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The Postsocialist Transitions in Comparative Perspective: Policy Issues and Recent Experience

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Summary. — This paper examines the postsocialist transition in Eastern Europe, the reforms in China and the "*postdirigiste*" transitions in Latin America. The paper analyzes: the initial conditions that gave rise to processes of reform in the different countries; the main strategies for economic reform — shock treatment, gradualism and mixed strategies — discussing their conditioning factors and rationale; the actual record of these policies in terms of key indicators of economic performance such as inflation, GDP growth, external sector sustainability, progress in privatization and the social costs of adjustment. In addition, the paper discusses interdependencies between economic and political reforms during the course of systemic transformation.

1. INTRODUCTION

The postsocialist transitions from plan to the market and from Stalinist-socialism to multiparty democracies is currently the most momentous change in the international milieu. Economies that were once run, with minor changes, on the model of central planning set out by Joseph Stalin in the 1930s and 1940s, are now engaged in attempts at reshaping their whole economic systems along free-market lines. The reform movement includes the former socialist countries of East-Central Europe, the former Soviet Union and small socialist economies in southeast Asia such as Vietnam and others. Moreover, China's record with economic transformation since the late 1970s is a (successful) case of gradual introduction of market mechanisms in the process of economic decision making, followed by high and sustained economic growth.

The new orthodoxy on economic reform places strong emphasis on the role of free markets for resource allocation and growth, smaller government, trade liberalization, business deregulation and privatization. Evidently the new paradigm represents a sharp departure from previous *dirigiste* (e.g., state-led) development strategies in nonsocialist developing countries and certainly from central planning.

This paper seeks to discuss several issues of the postsocialist transitions from a comparative perspective. It examines issues of design and performance of programs of economic reform; in particular: (a) the intensity of the programs, namely shock treatment, gradualism and mixed packages; (b) the actual record of these policies in terms of key indicators of economic performance such as inflation, GDP growth, the external sector and the social costs of adjustment. In addition, the paper discusses some interdependencies between economic and political reforms during the course of systemic transformation.

The paper introduces the comparative perspective by contrasting the policies of big-bang or shock treatment adopted in Eastern Europe during 1990–92 with the more evolutionary and gradualist approach followed by China after 1978. These alternative reform paths are examined in terms of policies and outcomes; highlighting differences in initial conditions and other determinants of performance. Moreover, the experiences of transition from *dirigist* development models to more market-oriented economies undertaken in the 1970s and 1980s in Lake America are discussed from the perspective of its lessons for the post-socialist transitions.

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2. ECONOMIC REFORM: CONTEXT AND INITIAL CONDITIONS

Socialism and "*dirigisme*" (e.g., state-led development) as modes of economic and social organization are being replaced by a model of society based in a market economy, with dominant private property and democratic political institutions. The starting conditions for reform vary from country to country in the former socialist world. Most of the economies of Eastern Europe started their process of transformation with shortages, large macroeconomic imbalances (open or repressed), substantial market suppression and pervasive microeconomic distortions. Moreover, 80–90% of GDP was generated in the state sector in most of these economies. China, a large size, low per-capita income country, shared most of the structural characteristics of a socialist economy at the beginning of reform in the late 1970s, though macroeconomic imbalances were less severe than in most of Eastern Europe in the late 1980s and early 1990s. In addition, the Chinese's reforms were started "from within" the existing political system and not as a consequence of the political collapse of the old regime as in Eastern Europe and the Soviet Union.

Market-oriented reform in Latin America, started in Chile in the 1970s, followed by Mexico and Bolivia in the 1980s,[1] was often initiated after macroeconomic crisis characterized by extreme inflation (except Mexico), the debt crisis and unsustainable external and fiscal imbalances. Moreover, their structures of relative prices were highly distorted, with a considerable degree of market repression (which is different from Eastern Europe, where the price mechanism was simply suppressed during the socialist period). In Latin America, the state sector represents near 25–30% of GDP. In addition, income distribution in Latin America is very unequal. That has been an important source of social conflict, economic populism and destablilizing political cycles often ending up in right-wing authoritarianism.

3. STRATEGIES OF REFORM: SHOCK TREATMENT, GRADUALISM AND MIXED PACKAGES[2]

Three views can be distinguished here regarding the intensity and sequencing of a program of market-oriented reform. One view, which can be termed as gradualist, emphasizes the fact that sharp and protracted demand restraint at macroeconomic level associated with shock treatment involves a contraction in both current and probably in future output, through its initial adverse effects on public and private capital formation.[3] A large currency depreciation may be also recessionary if the income effects of devaluation dominates its substitution (competitiveness) effects in the short run. Moreover, full price liberalization can depress real wages and consumption, cutting absorption and giving an additional recessionary bias to the program. This view also highlights the potentially destabilizing effects of rapid liberalization on macroeconomic stability[4] and the fact that overly costly programs from a social point of view may also give rise to future reversals because of the erosion of sociopolitical support to reforms that are associated with a protracted squeeze of living standards. This view calls for a more selective use of macro instruments, including incomes policy during stabilization, to support fiscal retrenchment and the use of additional foreign financing to smooth the costs of adjustment.

