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The Macroeconomics of Transition: The Comparative Experience of Seven Transition Economies

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Introduction

This paper reviews the macroeconomic and adjustment policies of seven countries in transition from centrally planned to regulated, market-based economies. The review is based on UNDP-supported studies of economic policies and poverty reduction in Armenia, Cambodia, China, Kyrgyz Republic, Mongolia, Uzbekistan and Vietnam[1]. Based on comparing these countries' experience, the review seeks to draw some general policy lessons for national policymakers on the macroeconomic and adjustment policies that are best suited to foster growth, employment and poverty reduction under conditions of transition.

The seven countries can be grouped according to their differing economic strategies for managing the transition—strategies that have involved distinctive combinations of macroeconomic and adjustment policies. Three of the countries—Armenia, Kyrgyz Republic and Mongolia—have followed a "Shock Therapy" model of transition, which has involved a rapid opening to the global economy, liberalization of the domestic economy, privatisation of state-owned enterprises and downsizing of the state, combined with generally restrictive fiscal and monetary policies. Their results have been generally negative.

Although like the other three countries in facing adverse supply shocks from the collapse of the Soviet bloc, Uzbekistan has followed a more state-led, gradual, inward-looking strategy. Trade liberalization and financial liberalization have been limited while many state-owned enterprises have been only nominally privatised. The state has used fiscal and monetary policies in a pro-active way to stimulate growth or counteract downturns. Compared to the three countries that have adopted "Shock Therapy", Uzbekistan has done moderately well.

Cambodia has also done moderately well, but with a more open-economy, rapid-liberalization approach that has simulated some of the features of the Chinese and Vietnamese strategies (as well as the earlier strategies of other East Asian economies). However, Cambodia's rapid opening to the global economy has made it heavily dependent on external demand and its rapid liberalization of the domestic economy has undercut the ability of the state to effectively manage the transition. Since the Cambodian economy is largely dollarized and the Government is unable to borrow domestically, national policymakers have only modest control over monetary and fiscal policies.

China and Vietnam have implemented the most successful transition strategies of the seven countries that this paper reviews (see Table 1). They have both been outward oriented but more cautious and gradual in their opening to global market forces than Armenia, Kyrgyz Republic, Mongolia and Cambodia. Also, in both China and Vietnam, the state has continued to play a much more central role in guiding the transition process than in almost all the other countries, with the exception of Uzbekistan. Policymakers have also been more pro-active in using macroeconomic policies, including exchange-rate policies, to advance the country's development goals of sustaining rapid economic growth and substantially reducing poverty while undergoing profound structural change.

[1] See the references for the seven studies, which were drafted between 2001 and 2003.

Table 1: Economic Performance

Countries	Annual GDP Growth Rate (1990-2001)	GDP Implicit Deflator % Annual Growth (1990-2001)	Industry as a Share of GDP 2001 (1990 in parentheses)	Gross Domestic Savings as a % of GDP 2001 (1990 in parentheses)	Gross Capital Formation as a % of GDP 2001 (1990 in parentheses)
Armenia	-0.7	172.0	34(52)	-2(36)	19(47)
Cambodia	5.0	21.7	22(11)	10(2)	18(8)
China	10.0	6.2	51(42)	40(38)	38(35)
Kyrgyz Rep.	-2.9	95.2	27(36)	16(4)	16(24)
Mongolia	1.2	51.4	17(30)	14(9)	30(38)
Uzbekistan	0.4	210.7	23(33)	20(13)	19(32)
Vietnam	7.7	13.8	38(23)	29(13)	31(13)

Source: World Bank, World Development Indicators, 2003

In the following section, this paper provides a broad review of the macroeconomic and adjustment policies that the seven countries have adopted, and in the final section the paper seeks to draw out some general policy lessons for transition strategies.

A Shock-Therapy Transition Strategy

Most of the policy lessons on macroeconomic and adjustment policies for the three countries following a "Shock Therapy" approach are negative. They were all counselled to privatise and liberalize their trade and financial regimes as rapidly as possible. They were also advised to substantially downsize their state apparatus and follow restrictive fiscal and monetary policies.

The disruption of economic relations with the Soviet Union immediately subjected Armenia, Kyrgyz Republic and Mongolia to large adverse supply shocks. Output collapsed and prices skyrocketed. Compounding the supply shocks were the demand shocks triggered by restrictive fiscal and monetary policies, which caused output to collapse further. In Armenia, for example, the cumulative decline in GDP from 1989 to 1993 was 60 per cent. By 1994, inflation had zoomed to almost 5,300 per cent. None of these countries used macroeconomic policies in a counter-cyclical fashion to arrest economic decline.

As recovery began in these countries in the mid 1990s, they continued with tight monetary policies. Price stability had become a goal in itself even though economic growth remained slow. By 1999, for instance, the rate of change in the Consumer Price Index in Armenia had slowed to a negative rate of 0.8 per cent. As in many other countries following tight monetary policies, deflation began to emerge as a threat to stability.

Fiscal policies remained restrictive in these countries, principally because of the substantial downsizing of the government budget. In Mongolia, for example, the level of government expenditures dropped by two thirds between 1989 and 1995 before recovering, but it was still only about half its 1989 level in 1999. Most importantly, public investment plummeted in these countries. Even as a percentage of total government expenditures, capital expenditures declined. In Armenia, for example, public investment declined from 21.5 per cent of the total in 1994 to 14.4 per cent in 2001.

