Transition to Market Economies in Asia

Yasutami Shimomura
Akira Kohsaka
Akifumi Kuchiki
Osamu Nariai
Nobuki Sugita
Shingo Hosaka
Tsuyoshi Mihira
Hiroshi Tsuchikawa
Motoi Tsunekawa
Munekazu Uchikawa

Economic Research Institute
Economic Planning Agency
Tokyo, Japan
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EXECUTIVE SUMMARY

Part 1 Theoretical and Empirical Issues of Transitional Economies

Chapter I Conceptual and Theoretical Framework
1 Introduction
2 Fundamental Issues for Transition Strategies
3 Transition Strategies
4 A “Pluralistic Approach” to Transition

Chapter II The Experiences of Five Asian Transitional Economies
1 Introduction
2 Background
3 Historical Review

Chapter III Lessons of the Experiences in Asia
1 Diversity
2 Determinants of Macroeconomic Performance

Appendix

Part 2 Country Report: Reform Achievement, and Future Perspective

Chapter I Cambodia
Chapter II People’s Republic of China
Chapter III Lao P.D.R.
Chapter IV Mongolia
Chapter V Vietnam
Transition to Market Economies in Asia

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Akifumi Kuchiki
Osamu Nariai
Nobuki Sugita
Shingo Hosaka
Tsuyoshi Mihira
Hiroshi Tsuchikawa
Motoi Tsunekawa
Munekazu Uchikawa

*) Yasutami Shimomura (Professor, Saitama University), Akira Kohsaka (Professor, Osaka University), Akifumi Kuchiki (Senior Research Fellow, Institute of Developing Economies), Osamu Nariai (Professor, Reitaku University), Nobuki Sugita (Director, Department of Research Cooperation, Economic Research Institute, Economic Planning Agency), Shingo Hosaka (City of Kitakyushu; Former Researcher, DRC, ERI, EPA), Tsuyoshi Mihira (Officer, Second Consumers' Affairs Division, Social Policy Bureau, EPA), Hiroshi Tsuchikawa (Kansai Electric Power Co. Inc.; Former Researcher, DRC, ERI, EPA), Motoi Tsunekawa (City of Sapporo; Former Researcher, DRC, ERI, EPA), Munekazu Uchikawa (Researcher, DRI, ERI)

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EXECTIVE SUMMARY

1 Introduction

The purpose of this paper is to analyze the process of the transition to market economies in Asia. While there are comprehensive studies dealing with the region of Eastern Europe and the former USSR, the number of studies concerned with an overview of transitional attempts in Asia is rather limited. Instead, most of the research has dealt with specific transitional economies, such as China and Vietnam. Our central purpose in this paper is to identify the characteristics of transition in Asia, compare them with those of Eastern Europe and Russia, and draw lessons for the improvement of transition strategy in general.

This study focuses on five Asian countries; China, Vietnam, Laos, Cambodia, and Mongolia. It was not possible to include the five republics in Central Asia due to lack of reliable time-series data on their macroeconomic indicators. Nor did we include Myanmar, as it is still at a very preliminary stage in its economic reform process.

2 The Conceptual Framework of Transition

The subject under discussion is “transition to a market economy”, a movement from a centrally-planned to a market-based economic system. This process is often called “economic reform”. International institutions such as the IMF and the World Bank prefer to use the term “market-oriented reform”. When we use such terms as these, we must be aware of the fact that economic reform is a much broader concept than transition. It therefore seems useful to clarify the definitions of these concepts at the outset, in order to prevent confusion.

Economic reform usually takes place within one of the following four frameworks:
(1) Reforms in the economic systems of developed countries

These are attempts at changing the economic systems of well-developed market economies to more efficient systems through the enhancement of the market mechanism. This type of reform was strongly advocated during the 1980s by the Thatcher administration in the UK and the Reagan administration in the US.

(2) Structural adjustment in developing countries

Since the late 1970s, many developing countries, in accordance with the suggestions of the IMF and the World Bank, have removed or reduced excessive regulation and government intervention in order to overcome macroeconomic imbalances. This is another strategy aimed at enhancing the market mechanism.

(3) Economic reform within the framework of a centrally-planned economy

This type of reform is reflected in plans for efficiency improvement or production increases under an existing centrally-planned system through measures such as the introduction of profit incentives and the delegation of power to factory managers. The basic philosophy is to combine the market with the plan with the dominance of the latter (plan). A typical case of this type of reform was seen in the strong movement termed “market socialism” in Eastern Europe in the late 1960s.

(4) Transition to a market economy

A distinct feature of this type of reform is the transformation of the ‘rules of the game’
from a command system to the market mechanism. This feature is not found in the other types of economic reform described above.

In practice, it is often quite difficult to define the borderline between economic reform within the traditional framework (Type3) and transition to a market economy (Type4). However, we believe it is important to keep this difference in mind, particularly so when dealing with transition strategies, for example the comparison between 'shock therapy' and 'gradualism'. In many countries, reforms begin as Type3 and subsequently develop into transitions. Under these circumstances it is not easy to accurately determine when the transition in a particular economy was initiated.

3 Diversity within Asia

In reviewing the transitional economies of Asia, the most striking aspect is their diversity, the major components of which are described below.

3-1 Political and Economic Reform

In China and Vietnam, the dominance of the respective Communist parties has been maintained despite extensive economic reforms. In contrast, Mongolia has changed its political system completely in parallel with economic reform and introduced parliamentary democracy. Cambodia also adopted a change in its system of governance; it reverted to being a Kingdom.

3-2 Initial Conditions

The socio-economic conditions prior to the beginning of reform differed significantly from one country to another.

(1) Duration of the Centrally-Planned System

Mongolia, the second oldest communist country, introduced a centrally-planned economic system just after World War II. In contrast, a command economy was adopted in the southern part of Vietnam in 1976, only a few years before the beginning of attempts at reform, which subsequently developed into transition to a market economy. The length of the centrally-planned system is considered to correlate closely to its penetration, the degree of price distortion and, as a result, the degree of reform necessity.

As an indicator of the penetration of the principle of a centrally-planned system, let us adopt the share of the labor force working in state enterprises. This figure was 18.8 percent in 1979, when China began its attempts at reform. In Mongolia in 1990, just before the beginning of reform, the figure was 70.1 percent (source: World Bank). In Russia in 1985, before Perestroika, 93.1 percent of total employment was in state enterprises (Sachs and Wing, 1994). It is therefore reasonable to conclude that the depth of reform required in Russia and Mongolia is greater than that in China.

(2) Legacy of the Pre-Command Economy Era

The coastal regions of China and the southern part of Vietnam operated market economies of their own before their leaders established centrally-planned systems, although these were not well developed. It is assumed that the memories of the rules of the market game experienced previously were maintained in these societies, either consciously or
unconsciously, until the onset of later reforms. These countries were fortunate in being able to utilize these assets when they began their attempts at reform.

On the other hand, Mongolia moved from being a nomadic society to the adoption of a centrally-planned system without the benefit of experiencing a market economy. This serious handicap can also be observed in the former Soviet Union, including the republics of Central Asia. In these countries, adjustment to the new and unfamiliar rules of the market economy was very difficult.

(3) Industrial Structure

Another important feature of transitional economies in Asia is the greater influence of agriculture, particularly in comparison with Eastern Europe and Russia. While in China in 1978 farmers accounted for 69 percent of the total labor force, the share was only 14 percent in the former USSR immediately prior to Perestroika (Kondo and Wada, 1993 and Sachs and Wing, 1994). This difference between the industrial structures played an important role as one determinant of the transitional strategies adopted in these two regions.

(4) The International Environment

Most of the transitional economies in Asia were closely related to the Council for Mutual Economic Assistance (CMEA). In particular the dependence on the CMEA was of great significance in the case of Mongolia-90 percent of its total trade during the 1980s was with the CMEA (source: IMF), and the CMEA was by far the largest aid donor. The role of the CMEA was also significant in Vietnam, although to a lesser extent-until 1988 trade with the CMEA accounted for more than 50 percent of its total and the CMEA was easily the largest source of capital flows. These economies were therefore inevitably severely affected when the CMEA collapsed in the late 1980s.

At the same time, most Asian transitional economies were able to take advantage of their close geographical proximity to the dynamic economies of East Asia (Japan, the Asian NICs and ASEAN). The merits of this are especially apparent in China and Vietnam. After the adoption of open-door policies, China and Vietnam became integral parts of the rapidly-developing intra-regional networks in East Asia. In particular, the connections with overseas Chinese and Vietnamese residents enabled these two countries to increase exports and attract foreign investment. They also enjoyed the advantages of being latecomers, learning the effectiveness of an outward-oriented development strategy from the experiences of their neighbouring predecessors. Thus they were able to adopt tried and proven methods to realize outward-oriented growth, taking advantage of the external economies of dynamic development in the region. Unfortunately, Mongolia is more physically remote from the spreading dynamism in East Asia and so has not benefited to the same degree from these factors.

4 Common Features of Asian Economies in Transition

Notwithstanding the diversity within Asia described above, at least two common features can be observed among the Asian economies in transition (with the exception of Mongolia and the former Soviet republics of Central Asia). These are their improved macroeconomic performance and the mode of economic reform adopted.
4-1 Better Economic Performance

The macroeconomic indicators of transitional economies in Asia compare favourably with those of Eastern Europe and Russia.

This is particularly apparent in terms of economic growth and export growth. During the period 1980-1992, China recorded annual growth rates of 9.1 percent and 11.9 percent in GDP and exports respectively (source: World Bank). These figures were among the highest in the world. Between 1981 and 1990, Vietnam's average GDP growth rate was 7.1 percent (source: ADB). This economic growth has accelerated in the 1990s and Vietnam has shown rapid and consistent export growth. Lao PDR and Cambodia have also maintained positive growth rates.

On the other hand, the Mongolian economy has suffered from a decline in production since the introduction of reform measures. This phenomenon has also been observed in Eastern Europe and Russia, although some Eastern European economies, notably Poland, have begun to experience a recovery in this regard.

Although the Vietnamese economy once suffered from hyper-inflation, this has recently been brought under control and is now under 10 percent, a considerable achievement. Inflationary pressure has been chronic in China since the mid-1980s, and there have been forced periods of stabilization brought about by belt-tightening policies. However, it should be noted that despite such pressures, the price situation in China has been much more stable than has been the case in Eastern Europe and Russia.

One very striking contrast between Asia (again with the exception of Mongolia) and Eastern Europe and the former USSR is the fact that the economic reforms in the former were accompanied by increases in production, whereas the latter economies suffered serious declines in GDP.

4-2 Mode of Economic Reform

Such countries as China, Vietnam and Lao PDR spent considerable time conducting reforms within the framework of a centrally-planned system before shifting to explicit transition-type reforms and policies. The smooth and continuous shift from the long preparatory stage to the overt transition to a market economy is an important characteristic feature of transition in Asia. In Mongolia and Russia, the preparatory stage (Perestroika in Russia) was very short, and in Eastern Europe the continuity aspect has been of lesser importance, as attempts at “market socialism” were severely suppressed for political reasons.

Similar reform measures were initiated in China, Vietnam and Lao PDR around 1980. A common component of which was the attempt to increase motivation in the agricultural sector by: (i) restoring the family as the basic unit of production-replacing the commune system of socialized agriculture, and (ii) raising procurement prices of major agricultural products.

The following section discusses the economic reform policies adopted by these countries in greater detail.

5 Reasons for Improved Macroeconomic Performance

Although initial conditions and a favourable international environment are clearly
important factors in the positive economic performances in China, Vietnam and Lao PDR, these two determinants do not entirely explain the progress made in these economies, particularly in China and Vietnam. Another crucial element has been the mode of reform in these countries. This section identifies and describes three aspects of reform which played significant roles in their successful development—gradualism, the priority given to agriculture, and the slow pace of privatization of state-run enterprises.

5-1 Gradualism

As has previously been pointed out, the transitions to market economies in China, Vietnam and Lao PDR were preceded by long periods of reform within centrally-planned economic frameworks. Chinese leaders carefully avoided using the term ‘market economy’ until 1992, having previously advocated an economic system which combined central planning and market forces. In Vietnam, the ‘Doi Moi’ movement, which signalled a clear commitment to abandon the centrally-planned system, came five years after the introduction of agricultural reform.

