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Inflation and Growth in Transition: Are the Asian Economies Different?

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Abstract

This paper examines the progress made in four Asian transition economies—China, Lao P.D.R., Vietnam, and Mongolia—to market-based systems. Overall, these economies appear to have had a more favorable experience with inflation stabilization and output growth than that of transition economies elsewhere. While initial conditions played an important role in determining the strategy and speed of the transition, growth performance benefited from continued macroeconomic stability and reforms in a key sector (such as agriculture); this confirms the need for sustained and rapid structural reforms and highlights the constraints for sustainable growth posed by weak financial and enterprise sectors.

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I. INTRODUCTION AND BACKGROUND

This paper assesses the progress made in four Asian transition economies—China, the Lao People's Democratic Republic (henceforth Laos), Vietnam, and Mongolia—to market-based systems, presents a comparative assessment to the economies of Central and Eastern Europe (CEE), the Baltics, Russia, and other economies of the former Soviet Union (BRO), and outlines the future challenges. The experiences of these economies are interesting in their own right; they also shed important and interesting light on the path from a centrally-planned towards a market-oriented economy. Substantial progress has been made in these countries in the areas of price and exchange market liberalization, and they are now firmly integrated into the world economy. Although much still remains to be accomplished, especially in the areas of structural reforms, these economies are very different from their initial positions. The transition to market-based systems in CEE/BRO and Asia is now on an irreversible path.²

The contribution of initial conditions to subsequent stabilization and reform in the transition economies has been widely discussed in the literature (e.g. de Melo et. al., 1998). A broad consensus appears to be that while favorable initial conditions indeed have a salutary effect on the success and speed of the transition, the willingness and ability to implement difficult stabilization policy choices and a wide array of structural reforms is critical in ensuring sustained growth in a low inflation environment. In the case of the Asian transition economies, it has often been suggested that conditions at the outset of the transition process may have been less adverse than in the CEE/BRO economies, and hence permitted an easier approach to market-based systems.

The favorable conditions for the Asian economies often alluded to include:

- **A more settled political situation**, so that institution building could focus on the economic domain without also having to weave a new political fabric. Reforms in China, Laos, and Vietnam were triggered without the collapse of the political structures. Mongolia, however, undertook far reaching, albeit peaceful, political reforms as it entered the transition in 1992 after the collapse of the former Soviet Union (FSU).
- **Relatively large size of the agricultural sectors and the availability of large rural labor surpluses**, which facilitated a natural acceleration of growth without a large scale dismantling of the “overindustrialized” state-owned sector as in the CEE/BRO countries. In China, agriculture accounted for about 40 percent of GDP in the late 1970s, and employed 70 percent of the economically active population; the share of agriculture in output in Mongolia, Laos and Vietnam in the late 1980s were similar or higher. In CEE/BRO economies, the share of agricultural output tended to be lower.

²For earlier cross-country transitional experiences, see Bruno (1992), Aghevli (1992), and McKinnon (1992). More recent developments are discussed in Fischer et. al. (1998).

Table 1. Asian Transition Economies: Macroeconomic Performance

	China		Vietnam		Laos		Mongolia		CEE/BRO	
	Initial condition 1979	Recent outcome 1998	Initial condition 1985	Recent outcome 1998	Initial condition 1987	Recent outcome 1998	Initial condition 1992	Recent outcome 1998	Initial condition 1997-98	Recent outcome 1997-98
Real GDP growth (percent) 1/	7.6	8.3	3.6	5.9	-3.2	5.8	-9.5	3.7	-10.0	4.0
Inflation (percent, end period)	1.9	-1.0	223.3	9.2	40.0	141.9	325.5	6.5	788.5	15.9
	(in percent of GDP)									
Overall budget deficit (excluding grants)	4.2	3.0	6.1	4.5	15.4	2.7	12.7	11.2
Current account deficit	-0.1	3.4	1.4	10.4	16.0	10.4	6.7	11.3
Official reserves (in weeks of imports)	9.4	43.2	0.0	8.9	0.0	2.1	0.6	11.5
Broad money	22.6	53.1	26.0	22.7	8.4	26.7	27.6	19.1

Source: IMF Recent Economic Developments (various issues); and Christoffersen and Doyle (1998).

1/ Average 1997-98.

- **Less integration with the CMEA system (except for Mongolia)**, which provided these economies a cushion against the large external shock associated with the collapse of the FSU. However, Laos, Vietnam, and Mongolia were to varying degrees dependent on transfers from the FSU.
- **A collective memory of market-oriented systems**, particularly in Indochina. In Vietnam, a significant nonstate sector continued to exist, with about 40 percent of industrial production and a large part of the service sector in private hands. Moreover, agriculture in the south had never been fully collectivized. In Laos, central planning had held sway fully only after the mid-1970s, and there remained a strong market legacy. This was, however, less the case in China and Mongolia where central planning had existed for a number of decades.

However, not all initial conditions in the Asian economies were favorable:

- A counterpart to the heavy dominance of agriculture was the low per capita income levels, extreme poverty, rudimentary infrastructure, and weak administrative capacity. Also, in China and Mongolia, larger state industrial sector had been built up and the parallel with the experience of the CEE/BRO economies is closer.
- The external environment was often unfavorable for these countries. While reforms in Laos and Mongolia were undertaken in the context of Fund-supported programs which paved the way for external assistance, Vietnam's isolation from the international community made this more difficult (though these difficulties were somewhat cushioned by oil exports and remittances).

Just as the initial conditions differed among countries, so too have the reform strategies adopted. China's reforms have often been characterized as gradualist (although, as argued below, early and rapid reforms were made in some areas, especially agriculture). In contrast, Mongolia adopted a road to rapid reforms. Laos and Vietnam may be considered intermediate cases, mirroring some features of the advanced CEE transition economies.

The remainder of the paper is organized as follows. Section II examines the inflation stabilization efforts of the Asian economies. Using a panel data set of 29 transition economies, it examines the disinflation and inflation stabilization experience of Asian economies. Since the CEE/BRO countries used in Christoffersen and Doyle (1998) form a part of this augmented data set, it is possible to compare the experiences of the Asian economies to results reported elsewhere (e.g. Cottarelli and Doyle, 1998). Section III takes a close look at the role of structural reforms in growth, and assesses the progress made in the Asian economies. Section IV concludes.

II. DISINFLATION AND INFLATION STABILIZATION³

Move to market-based systems and initial high inflations

Prior to the reforms, with the exception of China, all the other Asian countries faced major fiscal imbalances similar to (or even larger) than the CEE/BRO economies. These imbalances, whose true size was masked by the lack of transparency in public sector accounts, were exacerbated by the early phases of the reform, including wage adjustments, price liberalization, exchange rate devaluation, and monetization of in-kind payments. At the same time the revenue situation of the rudimentary tax systems weakened further as the performance of state enterprises deteriorated following reductions in budgetary transfers.

