Crises and Long-run Growth”, **NBER Working Paper Series, No. 5209**, August 1995.

interdependence below the annual inflation rate of 8%.[27/] In any case, there is no positive correlation between inflation and growth. Thus, it can be concluded that the trade-off between inflation and growth, based on the short-term Phillips curve, remains the central issue of monetary policy and of economic policy in general.

Many countries have encountered great difficulties in bringing down their inflation from moderate level to one-digit ones, whereby moderate inflation is deemed to be inflation whose rate has been ranging from 15% to 30% for three years already.[28/]

Fight against moderate inflation, which is experienced by the majority of CEE CIT, has gained in importance over the past years, since the time when these countries succeeded in bringing down their much higher inflations so as to be in the range of modern inflation. However, the complexity of moderate inflation is much greater than that of high or mega inflation, for example. Namely, very complex problems, which could not be observed in the case of higher inflation rates, become evident in the range of modern inflation, thus facing economic policy makers with very serious and complex tasks.[29/]

First, when inflation is high, it is relatively easy to reach a political consensus concerning the need to pursue a strict economic policy (especially in the monetary and fiscal field) as required for the disinflation process. However, when the inflation rate is lower, **it is more difficult to convince the public that long-term benefits from price stability exceed short-term costs associated with disinflation**.[30/]

The second significant problem arises from **difficulties associated with a change in the structure of contracts and transactions of the private sector in the disinflation process.** The shortening of the contract period and more widely used and increasing indexation based on foreign currency, which are characteristic of high inflation, make disinflation from a high level of inflation more easier than disinflation from a moderate one.[31/]

Third, when inflation is moderate, **recommendations for pursuing a disinflationary economic policy are also changed; this refers especially to the problems relating to capital inflow,** which is more intensive in those countries which have already made a greater progress in transitioning and achieving macroeconomic stability.[32/] Therefore, it is not surprising that inflation inertia is empirically more significant in the range of moderate inflation.[33/]

Fourth, transition is faced with sharp changes in the level of relative prices of goods and services, inputs and real exchange rate. This is characteristic not only of the initial phase of transition, but also of its later phases, with the inflation rate being already reduced to the range of moderate inflation. In the presence of nominal rigidities (e.g. the rigidity of nominal wages and prices), it is easier to establish new parities, i.e. the level of relative prices, by means of inflation. Should indexation be used, this process can be prolonged for a few years and the inflation rate can be maintained in the range of moderate inflation for a few years, too.

It can be concluded that there is a consensus **that high inflation generates a negative effect on growth and that the low inflation rate (0-2%) is actually harmless to growth.** What still remains unclarified is an answer to the question: what is the threshold of the inflation rate beyond which growth begins to be slowed down due to inflation.

Burton and Fischer gave a short survey of empirical studies devoted to this issue and stated that there was no evidence in support of the view that keeping a moderate (low two-digit) inflation rate would be good for growth. However, they established the fact that the two-digit or higher inflation rates would be harmful to

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[27/] See: Barro, R., “Inflation and Economic Growth”, **Bank of England Quaterly Bulletin**, Vol. 35, May 1995 i Sarel, M., “Non-linear Effects of Inflation and Economic Growth”, **IMF Staff Papers, Vol 43**, No. 1, 1996.

[28/] Dornbusch, R. and S. Fischer, “Moderate Inflation”, **World Bank Economic Review**, Vol. 7, January 1993, pp. 1-44.

[29/] On the relationship between macroeconomic stability and transition see in: Savić, N., “Macroeconomic Stability and the Transition Process”, in: N. C. Baltas, G. Demopoulos and J. Hassid, eds., **Economic Inter-dependance and Cooperation in Europe**, Springer Verlag, Berlin-Heidelberg, 1998, pp. 65-78 and: Pitić, G., “Macroeconomic Stability and How to Avoid the Frequent Use of Stabilization Therapies”, in: N. C. Baltas, G. Demopoulos and J. Hassid, eds., **Economic Inter-dependance and Cooperation in Europe**, Springer Verlag, Berlin-Heidelberg, 1998, pp. 89-98.

[30/] Cottarelli, C. and G. Szapáry, eds., **Moderate Inflation - The Experience of Transition Economies**. IMF, Washington, D.C., 1998.

[31/] Burton, D. and S. Fischer, “Ending Moderate Inflation”, in: Cottarelli, C. and G. Szapáry, eds., **Moderate Inflation - The Experience of Transition Economies**. IMF, Washington, D.C., 1998, pp. 15-96.

[32/] Gomulka, S., “Comment”, in: Cottarelli, C. and G. Szapáry, eds., **Moderate Inflation - The Experience of Transition Economies**. IMF, Washington, D.C., 1998, pp. 127-31.

[33/] Coorey, S., M. Mecagni, and E. Offerdal, “Disinflation in Transition Economies: The Role of Relative Price Adjustment”, in: Cottarelli, C. and G. Szapáry, eds., **Moderate Inflation - The Experience of Transition Economies**. IMF, Washington, D.C., 1998, pp. 230-79.

growth.[34/] In general, inflation, including a moderate one, causes distortions in resource allocation and income distribution (especially through its interaction with the tax system), reduces capital accumulation and slows down productivity growth.

2.2. Ending moderate inflation

Ending moderate inflation is primarily linked to the **implementation of tight economic policies** aimed at reducing the nominal aggregate demand. To this end, it is necessary to establish the fundaments at the appropriate level. This calls for a slowdown in the growth rate of money supply and fiscal tightening. Bearing in mind the potential instability of money demand in some CIT, it is difficult to anticipate the pace at which the growth rate of money supply should be decelerated. Thus, the opinion prevails that linking to the monetary target (and not to the exchange rate target) is not suitable. Despite this, money supply in the disinflation process will have to be lower than in the case of keeping the inflation rate unchanged, provided that the velocity of money will not decline more significantly as the result of disinflation. As for fiscal tightening, it is significant not only for easing the pressure of demand, but also for enhancing the credibility of the program.

As can be seen, ending moderate inflation should not pose any greater problem - the mechanisms are well known and can be implemented if there is political will.

However, a more difficult problem is **how to minimize the short-term costs of disinflation?** The disinflation process will bring about a decrease in the price growth rate. A deceleration in aggregate demand will bring about a rise in unemployment above the level that would be possible if a tighter economic policy were not pursued. This will finally result in a fall in output and we are now arriving at the above question concerning disinflation, i.e. how to minimize its costs (fall in output and the level of unemployment)?

Experience has shown that the key to the success of every disinflation process lies in its credibility. As is well known, if one wins the confidence of the private sector, so that it is convinced that all promises will be fulfilled, and if the government pursues a sound economic policy, as announced, it will be possible to make a relatively fast adjustment of wages and prices to the new, lower inflation rate. The key to success is in the hands of economic policy makers, since credibility depends primarily on the fiscal position.

However, if one fails to win the confidence of the private sector, so that it begins to suspect that the government will not be able to impose intertemporal budget constraints, the result will be the creation of a high fiscal deficit, which may lead to its monetization even in the economy with the developed securities markets. Such a situation will inevitably give rise to inflationary expectations.

Should disinflation be gradual or fast? This question was raised by Blanchard.[35/] Due to structural differences among the economies, their disinflation costs are also different. If one assumes that, in principle, all countries have a negative attitude towards a high rise in unemployment, it seems that a gradual approach to disinflation is more appropriate. However, Blanchard points out, on the basis of Ball's studies, that the costs of disinflation are not independent of the adopted speed of disinflation: fast disinflation is accompanied by a lower sacrifice ratio, which is **a strong argument in favor of fast disinflation**.[36/] A similar conclusion can be derived from empirical analyses of successful disinflations, which show that the costs disinflation from the level of moderate inflation are moderate.[37/]

Based on an assumption that stabilization can be carried out when the annual inflation rate drops below 40%,[38/] the data show (Table 4) that all Central European (CE) CIT were stabilized until 1993, all Baltic countries until 1994 and all South-east European (SE) CIT until 1995, although the inflation in Romania and Bulgaria reappeared in 1996 (which is attributed to “stop-go” policies pursued by these countries).

Tables 2, 3 and 4 show that the ECIT are faced with the trade-off between the speed of disinflation and the depth of initial recession, expressed by a fall in output, whereby the CE CIT recorded faster disinflation and lower costs associated with a fall in output as compared to the Baltic and SE CIT. There is still no evidence that faster stabilization helps all CIT; rather, it can be said that this experience points to the significance of economic and political conditions which enable some countries to initiate reforms with more credibility and,

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[34/] Burton, D. and S. Fischer, “Ending Moderate Inflation”, in: Cottarelli, C. and G. Szapáry, eds., **Moderate Inflation - The Experience of Transition Economies**, IMF, Washington, D.C., 1998, pp. 15-96.

[35/] Blanchard, O., “Optimal Speed of Disinflation: Hungary”, in: Cottarelli, C. and G. Szapáry, eds., **Moderate Inflation - The Experience of Transition Economies**, IMF, Washington, D.C., 1998, pp. 132-46.

[36/] Ball, L., “What Determines the Sacrifice Ratio?”, in: Mankiw, N. G., ed., **Monetary Policy**, University Press of Chicago, Chicago, 1994.

