

Economic Policy for Transition to Market Economy

~ Overview ~

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Introduction

There are at least three basic challenges that governments must tackle in countries pursuing a transition to market economies. The first is the market economy policy that governments in economies in transition have tackled and will have to continue to tackle. The second is the economic independence. Especially, countries that have won political independence must obtain their economic independence as well. The third is the economic development. This is because most economies in transition are low-income or lower-middle-income countries. The economic development is important particularly for the governments of Central and East European countries pursuing their accession to the European Union. Here, I consider the economic policy experiences of Russia and other former Soviet republics, and East European countries from the viewpoint of these challenges facing economies in transition.

As a decade has passed since the former Soviet republics and East European countries launched their transition to market economies, these countries have created market economy institutions and organizations. For example, market-oriented legal institutions have been established to provide for private ownership, central and commercial banks, securities markets, new fiscal and tax systems, enterprises, bankruptcies, free trading and monetary systems. A great number of private enterprises have emerged, including commercial banks and securities companies. They are clearly the fruits of transition efforts.

At the same time, however, some countries have developed phenomena that are unsuitable for market economies. The Russian economy's seven mysteries are often cited as examples: 1) Amid efforts for a transition to a market economy, barter trading has been dominant with various prices established for a single product. 2) The number of loss-laden enterprises has remained high and non-performing loans have expanded. Nevertheless, there has been no chain of bankruptcies and the number of bankruptcies has been limited to a very small amount. 3) The unemployment rate has remained below 10% while industrial production has been halved with gross domestic product plunging 40%. 4) Although Russia has been in transition to a market economy, business managers have tried only to maintain employment and production volume as in the past, instead of maximizing profits. While enterprises have been transformed into private stock companies, their managers have pursued their personal interests and ignored systematic corporate governance. 5) While people have hoarded massive cash, deposits at commercial banks have remained scarce. These banks have thus failed to mediate between savings and investment. 6) Voucher privatization has been forced to

create tens of millions of shareholders and a securities market. But stock trading has been extremely limited. 7) The president and legislators are publicly elected to establish a democratic government. But the government has failed to strictly collect tax. Russia thus features frequent phenomena that are inconsistent with a market economy.

The purpose of this paper is not to analyze the status quo and problems of these transition efforts, but to shed a light on policy problems behind the status quo from the viewpoint of basic economic policy challenges for economies in transition.

Chapter 1 Policy for Transition to Market Economy

The policy for transition to a market economy is one of the challenges that the governments of countries pursuing market economies have tackled and must continue to tackle. But questions still exist on what the transition to a market economy is and on what the right understanding of the transition is.

1-1 Transition to Market Economy

1-1-1 What Is Transition to Market Economy? What Is Market Economy?

The transition here is from a planned socialist economy to a market economy. In the market economy, the market works as a major adjustment mechanism between production and consumption, or between demand and supply. Its core consists of the pricing and free capital flow mechanisms.

At least the following conditions are required for the establishment of the market economy:

a. Development of Social Division of Labor

In economies in transition where modern industries have developed, the social division of labor has well been established. From the viewpoint of a market economy, they have had distortions including monopolized industrial organizations and underdeveloped small and medium enterprises. But we can conclude that they have had established the social division of labor.

b. Economic Units' Decentralized Decision-Making

Various market transactions are based on agreements between economic units that emerge from their respective independent decisions. Therefore, enterprises, households and other economic units' rights to make economic decisions must be guaranteed. Subject to such decision-making are not only trading in goods or services but also capital transactions. In order to guarantee individual economic units' free

decision-making, private ownership must basically be established. Disclosure and free flows of information are also indispensable. The systems for private ownership and compliance with contracts are the base for a market economy.

c. Free Competition

Free competition is required for the market to adjust production to consumption. At the same time, freedom of participation in the market must be guaranteed.

d. The government is required for the market economy to work well. The government must serve as a “watchman state” to establish the rules of the game and guarantee compliance with the rules. In a modern society, the government is also required to carry out other functions including covering market failures, establishing social security and promoting social development. It must create taxation systems to meet these functions.

1-1-2 Policy Challenges for Transition to Market Economy

In a planned socialist economy, economic decision-making powers had substantially concentrated in its government, which had conducted economic management by directing and encouraging other economic units to implement plans. Therefore, state ownership had been dominant, with enterprises deprived of powers to make their business management decisions. Free transactions and free competition had been eliminated usually. Any capital market had been eliminated and enterprise management had been linked to state finance. Any monetary system had been merely complementary to state finance. The following challenges are required for the transition from such planned economy to a market economy:

- a. Privatization of state-run enterprises
- b. Liberalization of domestic and foreign trade, introduction of exchangeability for currencies, establishment of free competition
- c. Creation of the banking sector consisting of a central bank and commercial banks
- d. Creation of securities markets
- e. Establishment of state finance and tax systems based on a market economy
- f. Development of bankruptcy law, enterprise law and other institutions for a market economy to work well

In order to build these market institutions and organizations, human resources must be developed to make up such institutions and act under the

institutions and for market organization purposes. People who have used to a planned socialist economy for a long time have no experience, knowledge or know-how for a market economy. In transition to a market economy, these people must jump into an unknown world that they have never seen. This is the case with Russia that has maintained a centralized, planned economy for 60 years. In a country like Russia, the development of human resources suitable for a market economy is indispensable during the transition, especially in its initial phase. The government in each economy in transition must create market economy institutions and organizations through efforts to develop people as market economy players or actors. This can be summarized below.

- g. Development of human resources suitable for a market economy

1-1-3 Goals of Policy for Transition to Market Economy

Each economy in transition must tackle the above challenges one by one. At the same time, its government must allow the economy to work well even during the transition. The construction of a new society has no choice but to build on the heritage of the old society. Even amid the transition, the society must remain. Therefore, any transition policy must be based on the maintenance of business activities for most of existing enterprises. The conditions and business environment must be secured for a great number of existing domestic enterprises to engage in free competition to make profit.

1-2 What Is Liberalization?

Liberalization is one of important policies for the transition to a market economy. Governments of economies in transition, the International Monetary Fund and the World Bank all emphasize the necessity of liberalization. Nevertheless, the liberalization has not necessarily been understood correctly. This is the reason why we here discuss what liberalization is.

1-2-1 Direct Meanings of Liberalization

The first important area for liberalization is domestic trade. The area's liberalization means the elimination of administrative regulations on choices of sellers and buyers. This should leave buyers and sellers to make choices freely. The liberalization in this area also includes a fundamental expansion of free trade. Prices are the second important area for liberalization. A socialist economy had fixed or restricted prices. Its government had fixed or restricted prices. Price liberalization

means the elimination of such price regulations. The third area for liberalization is foreign trade. Soviet republics had typically featured a state's monopoly of foreign trade. State agencies had undertaken foreign trade in most cases. Hungary had featured milder state regulations allowing producers to directly participate in foreign trade. But it had not eliminated state regulations on foreign trade. Liberalization of foreign trade means the thorough relaxation or elimination of regulations imposed on individuals' and enterprises' foreign trade. In order to allow free foreign trade, the introduction of domestic exchangeability for currencies is indispensable. Furthermore, a ban must be lifted on market units' capital transactions. The fourth area for liberalization involves production, investment and income distribution at enterprises. Government regulations on these business activities must be eliminated.

Therefore, liberalization directly means the elimination of business management regulations that had been dominant in a socialist economy. The direct result of such liberalization allows enterprises and other market units to make business decisions on their own.

1-2-2 What Is Freedom in Market Economy?

Having decision-making powers must be separated from making decisions. Market units, though having decision-making powers, frequently lack the ability to make reasonable decisions in various respects. In this case, market units are not necessarily free. Therefore, the elimination of regulations, though being a necessary condition for liberalization, is not necessarily a sufficient condition. Conditions must be developed for enterprise managers to make reasonable decisions from the market economy viewpoint. There are two kinds of conditions that must be considered in this respect.