With the collapse of the FSU and the elimination of, often high levels, of external assistance from the CMEA countries, the resulting large deficits had to be monetized and inflation escalated to hyperinflation levels. These high inflations were accompanied by substantial currency substitutions and a sharp decline in the broad money-to-GDP ratio. The need for large relative price changes also generated substantial price pressures. The role of relative price adjustments was particularly strong in the early phases when most prices were liberalized, but seemed to decline over time; the relative price adjustment process was fairly rapid, partly reflecting limited indexation.

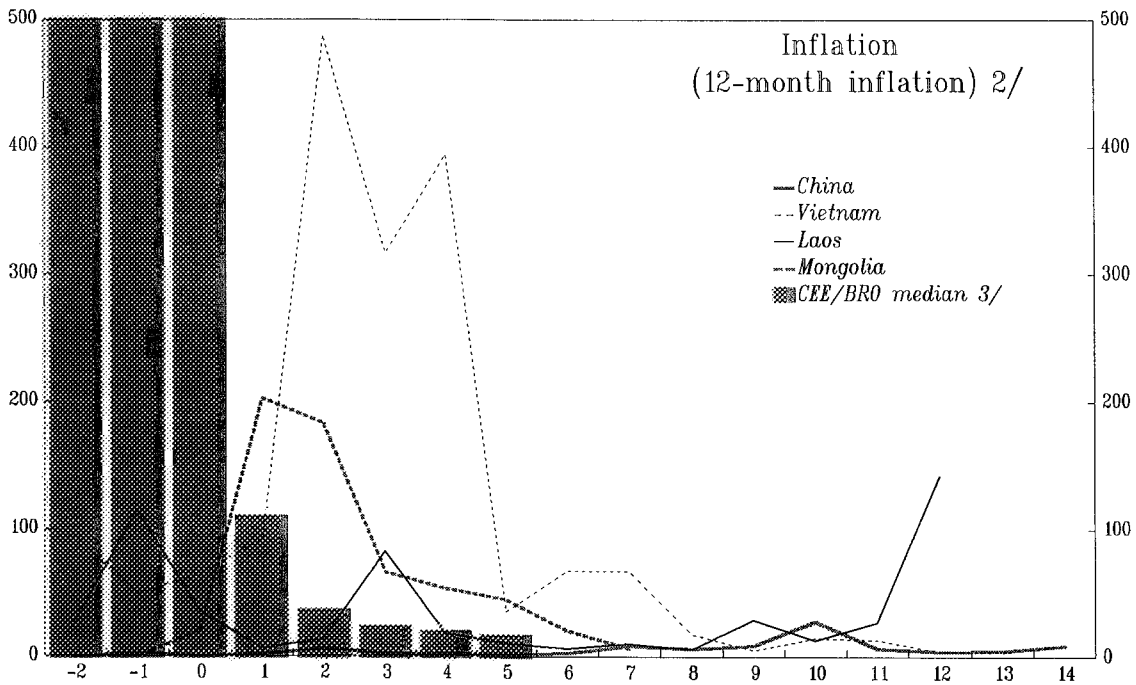
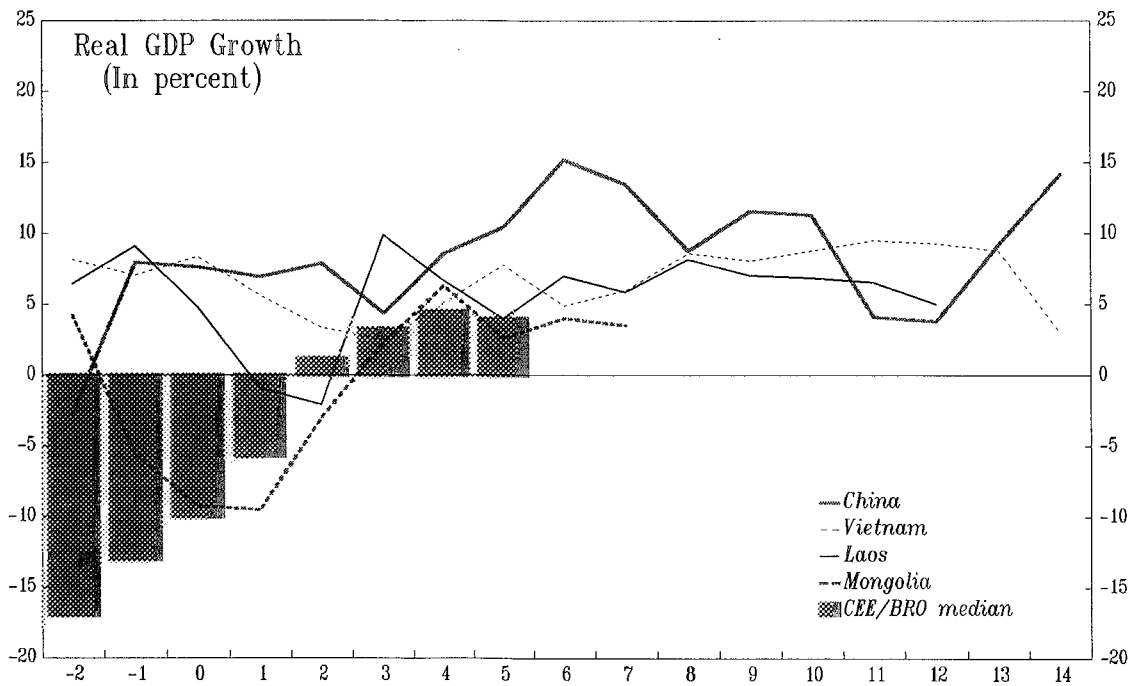
The initial inflation experience of the individual countries differed. With the exception of China, where inflation never rose above 30 percent, all the other countries experienced very high levels of inflation at the onset of the transition. Figures 1 and 2 show the inflation developments in the Asian transition economies in “stabilization time”. Inflation in Laos peaked at 100 percent in mid-1989, associated with an initial jump in prices after prices were liberalized; in Vietnam, inflation reached 500 percent in 1986 and continued above 300 percent in 1987 and 1988; and in Mongolia, inflation peaked at 420 percent in early 1993. Even in China, measured inflation became higher and more variable.

Policies to combat high inflation

Early and extensive reforms in the leading agricultural sector and fiscal consolidation were key factors underlying the successful disinflations in the Asian economies. The key relationships of the fiscal consolidation-disinflation nexus witnessed in the CEE/BRO economies were repeated. The fiscal position in China was already strong at the outset and required only modest adjustment. Sizable fiscal tightening was undertaken in Laos and Vietnam, initially focussed on expenditure cuts and later on revenue enhancement (Dodsworth, et. al., 1996b). In Mongolia, the availability of substantial external assistance reduced the need for domestic financing of the budget deficit to reasonably low levels.

³For a distinction between “disinflation”, “inflation stabilization”, and “moderate inflation” see Cottarelli and Doyle (1998).