Table 2
Trends in Investment and Savings in Armenia

Year	Gross Investment Ratio (% of GDP)	Gross Savings Ratio* (% of GDP)
1990	47.1	35.8
1994	23.5	-10.4
1996	20.0	-12.7
1998	19.0	-14.7
2000	19.1	-8.3

Source: Griffin, 2002.

* Gross investment minus net exports.

Public investment was not used as a stimulus to private investment—on the mistaken assumption that the two would compete for scarce loanable funds. As a result, gross capital formation sank in Armenia from 47 per cent of GDP in 1990 to only 19 per cent in 2001 (Table 2). This ratio also declined substantially in Kyrgyz Republic and Mongolia. Even though output declined by only 22 per cent in Mongolia between 1989 and 1993 and began to recover thereafter, the country's level of gross domestic investment in 2000 was still only about half its 1989 level. Thus, there was a weak foundation for accelerating and sustaining further economic growth.

Domestic savings collapsed along with domestic investment in these countries. Real rates of interest increased and the spread between saving and lending rates of interest widened. The spread between the two rates reached, for example, almost 25 percentage points in Kyrgyz Republic in 2001. The worst savings record has been in Armenia, where savings was a disastrous negative eight per cent of GDP in 2000 after dropping to a negative 14 per cent 1998 (Table 2). Financial liberalization was a debacle in all three countries. Banks were reluctant to lend for investment purposes and retreated from rural areas, where profits were uncertain. Consequently, investment stagnated and inequality in access to credit increased.

With the collapse of savings in these countries, there was no sustainable basis for an investment-led growth strategy. Consequently, recovery was slow and uncertain. In order to boost investment, these countries became more dependent on the inflow of external capital and increased their external debts. In Kyrgyz Republic, for example, the present value of is external debt rose to 91 per cent of Gross National Income in 2001. In Mongolia, Official Development Assistance accounted for about one quarter of GDP throughout the 1990s, making it one of the most aid-dependent countries in the world.

Partly due to rapid privatisation and trade liberalization, all three countries experienced radical de-industrialization. In Mongolia, for example, industry as a share of GDP dropped from 30 per cent in 1990 to 17 per cent in 2001. Workers fled to agriculture (i.e., herding), which increased its share of total employment from 32 per cent in 1989 to 49 per cent in 1998. Development was being thrown into reverse.

Table 3

Growth in Real GDP and Employment in The Kyrgyz Republic
(Cumulative percentage change between 1996 and 2000)

Sector	Real GDP	Employment
Agriculture	29.9	21.0
Manufacturing & Mining	49.2	-19.5
Construction	-25.5	-22.3
Transport	13.3	-27.6
Communication	10.6	-5.8
Trade, Hotels, Restaurants	36.5	21.3
Other Services	0.4	-2.7
Total Economy	22.2	7.0

Source: Reynolds 2002

These countries also dramatically opened their economies. For example, Kyrgyz Republic rapidly liberalized its trade regime, slashing average tariffs and quantitative restrictions, and boosted the share of exports in its GDP. But liberalization without export promotion has left its economy increasingly vulnerable. Its export base remains narrow and undiversified. In 2000, for example, gold accounted for 38 per cent of all exports. Instead of increasing exports, farmers have opted for producing mainly import substitutes, such as wheat. Also, the country's industrial enterprises have been unable to compete effectively with rising imports.

Along with de-industrialization in these countries, underemployment has spread and real wages have dropped. In all three, the privatisation of industrial enterprises has exacerbated unemployment; and the lack of investment opportunities has hindered the growth of small and medium enterprises. Even as these economies recovered, employment continued to stagnate. In the Kyrgyz Republic, for instance, real GDP increased by 22 per cent between 1996 and 2000 but employment increased by only seven per cent (Table 3). Moreover, employment increases were concentrated in low-paid agriculture and services, not in industry, construction or transport.

In all three countries, inequality increased to markedly high levels, even during the recovery period of the late 1990s (Table 4). By 1999, for instance, the Gini index of the distribution of income per person in the Kyrgyz Republic had risen to 47 and in Armenia it had shot up to 59—one of the highest levels of inequality in the world. While land reform in Armenia and Kyrgyz Republic helped to contain inequality in the distribution of wealth, the privatisation of industrial enterprises worsened it. In countries, such as Armenia and Kyrgyz Republic, where land is equitably distributed, current proposals to consolidate agricultural land in the hands of a small group of private farmers could have a devastating impact on poverty, which already affects a sizeable proportion of the population (Table 4).

Table 4: Poverty and Inequality

Countries	Share of Population that is Poor, By National Poverty Line, (Earliest Year)	Share of Population that is Poor, By National Poverty Line, (Latest Year)	Share of Population that is Poor, US$ 1 a day International Poverty Line (year in parentheses)	Gini Index of Expenditures (year in parentheses)	Gini Index of Income (year in parentheses)
Armenia	55(1996)*	51(2001)*	12.8(1998)	37.9(1998)	59.3(1999)**
Cambodia	39(1993/4)	36(1997)	--	40.4(1997)	--
China	6.0(1996)	4.6(1998)	16.1(2000)	40.3(1998)	38.2(1988)** 45.2(1995)**
Kyrgyz Rep.	44(1996)	48(2001)*	--	37(1999)*	47(1999)**
Mongolia	36.3(1995)	35.6(1998)*	13.9(1995)	44.0(1998)	--
Uzbekistan	23(1997)*	16(2001)*	19.1(2000)	26.8(2000)	31(1995)** 39(2000)**
Vietnam	51(1993)	37(1998)*	17.7(1998)	36.1(1998)	--

Source: World Bank, World Development Indicators, 2003.
* 1996-2001 estimates for Armenia, 1996-2001 estimates for Kyrgyz Republic, 1998 estimate for Mongolia, 1997-2001estimates for Uzbekistan and 1998 estimate for Vietnam are from the UNDP-supported case studies. Gini index for expenditures for 1999 is also from the UNDP-supported case study.
** Gini index for income for Kyrgyz Republic from World Bank 2000; Gini indices for income for Armenia, China and Uzbekistan are from UNDP-supported case studies.

