The Transition of Post-Soviet-Type Economies: Expected and Unexpected Developments *

I. Introduction

Literature on the transition of former Soviet-type economies (post-STEs for short) is growing fast, although given the pace of developments it is still mostly at the article and mimeo stage, with few serious book on the subject. Debates are already beginning to shape up: "shock therapy" *versus* the gradualist approach, the sequencing of transition measures, choice of privatisation methods, *etc.* They promise to fill pages of economics journals for years to come. The shift from the centrally-managed (and allegedly centrally-planned) economy to the market system has become a veritable "new frontier" for the economics profession.

What the present writer regards as missing in this avalanche of articles and papers on the subject is an attempt at stock-taking. After all, the Polish transition programme was formulated in late 1989 and more than two years have passed since it began to be implemented. The same, by and large, applies to Hungary. After extensive preparations, the Czechoslovak programme started in January 1991. Yugoslavia, Bulgaria and Romania, albeit with some reservations (mostly due to the unfinished political transition to the post-communist era: see Winiecki, 1991a), also contributed something to the growing pile of evidence.

There exists accumulated evidence, against which various concerns of theorists, including those dominant in implementing stabilisation-cum-liberalisation programmes, can be assessed. This paper is an early attempt at such an assessment. The present writer looked at theorists' concerns from two different angles: first, whether certain developments expected by theorists did or did not happen

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and, second, whether certain developments that happened were expected by theorists.

The selection of issues that are seen as being of concern to theorists is, of necessity, personal. Another theorist would, in all probability, make a somewhat different selection (especially in the – necessarily – more arbitrary choice of developments that surprised theorists). But even with all possible arbitrariness the approach yielded interesting insights.

One of the most important is that only a small part of theorists' expectations about the problems of transition did, in fact, materialise in a manner expected by theory. Transition to the market turned out to be a much more uncharted journey than that imagined by believers in simple (one is tempted to say simplistic) recommendations transplanted from economies with different institutional characteristics.

II. What was expected to happen and actually happened

As already noted, the list of developments in the transition process that had been expected to happen, and did happen, is rather short. Moreover, even when certain developments did take place they were more often than not qualified by various "buts".

Expectations based on the standard stabilisation programme recommended nowadays by the IMF (the new orthodoxy called the "heterodox programme") suggest that hyperinflation is reduced sharply once restrictive monetary policy is put in place and an attempt is made substantially to reduce budget deficit, and particularly its financing, through the resort to the printing press. In fact, Jeffrey Sachs (1987), arguably on the basis of the Bolivian experience, tended to be even more optimistic and expected inflation to disappear almost completely (although this was not the case in Bolivia itself: see, for example, Bernholz, 1988).

This extreme version did not materialise, although Yugoslav and Polish hyperinflation had in fact ended. But inflation, although reduced substantially, got stuck at levels higher than in known successful cases of stabilisation policies (Chile, Bolivia, Israel, Mexico). High monthly inflation rates (*e.g.* in Poland, apart from larger shifts caused by specific policy decisions or seasonal changes: 3-4% per month from April 1990) strongly affect macroeconomic policy, which in turn affects the performance of a post-STE in transition.

Considerations underpinning the same standard stabilisation programme generate associated expectations of reduction in budget deficit, although historical experience suggests that the process of deficit reduction, let alone elimination, takes place at a markedly slower rate. But the pattern in post-STEs has been the reverse to that registered earlier elsewhere. In country after country, initial balancing of the budget after the start to transition was achieved almost overnight with surprising ease. However, after some time, usually in the second year of the transition programme, surplus turned into deficit – and usually a fast-growing one. This had already happened in Poland and Hungary in the second year, and deficit is now looming in Czechoslovakia. Quite obviously, some factors not taken into account in the underlying theory of stabilisation have intervened forcibly in the fiscal area. These issues will be considered in Section IV.

The same reverse pattern has also been observed in the case of export expansion as an effect of external liberalisation. This has been asumed to take place once (1) exchange controls are lifted; (2) substantial devaluation of (strongly overvalued) national currency is instituted; and (3) distorting non-tariff barriers to trade are eliminated. These measures are expected to reveal true comparative advantages. However, the process of finding export markets under newly-revealed comparative advantages takes more time than ordering goods from abroad that were unavailable before liberalisation, due to – now eliminated – exchange controls. Therefore, an import surge is generally expected to precede an export surge (see, for example, Krueger, 1980).