Figure 1. Asian Transition Economies: Growth and Inflation
(In transition time) 1/



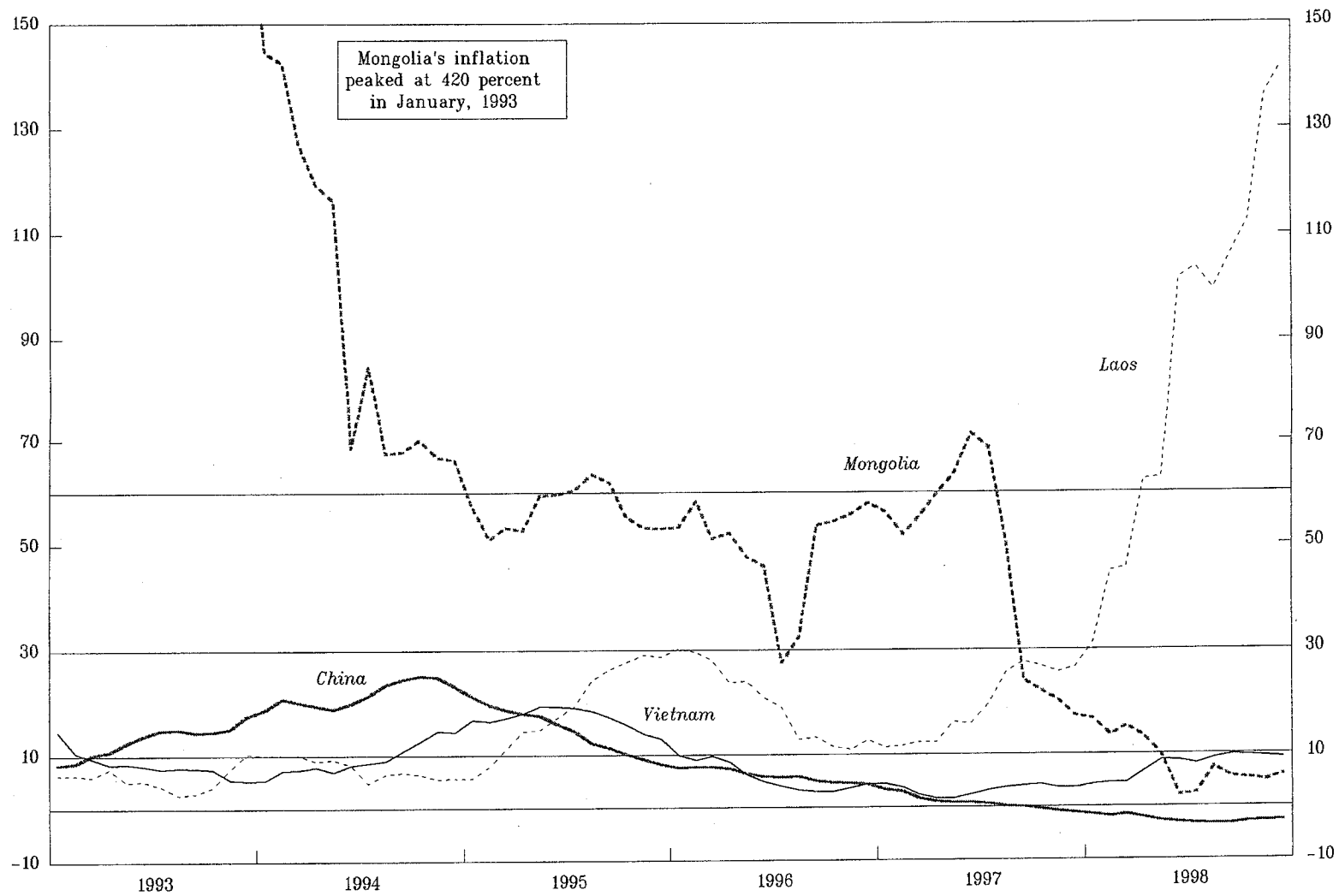
Sources: WEO and staff estimates.

1/ Period 1 is the first year of significant steps to transition: China (1979), Vietnam (1985), Laos (1987), and Mongolia (1992).

2/ Period average is used when 12-month inflation is unavailable.

3/ CEE/BRO median for periods -2, -1 and 0 are 892, 1021 and 789, respectively.

Figure 2. Asian Transition Economies: Inflation, 1993-98
(12-month percent change)



Sources: INS and staff estimates.

Exchange rate policy in all the Asian countries was flexible, with movements in the free market rate a key indicator for the official exchange rate. None of the countries used the exchange rate as a nominal anchor for stabilization, a feature that parallels the limited use of formal exchange rate and monetary targets in the CEE/BRO countries. These economies were thought to be undergoing substantial structural changes and uncertainty, and were faced with levels of international reserves clearly inadequate to make official pegs credible. The monetary frameworks were discretionary, and in the case of Laos and Mongolia relied on Fund supported programs to enhance credibility.

Disinflation and inflation stabilization

The tight financial policies were successful in reducing inflation in Laos, Vietnam, and Mongolia (Figure 3). Inflation in Laos was curtailed to 10 percent during 1991, and remained in single digits until end-1994, but rose steadily during 1995 and the first half of 1996, to settle in the 10–25 percent range. In Vietnam, inflation was reduced to 35 percent during 1989, and after increasing again to almost 70 percent in 1990 and 1991, declined to single digits during 1993–94. It rose to 15–20 percent during 1994–95, before falling again to single digits during 1996–97. In Mongolia, inflation had been reduced to single digits in 1998. In China, inflation never crossed the moderate double digits levels.