The privatisation of housing benefited the urban population in these countries but not the population at large. In Mongolia, for instance, it increased inequality by excluding the rural population and informal urban population living in *gers*. At the same time, contrary to expectations, privatisation of the herding stock served mainly to increase polarization in the countryside.

Not surprisingly, slow growth and rising inequality during the stage of recovery in these countries led to slow reductions in poverty. In the Kyrgyz Republic these factors led to a rise in poverty. The proportion of the population in poverty rose from 44 per cent in 1996 to 48 per cent in 2001. During the Soviet period, by contrast, dire poverty was rare in these countries as growth remained stable (although slowing), inequality was moderate and social benefits were widespread and guaranteed.

In all three countries, macroeconomic policies, such as fiscal and monetary policies, have slowed growth, not stimulated it. The rapid and indiscriminate implementation of adjustment policies, such as privatisation, financial liberalization and trade liberalization, has disorganized and weakened their economies, leaving a shrunken industrial base, lower real wages and more extensive unemployment and underemployment. High inequality and persistently widespread poverty have been the result.

A Gradual, State-Managed Transition Strategy

Subjected to similar shocks as Armenia, Kyrgyz Republic and Mongolia, Uzbekistan opted for a markedly different strategy of transition. Of course, it has a larger population and its domestic economy can generate much of its own aggregate demand. Nonetheless, it has demonstrated, in practice, that the CIS countries could have adopted a feasible alternative to shock therapy.

Protection of the domestic market and a moderate process of liberalization prevented the Uzbek population from suffering from a sizable drop in income and government benefits. Between 1992 and 1995, the Uzbek economy contracted by only 18 per cent and between 1996 and 2001 it expanded by over one quarter. In 2001, it was the first CIS country to regain its 1989 level of income (Table 5). By most measures, Uzbekistan's heterodox set of macroeconomic and adjustment policies has been superior to the standard shock-therapy package.

Table 5

Real GDP in 2001 (Percentage of 1989 Level)

Country	Percentage of 1989 GDP
Armenia	69
Azerbaijan	57
Georgia	36
Kazakhstan	78
Kyrgyz Republic	69
Moldova	35
Russia	62
Tajikistan	52
Turkmenistan	84
Ukraine	44
Uzbekistan	103

Source: Cornia 2003

Unlike many other transition economies, Uzbekistan achieved macroeconomic stabilization without inducing a depression. Government deficits have averaged about three per cent of GDP after 1996. Because of the government's ability to collect enough taxes, its share of expenditures was maintained at about 30 per cent of GDP in the late 1990s (Table 6). Maintaining adequate tax revenue is a major explanation of Uzbekistan's success and demarcates its experience from that of most other transition economies. Also, after 1997, it has been able to maintain its current account balance close to zero. Concomitantly, its domestic savings has been approximately equal to domestic investment.

Uzbekistan's record on inflation has been less impressive, however. Since 1997, its inflation rate has averaged about 25 per cent. Price liberalization has been introduced only gradually. Consequently, the real rate of interest has often been negative, leading to an excess demand for credit, and its quasi-fixed exchange rate has appreciated, leading to adverse pressure on the trade balance. When this pressure has become excessive, policies have been instituted to compress imports instead of devaluing the currency.

Table 6

Government Expenditure, Revenue and Budget Balance in Uzbekistan (Percentage of GDP)

	1991	1993	1995	1997	1999	2001
Expenditures	52.7	46.4	38.7	32.5	32.0	31.7
Revenue	49.1	36.0	34.6	30.1	29.2	30.7
Budget Balance	-3.6	-10.4	-4.1	-2.4	-2.8	-1.0

Source: Cornia 2003.

While Uzbekistan began moving toward more orthodox policies in 1994-1995, it quickly abandoned such reforms when it confronted a fall in the world market price of its main export, cotton. In order to counter-act the drop in foreign exchange, Uzbekistan began implementing more expansionary fiscal and monetary policies—accelerating the rate of growth of the money supply, lowering the real rate of interest (to a negative rate) and increasing its budget deficit to seven per cent of GDP. After 1997, however, policymakers eased off the pedal and the budget deficit fell eventually to one per cent of GDP by 2001 (Table 6). Uzbekistan's policy stance contrasts to that of many other transition economies, which refrained from using counter-cyclical macroeconomic policies—or had placed themselves in such a difficult situation that they were unable to use them.

During the downturn, policymakers also introduced a multiple exchange rate system and tightened controls on trade, maintaining tariff and non-tariff protection of strategic sectors. All along, Uzbekistan has not favoured rapid trade liberalization. Instead, it has implemented import-substitution policies, with significant success early in the transition. By 1995, it had achieved self-sufficiency in oil and substantially substituted the import of wheat with domestic output. At the same time, it diversified its agricultural exports through promoting the export of fruits and vegetables. However, it remains heavily reliant on the export of natural resources, such as gas, oil, gold and cotton.