The other view, shock treatment or big bang, prioritizes a rapid move toward a liberalized policy regime. It often down plays the existence of inflationary rigidities in chronic-inflation countries and the adverse effects of macro restraint on capital formation and growth. This view emphasizes the positive effects of market liberalization on the productivity of investment and the alleged efficiency of growth in a liberalized economy. Moreover, "big bangers" favor shock therapy at macro level along with rapid liberalization and privatization in the context of the postsocialist transitions, as a way to alter, in a dramatic fashion, the expectations of the private sector (existing or latent) and, thus, boosting capital accumulation and growth. This view rests upon the notion that a change in policy regimes, as distinguished from specific changes in policy instruments, is the fundamental force driving private sector response to the new set of policies put in place by a program of economic reform.[5] Examples of gradualism are China, Hungary and to some extent Mexico. Shock treatment would describe better most of the Eastern European programs of the early 1990s. Finally, a third view, the mixed approach, makes the distinction between shock treatment for stabilization purposes, say to reduce extreme inflation or cope with a balance of payment crisis, and gradualism in structural reforms (e.g., liberalization and privatization) that involve trade reform, the restructuring of enterprises, banks, tax systems and building of new financial and legal institutions.[6] The mixed approach to reform admits the need for shock treatment to face a macroeconomic crisis but recognizes that structural reforms take longer than expected and require a more gradualist approach.

4. POSTSOCIALIST TRANSITIONS

In this section we shall analyze the programs of Eastern Europe in the early 1990s and the Chinese reforms started in the late 1970s, both in term of main policies implemented as well as its main outcomes and comparative performance.

(a) *Eastern Europe*

Free-market experiments of economic reform in Eastern Europe started in 1990,[7] following the political collapse of the socialist regimes. The shock treatment programs implemented in Eastern Europe since 1990 placed a strong emphasis on the simultaneous undertaking of both macroeconomic stabilization and liberalization at the outset of the programs.[8] These packages have been carried out in the context of large external shocks associated with the collapse of the CMEA trade arrangements. Moreover, these programs are applied in economies in which the previous mechanism of economic coordination (central planning) was disintegrating. At macroeconomic level the chief objectives have been in avoiding protracted price increases after an initial outburst of inflation associated with price liberalization,[9] besides correcting external and fiscal imbalances. Poland and the Balkans countries started with more imbalanced macro situation in terms of either open inflation (e.g., Poland) or a large money overhang, severe shortages and critical balance-of-payments positions (e.g., Bulgaria). In terms of stabilization strategies, Poland, Hungary and Czechoslovakia were cases of exchange rate-based stabilization while Bulgaria and Romania implemented money-based stabilization as they were short in international reserves to defend a fixed exchange rate parity.

The liberalization component in the East European programs included rapid foreign trade liberalization and the dismantling of nonprice barriers in international trade, privatization of retail trade, services and small-scale manufacturing and agriculture. Progress in massive privatization of medium to large-scale, state-owned enterprises have been relatively reduced so far; though ambitious privatization schemes in Czechoslovakia (voucher system) and in Poland (certificates scheme) are attempts to encourage further progress in this area.

Let us examine the patterns of macroeconomic response to reform in Eastern Europe. This pattern is characterized by an initial sharp acceleration in inflation following price liberalization, currency devaluation and administrative price increases. The countries with higher inflation during 1990–92 have been Poland, Bulgaria and Rumania. In fact, the rate of inflation in Poland was near 250% of inflation in 1990 declining to 70% in 1991 and then further to 45% in 1992. Inflation in Bulgaria was 460% in 1991 and 49% in 1992. Inflation in Romania was 161% in 1991 and 181% in 1992, respectively (see Table 1). In most of these countries, the price hike in general exceeded what was expected.[10] In contrast, inflationary pressures were less severe in Czechoslovakia and Hungary. In 1991 the rate of inflation (CPI) in the two countries was 59% and 37%, respectively, dropping, in 1992, to 14% in Czechoslovakia and to 21% in Hungary.

An important issue in the stabilization front is how long will it take for inflation to converge to moderate or low levels[11] after the initial price shock. Inflationary persistence was more serious in Poland, Bulgaria and Romania. In Poland, the monthly inflation rate, after the initial price hike in early 1990, remained in the order of 4.5% for more than 20 months. The average inflation rate per month in Bulgaria was around 5% for more than 12 months after the initial price shock of early 1991. Monetary accommodation, wage indexation and credibility problems seem to be part of the explanation for inflationary persistence, though more research is still needed to have a full explanation for this phenomena in the context of the post-socialist transitions. A related issue is the medium-term or "core" rate of inflation after the initial phase of stabilization is consolidated. Will inflation rates in Eastern Europe converge to OECD-levels (single-digit rates) or to approach inflation-rates of successful (non-OECD) stabilizers like Mexico, Chile, Israel, namely to annual rates of inflation on the order of 10–15%. As of 1992, only the Czech and Slovak Republics had inflation rates below 15% per year with Hungary having an inflation rate still (slightly) over 20% per annum.