The first are subjective conditions. A market unit that has the power to make its own business decisions may fail to make decisions, if without market information, funds, assets or good judgment. It may not have business freedom. Without funds, freedom of investment does not exist. Any market unit lacking market information or good judgment lacks business freedom. In this way, liberalization as conceived generally gets market units free from regulations, but fails to bring about freedom of business activities. In a country that had maintained a Soviet-type centralized, planned economy for a long time, economic information required for trade had concentrated at central planning and management agencies, and enterprise managers had lacked any ability to make market-based business decisions. Many economies in transition have had remarkable investment fund shortages. In such circumstances, the

elimination of regulations does not necessarily lead to liberalization. Such countries' governments must not only eliminate regulations but also make positive policy efforts to promote the creation of subjective conditions.

Second, objective conditions must be met. They include competitive industrial organizations. If one producer exists in a certain industry sector, buyers will have no choice but to accept any request by the producer. This case is called a monopoly or an oligopoly. In Russia, a monopolistic or oligopolistic organization exists for each specific product, rather than for each industrial category. Furthermore, transportation ranges are long and transportation costs are massive, resulting in regional monopolies. Consumers have no freedom of choice. In such case, government regulations are required on monopolistic companies. In other words, regulations are required for liberalization.

The final conditions are for competitiveness. For example, a first-grade elementary school boy and an adult man compete in a 100-meter race. Fathers usually set such stage in a bid to tell their children of a joy in running or train them. However, the boy may get aware of his defeat soon and lose an incentive for running. If the boy is allowed to run only 40 meters and the adult man is forced to run 100 meters, a fair competition may be established between the boy and adult. Some adjustments are thus required to ensure fair competition. This is the same case with a situation where there are considerable competitiveness gaps between economic units. Weak units, though having business decision-making powers, lack their willingness to make decisions. Effectively, weak units have no freedom. If weak units are massive, therefore, the government must make adjustments.

Depending on objective conditions, liberalization itself may require government intervention. Russia's experiences in the past years provide a good example in this respect, as discussed later.

Liberalization for a transition to a market economy thus means that the government should not only eliminate and relax regulations, but also develop subjective and objective conditions to allow economic units to make reasonable decisions. Liberalization promoters tend to overlook this important point.

1-3 What Is Privatization?

As discussed above, a market economy cannot work smoothly in a country where most of enterprises are nationalized. In a transition to a market economy, privatization of enterprises is a basic problem facing the government. However, privatization should be designed to ensure conditions and the business environment

that allow most of existing enterprises to freely compete for private profit. We must not overlook this point.

1-3-1 Significance of Privatization

Privatization means the transfer of enterprises from the public to the private sector. The transfer itself is a revision to a certain law and can be implemented if the government is willing to make such change and gets social consensus to such change. However, the transfer is only the first step of privatization. This is because the transfer itself is separated from the problem of whether a new owner of a privatized enterprise can manage the enterprise as a private-sector owner. The essential problem with privatization rests on this point from the economic viewpoint. We must not overlook the point that any privatized enterprise requires people who have the ability and incentives to manage the enterprise reasonably. In this respect, the government must develop a business environment encouraging enterprise owners to manage their enterprises reasonably, establish corporate and other laws providing for reasonable activities of privatized enterprises, and train enterprise owners as market economy actors. These are key challenges for privatization. As a matter of fact, people can learn much from their daily activities and such daily learning is significant. But managers of privatized enterprises must be trained to develop their daily experiences into good management.

1-3-2 Incentives for Privatization

As for the legal aspect of privatization, political leaders and bureaucrats may be reluctant to implement privatization that could lead to their loss of economic powers. On the other hand, privatization revamps the socialist power structure and could face strong resistance in a country like any former Soviet republic where a vested interest structure has been firmly established under a long-lasting planned economy. Privatization is politically significant to overcoming resistance to the promotion of a transition to a market economy. The Yeltsin-Gaidar regime had tried to promote a transition to a market economy and had been isolated from people who had had vested interests in the socialist system. Its top priority might have been the elimination of resistance from people who had had vested interests in the national ownership system and the state management structure. It was reasonable for the regime to accelerate privatization in order to eliminate the resistance. The Yeltsin regime had to create a group of private enterprise owners and obtain social support. But any significant political challenge may not always be reasonable from the economic viewpoint. This is

the point we must understand in the context of social and political preparations for the transition in Russia in 1991.

Political leaders of an economy in transition, who may be reluctant to implement privatization, may have to realize that privatization is indispensable for their economy in transition to become independent and develop well amid the growing globalization, as discussed later. We must remember that the Hungarian Socialist Workers' Party paved the way successfully for a transition to a market economy on its own when the serious external debt problem was forcing the country to implement fundamental reforms in the 1980s.

Managers of state-run enterprises may oppose their privatization, concerned that they could lose their vested powers. Conflict of interests between social groups may halt progress in privatization. In other words, the motivation of enterprise managers to promote privatization is especially important. Any mistakes in this respect could affect corporate governance after privatization. Therefore, any economy in transition must develop reasonable incentives for privatization.

1-3-3 Privatization Methods

None of former Soviet republics and East European countries has depended 100% on selling or granting of state assets to the private sector for privatization of enterprises. In fact, they have combined the standard method of asset sales with grants through voucher coupons. But the weight of asset sales or grants in the combination is very important and has a great influence on the resulting private ownership and corporate management systems. Hungary primarily used the sale of state assets for privatization, while Russia and the Czech Republic have placed a greater emphasis on grants. Accelerated privatization amid domestic capital shortages may depend on grants, external liberalization and foreign funds. Privatization through grants fails to lead to fund-raising operations and tends to slow corporate restructuring.

Russia has adopted the so-called voucher method for privatization. Every citizen received a 10,000-ruble voucher that could be used for making bids for enterprise ownership through auctions to promote privatization. In order to eliminate enterprise managers' resistance to privatization, Russia introduced preferential treatments for enterprise employees. The first and second variants of the preferential treatments have played a great role in promoting privatization. The first variant gave employees of an enterprise registered preferred shares equivalent to up to 25% of its fixed capital on a free-of-charge basis and allowed them to buy up to 10% of total shares at 30% discount from face value with installment payments within three years.

It also allowed managerial employees to purchase up to 5% of the fixed capital. In this way, this variant allowed insiders to acquire up to 40% of the fixed capital. The second variant allowed employees to purchase common stock shares equivalent to up to 51% of the fixed capital before others acquire shares. In the privatization through vouchers, some 75% of enterprises chose the second variant. Most of the others adopted the first variant. Furthermore, managers of each enterprise purchased vouchers and took advantage of all legal and illegal possible tools to put as many as shares possible under their control and avoid any control by outsiders. For example, managers of an enterprise used corporate funds to establish their own investment fund to purchase vouchers. And these managers sold shares of their enterprise to such fund. As a result, none can find outsiders' real equity stakes in many Russian enterprises. Russian privatization has thus featured insiders' rigid pursuit of enterprise ownership and control.

The result in Russia has been a birth of quasi-private enterprises that are owned by insiders and the state. Similar results emerged in the initial phase of privatization in other former Soviet republics that adopted grants and preferential treatments for employees. The Russian government has had no policy on managing enterprises as their partial shareholder and has played little role in their management.

The Russian privatization has allowed employees of privatized enterprises, or part of the people, to enclose state assets. Especially, employees of natural resources-related enterprises have acquired massive assets. On the other hand, government agency employees, pensioners and employees of declining enterprises have become losers. The Russian privatization policy has created a great asset gap.

1-3-4 Formation of Enterprise Ownership Structure and Corporate Governance

The Russian privatization has resulted in a loss of corporate governance. As discussed above, the government had had no intent to exercise its rights as the shareholder of many enterprises and left insiders to dominantly control enterprises. Their managers have used various means to avoid the influence of outside shareholders on management. It has been impossible for outside shareholders to monitor corporate management. On the other hand, economic and corporate management crises, excessive employment and threats of dismissals have discouraged employees of enterprises from monitoring their management. In this way, enterprises have effectively lost corporate governance. Enterprise managers have become dictators engaging in illegal acts. They sold good parts of enterprise assets at discounts to private firms that their families have founded. They also transferred enterprise funds

to their own accounts at home and abroad. Enterprise managers have thus pursued their individual profit rather than profit for their enterprises. As a result of such privatization, the Russian economy has become a “barter economy (G. B. Kleiner)” instead of a corporate economy. The meanings of equity ownership have been lost for most of the people and a great asset gap has emerged. This has prompted the people to doubt the advisability of private ownership, destabilizing the private ownership system itself.