Uzbekistan has also proceeded slowly in the privatisation of large industrial enterprises. Although many such enterprises are now nominally part of the 'nonstate' sector, the state continues to exercise decisive influence over their decision-making (as well as over cotton and grain production). There has been only modest financial liberalization. The state exercises control over major investment decisions by directing cheap credit to particular sectors through the Central Bank. In this way, it has channelled substantial resources to the fuel and energy complex and infrastructure in the transport and communication sector. Domestic investment has been maintained at credible levels. Foreign direct investment has played only a minor role in the economy.

Although its gross domestic investment is close to 20 per cent of GDP, Uzbekistan needs to raise this share by 3-5 percentage points in order to accelerate its rate of economic growth to 5.5-6.0 per cent per year. This would be well above its current modest rate of four per cent, which is unable to generate enough employment. Currently, the driving force of growth is consumption, not investment. During 1996-2001, for example, consumption grew at 7.5 per cent while investment grew at only 2.4 per cent. However, such consumption-based growth is not sustainable.

The rate of growth of employment is slow, not only because economic growth is too low but also because its character is not employment-intensive. Large capital-intensive enterprises continue to absorb the lion's share of investible resources. Small and medium enterprises, which are more dynamic and labour-intensive, do not have adequate access to credit.

While inequality is not yet high, by international standards, it began to rise in the late 1990s: the Gini index of the distribution of gross income per person rose from 31 in 1995 to 39 in 2000. Part of the reason is that agriculture continues to be a net contributor to the rest of the economy and the large industrial enterprises that it helps finance are excessively capital-intensive. This has contributed to a growing disparity in real wage levels within the industrial sector and between industry and agriculture. As a consequence, 16 per cent of the population continues to suffer from income poverty, with a heavy concentration in rural areas.

Slow growth, rising inequality and sluggish employment generation are not likely to significantly reduce current levels of poverty. Uzbekistan needs a greater degree of trade and financial liberalization. But it should continue to approach these marked-based reforms cautiously. The state should continue its pro-active role in managing the transition but redirect its economic strategy to concentrate more resources on employment-intensive sectors of the economy, stimulate greater prosperity in agriculture and promote a wider diversity of exports.

An Open-Economy, Rapid-Liberalization Transition Strategy

Despite a multitude of major initial handicaps, Cambodia managed to increase its GDP by five per cent per year from 1990 to 2001. Its strategy has been to rapidly liberalize, privatise and open up to the global economy.

Such a strategy confronts major risks. For instance, much of Cambodia's growth has been based on external demand. Over half of its growth has been attributable, for example, to the export-oriented textile and apparel sector alone (Table 7). But this sector is facing stiff international competition, is concentrated in a few urban enclaves and, heavily dependent on imports, has a weak multiplier impact on the rest of the economy.

The Cambodian economy is heavily dollarized (dollar accounts amounting to 70 per cent of broad money). Dollarization has protected Cambodia, to some degree, from financial instability but it has also deprived national authorities of control over monetary policy. Monetary policy has been geared to building up international reserves as protection against the volatility of capital flows, especially since Cambodia has adopted an open capital account. Dollarization also has had a wealth effect. Since most of the poor hold domestic currency—riels, not US dollars—their wealth declines whenever the riel depreciates relative to the dollar. This has contributed to rising inequality between the rich and the poor.

Table 7

Sectoral Contributions to Growth in Cambodia, 1993-2001

Sector	**1993-2001 (Percentage Points)**	**1999-2001 (Percentage Points)**
Agriculture	27.3	7.4
Industry	43.9	56.7
--Textiles and Apparel	37.9	53.5
Services	17.3	24.4

Source: Beresford 2003.

Rapid trade and financial liberalization has largely bypassed the rural economy, where most of the poor work. Agriculture is not export oriented; it accounted for only about seven per cent of total growth in 1999-2001. As a result of financial liberalization, banks are reluctant to lend, particularly to a stagnant rural sector. Real rates of interest are exceedingly high and the spread between deposit and lending rates of interest is also wide. As a consequence, excess reserves in the banking system are estimated to be about three per cent of GDP—a significant loss of investible resources.

In addition, the government has maintained relatively tight monetary policies. After a spike in inflation of 15 per cent in 1997, the government squeezed inflation out of the economy. Monetary policies were so restrictive that in 2000-2001 the general price level fell. If export growth slows, either because of a global slowdown in demand or loss of markets to competitors, the Cambodian economy runs the danger of slipping into a deflationary trap.

Nonetheless, despite tight monetary policies, gross domestic investment has increased. While the export sector is dependent on foreign investment, domestic investment grew to exceed foreign investment in the late 1990s. Also, public investment doubled from about four per cent of GDP in 1993 to eight per cent in 2001, providing an important impetus to growth.

Yet domestic investment could be augmented further and spark a higher rate of economic growth if the government were able to tap the excess reserves of the banking system. But current conditionalities imposed by international financial institutions prevent the government from engaging in such borrowing and prohibit the central bank from lending to the government. If these restrictions were removed, fiscal policy could become more expansionary and help accelerate economic growth.

An increase in public investment in rural areas, where most of the poor are located, could have a powerful impact on reducing poverty. Because of the concentration of investment and growth in urban areas, poverty has declined only modestly in the late 1990s.

Since the economy has significant under-utilized capacity, particularly in rural areas, such investment is unlikely to be inflationary or to 'crowd out' private investment. Investment-led demand expansion concentrated on stimulating rural prosperity will be critical to making inroads against poverty

State-Led, Export-Oriented Transition Strategies

China and Vietnam have pursued similar transition strategies, which have been diametrically opposite to the Shock Therapy model. As in Uzbekistan, the state has played a central role in managing the process of transition. In contrast to the Uzbek model, however, the state has sought to integrate the domestic market more closely with the global economy. Cambodia has followed a rapid-liberalization, open-economy approach that is similar in some respects to that of China and Vietnam, but its state has played a much less decisive role and it is more vulnerable to external shocks because it has less control over the terms of its integration with the global economy.