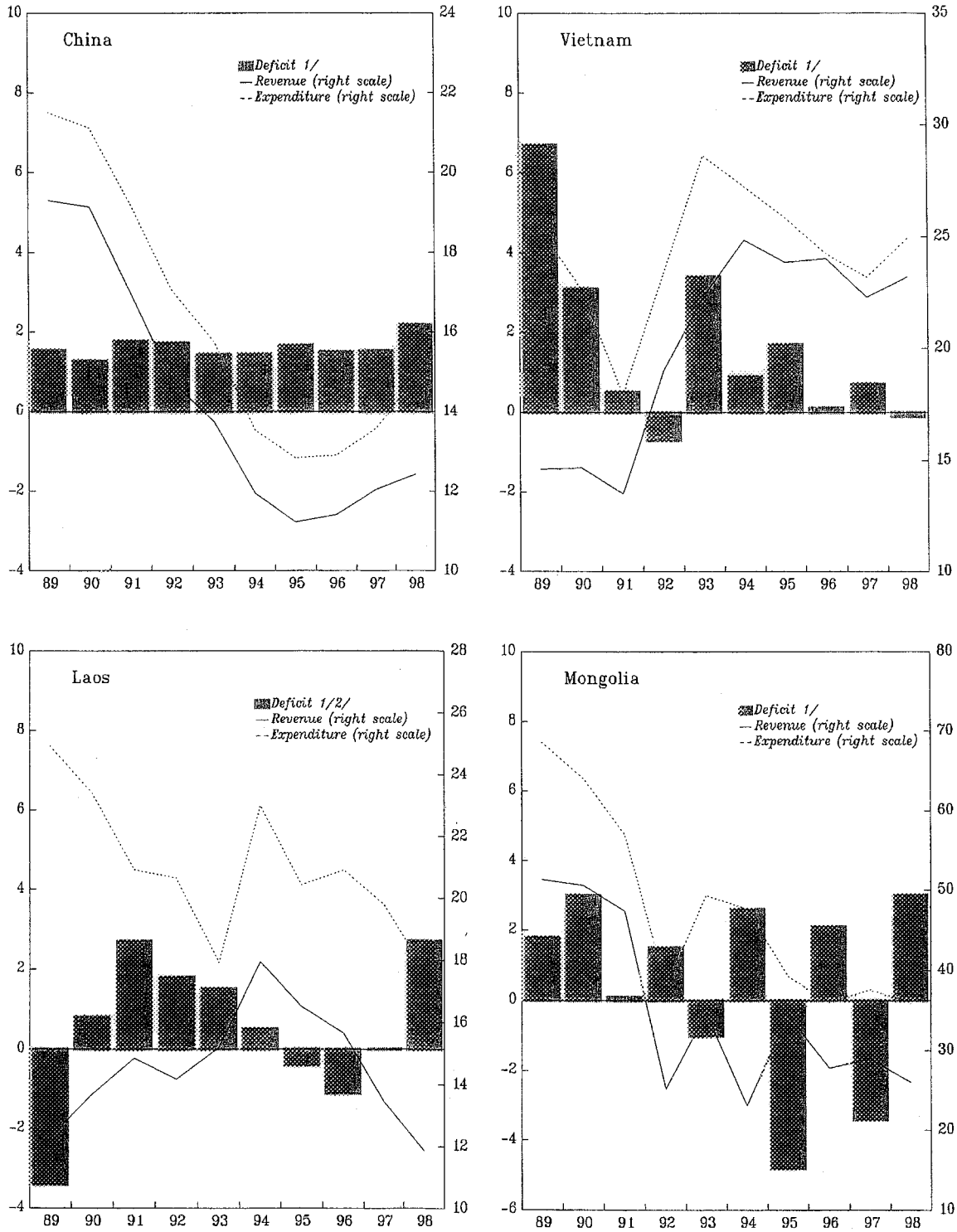
Notwithstanding the successful disinflations, the experience of the Asian economies points to the difficulties in maintaining a low inflation environment consistently over a long period. The disinflation gains in Laos were reversed in 1997; inflation in China has persisted at moderate levels for a while and, in addition, displayed a significant cyclical pattern. These developments, and the experiences of some advanced transition economies of CEE, suggest that inflation performance may remain variable and moderate inflations may persist in transitional economies for a while. It is also possible that the advanced transition economies may already be subject to inflation cycles of the type witnessed in market economies. Furthermore, as the transition has progressed, and inflation has fallen to more moderate levels, the link between fiscal tightening and disinflation may have grown weaker.

Inflation and growth in transition

The strong output growth in the Asian transitional economies (excluding Mongolia) during the disinflation period was in sharp contrast to CEE/BRO experience. Represented in “stabilization time”, output growth remained positive, buoyed by a strong supply response from agriculture (see Section III). In addition, contrary to the deterioration in the current account balance experienced in the CEE/BRO, the Asian economies saw improvements in the external accounts and a rapid build up of reserves associated with strong export growth and low fiscal deficits; import growth was relatively modest and often driven by investment needs.

Recent analyses have suggested that there may exist threshold levels in the relationship between inflation and growth (Sarel (1996) and Phillips and Ghosh (1998)). This hypothesis is

Figure 3. Asian Transition Economies: Fiscal Indicators
(In percent of GDP)



Sources: WEO and staff estimates.

1/ Domestically financed deficit.

2/ The fiscal year was changed from a calendar year basis to an October-September basis in 1992.

tested for the CEE/BRO transition economies by Christoffersen and Doyle (1998), and the threshold level of inflation is estimated at around 13 percent, higher than in industrial market economies. Cottarelli and Doyle (1998) suggest that this higher threshold inflation may be an indication that the threshold level falls in transition time, and may be lower for the advanced reformers. For the Asian countries, there appears to be no clear indication of a threshold level of inflation (Box 1). Adding the four Asian transition economies to Christoffersen and Doyle's panel data set reduces the inflation threshold to around 8 percent.

These results suggest that, while inflation has had a negative effect on growth in Asian transition countries, there is no evidence that the size of the negative effect increases when inflation passes a certain point. While more work needs to be done to explain this, it may in part reflect the existence of more moderate relative price distortions on account of the larger share of agriculture in total output (Coorey, et. al. (1998)). Also, the estimated fixed effects for the Asian transition countries are higher than the CEE/BRO economies, indicating that growth in the Asian transition countries has been higher than in non-Asian transition countries for given levels of inflation.

III. GROWTH AND STRUCTURAL REFORM

As has often been remarked, the output performance of the Asian transition economies has, overall, been remarkably good; with the exception of Mongolia, the Asian countries avoided the large output declines seen in the CEE/BRO economies.⁴ China's economic performance over the past two decades has been particularly impressive.⁵ The rapid growth experienced by the Asian countries—and in particular by China—which are perceived to have followed a gradualist approach to reform has caused some observers to question the view that rapid reforms are the best path to sustained growth.⁶ The remainder of this section reviews this debate, with particular reference to China where it has been most heated.

⁴See Fischer et. al. (1998) for evidence on differences in output performance across countries in the CEE/BRO countries, and Mongolia during 1992–95.

⁵Strong overall growth performance in China has been associated with considerable variation across provinces. These variations provide useful information about the determinants of growth, including the importance of agriculture, state enterprises, and nonstate sector activity.

⁶See for example, Fischer et. al. (1998) where an index of economic liberalization is found to be statistically significant in explaining growth performance. Havrylyshyn and Wolf (1998) examine the experience of the CEE/BRO countries over 1993–97, and highlight the importance of reforms in overcoming unfavorable initial conditions and the need for broad-based and comprehensive reforms to sustain growth.

Box 1. Inflation and growth in transition economies

Recent analyses have suggested that there may exist threshold levels in the relationship between inflation and growth: above the threshold inflation and growth may be negatively related, but below this level there may be no clear (or even a positive) relationship between growth and inflation (Sarel (1996) and Ghosh and Phillips (1998)). Using Sarel's methodology, Christoffersen and Doyle (henceforth CD, 1998) test this hypothesis for the CEE/BRO transition countries, and find a threshold level of inflation around 13 percent, higher than in industrial market economies (Ghosh and Phillips). For the Asian transition economies, there appears to be no clear threshold level of inflation. Using an augmented data set including Asian transition economies, the threshold level of inflation falls to 8.