1-3-5 Legal System Development for Privatization (Rights of Shareholders)

The results of privatization vary depending on the development of legal systems for privatization and activities of privatized enterprises. For privatized enterprises, laws must be established to provide for shareholders’ rights, legal status of enterprise managers, legal treatments of bankruptcies and many other aspects. If legal system development lags behind privatization, corruptions will become dominant with rights of outside shareholders ignored, as seen in Russia.

1-3-6 Coordination between Privatization and Macroeconomic Policy

Macroeconomic conditions involving business management may be able to exert a greater influence on the result of privatization than a choice of privatization methods or the degree of legal system development. If reckless anti-inflation tightening leads to operating fund shortages for enterprises and plunges massive enterprises into effective bankruptcies during privatization, stocks will lose their values to prompt business managers to lose interest in corporate system management and pursue their personal interests. The Russian “barter” economy can be viewed as the result of tight macroeconomic policy.

Import liberalization, if stepped up recklessly, could force uncompetitive industrial sectors, like the Russian textile sector, to cut production sharply and disappear, resulting in massive bankruptcies. Business managers, as inside shareholders for their enterprises, would then see their shareholdings becoming meaningless. This would be the same case with outside shareholders. A great asset gap would emerge between industrial sectors that have and do not have international competitiveness, for example, between oil, natural gas and other natural resources-related sectors, and light and machinery sectors in Russia. Such gap would lead many people to view the privatization result as unequal. A precondition for private ownership is that some people consider others’ ownership to be justifiable. If social approval of such precondition were shaken, the private ownership system itself would

be destabilized. For example, calls have emerged in Russia for reprivatization of natural resources-related enterprises. Privatization had been designed to bring about the formation of a middle-income class and private entrepreneurs. But Russian privatization has failed to do so.

If privatization alone were pursued, its significance could be halved and its goal of the private ownership system could be distorted in some cases. Therefore, we must pay attention to coordination between privatization and macroeconomic policy. It must be reiterated that the fundamental policy goal should be ensuring conditions and business environments that allow most of existing domestic enterprises to conduct free competition for profits. This is a key point that policymakers must remember even a decade after the transition was launched.

(See Appendixes for experiences of and lessons from privatization and industrial modernization in other countries than Russia.)

Chapter 2 Economic Independence and Development

From the international viewpoint, the transition to a market economy means the integration of economies in transition into the global market. Former Soviet republics and East European countries, even though with very low technological and economic development levels, have lost COMECON (Council for Mutual Economic Assistance) as their exclusive closed market and have been forced to compete with leading enterprises in the world. As a result, whether economies in transition could become independent internationally is now questioned again. Especially, former Soviet republics, the Czech Republic, the Slovak Republic and former Yugoslav republics have gained political independence upon the collapse of their respective unions and have been faced with economic independence challenges.

2-1 Economic Independence

2-1-1 What Is Economic Independence?

Economic independence means that a country's relations with others and international organizations are stably maintained on a commercial basis. In other words, one country's economic management must work well without depending on economic assistance from abroad. To this end, a country must stably maintain equilibrium in its international balance of payments and must be able to avoid default and other results running counter to commercial rules. Specifically, a country must have strong international competitiveness and must be able to make exports meeting its imports. One country's economic independence is usually supported by the

independence of domestic industries and enterprises and depends heavily on the efforts of enterprises.

2-1-2 International Balance of Payments in Economies in Transition

An outline of trade and current account balances in economies in transition (see appendix tables) indicate that most of economies in transition excluding Russia, Turkmenistan and other resources-rich countries have persistently run trade and current account deficits, failed to cover annual deficits with foreign direct investment and accumulated external debt. Some have seen changes worthy of attention, including changes in external debt mixes, cuts in government debt, and rises in private-sector debt. The expansion of external debt does not necessarily means that debt-ridden economies in transition may default immediately. In fact, however, these economies have no current account or trade balance improvement in sight. This means that whether most of economies in transition can achieve economic independence is still uncertain.

2-1-3 Japan's Postwar Experiences

History repeats itself. After World War II, colonies winning independence as well as war losers had to achieve economic independence. Resources-poor Japan lost its markets with its economy devastated by the war. Amid the difficulties, Japan had double challenges to achieve economic development and a transition from a government-controlled wartime economy to a free market economy. A basic policy goal was then to construct an independent economy requiring no American assistance. Indicating this is an outline of the government's postwar economic programs. Here is a brief introduction to these programs and their goals related to international relations (Source: Hirohisa Kohama , Machiko Watanabe, *50-Year History of Postwar Japanese Economy*, Nippon Hyoronsha Co., 1996, p. 135):

- 1) "5-Year Program for Economic Independence" (December 1955): Enhancement of export competitiveness amid growing trade liberalization.
- 2) "New Long-Term Economic Development Program" (December 1957): Expansion of exports under the spirit of a trading-oriented country.
- 3) "National Income Doubling Program" (December 1960): Economic assistance to least developed countries and promotion of import liberalization plans.
- 4) "Medium-Term Economic Development Program" (January 1965): Improvement of Japan's international position and a transition to an open economy, export

- expansion and import liberalization, achievement of current account equilibrium.
- 5) “Economic and Social Development Program” (March 1967): Liberalization of capital transactions.
 - 6) “New Economic and Social Development Program” (May 1970): Contributions to the global economy and society, positive promotion of trade and capital liberalization.
 - 7) “Basic Economic and Social Program” (February 1973): International cooperation under stable international payments balance surpluses, foreign aid at 1% of GNP, basic international payments balance equilibrium.

The above history indicates that the Japanese government in pursuit of economic independence had tried to enhance the nation’s international competitiveness and expand exports until the mid-1960s. We may have to prudently consider whether Japan’s various policies taken then, including prolonged import curbs and other protectionist policies, could be applied to economies in transition at a time when economic liberalization has made global progress. Undoubtedly, however, positive export promotion policies are indispensable to most of economies in transition. In this respect, these economies can learn lessons from Japan’s experiences.

2-2 Economic Development

Planned socialist economies of the 20th century emerged in underdeveloped regions of the world and played a great role in industrialization there to help these regions catch up with industrialized nations. However, they had lacked indigenous technological innovation capability and failed to get on an innovation track. Since the 1970s, they have remarkably lagged behind other economies in the world. None of economies in transition has developed into a high-income economy. Again, therefore, they have been considering the challenge to intentionally pursue economic development and catch up with industrialized economies.

2-2-1 Economic Development Levels of Economies in Transition

The table below indicates that most of economies in transition are low-income or lower-middle-income economies. In 1995, per capita gross national product in the European Union ranged from \$8,210 for Greece to \$27,510 for Germany. Per capital GNP in any of economies in transition, excluding Slovenia whose per capita GNP is the closest to that of Greece, is less than half the Greek level that is the lowest in the EU. Central and Eastern European countries are aspiring to join the EU and seeking to accelerate economic development to catch up with EU levels.

Table 1 Per Capita GNP in Economies in Transition (1995) (In U.S. dollars)

Low-income economies			
Vietnam	240	China	620
Mongolia	310	Albania	670
Georgia	440	Kyrgyz Republic	700
Azerbaijan	480	Armenia	730

Lower-middle-income economies		Upper-middle-income economies	
Macedonia	860	Croatia	3250
Moldova	920	Czech Republic	3870
Uzbekistan	970	Hungary	4120
Bulgaria	1330	Slovenia	8200
Kazakhstan	1330		
Romania	1480		
Ukraine	1630		
Lithuania	1900		
Belarus	2070		
Russia	2240		
Latvia	2270		
Poland	2790		
Estonia	2860		

(Source) *World Development Report 1997* pp.354~357

In this respect, Japan's experiences with high postwar economic growth may provide economies in transition with various implications and reference data.