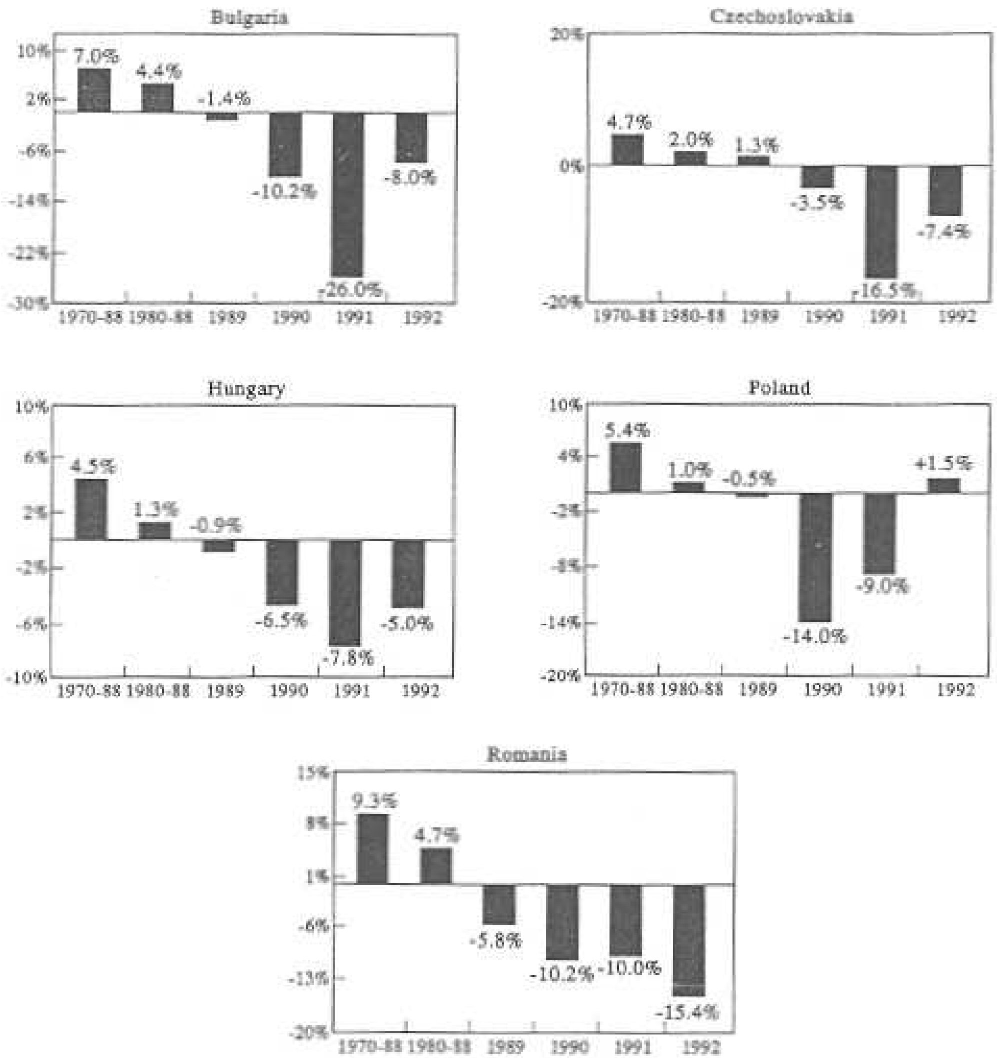
On the real side, the adjustment programs in Eastern Europe have been accompanied by unprecedent output contraction (see Table 1 and Figure 1). During 1990–92, the cumulative GDP decline was −21.5% in Poland, −44.2% in Bulgaria, −27.3% in Czechoslovakia, −19.3% in Hungary and −35.6% in Romania. These figures, in general, do not fully capture a growing private sector activity, though still they represent a worrisome trend.[12] This trend started to be reverted in Poland during 1992, the only East European economy with positive, +1.5%, GDP growth that year.

The contractionary output cycle is associated with large negative "external" shocks (collapse of CMEA market), demand restraint, supply disruption and "organizational shocks" coming from the disintegration of the old socialist regime. In a comparative perspective, the extent of the contraction in measured economic activity in Eastern Europe since 1990 is much greater than the corresponding declines in output initially observed in Chile, Mexico, Bolivia after the implementation of their stabilization and reform programs in the 1970s or 1980s (see section 4). The magnitude of the cumulative output decline taking place in Eastern Europe in 1990–92 are comparable to the output contraction in the United States in 1929–33 during the Great