[37/] Burton, D. and S. Fischer, “Ending Moderate Inflation”, in: Cottarelli, C. and G. Szapáry, eds., **Moderate Inflation - The Experience of Transition Economies**, IMF, Washington, D.C., 1998, pp. 15-96.

[38/] For the argumentation of this criterion, see: Bruno, M. and W. Easterly, “Inflation Crises and Long-Run Growth”, **NBER Working Paper, No. 5209**, 1995, NBER, Massachusetts, Cambridge.

thus, to be able to produce some results faster.[39/]

Table 4. Inflation in percent (end of year)

	1990	1991	1992	1993	1994	1995	1996	1997	1998*	1999†
Centra Europe	**84.8**	**90.0**	**36.1**	**25.0**	**18.3**	**14.8**	**12.3**	**11.4**	**9.7**	**9.7**
Czech	18.4	52.0	12.7	18.2	9.7	7.9	8.6	10.0	9.0	9.0
Hungary	33.4	32.2	21.6	21.1	21.2	28.3	19.8	18.4	13.5	12.2
Poland	249.0	60.4	44.3	37.6	29.4	21.6	18.5	13.2	10.0	9.9
Slovakia	18.4	58.3	9.1	25.1	11.7	7.2	5.4	6.4	9.0	8.3
Slovenia	105.0	247.0	92.9	22.8	19.5	9.0	9.0	8.8	7.0	9.0
Baltic countries	**n.a.**	**303.7**	**1,024.7**	**85.6**	**37.7**	**29.2**	**13.7**	**9.2**	**5.6**	**7.0**
Estonia	n.a.	304.0	953.5	35.6	42.0	29.0	15.0	12.0	8.0	8.7
Latvia	n.a.	262.0	959.0	35.0	26.0	23.1	13.1	7.0	4.6	6.2
Lithuania	n.a.	345.0	1,161.1	188.8	45.0	35.5	13.1	8.5	4.2	6.0
SE Europe	**91.8**	**229.2**	**655.9**	**353.8**	**50.4**	**15.9**	**77.6**	**155.7**	**14.5**	**13.5**
Albania	n.a.	104.0	236.6	30.9	15.8	6.0	17.4	42.1	10.0	12.4
Bulgaria	72.5	338.9	79.4	63.8	121.9	32.9	310.8	578.5	10.0	12.7
Croatia	136.0	250.0	938.0	1,149.0	-3.0	3.8	3.4	3.8	6.0	5.7
Macedonia	121.0	230.0	1,925.2	229.6	55.4	9.0	-0.6	2.7	1.4	4.7
Romania	37.7	223.0	100.2	295.5	61.7	27.8	56.9	151.4	45.0	31.8
FSU	**n.a.**	**138.3**	**2,265.0**	**4,330.3**	**855.1**	**184.9**	**33.6**	**28.2**	**77.3**	**48.5**
Belarus	n.a.	93.0	1,159.0	1,996.0	1,960.0	244.0	39.0	63.0	60.0	75.0
Russia	n.a.	161.0	2,506.1	840.0	204.4	128.6	21.8	10.9	150.0	47.6
Ukraine	n.a.	161.0	2,730.0	10,155.0	401.0	182.0	40.0	10.0	22.0	22.9

* - projection, † - forecasting; Source: **Transition Report**, EBRD, various volumes.

2.3. Macroeconomics of savings, investments and fiscal deficit

The basic macroeconomic equation, which defines the composition of GDP, reads:

$$\mathbf{C + G + I + NX = Y = C + S + T} \tag{1}$$

whereby the left side of the equation depicts the components of final demand (where **C** is consumption, **G** government purchases, **I** investments and **NX** net imports) and is equal to total output, **Y**, i.e. GDP. The right side of the equation depicts the allocation of disposable income (where **S** stands for the private sector's savings and **T** for taxes levied by the government). How do decreased domestic savings exert influence on the economy? On the basis of the equation (1), it follows that private savings, **S,** are:

$$\mathbf{S = Y - C - T} \tag{2}$$

and this is current income which was not immediately used for consumption; instead, it represents deferred household consumption.

Let us assume that $\mathbf{B^*}$ stands for the claims of domestic residents towards foreign residents, expressed in foreign assets (the asterisk denotes the foreign exchange variables); $\mathbf{B^*}$ is sometimes called "net international investment position" or "net foreign assets position". Such a claim may take different forms, ranging from bonds and money to equities. In fact, $\mathbf{B^*}$ depicts the claims of domestic residents abroad in foreign currency, reduced by foreign claims towards domestic residents. If it is positive, the country is the net creditor of the rest of the world countries and if it is negative, the country is the net debtor. Hence the current account balance of a country, **CA**, can be defined as a change in its net external financial position:[40/]

$$\mathbf{CA = B^{*} - B^{*}_{-1}}. \tag{3}$$

[39/] Beg, D, "Disinflation in Central and Eastern Europe: The Experience to Date", in: Cottarelli, C. and G. Szapáry, eds., **Moderate Inflation - The Experience of Transition Economies**, IMF, Washington, D.C., 1998, pp. 102-26.

[40/] Sachs, J. and F. Larrain, **Macroeconomics in the Global World**, Prentice Hall, 1993, pp. 150-4.

A surplus in the current account balance increases the claims from abroad and decreases foreign obligations. A deficit in the current account balance implies a decrease in the claims abroad or increased foreign obligations.

The equation (3) shows that the current account balance in some period, **CA,** is actually the balance of changes in relations with the rest of the world (denoted with B^*), between the current and previous period. Let us recall that the level of B^* in the current period is the result of the current account surplus and deficits in the past. Proceeding from some base year, arbitrarily designated with **0,** the net international investment position of a country in the year **t,** is equal to B_0^*, increased by the sum of the current account balances in the years between **0** and **t**:

$$B_t^* = B_0^* + CA_1 + CA_2 + ... + CA_t. \tag{4}$$

To establish the relation between the current account balance and savings and investments, it is necessary to return to the household budgetary constraint. Let us recall that a change in the assets of a household **i** is the difference between the disposable income of this household, Y_Q^i, increased by income from assets, e.g. bonds, $(1+r)B^i$, and its savings and investments:

$$B^i - B_{-1}^i = Y_Q^i + rB_{-1}^i - C^i - I^i. \tag{5}$$

Since the income of the **i**-th household is $(Y^i = Y_Q^i + rB_{-1}^i)$ and savings are $(S^i = Y^i - C^i)$, we obtain:

$$B^i - B_{-1}^i = S^i - I^i. \tag{6}$$

If we add the net claims of all households and all firms, we shall obtain the net position of the overall economy, B^*:

$$B^* - B_{-1}^* = Y_Q + rB_{-1}^* - C - I \tag{7}$$

and if we substitute first $(Y_Q + rB_{-1}^*)$ with **Y**, since **Y** denotes GNP, which is equal to the sum of GDP and net incomes from abroad, and then **(Y-C)** with **S**, since savings are equal to the difference between income and consumption, we shall obtain:

$$B^* - B_{-1}^* = S - I. \tag{8}$$

The equation (7) can be simply interpreted. After a minor rearrangement, we shall obtain:

$$S = I + (B^* - B_{-1}^*) \tag{9}$$

This equation shows that domestic savings can be used for the following two purposes: (i) domestic investments, **I**, and (ii) net foreign investments, $(B^* - B_{-1}^*)$. From the equations (3) and (8) it follows that the current account balance can be expressed as the difference between national savings and investments:

$$CA = S - I. \tag{10}$$

If domestic residents can borrow abroad and credit foreign residents, domestic savings and investments must be equal. The difference between savings and investments is shown in the current account balance.

2.4. The effects of excessive taxes and fiscal Deficit[41/]

There are numerous effects which can be generated by an unsound fiscal policy, such as an excessive tax burden, excessive fiscal expenditures or fiscal deficit. The key negative effect generated by such fiscal policy is a decrease in national savings. National savings are the sum of private savings (the part of income after tax which is saved by households) and public savings (the part of tax revenue which is saved by the government). When the government pursues the policy of fiscal deficit and high taxes, public savings are negative. This shows that such an economy has excessive public expenditure, which cannot be covered by increased taxes, so that it has to run a fiscal deficit.

How will decreased national savings influence the economy?

As could be seen in the equation (1), GDP consists of four expenditure components. By substituting the components of GDP so defined, we obtain the equation of national savings:

$$S + T = I + G + NX \tag{11}$$

The equation (11) shows that total national savings consists of both the private sector's and government savings, and if fiscal revenues are equal to fiscal expenditures, which means that the government does not create its savings, **T=G.** Thus, total savings are equal to private savings and are confined to the following:

$$S = I + NX. \tag{12}$$

The equations (11) and (12) show that national savings are equal to the sum of investments and net exports. In other words, if the fiscal deficit reduces national savings, it also exerts influence on a decrease in investments and/or net exports. The total decrease in investments and net exports must correspond to a decrease in national savings.