In addition to the length of time taken, the reforms in these countries shared another unique feature—the absence of a clear reform strategy or blueprint. Instead, a variety of measures, often partial ones, were tried. According to the World Bank (1992), Chinese reform has consistently maintained this feature, and in 1993 the IMF observed that in Vietnam piecemeal reform measures were taken until “the launching of a bold and comprehensive program of structural reform in March 1989 (under the guidance of the IMF)”.

Critics argue that this style of reform has fundamental shortcomings, the most serious of which are a lack of logical consistency in the measures taken and the possibility of provoking anti-reform political groups. On the other hand, this pragmatic approach allows people sufficient time to adjust to newly-introduced rules and modes of behaviour. In addition, the government has the opportunity to modify aspects of the reform program based on the results of experimentation. The experiences of China and Vietnam suggest that piecemeal reform measures, if adopted carefully, can contribute to progress in macroeconomic performance.

5-2 The Priority of Agriculture

In China, Vietnam and Lao PDR, the first efforts at reform were made in the agricultural sector. A ‘contract responsibility system’ was introduced with the objective of restoring the family as the basic unit of production. At the same time, procurement prices of agricultural products were raised. The purpose of these measures was to give incentives to farmers who were (and remain) the largest group in the labor force. The improved agricultural production (Chinese agricultural production grew at an average annual rate of 5.4 percent from 1980 to 1992, and Vietnam became the third largest exporter of rice in the world), provided a firmer basis for subsequent stages of reform, as these economies were basically agricultural ones. In China in particular, capital accumulation in rural areas led to the evolution of town and village enterprises which served as a driving force for rapid growth. If reforms had been initiated in all sectors of the economy simultaneously (as was the case in Russia and Mongolia), farmers would have experienced a deterioration in their terms of trade from the
5-3 Slow Privatisation of State Enterprises

Most transitional economies are faced with serious problems with regard to state enterprises, which form an essential part of any centrally-planned system. In China and Vietnam, the governments have not attempted a drastic transfer of ownership from the state to the private sector. This contrasts sharply with the approach taken in Mongolia where, as in Eastern Europe and Russia, ambitious mass privatization was attempted through the provision of vouchers or coupons. Instead, China and Vietnam focused their attention on promoting the private sector on the one hand, and establishing autonomous management in state enterprises on the other.

Although the slow progress of privatization in these countries has been widely criticised, we believe that perhaps too much importance has been placed by the critics on the rapid transfer of ownership. As the sustained growth of private investment (including direct foreign investment) can be anticipated, the seriousness of the problem of state enterprises in relation to the whole economy is likely to be progressively reduced. In other words, the approach adopted by China and Vietnam has been to ‘contain’ the problem of state enterprises, preventing their financial collapse.

Although the situation regarding state enterprises is quite serious, particularly in China, the pragmatic approach to this area described above does provide a reasonable possibility of a ‘soft landing’, as private investment is very active. At the very least, this approach has helped to reduce the likelihood of social unrest due to the restructuring of state enterprises.

6 Strategy: Shock Therapy vs Gradualism

In the study of economic transition, one of the most important issues has been the choice between two alternative approaches regarding the speed and sequence of transition reforms. These are ‘shock therapy’ (also termed the ‘big bang’ or ‘radical approach’) and ‘gradualism’ (or ‘conservative approach’). Some experts argue that this choice is a central policy issue; in 1993 the IMF stated that, “It is important to establish whether a gradual or big bang approach is to be pursued”. In 1990, reports prepared by four international institutions (the IMF, IBRD, OECD and EBRD) on the economy of the former USSR strongly recommended that a radical approach to transition should be taken, arguing that “the conservative approach would certainly fail”.

However, the polarization of these two approaches is not, we believe, the most appropriate way to view strategic options for reform. Instead, we should combine elements of these two methods to form a third approach.

In some fields, the introduction of radical and drastic measures on all fronts is crucial, a typical example being the control of hyper-inflation. In other fields however, for instance state enterprise reform, a patient, step by step approach is preferable. A third category of issues, which would include price liberalization, financial reform, and trade liberalization, may offer a real choice between rapid or gradual implementation (eg. covering all major commodities or adopting a ‘two-track pricing system’). This combined approach can provide a wider range of options for policy-makers in transitional economies and contribute to more
effective reform strategies. The results of attempts at transition in Asia suggest that gradualism definitely has advantages, and that its effectiveness should not be overlooked.

7 A ‘Pluralistic Approach’ to Transition

What kind of market economy will be realized once the transition process is complete? Although this question has not been overtly taken up by the IMF and World Bank, in our view it is a crucial issue, since the course of transition, i.e. the contents of reform programs, are determined by three elements: (i) initial conditions (ii) speed and sequence of transition and (iii) the ultimate goal of the movement from centrally-planned economies.

Recent studies have established that there are various types of market economy. These include the American model, that of Continental Europe, and the Japanese model. If there existed a single type of market economy, the path of transition may be relatively simple. However, once we acknowledge that there are various types of market economy, decisions regarding the contents of reform programs become more complex. At the same time, broader alternatives can be offered to policy makers in transitional economies. An example of this is the role of directed credit with subsidized interest rate. If the goal is to realize a market economy which is similar to that of the United States, this policy would be an unacceptable method of financial reform. However, if the aim were to establish a Japanese-style market economy, such a policy could become an important component of the financial system.

We therefore propose a pluralistic approach to transition, one which is based on the recognition of multiple market economy models. The resulting broader range of options would, we believe, lead to more effective reform strategy.

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Part 1  Theoretical and Empirical Issues of Transitional Economies

Chapter I  Conceptual and Theoretical Framework

1 Introduction
1-1 Conceptual Framework

Our subject is “transition to a market economy”, or a movement from a centrally planned to a market-based economic system. This is often called “economic reform”. As the concept of economic reform is much broader than the transition to a market economy, and accordingly, include concepts which are quite different from the latter, it seems useful to confirm the definition of these concepts at the very beginning.

1-1-1 Economic Reform

In our opinion, the broad concept of economic reform is composed of the following four components:

(1) Reforms of the Economic Systems of Developed Countries

This is the attempt at revitalization of developed economies through the enhancement of market mechanisms, such as deregulation, liberalization, decentralization, and privatization. The recent movement of economic or structural reform was initiated by the adoption of the “positive adjustment policy” by OECD, in 1978. The purpose was to overcome the macroeconomic stagnation caused by the oil crises. The movement was accelerated by the Thatcher administration in the U.K. and Reagan administration in U.S., during the 1980s.

(2) Structural Adjustment in Developing Countries

The enhancement of market mechanisms has also been attempted in developing countries since the late 1970s. The rationale is that the removal or reduction of excessive regulation and government intervention is crucial in overcoming macroeconomic disequilibria and leading to sustained growth. In the late 1970s and early 1980s, many developing countries suffered from high inflation, unsustainable current account deficits, high fiscal deficits, and stagnant growth. As is well known, the endeavor of structural adjustment has been urged and strongly supported by the World Bank through structural adjustment lending (SAL) and the IMF through structural adjustment facility (SAF).

(3) Economic Reform within the Framework of Centrally Planned System

There were various reform attempts of centrally planned economic systems. They were “campaigns” for efficiency improvement or production increases under the existing system. Particularly, in the late 1960s, there were strong reform movements called “market socialism” in Eastern Europe (East Germany, Czechoslovakia, Hungary, Poland, Yugoslavia etc.) and the former USSR; typical examples are the “new economic mechanism” in Hungary. Despite a wide variety of features, some common aspects are observed among these reform attempts. First, the central purpose was to overcome chronic inefficiency through the introduction of profit incentives and delegation of power to factory managers. Second, the basic idea was to combine plan with market, with the dominance of the former (the idea of “regulated market mechanism” or “guided market model”). Third, economic reform was indirectly related to political reform, for example through labor participation in management.
However, all of these reform movements experienced setbacks in the early 1970s, due to the unfavorable changes in the political environment.

(4) Transition to a Market Economy

This is defined as a movement from a centrally planned economy to a market economy. Unlike (3), this is not a reform within the traditional system but a transformation of the economic system itself. The IMF and the World Bank often call this “market-oriented reform”. Although there have been arguments about the analogy between structural reform and transition to a market economy, it should be pointed out that there is a distinct difference between them in terms of the initial conditions.

1-1-2 Initial Conditions

The abovementioned reforms are divided into two groups in terms of “initial conditions”. In the case of the first two, that is (1) and (2), the initial condition is basically a market economy, although in some developing countries market mechanism is very much underdeveloped. It should be pointed out that the distinguishing feature of the initial condition of (3) and (4) is not the fact that the role of market mechanisms is negligible or market mechanisms do not exist at all. As a matter of fact, in some centrally planned economies such as Vietnam and the southern China the state enterprises sector accounted for relatively low share of GDP, and the non-state sectors played some important roles even before the start of reforms. The most important point is that the principle of command economy, which is completely different from a market mechanism, was well developed and established, at the beginning of the reform.

Because of this essential distinction, the process of transition to a market economy inevitably leads to fundamental changes in social structure, rather than changes in institution, procedures, and policy measures.²

1-1-3 From Reform Campaigns to Transition

One interesting feature of the recent economic reforms in the former centrally planned economies is that reforms within the traditional framework and transition to a market economy occurred in a series, and the distinction between the two phases is not necessarily clear.

There is a consensus among experts that the reform program in China was launched in December 1978, at the Third Plenum of the Central Committee of the Communist Party.³ It should be pointed out that the reform program in the initial stage dealt with only limited issues, such as agricultural reforms, the opening up to the outside world, and very limited decentralization in state enterprises. The nature of the reforms in the early stages was quite similar to the “market socialism” of Eastern Europe in the 1960s.

In those days, the word “market economy” was avoided very carefully. Even in 1987, the economic system was described officially as “planned commodity economy”, in which “the state regulates the market, and the market guides the enterprises”.⁴ However, in February 1992, the Communist Party finally announced their intention to establish a “socialist market economy”; this is “a new paradigm”, aiming “to establish an economic structure in which market forces, under the macroeconomic influence of the state, will determine relative prices
It took more than a decade for the Chinese government to advocate the movement to a market economy.

It is agreed that the reforms in the former USSR were initiated in 1986 in the form of perestroika (“restructuring”). However, it is to be admitted that the reforms in the early days of perestroika were basically in the nature of traditional campaigns rather than the reforms of the economic system itself, although more emphasis was later placed on the reform of the system. In early 1990s, the reform was accelerated; in January 1991, many prices were shifted from fixed to contractual. Further in January 1992, controls on most prices were officially lifted. Following this drastic change, the G7 began giving financial assistance to Russia.

It is possible to call the early part of the reform a “piecemeal approach”, and the later part “comprehensive approach”, but the transition from the former to the latter is blurred. In our opinion, it is better to regard the former as an integrated part of the reform, although the original intention might be far from the transition to a market economy.

We would like to propose to treat the long series of reform attempts in Vietnam and Laos since the late 1970s as an integrated reform. Usually the reforms in Vietnam are considered to have been initiated in 1986, by “đổi mới” (renovation). However, it should be pointed out that in Vietnam, the “output contract system” was introduced in the agricultural sector in 1979-80, in order to motivate farmers, and, in the industrial sector as well liberalization measures of state enterprise management were introduced in 1981, under the name of “three plan system”. The nature of the series is basically similar to the cases of China. A similar situation is also observed in Laos.

(Shimomura)
FOOTNOTES

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1-2 Worldwide Trend of the Transition to a Market Economy

The worldwide trend of the “transition to a market economy” in the former centrally planned economies since the late 1980s can be referred to as an historical event. Since 1986, Perestroika in the former USSR spread over Eastern Europe and caused major economic and political upheaval in the area in 1989. Market-oriented reforms were also observed in the planned economies of Asia, including China, Vietnam, Laos and other countries.