Clearly, the Chinese and Vietnamese models have been the most successful of the seven examples that this paper reviews. They have grown rapidly throughout the transition—without interruption. Between 1990 and 2001, China's GDP grew by 10 per cent and Vietnam's by 7.7 per cent. In no year during the transition did growth in either country turn negative.

One reason for the lack of recession is that these countries did not seek to institute 'Big Bang' reforms but took a more gradual and cautious approach. They undertook restructuring of their economies through promoting varying rates of growth across sectors, not through the attempted re-allocation of resources under general conditions of depression, as happened under the Shock Therapy model. Corresponding to the rapid rates of economic growth have been substantial falls in poverty in both countries. In Vietnam, for example, during the brief period between 1993 and 1998, the proportion of people in poverty dropped from 51 per cent to 37 per cent (see Table 4, p. 4).

The downside of unleashing market forces in an economy formerly governed by central planning is the probability of a rise in inequality. The available statistics suggest that Vietnam has, so far, been able to contain the rise of inequality. A much larger country, with marked regional disparities, China has been less successful in this regard. By 1995, the Gini index of the distribution of income per person in China had risen, for example, to over 45 (Table 4, p. 4). This represented a sharp increase from the relatively low level of inequality at the start of the transition.

While China has grown incredibly rapidly, its pattern of growth has not, generally, been pro-poor. Neither has been the impact of its public finances. In only two periods since the late 1970s—namely, 1978-1984 and 1993-1996—has poverty in China been substantially reduced (Table 8: Column 1 for 1978-1984 and Column 2 for 1993-1996). And these were the periods in which the terms of trade with agriculture were markedly improved. Clearly, agricultural prosperity, though periodic, has been the main road to poverty reduction in China.

The powerful but episodic impact of this kind of pro-poor growth has overcome the continuous impact of an inequitable fiscal system. The rural population has a level of income per person that is only two-fifths that of the urban population yet the rural population pays more in taxes than it receives in state transfers. The opposite is the case for the urban population, i.e., it enjoys positive net transfers from the state.

The early transition success of both China and Vietnam was based on concentrating resources on sectors, such as agriculture, rural nonfarm enterprises and housing construction, which had a high elasticity of supply. Such sectors responded quickly to improved price incentives and dramatically boosted their output. Moreover, the increased income that they generated benefited broad segments of the population.

Table 8. Poverty Incidence in Rural China, 1978-2000

Year	National Statistical Bureau	World Bank (Earlier Study)	World Bank (Chen and Wang)
1978	31		
1984	15		
1985	15		
1986	16		
1987	14		
1988	11		
1989	12		
1990	9	31.3	42.5
1991	10	31.7	
1992	9.4	30.1	40.6
1993	8.8	29.1	40.6
1994	8.2	25.9	34.6
1995	7.6	21.8	30.8
1996	6.7	15.0	24.1
1997	5.8	13.5	24.0
1998	4.6	11.5	24.1
1999	3.4		24.9
2000	3.2		

Source: Riskin 2003, (based on S. Chen and Y. Wang, "China's Growth and Poverty Reduction: Recent Trends between 1990 and 1999," World Bank 2001.

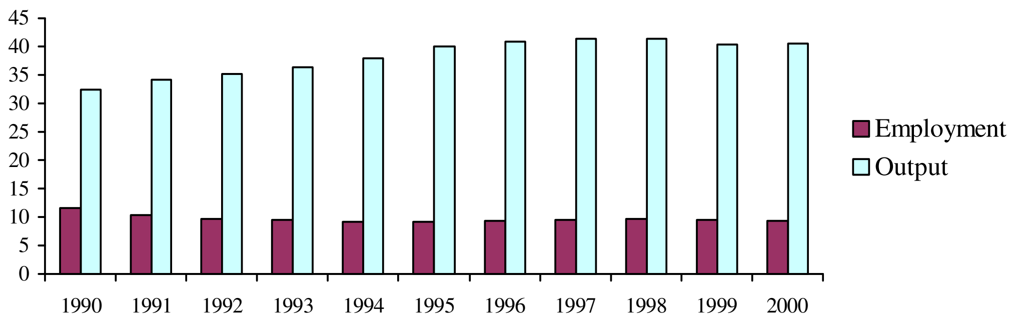
Later in the transition, China moved away from this model and based growth more in the rich coastal regions, which could attract FDI and export effectively to the global market. The Chinese economy became much more outward-oriented and inequality was exacerbated. Even in Vietnam, the agricultural boom that occurred early in the transition benefited mainly the richer rural areas. Now market-determined inequality is on the rise. Farmers face declining terms of trade and regional disparities are growing. Inequality is likely to continue rising in the wake of accession to the World Trade Organization.

A major part of the success of both China and Vietnam has been their high rates of capital accumulation. China already had a high rate of capital accumulation in 1990, with a ratio of gross capital formation to GDP of 35 per cent, and managed to raise it to 38 per cent in 2001. Vietnam has a remarkable record, expanding gross capital formation from only 13 per cent of GDP in 1990 to 31 per cent in 2001. Public investment has played a leading role in Vietnam's expansion, rising from 5.5 per cent of GDP in 1995 to over 10 per cent in 2002.