Short-term effects of fiscal deficit. - On the basis of the previous analysis, it can be directly concluded that **the fiscal deficit increases the foreign trade deficit,** and this means that it decreases net

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[41/] For more detail see in: Ball, L. and N. G. Mankiw, "What Do Budget Deficit Do?", **NBER Working Paper Series, No. 5263**, September 1995, NBER, Cambridge, Massachusetts.

exports, so that other effects are automatically generated: **the budget deficit creates the flows of assets abroad**; this is directly linked to the current and capital account balance in the balance of payments; if a country's imports exceed exports, this is covered by the outflow of assets; in other words, when the fiscal deficit converts a country into the net importer of goods and services, such a country also becomes a net exporter of assets.

Business agents determine the level of investments with their decisions, and domestic and foreign consumers determine the level of net exports. These decisions seem to be independent of political decisions concerning the fiscal deficit only at first sight. Therefore, it is important to determine as to what induces firms to investment less and foreigners to buy less domestic goods when the government decides to run a fiscal deficit?

Ball and Mankiw find an answer to this question in changes caused by the interest rate and exchange rate. Interest rates are set on the credit market, where those who save money borrow it to households and firms wishing to invest. A decrease in national savings reduces the supply of available credits to private debtors, thus bringing about the increase of interest rates. Faced with higher investment rates, households and firms decide to cut their investments.

Increased interest rates will also exert influence on international capital flows. Should the returns on domestic assets be higher, they will become more attractive for foreign and domestic investors. The growing demand for domestic assets exerts influence on the flows on the foreign exchange market: **an increase in domestic interest rates boosts the demand for domestic currency, thus causing currency appreciation.**

The appreciation of domestic currency exerts influence on trade in goods and services. With domestic currency being stronger, domestic goods become more expensive for foreigners and foreign goods cheaper for domestic residents. This results in a decrease in exports and an increase in imports, which pushes the economy into the foreign trade deficit.

Long-term effects of fiscal deficit. - Pursuing the policy of fiscal deficit over a long term leads to the cumulation of public debt, and the effects of the policy of long-term deficits exert influence on both output and assets in the economy.

First, the output of an economy is determined over a long term by its production capacities, which are largely determined by capital stock. If investments are cut due to the policy of fiscal deficits, capital stock increment will be slowed down. If such a tendency persists for a few years or for a decade, it may even decrease the capital stock, i.e. the capacities of the economy, coupled with very unfavourable effects on the level and rate of GDP.

Second, the flows linked to the assets disposed by foreign residents generate a similar effect. When foreign residents increase their assets, such as domestic bonds, real property or equities, an increasing part of income earned in the domestic economy goes out of the country. The value of domestic output, which belongs to foreign residents (and this is GNP), is declining because returns on domestic assets owned by them are increasing.

In other words, due to decreased domestic savings, fiscal deficits will lead inevitably to a cutback in investments and/or net exports over a long term. This will result in a decrease in capital stocks and/or an increased share of foreign residents in the ownership structure of the economy.

There is a controversy in the economy as to the intensity of the two effects, although is it is clear that the first effect, a cutback in investment and, finally, in capital stock will lead to a fall in output, while the second effect, an increase in the foreign trade deficit, will lead to a decreased share of domestic residents in the structure of earned income.

Third, public debt arising from the persistent policy of fiscal deficits can force the government to increase taxes so as to meet its obligations that have become due, thus decreasing the disposable income of households.

2.5. Fiscal position of CEE CIT

The fiscal position of CEE CIT has been analyzed on the basis of the level of public expenditure (Table 5) and fiscal surplus/deficit (Table 6).

All CE CIT are recording a decrease in public expenditure, which ranges from 42% to 53% of GDP. The Baltic countries have succeeded in keeping their public expenditure at the level below of 40% of GDP. As for the SEE CIT, Romania and Albania keep their public expenditure at the level of about 28-34 of GDP, while Croatia maintains it at the level of 46% of GDP. The analyzed FSU CIT succeeded in reducing their public expenditure close to the level of public expenditure of the SEE CIT and this is about 40%, although. Thus, the question that imposes itself here is whether public expenditure can be sustained at this level over a long term.

As for a fiscal surplus or deficit, the CE CIT have the deficits of 1-5% of GDP, whereby Hungary, Poland and the Czech Republic are implementing very exhaustive programs of fiscal adjustment. In general, it can be observed that all countries in the sample have moderate deficits and that their fiscal deficits - should they persist in fiscal adjustment - will be reduced to less than 3% of GDP, which corresponds to the Maastricht Agreement.

Table 5. Public expenditure as percent of GDP

	1990	1991	1992	1993	1994	1995	1996	1997
Central Europe	**47.6**	**48.5**	**51.5**	**50.1**	**49.4**	**47.5**	**46.3**	**47.9**
Czech	n.a.	n.a.	n.a.	41.9	43.3	42.8	41.8	41.6
Hungary	53.5	55.4	59.4	60.6	60.9	53.9	48.3	52.9
Poland	39.8	49.0	49.5	50.5	48.9	47.9	47.5	48.1
Slovakia	n.a.	n.a.	n.a.	51.0	48.0	47.0	49.0	51.0
Slovenia	49.6	41.1	45.6	46.7	46.1	45.7	44.9	45.7
Baltic countries	**49.1**	**38.7**	**31.5**	**36.9**	**38.3**	**38.1**	**39.3**	**35.6**
Estonia	n.a.	n.a.	34.9	40.3	39.2	41.4	40.5	37.4
Latvia	n.a.	n.a.	28.2	35.2	38.2	38.2	38.0	38.2
Lithuania	49.1	38.7	31.5	35.1	38.5	36.8	34.1	34.7
SE Europe	**55.6**	**48.7**	**42.8**	**41.5**	**38.3**	**38.1**	**39.3**	**35.6**
Albania	62.1	61.9	44.0	34.9	31.2	30.8	29.0	27.6
Bulgaria	65.9	45.6	43.6	48.1	45.7	41.3	42.3	33.4
Croatia	n.a.	n.a.	36.1	35.0	40.6	44.9	45.6	46.1
Macedonia	n.a.	n.a.	48.2	55.3	50.5	43.1	41.5	39.4
Romania	38.7	38.7	42.0	34.2	33.9	34.5	34.1	34.3
FSU	**n.a.**	**n.a.**	**47.2**	**50.5**	**47.2**	**39.7**	**38.1**	**40.8**
Belarus	n.a.	n.a.	46.0	56.2	50.0	44.6	42.6	46.8
Russia	n.a.	n.a.	37.2	40.7	45.9	37.0	40.1	40.7
Ukraine	n.a.	n.a.	58.4	54.5	45.8	37.4	31.6	34.8

Source: **Transition Report**, EBRD, various volumes.

It should be noted that fiscal expenditure and fiscal deficits are the result of political processes taking place in the country and, thus, political decisions exert a very strong influence on them. The key to overcoming this situation lies in the complex process of economic-political-social adjustments, as well as of an adjustment to the need to reduce fiscal expenditure. This is not a simple process in which only public expenditure is reduced, because experience has shown that in such cases government investments are cut back first; at the same time, this means that investments in the necessary infrastructure - physical, human, social, legal and supervisory - are also cut and without it growth cannot be achieved.

In the segment linked to fiscal policy, it is very important to achieve two things: to establish a fiscal balance and to considerably reduce the overall burden.[42/]

On the basis of all this, it is possible to draw the following conclusions:

- **Not one observed country has the share of public expenditure in GDP which exceeds 48%;**
- **Almost all countries are recording a downward tendency as regards their share of public expenditure in GDP;** at the same time, they are trying to provide scope for the creation of domestic savings and
- **Almost all observed countries are trying to pursue the policy of balanced budget** with very moderate deficits.

The conclusion concerning the success of the fiscal sector's stabilization in CIT depends on the quality of fiscal adjustment, and not only on the level of fiscal deficit, considered from a narrower aspect, which is

[42/] On the experience of CIT see: Chu, K., S. Gupta and ots., “Unproductive Public Expenditures - A Pragmatic Approach To Policy Analysis”, **IMF Pamphlet Series, No 48**, IMF, 1995 and: “Guidelines for Fiscal Adjustment”, **IMF Pamphlet Series, No 49**, IMF, 1995, Washington, D.C.

basically the resultant of fiscal adjustment. Of utmost significance for this process is the quality of restructuring public expenditure from unproductive into productive one, such as, for example, primary health care and education. In this sense, it is also extremely important to make a correct adjustment of tax structure, that is, the revenue side of the fiscal system, with a view to ensuring the stability of fiscal revenues, incentives to a rise in employment, investments and growth. The mentioned qualitative components determine basically the sustainability of fiscal adjustment over a long term. Numerous examples show that, if the monetary and budgetary faucet on politically acceptable segments is simply turned off, fiscal expenditure and fiscal deficit can be reduced over a short term. In the absence of the mentioned qualitative components of restructuring the fiscal components, on the expenditure side in particular, it will not be possible to make a fiscal adjustment over a long term.