However, those economies actually started their “economic reform within the framework of centrally planned system” much earlier. Several attempts of “market socialism” were tried in Eastern Europe and USSR in the late 1960s, e.g. the “New Market Mechanism” in Hungary, as well as other attempts. Also, in Asia, China and Vietnam started their reforms in the late 1970s, with China’s Third Plenum of the 11th Party Congress in 1978 and Vietnamese “New Economic Policy” approved in 1979.

1-2-1 Domestic Factors

The problems which urged them to reform their economies can be summarized into the following three points: (1) stagnation of production, (2) mismatch between demand and supply and (3) macroeconomic imbalances such as inflation, fiscal deficits and external imbalances.

These problems can be attributed to the two major defects of planned economies, namely (a) lack of profit incentives and (b) lack of the mechanism which secures efficient allocation of resources.

In the planned system, enterprises were required not to earn profit but to fulfil the planned norms, with all the necessary materials, labor forces and capital provided by the state. In addition, these enterprises did not face hard budget constraints, with easy access to direct or indirect subsidies. In such a no-incentive environment, we cannot expect rational behavior toward profit maximization or cost minimization by the enterprises.

Even if the enterprises acted with economic rationality, with the relative prices determined by the state—which did not reflect demand-supply conditions—, efficient resource allocation could not be expected.

Consequently, we can conclude that (a) lack of incentive brought about (1) stagnation of production, and (b) lack of market mechanism caused (2) the mismatch of demand-supply, and they finally resulted in (3) macroeconomic imbalances.

In the stage of the “reform within the framework of the planned system,” the main feature of the reform was (a)’ to give incentives to enterprises (or farmers) by establishing their autonomy regarding management or economic decisions. (b)’ introduction of market-based resource allocation, which includes price liberalization and the abolition of plan based resource allocation, was virtually neglected in this stage.

However, progress of the reform (a)’ inevitably causes pressure to implement the reform (b)’ from the enterprises sector. The Eastern European and Asian planned economies pursued different courses from this point.

In Eastern Europe, where the potential requirement of political democratization was strong, (b)’ introduction of a market could lead directly to a structural change of the political system since it weakens the justification of the dictatorship of the communist party.
Therefore, the authorities in Eastern Europe had to suppress reforms whenever the requirement for reform (b)' came up. As a consequence, Eastern Europe experienced a repeated history of reform and suppression until the political pressure from the USSR was removed in the late 80s. Once the political pressure was removed, these countries experienced drastic political shifts, until finally the dictatorship of the communist party was broken down. Under the new regime, radical economic reforms were also pursued partly reflecting the commitment of the IMF and World Bank.

On the other hand, the Asian planned economies succeeded in implementing reforms beginning with (a)' and gradually moving to (b)' without drastic changes in their political systems. Thus, the reforms in the Asian planned economies have displayed more continuity.

1-2-2 External Factors

In addition to the above-mentioned inefficiency of these domestic economies, we can point out the inefficiency of the external transaction system of the planned economies as well.

The Council for Mutual Economic Assistance (CMEA) had the following problems.

First, there was no rationality in the international division of labor in the CMEA. Although the division of labor was in principle to be determined by considering both efficiency and equality, in actuality greater importance was given to equality, which sacrificed efficiency.

Second, international trade, both in volume and price adopted, was prescribed in advance by bilateral trade plans for each item. In the trade plans importance was attached to the bilateral trade balance. The prices had little flexibility and an irrational price system which reflected little of the price changes in the international market was generated.

Third, the multilateral settlement mechanism did not work. Though in principle multilateral settlements became possible with the introduction of the transferable ruble and the establishment of the COMECON Bank in 1963, since actual trade was still based on bilateral trade plans which attached importance to the bilateral trade balance, the transferable ruble lacked not only the function as a settlement currency but also the function as a purchasing means. (Even if a country acquired reserves of transferable ruble, the country couldn't use it unless it concluded a bilateral trade plan with another country.)

These problems enlarged the defects of the planned economies, which are (a) lack of incentive and (b) inefficient resource allocation, and brought about several unfavorable results, including the fall of international competitive power, accumulation of international debt, and so on.

China, which did not participate in the CMEA, was aware of these demerits of the planned international transactions. Thus it has adopted an open policy since the early stage of reforms e.g. the establishment of “Special Export Zones” in Guangdong and Fujian provinces in 1979. The open policy of China, and of other East Asian countries such as the Asia NIEs and ASEAN, brought amazing dynamism to the region. The success of the open policies and the dynamism of the neighboring economies must have put great pressure on the Asian planned economies to open up their economies.

The CMEA collapsed in 1991. This seems to have accelerated the confusion in Eastern European economy. Most of the former Asian planned economies, to the contrary, especially
Vietnam, seems to have gained much more merit from the economic opening than the

demerits of the collapse, owing to its geographic proximity to the dynamic Asian economies.
Currently, Vietnamese trade with the Asian economies accounts for 68 percent of exports and
44 percent of imports, and foreign investment is about to rush into Vietnam. The exception is
Mongolia, which is landlocked and located far from the dynamic Asian economies, and could
not make use of openness and suffered seriously from the collapse of the CMEA.

(Mihira)

1-3 Market Mechanism and the Role of Government in the Process of Economic
Development
1-3-1 Introduction
The importance of the role in governments is changing over time, and has, in recent years,
been reconceived in the United States, Macroeconomics has undergone dramatic changes,
especially from the second half of the 1980s. This is not unrelated to the deterioration of the
real economy in the United States following the Great Depression (Stiglitz, 1993a). At the
beginning of the 1980s, there emerged the school of real business cycles in line with the
currents of the neoclassical school, which conceived of economies as the continuation of
equilibrium points. Actually, however, unemployment arose in the American economy and
economic growth --rather than stabilization of the macroeconomy-- become problematic. This
had an impact on Lucas (1993) and others of the neoclassical school, and analysis on
economic growth in Korea and elsewhere in East Asia began. What these economists
advocate is investment in human resources. This is also the field in which the results of many
years of research by the Nobel prize winner, G. Becker, and others belonging to the Chicago
school have grown. What is especially important here is the emphasis by the neoclassical
school on the existence of market failures in the course of economic growth (development). In
other words, the role which government should play in development has been clarified.

In the 1980s, the so-called “New Keynesian” school of thought captured a wide following.
This school clarified the role of government with respect to various points in economic
development such as coordination failures, credit rationing and information-related
externalities. In particular, a paper recently published by Stiglitz (1993b) is expected to have
a revolutionary impact on macroeconomic debates. Analysis took place, for example, not from
the effective demand side, as stressed by Keynes, but from the effective supply side. In this
connection, the impact of credit rationing on the business climate is analyzed from a
microeconomic foundation, and the necessity of government intervention is advocated.

In this debate, there is a close connection between development theory and “the East
Asian Miracle” issued by World Bank (1993). Stiglitz was influential in the writing of this
work. In it, the World Bank recognizes the role of government in making selective
interventions, and analysis was made from the standpoint of economic development through
an export-push strategy. It is especially noteworthy that this strategy also parallels that of
the Clinton Administration.

Agreement will be found on the supposition by the IMF and the World Bank that
macroeconomic stabilization is a “prerequisite condition” for the implementation of struc-
tural adjustment policies and industry policies. What is more, the World Bank has come to
recognize the role of government with a wider range than before in responding to market failures during development, and this fact may be looked upon as a great change appearing in the 1990s.

In the sections that follow, we want to make clear the role of the government in countries in transition to market economies. The next section explains transmission of the function of market mechanism in the 1980s by historical analysis. Also, we illustrate new examples of market failures, particularly from Stiglitz (1988a), (1988b). Industrial policy is focused on to discuss the role of government in section 1-3-3. Our discussion is based on “The East Asian Miracle” (World Bank, 1993), which is useful to find the optimal policy mix of the “market-friendly” view with the “developmental state” view.

1-3-2 Function of Market
(1) Market Mechanisms

The precipitous drop of share prices on Wall Street, New York, referred to as “Black Thursday,” which occurred in October 1929, marked the beginning of a worldwide depression. In order to prevent the birth of such a bubble in capitalism, as well as the onset of panic caused by a “negative bubble”, a financing system was established and maintained according to regulations created after the panic. Nevertheless, about forty years later (around 1970) there was a dramatic change in the economic environment. On the one hand, there was the remarkable recovery from the World War II in Japan and in West Germany, and on the other, a loss of economic power began to appear in the United States due to factors such as the Vietnam War.

Under such conditions, the world economy was forced to make a major shift in orientation toward deregulation. Moreover, there was an inevitable adjustment of relative prices, as pointed out by Miyohei Shinohara, professor at Tokyo International University. Examples include adjustment of exchange rates, of crude oil prices and of the price of gold. After World War II, the yen rate was fixed at 360 yen to the US dollar, but a floating exchange rate system was introduced in 1973, and the yen steadily appreciated. Up to 1970s the price of oil was held constant under the control of the major oil companies, but in the 1970s it climbed dramatically following two “oil shocks”.

One of the great currents in the course of the world economy after 1970 was the transmission of the function of market mechanisms due to deregulation. In the midst of this current, the former Soviet Union and Eastern Europe collapsed, and socialist countries which had depended upon assistance from the Soviet Union were forced to shift to market economies. Similarly, the socialist countries in Asia, including Vietnam, Laos and Mongolia, began to shift to market economics.

Early in the 1980s, the budget deficits of nations worsened drastically and calls for economic liberalization became frantic. The national leaders who appeared at this time in the United States, England and Japan were Reagan, Thatcher and Nakasone, respectively, and each was a firm advocate of economic liberalization. In the realm of economics, the Keynesian policies of intervention through the national budget lost their effectiveness, and it was even declared that Keynesian economics had died. Meanwhile, in the realm of policy, the school of hypothesis of rational expectations, who advocated laissez-faire in line with
classical economics, together with the real business cycle (RBC), exerted great influence. The Keynesian model, however, did not die; it was transformed into the so-called “New Keynesian model”. Economists such as J. E. Stiglitz argued for the effectiveness of government intervention after re-examining Keynes’ analysis of fundamentals at the microeconomic level. In addition, Lance Taylor used theoretical models to criticize to the World Bank and the IMF, which had supported deregulation, that there are cases in which government intervention is necessary.

By what process does the shift to market economies progress? If we understand this, we will understand the major current in the world economy.

There are two major factors behind the development of the markets. One is the development and advancement of exchange markets such as the markets for futures, options or warrants. The diffusion of computers contributed greatly to the advancement of these exchange markets. Another force is the conditionality of the IMF and the World Bank. Conditionality refers to the conditions set whenever financing is provided by the IMF or the World Bank. Normally, financing from the IMF or the World Bank is broken down into two or three tranches over time, and conditions are set for each tranche. If the recipient country cannot satisfy this conditionality, or if financing conditions worsen, disbursement is halted; so it is imperative for developing countries that they satisfy this conditionality. Essentially, this conditionality calls for introduction of market mechanisms through deregulation and economic liberalization. More specifically, it calls for the liberalization of exchange rates and of interest rates, and for the abolition of price controls.

Official development aid from the Japanese government is very closely interrelated with this conditionality of the IMF and the World Bank. In recent years, the weight of co-financing with the World Bank, etc., by institutions such as the Overseas Economic Cooperation Fund (OECF) has been escalating. This co-financing is also referred to as structural adjustment lending (SAL). In this financing, the conditionality of the World Bank applies. Consequently, in carrying out co-financing with the World Bank, it is essential to bolster penetration of the market mechanism as advocated by the World Bank.

(2) The Market Failure and Government Intervention

Structural adjustment policies based on SAL were implemented in developing countries throughout the 1980s, but very few were successful. In East Asia, on the other hand, high-level economic growth was conspicuous. It has been hypothesized that a major factor behind growth in the East Asian countries is the fact that industrial policies implemented in the past in Japan by the Ministry of International Trade and Industry (MITI) were taken as models, and in recent years a study regarding this hypothesis was conducted by the World Bank. It is suspected that industrial policies through government interventions are preferable to market mechanisms. It thus becomes a matter of choosing the optimal mix between market mechanisms and government intervention.

