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China in Light of the Performance of Central and East European Economies

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Figure 3.1

Growth of GDP Index (1989 = 0.00)

1. Introduction

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

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

Figure 3.1

Growth of GDP Index (1989 = 0.00)

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

The Soviet-style centrally planned system, adopted to a large extent also by China, was relatively well suited to mobilizing resources for expanding existing productive activities, such as during World War II and the post-war reconstruction. China is reported to have achieved … **(Tom and Loren, please give me the numbers you most believe here)** percent rate of growth in the 1950s, … growth in the 1960s and … growth rate in the 1970s. The Soviet bloc countries started with an impressive 4.5 percent annual growth rate in per capita GNP during the 1950s, exceeding the 3.7 percent rate of growth of a comparison group of market economies (Gregory and Stuart, 1997).[1] However, the rigidities of the command economy made it much less suitable for invention, innovation and efficient allocation of resources, resulting in a long-term slowdown in the entire Soviet bloc since about 1960. While the comparison group of market economies averaged rates of growth of GNP per capita of 4.5 percent in the 1960s, 2.8 percent in the 1970s and 2 percent in the 1980s, the growth of per capita GNP of the Soviet bloc countries is estimated to have fallen to 3.6 percent in the 1960s, 2.8 percent in the 1970s, and 0.8 percent in the 1980s.

The long term economic slowdown in the Soviet bloc relative to the western economies and the rapid economic growth in China in the 1980s created expectations that after the fall of communism the CEE and CIS economies would generate rapid economic

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

Figure 3.1

Growth of GDP Index (1989 = 0.00)

growth and gradually catch up with the developed countries as they moved to a market system.

2. Strategies for Transition

In the 1980s, China emphasized dual track reforms that had relatively few visible losers, maintained existing production by permitting only gradual relaxation of central controls in the existing state sector and aborting attempts at big bang style reforms, and allowed the establishment and major expansion of township and village enterprises (TVEs) that greatly expanded economic activity (Byrd and Lin, 1990, Qian, Lau and Roland, 2000 and Naughton, 2002). The gradualist strategy changed somewhat around 1993 as the central government reasserted itself, increased the share of budgetary and extra budgetary revenues in GDP (Wong, 2002), invested more in infrastructure, and permitted losers to appear, especially in form of laid off SOE workers (Naughton, 2002). This shift also reflected increased competition within the economy and rising influence of market forces.

The policymakers in the former Soviet bloc formulated transition strategies that focused on abandoning the centrally planned system and substituting it with a market system in the context of macroeconomic stabilization and microeconomic restructuring, along with institutional and political reforms. While China adopted a relatively gradual and unified overall approach, albeit with much experimentation at the local level, the implementation of transition strategies in CEE and CIS was relatively fast, although it varied across countries in speed and specifics. While a major debate took place about the merits of fast or "big bang" reform vs. gradual reform, almost all the CEE and CIS

Figure 3.1

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governments plunged ahead in rapid "big bang" style with what I have called Type I reforms (Svejnar, 2002, 2007). However, significant policy differences ensued in what I call Type II reforms, which many CEE and CIS governments carried out slowly and incompletely.[2]

Type I reforms typically focused on macro stabilization, price liberalization and dismantling of the institutions of the communist system. The macroeconomic strategy emphasized restrictive fiscal and monetary policies, wage controls, and in most cases also a fixed exchange rate. The micro strategy consisted of price liberalization, dismantling the Soviet bloc trading area, the Council for Mutual Economic Assistance (CMEA), opening up to varying degrees to international trade (thus inducing a more efficient allocation of resources based on world market prices), reducing direct subsidies to trusts and state-owned enterprises (SOEs), and allowing the SOEs to restructure or even break up. The strategy also aimed at removing barriers to the creation of new firms and banks, carrying out small-scale privatization, breaking up the "monobank" system, whereby a single state bank system functioned as a country's central bank as well as a nationwide commercial and investment bank, and allowing the creation of new and independent banks. A final feature was the introduction of some elements of a social safety net. The Type I reforms proved relatively sustainable.