Chapter 3 Economic Policy Problems

The discussions above demonstrate great roles that governments must play in economies in transition. First, the governments must ensure right incentives for enterprise managers and create appropriate conditions and environments for competition. Second, they must enhance international competitiveness and accelerate economic growth. Third, they must train people as market economy actors. In fact, economic policies in economies in transition do not necessarily indicate a persistent pursuit of these goals. I here discuss what economic policies should be, focusing on the first point.

3-1 Importance of Macroeconomic Policy

As known well, the Russian financial crisis in 1998 paradoxically created conditions for later economic growth. The 50% devaluation of the ruble amid the crisis has served to push up prices of imports, enhance domestic products' competitiveness against imports in the domestic market and stimulate production of goods replacing imports. As a result, imports' share of domestic retail sales has dramatically declined.

Table 2 Exchange Rates, Exports and Imports, Imports' Share of Retail Sales

	1991	1992	1993	1994	1995	1996	1997	1998	1999
Ruble per dollar	0.169	0.415	1.247	3.550	4.640	5.570	5.974	20.65	27.00
Consumer Price Hike (%)	161	2506	840	204	129	22	11	84.4	36.5
Real rate (times from the previous year)	-	10.6	3.1	1.1	1.7	1.0	1.0	0.5	1.04
Exports (\$100 million)		536	597	675	811	886	883	742	743
Imports (\$100 million)		430	443	505	610	688	736	589	411
Imports' share of retail sales (%)	14	23	29	48	54	52	49	48	27

(Note) Exchange rates are for the new ruble after redenomination. Imports' share of retail sales in 1999 is for the year's third quarter. The data are from publications of the Russian Central Statistics Agency.

The ruble devaluation has also served to promote exports and boost export sales, and a substantial fall in real wages amid fast inflation has reduced production costs at enterprises. These developments have led to improvements in financial performance of Russian enterprises and prompted them to expand investment, stimulating their production of investment goods for domestic use. The Russian government had not designed these improvements, which are attributable to external factors. But they indicate the importance of macroeconomic policy for improving economic performance. In turn, they also indicate negative effects on the Russian economy of thorough import liberalization since 1992 and incomplete revisions to the liberalization since 1995.

Another point we must not overlook in the economic recovery course is a change in the policy stance of the Central Bank of the Russian Federation. Anti-inflation measures have emerged as an urgent challenge again since the 1998 financial crisis. The central bank has tried to hold down inflation while easing liquidity shortages after the crisis. Such monetary policy is indicated in Russian Central Bank Governor Viktor Gerashchenko's report on "Transition to New Currency and Credit Policy in 1999." His report emphasizes a transition to a balanced policy that prevents anti-inflation money supply restrictions from hurting the revitalization of production. The stance of the Russian Central Bank is close to the monetary policy stance that the National Bank of Hungary had maintained in 1990. The Hungarian central bank then adopted the policy of guaranteeing money supply required for economic functions and anti-inflation monetary tightening that enterprises and citizens could tolerate. It rejected any one-sided, rough monetary tightening policy. The balanced monetary and credit policy that gave priority to the real economy could successfully prevent any

excessive increase in overdue debt and deficit-ridden enterprises and made the implementation of a bankruptcy law (a new bankruptcy law established in 1991) feasible. Russia was too late in departing from a rough money supply restriction policy.

The Russian economy's remarkable recovery is indicated in the next table. Noteworthy is basic investment that recovered in 1999 after a persistent decline since 1992 and scored substantial growth in 2000. Russia has resumed economic growth even in the absence of effective improvements in the transparency of the enterprise ownership structure, commercial banks' malfunctions and other structural microeconomic problems. This indicates how great the impact of macroeconomic conditions and the central bank's monetary and credit policy on the economy is. In respect to Russia, macroeconomic conditions include the exchange rate and terms of trade. The purpose of macroeconomic policy must thus be to set a normal economic environment where most of existing enterprises can usually compete for profit.

Table 3 Russia's Recent Economic Performance

	1997	1998	1999	2000 (estimate)	2001 (forecast)
GDP	+0.9	-4.6	+3.2	+7.7	+4
Industrial production	+2	-5	+8.1	+9.0	+4.5
Investment	-5	-7	+1.1	+17.4	+7.1
Real disposable income for citizens	+5.8	-18.1	-15.8	+9.1	+5
Retail sales	+4	-4	-7.7	+8.9	+5
Inflation rate	10	80	36.5	20.2	12
Trade balance (\$100 million)	+147	+152	+333	+610	+400

(Note) Data for 1997-1999 are from the Russian Central Statistics Agency. The estimate and forecast are of the Russian Economics Ministry.

3-2 Macroeconomic Policy and Enterprise Reform

The Russian economy has featured the prevalence of deficit-ridden enterprises, overdue debt and barter trade, as well as irresponsible corporate governance that has led to the "barter economy." These problems involving acts of enterprises and their managers have frequently been attributed to defects of privatization methods, lagging development of law, insufficient enterprise reform, etc. They have also been interpreted as factors to explain Russia's deteriorating macroeconomic performance. Such interpretation is right in a sense. At the same, we can also note that macroeconomic policy has deteriorated the enterprise management environment and caused the

problematic acts of enterprises and their managers, as indicated by the Russian economy's recovery since the latter half of 1998. Enterprise bankruptcies and other negative incentives, as well as acquisition of profit, private obtainment of wealth and other positive incentives, are required for a market economy to work well. If macroeconomic policy is too rough and forces a great number of enterprises to go bankrupt, implementation of bankruptcies will become impossible to prevent negative incentives working well and will cause malpractices in enterprise management. We cannot overlook such great negative effect of rough macroeconomic policy.

3-3 Policy Mix

During the transition to a market economy, as discussed earlier, the government must abolish or relax various regulations set by a socialist regime. Also as noted earlier, liberalization itself requires appropriate government regulations.

In Hungary, for example, price liberalization was promoted as outlined in Table 4. Hungary took three years to increase liberalized-price products' share of consumer goods transactions from 41% in 1987 to 77% in 1990, while maintaining reports and consultations on prices to fight against monopoly or oligopoly. It also adopted rules to link prices of raw and other materials for massive consumption to global market prices. The basic idea behind such approach was that the introduction of an overall free market price system must be gradual to prevent inflation and other negative effects from outdoing positive effects of a market price system. Hungary mixed gradual price liberalization with administrative intervention.

Table 4 Hungary's Consumer Goods Price Liberalization Rate (%)

	1980	1987	1988	1989	1990
Administrative interventions	60	59	48	38	23
Official prices	45	38	22	19	16
Reporting requirements	15	21	21	12	6
Price consultations	-	-	5	7	1
Liberalized prices	40	41	52	62	77
Inflation	-	8.6	11.5	17.0	28.9

(Note) Each price category's share of sales.

Hungary also implemented gradual trade liberalization. Imports free from import licenses or quotas accounted for only 40% of total imports in value in 1989. The percentage was raised to 65% in 1990, 90% in 1991 and 95% in 1995. Hungary, which joined the Central Europe free trade agreement in 1993, has been a member country of the General Agreement on Tariffs and Trade and the World Trade Organization. In

March 1995, however, it introduced an 8% import surcharge in the face of trade balance deterioration. In this way, trade liberalization was accompanied by government regulations. As discussed earlier, we must remember that if a great competitiveness gap exists between domestic and foreign enterprises, any reckless import liberalization can effectively deprive domestic enterprises of freedom in management and fail to lead to real liberalization.

3-4 Policy Sequencing

From 1991 to 1992, Russia was dominated by excess liquidity on one hand and by monopolistic industrial organizations on the other. In such circumstances, thorough price liberalization was unreasonable. Some economists then insisted that Russia should begin with sales of state assets to absorb excess liquidity. This was reasonable. A reasonable argument may be that values of goods including state assets cannot be determined unless prices are liberalized. However, there is no guarantee that price liberalization could result in reasonable prices under a distorted market structure. Price liberalization, including a price system formation process, should be gradual. It may also be reasonable that antimonopoly measures should be enhanced before price liberalization.