In Japan, there has been a shift away from industrial policy in the narrow sense to industrial policy which highlights the importance of infrastructure and of human resources in the broadest sense. Another opinion is that deregulation should be implemented in large measure. This is manifested by the fact that in Japan, reforms have had to be made in such things as politics, education and the bureaucracy. In the United States, under the Clinton
Administration, the emphasis has shifted away from market mechanisms toward the introduction of a kind of industrial policy. Meanwhile, in the countries of Latin America, export-oriented economic liberalization has been advancing in the 1990s, which improved the macroeconomic performance. The large countries of India and Egypt are also moving toward free market economies. Of course, almost all other developing countries in need of IMF or World Bank financing are working to introduce market mechanisms still further. In other words, as the movement toward deregulation and economic liberalization has gained momentum worldwide, especially from the 1980s on, attention has focused in the 1990s on the optimal policy mix of market mechanisms with government intervention.

The role of government is to intervene in market failures. Textbooks show the following examples of the Pareto-inefficient cases in which the public sector plays a role of increasing returns to scale, public goods, externalities, and imperfect information (see Stiglitz 1988a).

In addition, Stiglitz (1988b) illustrates the role of government in the development process as follows: undersaving, financial intermediaries, barriers to the flow of capital, shortage of skilled labors, landlord's resistance of innovation, and inappropriate technology.

1-3-3 Economic Growth and the Role of Government

After macroeconomic stability has been reached, macroeconomic growth becomes a major issue for the state. Economic growth requires high levels of productivity growth, and what improves productivity is technological progress. Technology is then disseminated through investments in physical and human capital and through trade. In recent years, attention has been focused especially on the diffusion of technology through investments in human capital and through trade.

In one sense, “The East Asian Miracle” was epoch-making. Its contents were already foreshadowed in the Development Report by the World Bank in 1991. Its main point was a more positive affirmation by the World Bank of government intervention in the course of development. Let us explain this point in more detail below, according to the World Bank (1993).

Viewpoints regarding the role of government in economic development are divided here into three categories by the World Bank.

(1) The Neoclassical View
(2) The Market-Friendly View
(3) The Developmental State View

The Neoclassical View (1) proposes the following four roles for government in support of development.

(i) Stabilization of the macroeconomy
(ii) Establishment of rules for the promotion of competition domestically and internationally
(iii) Promotion of international trade and abolition of price controls
(iv) Investment in human resources (education and health)

The Developmental State View (3) calls for sector-specific industrial policy as adopted by Japan and Korea. The World Bank does not endorse such policies. The reason is that implementation of such policies requires such things as a technocratic elite of special
competence, and it is difficult to establish such conditions in nearly all developing countries. On the other hand, the Market-Friendly View (2) calls for an even greater role for government than the roles proposed by the Neoclassical View (1). The fundamental concept behind this view is competitive discipline: it allows for government intervention aimed at the promotion of competition. A type of government involvement is called “selective interventions”. In the course of market failure, this intervention focuses on the following factors: (i) coordination failures between public sector and private sector (ii) credit rationing (iii) information-related externality

These three factors have become topics of heated debate among economists in recent years. Nevertheless, it must be noted that these factors run contrary to the role of government in relation to sector-specific industrial policy as postulated by the Developmental State View. In response to coordination failures (i), as well as the exchange of information (iii), the role played by deliberation councils in Japan in the coordination of the public and private sectors has been highly esteemed. What is more, with respect to credit rationing, deliberation council policy calling for contest-based competition through corporate contests has also won high esteem. Nevertheless, in implementing these policies, government officials of outstanding competence are required. Generally speaking, it is not likely that these policies can be adopted effectively in other developing countries.

In particular, the World Bank (1993) approves of export promotion as government intervention policy. East Asia is divided into two major categories according to the World Bank.

(a) Northeast Asia (Japan, Korea, etc.), where exports have been promoted in accordance with the Developmental State View (sector-specific industrial policy).

(b) Southeast Asia (Thailand, Malaysia), where exports have been promoted in accordance with the Market-Friendly View.

The type of export promotion practiced in Thailand, Malaysia and Indonesia, which depends upon direct foreign investment and market competition through incentives rather than selective interventions, is being advanced in other developing countries as the “export-push” strategy.

For export promotion in Northeast Asia by the World Bank, the following measures were taken:

(i) Provision of export credit
(ii) A duty-free system for related enterprises to promote exports
(iii) Establishment of export targets
(iv) Preferential tax treatment system
(v) Monitoring: adjustments were made continuously, and steps were taken to upgrade industries.
(vi) Effective use of information-related externality through exchange of information.

Nevertheless, these policies were not always successful, as witnessed in the course of industrialization of the heavy and chemical industries in Korea.

The definition of the Developmental State View by Murakami (1992) is different from the World Bank regarding the following:
(i) Private ownership and market competition
(ii) Industrial policy
(iii) Export promotion
(iv) Policy to foster small- and medium-scale industries
(v) Redistribution of income
(vi) Egalitarian policy for farmers
(vii) Education
(viii) Modern bureaucracy

In contrast, the following Market-Friendly policies were implemented in the Thailand-Malaysia model [B] by the World Bank (1993).

(i) Creation of a free-trade environment for exporters
(ii) Financing and support services to small- and medium-size exporters
(iii) Improvement of trade-related government services
(iv) Incentives for export-oriented, direct foreign investment
(v) Preparation of infrastructure for exports

Moreover, at the time of government intervention, the following four principles are demonstrated.

(i) The targets of intervention are concentrated in fields where market mechanisms do not function.
(ii) Objectives are established and various policies in line with these objectives are implemented
(iii) Endeavors by the private sector are evaluated fairly and systems for providing bonuses are introduced
(iv) Upon achievement of the objective, intervention is ceased and the market mechanisms are allowed to function freely.

From the above analysis, the conclusion of the World Bank is that government intervention should be of the market-friendly type as exemplified by the Thailand-Malaysia model.

Nevertheless, the following three problems can be noted with this approach.
(1) In the Thailand-Malaysia model, if we assume that export-oriented, direct foreign investments have played a major role, the question becomes whether or not other developing countries have enough attractive features, like the countries of Southeast Asia, to invite foreign investments. If a country has problems with national security or political instability, for instance, these can become great hindrances.

(2) In principle, the World Bank is opposed to application of the Developmental State View to other developing countries, but it acknowledges the role of coordination failures, credit rationing and information-related externality in supplementing for market failures under selective intervention. It also esteems the role of inter-corporate contests as a mode of competitive discipline under the Developmental State View. Hence the Bank is not opposed to all sector-specific industrial policies. The following question thus arises: Is it not possible to consider intervention policies aimed at preparing conditions so that industrial policies are maximized for the promotion of competition?

(3) Is it not possible to find the optimal policy mix of the Developmental State View with the Market-Friendly View, and search for ways to apply the model to other developing countries? These questions have become important topics. (Kuchiki)
Chart 1-I-1 Development Policy

The Neoclassical View

The Market-Friendly View

(The Thai-Malaysia Model)

Stable Macroeconomic Environment
Legal Framework to Promote Competition
Absence of Price Controls
Investment in People

A Functional Approach

Selective Interventions

Market Failures
1. Coordination Failures
2. Credit Rationing
3. Information-Related Externalities

The Developmental State View
(Sector-Specific Industrial Policy)

(The Korea-Japan Model)

Provision of export credit
A duty-free system for related enterprises to promote exports
Establishment of export targets
Preferential tax treatment system

Creation of a free-trade environment for exporters
Financing and support services to small and medium-size exporters
Improvement of trade-related government services
Incentives for export-oriented, direct foreign investment
Preparation of infrastructure for exports

the EPZ model
REFERENCES

2 Fundamental Issues for Transition Strategies
2-1 Introduction: Relevance of “Structural Adjustment”

It seems that policy advice for ‘transition economies’ or former centrally planned economies in transition to a market economy had been based on multilateral agencies’ experiences in many developing economies such as those in Latin America. Many Latin American developing economies had suffered from serious economic troubles with heavy external debt, which itself was regarded as resulting from both external shocks and domestic mismanagement.

Developing economies had suffered from the same or similar kinds of external shocks and domestic mismanagement during the 1980s. Most of these economies were hard hit by oil price hikes, declining primary commodity prices, higher international interest rates, and the slowdown of developed economies’ imports. Most of their policy authorities coped with these situations through external borrowing and enlarged budget deficits, resulting in heavy external debt overhang and implicit or explicit domestic inflation. These economies have been advised to take decisive measures for short-run stabilization and long-run structural adjustment as conditionalities imposed on their borrowing from the multilateral agencies.

Such transition economies as those in Eastern Europe also shared some features of economic difficulties in common with those Latin American economies. In fact, some of them were hard hit by a series of external shocks in the early 1980s and joined the group of heavy debtors along with some Latin American economies. The Eastern European economies, in particular, can be also categorized as middle-income developing economies as can some Latin American economies. In fact, they had attained certain levels of per capita income, education and public health. Therefore, there is a reason to draw lessons from the experiences of middle-income developing economies like in Latin American for Eastern Europe and to give a similar line of policy prescription for their economic reforms.

More generally, the application of policy prescriptions for developing economies to former centrally-planned economies has without doubt some reasons. They share in common the objective and means of economic reforms. They aim at both short-run economic stability and long-run development by controlling domestic inflation and opening up their economies to the rest of the world.

Recently, however, more people have become doubtful of the effectiveness of this type of policy advice. The doubt comes from two fronts. First, it has become a target of hot debate whether the structural adjustment policy in practice is effective in the different contexts of a variety of developing economies. This may be rather technical. Second --- and more important here --- it has become less clear whether this type of structural adjustment policy can be easily applied to these transition economies. In fact, recently, we have heard more and more arguments against straightforward application of policy prescription designed for developing economies in general to former centrally-planned economies.

First, because they were under the CMEA regime, the degree and timing of those external shocks were different for the former CMEA and the other developing economies. In particular the collapse of the CMEA regime gave a deep-rooted blow to the member economies.

The CMEA regime was a system of intra-regional trade based on distorted prices. Once
the system collapsed, the member economies were exposed to international trade based on competitive prices, which were totally different from those distorted prices. Also, the CMEA regime was a system of regional integration. Once it collapsed, it was revealed that the whole production location system based on distorted prices had to be reshuffled.

Second, no less important, the former CMEA economies had to confront the collapse of their economic system as a whole. Namely, their economic reform requires not just partial revisions, but revolutionary changes in their entire institutional arrangements. The reforms are to introduce a new ownership system based on private property rights, a new corporate system by privatization, a new banking system to replace the mono-bank system, and a new fiscal and social security system.

Of course, we have often observed in capitalist developing economies such as 'soft budget constraints' between governments and state enterprises and 'financial repression.' But at least we could say that those economies are based on private property rights and decentralized decision making processes. The difference between the 'capitalist' developing economies and the former socialist economies is not a matter of degree. Thus we must realize that there is 'a sea of difference' between the start and the goal of economic reforms in the case of the former socialist economies, which requires far more comprehensive reforms than in the other developing economies.

Another recent development and/or turmoil in policy thinking around transition economies is how to evaluate or reconcile contrasting economic performances in Eastern Europe and the former Soviet Union on one hand, and in China and Vietnam on the other (see McKinnon [1994] and Sachs and Woo [1994], for example). The present discussion proceeds toward the method of reform management, and the initial conditions of the reform. Before doing so, we are going to clarify the mechanism inherent to transition economies which creates a variety of economic responses in the process.

2-2 Reform Process: Stabilization and Structural Reforms

At the start of economic reforms, typical problems are domestic inflation, fiscal deficit, external imbalance, pervasive price distortion and financial repression. Then, the prescription for stabilization should be fiscal restraint or reduced subsidies, domestic price liberalization, foreign exchange rate devaluation and monetary restraint. In Eastern Europe and the former Soviet Union, the result has been a disastrous combination of unexpected price inflation and output decline despite transitory improvement in the external balance.

2-2-1 Inflation

The extent of price explosion due to price liberalization has been harsh, sometimes far beyond initial expectations, and this inflation has not subsided swiftly in Eastern Europe and Vietnam. In China, where price liberalization was undertaken at a slower pace, inflation was fairly high (as much as 20 percent), but not accelerated as much as in the others.