Table 6. Fiscal deficits as percent of GDP

	1990	1991	1992	1993	1994	1995	1996	1997	1998*
Central Europe	**1.1**	**-2.2**	**-4.1**	**-3.0**	**-2.8**	**-2.2**	**-1.8**	**-3.0**	**-3.1**
Czech	n.a.	-1.9	-3.1	0.5	-1.2	-1.8	-1.2	-2.1	-2.4
Hungary	0.4	-2.9	-6.8	-5.5	-8.4	-6.7	-3.1	-4.9	-4.9
Poland	3.1	-6.7	-6.7	-3.1	-3.1	-2.8	-3.3	-3.1	-3.1
Slovakia	n.a.	n.a.	n.a.	-7.0	-1.3	0.2	-1.3	-3.8	-4.0
Slovenia	-0.3	2.6	0.2	0.3	-0.2	0.0	0.3	-1.1	-1.0
Baltic countries	**-5.4**	**4.0**	**-0.2**	**-1.1**	**-2.8**	**-3.1**	**-2.5**	**1.8**	**0.0**
Estonia	n.a.	5.2	-0.3	-0.7	1.3	-1.3	-1.5	2.2	2.5
Latvia	n.a.	n.a.	-0.8	0.6	-4.1	-3.5	-1.4	1.4	1.0
Lithuania	-5.4	2.7	0.5	-3.3	-5.5	-4.5	-4.5	-1.8	-3.6
SE Europe	**-7.0**	**-13.9**	**-8.7**	**-8.1**	**-5.3**	**-3.5**	**-5.2**	**-3.5**	**-4.1**
Albania	-15.0	-31.0	-20.3	-14.4	-12.4	-10.3	-12.1	-12.7	-13.9
Bulgaria	n.a.	n.a.	-5.2	-10.9	-5.8	-5.6	-10.4	-2.1	-2.0
Croatia	n.a.	n.a.	-3.9	-0.8	1.6	-0.9	-0.4	-1.3	-0.5
Macedonia	n.a.	n.a.	-9.6	-13.8	-2.9	-1.2	-0.5	-0.4	-0.8
Romania	1.0	3.3	-4.6	-0.4	-1.9	-2.6	-4.0	-3.6	-5.5
FSU	**n.a.**	**n.a.**	**-14.8**	**-8.5**	**-6.9**	**-4.9**	**-4.4**	**-5.0**	**0.7**
Belarus	n.a.	n.a.	n.a.	-1.9	-2.6	-1.9	-1.6	-2.1	-3.0
Russia	n.a.	n.a.	-4.1	-7.4	-9.0	-5.7	-8.3	-7.4	8.0
Ukraine	n.a.	n.a.	-25.4	-16.2	-9.1	-7.1	-3.2	-5.6	-3.0

* - estimation; Source: **Transition Report**, EBRD, various volumes.

Are the fiscal fundamentals essential to the success of disinflation process? The analyses of monetary and fiscal policies in the CIT show that emphasis on a sound fiscal policy was crucial for the success of disinflation processes.[43/] As a rule, the countries, which were capable of adopting and pursuing sound fiscal policies, have succeeded in achieving macroeconomic stabilization as well (see Table 7).

In conclusion, it can be stated that sound macroeconomic policies are a vital prerequisite for stabilization and that without stabilization it is impossible to effect institutional changes, without which the transition process in the next decade cannot be improved. In other words, a sound economic policy, especially in the fiscal and monetary field, is a vital prerequisite for the first and second generation of economic reforms (which will be discussed in further text).

[43/] Begg, D., "Monetary Policy in Central and Eastern Europe: Lessons After Half a Decade of Transition", **IMF Working Paper No. 96/108**, 1996, IMF, Washington, D.C. and: Buiter, W., "Aspects of Fiscal Performance in Some Transition Economies Under Fund-Supported Programes", **IMF Working Paper No. 97/31**, 1996, IMF, Washington, D.C.

Table 7. Sustainability of fiscal policies from 1995

Sustainable	Unsustainable
Croatia	Albania
Czech	Bulgaria
Estonia	Hungary
Latvia	Lithuania
Macedonia	Romania
Poland	
Slovakia	
Slovenia	

Source: Beg, D., "Monetary Policy in Central and Eastern Europe: Lessons After Half a Decade of Transition", **IMF Working Paper**, No. 96/108, 1996, IMF, Washington, D.C.

3. ECONOMIC POLICY MANAGEMENT IN ECIT

3.1. Possible exchange rate regimes

The choice of the exchange rate regime and the choice of the nominal anchor have been the subject of debate among the economists for a long time already. The fact that this problem has not yet been solved shows that there is not one exchange rate regime which is superior in all situations. The same is true of the choice of the nominal anchor. Table 8 shows that, at the beginning (or after a short period), most CEE CIT opted for the targeted exchange rate as the nominal anchor.

Table 8. Foreign exchange regimes in CIT (as of August 1997)

Regime	Exchange rate policy	Monetary frame
Currency board		
Bulgaria	DM	Currency board
Estonia	DM	Currency board
Lithuania	US$	Currency board
Foreign exchange as a nominal anchor		
Croatia	Targeted band against DM	Targeted exchange rate
Hungary	Crawling band against basket DM and US$, ±2.25%	Targeted exchange rate
Latvia	Fixed exchange rate against SDR	Targeted exchange rate
Macedonia	Fixed exchange rate against DM	Targeted exchange rate
Poland	Crawling band against basket, ±7%	Targeted exchange rate with monitoring of credit and money growth
Slovakia	Targeted band against basket US$ and DM, ±7%	Targeted exchange rate
Managed flexible exchange rate		
Czech	Ad hoc interventions limiting floating of DM	Targeted money growth
Slovenia	Ad hoc interventions	Targeted exchange rate reserves
Flexible exchange rate		
Albania	...	Targeted money growth
Romania	...	Targeted money growth

Source: IMF data

Advantages of a fixed exchange rate. - Are fixed exchange rates essential to the implementation of disinflation strategy? Let us recall Beg's view that CIT differ greatly among themselves as regards their initial conditions.[44/] He pointed out that at the start of transition most western economists held that it would be necessary: (1) to correct fiscal and external fundaments, (2) to adopt multiple nominal anchors, while at the same time giving precedence to the exchange rate, (3) to initiate the program of structural adjustment and (4)

[44/] Begg, D., "Monetary Policy in Central and Eastern Europe: Lessons After Half a Decade of Transition", **IMF Working Paper, No. 96/108**, IMF, Washington, D.C.

to secure political support to structural reforms. Experience has shown that emphasis on fiscal policy was justified, that slower than expected stabilization reflects political difficulties, although it rarely brought about a decrease in transition costs, and that the advantages of stabilization based on the exchange rate were quite satisfactory. Those countries which pursued relatively sound fiscal policies should have adopted a fixed exchange rate.[45/]

An argument in favor of a fixed exchange rate is that the demand for money during the initial transition period is often unstable, so that the adoption of a flexible exchange rate would impart instability to the definition of the targeted monetary aggregates. Experience has shown that the velocity of money decreases as stabilization progresses.

The monetary authorities use a fixed exchange rate regime as a mechanism for keeping inflation at the low level, but it should be abandoned if it cause a great shock to output.[46/] The monetary authorities compare the costs of sustaining a fixed exchange rate (a fall in output, a rise in unemployment) with the costs of its abandonment (the loss of credibility, inflationary growth).

Advantages of the currency board. - The second possibility is to implement the currency board. The currency board differs from a fixed exchange rate primarily due to the fact that the monetary authorities are appointed by legal procedure (Argentina and Estonia) or by some automatic arrangement (Hong Kong) with the aim to subordinate implementation of monetary policy to sustaining a fixed exchange rate.

The currency board will produce the best results in the case of:

- small and open economies with a large tradeable sector (Hong Kong and Estonia) and
- the economies which were very unstable; the currency board should restore the credibility of monetary policy (Argentina, Bulgaria and Bosnia and Herzegovina).

In addition, for a successful implementation of the currency board it is necessary: (1) to pursue a tight fiscal policy with fiscal surpluses, (2) to provide for flexibility on the labor market and (3) to have sufficient initial foreign exchange reserves so as to ensure credibility.

Experience has shown that the currency board is not only a strong short-term stabilization mechanism, but also a very good exchange rate regime for small open economies over a long term. An empirical analysis has shown that the currency board is a superior solution not only for inflation but also for growth.[47/] This analysis has also shown that the countries with the currency board have lower inflation rates by 4 percentage points on the average, as compared to other forms of fixed exchange rate. This is explained, above all, by greater credibility of the currency board and, thus, the growing demand for money and not by a slower increase in money supply in the countries with the currency board.

Empirical studies have also shown that the countries, which pursue a fixed exchange-rate policy have lower inflation rates than the countries which adopted a flexible exchange-rate policy.[48/] Thus, it follows that the currency board is a superior solution from the aspect of bringing inflation under control.

Crawling band and monitoring band as an exchange rate regime. - In addition to the above mentioned modalities of the targeted exchange rate (currency board and fixed exchange rate), one possible solution is exchange-rate policy based on crawling bands, which is becoming increasingly more popular in middle-income countries with moderate inflation (Chile, Columbia, Israel and Mexico) as well as in some CIT (Hungary, Poland and Russia).[49/]

These countries are trying to combine the nominal anchor with a sufficiently flexible rule for the appreciation of the real exchange rate. If disinflation and structural adjustment are continued, the rate of the anticipated crawl will be increasingly lower.

The initial experiences with this modality show that the band should not be too narrow because uncertainty will remain high, potentialities for further fiscal reactions to shocks will be exhausted and capital inflow may also occur.