Table 1. *Eastern Europe: Main economic indicators, 1989–1992*

Countries	GDP US$Bill.	Growth rates (percentage) NMP		GDP				CPI Inflation (percentage, year end)				Current Acct./GDP (Conv. Curr percentage)				Ext. Debt/GDP (Conv. Curr.) (percentage)
	1990	1970–80	1980–88	1989	1990	1991	1992	1989	1990	1991	1992	1989	1990	1991*	1992*	1990
Bulgaria	22.4	7.0	4.4	–1.4	–10.2	–26.0	–8.0	6.3	64.0	460.0	49.0	–6.4	–2.7	0.0	–0.3	40.2
Czechoslov.	46.5	4.7	2.0	1.3	–3.5	–16.4	–7.4	1.3	13.9	59.0	14.0	0.9	–1.0	–5.1	1.5	16.5
Hungary	32.1	4.5	1.3	–0.9	–6.5	–7.8	–5.0	18.0	30.0	37.0	21.0	–4.9	–0.2	1.0	2.8	62.2
Poland	62.3	5.4	1.0	–0.5	–14.0	–9.0	1.5	640.0	249.0	70.0	45.0	–2.7	–2.5	–1.2	–0.2	74.3
Romania	35.5	9.3	4.7	–5.8	–10.2	–10.0	–15.4	2.5	27.0	161.0	181.0	5.4	–3.9	–4.8	–8.3	5.6
Average	39.8	6.2	2.7	–1.5	–8.9	–13.8	–6.9	133.6	76.8	157.4	62.0	–1.5	–2.1	–2.0	–0.9	39.8

Source: World Bank and IMF.
*Cash basis.



Note: Figures for 1970–80 and 1980–88 refer to NMP growth rates.

Figure 1. *GDP growth rates in Eastern European countries.*

Depression and in Germany and Italy in 1943–44 and 1946–47 in the aftermath of World War II.[13]

Several hypothesis are proposed to explain the drop in output in the region after the adoption of the reforms. The first is that demand contraction is part of the stabilization effort. The combination of tight credit and fiscal policies as well as large drops in real wages lead to a decline of effective demand and a drop in output in Keynesian fashion.[14] The second concerns adverse supply and organizational shocks. The dismantling of central planning has involved a disruption of the traditional supply networks of inputs and capital to enterprises, thus contributing to the decline in production. In addition the sudden increase in uncertainty after the collapse of socialism on the new rules of the game also has a discouraging effect on worker effort and managerial motivation. At a macro level, another adverse supply side effect comes from a crunch in the supply of working capital.[15] The third hypothesis concerns "external" shocks associated with the disintegration of the CMEA. The elimination of the subsidies in Soviet exports to CMEA countries in the early 1990s, typically oil, coal and other forms of energy and the removal of the implicit (soviet) subsidy in imports of manufactures, amounted to a terms-of-trade shock for Eastern Europe with the ensuing adverse real income effect.[16]

The fourth hypothesis concerns too rapid trade liberalization. A rapid switching in production toward foreign goods is unlikely to take place in the short term, in spite of highly competitive exchange rates, because of potential rigidities in resource reallocation, product design and technology.[17] On the correction of external imbalances as of 1992 most of the Eastern European programs have been successful in terms of having either small current account deficits or surpluses (e.g., Czech and Slovak Republics, Hungary). Of course, the real test for external sustainability will come when the economies start growing again on sustained basis. On the fiscal side a major effect of the reforms on the fiscal budget has been a drastic decline in revenues associated with the shrinking in taxes paid by public enterprises and the fact that the growing private sector still pays very little taxes to the government.[18]

To sum-up, the initial stage of economic transition in Eastern Europe indicates that, at the macroeconomic level, adjustment may come with an acceleration in inflation (with considerable crosscountry differentials) that lasts between one and two years but is followed by a moderately slow convergence to lower inflation levels (say below 15% per year). On the real side, the postsocialist transitions in Eastern Europe have produced a massive decline in aggregate measured output and a cut in living standards. On the structural front, however, progress has been made in opening the economy to international competition and investment and in allowing the emergence of a dynamic private sector in the services and trade sectors. Nevertheless, privatization of large scale public enterprises seems to be a more difficult task. In addition, steadily increasing unemployment is a worrisome trend as the restructuring process in the state-owned enterprises has barely started.

(b) *Gradual economic reform: China*

China's reform, begun after 1978 following the death of Mao Dze Dong and the abandonment of the policies of the cultural revolution of 1966–76, provides another interesting experience of economic reform. In contrast to Eastern Europe, economic reform in China was perceived as a gradual process of increasing coexistence between markets and the state following a kind of evolutionary approach. There are several basic differences between the Chinese and East European experiences. First, in China, the process of economic reform was propelled "from within" the socialist regime. It was the leadership of the communist party that became convinced that moving away from central planning was needed in order to accelerate economic growth and improve the standards of living of the population. Unlike Eastern Europe, economic reform in China was not the natural corollary of a political crises of the whole socialist system. Second, the economic reform process in China was not openly envisaged as the replacement of the socialist economic model by a market economy based in private property. Socialism was never officially dismissed in China and public property has not been officially challenged. Third, economic reform was perceived as a gradual process taking place in a framework of considerable price stability and macroeconomic balance; this consideration apparently, had preeminence over rapid liberalization. Fourth, the structural characteristics of the Chinese economy at the starting of the reform process makes it very different from those of Eastern Europe. China is a large economy with a population above one billion, with a large agricultural sector and belongs to the group of countries with a presumably low level of per-capita income.[19]