This is the logic behind stabilisation funds set up under the aegis of the IMF to help post-STEs in the early transition period withstand the pressure on foreign exchange reserves due to increased imports, since exports were supposed to pick up much more slowly. The need for stabilisation funds had been stressed from the very beginning of post-STE transition until, surprisingly, as late as 1991 (see, for example, Asselain, 1991, and Portes, 1991).

The present writer regards this concern as surprising: by 1991 it should have been clear that the export surge materialises early since a steep growth in exports is registered almost immediately after liberalisation. Only in the case of Czechoslovakia, where it did not, the fall

in imports exceeded that of exports. Thus there was no need to draw upon a stabilisation facility in this case either.

What threatens export expansion is not, as widely expected, an early import surge with its attendant political pressures to reimpose exchange controls and distortionary non-tariff barriers, but a late import surge following an export surge. The threat comes from the inconsistency of a fixed (or "pegged") exchange rate, regarded as an indispensable nominal "anchor" in the standard stabilisation programme, with steady export expansion based on comparative advantages. This is what, *inter alia*, was observed by Edwards (1992) in the Chilean case.

As a fixed exchange rate is used as an anti-inflationary weapon, the policy bias favours mantaining it for too long. In the extreme case of Poland, it was maintained for 17 months during which prices rose by about 300%. It is clear that such a large difference between inflation rates in Poland and in Poland's main trading partners could not be made up by efficiency-increasing, cost-reducing mesures. An increasing overvaluation of the zloty ensued, with the resultant loss of competitiveness.

Effect on the trade pattern was dramatic. In the first half of 1990, exports amounted to 119.7% of those in the first half of 1989, while imports were only 54.1%. In 1990 as whole, exports rose to 140.9% of those in 1989, while imports were equal to 106.3%. In the first nine months of 1991, exports were 117.9%, while imports were a huge 196.5% of the equivalent period of 1990.

In Hungary, the situation was exactly the same, although overvaluation grew more slowly (due to lower inflation differentials *vis-à-vis* main trading partners). Nonetheless, while 1990 exports amounted to 131% and imports 112% of those in 1989, respective figures for the first half of 1991 *vis-à-vis* those of 1990 were 127% and 177%. In Yugoslavia import pressures were so strong toward the end of 1990 that the currency had to be sharply devalued and its convertibility suspended.

The issue involved is not well presented in textbooks on international economics. The benefits of opening up the economy come in two phases. Phase one is rather short and associated with the liberalisation of foreign exchange and foreign trade. Domestic producers realise that shifting some of the output to foreign markets will bring higher profits. The result is an increase in exports from the existing capacities and a resultant one-off increase in the value-added. This is what happened in post-STEs right after external liberalisation.

But it is only the beginning of such benefits. As comparative advantages are revealed, some goods become permanently more profitable than others. Over time there is, as a consequence, a shift of production factors from less to more profitable activities. A more profitable export-oriented sector becomes increasingly larger and contributes more value-added. However, in order to become a permanent feature of the newly-opened economy, the real exchange rate should remain reasonably stable.

This is what post-STEs that chose a fixed exchange-rate regime have been deprived of. The second phase of reaping the benefits in question did not materialise. The real exchange rate fluctuated strongly as overvaluation superseded undervaluation existing at the start of the transition, and production factors did not shift to more profitable uses (for the simple reason that these uses were rapidly losing their profitability). Partial corrections made on an *ad hoc* basis did not help very much and indeed undermined the credibility of the desired structural change in favour of the export-oriented sector.

These considerations give a foretaste of the stock-taking attempted in this paper. As can easily be seen, even the less numerous developments that duly happened as expected did not follow the pattern observed under earlier stabilisations. The following two sections on expected developments that did not happen, and unexpected developments that took most of the economics profession by surprise, reinforce this assessment.

III. Expected developments that did not happen

One general comment should be made before beginning the overview of unexpected developments – those that were expected to happen but did not, or those that took most of the profession by surprise. In neither case were surprises always due to the uniqueness of post-STE transition. The underpinnings of alternative interpretations allowing us to "expect the unexpected" were already in place in some writings, or could have been deduced from the existing literature. Consequently, their adverse effects on the economies in question might have been avoided or to some extent alleviated, had that knowledge been applied in transition processes.

In fact, the same may be said about the expected developments that duly happened – but not according to the established pattern of the past. There have been extensive critiques of the orthodoxy of the fixed or pegged exchange rate as a solution in the short run by economists of varying theoretical persuasions (see, *inter alia*, McKinnon and Mathieson, 1981, repeated in McKinnon, 1991; Murrell, 1992, with respect to all "nominal anchors"; Walters, 1991; and Winiecki, 1991c). In fact, one of the founders of the new stabilisation orthodoxy also began criticising the use of exchange rates as a means of controlling inflation (Dornbusch, 1990). And consequences of an exchange rate "anchor" for export performance of a liberalising economy could easily be deduced from textbooks on international economics.