The simplest version of the equations estimated in CD is:

$$(1) g_y = b_1 * \log \pi + b_2 * (\log \pi - \log \pi^*) + \text{fixed effects and control variables}$$

where g_y is growth rate of GDP, π is inflation and π^* is the threshold level of inflation. (The threshold value of inflation is defined as the value that maximizes R^2 for (1). For the variable inflation minus threshold, negative values are assigned the value zero. The coefficients are interpreted as follows: if inflation is below the threshold level then inflation has the coefficient b_1 , whereas if inflation is above threshold the coefficient becomes $b_1 + b_2$). Cottarelli and Doyle (1998) suggest that differences between transition and industrial countries may suggest that threshold levels of inflation may fall in "transition" time, and may be lower for the advanced reformers.

Figure 1 shows a cross-plot of growth and inflation for the four Asian countries; there appears to be no clear indication of a threshold level of inflation. The four Asian transition economies were added to CD's panel data set and equation (1) was estimated using fixed effects, allowing the two groups of countries (Asian and non-Asian) to have different fixed effects. The reestimated equation is:

$$(2) g_y = 1.66 * \log \pi - 5.55 * (\log \pi - \log \pi^*)$$

(2.40) (5.81)

$R^2 = 0.54$ S.E. = 7.64

Two results follow this reestimated equation: First, the fixed effects of equation (2) is 7.0 for the Asian transition countries and 1.6 for the transition countries from non-Asia. This indicates that for the same level of inflation, growth was higher in Asian transition countries. Second, the inflation threshold for the augmented data set is 8. (The R^2 from the estimation using the CD and the augmented panel data set is shown in Figure 2.)

Figure 1. Inflation and growth in Asian transition economies

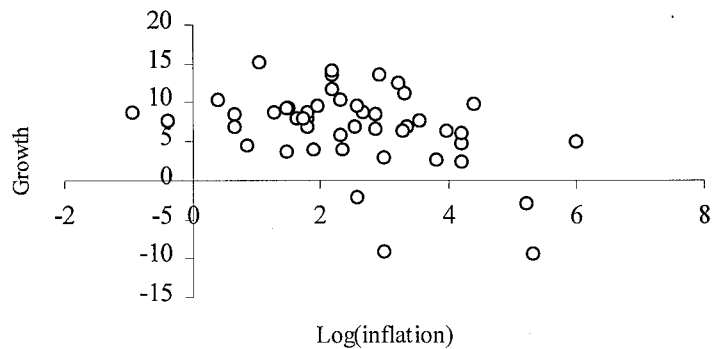
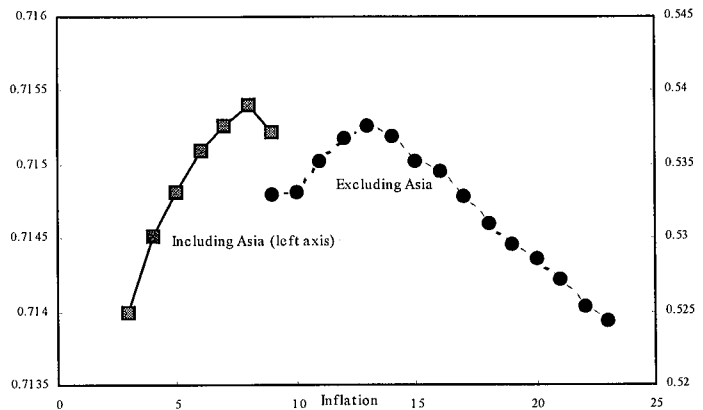


Figure 2. Threshold levels of inflation



The Chinese experience: does gradualism pay?

China's strong economic performance since the onset of reforms has been the centerpoint of a lively debate about alternative approaches to structural reforms. Sachs and Woo (1997) divide the debate neatly into two camps: the **experimentalists** who explicitly attribute China's success to the evolutionary, experimental and incremental nature of the reform process (see Naughton (1994) and Rawski (1994)); and the **convergence school**, which include Sachs and Woo themselves, who view gradualism not as a strategy, but a result of continuing political conflict and other difficulties. The experimentalists argue that China is groping toward a unique economic model, and that a faster approach to reforms would have led to worse results. The convergence school, in contrast, believe that favorable outcomes have occurred despite gradualism not because of it; and that the best results have been achieved precisely where reforms have been fastest. While a full assessment of this debate is beyond the scope of this paper, the following provides a brief summary of some of the key issues.

China's approach to economic reform needs first to be set in an historical context. China's reforms began in late 1978, just two years after the end of the Cultural Revolution, a time of political and economic upheaval. As Fang Gang (1994) points out, economic conditions were improving fast, and neither the economic nor the political conditions were in place for shock therapy, even if that had been envisioned at the time. It is also important to recognize that the objective of a "socialist market economy with Chinese characteristics" was not adopted until 1992, nearly fifteen years after the reforms had begun. For all these reasons, therefore, a gradual approach to reform was inevitable in China.

Gradualism, however, is rather a crude way to describe the reform process in China. In very broad terms, the reform process in China could be characterized as having at least four elements. *First*, China has followed what Fang Gang has called an "easy to hard" reform sequence starting with the sectors where the gains were easiest and greatest. The development of the household responsibility system in agriculture gave families the right to most revenue from farming (although production controls remained, and a substantial part of their output had to be sold at below market prices). The relaxation of entry into industry in rural areas led to the development of the Township and Village Enterprises (TVEs) which have grown very rapidly, fueled by the large rural labor surplus. Finally, the setting up of Special Economic Zones proved a magnet for foreign direct investment in the coastal provinces, and had major spillover effects to the local economies. *Second*, the reform process in China has been characterized by a "dual track" approach with the aim of having the old gradually give way to the new. This has been particularly evident for prices and the foreign exchange market, where marginal prices and administered prices coexisted for some time, before the systems were finally unified. While this dual approach clearly had costs, in terms of encouraging illegal arbitrage between the market and administered sectors, it had the important advantage of allowing market forces to operate at the margin. *Third*, there has been a cyclical pattern of implementation, with major periods of advance followed by periods of consolidation, as economic problems such as excess demand or inflation have occurred. This has partly

reflected the authorities' determination to maintain overall macroeconomic stability, and partly the lack of effective indirect instruments for macroeconomic control. *Fourth*, the reforms in China have been carried out with considerable pragmatism and flexibility. The Chinese have often allowed different norms to coexist and compete (embodied in the phrase "seeking to cross the river by feeling the stones"—a phrase that contrasts interestingly with the Eastern European reformers slogan that "one can only cross a chasm in one jump).” A number of the most important developments—such as the household responsibility system in agriculture and the growth of TVEs—were developed at local levels rather than introduced by the central government.