The program of economic reform started in 1978 with the deregulation of the agricultural sector (the "household responsibility system").[20] This implied an increase in agricultural procurement prices paid by the state, allowing farmers to sell their production surpluses in free markets after delivering a predetermined quota to the state. In addition, they were allowed to retain profits. This led to flourishing agricultural activity and the growth of small-scale enterprises in rural markets and townships. Starting in 1984, an "enterprise responsibility system" was established for state enterprises in the industrial sector. The system comprised a dual or two-tier price scheme. As in agriculture, state-owned enterprises were allowed to sell at market-determined prices the excess of output over the quota delivered to the state agency.[21] In 1986, the system of compulsory remittance of profits to the central government was abolished and a corporate income tax of 55% was instituted. The rationale was to accept the profit motive in the behavior of public enterprises in order to promote efficiency and decentralization. As of 1991, around 50% of prices were determined in unregulated markets (Schmidt-Hebel and Xu, 1991). In other front, "special economic zones" were created, mostly in the south of the country near to other East Asian markets. In these "special economic zones," particularly in the Guangdon and Fujian province, direct foreign investment, oriented to export processing, receives special treatment for profit remittances and tax obligations. The basic aim of those special zones is to attract foreign investment and expose segments of the economy to foreign competition and new technologies and markets.[22]

In contrast with other experiences of economic reform, the Chinese process has evolved in a context of relative macroeconomic stability, albeit punctuated by periods of inflationary acceleration following price reforms. In particular, inflationary outbursts took place in 1980–81, 1985–87, and 1988–89. The most serious acceleration of inflation was in 1988–89 when the retail price index rose to near 20% on an annual basis (see Figure 2). Inflationary pressures were, in part, compressed: subsidies for consumer agricultural goods increased from 0.3% of GDP in 1978 to around 4.0% in 1984. In 1991 the price subsidies on consumer goods still represented around 1.5% of GNP (Schmidt-Hebbel and Xu, 1991). At macro level, the policy response to outbursts of inflation observed after the periods of price reform have been one of tightening credit policy and restraining wage increases in state owned enterprises. In general, the Chinese government seems to have a genuine distaste for inflation.[23] Table 2 shows that the fiscal deficit (central government) has been maintained at a relatively modest level throughout the reform period, say around 2.0% of GDP during 1978–92. Moreover, it is interesting to note that fiscal deficits tended to widen during the years of price reform. In particular, the share of subsidies on operating losses of state-owned enterprises increased after 1986, as the enterprises sector moved toward greater decentralization and away from forced profit remittances; in fact the share of subsidies to state-owned enterprises went up from 1.3% of GNP in 1978–85 to 3.5% of GNP, on average during 1986–91 (Schmidt-Hebbel and Xu, 1991). Finally, on the external sector China enjoyed a relatively comfortable position during the reform process with considerable levels of international reserves (as share of imports) and with moderate, though increasing, levels of external debt (Table 2).

The response of the Chinese economy to the reforms started in the late 1970s was impressive, in terms of output growth (see Table 2 and Figure 3). Average GDP was growing at 9.0% per year during 1978–92. In contrast, the rate of growth of national income during 1970–77 before reform was 4.6% (Hussain and Stern, 1991). During 1978–92 GDP per capita grew 7.3% per year with a similar trend in per-capita consumption; clearly the standards of living of the population increased drastically over the reform period; though they are still at a low level, as proxy by the level of income per capita.

Figure 2. *Annual inflation rates in China, percent.*

To summarize, the Chinese reform process has been gradual, conservative in macroeconomic terms and apparently it has preserved the gains in social welfare and distribution achieved in the pre-reform period (see Perkins, 1988). In contrast with the recent experience of Eastern Europe, the economic reforms in China have taken place without serious macroeconomic dislocation. Nevertheless, the reforms are still partial: near half of the economy still operates under controlled prices, and national wealth is almost completely in the hands of the state. Clearly, China is still far from being a capitalist country.

5. *POSTDIRIGISTE* TRANSITIONS: LATIN AMERICA

The experience with market-oriented reform in Latin America in the last one or two decades can teach some useful (good and bad) lessons for the postsocialist transitions in Eastern Europe and elsewhere, in spite of some basic structural differences between the two regions. The initial macroeconomic conditions of economic reform in countries such as Mexico, Chile, Bolivia and others in the 1970s and/or 1980s or early 1990s were characterized by severe macroeconomic crisis.[24] In this sense, conditions not entirely different from that of some Eastern European countries at the start of the reform programs, e.g., Poland.

The experience with stabilization in Chile and Mexico and, to a less extent, Bolivia shows that reducing and stabilizing inflation is a costly and often lengthy process. In Mexico and Chile, it took between 6–7 years from the beginning of the program of stabilization, to reduce three-digit inflation to levels of 15–20% per annum (see Tables 3 and 4). In Chile the rate of inflation was over 600% in 1974 converging to levels below 15–20% per year just after 1981 in spite of stiff stabilization measures. In Mexico the rate of inflation was near 100% in 1982 reaching the critical range of 15–20% per year just in 1989. The speed of stabilization in Bolivia was faster than in Chile and Mexico (it took around two years to get to 15–20% annual), though Bolivia had an hyperinflation in 1984–85. In fact, the international evidence shows that the stabilization of an hyperinflation is often more rapid than the stabilization of chronic inflation.[25]

Stabilization and adjustment in the three countries came along with initial output contraction though the degree of the output decline varied in each case: GDP fell by 12–15% points in the recessions of 1975 and 1982–83 in Chile; output contracted (cumulatively) by near 5% in Mexico in 1982–83 and in Bolivia it fell by 2.5% in 1986.