An idea has also been recently put forward with respect to monitoring band policy management as a

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[45/] At the beginning, Latvia, Bulgaria and Kyrgyzstan adopted a flexible exchange rate despite the evaluation that they would be capable of pursuing a fixed exchange rate policy; namely, it was concluded that the countries with greater problems should adopt a flexible exchange rate.

[46/] Obstfeld, M. and K. Rogoff, **Foundations of International Macroeconomics**, 1993, MIT Press.

[47/] Ghosh, A., A. Gulde i H. C. Wolf, “Currency Boards: The Ultimate Fix”, **IMF Working Papers WP/98/8**, IMF, Washington, D.C.

[48/] Ghosh, A. R., A. Gulde, J. D. Ostry and H. Wolf, “Does the Exchange Rate Regime Matter for Inflation and Growth?”, **IMF Working Papers, No. 121**, 1995.

[49/] Williamson, J., **Crawling Band as an Exchange Rate Regime: Lessons From Chile, Columbia, and Israel**, Institute for International Economics, October 1996, Washington, D.C. and: Helpman, E., L. Leiderman and G. Bufman, “A New Breed of Exchange Rate Bands: Chile, Israel, and Mexico”, **Economic Policy: A European Forum, Vol. 9**, October 1994, pp. 260-306.

reaction to the experience of the East Asian economies concerning their latest crisis.[50/] In the present circumstances, characterized by high capital mobility, a prudential solution can be the system of **limited flexibility in the form of crawling band,** and this is the band within which, with minor adjustments, can be in harmony with the fundaments, or in the form of **monitoring band,** which is broader and has similar characteristics but the defense mechanism is applied only when the exchange rate goes outside the band. The idea with monitoring bands is linked to the implementation of soft margins. It is implied that there would be no intervention if the exchange rate moves within the band.

Monetary aggregates as the nominal anchor. - It is an established fact in a macroeconomic analysis that a fixed exchange rate is not desirable if the country has:

- insufficient foreign exchange reserves and
- if it does not pursue a sound and sufficiently tight fiscal policy.

Both these deficiencies make disinflation and/or anticipated stabilization policy noncredible and the expected duration of the fixed exchange rate regime will be very short: in addition, the problem relating to an insufficiently tight fiscal policy is much more complex, because the temporary shortage of foreign exchange reserves can be resolved with the IMF assistance. It should also be noted that if a country has no sufficient foreign exchange reserves or does not pursue a sound fiscal policy, not one exchange rate regime will be sustainable. In other words, if the fundaments are endangered, not one exchange rate regime is sustainable.

The nominal anchor, defined in the form of monetary aggregates, such as net domestic assets (NDA) and money supply (M1, M2), has a disadvantage not to be transparent. Namely, such nominal anchors, even if the public is informed about them on a regular basis, do not send an easily understandable message as to what the monetary authorities intend to do and what result with respect to inflation can be expected. It should also be noted that restrictive monetary targets usually incur high costs. In contrast to the situation when a fixed exchange rate is the nominal anchor, under this regime all costs are instantaneously incurred, especially if the stabilization program is credible. If disinflation is expected, the real money balance is increasing (at the given real exchange rate). In the stabilization program which is based on monetary targets, the nominal money supply remains unchanged, domestic prices are rigid as regards downward movement, so that the real money supply cannot be sufficiently increased, thus bringing about an increase in the real exchange rate, a fall in output and a rise in unemployment.

Regardless of some successes achieved in determining the targeted money supply in CIT, the opinion prevails that the exchange rate is more convenient as the anchor. Doubts about the use of monetary aggregates as the anchor are based on two arguments: (i) instability of money demand during transition (especially during the process of deregulation of financial markets and financial innovations in CIT, as well as due to widespread dollarization) and (ii) due to the possible overshooting of the exchange rate during stabilization based on the monetary target.

The exchange rate as the most frequent nominal anchor. - The exchange rate was the most frequent anchor in stabilization programs. In most cases, it was tied to one currency, mostly to DM or US$, or to the currency basket, mostly DM or US$. As the nominal anchor, the exchange rate has the following characteristics due to which it was given the mentioned role:

- **signal effect** provides the private sector with very transparent information about the anticipated inflation rate, especially over a short term;
- fixed exchange rate has a **disciplinary effect** on monetary and fiscal policy; if the economy has a higher inflation rate than the country to whose currency its currency is tied, real appreciation will occur; this will decrease the demand for domestic goods and boost the demand for imports, which will push the economy into recession and increase prices; in the end, the economy will have to adjust to such the low inflation rate of its foreign partners and
- fixed exchange rate as the means for **bringing down inflation** was used by many CIT; the nominal exchange rate system makes their inflation rates exogenous, while a rise in the prices of tradeables is adjusted to the inflation rate on the world market: however, inflation will be stabilized over a long term only if this stabilization effect is also transferred to nontradeables.

In the group of slow reformers among CIT, the targeted exchange rate and targeted monetary aggregate should have priority, while crawling peg or crawling bands are more suitable for advanced CIT; as for targeted inflation or even targeted nominal income, they can be applied only in very advanced CIT.[51/]

The sustainability of a fixed exchange rate becomes more difficult if financial liberalization is undertaken. Especially the countries, which are trying to sustain fixed exchange rates or crawling pegs, are often faced with inconsistency between the foreign interest rate and the interest rate they would prefer on the

[50/] Williamson, J., "Crawling Bands or Monitoring Bands - How to Manage Exchange Rates in a World of Capital Mobility", **International Finance**, October 1998.

[51/] Wagner, H., "Central Banking in Transition Countries", **IMF Working Paper, No. 98/126**, August 1998, IMF, Washington, D.C.

domestic market. When a country implements a tight monetary policy in an effort to combat inflation, domestic interest rates have to be considerably higher than the world interest rate. The resultant capital inflow offsets the effects of tight monetary policy. This problem of capital inflow is very well known and hit numerous economies.

Williamson points out that the most important experience gained during the past years is that if a country wishes to pursue a fixed exchange-rate policy, it should implement the currency board. Thus, the debate over exchange rate policy should not be focused on the dilemma whether to adopt a fixed or flexible exchange rate, but whether the currency board or crawling bands should be implemented.[52/]

In conclusion, it should be noted that, in the empirical sense, the choice between stabilization based on a fixed exchange rate and stabilization based on a flexible exchange rate is actually the choice between deferred and immediate recession. This means that if the initial conditions in a country are not favorable for stabilization and if it decides to implement the currency board, it can be expected with good reason that recession will occur later and, what is very important, in the period when its economy will already be strengthened.

3.2. Dilemmas over the Washington Consensus

The basic aims of every economic and development policy are confined to the growth of per capita GDP, coupled with a rise in the living standards of the population; this growth is acceptable only if it can be sustained. To ensure sustainable economic growth, it is necessary to broaden the frameworks set by the so-called neoliberal model, which was dominant until recently.[53/]

The term "Washington Consensus" stands for an agreement reached by the World Bank, the International Monetary Fund and the United States relating to the nature of economic policies to be implemented. This consensus was reached under a strong influence of the debt crisis during the 1980s and experiences gained in the implementation of stabilization and, specifically, anti-inflation programs in Latin America during the 1980s, and it focuses on the low inflation rate.

In the spirit of the Washington Consensus, a "good" economic policy is such a policy which stimulates a low inflation rate, trade liberalization, very small deficit in the current account balance and elimination of a fiscal deficit.

Such policies are indispensable for the smooth operation of the market but if one wishes to ensure economic growth, the implementation of the above mentioned measures only will not be sufficient. In other words, it is not sufficient to think only about stability and neglect policies which exert influence on growth and development. On the other side, for growth and development policy to be successful, it is necessary to achieve stability first. In other words, stability has priority at the first moment, because short-term problems and crises cannot be solved by using long-term economic policy instruments.

The results achieved by CIT, including all positive and negative examples, started a new debate on the character of the Washington Consensus, i.e. whether it should remain unchanged. The raising of these issues was especially prompted by the results achieved by CIT, the crisis of the East-Asian economies and, finally, the discussions on the role of the government in the economy.

In prescribing the therapy for CIT, the IMF has remained true to its previous, already defined recipes. However, the chief economist of the World Bank, prof. Joseph Stiglitz, raised the question as to whether the already mentioned four basic elements of the Washington Consensus are sufficient and whether they lead to biased policy which is turned exclusively to stabilization and the lowering of the inflation rate, which is both necessary and inevitable, but those are primarily short-term development aims. He argues that some corrections are necessary due to the underestimated significance of (1) regulation of financial markets, (2) competition policy, (3) technological transfer policy and (4) transparency.

Hence the idea about the design of the second generation of economic reforms. It is now almost certain that they will become dominant both in economic theory and practice in CIT in the very near future. The essence of the second generation of economic reforms lies in the establishment of new market institutions, which would correspond to market economies, and specifically financial institutions.

Most CIT laid emphasis on privatization, which was good but, in doing so, they neglected the significance of strengthening competition without which there is no real market economy. On the other side, China disregarded privatization (of the existing state-owned enterprises), while at the same time strengthening

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[52/] Williamson, J., “Crawling Bands or Monitoring Bands - How to manage Exchange Rates in a World of Capital Mobility”, **International Finance**, October 1998.