It was unreasonable for Russia to promote privatization before developing law to govern enterprise management after privatization. It was also problematic for Russia to liberalize trade before taking measures to enhance the competitiveness of domestic industry.

These Russian experiences indicate that policy sequencing is very important for the course of transition to a market economy.

3-5 Industrial Policy

Most of economies in transition have prepared government programs for economic development and are trying to implement industrial policy. Russia has introduced a development budget and created the Russian Development Bank. But its industrial policy is still in embryo. Most of economies in transition have to enhance international industrial competitiveness, promote exports and accelerate economic development in order to achieve economic independence. An industrial policy approach may be effective for such challenges. But many of these economies have yet to develop information flows, organizations, policy tools and other things to ensure the preparation and implementation of industrial policy. Economies in transition that are trying to join the EU may have to narrow their scope of industrial policy because the

EU has authorized industrial policy limited to the promotion of small and medium enterprises, technological development, regional development and some other areas. These economies could have difficulties implementing policies that are required in accordance with their economic realities and development levels. The EU's approach on industrial policy tends to exclude sector-specific promotion. In the circumstances, governments of Central and East European countries may be required to give practical and pragmatic considerations to industrial policy. Financial difficulties have prevented some of them from developing sufficient policy tools. These problems exist regarding industrial policy of economies in transition. But Hungary has implemented and is systematizing industrial policy, as indicated below:

(Basic Government Documents)

- 1) *Industrial Policy in 1990s* (January 1993)
- 2) *Industrial Policy for Enhancing Competitiveness* (drafted in November 1995)
- 3) *Hungary in New Europe* (1997)
- 4) *Szechenyi Plan* (2000)

(Policy)

- 1) A 50% corporate tax cut for export-expansion investment (just before the accession to the WTO in January 1996)
- 2) Exemption of corporate tax for investment in recession-hit regions (since 1996)
- 3) Accelerated depreciation (since 1996)
- 4) Technology Development Fund (National Technology Development Commission)
- 5) Industrial Development Fund (Ministry of Industry and Trade, marketing aid)
- 6) Financing for equipment investment at small and medium enterprises
 - a. START loan
 - b. REORG START loan
 - c. Export-Import Bank of Japan loan
 - d. Energy-saving investment loan
 - e. "25%" Loan System
 - f. PHARE loan
 - g. Micro Credit
- 7) Credit guarantee for small and medium enterprises
 - a. Credit Guarantee Co. Ltd.
 - b. Start Guarantee Fund
 - c. Tariff-free zone
Tariff-free zone enterprises numbered 116 in 1999, accounting for 43% of foreign trade.

(Organizations)

- 1) Ministry of Industry and Trade, Ministry of Economic Affairs
- 2) Enterprise Promotion Foundation of Hungary (SME promotion, 1990) (?)
- 3) Hungarian Investment and Trade Development Corp. (?)
- 4) National Technology Development Commission (?)
- 5) Hungarian Investment and Trade Information Center (?)
- 6) Hungarian Export-Import Bank (1994)
- 7) Hungarian Export Insurance Corp. (1994) (?)
- 8) Hungarian Investment Development Bank (1991) (?)
- 9) Hungarian Productivity Center

Hungary, which has been leading in making a transition to a market economy, has thus positively implemented industrial policy. As indicated by the tariff-free zone, industrial policy has some economic development effects.

Conclusion

The need for liberalization has been emphasized since former Soviet republics and East European countries launched their transition to market economies. The International Monetary Fund and other international financial institutions have frequently forced radical liberalization as the conditionality for credits to economies in transition.

Liberalization has also been adopted as the benchmark to assess progress in transition. For example, “World Development Report – from Planned Economy to Market Economy” argued that “Central and Eastern European economies, which won independence seven years ago, and newly industrializing economies are leading” and that “countries that have implemented faster and broader liberalization have achieved faster recovery.” Are these arguments true? Liberalization as elimination of regulations may be relatively easy. As discussed in Chapter 1, real liberalization in economies in transition has never been easy.

The World Development Report (1996) translated liberalization of domestic trade, liberalization of foreign trade and participation of new enterprises (privatization as an alternative indicator) into scores, used the scores to calculate degrees of liberalization for each year from 1989 to 1995, and worked out seven-year averages. It then classified economies in transition in the order of the average scores. According to the assessment, seven countries – Hungary, Poland, the Czech Republic, the Slovak Republic, Slovenia, Macedonia and Croatia – were classified as the most advanced in

transition to market economies (see World Development Report 1996, pp. 31). The indices of liberalization for the six years to 1994 are given in Table 5 as the base for the classification.

Table 5 Indices of Liberalization

	1989~1994	Gap	Total		1989~1994	Gap	Total		
1 Slovenia	0.41	0.82	0.41	4.16	Moldova	0.04	0.55	0.51	1.62
Poland	0.24	0.86	0.62	4.14	Kazakhstan	0.04	0.39	0.35	1.31
Hungary	0.34	0.86	0.52	4.11	4 Uzbekistan	0.04	0.43	0.39	1.11
Czech Republic	0	0.9	0.9	3.61	Belarus	0.04	0.36	0.32	1.07
Slovak Republic	0	0.83	0.83	3.47	Ukraine	0.04	0.26	0.22	0.8
2 Estonia	0.07	0.89	0.82	2.93	Turkmenistan	0.04	0.22	0.18	0.63
Bulgaria	0.13	0.64	0.51	2.9	w Azerbaijan	0.04	0.35	0.31	1.03
Lithuania	0.04	0.89	0.85	2.72	Tajikistan	0.04	0.3	0.26	0.95
Latvia	0.04	0.81	0.77	2.45	Croatia	0.41	0.82	0.41	3.98
Albania	0	0.7	0.7	2.3	Macedonia	0.41	0.78	0.37	3.92
Romania	0	0.68	0.68	2.29	Armenia	0.04	0.42	0.38	1.44
Mongolia	0	0.67	0.67	2.27	Georgia	0.04	0.35	0.31	1.32
3 Russia	0.04	0.66	0.62	1.92	Vietnam	0.53	0.62	0.9	3.42
Kyrgyz Republic	0.04	0.76	0.72	1.81	China	0.46	0.59	0.13	3.08

(Source) Appendix (Indices of Liberalization), de Melo, etc. [17]

(Note) 1. The original table gave scores for the three liberalization areas for each year from 1989 to 1994. The author omitted these scores and added gaps between 1994 and 1989.

2. War-torn countries in the w class were distributed into the four groups with economic performance revised. Among them, Croatia and Macedonia were put into the first group.

However, this assessment includes clear mistakes. This is because five of the seven countries classified as the most advanced in the transition, excluding the Czech and Slovak Republics, had already promoted liberalization before 1989. The five's liberalization indices were thus higher in 1989 and remained higher until 1994 than those of others. As indicated by gaps between 1989 and 1994 in Table 5, however, their liberalization progress in the five countries during the five years was less than in other countries. In other words, the five never implemented faster or more positive liberalization than others during the period. As well known by those who have followed former Soviet republic and East European economies, the former Yugoslav republics of Slovenia, Croatia and Macedonia have promoted liberalization since the early 1950s, Hungary has introduced commodity markets since 1968 and Poland has implemented similar reforms since 1981. These five countries have been historically advanced in

transition to market economies or in liberalization. In fact, the reason for their good economic performance is that they have been historically advanced in liberalization.

From the viewpoint as discussed earlier, this is a natural development. Subjective and objective conditions must be developed over a long time for meaningful liberalization or privatization. Hasty development of these conditions cannot be successful in achieving meaningful liberalization or privatization. This may be clear if considerations are given to enterprise managers' business senses and market economy practices that cannot be developed over any short term. Every economy in transition must promote liberalization and privatization. At the same time, each has to develop conditions for liberalization and privatization that must be implemented firmly and steadily.