There are three possible reasons for this hyper-inflation. The first is, of course, excess liquidity. To the extent that pre-reform price distortions were serious, price liberalization would expose mismatching demand and supply in various aspects of economies. Excess demand, however, could not necessarily generate inflation without the support of excess
liquidity. Accordingly, it could be said that monetary restraint has not been strong enough to control domestic demand.

Second is the effect of exchange rate devaluation to correct relative price distortion. This might be sometimes underestimated in affecting domestic inflation. Third is the monopolistic behavior of state enterprises. Confronting liberalized higher input prices, they might have set their selling prices at higher than market-determined levels.

There seems to be a consensus view that, to cope with this kind of hyper-inflation, the larger the once-and-for-all price shocks, the shorter the duration of its impact. But we must note also that industrial adjustment would take time so that price liberalization could not necessarily guarantee quick improvement in resource allocation but may even hamper it through increasing risks. Then, sectoral imbalances and the resulting inflation could be prolonged for a while.

2-2-2 Output Decline

Output response to the new incentive system or liberalized prices has sometimes been greater than expected. Among other things, a decline of output has been sharp and its duration has been unduly long in Eastern Europe and the former Soviet Union. Especially, the reaction of the ‘ancient’ structure of production, namely state enterprises, has been generally slow and their output decline has also been pervasive. On the contrary, output decline in Vietnam was relatively short-lived with only transitory stagnation, and there was nonnegative output growth in China.

This ‘output collapse’ during the reform, which has generated explicit and implicit unemployment and helped reduce real wage rates, can be attributed to a variety of factors.

First, one can point out demand-side factors such as prevailed hoarding of goods and materials based on inflationary expectation and, then, reduced demand afterwards, real reduction of money, credit and wages due to unexpected inflation and monetary tightening, and the ‘terms-of-trade effect’ due to the collapse of the CMEA regime.

Second, more important, however, there are supply-side factors which include a decline of real credits, a rise in nominal interest rates due to price shocks, high real interest rates maintained thereafter, and risk averseness intensified by management shocks due to regime changes. Moreover, while price liberalization resulted in increased input goods prices, the collapse of the CMEA regime itself has brought about a sharp cut of imports of materials and intermediate goods.

2-2-3 Transmission Mechanism

This output response resulted directly from stabilization measures in the reform and the close relationship among the fiscal budget, financial market, and enterprise organization as described below.

First, fiscal reform consists of an overall cut in subsidies, which means an overall cut in profit and investment finance of state-owned enterprises (SOEs). In view of a significant role played by these SOEs in raising revenue to the government budget under the ‘soft-budget constraint,’ this kind of expenditure cut could, after all, expand the budget deficit rather than vice versa. On the other hand, it may need time and resources to enlarge the tax base and to
introduce new tax instruments, especially in transition economies. In addition, structural adjustments require increasing expenditure for a social safety net, particularly in the transition period. In Eastern Europe, increased unemployment has increased expenditures for social security purposes under their relatively advanced safety net systems.

Second, price liberalization leads to an increase in input price as well as output price to existing enterprises. Because of generalized price distortions, it could lead to a fall in profits, thereby reducing output and then employment, particularly in the case of SOEs. Naturally, newly-established private enterprises can take an advantageous position. In fact, non-state enterprises, generally small- and medium-sized, labor-intensive industries, have shown far better performance than SOEs, in both Eastern Europe and Asia.

Third, monetary tightening implies higher interest rates and a credit crunch. This in turn frustrates financing needs not only for investment, but also for working capital, leading to output reduction. This type of stagflationary impact has been typical to developing economies under ‘financial repression’ and/or imperfect capital markets as pointed out by Taylor [1980] and Calvo and Coricelli [1992]. In the case where financial repression is so serious that households or domestic savers can hardly have a strong financial intermediary link with enterprises or domestic investors, enterprises themselves establish intra-firm networks of claims/liabilities. Then, these stabilization measures accelerate the piling-up of these claims, thereby undermining the managerial foundation of those enterprises and then their lending banks, which in turn would shake the stability of the financial system as a whole.

2-3 Initial Conditions for Reform Program

Now, if we turn to the recent economic performance in transition economies, no one can deny the shocking contrast between Eastern Europe/the former Soviet Union and China/Vietnam. While Eastern Europe and Russia have suffered from consecutive negative economic growth and persistent inflation, China has realized double-digit growth with limited inflation and Vietnam has also attained fairly steady growth with successfully controlling inflation to date (see Chart 1-I-2, 1-I-3).

In the previous section we have seen the transmission mechanism through which the reform measures affect macroeconomic variables such as inflation, fiscal deficit, money supply, and employment. With this respect there is no difference between Eastern Europe and China and/or Vietnam. Then what could generate such contrasting results?

One probable reason would be a difference in initial conditions of the recent economic reforms². Among various initial conditions, three aspects could be essential to produce this much contrast. They are 1) industrial structures, 2) macroeconomic situations and 3) pre-reform regimes.

2-3-1 Industrial Structures

In Eastern Europe, the industrial sector was dominant, while agriculture was minor in terms of both output and employment. But the situation is the opposite in China and Vietnam (see Chart 1-I-4). Considering central planning would be more penetrating in industry than in agriculture, it is not hard to see that the above impact of reforms on output and employ-
ment would be larger in industrial economies than in agricultural economies.

It is known that a large agricultural sector in developing economies could be regarded as a reserve of underemployment. The agricultural sector could provide burgeoning non-state enterprises with its surplus labor force. This is what happened particularly in China in the case of well-known township-and-village enterprises (TVEs).

We must emphasize here that the steady growth of the agricultural sector in China played a significant role in providing with increasing demand and adequate domestic saving in addition to labor force. Note that the increase in domestic saving has been accomplished with a parallel increase in monetary asset holding, which must have contributed to domestic investment through financial intermediation. Therefore, agricultural growth supported not only the supply-side, but also the demand-side of the economy.

2-3-2 Macroeconomic Situations

If we focus on the recent efforts in economic reforms in the late 1980s, macroeconomic situations at the start of the reform were found to be far worse in Eastern Europe than in China. Real growth rates were either seriously stagnant or simply negative, exports were slowed down, current account deficits increased and consequently external debt piled up. China, in contrast, grew at not remarkable but significantly positive rates, and its external debt was virtually negligible.

The heavy external borrowing had not only postponed necessary domestic adjustments, but also enlarged the degree of those adjustments acceleratingly. Then, the international debt crisis halted the debt flow to developing economies so that they were forced to cut their domestic consumption levels abruptly. This is an additional demand-side factor that could explain the sharp and persistent fall of total output in Eastern Europe.

2-3-3 Pre-Reform Regimes

The degree of pervasiveness of central planning varied across economies. First, the presence of state-owned enterprises (SOEs) was far greater in Eastern Europe than in China. Output by and employment in SOEs had a share of more than 80 percent in the former, but of less than 20 percent in the latter (see Table 1-I-1). Thus, there is no wonder that the negative impacts of price liberalization, fiscal reforms, and monetary restraints through SOEs must have been relatively larger in Eastern Europe.

Second, agriculture had been decentralized earlier in China than in Eastern Europe so that agricultural development had started prior to industrial growth. This could make the transition process easier through relatively smooth transfers of resources across sectors.

Third, the share of CMEA trade was explicitly larger in Eastern Europe (and Vietnam) than in China, so that the collapse of the CMEA had a more serious negative impact on external trade in the former than in the latter. Note that this is only a short-run impact effect like terms-of-trade changes, while the CMEA regime itself gave a long-term negative effect through misguided industrial structures based on distorted prices.

2-4 Transition Strategies

In this final section, we discuss the role of policy factors in generating the wide range of
Table 1-I-1
EMPLOYMENT BY TYPE OF ENTERPRISES (%)

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<tr>
<td>State Owned Enterprises</td>
<td>18.6</td>
<td>17.9</td>
<td>18.3</td>
<td>93.1</td>
<td>86.1</td>
</tr>
<tr>
<td>Collective Enterprises</td>
<td>72.0</td>
<td>67.0</td>
<td>63.9</td>
<td>6.0</td>
<td>5.3</td>
</tr>
<tr>
<td>Township-Village Enterprises</td>
<td>4.3</td>
<td>7.6</td>
<td>10.0</td>
<td>N. A.</td>
<td>N. A.</td>
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Source: Sachs and Woo [1993]

Chart 1-I-5
(MERCHANDISE EXPORTS ($ BILLION))

(Notes)  * reduced to 1/3  ** doubled
economic performances across transition economies. Initial conditions are not the sole factor that can explain the above performance gap. In fact, policies and/or strategies undertaken in transition economies were known to be diverse over a few aspects. We focus on 1) the pace of reform, 2) the role of government, and 3) regional externalities.

2-4-1 ‘Shock Therapy’ vs. ‘Gradualism’

There has been a lot of debate on whether the ‘big bang’ approach (or the ‘shock therapy’) is a useful strategy to tackle the difficulties these transition economies are confronting. On average, it seems that those who have studied the recent Chinese reform experience tend to be in favor of a ‘gradualism’ approach instead of the ‘shock therapy’ as a strategy toward market transition (see, for example, McKinnon [1994]). They assert that the gradual approach can be successful in building an efficient industrial structure both for non-state and state-owned enterprises. Therefore, they say, “a ‘Big Bang’ is not necessary for economic reasons, unless addressing initial macro-imbalances justify it.” It has been even claimed that Eastern Europe and the former Soviet Union could learn from the Chinese experience in view of their disastrous results from the Big Bang.

A majority of those who have observed and advised the transition economies in Eastern Europe and the former Soviet Union have strongly refuted these claims above (see Aslund [1994], for example). They say, first, that the above argument against the Big Bang is ignorant of the difference in initial conditions and political regimes given to each individual transition economy, and, second, that the gradual approach had already been undertaken in Eastern Europe and the former Soviet Union and completely failed. They even claim that “the lessons will continue to flow to China from the market economies, including the fast reformers of Eastern Europe such as Poland, rather than in the other direction.” (Sachs [1993]).

Generally, however, we know that lessons could be drawn from either side in both positive and negative senses. Also, we know that there are fields where we need radical and decisive actions, but political constraints do not always allow them. Good reform packages should, without doubt, take these constraints into consideration. Sometimes, therefore, a gradualism approach must be resorted to at least as a second-best strategy.

More than that, of course, there are fields where we need a step-by-step approach instead of one-time big changes. Regarding institutional reforms such as judicial and accounting rules, they would naturally take time, which would also be the case for the establishment of private property rights in transition economies. This line of argument has much to do with a general issue of ‘sequencing’ of economic liberalization policies in developing economies in general.

There seems to be a consensus in understanding that macroeconomic stabilization through monetary control and fiscal reform should come first and at once, but that domestic financial liberalization should be implemented in a gradual and cautious way. But we have not found a consensus on an appropriate pace of trade liberalization.

To sum up, there is no solid rationale for the validity of either overall shock-therapy or overall gradualism for developing economies in general including transition economies. So
that, it would be futile to claim that one strategy is generally superior to the other without considering the effectiveness and feasibility of each policy instrument in each economy's context.

2-4-2 Role of Government

The economic role of government in the capitalist economy has been well-articulated. It is to provide a basic infrastructure both tangible and intangible which makes a foundation on which the market mechanism works, and to complement the market by supplying a wide spectrum of public goods. In other words, we may be able to widen the definition of 'public goods' by including all intangible and tangible goods and services to be provided by government.

According to this broad definition, 1) macroeconomic stability and 2) credibility of a policy framework in fighting against system risks are two of the most important 'public goods' that can be provided only by government. These two public goods are not mutually exclusive. Rather, they are closely linked with each other.

Macroeconomic stability has become generally accepted as the first priority not only in transition economies but in general. It is a basic precondition to mobilize domestic saving and attract foreign saving and then to boost domestic investment, thereby embarking on a dynamic growth path. If macroeconomic stability does not exist initially, adjustment costs to regain it would be unavoidable to some extent in the transition process as in the case of Eastern Europe.