One of the issues that greatly concerned theorists (and those at the helm of transition programmes) was monetary overhang, forced savings in the hands of the population – a legacy of decades of repressed inflation under the STE regime. Proposed solutions ranged from outright confiscation (so-called "monetary reform"), consolidation as debt, conversion into financial or real assets or correction through the process of price liberalisation.

But in fact only the first and the last were seriously considered by theorists, while in all countries considered here (Poland, Yugoslavia, Hungary and Czechoslovakia) correction through price liberalisation was chosen – wisely – by respective decision-makers. For although there exists a theoretical equivalence between these two options, outright confiscation is politically untenable in newly-evolving democracies, as well as requiring knowledge that does not exist about the size of monetary overhang (see Edwards, 1992).

In any case, monetary overhang turned out to be a non-issue after the start of transition. This assessment applies not only to countries where preceding hyperinflation already wiped out a large part – if not all – of monetary overhang, *i.e.* Poland and Yugoslavia, but also to the remaining countries in transition. Actually, in the former countries the opposite problem emerged. Since the overhang was wiped out, the restrictiveness of monetary policy did not need to be as strong as it was (Beksiak and Winiecki, 1990). As households tried to rebuild savings to the desired levels, even at the cost of further reducing already-reduced consumption, decision-makers were free to pursue somewhat less restrictive macroeconomic policy than that aimed *inter alia* at eliminating the already non-existent monetary overhang.

The Damocles' sword of forced savings overshadowed actual developments, however, with the resultant larger nominal decrease in consumption than desirable for a general turnaround in the supply/demand relationship under the new rules of the economic game (on the rationale for macroeconomic restraint at the start of the transition going beyond the elimination of disequilibrium and, more specifically, forced savings see, *inter alia*, Winiecki, 1990a).

Another widely feared development that did not materialise was that of widespread bankruptcies. Although over time more and more state-owned enterprises (SOEs) as well as Soviet-style pseudo-cooperatives, were regarded as decreasingly creditworthy, bankruptcies were almost non-existent. When they did happen, they usually affected small firms.

The foregoing should not be construed to mean that the performance of non-privately-owned firms was better than expected: just the opposite (see the next section). But various factors of the economic situation and the political economy slowed down the adjustment process under the market rules.

Two factors were decisive for the almost non-existent selection through bankruptcy. The first, in my opinion, related to another nominal "anchor" of the standard stabilisation programme: wage controls. In all programmes in question, wage controls became a norm and slowed down the badly-needed adjustment process (Beksiak and Winiecki, 1990, and Walters, 1991). Thus, quite apart from the theoretical inconsistency of using more than one nominal variable as an "anchor" (see Claassen, 1991), money wage controls have had other adverse consequences.

On the one hand, by restraining both efficient and inefficient SOEs from increasing employment and money wages, they petrified the existing output structure. On the other, by restraining inefficient SOEs from increasing wages, they considerably reduced the probability of bankruptcies. Although this was precisely one of the reasons for their introduction, the "nanny" role of wage controls undermined the credibility of macroeconomic restraint and the new rules of the (market) game.

The second factor is associated with the extended tradition of the "soft" budget constraint of SOEs (see Kornai, 1980 and 1986) that did not completely disappear after the transition. In all countries under consideration, with some exceptions concerning Hungary, large SOEs continued to exert strong political pressure due to their sheer

size and the resultant unemployment consequences. The political economy of "soft" budget constraints under the transition regime will be discussed in the next section.

Yet another major threat to stabilisation that did not materialise was an import surge that was immediately supposed to follow external liberalisation. As stressed earlier, this was the rationale behind the establishment of stabilisation funds for economies in the process of liberalising their foreign economic relations. But import surges preceding export expansion did not happen and the explanation for this could be found in the comparative economic systems literature (see Winiecki, 1983, repeated in Winiecki, 1985, and Ellman, 1989).

STEs were characterised by very strong import pressures because SOEs preferred imports from Western market economies to lower quality domestic products (or those from other COMECON countries). Since they paid the same price for products of differing quality, they always pressed for imports originating from the West. They also tried to ensure excessive inventories of imported high-quality inputs, as part of the system-specific high inventory-to-output ratio policy of state enterprises that could afford to disregard the usual financial constraints.