Table 2. *China — Main economic indicators, 1978–1992.*

	(1) GDP (annual growth rate, percentage)		(2)	(3) Inflation rate		(4)	(5)	(6)
	(a) Total	(b) Per capita	Agriculture output (annual growth rate percentage)	(a) GDP deflator (percentage)	(b) Retail price index (percentage)	Budget deficit (percentage of GDP)	Internation reserves (months of imports)	External debt (percentage of GDP)
1971–77	4.6*		1.6		0.4			
1978	12.3		3.4		0.7	-0.3	4.9	0.3
1979	7.2	5.8	6.4	3.6	2.0	5.2	6.7	0.9
1980	7.9	6.6	-1.8	4.0	6.0	3.3	6.1	1.5
1981	4.5	3.2	7.1	2.2	2.4	1.3	5.5	2.1
1982	8.7	7.1	11.7	0.1	1.9	1.4	10.7	3.1
1983	10.1	8.7	8.5	1.4	1.5	1.7	11.1	3.3
1984	14.5	13.2	13.0	4.6	2.8	1.6	9.3	4.0
1985	13.0	11.7	1.7	9.1	8.8	0.5	4.8	5.7
1986	8.4	7.1	3.7	4.6	6.0	1.9	4.6	8.5
1987	11.2	9.9	4.8	5.0	7.3	2.0	6.2	11.6
1988	10.8	9.5	3.2	11.5	18.5	2.6	5.2	11.3
1989	3.9	2.6	3.3	9.0	17.8	2.3	4.6	10.0
1990	4.5	3.1	7.5	4.9	2.1	2.1	8.6	14.4
1991	7.7	6.5	3.0	—	2.7	2.5	10.6	15.3
1992	12.0	10.8	3.0	—	5.3	2.3	9.1	14.6
Average: 1978–92	9.1	7.6†	5.2	5.0‡	5.7	2.0	7.2	7.1

Source: World Bank, Schmidt-Hebbel and Xu (1991).
*Net national income. Hussain and Stern (1991).
†1979–92.
‡1979–90.

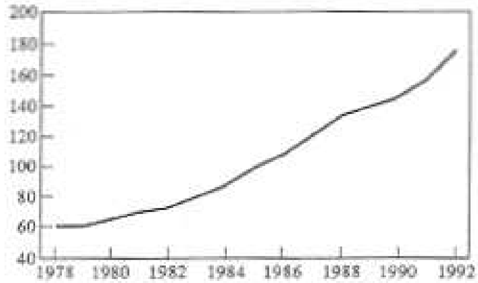


Figure 3. *Real GDP in China, 1985 = 100.*

In all these episodes, these economies also suffered negative external shocks so part of the output decline has to be attributed to external disturbances and not only to domestic policies.

Regarding investment, the experience of Chile since the mid-1970s and Mexico in the 1980s is that public investment tends to suffer in the initial phases of an adjustment program. In Chile, during 1976–84 public investment was around three to four percentage points of GDP below its level of the 1960s. In Mexico, public investment declined by nearly five percentage points of GDP during 1982–89 as compared to 1978–81. In contrast, public investment started to recover in Bolivia after the program of 1985. The response of private investment to the reform process in the three countries was mixed.[26] In Chile, private investment increased strongly in the second half of the seventies, to drop sharply during the recession of 1982–83 and recover a few years later. In Mexico, private investment declined during 1981–83, then it remained virtually stagnant until 1987, recovering afterward. In Bolivia, private investment fell before the program, in the first half of the 1980s; the adjustment program of 1985 stopped the decline in investment though it remained quite depressed afterward (see Table 4).[27]

To sum up, the review of three Latin American experiences with market-based economic reform in the 1970s and 1980s shows that reforming distressed economies is a long process. Putting the "house in order" in macroeconomic terms is not easy. In the cases reviewed, stabilizing inflation took longer than anticipated and involved considerable short-term costs in terms of real economic activity and real wages. Moreover, the transition to sustainable growth in the aftermath of stabilization is cumbersome. Public investment tends to suffer in the initial phases of an adjustment program and the recovery of private investment after a large initial contraction may take several years to come as building up credibility on the new reforms and overcoming coordination failures by decentralized markets are rather parsimonious processes.