Type II reforms involved the development and enforcement of laws, regulations and institutions that would ensure a successful functioning of a market-oriented economy. These reforms include the privatization of large and medium-sized SOEs, establishment

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

Figure 3.1

Growth of GDP Index (1989 = 0.00)

and enforcement of a market-oriented legal system and accompanying institutions, further in-depth development of a commercial banking sector and the appropriate regulatory infrastructure; labor market regulations; and institutions related to public unemployment and retirement systems.

I will use the key dimensions of the two sets of reforms to compare the transformation of China's economy, documented in the various chapters of this book, and the transition in the CEE and CIS countries.

Privatization

While China proceeded relatively fast with the introduction of local public ownership through TVEs and private ownership through private agricultural plots, it proceeded relatively slowly with privatization. Indeed, significant privatization of TVEs occurred only after about 15 years of their founding, and substantial privatization of larger firms commenced only about two decades after the start of China's transition. In CEE and CIS, remarkable differences exist across countries in the strategy of privatizing large and medium-sized firms, but all countries proceeded fast, relative to China. For example, Poland and Slovenia moved most slowly in privatizing state-owned enterprises, relying instead on "commercialization" (where firms remained state-owned but were run by somewhat independent appointed supervisory boards) and on the creation of new private firms. Yet they took only ten years to privatize the majority of their industrial firms. Estonia and Hungary proceeded assiduously and surprisingly effectively with privatization of individual state-owned enterprises by selling them one-by-one to outside owners. This method of privatization was originally viewed by many strategists as being too slow. Yet it provided much-needed managerial skills and external funds for

Figure 3.1

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investment in the privatized firms, it generated government revenue and effective corporate governance, and it turned out to be relatively fast, taking about 6-7 years when carried out by determined governments. Russia and Ukraine opted for rapid mass privatization and relied primarily on subsidized management-employee buyouts of firms. This method had the advantage of speed (2-5 years), but it led to poor corporate governance in that existing management usually was not able or willing to improve efficiency. The method also did not generate new investment funds and skills, and it provided little revenue for the government. Finally, countries such as the Czech Republic, Lithuania and to a lesser extent Slovakia carried out equal-access voucher privatization, whereby a majority of shares of most firms were distributed to citizens at large. While this approach may have been most fair and one of the best in terms of speed (2-5 years), it did not generate new funds for investment, nor did it bring revenue to the government. Instead, it resulted in dispersed ownership of shares and, together with a weak legal framework, it resulted in poor corporate governance. The poor corporate governance often permitted managers or majority shareholders to appropriate profit or even assets of the firms ("tunnel") at the expense of minority shareholders.

Banking System

In the development of a banking system, China first only gradually supplemented the traditional Soviet-style monobank system with new banks and financial institutions. However, the last ten years have witnessed a rapid rise of private financial institutions. In contrast, virtually all CEE and CIS countries rapidly abolished the monobank system as part of Type I reforms. Some countries, such as Russia, allowed spontaneous growth of new banks from the bottom up at the very start of the transition, resulting in the creation

Figure 3.1

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of hundreds of banks virtually overnight. In CEE, the process was much more government-controlled, but even there dozens of small private banks rapidly emerged in countries like Czech Republic and Poland. While the banking systems in CEE and CIS differed in various ways, at the start they shared some discouraging patterns. Many of the small banks quickly collapsed. In most CEE and CIS countries, large banks started the transition with a sizable portfolio of non-performing enterprise loans and, upon restructuring, they rapidly accumulated new non-performing loans. The large banks survived primarily because they were "too large to fail" and governments bailed them out. The need for repeated bailouts of banks has in the late 1990s led Hungary, Czech Republic and Poland to privatize virtually all domestic banks to large western banks. This was followed by similar privatizations in Slovakia, Bulgaria, Romania, Croatia and other countries, with the CEE region becoming a laboratory for observing the introduction of a western banking system with virtually no local banks.