However, the costs should be minimized and limited as far as possible only to relevant sectors. Economic reforms inevitably require income and/or asset redistribution as well as resource and/or production factor reallocation across various sectors. In China, the agricultural sector has realized steady growth and successfully supported non-state industrial sectors. In contrast, it seems that, in Eastern Europe, non-state sectors have been burdened by adjustment costs incurred by state-owned enterprises, although this observation might be too early to be definite.

Moreover, macroeconomic stability could be regarded as a guarantee for adequate managerial skills and determined political will of the government. Long-term economic decisions and plans could not be made without credibility of the policy framework or confidence on the continuity of the overall political-economic framework. This is more crucial in transition economies than elsewhere.

In this respect, the reform experience in China has told us much. Aside from political discussions, the government has loosened its leash step by step from centrally-planned to market-orientation, so that the short-and, perhaps, medium-term course of events has been more visible to economic agents than in Eastern Europe, at least relatively speaking.

It is sometimes pointed out that the recent dynamic growth of China has been accomplished significantly by the non-state sector so that substantial decentralization is the key factor. This observation does not necessarily contradict the above assertion, but rather strengthens it, because this decentralization reflects just a continuous reallocation of resources within the same policy framework. Note, however, that this is not to say that the present policy framework will continue to be effective and/or viable in the final stage toward
a ‘full-fledged’ market economy.

2-4-3 Regional Externalities

Finally, more emphasis should be placed on the difference in location of each transition economy. That is, we are going to discuss the role of ‘regional externalities.’ The collapse of the CMEA regime is seen to have had a serious negative impact on those economies dependent on it. While we may be able to call this an external diseconomy due to formal regional disintegration, China as well as Vietnam have enjoyed external economies generated by natural or informal integration through trade and capital flows in the Pacific Asia.

Before the reform, China was not only less dependent on CMEA trade, but also on external trade in general than Eastern Europe and even Vietnam. During the process of transition, China has been opening up and its dependence on external trade has increased rapidly, which must have much to do with dynamic development of the region as a whole (see Chart 1-I-5). This is without doubt a good example of a virtuous circle of trade, investment and economic growth. Unfortunately, this sort of environment could not be found in Eastern Europe and the former Soviet Union.

Increased interdependence through trade and capital flows would not only expand available opportunities, but also bring in additional beneficial impacts such as technology transfers, policy management skills, and discipline through international competition. This is generally the point to make in explaining the dynamic growth in the Asia Pacific region as well as, in particular, the case of China, where several authors stressed the role of ethnic Chinese communities in the Asia Pacific in the financial, commercial and technical developments.

2-5 Concluding Remarks

We have discussed that the experiences of structural adjustment in Latin America cannot be applied straightforwardly to the transition economies. We have also examined the different recent economic performances across the transition economies and identified some determinant factors in initial conditions, policy strategies and external environments. What policy implications have we learned so far?

One simple lesson can be drawn from the above. Successful results can be obtained even by an incomplete set of policy packages. ‘Partial reforms’ in China are a good example. There would be no unique all-weather or all-purpose policy strategy for transition such as either ‘big bang’ or ‘gradualism’. Appropriate policy strategies to each individual economy in transition would depend on initial conditions, policy management, external environments, and so on. Partial reforms in China may be disastrous to some other transition economies, for example.

It seems that we have returned to the original point where the best mix of market and government has been pursued. The issue of the transition to a market economy urges us to learn more about the nature of the desirable relationship between the market and government. (Kohsaka)
FOOTNOTES

1/ For example, Bruno [1992, p.742] writes, “In that superficial respect the adjustment and structural reform problem of Eastern Europe would seem to be akin to that of other middle-income countries, such as Brazil, Mexico, or Israel;...The delayed effects of some of these shocks are only now being felt in Eastern Europe. ...the distance between the initial point and the desired goal is not only wider but substantially deeper.”

2/ Generally, in order to identify initial conditions, we must pinpoint the start of economic reforms. The transition economies, however, have experienced various reform attempts at various stages. Thus, instead of pursuing exact years of transition attempts, we regard the conditions at the collapse of the CMEA regime as initial, because it is convenient for a comparative analysis of the recent diverse performances among those economies.

3/ ‘Market failures’ do not necessarily justify government intervention. Namely, whenever the market fails, the government could also fail. Thus, there are adequate interventions and inadequate ones.

4/ See Rawski [1994]. He also writes, “There was no clear strategy and no planned sequence of reform measures. Policy makers responded to a succession of problems and opportunities with ad hoc improvisation (p.272).”

5/ The point here can be summed up as ‘Chinese skepticism toward the recommendations of globe-trotting consultants untutored in local economic structures and institutions (Rawski [1994])’ not being a bad thing.
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3 Transition Strategies
--Beyond Shock Therapy and Gradualism--

3-1 The Background to Transition from Socialism to the Market

3-1-1 Forces for Change at the End of the 1980s

(1) Renaissance of the Neo-classical School in the Major Developed Countries

In the developed economies in the 1980s, the improvement of market function was a keenly pursued policy target. The collapse of socialist economies in the post-cold war era meant that most of the world's economies were suddenly becoming market-oriented. Even before that, however, the promotion and better functioning of the market mechanism had been a keen issue in capitalist economies. One of the major principles in economic management in the 1980s was neo-classical or anti-Keynesian theory. It emphasized deregulation, specifically, the drastic reduction of government intervention in business activities. Based upon this principle, Reaganomics, Thatcherism, and Nakasone economic policies developed. In Japan this main stream was elaborated into a comprehensive policy program under the name of the Maekawa Report, which mainly emphasized the promotion of the market function, both domestically and internationally. It stressed that efficient allocation of resources raises the level of real income as competition reduces prices.

(2) The Collapse of Socialism as an International Economic System

The socialist economic system, which was in truth heavily dependent upon the capitalist system even in the early stages of its establishment, finally collapsed in the late 1980s.

In principle, the socialist economic system works on the assumption that all participating economies are operating under purely socialist principles. In other words, a socialist bloc is supposed to be an internationally closed system, in which the division of labor, production and distribution of commodities, and movement of capital are controlled by a central authority, such as Moscow. Thus, in theory, the former COMECON was an autocratic economic system, the members of which were completely independent from any external economic system. But, in fact, the socialist principle had not been realized even in the early stages of the system's establishment. COMECON countries were deeply dependent upon capitalist countries for capital inflow. From the beginning, large sums of capital were needed in order to finance budget deficits, which had arisen mainly in the form of subsidies to inefficient state-owned enterprises. This is the ironic result of socialism. Failures in economic management necessarily strengthen a deep dependence on the opposing economic system-capitalist countries-or on international bodies like the IMF and the World Bank. Such dependence was a suicidal path for the socialist system, because economic reliance on capitalism was inevitably the precursor of capitalist ideas and thinking. However, it was otherwise impossible for them to finance the huge deficits within COMECON. In the late 1980s, the collapse of the former USSR became the final signal to the COMECON member countries that they must fully embrace capitalism.

(3) The Enviable Development of Surrounding Capitalist Countries

The economic development in the second half of 1980s of the Asian capitalist countries surrounding the socialist countries was driven mainly by direct foreign investment. The ASEAN countries' rapid economic growth, and the dynamic formation and development of an economic network through trade and direct investment, put great pressure on Vietnam
and China to participate in such a network.

3-1-2 Particular Factors Underlying Eastern European and Asian Transitions
(1) Income Level and History of Democracy Determines Individual Approaches

Backgrounds to transition and approaches to transition naturally vary between transitional economies. The direct trigger for Eastern European reform, in both political and economic terms, was the collapse of Russian hegemony, whereas in China, Vietnam, and other Asian countries, there was reaction to the rapid economic development of the surrounding market-based ASEAN countries. In general, in socialist countries whose income level is relatively high (for example, using the World Bank standard, countries classed as 'middle-income economies'), political reform has been more significant for the people than in the 'low-income economies,' where economic issues have been more acute. Another reason for different approaches is the historical experience of each country. Eastern European countries have a long history of democracy and, having lost their democratic rights after the War, the peoples of Eastern Europe were naturally eager to recover a degree of political freedom.

(2) What were the Most Serious Economic Bottlenecks?

Among the numerous economic difficulties in socialist economies, the following three were the most significant reasons for the transition to a market economy.
(i) Huge twin deficits (budget deficit and trade deficit) not being financed by the USSR or COMECON
(ii) Deadlock on the domestic supply side
(iii) Foreign policy intervention attached to the new supply of funds from the IMF or the World Bank.

3-2 Price Liberalization as the Most Fundamental Transition Factor
3-2-1 Price Liberalization as the Essential Pre-condition for the Establishment of a Market Economy

Price liberalization in the initial stages of transition to a market economy inevitably tends to create hyper-inflation due to excessive demand. Dr. Sachs has described the mechanism by which hyper inflation arises: under zero-inflation in a centrally-planned economy, excess but hidden demand builds up with the increase of real income. Once prices are liberalized, this pent-up demand is released, which forces up price levels from the demand side. Then, if the market function is to be established, hyper-inflation must be controlled. Price levels should be signals for both buyers and sellers in the market. Hyper-inflation therefore deprives the economy of the most important function of the market mechanism: efficient allocation of resources.

So, price liberalization has two contradictory effects: hyper-inflation, and the establishment of market function. The point is how gradually inflationary forces should be released and by what means they should be brought under control. We will consider this in part 4 of this section.
3-2-2 Price Liberalization as an Integral Part of the Process of Macroeconomic Stabilization

Traditionally, two approaches to stabilization and reform have been put forward: shock therapy (including the immediate and universal liberalization of prices) and the gradual approach. There are many arguments for the superiority of the shock-approach over the gradualist approach. The consensus among economists is, as Dornbush and Fisher stress in their macroeconomics textbook, that shock therapy is the only way to ensure that stabilization programs win the necessary domestic and international credibility. After the initial shock, which includes extremely painful costs to the people, there is more chance of recovery based upon the market mechanism, which in turn creates production recovery and economic development in general.

The traditional arguments regarding the two alternative approaches can be summarized as follows:
(i) Two targets are separated: stability and reform.
(ii) To achieve the first goal (stability), shock therapy is the only approach.
(iii) To achieve the second goal (reform), two approaches are feasible: shock or gradual.

But this dualistic framework tends to overlook the overarching importance of price liberalization at all stages of the stabilization and reform process. The validity of the traditional framework is reconsidered and challenged in the following sections of this chapter.

3-3 The Aims, Measures, and Speed of the ‘Structural Adjustment Programs’
3-3-1 Main Aims

During the 1980s, the World Bank played a visible role by helping countries to design structural adjustment policies, and by lending money to help them reduce the costs of restructuring. At the same time, the IMF supervised the introduction of accompanying macroeconomic measures, including budget deficit cuts and exchange rate devaluation. The policy packages implemented jointly by the World Bank and the IMF generated considerable controversy, both as to their effectiveness and as to the sufficiency of the money the two institutions were willing to lend to support such policy measures. Several criticisms have been made concerning the role of the World Bank in the process of this structural adjustment. Among them are: insufficiency of the amount of resources devoted to adjustment loans; over-optimism of the World Bank regarding the response of the private sector to price incentives; and lack of attention to equality issues such as distribution of income and assets.

3-3-2 Main Measures

On the microeconomic side, structural adjustment programs include the following kinds of measures:
(i) policies that improve efficiency in the use of resources by the public sector, including the rationalization of public investment, the restructuring of state-owned enterprises, and the privatization of some of those enterprises
(ii) trade liberalization and other measures to improve the structure of economic incentives, and efforts to promote the working of the price mechanism, especially in agriculture and
public enterprises
(iii) measures that strengthen the economic institutions considered to be crucial for the success of the adjustment program, such as the legal system, tax administration, and customs services.

These microeconomic measures designed to enhance the flow of resources are supplemented by macroeconomic measures that include fiscal austerity, a tight monetary policy, and often a currency devaluation.