[Appendix 1] Outlines and Lessons of Privatization in Countries Other Than Russia

1. Czech Republic

(1) Radical Klaus Regime's Policy and Business Managers

Vaclav Klaus, who took government in the “velvet revolution” of 1989, was known as radical. In fact, Czechoslovakia that had maintained a Soviet-type centralized, planned economy until 1989 unlike Hungary and Poland undertook aggressive policies for the transition to a market economy. Especially, the grant-oriented privatization using coupons was initially praised internationally as a successful example of radicalism, making Klaus very famous rapidly. Later, however, the IMF began to give a negative rating to the privatization policy. This privatization met little resistance from managers of state enterprises. Reportedly, behind the absence of firm resistance was some conspiracy between enterprise managers and banks that played a great role in the coupon privatization.

(2) Privatization Method

Under the coupon-type privatization method of Czechoslovakia, every citizen aged 18 or more received 1,000 investment points by paying 1,000 koruny and invested the points in auctions to acquire equity shares. The first and second waves of coupon privatization transferred the basic part of Czech industry to the private sector. It was a typical grant-oriented privatization. Unlike the Russian voucher privatization, a ban was imposed on trading in coupons.

In the course of privatization, many investment privatization funds were created to collect investment points in exchange for their equity shares and invest such points in auctions to acquire equity shares in enterprises. Commercial banks had many investment privatization funds through their respective investment companies to concentrate equity shares in their hands and become dominant shareholders of enterprises.

(3) Formation of Ownership Structure and Corporate Governance

As a result, banks had cross shareholdings and dominated enterprises through their investment companies and investment privatization funds. This brought about a kind of main bank system or financial capitalism. Coupon privatization is usually criticized for distributing equity shares broadly among citizens to make corporate governance difficult. But this was not the case with the Czech Republic. Until around 1995, the government had remained a major shareholder of each commercial bank and

retained some influence over privatized enterprises. But the government influence has declined as privatization of banks has made progress with foreign funds injected into them.

(4) Flawed Investment Fund Regulations and Securities Market

While privatization of state enterprises has been rapid in the Czech Republic, capital market laws have remained underdeveloped. This has left the capital market to lack transparency and any stock market has failed to develop, with equity trading done in black markets. Flaws in regulations on investment privatization funds have allowed a commercial bank to create a great number of such funds for owning one enterprise, making a ban meaningless on an equity ownership of 20% or more in one enterprise. The Czech privatization has left various problems. In countries like Russia and the Czech Republic that have radically promoted privatization, defects have generally remained in legal systems. In such countries, regret always comes after. (See Ikemoto Report.)

(5) Delayed Corporate Restructuring

One defect of the coupon privatization is the dependence on grants that fails to lead to aggressive fund-raising operations, eliminating opportunities for corporate restructuring. In fact, Czech economic performance indicates a tendency toward stagnation. If compared with the Hungarian case, this tendency will look clearer.

2. Hungary

(1) Government Policy

Hungary is the only country where a socialist regime initiated privatization in the mid-1980s. Its massive external debt was a factor that prompted the Hungarian socialist regime to initiate privatization. Under the pressure of external debt, the then regime thought the enhancement of international industrial competitiveness and the revitalization of the economy would be indispensable and feared that the country could fail to get on innovation track and could be left lagging behind the world economy. The regime then saw the need for economic units having concerns about capital profit and foreign currency acquisition capability (called asset or capital concerns). Therefore, it explored the introduction of a non-government asset center, workers' equity ownership and joint stock companies. In 1989, it implemented a business law to transform state enterprises into private stock companies. The government then had realized that since it would represent social interests and could not have primary concerns about

maximizing profit or efficiency, economic units having asset or capital concerns would have to be created. Earlier, the government had learned that such economic units had not emerged from its enterprise reform in 1984 to give enterprise ownership to enterprises themselves, which had led enterprise management organizations to become those for protecting interests of employees.

As the transition to a market economy started in 1989, foreign currency acquisitions and government debt repayments through sale of state assets became one of the major purposes of privatization.

Managers of state enterprises were able to maintain their own positions as sellers in sales negotiations. Big enterprises founded their subsidiaries to develop a great number of new business managers. These served to promote privatization.

(2) Privatization Method

The Hungarian idea about privatization methods was clear. It saw the grant-oriented privatization as ineffective and the standard privatization method of sale as right. Hungary's privatization aimed at promoting corporate restructuring and attracting foreign investment in areas short of domestic capital to modernize equipment and management of enterprises. However, grants were exploited for returning assets to former enterprise owners. We must take note of the fact that the Hungarian privatization did not necessarily depend 100% on selling.

(3) Formation of Ownership Structure

The Hungarian privatization has brought about a unique ownership structure. The most important point of the structure is that foreign capital has accounted for one-third of overall paid-in capital and nearly 60% of such capital for manufacturing industries. Technology transfer through foreign investment for business management and technological innovation has made a great role in bringing about export-led economic growth. (Industrial growth came to 11.0% in 1997 and to 10.6% in 1998.) An analysis of details of economic growth indicates that privatization has had a clearly positive effect on macroeconomic performance. The second important point is that inter-enterprise ownership has been developed along with the parent-subsidiary relationship where a large enterprise is surrounded by its subsidiaries. The inter-enterprise ownership has developed through debt-equity swaps between enterprises and enterprises' participation in privatization.

(4) External Debt Issue

The government has used foreign currency income through privatization for repaying external debt to successfully reduce its outstanding external debt. Foreign direct investment has had complex influences on the trade and current account balances. The largest factor behind expansion in imports and trade deficits has been foreign investment in domestic enterprises. Foreign investors' profit and royalty transfer to their home countries has increased to cause a current account deficit. In this respect, the Hungarian economy's independence is still uncertain. The high foreign share of manufacturing industry capital means that Hungarian industry depends on foreign investment for its development. Concerns exist on the instability of such development.

3. Poland

(1) Government during Transition and Labor Unions (Solidarity Movement and Employees' Council)

The Balcerowicz government is known as radical, but privatization under this government has marked time. This is because the law for privatization of state enterprises bans privatization without the consent of the employees' council (that might have stemmed from the Solidarity movement).

(2) Privatization Method

Among Poland's privatization methods, liquidation and national investment funds are important in addition to state enterprises' shift to joint stock companies and share sales. Under the liquidation method, not only debt-ridden small enterprises but also blue-chip ones were liquidated before sales. Most of enterprises subject to the liquidation were transformed into those owned by their employees as shareholders. Under the national investment fund method, 15 government-invested national investment funds were established to receive shares of state enterprises to become the largest stable shareholders of individual enterprises. Domestic and foreign fund management professionals have undertaken their management. Any Polish citizen aged 18 or more received one coupon as a package of the 15 funds' shares for 20 zlotys (some US\$8 then). The coupon had been expected to rise to some \$200. But the price now stands at less than \$10, betraying expectations of investors. Foreign investors participating in privatization have favored portfolio investment, putting Polish enterprises under the control of hedge funds. They have been criticized for failing to stimulate restructuring of enterprises.

(3) Stalled Privatization and State-run Enterprises' Great Presence

Since privatization has been stalled for the above reason, state-run enterprises' weight in industry in Poland is relatively heavier than in other Central European countries. But a view exists that business performance of state-run enterprises is not necessarily inferior to that of private ones. This may be attributable to the government's positive efforts to restructure state-run enterprises. Poland has thus provided a case where economic performance is good in spite of state-run enterprises' relatively heavier weight in industry.

4. Uzbekistan

(1) Government Stance

Dominating Uzbekistan is a strong nationalism aiming to construct an independent state. Its government has emphasized government roles during the transition to a market economy. The government has refrained from taking radical steps and pursued a gradual transition to a market economy. It has apparently considered Asian development models in this respect. The nation's privatization is aimed at establishing enterprise owners who can make efficient use of assets. But privatization has been slow in the face of resistance from economic federations.