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

Labor and Social Institutions

For almost two decades, China maintained much of its original labor and social system, with urban workers enjoying considerable protection and job security and the rural population receiving only limited social transfers from the central government. The CEE and CIS countries have differed in the nature and speed of the development of labor

Figure 3.1

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and social regulations and institutions, but most proceeded relatively fast in comparison to China. By the end of 1991, all the CEE countries developed relatively well-functioning unemployment compensation and social security benefit schemes, with the originally generous benefits becoming somewhat more modest over time (Ham, Svejnar and Terrell, 1998). In Russia and the other countries of the CIS, the official benefits were low to start with and decreased dramatically in real terms over time -- and even the low official benefits were often not paid.

Hence, China proceeded with limited social transfers and in this sense it has resembled more the CIS than the CEE countries.

Legal System and Institutions

China maintained and gradually reformed its legal and institutional system as it proceeded with its gradual economic reform. The major systemic transformation in the CEE and CIS countries required completely new laws and institutions, yet virtually none of these countries succeeded in rapidly developing a legal system and institutions that would be highly conducive to the preservation of private property and to the functioning of a market economy, although some countries did better than others. This lack of a market-oriented legal structure appears to have been the Achilles heel of the first decade of transition in the former Soviet bloc countries. Many policymakers underestimated the importance of a well-functioning legal system or believed too readily that free markets would take care of any major problems. In addition, many newly rich individuals and groups in the transition economies -- especially those who have contributed to the corruption of public officials -- did not desire a strong legal system.

Figure 3.1

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In recent years, an important impetus for carrying out legal and institutional reforms in the CEE countries has been the need to develop a system that conforms to that of the European Union (EU) as a prerequisite for accession to the EU. In China, a major recent impetus for legal and institutional change has been the entry into the World Trade Organization (WTO), a factor that has also been playing a part in Russia.

An important recent school of thought attributes the failure of many countries to grow and develop to corruption. Yet corruption has been present in China throughout the three decades of rapid growth, and it has been an important phenomenon in the former Soviet bloc economies, including Russia, both during the economic decline in the 1990s and the subsequent period of rapid growth. The record of these economies hence indicates that corruption alone is not an adequate explanatory factor for the presence or absence of economic development and growth.

2. Performance of China Since 1978 and the CEE and CIS Economies Since 1990

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

Figure 3.1

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indicators and then turn to more microeconomic measures of restructuring and performance.

Gross Domestic Product

Calculating the evolution of GDP is difficult for the early phases of the transition because the communist countries used gross material product, a measure which ignored the production of services. Moreover, the dramatic growth in the number of small firms during the transition was not well-captured in the official statistics – to say nothing of the course of the underground economy in these countries both before and during the transition. National statistical offices and the international institutions have devoted significant resources to estimating GDP for the pre-transition years and tracing out GDP accurately thereafter, but the early data obviously have to be interpreted with caution (see e.g., Rawski, …(**Tom, please give me a good reference here**), Filer and Hanousek, 2000 and 2002, and Brada, King and Kutan, 2000).

With the above caveats in mind, one may carry out a number of comparisons. In 1990, at the start of the transition in CEE and CIS, the sectoral structure China's economy resembled most that of Ukraine and Kazakhstan in that in all three economies agriculture accounted for a bit over 25 percent and industry for 42-45 percent of GDP (Russia's shares were 17 and 48 percent, respectively). Since then, China reduced the share of agriculture in the same proportion as Ukraine and some other countries, but it deviated from the other countries in that it increased rather than decreased the share of industry. In particular, between 1990 and 2003 China's share of industry in GDP increased from 42 to 53 percent, while Ukraine's share declined from 45 to 40 percent. In

Figure 3.1

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general, the CEE and CIS economies moved from agriculture and industry to services, while China moved from agriculture to industry and to a lesser extent to services.