3-3-3 The Speed of Reform

The World Bank Development Report of 1991 classifies and compares two different approaches to the speed of reform; ‘shock treatment’ and ‘gradualism’. The report on the one hand points to the merits of shock treatment, noting, “shock treatment implies that efforts are implemented quickly in a concentrated period lasting less than two years... the optimal policy is to implement the program rapidly so that the welfare gain is achieved as quickly as possible. It may be that adjustment costs increase more than proportionately with the length of time taken to implement a reform.” On the other hand, the report describes the following advantages of gradualism: “Gradualism in implementing reforms is defined to mean that reform is spread out over more than two years... In an economy with rigid prices and wages or other structural distortions, shock therapy may have perverse effects. If the policy shift is sudden, potentially viable factories may collapse... In such a distorted climate, a gradual policy change may reduce the overall costs of adjustment by spreading out the adjustment over time.”

But this kind of dichotomy is not appropriate in considering strategies for the market transitions now underway. The World Bank’s arguments are based upon the experience of those economies, especially in Latin America, where a market economy had already been established at least partially. But acceptance of the shock therapy vs. gradualism dichotomy has led to the widespread conclusion that economic stabilization, as a fundamental condition for economic reform, is best achieved only through the shock approach.

3-4 Strategies of Transition: beyond the Traditional Arguments
3-4-1 The Price Liberalization Process Itself Determines the Stabilization Process

In the present discussion of transition, the main departure from traditional ideas concerning structural reform is the argument that ongoing price liberalization must be seen as an integral part of the whole stabilization process. To clarify this argument, let us consider two alternative scenarios for price liberalization: once-and-for-all price liberalization and phased price liberalization. The analytical framework here is aggregate demand and aggregate supply model which might not be suitable to apply to transitional economies. However this is still useful to understand price-and output determination through both demand and supply shifting, which are brought about by changes in economic variables.

(1) Scenario One: Once-and-For-All Price liberalization

This brings about hyper-inflation in a short time. To control this inflation, restrictive monetary and fiscal policy-the so-called shock approach-is necessarily required. As we have learned from the experiences of Poland and then Russia, for example, such tight stabilization
programs not only depress aggregate demand but also tend to constrain production activity, thus reducing total domestic supply. One reason for this is that inefficient state-owned companies cannot continue their production under high interest rates. Chart 1-I-6 illustrates how too tight a demand control policy can hamper the supply-side benefits of price liberalization.

The initial price is assumed to be P0, assuming a centrally-planned economy. After price liberalization, pent-up demand pushes the price level up to P1. With tight demand policy, the government tries to reduce the price level to P2. However, price liberalization increases producers’ input prices, which then causes the supply curve to shift to the left. After this, the price level will be at P3-highest than price level P2.

Policy makers assume that price liberalization will automatically create competition on the supply side, shifting the AS curve in Chart 1-I-6 to the right. In fact, however, it takes longer than policy makers expect for this effect be realized.

(2) Scenario Two: Phased Price Liberalization

In this scenario tentative price controls are retained over commodities essential for people's daily life, and over fundamental input materials. Initial inflation should not be as high as in Scenario One. Still, the initial shock must be strong enough to deal a blow to vested interests within the socialist system. And demand control may still be necessary to combat excess demand which will have built up with the increase in real purchasing power under zero-inflation in a centrally-planned economy.

Such a phased strategy has merits and dangers. Its greatest merit is to allow supply capability to recover under mild inflation. Also it should allow basic resources to be allocated to strategic sectors, which will contribute further to supply growth. The main danger is the increased risk of future inflation. After the prices of the main regulated commodities have been liberalized, renewed inflation may ensue, induced from the upward shift of the aggregate supply curve. Therefore, the phased strategy needs to be carefully managed in order to prevent a second round of hyper-inflation.

In Chart 1-I-7, the initial price level is P0. Following an initial, limited price liberalization, the price level rises to P1. After demand control policy is implemented, the price level falls back to P2 (with no leftward shift of the supply curve AS). Then if gradual price liberalization succeeds in increasing aggregate supply, the supply curve will shift to the right, which will lower the price level to P3. However, this will not be a sustainable equilibrium. Stabilization will require a second price liberalization, accompanied by another tight demand policy. Overall, such phased demand control should ultimately result in a lower price level than the crude shock approach of Scenario One.

3-4-2 The Need for Phased Inflation Control, from Both the Demand Side and the Supply Side

Phase I (demand-side): In a supply shortage economy, price liberalization induces hyper-inflation due to excessive demand. The necessary response is tight demand policy, the shock approach.

Phase II (supply-side): Delay in supply recovery causes inflation from the other side of the demand-supply equation. In order to combat this kind of inflation, supply should be
increased through such measures as privatization of inefficient state-owned companies, establishment of private companies, and an increase in productivity. However, still another risk exists in this supply promotion strategy- it may expand budget deficits and money supply, providing yet another potential cause of further inflation.

3-4-3 Japan's Experience during Its Postwar Recovery

In post-War Japan the 'priority-production formula' called for the priority supply of steel to the coal mining industry, followed by the priority supply of the increased coal output to the steel industry. The idea was to expand coal and steel production first and then to supply this coal and steel to other industries according to a set order of priorities, so that the resurgence of production would eventually spread throughout all segments of Japanese industry. In other words this was a plan for resuming full production by giving top priority to certain key industries. This priority-production program was financed by the Reconstruction Finance Bank, which led to expansion of the money supply, because the Bank's bonds were financed by the Bank of Japan. The increase in the money supply, together with expanded budget deficits, created a further round of inflation. Eventually, the Dodge Line (from the work of Joseph Dodge, economic adviser to Japan in 1949) was implemented. This was a set of drastic anti-inflation measures, such as:

(i) balanced budget (elimination of deficits)
(ii) halting the Reconstruction Finance Bank loans
(iii) single exchange rate of $1 = 360 (at which the Yen was considered overvalued at that time)

These measures created a sharp economic slump, and there was much heated debate within Japan about this rapid stabilization. Some supported the tight demand policy implemented following the Dodge Line; others objected because the program induced steep deflation. Japan in fact remained in a deflationary slump until the outbreak in 1950 of the Korean War, which generated huge additional demand for Japanese goods and services, lifting the economy out of the recession and onto the path of rapid recovery. Evaluation of the Dodge Line is debatable. Some appreciate these tight demand policies contributed to combat high inflation, others emphasise that Dodge provided Japanese economic sectors particularly enterprises so-called 'hard budget constraint' by stopping subsidies.

3-4-4 How to Minimize the Costs of Deflation?

As mentioned above, the gradual or phased approach to price liberalization necessitates caution with regard to the potential byproduct of inflationary money supply growth. The answer must be a second stabilization stage in which another tight demand policy is endured. Policy makers need to consider how to minimize the costs of such deflationary action. As Chart 1-I-7 shows, as long as supply capacity can be expanded, a rigid demand policy need not drastically reduce output levels.

3-5 Issues in Supply Reform
3-5-1 Two Traps Attached to Gradual Price Reform
(1) Price Liberalization of Output Goods but not of Input Goods
Most of the former socialist countries are proud of their free pricing system. In China the prices of more than 60 percent of all commodities are governed by the free market system, and in Vietnam the government controls only a limited number of goods. However, if many basic input materials are produced by state-owned enterprises, the ratio of commodities whose prices are effectively liberalized to total commodities is likely to be low. To provide incentives for the private sector to enter into new production, liberalization of the prices of the factors of production (raw materials, energy, basic intermediate goods, capital, labor, and so on) becomes urgent. Also the free mobility of the factors of production needs to be facilitated, consistent with their price liberalization.

(2) Distortion of the Relative Price Structure

Gradual price liberalization may create distortions in the relative price structure. The relative price structure, in turn, affects real income through the terms of trade. In Vietnam's transition, for example, most of the manufacturing sector's output prices remained under strict government control because the products were made in state-owned enterprises. The prices of agricultural products, however, were liberalized at an early stage. As a result of the market function, therefore, the price increase of agricultural products exceeded the price increase of manufactured goods. In other words, the price of agricultural commodities rose relative to manufactured goods. For example, the ratio of the price of rice against the price of steel jumped from 0.17 in 1987 to 0.65 in 1991. This improvement in the terms of trade of the agricultural sector caused a relative increase of real income in that sector. Meanwhile, in the manufacturing sector (in other words, the state-owned sector), trade deteriorated, putting further burdens on the government to compensate the declining real income of workers in the state-owned sector. Thus, ironically, partial price liberalization sometimes creates the need for further subsidies from the government.

3-5-2 Reform of State-Owned Enterprises

The most difficult task in the transitional period is that of reforming a huge number of state-owned enterprises. Most former socialist countries have been eager to introduce a privatization policy. Privatization has been seen as a panacea for such diverse problems as government budget deficits, low productivity, unemployment, poor capital formation and so on. However, experience shows that confusion has surrounded privatization in the following areas:

(i) main purpose of privatization—change of ownership or management reform, reduction of budget deficits; promotion of competition
(ii) how to finance privatization—domestic savings, foreign capital, new money supply, establishment of capital markets
(iii) social cost—unemployment, social safety net.

Looking at Central European privatisations, regarded as an example of the shock approach, we see that only small-scale privatisations—e.g. shops—have gone well. The progress of large-scale privatisations has been very slow. The Mongolian experiment with privatization also has been a failure: only ownership of the state-owned enterprises has changed—there has been no change in management, and no contribution to supply improvement.
These cases demonstrate that the shock therapy type of privatization reform is not effective in increasing production. The shock approach has significant benefits in improving the basic conditions in which enterprises operate, but not in bringing about enterprise reform itself. As Dr. John Flemming, Chief Economist of EBRD, has pointed out, enterprise reform takes a longer time, and therefore a gradual approach is required.

Though the gradual approach to enterprise reform may thus generally be preferable, the government must in any event instill financial discipline and restrain the demands of state enterprises for support—so-called ‘hard budget constraints’ have to be established. But the most essential environmental prerequisite for reform of state-owned enterprises is the establishment of the market function in terms of both output prices and input prices. Competition with private enterprises or foreign companies is the best way to reform state enterprises.

3-5-3 Promotion of Private Enterprise

Efforts to create and expand the role of private, nonagricultural enterprises in transitional economies, have centered not so much on the widespread privatization of state-owned enterprises, but more on opening up areas of economic activity for non-state-owned enterprises, through liberalizing measures. Private enterprise has responded mainly through small-scale activity, particularly in trading, services, crafts, and light industry, while foreign direct investment has been attracted to larger scale ventures, typically joint-ventures with state-owned enterprises. However, given the early success of private business, for example, in China and Vietnam, large scale private enterprises can be expected to emerge rapidly. Also, something close to private business may emerge from the spontaneous evolution of state-owned enterprises.

In Vietnam, while the government has been actively attempting to improve the investment environment, the lack of an effective legal framework remains a source of risk and uncertainty. Various decrees, including the Law on Equity Companies, have sought to reduce this uncertainty. Nevertheless, the lack of willingness of local government to implement central government legislation, and the ambiguity facing many investors regarding the division of administrative responsibility between central and provincial authorities, have been an important constraint on the growth of the private sector. Thus the establishment of price mechanisms may not be sufficient in itself for the nurturing of the private sector. Supporting legal and administrative frameworks should also be established as quickly as possible.

3-5-4 Financial Reform as an Urgent Job for Sustainable Growth without High Inflation

Like in Vietnam, transitional countries which are lacking in absolute capital may have limits for their macroeconomic development. Expansion of spending for basic infrastructure will be financed by issuing additional government bonds, which become causes for new inflation through two reasons; one is total demand is pushed up by money supply increase, the other is total supply will be reduced by high interest rate, so-called crowding-out effect. To prevent it, monetary policy should be more effective based on establishment of financial
market and banking sector. Financial institutional reform cannot be done in a few years. Legal system does not automatically brings about functional financial mechanism. Interest rate structure, reserve ratio and other economic factors must be considered by gradual way.

3-6 Conclusions-Interdependence of Macroeconomic Stabilization and Enterprise Reform, and the Need for Pragmatism

In the reform process, as reliance upon market allocation increases, the government must replace many of its direct economic interventions with indirect measures, mainly fiscal policy and monetary policy. An appropriate fiscal policy will achieve a reasonable degree of macroeconomic balance, generating sufficient tax revenue to finance regular expenditure. An appropriate monetary policy will allow an increase in the money supply consistent with macroeconomic stability.