Has “gradualism” succeeded in China, or would a faster approach been better? It is difficult, of course, to argue with success: China’s growth rate during the reform process has been remarkably high, resulting in an enormous improvement in welfare for one quarter of the human race. But as Sachs and Woo cogently argue, it is far from clear that this was the *result* of gradualism: indeed, the fastest growth took place in the sectors where reforms were most comprehensive. Rather, China’s initial conditions—including the large rural labor surplus and the relatively large agricultural sector—permitted rapid growth without requiring politically difficult reforms of the state enterprises. In addition, starting from a position of near autarky, significant gains from trade were to be had as well. These conditions did not, of course, exist in the CEE/BRO economies.

The gradual pace of reform in public enterprises and in the financial sector has helped maintain social stability in China, but this has been bought at a price. While the share of state enterprises in output has steadily declined in China, they continue to use a disproportionate share of inputs. This has resulted in growing waste and financial losses, exacerbated by competition from the TVE and foreign enterprise sectors; these losses have been financed by the banks, resulting in a rising level of nonperforming loans and ultimately contingent fiscal liabilities which will not be sustainable over the medium term (Lardy, 1998). Now China has completed the “easy” phase of reforms, success in addressing these difficult issues holds the key to its continued success over the medium term.

Other Asian transition economies: the pitfalls of partial reform

The experiences of other Asian transition economies echo a number of themes seen in the case of China and the CEE/BRO economies (see Annex for details):

- The initial impetus for the move to market-based systems came from exogenous shocks and was facilitated by domestic discontent with the performance of centrally planned systems. This was perhaps clearest in Mongolia where the disruption stemming from the loss of large transfers from the FSU and the breakdown of the CMEA system was large, and the collapse of the FSU provided the opportunity to break away from an economic system that had been grudgingly accepted. Ironically, Laos initiated a move to decentralized decision-making in 1979 after the loss of

Western aid and an economic embargo, which combined with poor weather conditions to generate a near economic collapse.

- The existence of a large agricultural sector has been perceived as an advantageous initial condition for many reasons, and often suggested as an important factor in avoiding an output collapse in the transition economies of Indochina (Dodsworth et. al. (1996), Woo et. al. (1997)). It has been argued that institutional structures in agriculture are, or can rapidly become, more flexible than in state-owned industrial enterprises, and permit a larger supply response to price incentives.⁷ Other advantages have also been cited. Agricultural growth is a natural developmental process and in the Asian economies helped absorb large rural labor surpluses; the sector also helped alleviate redundancies from the industrial sector because it had less pronounced wage and price rigidities. In contrast, the transition in the CEE/BRO economies involved reversing “overindustrialization” and socially-painful and costly labor retrenchment.
- The choice of speed and scope of the transition—in the initial stages and as the transition progressed—was heavily influenced by initial conditions, political acceptance of the market mechanism, the ease with which difficulties associated with partial reforms could be contained initially and eventually remedied, and the availability of external financial assistance and foreign direct investment flows.
- Within the Asian economies, the experience of Vietnam was similar to that of China: the market was seen as an important instrument for higher growth, and introduced selectively and in stages. Administrative measures continue to play an important role in the nonagricultural sector and the trade regimes remain relatively restrictive. Laos and Mongolia appear to have similarities: there has been a greater acceptance of the market, the role of administered prices is minimal, and outward orientation is strong. Greater reliance on decentralized decision making and market forces is also reflected in the privatization process which is quite advanced in both countries even in the nonagricultural sector.
- The process of decentralization was often initiated in response to popular unrest with central control (as in Laos). Furthermore, once initiated, the process was not always be fully controllable: considerable “spontaneous” privatization took place in Mongolia, decision making was often under weaker control in the agricultural sector in Vietnam than envisaged, and asset stripping is often encountered in state-owned enterprises.

⁷The claim of a more favorable supply response in agriculture is perhaps not as tight as may appear. In particular, it is difficult to disentangle the extent to which price liberalization may have increased overall supply and to which it merely reflected an increase in the *marketed* surplus, and hence *measured* output. This parallels the argument for the CEE/BRO economies where underreporting of private sector activity may be substantial.

These developments underline the need for a transparent and effective legal and regulatory framework to assist the transition.

- China and Vietnam's selective and "gradualist" strategy appears to have provided rich dividends, but cannot unambiguously be seen as validating "gradualism". Indeed, high growth came from the sector in which reforms were the fastest, such as agriculture. The speed and depth of the reforms in this sector were akin to the "shock therapy" applied in many CEE/BRO countries. Furthermore, as the scope for further efficiency gains in agriculture is exhausted, the need to widen the scope of reforms is becoming increasingly more apparent.
- As the transition unfolds, the response to impending instability has been unpredictable. At times, macroinstability has spurred liberalization and reform (as in Vietnam in the mid-1980s); at other times, most recently in Vietnam and Laos in the wake of the Asian crisis, there has been some backtracking and recourse to old methods of control and command.
- Partial reforms inevitably generated tensions and macroeconomic imbalances suggesting the need for continuation of, and often providing spurs for, the reform process. The "dual track" pricing and exchange rate systems in Vietnam and Laos were useful in providing market signals on the margin, but also produced macroimbalances when the market and official rates were unsynchronized, and generated considerable scope for corruption and rent seeking activity. Similarly, continuing weaknesses in the financial system, governance problems, and absence of controls over enterprise access to bank credit generated inflationary pressures. Such factors generated crisis conditions in Vietnam in the late eighties, price and exchange market instability in Laos in late 1994, and threatened inflation reduction gains in Mongolia in 1998.
- The need for reform of state-owned enterprise and the financial sectors is becoming increasingly apparent in the Asian transition economies. The growth impetus from the agricultural sector appears to have diminished, and sustained growth would have to come from the nonagricultural sector. This could be a combination of light manufacturing with an export orientation and further development of the service sector. To provide room for the development of these sectors, the claim of state-owned industrial enterprises on resources would have to be progressively reduced. The inefficiency of enterprises is only masked by budgetary subsidies, quasi-fiscal deficits, and state support through protectionist trade policies. The adverse effects are manifest in the weak commercial bank balance sheets and reflect poor managerial and risk assessment skills. Reforms in the financial sector are urgently required to maintain macrostability and to provide efficient financial intermediation to support growth.

IV. CONCLUDING REMARKS

Overall, the experience of the Asian transitional economies appears to have been somewhat more favorable than that of the CEE/BRO economies. Inflation remained low, as in the case of China, or was rapidly brought down to more favorable levels. In addition, the output performance was generally better than the CEE/BRO economies, and—except in Mongolia—the large output declines witnessed by the latter was avoided. Substantial progress has also been achieved in moving towards market-based systems, though much more remains to be accomplished. These overall outcomes materialized under fairly different initial conditions and pace of change in the transition towards market-based systems.

The initial conditions were perhaps the most unfavorable in Mongolia, and similar to the economies of the CEE/BRO. These economies were affected most directly by the collapse of the CMEA system, and experienced a significant worsening of their fiscal positions as the large external transfers vanished almost overnight. China may have had the best starting point, with a relatively favorable fiscal position, and with the least amount of political strife. Laos and Vietnam could be considered intermediate cases, somewhat removed from the difficulties associated with the CMEA system, and located in the still fast-growing East Asian region.