In terms of GDP growth, China's performance since 1978 has been unexpectedly strong, while that of the CEE and CIS was disappointing to disastrous in the early-to-mid 1990s and fairly strong thereafter. Figure 1 provides indices of GDP growth for selected CEE and CIS economies. Unlike China, which grew fast continuously since the start of the reforms, all the transition economies experienced large declines in output at the start of the transition. The decline varied from 13 to 25 percent in the Central European countries; over 40 percent in the Baltic countries; and as much as 45 percent or more in Russia and almost 65 percent in Ukraine. While the CEE countries reversed the decline after 3-4 years, in Russia and most of the CIS no turnaround was visible through most of the 1990s. Almost all the CEE countries have generated sustained economic growth since the early to mid-1990s and the CIS countries have done so since the late 1990s. In fact, since the late 1990s, the Baltic and CIS countries have grown considerably faster than the countries in Central Europe (Figure 2). The engine of growth has shifted east and the current debate is whether this represents real sustainable growth or a temporary surge driven in key economies by high natural resource prices.

The strength and persistence of growth in China and the depth and length of the early transition depression in the CEE and CIS countries were both unexpected. A number of explanations have been offered for both. The various chapters in this book present the most recent set of analytical explanations for China. For CEE and CIS, the arguments for the initial decline (transformation recession) include tight macroeconomic policies (Bhaduri et al., 1993; Rosati, 1994); a credit crunch stemming from the reduction

Figure 3.1

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of state subsidies to firms and rise in real interest rates (Calvo and Coricelli, 1992); disorganization among suppliers, producers and consumers associated with the collapse of central planning (Blanchard and Kremer, 1997; Roland and Verdier, 1999); a switch from a controlled to uncontrolled monopolistic structure in these economies (Li, 1999; Blanchard, 1997); difficulties of sectoral shifts in the presence of labor market imperfections (Atkeson and Kehoe, 1996); and the dissolution in 1990 of the CMEA. My assessment is that while each explanation contains a grain of truth, none is in itself completely convincing. All the CEE and CIS countries have gone through the decline, yet cross-country differences in initial conditions and the nature of reform are substantial enough to make one question the universal applicability of any single explanation. Interestingly, China avoided or delayed all of the above phenomena.

Inflation

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

Figure 3.1

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financial sector crises. However, by the later part of the 1990s, Type I reforms had shown that they could reduce inflation rates with speed and effectiveness.

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

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

Exchange Rates, Current Account and Exports

For the last three decades, China has kept an increasingly undervalued fixed exchange rate, avoided major revaluations, and maintained first balance and then surplus on its current account. Domestic demand has been an engine of growth but exports have increasingly provided an outlet for China's production.

Most CEE and CIS economies strongly devalued their currency as a means of ensuring global competitiveness and adopted a fixed exchange rate as part of macroeconomic stabilization. The CEE countries also significantly reoriented their foreign trade away from the old CMEA region and toward market economies – primarily Western Europe. However, as domestic inflation exceeded world inflation in the 1990s, the fixed exchange rates often became overvalued, leading in some cases to substantial

Figure 3.1

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current account deficits. Most countries responded by devaluing their currencies again and adopting more flexible exchange rate regimes, although Bulgaria, Estonia and Lithuania have fixed their exchange rate through currency boards as a means of long-term economic stabilization. Recently, Slovenia went furthest in fixing its currency to its principal trading partners by joining the Eurozone at the start of 2007. Most of the CEE economies became very open economies, while the CIS economies have on average remained relatively more closed.

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

External Debt and Financial Crises

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

A number of transition countries started the 1990s with high foreign indebtedness. In Bulgaria, Hungary, and Poland, external debt exceeded 50 percent of GDP in 1990. In Russia, external debt in 1990 was a whopping 148 percent of GDP. Other transition economies, such as Romania, Slovenia, Czech Republic, and Slovakia, had conservative regimes where foreign debt was less than 20 percent of GDP in 1990.

By the mid-1990s, many of the highly indebted countries reduced their debt relative to GDP, while a number of the less indebted countries raised theirs. But since

Figure 3.1

Growth of GDP Index (1989 = 0.00)

about 1996, foreign indebtedness appears to have risen in the relatively more indebted countries and in 1988 Russia defaulted on its sovereign debt. Interestingly, while the Russian financial crisis had a major impact on the CIS countries that still have close trading relations with Russia, it had relatively little impact on the CEE countries which had already reoriented most of their trade to western Europe.