(2) Privatization Method

Privatization has been lagging behind. Privatization of small-scale enterprises has been complete, but that of large-scale enterprises has just started. State-owned economic federations have put state-owned shares of enterprises under their control and have had access to financing and foreign currencies, serving as intermediate management organizations. Uzbekistan has first transformed these federations and their enterprises into state-owned joint stock enterprises and implemented their public offerings for their partial privatization. It launched a private investment fund system in late 1996. Of a 74% government stake in an enterprise, 30% has gone to a private investment fund, 21% to a stock exchange and 23% to its employees. The investment fund has been allowed to sell public participation shares to citizens for 100 sums (2% of an average wage). One investment fund can own up to 35% of an enterprise. In reality, economic federations (state-owned joint stock enterprises) have created private investment funds to acquire shares of enterprises under their control.

Uzbekistan has also adopted special treatments for employees of enterprises, allowing them to use profit of their respective enterprises and make installment payments for purchasing assets of their respective enterprises.

(3) Ownership Structure

State enterprises are still abundant as privatization has lagged behind. Privatized enterprises feature a combination of insiders' and state ownership. Their shares are owned by the government, investment funds created by economic federations, and employees of enterprises. Unlike Russia, Uzbekistan's government has played a greater role in managing privatized enterprises. Enterprise resources have been distributed through government monitoring, modernization of enterprises and economic federations.

(4) Positive Government Roles and Economic Growth

Uzbekistan started economic recovery in 1996, faster than other former Soviet republics, and has maintained positive economic growth. The government has taken positive economic policies to ease shocks of the Soviet Union breakup and has adopted a gradual approach on modernization of enterprises. The economic growth achievement may be attributable to such positive government policies. However, Uzbekistan has had problems including a delay in the unification of foreign exchange rates and a slowdown in liberalization and privatization. It also has had difficulties in international relations now that the IMF has closed its Uzbek office. But the Uzbek experiences have indicated that liberalization and privatization do not necessarily lead to growth in an economy in transition to a market economy and that such economy can achieve growth despite a delay in liberalization or privatization. In this respect, the Uzbek experiences are worthy of attention.

5. Kazakhstan

(1) Government Stance

The Kazakh government, known for its radical policy for a transition to a market economy, has featured the introduction of foreign capital for management of state enterprises.

(2) Privatization Method

Kazakhstan has implemented three privatizations programs one by one, from 1991 to 1992, from 1993 to February 1996, and from March 1996. The three are 1) privatization of small-scale enterprises, 2) general privatization of medium- and large-scale enterprises with the number of employees ranging from 200 to 5,000, and 3) case-by-case privatization of selected large-scale enterprises that are important for the nation and have more than 5,000 employees. Under the general privatization based on

grants, citizens have been given investment coupons and have invested them in privatization investment funds to acquire shares. Investment funds have participated in auctions to acquire more than 51% of each enterprise with the remainder left for government ownership. The case-by-case privatization of giant enterprises has failed to make progress. The introduction of foreign capital has been difficult for these enterprises that have to shoulder social security costs and have been plagued with massive debt. Furthermore, a resistance to privatization of these enterprises has been strong since their massive shares have been held by the government and their managers. In order to overcome such difficulties, Uzbekistan has adopted the so-called management agreement system to instantly introduce foreign capital (see a report by Wajima). Under a management agreement, an investor acquires the business management right (for five to 10 years) in exchange for certain investment. Such outsider investor is given the right to share profit and obtain equity shares.

(3) Problems with Management Agreement

The management agreement system has attracted foreign investors and led to more than 20 privatization deals. But this system has had some problems. Since foreign investors are interested primarily in effectively exclusive rights to sell products of their investment targets, the system fails to promote modernization and restructuring of enterprises. Another problem is the system's lack of transparency in the absence of any law to authorize the system. Of more than 20 management agreement deals that have emerged, only two have led to joint ventures and the remainder are expected to be cancelled.

(4) Developments in Case-by-Case Privatization

The case-by-case privatization under the third program has made a breakthrough since foreign investment has been allowed in the energy area. But concerns have emerged on dependence on foreign capital for production and development of key resources. Some people have pointed to the risk of the so-called Dutch disease.

6. Lessons

We may learn the following lessons from the above:

First, political leaders' recognition of the need for privatization is important in respect to motivation for privatization. This should be emphasized in such countries as China and Vietnam. Enterprise managers must also be motivated to privatize their

enterprises. Motivation for enterprise managers has tended to cause insiders' ownership of privatized enterprises. As indicated by experiences in Hungary and the Czech Republic, however, such motivation does not necessarily lead to insiders' ownership or control, which can be avoided.

Second, the standard sale-oriented method is significant among privatization methods. As indicated by Russian and Czech experiences, vouchers and other grant-oriented privatization methods fail to promote restructuring of enterprises. They have limits on improvements of enterprises.

Third, every economy in transition should establish outsiders' monitoring of enterprises after privatization to avoid a loss of corporate governance as seen in Russia. Key outsider monitors include foreign and other outside investors in Hungary, commercial banks in the Czech Republic, and the government in Poland and Uzbekistan.

Fourth, delays in legislative developments have always accompanied hasty privatization, causing infringements on shareholders' rights, malpractices and corruptions. Legislation must be readied in advance not only for privatization but also for management of privatized enterprises. This is still an important issue even a decade after the transition to market economies was launched.

Fifth, environments surrounding business management must be adjusted to privatization. If privatization is accompanied by macroeconomic policy that destroys the real economy, as seen in Russia, privatization will lose its meaning.

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[Appendix Tables] Current Account Balance, Trade Balance, Foreign Direct Investment and External Debt of Former Soviet Republics and East European Countries

(Source: EBRD Transition Report 1999, 2000. Estimates for 1999.)

[1] Former Soviet Republics

Armenia

(In millions of dollars)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Current Account Balance	na	na	na	-67	-104	-218	-291	-307	-390	-277
Trade Balance	na	na	-102	-98	-178	-403	-469	-559	-578	-462
Foreign Direct Investment	na	na	na	1	8	25	18	52	221	131
External Debt	na	na	na	na	200	375	614	786	812	855

Azerbaijan

(In millions of dollars)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Current Account Balance	na	153	-198	-160	-123	-318	-821	-914	-1363	-600
Trade Balance	na	-41	-153	-122	-163	-275	-549	-567	-1046	-408
Foreign Direct Investment	na	na	na	0	22	282	661	1093	1024	510
External Debt	na	na	na	52	239	425	466	406	506	964

Belarus

(In millions of dollars)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Current Account Balance	na	na	na	-435	-444	-458	-516	-788	-989	-257
Trade Balance	na	na	na	-528	-490	-666	-1149	-1335	-1447	-599
Foreign Direct Investment	na	na	na	18	11	15	73	198	142	225
External Debt	na	na	na	na	2197	2684	2142	2345	2612	2457

Estonia

(In millions of dollars)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Current Account Balance	na	na	na	22	-167	-158	-398	-563	-478	-294
Trade Balance	na	na	-90	-145	-357	-666	-1019	-1125	-1115	-877
Foreign Direct Investment	na	na	na	156	212	199	111	130	574	222
External Debt	na	na	na	298	534	785	1387	2562	2900	2871

Georgia

(In millions of dollars)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Current Account Balance	na	na	-248	-354	-278	-216	-275	-375	-389	-221
Trade Balance	na	na	-378	-448	-365	-338	-351	-559	-685	-528
Foreign Direct Investment	na	na	na	0	8	6	54	236	221	96
External Debt	na	na	95	597	999	1212	1352	1516	1636	1754

Kazakhstan

(In billions of dollars)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Current Account Balance	na	-1.3	-1.9	-0.4	-0.91	-0.21	-0.75	-0.80	-1.23	-0.17
Trade Balance	na	-3.2	-1.1	-0.4	-0.92	-0.11	-0.34	-0.28	-0.80	-0.34
Foreign Direct Investment	na	na	na	0.47	0.64	0.96	1.14	1.32	1.14	1.59
External Debt	na	na	1.48	1.85	3.27	3.48	4.44	6.34	8.22	7.91

Kyrgyz Republic

(In millions of dollars)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Current Account Balance	na	na	na	na	-84.3	-234.8	-424.8	-139.2	-369.4	-184.9
Trade Balance	na	na	na	na	-86.1	-122.0	-251.7	-16.0	-220.0	-84.0
Foreign Direct Investment	na	na	na	na	38.2	96.1	46.8	83.0	108.6	35.4
External Debt	na	na	na	na	413.8	763.9	1151.2	1356.1	1472.6	1718.7