The pace of stabilization and reform has also differed among the Asian economies. Mongolia appears to have taken the longest strides in most areas, including price liberalization, trade reform, and privatization. The pace was more differentiated in the other economies. In China, Laos, and Vietnam, early and quick action was taken in agricultural sector reform; the pace of price, exchange and trade system liberalization was selective and moderate; and reforms in the state-owned enterprises and the financial sector were either relatively slow or lagged significantly.

What are the lessons of the transitional experiences of the Asian countries? For one, these experiences confirm that while favorable initial conditions do indeed have an important bearing on the subsequent course of the transition, implementation of difficult stabilization policies and fundamental structural reforms is critical to ensuring sustained growth while maintaining inflation at low levels. This has also been true in China, where growth has been fastest in those sectors where liberalization is most advanced, and where the risks to future growth are largest in the sectors where most remains to be done. Economic transactions, even in the tightly centrally controlled economies, begin to reflect market forces soon after decentralized decision-making is permitted; what cannot be quickly replicated is a full complement of efficient institutions to support market transactions.

The stabilization experiences of the Asian transition economies indicate that external deterioration and spiraling inflation can be checked through appropriately tight financial policies, even in a period of rapid structural economic reforms. Prior to the reforms, barring China, all the other countries faced major fiscal imbalances. Tight financial policies were successful in reducing inflation in Laos, Vietnam, and Mongolia. While fiscal reforms provided new sources of revenue as enterprise surpluses were no longer available to government, the

authorities maintained tight monetary conditions and ensured that interest rates remained positive in real terms. The experiences also point to the need for vigilance to ensure that the fruits of stabilization are not lost, as temporarily occurred in Vietnam in 1990 and 1991, and in Laos in 1995 and 1997.

The Asian experiences also highlight the importance of liberalization of price and exchange markets to ensure a market-based resource allocation. These efforts were crucial to reducing economic distortions, and liberalized prices were critical to generating the supply response in the key agricultural sector. In this context, the dual price and exchange rate systems in China, Laos, and Vietnam, while leading to much inefficiency and rent seeking, had the important advantage of providing market signals at the margin.

How do the experiences of the Asian economies stand in light of the so-called “orthodoxy”—the more the better, the faster the better? Undoubtedly, early clarification of property rights in the agricultural sector was key to the strong output response experience in all the Asian economies. While this resilience of output is often associated with the relatively large share of agriculture, it is important to bear in mind that important institutional changes which decentralized and privatized economic decision-making were undertaken in this sector in all these economies at an early stage. And the gains were substantial. Indeed, even in the case of China, which is often viewed as being the model of “gradualist” success, agricultural reform was very rapid, and rivaled the “shock therapy” approach of some CEE/BRO economies. By the same token, the slow pace of reform in the relatively small enterprise sector did not act as a constraint on growth in the initial stages. The lack of extensive financial sector reform may also not have acted as a brake on agricultural growth because of the weak linkages between the two sectors.

However, the relatively slow pace of reform of state-owned enterprises and continued weaknesses in the financial sector in all the Asian economies is a matter of increasing concern. As further gains from reform in the agricultural sector become harder to come by, sustained growth will have to come from fundamental reforms in industry where the state-owned enterprises still play a dominant role. The weak performance and inefficiency of these enterprises continues to be a drag on overall growth, and has spilled over into the banking sector where the recurring losses have accumulated in large portfolios of nonperforming loans, and are reflected in high interest rate levels and spreads. As is becoming increasingly evident in the CEE/BRO economies also, it is the more difficult reforms in the industrial and financial sectors which would likely be the binding constraint in the future, and it is the vigorous pursuit of reforms in these areas that hold the key to future sustained growth.

Annex: Country Experiences

Vietnam's transition was facilitated by favorable conditions at the outset of the transition process: agriculture accounted for almost 40 percent of output; the economy's integration with the CMEA system was relatively low; and it was located in a buoyant region of the world economy, both in terms of export markets and sources of foreign savings. Furthermore, the availability of substantial foreign savings from fast-growing neighbors and the fortuitous coming-on-stream of domestic oil production in the early-1990s relieved important growth constraints. On the overall objectives, the official position has been that Vietnam does not aim to become a full-fledged market economy; rather the market mechanism is intended to promote growth and ensure overall stability (Reidel and Comer (1997) and Mihaljek (1998)). Reflecting this overall objective, the pace of reforms has varied. In sectoral terms, reforms in agriculture have been quite substantial with extensive, progressive decentralization and liberalization; reforms in the financial and enterprise sectors have lagged behind and difficulties associated with the onset of the Asian crisis have led to some backtracking.

Reforms were first undertaken in late 1979 after the Sixth Plenum of the Fourth Party Congress. The most important steps were taken in agriculture where responsibility for output targets was shifted from the cooperatives to households and surpluses above the targets could be retained and traded. This change in the "contractual" arrangement was very successful and agricultural growth increased sharply. These reforms were carried further in 1986 under *doi moi* (economic renovation) when the quota obligations were eliminated and all agricultural produce could be sold in the market. Still deeper reforms came in 1988 when long-term land leases were introduced, and were transferable under specified circumstances. With this important step, almost all operational control over the dominant sector of the economy had moved to private hands. Other reforms were also undertaken, including in the external sector where the state monopoly over international trade was dismantled, quotas were replaced by import duties, albeit at high levels, and steps were taken to attract foreign investment.

The onset of a macroeconomic crisis in early 1989 following the collapse of the FSU and the CMEA spurred price liberalization, exchange rate unification, and dismantling of extensive state controls over internal trade. By then, the system of administered prices and exchange rate controls had resulted in widespread parallel markets, wide divergences between the official and black market prices, and a grossly overvalued dong. The stabilization program included a sharp fiscal contraction, unification of the multiple exchange rates at the level of the parallel market (entailing a five-fold increase in the official rate), and substantial increase in interest rates. The program was successful and, by mid-year inflation had been reduced significantly. The fiscal consolidation continued during 1989-91 as government spending was reduced by 6 percent of GDP through large reductions in budgetary subsidies, capital spending, and reduction in the wage bill, and a large demobilization of the armed forces.

Reflecting the philosophical basis of the reform strategy, as the macroeconomic situation stabilized and a balance of payments crisis was averted through large rice and oil exports, the

reform imperative receded after 1992, and a large unfinished agenda remains. In the area of trade reforms, significant obstacles towards an open and liberal trading regime remain, including continued targeted support to import-substituting state industries and controls over the exchange rate and trade flows through rationing of foreign exchange in the interbank market. In the financial sector, while a two-tiered banking system has been established, the central bank needs to firmly assume its role as guardian of macroeconomic stability and develop the necessary market-based instruments of monetary management. Restrictions on commercial banks have been reduced over time and a growing number of foreign banks have been permitted to open branches. Nevertheless, the domestic commercial banks remain large public institutions, dependent on the central bank and accustomed to lending to state enterprises without credit risk appraisal. Progress in the reform of state enterprises has been minimal and loss-making enterprises continue to remain afloat through protectionist measures and directed credit from the banking system.