Because China and Vietnam have managed to maintain high rates of domestic investment and grow rapidly, foreign investment has flowed into both countries to take advantage of profitable opportunities. After the United States, China is the biggest recipient of FDI in the world. But FDI still amounts to only about 10 per cent of its gross capital formation. Neither country is excessively reliant on external capital. Vietnam remains more exposed to external shocks, partly because it has incurred an increasing external debt—mostly on the basis of borrowing long-term concessional funds.

Both countries maintain capital controls, especially on short-term external borrowing. Vietnam learned the hard way about the need for regulation, when financial liberalization in the 1990s led to excessive short-term borrowing abroad that sparked a mini financial crisis in 1997. Since then, the central bank has instituted strict controls on such borrowing. Contrary to conventional predictions, however, neither China nor Vietnam has lost access to external capital as a result of their controls on the capital account.

Figure 1: Shares of State Sector in GDP and Employment in Vietnam (%)



Source: Weeks 2003.

In contrast to the Shock Therapy strategy of transition, both China and Vietnam have been slow to privatise state-owned enterprises (SOEs) and liberalize their financial sectors. In Vietnam, SOEs have prospered under economic reforms and contributed to the rapid growth of GDP. In both countries, SOEs have often established joint ventures with foreign firms. But small and medium enterprises continue to have difficulties in both countries in gaining access to adequate sources of financing. As a result, as SOEs restructure and shed labour, the private sector is unable to generate enough jobs to absorb the surplus labour.

Overall, employment generation is too slow in both countries. In China, urban poverty is on the rise as a result. In Vietnam, while the share of SOEs in GDP increased between 1990 and 2000, their share of total employment dropped (Figure 1).

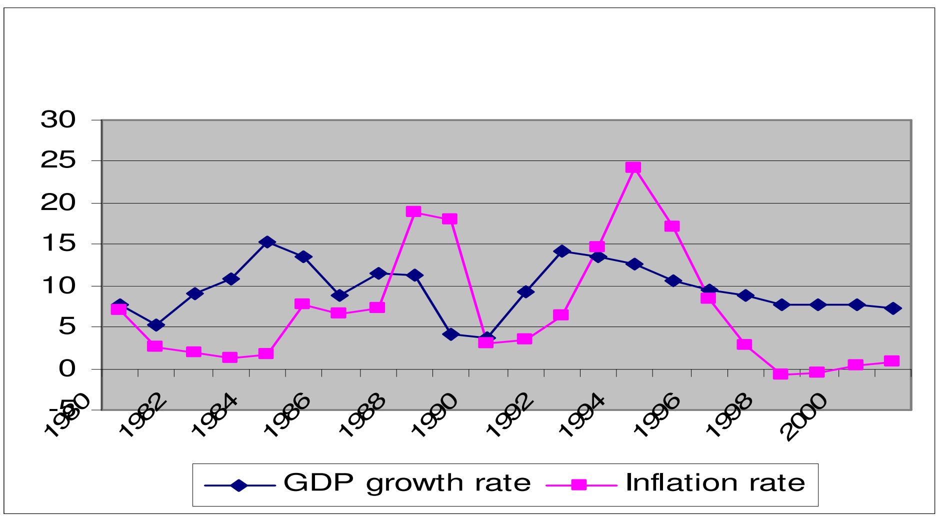
In both countries, the banking systems are still in need of more thorough reforms. State-owned banks continue to hold a large number of non-performing loans to SOEs. The costs of restructuring the banking system in each country are expected to be large. This could adversely affect the fiscal stance of each country and continue to expose it to financial vulnerability.

As part of the financial reforms, Vietnam is bifurcating its banking system, setting up state banks for policy lending along with commercial banks for most financial transactions. For example, the Development Assistance Fund has been established to lend for strategic investment and the Social Policy Bank has been set up to lend to low-income households, especially in rural areas. So financial liberalization will continue to be partial, in contrast to the experience of many other transition economies. Such an approach addresses the needs of poorer households, who are often excluded from access to credit by an unregulated financial system, and private enterprises, which have difficulty in securing loans for long-term investment.

Because of their export orientation and their financial vulnerability, both China and Vietnam have implemented relatively tight monetary policies since the late 1990s. As a consequence, both have faced deflation, China in 1998-1999 and Vietnam in 2000-2001. Whereas banks are building up excess reserves, they should be expanding credit to small and medium enterprises and the rural sector, especially in order to generate more employment.

The financial turmoil in the region in the late 1990s led both countries to take a cautious stance toward monetary policy. But China's growth momentum slowed in the late 1990s partly as a result of tight monetary policies. The slowdown in growth corresponded to a lowering of inflation (Figure 2). In order to sustain growth, both countries will have to use monetary policy mainly to support expansionary fiscal policy. China has already begun to do so in the most recent period. Because of their limited liberalization of financial institutions, neither country has experienced a sharp jump in real interest rates or a widening spread between the deposit and lending rates of interest. And because of their high rate of domestic investment, they have been able to remove many of the supply bottlenecks that exert cost-push pressure on inflation rates in other developing countries. These factors help explain why they are able to grow rapidly but maintain low rates of inflation. But neither country insisted on very low inflation rates at the start of the transition as the foundation for their economic growth. This would have choked off the prospects for growth.

Figure 2. Inflation and GDP growth in China (%)



Source: Riskin 2003.

Because both countries have followed an export-led strategy of transition, they have been keen to maintain a competitive exchange rate. China has pegged its currency to the US dollar. Normally, such a "nominal anchor" approach would be aimed primarily at combating inflation. But recently, this arrangement has allowed China's currency to depreciate along with the fall in the US dollar. This has helped its export to continue growing and helped its international reserves to expand (to become the second largest in the world after Japan's).