The one overriding difficulty in this is that successful macroeconomic reform depends upon effective changes in how enterprises operate at the microeconomic level. On the one hand, stabilization through effective macroeconomic policy is a fundamental prerequisite for the creation of a decentralized and efficient enterprise system. On the other hand, successful enterprise reform is a necessary ingredient for successful macroeconomic stabilization. Prolongation of the life of state-owned enterprises represents an obstacle from both the microeconomic view and, because of its detrimental effect on fiscal and monetary policy, from the macroeconomic view also.

Policy makers must therefore take plural approaches. They must remain attuned to changing economic realities, must judge between shock or gradual approaches as occasion demands, and must implement appropriate price-liberalization, demand-control, and supply-expansion policies, with pragmatism and skill. Above all, they must be flexible enough to change policies whenever an original policy has been seen to be harmful. (Nariai)
Crude Once-and-For-All Approach to Price Liberalization
Centrally-planned Economy: $P=P_0$ (fixed price level)
After Price Liberalization: $P=P_1$
Shock Therapy (Tight Demand Policy): $P=P_2$
Sharp Increase of Input Prices: $P=P_3$
Phased Price Liberalization as Part of a Skillful Stabilization Policy

(1) Centrally-planned Economy: $P = P_0$

(2) After Price Liberalization: $P = P_1$

(3) Gradual Price Liberalization + Mild Demand Control Policy: $P = P_2$

(4) Increase of Supply under Skillful Governmental Policy: $P = P_3$

(5) Tight Demand Policy: $P = P_4$
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4 A “Pluralistic Approach” to Transition

4-1 Introduction

“Transition” is a movement from a centrally planned to a market economy. This leads to a question: what kind of market economy will be realized after the completion of the transition process? Although this topic is not treated by the IMF or the World Bank in their articles on market-oriented reforms, in our opinion, this is a crucial issue, since the course of the transition—in other words the contents of the reform program—inevitably depends on the type of market economy which is desired.1

Alan Blinder is one of the few Western scholars who deals with this issue in an explicit manner. According to him, neoclassical economics has a weakness in analyzing transitions from one equilibrium to another. To overcome this problem, he proposes to divide the “transition problem” into the following two questions:2

(1) Where do we want to go?
(2) How do we get from here to there?

In our opinion, the first question is more crucial than the second because, as we mentioned, the path of transition is determined to a certain extent, once the goal is given. From this viewpoint, in this section, we are going to deal with the issue of the goal (“destination”) of transition.

4-2 “Destinations” and Transitional Paths

4-2-1 Patterns of Market Economies

Recent studies3 give insight into the diversity of market economies. Although each market economy has its own unique features, we can envisage the following three basic models of a market economy (needless to say, this is not an exclusive list):

(1) American model
(2) European model
(3) Japanese model

There are two important factors determining the characteristics of these models:4

(a) relations between the government and market (or private sector)
(b) relations among main actors or players in the economy: firm vs firm, bank vs firm, firm vs workers, supplier vs consumer etc.

In the American model, the role of government is relatively small. The basic idea is “leave it as far as possible, to the market mechanism”, so as to realize the optimal resource allocation. In the Japanese model, on the other hand, government plays a crucial role in overcoming “market failure” and realizing “dynamic” optimum of resource allocation, which is beyond the capacity of the market mechanism alone.5 Meanwhile, relations among the main actors of the economy are based on long-term viewpoints, in the Japanese model, in order to maximize the long-term rate of return; initial loss is accepted if sufficient return is expected in the future. The typical cases are “life-time employment system”, “keiretsu”, “main bank system” etc. In the American model, the most appropriate way of collaboration under any given specific situation is chosen in order to maximize the short-term rate of return. Therefore ad hoc relations are very common.

The European model is often placed in the middle between the American and the
Japanese, but Michel Albert claims that the European model ("Rhine capitalism" according to his terminology) includes the Japanese system.\textsuperscript{6}

### 4-2-2 Alternative Models and Goals

If there is a single pattern of market economy -- the goal of transitional movement -- the path connecting the initial position (a centrally planned economy) with the goal is less diverse; this is the case of a "single model". However, if there are plural patterns of market economies as the possible goals, the transitional path is more complicated, and the leaders of a transitional economy can choose a pattern of market economy out of plural alternatives; the path depends on the selection of the goal. This is the basic idea of "pluralistic model".\textsuperscript{7}

The selection of goals is a complicated decision making process, which is composed of political, cultural, and economic aspects. In our opinion, the initial conditions of the transitional economy are the most important factor in the decision. This subject will be treated later.

Neither the World Bank nor the IMF argue explicitly on the goal of transition. This suggests that they assume a single pattern of market economy, which is very close to the American model ("hidden assumption of single pattern of market economy"). In our opinion, however, it is meaningful for a transitional economy to consider plural patterns of market economies and choose the most appropriate or preferable one, as each economy has its own unique conditions.

A transitional economy can draw a lesson from the pluralistic approach of Malaysia, which is called "look east policy". In his article titled "On the Look East Policy", Mahathir Bin Mohamad, the prime minister of Malaysia, advocates his preference of the socio-economic pattern of Asian countries, in particular of Japan and Korea, to the European one. His argument is as follows:\textsuperscript{8}

1. The basic feature of the value system in Europe is the emphasis on the right of citizens. Rights of minorities are often protected even if these are not compatible with the national interest or the interests of the majority. European societies can afford to maintain such a value system, as their societies are affluent, but Malaysia, which is a developing country can not afford to do so.

2. On the other hand, under the democracy of Japan and Korea, the rights of citizens are protected only when it is compatible with the national interest or the interest of the ‘group’. Such a philosophy, which is reflected in their labor ethics, ensures economic success and social stability.

3. After comparing these two types of societies very carefully, Malaysia determined to "look East".

Similar attitudes comparing different socio-economic types in order to look for a model is adopted by Chinese and Vietnamese leaders as well these days; for example, the Report of the First Vietnam-Japan Joint Economic Conference introduces a statement from a leader of the Communist Party of Vietnam, which resembles with Mahathir's viewpoint.\textsuperscript{9} Alan Blinder's lecture for the former USSR people appears to be a kind of pluralistic approach. After considering the socio-cultural characteristics of the former centrally planned economies in Europe, he suggests that, "given where they are coming from, the formerly socialist
countries of Europe might do better by emulating the Japanese model than by emulating the American model. --- part of the reason pertains to the likelihood of making the transition successfully."

4-2-3 Alternative Reform Programs

There may be an argument that the leaders of transitional economies do not necessarily keep some specific types of market economies in their minds as goals of transitions. This argument is correct. However, in our opinion, it is advisable for the leaders to envisage the goals of their transitions, since this inevitably influences the specific features of their reform programs.

Suppose there are two transitional economies: one is aiming at an American model and the other is moving toward a Japanese model. The substantial difference in the relationship between government and market of these two models inevitably influences the contents of reform programs.

Let us take the case of financial sector reform. The standard menu of financial sector reform is composed of the establishment of a central banking system, breaking up of "mono bank system", and commercialization and privatization of specialized banks owned by the state. Although the fundamental structure is not influenced by the selection of model, there is one crucial issue that causes differences in the reform program. The issue is whether to maintain a state owned specialized bank to provide preferential (or direct) credit with subsidized interest rates to state-designated activities, such as export promotion, agricultural development, promotion of small and medium sized industries, and R & D of advanced technology.

In the American model, the principle is that commercial banks finance these activities with market interest rates. The World Bank and the IMF tend to be reluctant to accept the idea of specialized bank and direct credit with subsidized interest rate, particularly the latter. In their recommendation to the former USSR, four international institutes (IMF, IBRD, OECD, EBRD) claimed:

"Experience in other countries suggests that subsidized state directed lending easily becomes subjects to special interests, is frequently inefficient and can ultimately undercut the soundness of the bank itself."

Needless to say, various types of direct credit with subsidized interest rates play an important role in a Japanese model. The purpose is to overcome market failures. Therefore the selection of the model causes substantial differences in the banking system of a transitional economy, therefore in the feature of reform program of the financial sector.

4-3 Other Factors to Influence Reform Programs

It should be stressed that, in addition to "destination" (goal), three factors play major roles in determining the features of a reform program. In other words, the path of transition is a function of the following three variables plus "destination".

(1) Initial Conditions

Initial conditions of an economy have strong effects on the process of development.

Typical examples of initial conditions are shown below:
In addition to these viewpoints, some specific factors are especially important in the case of transitional economies. It is historical background particularly (a) the length of the former regime of command economy and (b) the socio-economic conditions before the start of that regime. First, the longer the life of the centrally planned system, the harder the transition, as the former regime is well-established and firmly rooted. Second, the functioning of a market mechanism is more difficult if the society has insufficient experience in capitalism or a market economy before the introduction of the centrally planned system.

Let us illustrate these points by contrasting Vietnam with Mongolia. The experience of the centrally planned system in Vietnam is much shorter than in Mongolia. In the southern part of Vietnam, the centrally planned system started in 1975, after the fall of Saigon, only four or five years earlier than the beginning of the economic reform. In the north, extensive application of the centrally planned system began in the mid 1950s, after Geneva Peace Treaty, although the independence of North Vietnam was announced in 1945. The inheritance of capitalism or a market economy was still notable, particularly in the South, when the government started the reform. On the other hand, “For most of its 70-year history as an independent state, Mongolia has been a centrally planned economy with extremely close ties to the Soviet Union, particularly since 1946”.[13] Before that period, Mongolia was essentially a nomadic economy with very limited experience in market mechanisms. This historical background became a serious handicap in comparison with Vietnam.

The initial conditions in Laos and Cambodia were fundamentally similar to those in Vietnam, although the centrally planned system was rooted less deeply in these two countries. In the meantime, the situation in the Central Asian republics resembles that of Mongolia. The initial conditions in China could be placed in the middle between Indochina and Mongolia.

(2) “Reference Case”

For the leaders or technocrats of developing countries or transitional economies, learning from the experiences of other economies is very useful. They can follow success stories and avoid failures made by predecessors in order to minimize the costs and time of the transitional process, especially when the basic conditions are not so different between the predecessors and the transitional economy. The useful “reference cases” can be of two types; one is the experience of other transitional economies, and the other is the experience of neighboring developing countries.

Recent studies of East Asian economies such as the East Asian Miracle by the World Bank could furnish transitional economies with various hints of successful macroeconomic management and outward oriented development. As a matter of fact, some leaders and
technocrats have begun to study these cases.
It should be pointed out that a reference case is not necessarily a model of market economy as a goal of the transition. When a country construct export processing zones, taking into account the success of such an attempt in Taiwan, the country may simply borrow the idea from Taiwan without any intention to construct a market economy which resembles Taiwan.

(3) Recommendation and Suggestion of International Institutes
It is to be admitted that the reform programs of transitional economies are not feasible without financial support by international institutes such as the IMF and the World Bank. In most cases, financial support is accompanied by "policy dialogue" and "conditionalities". As a result, most of the reform programs are fundamentally compatible with the recommendations and suggestions of the international institutes. Perhaps the reform program in China is less influenced by these international institutes, as China has relied less on the financial assistance with conditionalities.

4-4 Concluding Remarks
The path of transition or the feature of a reform program is a function of four variables: (a) the pattern of a market economy aimed at as a "destination" (goal), (b) initial conditions of the transitional economy, (c) "reference case", and (d) recommendation and suggestion of international institutes. These variables lead to diversity of the reform process. While the IMF and the World Bank stress the diversity of initial conditions, they do not deal with the diversity of the patterns of market economies. In our opinion, such a "single model approach" suffers from a lack of flexibility and applicability. Under these circumstances, we wish to propose a "pluralistic approach" paying due attention to all of the abovementioned four variables. (Shimomura)
FOOTNOTES

1/ See Chart 1-I-4.
2/ BLINDER, [1992]
5/ MURAKAMI, [1992]
6/ ALBERT, [1991]
7/ See Chart 1-I-4.
8/ MAHATHIR, [1983]
9/ Keidanren, [1993]
10/ BLINDER, [1992]
11/ IMF, IBRD, OECD, EBRD, [1990]
12/ ISHIKAWA, [1990]
13/ World Bank, [1992b]
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