[53/] Although the terminology has not been precisely defined in this case, the model has lately been called the “Washington Consensus". For more detail see in: Williamson, J., "What Washington Means by Policy Reform", in: J. Williamson, ed., **Latin American Adjustment: How Much Has Happened?**, 1990, Institute for International Economics, Washington, D.C.

competition and developing the system of incentives for entrepreneurs and the emerging private sector. Consequently, instead of focusing on the problem of privatizing the existing state-owned enterprises, China's strategy was to establish new private firms.

In the implementation of the privatization project in CIT, it can be observed that unless the project was not accompanied by the strengthening of competition, it was not possible to avoid danger that the economic and development effects of privatization would be much more modest than the possible ones. This important experience of China shows that CIT should strengthen competition parallel to undergoing privatization.

New views on the concept of transition and the second generation of economic reforms. - Two things are apparent here: first, some important elements have been neglected, which does not disparage the importance of those elements which have already been included but makes them insufficient and, second, the development concept is treated from a narrow aspect.[54/]

First, the selected instruments - trade liberalization, privatization and macroeconomic stabilization - albeit very significant, often confuse the means and aims, while at the same time disregarding other important instruments.[55/] Let us take the example of China which raised its GDP fourfold in the last twenty years, thus becoming the most dynamic CIT. However, China did not observe the authority of the Washington Consensus, but gave priority to the strengthening of competition over the development of privatization. Let us recall that economic theory points out that both requirements should be met for the development of a market economy. However, the Washington Consensus laid emphasis only on one requirement and China only on the other. Therefore, we should not be surprised if the privatization of some state monopoly in CIT creates a private monopoly with high prices and continuing inefficiency.

Therefore, those topics which have not been included in the Washington Consensus are of great significance, i.e. the strengthening of (1) financial markets, (2) competition and regulation, (3) technology transfer and (4) development institutions.

Second, the Washington Consensus regards development from a narrow aspect, because it is not only the question of a rise in GDP, but also of (1) the need to raise the standard of living, reflected also in an increase in the level of health of the nation and the level of literacy, (2) creation of sustainable development, which would enable the implementation of economic reforms parallel to the democratization of the country.

4. INSTITUTIONAL CHANGES AS THE BASIS FOR MORE DYNAMIC GROWTH IN THE FUTURE

The final section of this paper is devoted to institutional changes which should be the basic instrument in stimulating sustainable growth in CIT in the next decade.

In addition to stabilization measures of economic policy, the future transition strategy will require the implementation of profound institutional changes without which the functioning of a market economy is not possible.

4.1. Composition of institutional changes

Only profound institutional changes can ensure the development of market institutions, whose lack is felt in CEE CIT at the turn to the second decade of developing market economies in them. The situation in CEE CIT relating to institutional and structural reforms at the end of the first decade of transitioning is shown in Table 10. In general, the CE CIT and Estonia have so far made the greatest progress in the effectuation of institutional changes, while the other Baltic countries are behind them just a little. The SE CIT are lagging more significantly, while the FSU countries are well behind all countries under observation and cannot keep pace with advanced reformers.

If considered by components of institutional reforms, it can be observed that these reforms are primarily oriented to enterprise reforms in the privatization sector, but a delay in the corporatization of governance in enterprises is apparent. Market and trade reforms are implemented at a slower pace than the above reforms, whereby the liberalization of the foreign trade and foreign exchange regimes is making faster progress than price liberalization; in this segment, the strengthening of competition is the slowest. The third segment, that is, the reforms of financial institutions, is making the slowest progress. This refers especially to the development of securities markets and nonbank financial institutions.

Successful institutional changes call for a number of measures which, inter alia, include:

- **privatization, coupled with the improvement of competitiveness;**
- **restructuring of large enterprises, coupled with the elimination of state monopolies,**

[54/] Stiglitz, J., "Distribution, Efficiency and Voice: Designing the Second Generation of Reforms", presentation at the: **Conference on Asset Distribution, Poverty, and Economic Growth**, Brasilia, July 14, 1998, mimeo.

[55/] Šire o tome vidi in: Stiglitz, J., "More Instruments and Broader Goals: Moving Toward the Post-Washington Consensus", **The 1998 WIDER Lecture**, January 7, 1998, Helsinki, mimeo.

- **reform of the financial and banking sector and the imposition of financial discipline,**
- **social safety net** aimed at eliminating the social welfare system covering all citizens and
- **reform of the government and the implementation of the rule of law.**

Privatization and improvement of competitiveness. - The first step in the process of institutional reforms must be made towards implementing the privatization program. The aim of privatization is to improve enterprise efficiency.

Tabela 10. Path of institutional and structural reforms in CIT

	Private sector share in GDP (%)	Enterprises			Market and trade			Financial institutions		Total
		Large scale privati-sation	Small-scale privati-sation	Corpo-rate gover-nance	Price liberali-zation	Trade &foreign exchange system	Compe-tition	Bank. reform & interest rates	Securities mar-kets& non-bank institut.	
Central Europe										
Czech	75	4	4+	3	3	4+	3	3	3	27
Hungary	80	4	4+	3+	3+	4+	3	4	3+	28
Poland	65	3+	4+	3	3+	4+	3	3+	3+	26
Slovakia	75	4	4+	3-	3	4+	3	3-	2+	26
Slovenia	55	3+	4+	3-	3	4+	2	3	3	25
Baltic countries										
Estonia	70	4	4+	3	3	4	3-	3+	3	27
Latvia	60	3	4	3-	3	4	3-	3-	2+	25
Lithuania	70	3	4	3-	3	4	2+	3	2+	24
SE Europe										
Albania	75	2	4	2	3	4	2	2	2-	21
Bulgaria	50	3	3	2+	3	4	2	3-	2	22
Croatia	55	3	4+	3-	3	4	2	3-	2+	24
Macedonia	55	3	4	2	3	4	1	3	2-	22
Romania	60	3-	3+	2	3	4	2	2+	2	21
FSU										
Belarus	20	1	2	1	2	1	2	1	2	12
Russia	70	3+	4	2	3-	2+	2+	2	2-	20
Ukraine	55	2+	3+	2	3	3-	2	2	2	19

Source: **Transition Report 1998**, EBRD

There were numerous experiments with privatization, ranging from extensive efforts to sell enterprises to strategic owners (like in Estonia and Hungary) and the programs based primarily on employee shareholding (like in Slovenia and Russia) to innovative, mass privatization programs, including the creation of large and strong new financial intermediaries (like in the Czech Republic, Slovakia and Poland). Each approach has its advantages and shortcomings. However, if the aim is to break the link between the government and enterprises, to educate the population so as to know the basics of market behavior and to encourage ownership transformation, the initial results will favor greater reliance on voucher-based privatization, bearing in mind the difficulties faced by most countries in search of investors with fresh capital.[56/]

However, the privatization program must also include the improvement of competitiveness so as to prevent the former state monopolies from becoming private monopolies after privatization.

Enterprise restructuring and the elimination of state monopolies. - Enterprise restructuring is one

[56/] Gray, C. W., "In Search of Owners: Lessons of Experience with Privatization and Corporate Governance in Transition Economies", **World Bank Working Papers No. 1595**, April 1996, Washington, D.C.

of the most important components of microeconomic transition**.** Without this component, the overall transition process can be brought to question, as shown by all reforms implemented in CIT so far.

CIT inherited a bad situation in enterprises: low competitiveness, as the result of obsolete equipment and an excessive number of employed, inferior product quality which does not up to demand, production programs which are not adjusted to the market and inadequate managerial staff, so that restructuring poses a challenging task.[57/] In addition, a special problem is posed by a high concentration on the supply side.

State-owned enterprises in CIT were meeting numerous social obligations towards the employed and population, but whereby those costs were not linked to their production costs of enterprises, thus increasing their total costs and decreasing competitiveness.

An analysis devoted to the financing of Russian enterprises also points to the significance of the public sector in CIT. Thus, it can be noted that public expenditure accounts for 20% of the gross wage fund.[58/] Another analysis, which deals with Bulgarian enterprises and relative significance of their integration into the world economy, shows that this is a significant source of productivity growth. The analysis shows that foreign trade is a significant source of growth of total factor productivity at the enterprise level.[59/]

Reform of the financial and banking sector and the imposition of financial discipline. - The key to the further progress of the entire transition project lies in the sphere of the financial system and its modernization.[60/] Transition will be successful to the extent to which this system is developed on the market principles. However, the reform of the financial sector must be closely linked to the process of privatization and restructuring of enterprises. Without this link between the two economic sectors, microeconomic reforms can hardly be successful.

Analyses have shown that better financial systems increase the probability of successful innovations and, thus, speed up economic growth. On the other hand, distortions of the financial sector lower the rate of output growth. Thus, it follows that the financial system is significant for both productivity growth and output growth.[61/]

The banking system is the major segment of the financial system in CIT. Institutional capacities of the banks in CIT are improved all the more faster if new private banks can be founded, while at the same time making an effort to reform old state banks.

There was an important debate as to whether the government - within the reforms of the financial sector in CIT - should try to reform the existing state banks - **rehabilitation approach** - or, to enable the founding of new private banks - **innovative approach**, or whether these two approaches should be combined.