Although it is under intense US pressure to adopt a flexible exchange rate regime, China would be ill advised to do so if it hopes to contain exchange-rate and financial volatility. An intermediate regime, such as a 'soft peg' or 'crawling band', is probably preferable if China wants to continue using the exchange-rate regime principally to support export promotion and development.

By joining WTO, both China and Vietnam are committed to further trade liberalization. The effects on growth and poverty reduction remain uncertain. Prior to accession, China carried out substantial liberalization of its trade regime. Despite this, the effects of WTO accession on agriculture and some capital-intensive sectors, such as automobiles, are likely to be negative. China's agricultural sector is unlikely to be able to compete, for instance, with the large technology-intensive and subsidized farms of industrial countries.

Vietnam's growth has been strongly export led during the transition, with exports rising to 55 per cent of GDP by 2001. The foreign exchange that exports have earned has been used to finance the import of intermediate and capital goods and allow the government to pursue more expansionary fiscal policies. However, this approach is not likely to succeed in the future if growth in the world economy is not sustained. The recent global slowdown has prompted a re-evaluation. Domestic public and private investment will eventually have to take over as the primary engines of growth.

Vietnam is able to finance public investment since it runs a current fiscal surplus of 4-6 per cent of GDP. This is partly attributable to a rise in its total revenue, from about 16 per cent of GDP in 1990 to about 21 per cent in 2000 (Table 9). However, revenue could be increased further—such as back up to the level of 24 per cent of GDP that the government achieved in 1994. The downside of Vietnam's fiscal condition is that it faces potentially large costs associated with the restructuring of state-owned banks and enterprises.

Table 9: Revenue Trends in Vietnam (Per cent of GDP)

Category	1990	1992	1994	1996	1998	2000
Total Revenue	16.1	18.3	24.0	22.9	20.2	21.1
Tax Revenue	4.4	13.2	19.0	18.5	15.4	14.9
Trade Taxes	1.9	2.0	5.9	6.0	4.5	3.1
VAT	--	--	--	4.1	3.3	4.0
Non-Tax Revenue	11.7	5.1	5.0	3.9	4.2	5.7

Source: Weeks 2003.

Theoretically, China could implement more expansionary fiscal policies since it holds enormous international reserves and runs manageable deficits of less than three per cent of GDP. But fiscal decentralization has sapped the ability of central government to strategically deploy public investment. The country's revenue base declined from 35 per cent of GDP to 17 per cent in 2001. In order to mitigate this effect, the central government raised its share of total public revenue back up to 52 per cent in 2001 from a low of 22 per cent in 1993.

Despite fiscal decentralization, public spending is biased against rural areas and against the poor. On the revenue side, poor rural households have had to shoulder a heavier burden of local taxes and fees. The government's "Great Western Development Strategy", launched in 2000 to boost the development of China's poorer regions, will hopefully help reverse the regressive trends in the government's fiscal stance.

Both China and Vietnam are doing remarkably well, but are not immune to major risks or free of problems. Further reforms are needed in some areas, such as state-owned banks, in order to enhance efficiency in the allocation of resources. In other areas, such as trade liberalization, the effects on inequality and poverty threaten to be adverse. There is room for improvement in both monetary and fiscal policies, despite their past successes, if a rapid rate of growth is going to be maintained and public investment is going to be effectively targeted to reduce poverty.

Policy Lessons

China and Vietnam

The state-led, export-oriented strategies of China and Vietnam have been the most successful of the seven countries that this paper examines. Much of their success has hinged on maintaining high rates of domestic savings and investment. The state has played the key role in managing this process, ensuring that economic growth has been both rapid and sustainable.

While both countries have emphasized opening their economies and attracting foreign capital, their approach has been heterodox. They have opened to the global economy and liberalized their domestic economy more gradually and cautiously than most other countries in transition. Also, their liberalization of the capital account has been slower than their liberalization of the current account. Capital controls remain the norm in both countries—although they continue to receive large capital inflows despite such regulation.

Even though export promotion has been for them a goal of overriding importance, adopting a flexible exchange-rate regime has not been. China has opted to fix its currency to the US dollar, because it seeks to boost exports as its primary engine of growth. However, the process of accession to the World Trade Organization is likely to subject both countries to substantial losses of jobs and incomes in certain economic sectors. Both countries are entering a stage of more rapid, 'forced' trade liberalization that could oblige poorer households to pay the heaviest price.

Privatisation of state-owned enterprises has not been an early priority for either country. Often through joint ventures with foreign firms, SOEs in both countries have continued to contribute significantly to output growth. Their contribution to employment generation has been, however, less impressive.

Domestic financial liberalization has also been gradual in both countries, as segments of their banking systems continue to lend primarily for policy objectives, such as for promoting poverty reduction or the growth of strategic industries. However, due to the lack of thorough restructuring of state-owned enterprises, the state banks in both countries, having lent heavily to SOEs, hold high proportions of non-performing loans. The impending financial costs could be large, depending on how the state is able to manage the process.

Because of their trade and financial regimes, both China and Vietnam have maintained relatively tight monetary policies since the mid 1990s in order to keep inflation rates low. This has been one point of intersection with the standard "Washington Consensus" approach. But their fiscal policies have generally been expansionary, with public investment playing a leading role in generating growth and, more recently, in focusing resources on poor regions.