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

Budget and Taxes

China has proceeded gradually in reforming its tax system and ensured adequate budgetary revenues in the face of a rapidly growing economy.

In contrast, as the transition unfolded, CEE and CIS governments had to develop new fiscal institutions for collecting taxes. This institutional development was one of the hardest Type II reforms to achieve. While tax collection was relatively effective even at the start of the transition in the CEE region, Russia and some other countries of the CIS initially faced significant declines in tax revenues as many producers operated through barter and accumulated tax arrears. At the same time, the governments were facing numerous public expenditures, including infrastructure and the new social safety net. The relative inability of Russia and other CIS nations to collect taxes was one reason why their social safety nets were from the start weaker than those in CEE.

While Russia and some other CIS economies have successfully reduced tax rates and simplified the tax system dramatically to improve tax collection, many of the CEE economies have higher tax rates than other countries at a similar level of GDP per capita. Yet, the relatively high ratios of taxes to GDP in these transition economies have not

Figure 3.1

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prevented many of their governments from running budget deficits. Russia and other natural resource exporting countries, however, have been running budget surpluses throughout the 2000s.

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

As the discussion indicates, the gradual transformation and rapidly growing economy has enabled China by and large to avoid the various budgetary problems encountered in the CEE and CIS economies. For different reasons, China and the resource rich CIS countries (Russia in particular) enjoy a similarly favorable budgetary situation.

Privatization and Creation of New Firms

Figure 3.1

Growth of GDP Index (1989 = 0.00)

While experimenting with private ownership, the Chinese authorities decided to delay for over two decades substantial privatization of state-owned enterprises. However, from the early 1980s they permitted the creation of township and village enterprises (TVEs), which filled niches, supplied the SOEs and many eventually started competing head on with the SOEs. The TVEs generated considerable economic activity and provided industrial and service employment in rural areas. In the last decade, most have turned into private firms and thus constituted a gradual process of de-etatizing China's economy.

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

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

A large number of new (mostly small) firms were founded in most transition economies. Like the TVEs, these firms filled niches in demand and started to compete with existing state-owned enterprises. Since many of the transition economies also became very open economies, the new private firms were also competing with imports.

Figure 3.1

Growth of GDP Index (1989 = 0.00)

The growth of new firms has varied across countries. In general, it proceeded faster and smoother in the CEE countries than in the CIS.

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

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

Figure 3.1

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Estrin, Hanousek, Kocenda, and Svejnar (2007) finds that privatization to foreign owners has by and large increased efficiency and scale of operations, while the effects of privatization to domestic owners have been mostly insignificant. Many of the early microeconometric studies suffer from serious problems: small and unrepresentative samples of firms; misreported or mismeasured data; limited controls for other major shocks that occurred at the same time as privatization; a short period of observations after privatization; and above all, not controlling adequately for selectivity bias. Selectivity bias is likely to be a particularly serious problem since better performing firms tend to be privatized first (Gupta, Ham and Svejnar, 2001). Thus, comparing the post-privatization performance of privatized firms to the performance of the remaining state-owned firms without controlling for selectivity bias, as many studies do, will erroneously attribute the superior performance of the privatized firms to privatization.

Studies of China provide a similar picture. For instance, studies of total factor productivity find diverse results, with the effect of non-state ownership being mostly positive but often statistically insignificant. As in the studies of CEE and CIS, in the studies of China the effect of foreign ownership is more positive than that of other forms of non-state ownership. The findings from the transition economies and China provide sobering evidence since the general expectation was that there would be much improvement in the efficiency of firms as a result of privatization.

Domestic and Foreign Investment

Throughout the 1980s, 1990s and 2000s, China maintained a high rate of investment. In this sense, China has joined the East Asian tigers. China has also

Figure 3.1

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generated a significant inflow of foreign direct investment that has had a positive effect on the modernization of China's economy.