In most countries, even in those with a good banking infrastructure and large segment of sound banks, the process should be based on both approaches, which will increase differences between weak and strong banks. Regardless of the approach to the banking system reform, weak banks will be gradually separated from the state**.**

The regression analysis has shown that three basic reasons for a slowdown in the banking system reform in CIT are: (1) too high concentration in the banking sector, (2) preferential treatment of old banks on the part of the government and (3) limited entry for new banks.[62/]

In implementing the financial sector reform, CIT have to fulfil two basic tasks:

- to develop their own central bank into an institution which will independently formulate and pursue monetary policy and
- to remove deficiencies in commercial banking.[63/]

The opinion prevails that in the implementation of the financial sector reform, it is necessary:

- to provide for the normal and unhindered operation of the existing reliable banks (if any), because they serve as a positive example and

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[57/] Gerling K., and K. D. Schmidt, "Restructuring and Competitiveness in the Transition Process: Evidence from an Eastern German Firm Panel", **Kiel Working Paper 791,** Institut für Weltwirschaft, Kiel, January 1997.

[58/] Freinkman, L. M. and I. Starodubrovskaya, "Restructuring of Enterprise Social Assets in Russia: Trends, Problems, Possible Solutions", **World Bank Workings Paper No. 1635**, Washington, D.C., August 1996.

[59/] Djankov, S. and B. Hoekman, "Trade Reorientation and Productivity Growth in Bulgarian Enterprises", **Policy Research Working Paper No. 1707**, January 1997, The World Bank, Washington, D.C.

[60/] Fischer, S., "Financial System Soundness", **Finance and Development**, The IMF & The World Bank, Vol. 34, No. 1, March 1997, pp. 14-6, based on prof. Fischer's lecture delivered at the symposium held on May 10, 1996, on the occasion of the 25th anniversary of the constitution of the monetary authorities in Singapore.

[61/] King, R. G. and R. Levine, "Finance, Entrepreneurship, and Growth: Theory and Evidence", **Journal of Monetary Economics,** Vol. 32, No. 3, 1993, pp. 513-42.

[62/] Claessens, S., "Banking Reform in Transition Countries", **World Bank Working Papers No.1642,** The Wold Bank , Washington, D.C., August 1996.

[63/] See: **From Plan to Market - World Development Report**, The World Bank, 1996, pp. 98-109.

- to decrease the activities of inefficient (state) banks, while at the same time providing incentives for the development of new banks and the appearance of foreign banks,

which would create conditions for the development of a new, modern financial system.

The banks in CEE CIT are less active in enterprise restructuring than anticipated**. Should the banks be primarily concerned with the restructuring of their weakest clients, they would actually shift attention from granting loans to their first-rate clients, which should be the essence of their operations, to the problems of loss-making enterprises. In addition, the banks do not have knowledge about enterprise restructuring. Therefore, enterprises should not be restructured primarily by banks or state agencies but by strong market stimuli.**

Social welfare net. - The aim of implementing the social safety net is to free the enterprise of the social function, on one side, and to eliminate the social welfare system covering all citizens, on the other.

In this way, enterprises will increase their cost efficiency and decrease the number of employed to an optimal level, while social welfare will be available to those who are really incapable of supporting themselves.

Reform of the government. - Reform of the government has at least two segments. The first refers to the functioning of the government based on the rule of law, enforcement of law and withdrawal from the regulatory role in the economy: the second concerns the rationalization of government and the alleviation of a tax burden.

Three important elements for the establishment of the legal framework are: reasonable laws, appropriate institutions and market-oriented incentives.

CIT need not only new legislation. It is also necessary to establish and develop simultaneously the relevant institutions (including formal legal institutions and monitoring institutions which still do not exist in CIT).[64/]

4.2. The establishment of the financial market in CIT

The nature of more recent financial crises and, above all, of the current crisis faced by the East-Asian countries, points to the need for strengthening the link between the financial sector and the real sector of the economy.[65/] In economic theory and practice, this link has not been sufficiently taken into account and, thus, not sufficiently developed. As is well known, the financial system is the brain of every economy; on one side, it mobilizes savings and, on the other, allocates them to investments. When this mechanism does not function properly, the economy is faced with serious disruptions whose consequences can be dramatic, as shown by the current financial and development crisis in Asia.

Therefore, the reforms of the financial system in CIT, despite their relatively insignificant results at the moment, should contribute to a better resource allocation and higher rate of economic growth, due to which this issue is given special attention.

It is very important to initiate institutional, that is, structural reforms and, including specifically the reform of the financial sector, as early as possible because their implementation requires a longer period.

The first experiences with the reforms of the financial sector in CIT. - There is a consensus among the economists that the key to the success of the entire transition project lies in the sphere of the financial sector and its modernization.[66/] To the extent this sector is developed on the market principles, transition will be more successful.

Whether a financial system is efficient and consistent with other segments of the economic system, can also be determined as to whether it generates:

- sufficient domestic savings for stimulating sustainable growth,
- (in)efficient allocation of financial resources and
- adequate liquidity with maintaining macroeconomic stability.

CIT have so far financed and will continue financing their investments primarily out of domestic savings. In a great number of CIT, the households substituted the public sector as the main source of savings but, in contrast to developed economies, the potentialities and nature of financial institutions, by means of which these savings can be accumulated, have remained limited. So, for example, contractual savings, through

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[64/] Gray, C. W. and K. Hendley, “Developing Commercial Law in Transition Economies: Examples from Hungary and Russia”, **World Bank Working Papers No. 1528,** the lecture delivered at Harvard University within a series of lectures dedicated to John M. Ohlin, The World Bank, Washington D.C., November 1995.

[65/] On the concept of strengthening the international financial sector see: Fischer, S., “On the Need for an International Lender of Last Resort”, paper prepared for the annual conference **The American Economic Association and the American Finance Association**, January 3, 1999, New York.

[66/] Fischer, S., “Financial System Soundness”, **Finance and Development**, The IMF & The World Bank, Vol. 34, No. 1, March 1997, pp. 14-6, based on prof. Fischer's lecture delivered at the symposium held on May 10, 1996, on the occasion of the 25th anniversary of the constitution of the monetary authorities in Singapore.

the pension and insurance funds, are virtually nonexistent and we know that they represent the best quality source for long-term investment.

The significance of the financial system for development has already been discussed in the section devoted to the theory of endogenous growth. Here one should be recalled that there is a strong empirical evidence of this link, i.e. in the studies of R. Levine and others who have pointed to a strong relationship between economic growth and the depth of the banking system and liquidity of financial markets.[67/]

On the basis of all this, it is possible to perceive three important issues that should provide guidance for the future development of financial markets; they concern the role of the government, nature of stabilization policies and the policy of competition.

The role of the government in the financial markets. - Here attention will be devoted to the first issue, because the other two have already been analyzed. As is well known, information is imperfect, so that even minor changes in information assumptions may generate serious effects.[68/] For this reason, financial markets, which are basically linked to the nature of available information (which is confined as to the question how to use scarce capital in the most productive way and monitor this use) - are characterized by significant deficiencies, whose causes should be sought in imperfect information.[69/] Such imperfect information exerts influence on the performance of the financial market and the economy and points to the significance of the role of the government for the functioning of financial markets.[70/]

The financial system can have a stimulative effect on economic growth. This will happen if the margin between positive and negative interest rates is based on (1) real positive yet low interest rates and (2) relatively low margins. The financial market and the financial system so established will induce investments and, thus, provide impetus to growth. Let us recall, for example, that in the traditional growth model, the major source of growth, i.e. the growth of TFP was created exogenously and was not linked to the financial system.

Within an exhaustive debate about the second generation of economic reforms the question of the role of the government in the economy and, in particular, in financial markets, imposed itself as well. As an example of the need for the presence of the government, reference is made to the control of deposit interest rates and the problem of limited competition in the financial sector and their effects on growth.[71/]

High financial repression is very harmful to the economy. A negative example of the excessive role of the government is the repression of lending interest rates by the government. In that case, the government virtually draws a rent from the private sector so as to finance high fiscal deficits. As a result of such policy, we obtain undercapitalized banks, the banks which have abandoned their commercial orientation, and, as a rule, the beginning of unsound banking practice. Such financial repression is accompanied by high (variable) inflation rates and the low rate of economic growth. It is evident that the effects of government interference in financial markets and the financial system are negative and generate disastrous effects.

However, it would be wrong to conclude that the government should not play any role in the financial market and the financial system. The role of the government is very significant, but it must be moderate, confined to very narrow segments and, above all, indirect. By cutting borrowing costs, the government in such a role increases the profitability of firms and, thus, their investments. At the same time, the population is offered a lower interest rate which can, only to a small degree, influence a decrease in savings, since most evaluation suggest that the elasticity of savings, as compared to the interest rate, is close to zero. Finally, lower interest rates mean that the banks will attract more reliable borrowers, thus decreasing the probability of debtors' fulfilment of credit obligations, and increasing the security of banks.

This is only one example of the general principle: the government can help in improving the performance of financial markets, but this must be done indirectly and to a small degree.

On the other side, there is virtually no example of a successful financial market in which the government does not have an important role. The debate about the deregulation of financial markets, which was held up to one decade ago, seems now to have been wrongly founded. The question is not whether the role of the government is necessary but what the role of the government should be.[72/]

[67/] Levine, R., "Financial Development and Economic Growth", **Journal of Economic Literature**, Vol. 35, No. 2, 1997, pp. 688-726.