Table 3. *Economic indicators — reforming economies in Latin America: Chile, Mexico, Bolivia (annual averages, percentage)*

			GDP	Growth rate of Exports	Growth rate of Real wages	Inflation rate (CPI)	Investment (ratio of GDP)	Terms of trade (1980=100)
Chile	Prereform Period	1960–70	4.3	3.6	6.0	25.7	20.6	165.1
		1971–73	0.7	−3.8	−8.7	296.0	14.7	175.3
	Reform Period	1974–81	3.9	14.4	10.0	163.9	17.2	121.5
		1982–85	−1.5	4.8	−4.4	19.0	10.5	82.4
		1986–92	6.7	11.1	3.2	18.2	16.9*	86.3
		1974–92	3.8	11.8	3.8	80.2	15.7*	100.3
Mexico	Prereform Period	1970–81	6.8	7.7	0.9	16.8	22.1	105.9
	Reform Period	1982–85	0.4	9.2	−7.0	71.0	16.8	99.4
		1986–92	1.8	3.7	2.7	60.2	17.5*	68.3
		1982–92	1.3	5.6	−1.3	64.0	16.9*	79.6
Bolivia	Prereform Period	1970–81	3.5	−0.9	1.0	19.6	14.4	76.2
		1982–85	−2.5	2.2	−3.3	3358.3	7.2	87.9
	Reform Period	1986–87	0.0	1.3	−7.3	38.4	5.1	56.0
		1988–92	3.1	1.7	9.5†	14.6	6.2*	55.6
		1986–92	2.1	3.7	—	24.8	6.5*	55.8

Source: World Bank, ECLA (1990, 1992).

*Real investment figures are available only up to 1991.

†This figure refers to the 1988–90 period and is not directly comparable to previous years.

Table 4. *Indicators of speed of adjustment in reforming economies in Latin America (Chile, Mexico, Bolivia)*

	No. of years for inflation to reach the threshold of 15–20% per year	No. of years for private investment to recover to sustained levels (more than three years of consecutive expansion)
Chile* 1974–92	7 years	5 years
Mexico 1982–92	7 years	6 years
Bolivia 1985–92	2 years	—

*Counting from the stabilization plan of 1975

6. SOCIAL COSTS OF ADJUSTMENT AND POLITICAL ECONOMY CONSIDERATIONS

An important dimension of the process of system transformation relates to the social costs of adjustment and the political economy of reform. In Eastern Europe after 1989 real wages have declined substantially, 30% or so on average, and unemployment is growing, over 10%, in some countries of the region (e.g., Hungary, Poland, Bulgaria), following the implementation of adjustment measures. The rise of unemployment in economies in which full employment was an entitlement, is bringing a sense of economic insecurity and anxiety, new for people raised under socialism. In addition, the Darwinian-Schumpeterian process of economic differentiation under capitalism is bound to increase (through fair and unfair mechanisms) the degree of economic inequality in these societies. In contrast, economic reform in China came along with a steady growth in real wages and living standards.

Economic reform in Latin America also entailed considerable social costs. Chile had high open unemployment during 1975–88 and in Mexico the average real wage in 1990 was near 30% below its level of 1980. These costs were partly ameliorated by social policies focusing more in targeting and protection of vulnerable groups than in across the board subsidies.[28]

The political economy of reforms has several dimensions; one issue is the sequencing between economic and political reform. In the case of Eastern Europe after 1989, the case was that the implementation of market oriented reform was made possible by the political (and economic) collapse of the socialist regime. In contrast, China's government chose to undertake the economic reforms first. In the Latin American context, Chile carried out most of the reforms under authoritarian conditions (Pinochet), though the first democratic government elected in 1990 ratified the existing ecnomic model implemented, harshly, by the military before. At another level, the choice between shock treatment and gradualism is largely dependent upon the political feasibility of each strategy. Shock treatment is probably more likely to be adopted in a situation of economic crisis when there is ample social support for strong economic measures to address the crisis. In contrast, gradualism is more likely to be adopted when the economic conditions have not deteriorated severely and the political support for radical action is unclear. In turn, the medium-term sustainability of any reform program hinges upon the ability of the reformed economy to deliver improvement in living standards for at least some part of the population without being blocked for those affected by the reforms. In general, however, overly costly programs are unlikely to have political and social support for very long.

7. FINAL REMARKS

This paper reviewed the main features of the postsocialist transitions in a comparative perspective. Three years of experience with shock treatment in East-Central Europe is showing that the postsocialist transitions are coming with substantial macroeconomic dislocation: inflation, massive output contraction in the socialized sector, drop in fiscal revenues, decline in real wages and growing unemployment are all elements of the initial phase of the transition. On the positive side, however, inflation is declining in most of Eastern Europe and current account deficits have been reduced substantially (on a cash basis). In general, the joint cycles of sharp price increases followed by slow disinflation and a deep and protracted contraction in aggregate (measured) economic activity are the most complicated features, at the macro level, of the postsocialist transitions in Eastern Europe. These elements have to be considered for the design of programs in other (still) unreformed socialist countries (e.g., Cuba, North Korea).

In the field of structural reforms considerable progress in the first three years of reform has been made in opening the economy to foreign competition and allowing the emergence of a growing private sector in the retail trade and services sectors; however, the privatization of large scale state-owned enterprises has been a slow and difficult process. In addition, these transition are taking place in a context of political fragmentation with volatile social support for economic reform.