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

As may be seen from Table 3.3, until 1996 Hungary was the only transition economy receiving a significant inflow of foreign direct investment, in part because of its more hospitable business climate and well-defined rules and regulations for foreign direct investment. But starting in 1998, major foreign investments went to the Czech Republic, Poland, Slovakia, and the Baltic countries. Overall, with one-tenth of the population of China, the CEE economies have been receiving roughly one-half of the annual FDI inflows going to China. These sizable FDI inflows have had a major effect on GDP growth and export competitiveness of the CEE countries.

Employment Adjustment, Wage Setting, Unemployment and Income Distribution

China's employment and more generally labor market adjustments have been different from those observed in the CEE and CIS transition economies, although the limited system of social transfers made some features similar to those in the CIS. China's SOEs have been adjusting employment but at a slower pace than their counterparts in the

Figure 3.1

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CEE and to a lesser extent CIS countries. A big employment adjustment occurred in China through the formation of the TVEs, which generated sizable employment for the rural labor force. More recently, China's private firms have been creating employment on a significant scale. Open unemployment is a significant phenomenon in the urban areas but less in the countryside. Despite administrative limitations on migration, Chinese workers move substantially in search of more lucrative employment opportunities. Finally, with the rapid economic growth, China's income distribution has become quite unequal, with the Gini coefficient being estimated to be around 50.[3]

In the CEE and CIS economies, SOEs rapidly decreased employment and/or real wages in the early 1990s (Svejnar, 1999). At one extreme, Hungary experienced a more than 20 percent initial reduction in industrial employment with real wages rising almost 20 percent. At the other extreme, Czech industrial wages declined almost 25 percent with employment falling less than 10 percent (Basu, Estrin and Svejnar, 2005). In Russia and the rest of CIS, the adjustment brought a mixture of wage and employment adjustment (Desai and Idson, 2000) and the wage decline was more pronounced than in the CEE region (Boeri and Terrell, 2002). In Central Europe, labor demand elasticities with respect to output and wages rose rapidly to western levels as the transition was launched. Depending on the institutional setting in a given country, the sharp decline in output at the start of the transition was hence absorbed more by employment or wage decreases.

The GDP and employment data suggest that restructuring in the transition economies involved an initial decline in labor productivity as output fell faster than

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[3] The Gini coefficient varies from 0 to 100, with 0 representing a perfectly egalitarian distribution of income (every individual or household receiving the same income) and 100 denoting the most inegalitarian distribution (one person or household receiving all income).

Figure 3.1

Growth of GDP Index (1989 = 0.00)

employment, and a subsequent rise in productivity as output has been growing fast but employment only slowly. This recent pattern has given rise to a concern over jobless growth.

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

Over time, the patterns of unemployment have shown considerable differentiation. The Czech Republic was the only central European country to enter recession in the second half of the 1990s and its unemployment rate correspondingly rose to 8-10 percent. The fast-growing economies of Poland, Hungary, Slovenia, and to a lesser extent Slovakia managed to reduce their unemployment rates in the late 1990s. Conversely, the CIS and Baltic countries experienced gradual increases in unemployment as their transition proceeded. By 1997, unemployment rates in Russia and Estonia were near 10 percent. By 1999-2000, the unemployment rate rose again in Bulgaria, the Czech Republic, Poland, Slovakia and Slovenia, and many transition economies have

Figure 3.1

Growth of GDP Index (1989 = 0.00)

unemployment rates that are at least as high, and often significantly higher than, those observed in the European Union.

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

The reduction in employment in the old state-owned firms, rise in unemployment and establishment of new firms have brought about considerable destruction and creation of jobs, as well as mobility of labor. Contrary to the main models of the transition process, however, Jurajda and Terrell (2001) show that job creation in new firms has not been necessarily tightly linked to job destruction in the old firms since many new jobs have been created even in economies that experienced low rates of job destruction. Sabirianova (2000) provides a related structural insight, namely that much of the labor mobility in Russia consists of occupational rather than geographic change, with individuals moving from one occupation to another within regions, as jobs in old occupations are destroyed and opportunities in new occupations are created. Compared to the U.S. and China's labor market, where individuals move geographically, the transition in CEE and CIS has led to more occupational rather than geographic mobility.