Public finance has been in better shape in China and Vietnam than in other countries in transition but it has not been free of problems. Fiscal decentralization in

China has led to a decline in revenue and put a greater fiscal burden on poorer households and rural areas in general. While Vietnam has managed to maintain adequate levels of domestic public revenue, it has increased, unfortunately, its external debt burden because of increasing reliance on multilateral loans for financing public investment.

While growth in both countries has been rapid, it has not always been equitable in its impact. This has been well documented in China, where its aggressive export-led model of growth has widened regional disparities, intensified economic insecurities, such as unemployment, and slowed progress against poverty. This is the price that China has had to pay for a path of liberalization that has delivered benefits disproportionately to the richer, coastal regions, which had already been better positioned to integrate their economies with global trade and financial flows.

Cambodia

Cambodia has followed a path of export-led growth similar to that blazed by China and Vietnam but from a more disadvantaged starting position, and with a weaker state and greater dependence on external private capital and development assistance. While undoubtedly impressive, its gains are more fragile and its vulnerability to external shocks greater.

Under pressure from external financial institutions, Cambodia has liberalized its current and capital accounts more rapidly than either China or Vietnam. Its economy is much more dependent on external demand—perilously dependent, in fact, on one subsector, namely, textile and apparel exports, which faces fierce international competition from similar subsectors in other developing countries with better infrastructure and more productive labour.

Since the Cambodian economy is highly dollarized, national authorities have little control over monetary policy. They also exercise little control over fiscal policy since they are unable to borrow domestically, even though the excess reserves in the domestic banking system could supply resources for more expansionary policies.

Cambodia's open-economy strategy has benefited a few urban enclaves but bypassed much of the agricultural sector and most poor households. As a consequence, poverty has declined only modestly despite moderate rates of economic growth.

The Government needs to gain greater control over fiscal and monetary policy in order not only to lessen the country's dependence on the impact of unpredictable external market forces but also to direct more of the benefits of growth to rural areas. This could create a broader basis for the growth of domestic aggregate demand. Greater regulation also needs to be exerted over domestic financial institutions so that rural households, and poor households in general, can gain greater access to affordable credit.

Armenia, Kyrgyz Republic and Mongolia

All three of these countries suffered markedly from the dissolution of the Soviet Union. Their common response to this severe supply shock, namely, "shock therapy", only worsened the situation by depressing the domestic sources of aggregate demand, principally government expenditures. This led to an even more catastrophic drop in output and incomes.

Instead of being cautious and pragmatic, all three countries followed the prevailing international advice of rapidly privatising and liberalizing their economies. Some of the adjustment policies, such as mass privatisation, could have been instituted later or in a different form. Also, rapid trade liberalization led mostly to a surge in imports and ballooning trade deficits, instead of gains in exports.

Early in the transition, when deep depressions occurred, these countries radically reduced their state expenditures, thereby diminishing their ability to use counter-cyclical fiscal policy to contain the freefall of aggregate supply. Domestic public and private investment collapsed and domestic savings followed suit, sometimes turning negative. Hence, when recovery finally occurred, it remained slow, unsustainable or narrowly based. Much of the industrial base in these countries had been liquidated, its demise hastened by rapid trade liberalization and privatisation.

Agriculture had to serve as a safety net for the industrial unemployed and help contain their losses of income. When the rate of economic growth picked up in the late 1990s, it was often confined to agriculture, or a few industrial or service subsectors with weak multiplier impacts on the rest of the economy.

Even during recovery, governments continued to pursue restrictive fiscal and monetary policies instead of providing greater stimulus to growth through augmented public investment. Adjustment policies had laid the basis for rapidly rising inequality in income and wealth and restrictive macroeconomic policies continued to rein in economic growth. During recovery, poverty remained persistently widespread or even intensified as the growth process bypassed a significant proportion of the population.

Uzbekistan

Uzbekistan suffered supply shocks similar to those experienced by Armenia, the Kyrgyz Republic and Mongolia but it had a larger domestic market on which to rely for maintaining aggregate demand and, unlike the other three countries, it used fiscal and monetary policies to mitigate the adverse impact of the dissolution of Soviet economic ties and external assistance.

Uzbekistan was also one of the most cautious of the countries in transition in opening up to the global economy. It followed a gradual, state-managed transition strategy in which the standard adjustment policies, such as trade liberalization, financial liberalization and privatisation, were pursued much more slowly and partially. Instead of export promotion, such as adopted by China and Vietnam, Uzbekistan emphasized import substitution, especially for industrial raw materials such as oil and food items such as wheat. Hence, the country became less dependent on the global economy for its development during the transition.

A key to Uzbekistan’s success has been its fiscal policies, particularly its ability to maintain tax revenues at an adequate level. This has enabled it to use government expenditures as a counter-cyclical tool to counteract recessions. The government has also used accommodating monetary policies—principally through state-directed credit—to stimulate economic growth.

In contrast to the experience of countries adopting a “shock therapy” approach, Uzbekistan has succeeded, for the most part, in achieving macroeconomic stabilization without suffering from recession. Its public budget and current account have been roughly in balance. However, a major weakness has been its relatively high rate of inflation, which has eroded real incomes and appreciated its quasi-fixed exchange rate, undercutting the competitiveness of its industrial exports.

The country remains heavily dependent on the export of primary commodities, such as oil, gold and cotton. Similar to the experience of other countries adopting import substitution, agriculture has financed the rest of the economy. Hence, rural poverty remains widespread and inequality has risen during the transition, particularly between rural and urban areas and between agricultural and industrial incomes. Economic growth has been steady but modest. Employment growth has been slow, as labour-intensive sectors of the economy, such as industrial and service SMEs, have lacked access to adequate credit.

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