China constitutes a different path for economic transformation in socialist countries. The Chinese process has taken place in the context of the existing political regime following a gradual move toward market-oriented reform based in selective deregulation of agriculture and industry in the context of dual prices, in the opening foreign trade and investment, all this while avoiding large macroeconomic dislocation. The response of the Chinese economy to the new incentives was spectacular: GDP grew at an average rate of 9% per annum during 1978–92 with an annual rate of increase in per-capita consumption on the order of 7% over the same period. Of course, in the case of China the question is whether economic reform is oriented to construct capitalism given the conspicuous absence of private property rights in the reform agenda.

The experience with market-based reforms in Latin America during the 1970s and 1980s offers some important lessons for the postsocialist transitions. In particular, they show that in economies hit by large external shocks and where initial imbalances are large, macroeconomic stabilization and adjustment is a protracted process. In Chile and Mexico it took roughly seven years to reduce three-digit inflation levels down to 15–20% per year. In addition, initial output contraction was severe followed by a slow resumption of capital formation and growth.

Finally, economic and political reform are interdependent processes: on the one hand, the consolidation of market-based economic reform requires solid and stable political institutions that can produce working majorities in favor of economic transformation; on the other, the consolidation of new democracies in formerly authoritarian states requires economic reform to succeed and bring about an improvement in living standards for the population at large that legitimize the emerging democracies and market economies. Political destabilization and/or economic failure are the main threat to successful systemic transformation after socialism.

NOTES

1. Argentina, since 1991, has followed a very ambitious program of liberalization and privatization. On the macro front, stabilization is pursued, chiefly, by a fixed exchange rate regime.

2. This and the next subsection are partly based on Solimano (1993).

3. See Servén and Solimano (1993).

4. For example, a cut in tariffs may involve a reduction in fiscal revenues hampering an already flimsy fiscal budget position.

5. An influential paper along these lines, in the context of stabilization programs, is Sargent (1982).

6. See Bruno (1992).

7. Attempts at partial economic reform are much older in Eastern Europe. Hungary started, with setbacks, a program of economic decentralization and gradual "marketization" in 1968. Poland and Yugoslavia also tried reforms in the early 1980s though those programs were seen as reforms within the existing economic system rather than as reforms to replace the socialist regime for a market economy.

8. Overviews of the programs in Eastern Europe appear in Bruno (1992) and Solimano (1993). For recent literature on the Polish case see Lipton and Sachs (1990), Berg and Sachs (1992), Calvo and Coricelli (1992). Dervis and Condon (1992) discuss the Hungarian case and Demekas and Khan (1991) discuss the Romania case and Solimano (1991) the case of Bulgaria.

9. The initial price shock was 77.3% in Poland in January 1990, 110.1% in Bulgaria in February and 46.7 % in March 1991; in Romania there was a succession of price shocks: 23.4% in November 1990, 14.9% in January 1991, 26.5% in April 1991; see Solimano (1993).

10. See Bruno (1992).

11. See Dornbusch and Fischer (1993) for an analysis of different experiences on transition to "moderate inflation" in market economies.

12. Part of the decline in output also corresponds to the decline in the production of "soft goods" without demand in a more competitive economy.

13. See Maddison (1991), Appendix A.

14. Berg and Sachs (1992) argue that demand contraction, in the context of the stabilization program, has been the main cause behind the drop in GDP in Poland in 1990–91.

15. See Calvo and Coricelli (1992) for the credit-crunch hypothesis.

16. Rodrik (1992) provides estimates of the impact of these external shocks on Eastern Europe.

17. See McKinnon (1991) for an argument in favor of gradualism in trade reform in postsocialist transitions.
18. See Tanzi (1993).

19. The *World Development Report* of the World Bank puts the GDP per capita of China in US$350 in 1989. Calculations using PPP exchange rates, however, give a GDP per capita of US$1,500–2,000 for China. See Gelb, Jefferson and Singh (1993).

20. Good references on the Chinese experience with economic reform are: Perkins (1988, 1993), Blejer, Dunaway and Szapary (1991), Hussain and Stern (1991), Schmidt-Hebbel and Xu (1991).

21. See Schmidt-Hebbel and Xu (1991).

22. See Perkins (1993).

23. This may have historical roots as China experienced a virulent hyperinflation in the 1940s before the revolution.

24. See Meller (1993) for a recent analysis of reform experiences in Latin America. Corbo and Solimano (1991) discuss the Chilean experience, Ortiz (1991) the Mexican one, and Morales (1991) the case of Bolivia.

25. See Solimano (1990), Kiguel and Liviatan (1992). A chief explanation behind this empirical observation is that hyperinflation destroys the existing contract structure and makes price and wage inertia almost disappear; factors that tend to make inflation an inertial or "chronic" phenomenon.

26. A detailed analysis of the cycle of private investment in adjustment programs in Latin America appears in Solimano (1992).

27. In Bolivia, however, an important part of the economy (the most dynamic one?) is not measured. This may also affect the measurement of investment.

28. See Meller (1991) and Lustig (1992) for an analysis of the social costs of adjustment policies in Chile and Mexico during the 1980s.

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