[68/] Stiglitz, J., "Information and Economic Analysis: A Perspective", **Economic Journal**, Vol. 95, 1985, pp. 21.

[69/] Stiglitz, J., "Knowledge for Development: Economic Science, Economic Policy, and Economic Advice", paper prepared for: **Annual World Bank Conference on Development Economics**, April 20-21, 1998, The World Bank, Washington, D.C.

[70/] See: Stiglitz, J., "The Role of the State in Financial Markets", in: **Proceedings of the World Bank Conference on Development Economics 1993**, 1994, The World Bank, Washington, D.C.

[71/] Murdock, K. and J. Stiglitz, "The Effect of Financial Repression in an Economy With Positive Real Rates", background paper for: **East Asian Miracle**, The World Bank, Washington, D.C., 1993.

[72/] The crisis in Thailand, for example, is the result of a limited role of the government and not of its excessiveness.

Experience with the restructuring of the banking sector in CIT has not yet produced positive results. There are only three successful examples: Estonia, Latvia and Slovenia.[73/] It is also worth mentioning the efforts made by Hungary and Poland but the final conclusions still cannot be drawn.

The development of the banking system on the market principles calls for the transformation of state banks into market-based institutions through their rehabilitation and/or creation of a new banking system through the entry of new banks. CIT have adopted various combinations of these two approaches - through rehabilitation and through the entry of new banks. In Estonia and Russia, a great number of new banks has appeared on the market, state banks have been broken into smaller units and privatized and, in some cases, liquidated. Poland and Hungary opted for the recapitalization of state banks and the promotion of extensive programs relating to the development of such banking institutions and their privatization.[74/]

The outline of the basic lines of development of financial markets. - In summing up the recommendations for determining the basic lines of further development of the financial market, it can be concluded as follows:

- the questions as to whether the government should be present on financial markets should be replaced by the question **what should be the role of the government?** In this regard, one should observe the principle that the government can contribute to the performance of financial markets, but this should be done indirectly and to a small extent;
- it is necessary to improve the relationship between the financial sector and the real sector of the economy;
- after achieving stability, the concept of economic policy should be also aimed at securing sustained growth and
- it is necessary to develop institutional infrastructure in view of the fact that high-risk materials are traded in the financial market.

5. CONCLUDING REMARKS

The ten-year experience of advanced CIT has already contributed to the accumulation of a certain knowledge and experience on the basis of which it is possible to speak about the basic elements of CIT. In the process of their development, one can clearly distinguish two subperiods: (i) the subperiod of decline (1990-1993) during which the advanced CIT began their recovery and (ii) recovery period (1994-98) during which half of CIT recorded 4-5 years of positive growth rates.

The opinion prevails that macroeconomic stabilization and structural reforms are crucial for sustainable growth of CIT. It can be said that those CIT which achieved stabilization as early as possible and in which structural reforms were implemented at a faster pace, produced better results relating to growth recovery.

On the basis of experience gained so far, it is possible to draw the following conclusions: (i) the faster and thoroughgoing economic reforms, the greater are the prospects for minimizing their costs, (ii) political democratization contributes to the success of transition, (iii) it is very difficult to avoid a relatively great fall in output at the start of transition, especially in the state-owned industrial sector and (iv) the government should not be afraid of highly set aims when opting for a stabilization program and transition.

Today, there is a consensus in economic theory that stabilization must precede structural reforms. Stabilization must be accompanied by liberalization. Price liberalization is indispensable due to numerous monopolist positions and the presence of regulated prices, while trade liberalization is a precondition for implementing the strategy of open economy and opening of the domestic market. This should be accompanied by the devaluation of domestic currency and provision of residents' convertibility. This will create conditions for the strengthening of competitiveness; elimination of price distortions, coupled with price adjustment to the price structure on the world market; after devaluation, the exchange rate would be used as the nominal anchor; and devaluation would make imports more expensive, thus eliminating a need for the imposition of high tariffs during the process of opening the economy.

For economic policy management, an answer to the question whether **inflation stimulates growth** is of great significance. The view that inflation provides an impetus to economic growth, which is often put

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Had Thailand retained regulation like in the period of the so-called "Asian Miracle", when it restricted speculative flows of borrowing against real property, and had it not been under the influence of foreign advisors who suggested that such restrictions would generate an adverse effect on the efficiency of resource allocation, since investment in empty offices (real property) would be more profitable than investment in a productive enterprise, Thailand would probably avoid the crisis which, in 1997, pushed it into the first year of negative growth after thirty years of intensive growth.

[73/] Siegelbaum, P. J., "Financial Sector Reform in the Transition Economies: What Have We Learned; What are the Next Steps?", **2nd Annual Conference on Bank Credit in Central and Eastern Europe**, Prague, September 2, 1997.

[74/] "Reforming the Financial Sector in the Transition Economies of Central and Eastern Europe and the Former Soviet Union", **The World Bank**, 1998. (See: http://www.worldbank.org).

forward for political reasons, **has neither theoretical nor empirical ground.** It has been unambiguously confirmed that there is a negative correlation between two-digit and higher inflation rates and output growth. Some dilemma has remained with respect to low inflation rates (below 10% yearly). It is still unclear whether inflation, if its level is low, say, below 8% annually, has a neutral or negative effect. In any case, there is no positive correlation between inflation and output growth. Therefore, it can be concluded that the trade-off between inflation and output growth on the short-term Phillips curve remains the central problem of monetary and economic policy in general.

Many countries were faced with great difficulties in an effort to bring down inflation from the moderate to one-digit level. Moderate inflation is inflation whose rate is sustained in the range of 15-30% for three years.

Over the past years, a fight against moderate inflation, waged by most CEE CIT, has gained in importance, when these countries succeeded in bringing down their inflation rates from much higher levels to moderate ones. However, the complexity of moderate inflation is much greater than that of high or mega inflation, for example. Namely, very complex problems, which cannot be observed when inflation is high, become evident when inflation is moderate, thus facing economic policy makers with very serious and complex tasks. **First,** when inflation is high, it is relatively easy to reach a political consensus. If inflation is lower, however, **it is more difficult to convince the public of long-term benefits from price stability. Second, the difficulties arising from a change in the structure of contracts and transactions of the private sector in the disinflation process** also pose a significant problem. The shortening of the contract period and increasingly used and increasing indexation based on foreign currency, which characterizes high inflation, make disinflation from a high inflation level easier than inflation from a moderate one. **Third,** if inflation is moderate, **the recommendations concerning the implementation of disinflationary economic policy are also changed; this refers especially to the problems relating to capital inflow,** which is more intensive in those countries which have already made greater progress in transitioning and macroeconomic stability. Therefore, it is not surprising that inflation inertia is empirically more significant in the moderate range. **Fourth,** transitioning is faced with sharp changes in the level of relative prices of goods and services, inputs and real exchange rates. This is characteristic not only of the initial phase of transition, but also of its later phases, with the inflation rate being already lowered to the moderate level. In the presence of nominal rigidities (e.g. nominal wage and price rigidities), it is easier to establish new parities, i.e. the level of relative prices, by means of inflation. If indexation is used, this process can be prolonged for a few years and the level of inflation can be maintained in the moderate range for a few years, too.

While recognizing the need for sustained growth in the ECIT, among which there are also the most advanced reformers, it was arrived at the conclusion that it would be necessary to take a new approach to the concept of transition in the next decade, which would be based on the supplements provided by the second generation of economic reforms. This is necessary because it was concluded that, **first,** some important elements have been partly neglected and, although they do not disparage the importance of the elements already included, they make them insufficient for the successful development of a market economy and, **second,** the concept of economic development has been treated too narrowly so that it has to be expanded.

First, the selected instruments - trade liberalization, privatization and macroeconomic stabilization - albeit very significant, often confuse the means and aims, while at the same time disregarding other important instruments. Let us recall that economic theory points out that the requirement for privatization and the requirement for the strengthening of competition are necessary for the development of a market economy. However, the Washington Consensus lays emphasis only on the requirement for privatization. Therefore, we should not be surprised if the privatization of some state monopoly in CIT ends in the private monopoly with high prices and continuing efficiency.

Therefore, in addition to reliance on the Washington Consensus, it is necessary to reaffirm those components which have not been dealt with in it in more detail, including the strengthening of (1) financial markets, (2) competition and regulation, (3) technology transfer and (4) development institutions.

Second, the Washington Consensus considers development only as a relatively limited form of an increase in GDP. Thus, it should be expanded to include (1) the need for raising the standard of living, reflected also in an increase in the level of health of the population and the level of literacy, (2) the concept of sustainable growth and economic reforms, coupled with democratization.

Therefore, the second generation of economic reforms in CIT, which should provide an impetus to sustained growth, must be based on institutional changes, while at the same time maintaining macroeconomic stability. Institutional changes should include: privatization, coupled with to the strengthening of competitiveness; restructuring of large enterprises, coupled with the elimination of state monopolies; reform of the financial and banking sector and the imposition of financial discipline; the social safety net that would eliminate the social welfare system covering all citizens: the reform of the government and implementation of the rule of law. The reforms of the financial system within institutional changes in CIT are given the highest priority.

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