Data on income distribution, expressed in the form of Gini coefficients, are summarized in Table 3.4. The communist countries had highly egalitarian income distributions but inequality increased in the CEE and CIS economies during the 1990s and 2000s, with the Gini coefficient rising from 20-25 in the late 1980s to 24-32 in

Figure 3.1

Growth of GDP Index (1989 = 0.00)

Central Europe, low 20s to low 30s in Bulgaria and Romania, 23 to 30 in Ukraine, and 26 to 40 in Russia. These coefficients bring inequality in the transition economies into the range spanned by capitalist economies and in line with developing countries such as India. However, the Russian and Ukrainian data in Table 3.4 may well understate the extent of inequality. In particular, the data from the Russian Statistical Office (Goskomstat) are based on wages that firms are supposed to be paying to workers, but until recently many Russian firms were not fully paying contractual wages (Desai and Idson, 2000). Inequality calculations based on survey data from the Russian Longitudinal Monitoring Survey of households suggest that income inequality in Russia has reached much higher levels – a Gini coefficient of 52 – resembling the level of inequality found in China and developing economies with relatively inegalitarian distribution of income. Interestingly, the relatively egalitarian structure of income distribution in Central European countries has been brought about by their social safety nets, which rolled back inequality that would have been brought about by market forces alone (Garner and Terrell, 1998), while the Russian social safety net has been regressive, making the distribution of income more unequal than it would have been without it (Commander, Tolstopiatenko and Yemtsov, 1999).

The key finding is that inequality has increased during the transition, the increase has been greater in the east and has depended on the relative importance of changes in the distribution of wages, employment, entrepreneurial incomes, and social safety nets. Unlike in Central Europe, in Russia there has been a rapid rise in wage inequality, which has in turn had a strong effect on income inequality dynamics. What seems to have been a dominant common driver of inequality in all the transition economies is wage

Figure 3.1

Growth of GDP Index (1989 = 0.00)

decompression, resulting from the attenuation of the centralized wage setting and the high return to skills associated with globalization (Munich, Svejnar and Terrell, 2005, and Gupta and Yemtsov, 2005).

Assessment by the Financial Markets

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

3. Concluding observations

While China shared many systemic, initial conditions with the transition economies of Central-East Europe (CEE) and the Commonwealth of Independent States (CIS), it had a more agricultural economy and a more stable political system than many CEE and CIS countries. Unlike most of the CEE and CIS economies, China adopted a strategy of gradual economic transformation that maintained the existing system and created new economic activities on top of it. This enabled China to avoid the transformation depression observed in CEE and CIS, and allowed it to generate high rates of economic growth that have now lasted for almost three decades. At the time of this study, the CEE and CIS economies have also completed a decade or more of respectable

Figure 3.1

Growth of GDP Index (1989 = 0.00)

economic growth, demonstrating that numerous forms of the transition process can generate long term economic growth. In retrospect, the tradeoff for avoiding an initial depression is the willingness to maintain most of the existing economic and political system rather than embarking on a rapid economic and political transformation. With a rising economic instability and political pressure, countries such as Poland and the Soviet Union had little choice but to proceed relatively fast. Others, such as East Germany and Czechoslovakia, could have retained the centrally planned system, but they abandoned it and communism for political reasons. Looking forward, the current situation is an optimistic one, with China, CIS and CEE belonging among the fastest growing regions of the world. It will be interesting to see whether all or only some of these models will turn out to be successful in the long run.

Figure 3.1

Growth of GDP Index (1989 = 0.00)

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Figure 3.1

Growth of GDP Index (1989 = 0.00)

Real GDP Index (Base Year 1989)

Real GDP Index (Base Year 1998)

70
60
50
40
30
20
10
0
-10

1998 1999 2000 2001 2002 2003 2004 2005

Ukraine
Russia
Latvia
Lithuania
Estonia
Bulgaria
Hungary
Romania
Slovenia
Poland
Slovak Republic
Croatia
Czech Republic