In Laos, the disappointing performance of the centrally planned economy, which was established in 1975 after two decades of protracted civil war, provided the impetus towards a market-based system in 1979 (Otani and Pham (1996)). The overall commitment to a market economy has been strong, even as implementation of reforms has lagged at times.

The seeds for a transition to a decentralized system may already have been sown when already low living standards deteriorated under a poor output performance and high inflation soon after central planning was introduced. External and internal resistance to central planning was high. Aid from Western nations, especially the U.S., came to an abrupt end and the economic blockade of the country disrupted trade flows. Internally, resistance in the agricultural sector to forced collectivization and taxation was strong and dissent with the new system was also reflected in a flight of skilled human and financial capital. Stagnant exports and loss of import financing combined to generate considerable pressures on the balance of payments. Widespread parallel markets mirrored the intense goods shortages.

Substantive progress was made in economic liberalization and structural reforms over the first decade (1979–88) creating a foundation for private sector activity. The reform process gathered momentum under the New Economic Mechanism as the system of official prices based on “cost plus pricing” was abandoned in favor of the principle of “one market, one price” in mid-1987 and almost all retail prices were liberalized, eliminating the distortions created by a “two-track” pricing system. The process was also facilitated by the progressive easing of restrictions on internal and external trade starting mid-1987. The unification of multiple exchange rates at a level close to the prevailing parallel market rate in early 1988 was another important step in eliminating distortions. Moreover, starting 1983, larger numbers of public enterprises received considerable freedom to make production, pricing, employment, and wage decisions, and were held accountable for their budgetary obligations. However, banking sector reforms lagged and negative real deposit interest rates continued to hinder resource mobilization.

Since 1988, reforms have focused on raising domestic savings through fiscal consolidation and positive real interest rates, and on inflation reduction through limits on credit expansion to state-owned enterprises. Fiscal consolidation has been centered on a fundamental reform of tax administration, elimination of budgetary subsidies, and rationalizing expenditure priorities. The final steps in external sector liberalization, which had contributed to substantial export growth, were taken in mid-1994 with the elimination of all restriction on international current account transactions. Progress was also made in financial sector reforms, including the opening up of private banks, and improvements in monetary control. However, monetary management continued to be complicated by the financial sector's tendency to accommodate credit demands passively, resulting in excessive wage increases by the enterprises.

A lax monetary stance in late 1994 and early 1995, combined with the initial effects of import liberalization, led to strong surge in demand and a period of inflationary pressures and exchange market instability ensued. The initial policy response—small depreciation in the official exchange rate and administrative controls—proved quite inadequate as transactions shifted to the parallel markets, widening the divergence between the parallel and official rates.

As remedial fiscal measures were undertaken and monetary conditions tightened, in conjunction with removal of the exchange restrictions and abolition of the official exchange rate in mid-year, macroeconomic stability returned and inflationary pressures dampened. Simultaneously, enterprise budget constraint were hardened by curtailment of budgetary subsidies and the privatization of state-owned enterprises. When these enterprise reforms met with limited success, the government embarked on a broad program of disengagement from all "non-strategic enterprises". Later divestment from "strategic" enterprises was initiated and, by early 1997, the privatization process was nearing completion. With the basis for a market-economy well-entrenched by end-1998, important elements of the reform agenda include improvements in the banking framework to promote efficient financial intermediation, resolution of insolvencies among banks, and greater flexibility in the foreign exchange market to reduce dollarization and enhance confidence in domestic financial assets.

Among the Asian transition economies, the commitment to a market-based economy was perhaps the strongest in **Mongolia**, where the long-standing unease with the Soviet planning is often cited for the relatively readier acceptance of a market orientation (Boone et. al., 1997). In addition, the young age structure of the population favored a move to a new system. This favorable climate was supported by concerted efforts to install a democratic system of government with general elections at an early stage. The broad consensus around the required transformation was reflected in the inclusion of several important opposition members in the coalition government formed by the former communist party (the MPRP) in 1990. When the FSU and the CMEA system finally collapsed in 1991, the external shock—the substantial loss in transfers from the FSU and the sharp decline in trade volumes—was large even by comparison to the dislocation affecting the CEE/BRO countries. Western donor assistance stepped in to fill the large budgetary and external financing gaps, with foreign financing of the budget through project and cash loans in the range of 10–15 percent of GDP.

The favorable conditions for change notwithstanding, only partial reforms were undertaken initially, reflecting differences within the government on the speed and scope of the reforms: some price and trade liberalization was undertaken, a voucher privatization program—the first in a transition country—was initiated, and the banking system was deregulated. The disadvantages of partial reforms were soon reflected in a loss of monetary control and near hyperinflationary conditions that developed in 1992–93. The macroeconomic instability was closely associated with a lack of significant reforms in the enterprise and financial sectors which permitted commercial banks to start operations under weak bank supervision, poor bank management, and governance problems which led to considerable insider lending.

Conditions for macroeconomic stability were restored only in mid-1992 after fresh elections returned a clear parliamentary majority for the MPRP. The new government made significant progress in a number of areas, including the unification of the exchange rate, the elimination of all quantitative export and import controls by mid-1993, and improvements in tax administration and budget management. Together with the progress in macroeconomic stabilization, the effects were finally manifest real GDP growth in 1994 after a prolonged decline, reflecting a rebound in the livestock sector, higher exports in response to a recovery in major export prices, and accelerated growth in the construction and service sectors.

The pace of structural reforms was accelerated during 1994–95 and received fresh impetus with the electoral victory of the reform-minded coalition of opposition parties in mid-1996. Progress in privatization was especially noteworthy. By end-1994, the livestock was almost entirely in private hands and the voucher-based privatization program had been completed. By end-1995, through the cash privatization program, the bulk of small and medium-sized enterprises had been privatized. A thriving secondary market in private housing had developed by end-1997. A notable development which reflected the bold stance of reform policies was the complete elimination of import duties in early-1997, which enhanced the already substantial outward orientation of the economy. A major bank restructuring was initiated at end-1996, and tax reform was undertaken including the introduction of a VAT in mid-1997.

The reform effort stalled in 1998. As principal export prices fell, the deterioration in the external environment exposed continuing weaknesses in the financial system, including weak supervision, poor commercial bank management practices, and ongoing governance problems in large state-owned enterprises. Domestic political turmoil further delayed the implementation of corrective fiscal measures.

With political conditions more settled starting end-1998, the challenge is to restore the reform momentum while locking in impressive inflation and resilient growth performance of 1998. In particular, substantial efficiency gains could be garnered from comprehensive bank restructuring to resolve insolvencies of commercial banks and strengthening of the banking sector framework, further reduction in the size of government, improved governance in the enterprise sector, and completion of state divestment in the large enterprises and utilities.

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