Latvia

(In millions of dollars)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Current Account Balance	na	na	na	417	201	-16	-279	-345	-650	-646
Trade Balance	na	na	na	3	-301	-580	-798	-848	-1130	-1027
Foreign Direct Investment	na	na	na	50	279	245	379	515	303	331
External Debt	na	na	na	na	na	1415	2025	2731	3060	3803

Lithuania

(In millions of dollars)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Current Account Balance	na	na	na	-86	-94	-614	-723	-981	-1298	-1194
Trade Balance	na	na	na	-155	-205	-698	-896	-1147	-1518	-1405
Foreign Direct Investment	na	na	na	30	31	72	152	328	921	478
External Debt	na	na	na	na	529	1374	2081	3146	3577	4335

Moldova

(In millions of dollars)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Current Account Balance	na	na	-39	-150	-82	-98	-202	-285	-323	-33
Trade Balance	na	na	-37	-148	-53	-70	-260	-348	-388	-123
Foreign Direct Investment	na	na	17	14	18	73	23	75	86	33
External Debt	na	na	16	256	620	668	815	1048	1014	1055

Russia

(In billions of dollars)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Current Account Balance	na	na	na	na	5.9	5.0	7.0	0.4	2.1	24.7
Trade Balance	na	na	10.6	15.3	17.0	20.2	19.8	14.8	16.9	35.3
Foreign Direct Investment	na	na	na	na	0.5	1.7	1.7	4.0	1.7	0.7
External Debt	na	na	na	na	120.9	127.0	135.1	134.1	157.7	158.5

Tajikistan

(In millions of dollars)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Current Account Balance	na	na	na	-200	-164	-86	-76	-68	-121	-36
Trade Balance	na	na	na	-177	-122	-57	-20	-71	-154	-59
Foreign Direct Investment	na	na	na	9	12	20	25	30	24	21
External Debt	na	na	na	509	760	817	867	1104	1178	1033

Turkmenistan

(In millions of dollars)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Current Account Balance	na	na	927	776	84	24	2	-580	-935	-527
Trade Balance	49	590	1140	1100	485	441	304	-231	-523	-166
Foreign Direct Investment	na	na	na	79	103	233	108	108	62	89
External Debt	na	na	na	na	418	550	668	1356	1750	2050

Ukraine

(In billions of dollars)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Current Account Balance	na	na	na	na	-1.2	-1.2	-1.2	-1.3	-1.3	-0.8
Trade Balance	na	na	-0.6	-2.5	-2.6	-2.7	-4.3	-4.2	-2.6	-0.5
Foreign Direct Investment	na	na	na	na	0.2	0.3	0.5	0.6	0.7	0.5
External Debt	na	na	na	na	7.2	8.1	9.2	11.8	11.7	11.5

Uzbekistan

(In millions of dollars)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Current Account Balance	na	na	-237	-429	119	-21	-979	-548	-39	-202
Trade Balance	na	na	-235	-378	213	237	-706	-72	171	125
Foreign Direct Investment	na	na	9	48	73	-24	90	167	226	201
External Debt	na	0	62	1039	1107	1771	2381	2594	3484	4289

[2] [East European Countries]**Bulgaria**

(In millions of dollars)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Current Account Balance	-1180	-406	-360	-1099	-31	-26	16	428	-62	-681
Trade Balance	na	404	-212	-885	-17	121	188	380	-381	-1081
Foreign Direct Investment	na	56	42	40	105	98	138	507	537	806
External Debt	100	118	138	138	113	101	96	97	103	100

(Note) External debt is in hundreds of millions of dollars.

Czech Republic

(In billions of dollars)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Current Account Balance	na	na	na	0.5	-0.8	-1.4	-4.3	-3.2	-1.3	-1.1
Trade Balance	-0.8	-0.5	-1.9	-0.5	-1.4	-3.7	-5.9	-4.5	-2.6	-2.1
Foreign Direct Investment	na	na	1.0	0.6	0.7	2.5	1.3	1.3	2.6	4.9
External Debt	6.0	6.7	7.1	8.5	10.7	16.5	20.8	21.4	24.0	22.6

Hungary

(In billions of dollars)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Current Account Balance	0.1	0.3	0.3	-3.5	-3.9	-2.5	-1.7	-1.0	-2.3	-2.1
Trade Balance	0.3	0.2	0.0	-3.2	-3.6	-2.4	-2.6	-2.0	-2.4	-2.2
Foreign Direct Investment	0.3	1.5	1.5	2.3	1.1	4.5	2.0	1.7	1.5	1.4
External Debt	na	22.7	21.6	24.6	28.5	31.4	27.6	23.7	26.7	29.3

Poland

(In billions of dollars)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Current Account Balance	0.6	-2.0	0.9	-0.6	0.7	5.3	-1.4	-4.3	-6.8	-11.6
Trade Balance	2.2	0.1	0.5	-2.5	-0.9	-1.9	-8.2	-11.3	-13.7	-14.5
Foreign Direct Investment	0	0.1	0.3	0.6	0.5	1.1	2.7	3.0	5.0	6.6
External Debt	49.0	48.0	47.6	47.2	43.6	45.2	47.4	48.9	56.9	59.0

Romania

(In millions of dollars)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Current Account Balance	-1656	-1290	-1564	-1174	-428	-1774	-2584	-2137	-2917	-1308
Trade Balance	-1743	-1345	-1420	-1128	-411	-1577	-2494	-1980	-2625	-1092
Foreign Direct Investment	18	37	73	87	341	417	415	1267	2079	949
External Debt	1140	2131	3240	4249	5509	6787	8597	9467	9974	9233

Slovak Republic

(In billions of dollars)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Current Account Balance	na	na	na	-0.60	0.67	0.39	-2.10	-1.95	-2.06	-1.08
Trade Balance	na	na	-0.71	-0.93	0.06	-0.23	-2.29	-2.08	-2.29	-1.10
Foreign Direct Investment	na	0.08	0.10	0.10	0.24	0.19	0.20	0.08	0.37	0.70
External Debt	na	na	2.83	3.38	4.66	5.68	7.67	9.90	11.90	10.47

Albania

(In millions of dollars)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Current Account Balance	-122	-249	-427	-357	-279	-177	-245	-276	-186	-293
Trade Balance	-150	-208	-454	-490	-460	-475	-692	-518	-621	-846
Foreign Direct Investment	na	8	20	45	65	89	97	42	45	51
External Debt	377	628	811	936	1012	683	732	757	874	972

Croatia

(In billions of dollars)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Current Account Balance	1.05	-0.59	0.33	0.61	0.83	-1.45	-1.15	-2.34	-1.55	-1.54
Trade Balance	-1.17	-0.54	-0.30	-0.74	-1.17	-3.27	-3.69	-5.22	-4.17	-3.30
Foreign Direct Investment	na	na	0.01	0.08	0.11	0.10	0.51	0.30	0.78	1.35
External Debt	na	2.98	2.74	2.64	3.02	3.81	5.31	7.45	9.59	9.77

Macedonia

(In millions of dollars)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Current Account Balance	-400	-262	-19	15	-180	-222	-289	-277	-309	-135
Trade Balance	-418	-225	-7	43	-186	-221	-317	-386	-419	-408
Foreign Direct Investment	na	na	0	0	24	12	12	18	175	27
External Debt	na	744	758	818	844	1062	1118	1139	1437	1484

Slovenia

(In billions of dollars)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Current Account Balance	0.53	0.13	0.93	0.19	0.57	-0.10	0.03	0.01	-0.15	-0.78
Trade Balance	-0.61	-0.26	0.79	-0.15	-0.34	-0.95	-0.83	-0.77	-0.79	-1.25
Foreign Direct Investment	0	0.04	0.11	0.11	0.13	0.18	0.19	0.34	0.25	0.14
External Debt	na	1.87	1.74	1.87	2.26	2.97	4.01	4.18	4.96	5.49