With the new rules of the game, price differentiation introduced an element of choice between domestic and imported goods. If the price differential was larger than the quality differential, SOEs chose domestic over imported inputs. They also started reducing high levels of inventories that became more difficult to finance under new rules reinforced by macroeconomic restraint. A not unexpected result, in the light of the preceding considerations, was a sharp fall in imports exceeding the aggregate fall in domestic output in all countries in question (except Czechoslovakia). Stabilisation funds were left unused everywhere.

But the early fall in imports instead of the expected surge was only a part of an even more puzzling development that took most of the profession by surprise. The present writer has in mind the unusually deep fall in output. For prices in post-STEs behaved on a "yes-but" basis: they skyrocketed after liberalisation but later stabilised at higher than expected levels, but output behaved completely against expectations. This story, however, belongs to another category of unexpected developments.

IV. Unexpected developments that surprised decision-makers and the economics profession

There are serious problems with expectations based on the standard stabilisation programme. In the model underlying the "heterodox programme" (see Dornbusch and Fischer, 1986) policies aiming at the elimination of hyperinflation (and severe disequilibria) concentrate on the reduction of aggregate demand through restrictive monetary policy and rapid decrease in budget deficits. Severe restraint, *i.e.* the "shock treatment", is preferred, as more credible, to gradual restraint. This credibility is reinforced by nominal "anchors" that, by freezing some nominal variables, help to drive down inflationary expectations.

A natural, one would say textbook, consequence should be the fall of output. The model covers neither the degree of macroeconomic restraint necessary to eliminate hyperinflation or severe disequilibrium, nor an extent of the resultant fall in output. This is what one might expect from the programme based on the new orthodoxy, with the output fall corresponding, intuitively, to the level of hyperinflation or disequilibrium. It is even more surprising, then, that empirical analysis of earlier applications of such programmes resulted in rather shallow recessions or, as in the case of Israel, a small expansion (see, *inter alia*, Bruno, 1986 and 1991; Kiguel and Liviatan, 1990; Corbo and Solimano, 1991).

Programmes, the applications of which seem to contradict the underlying theory, should be immediately suspect (and certainly do not deserve the name of orthodoxy, whether old or new!). Be that as it may, almost none of the protagonists of the standard stabilisation programmes expected the extent of output fall that took place in almost all the countries in question, plus East Germany. Hungary, which decided in favour of gradualism, performed differently with respect to the initial output fall (although not with respect to the aggregate output fall over the period under consideration).

Initial fall in industrial output in the first year of the transition amounted to over 40% in East Germany and some 25-30% in Poland and Czechoslovakia. Only in Yugoslavia was it much lower (over 10% in 1990) as macroeconomic policy became traditionally lax after initial restraint later in the year, when effects of the squeeze began to be felt.

It has been posited by this author on several occasions (Winiecki, 1990a, 1991b and 1991d) that a substantial fall in output was to be expected, on the basis of existing knowledge about the behaviour of enterprises in the STE. The very change from a wasteful Soviet economic system entails an autonomous fall in output, quite apart from the degree of restraint of macroeconomic policy or external environment.

The "mystery of vanishing output" is in fact rather simple. The STE was known for its persistent shortages, to which economic agents – especially SOEs enjoying "soft" budget constraints – adapted by hoarding inputs, fixed assets and labour. The best known are probably very high inventory-to-output ratios. To give an example, according to Shmelev and Popov (1989), the ratio in the USSR in 1985 stood at 82%, compared to 31% in the United States.

Quite obviously, once the beginning of the transition brings about the reversal of the traditional supply/demand relationship, SOEs begin to adjust to new conditions of excess supply by drawing down their inventories and simultaneouly lowering or altogether cancelling new orders for inputs, machinery and equipment. Hence stems the fall in domestic demand for, and consequently output of, raw materials, intermediate products, lathes, instruments, construction and transport equipment, *etc.*

Not only state enterprises but also households, with their harder budget constraints, adjust to the new relationship. In fact, the latter adjust much faster for that very reason. The re-emergence of goods in the shops is met by purchases of smaller quantities of food products, for example. Previously they used to buy larger quantities whenever they got hold of them, not knowing when they would be able to buy the next batch. Part of these larger quantities were later spoiled.

The foregoing leads to the conclusion that transition from the STE to the market system is bound to entail larger output fall than in other cases of stabilisation-cum-liberalisation. Of course, not all output fall could be ascribed to the departure from the wasteful Soviet economic system. Therefore, it is a legitimate question to ask whether the size of output fall that these countries registered was necessary to achieve the initial aim of the stabilisation programme, *i.e.* sharp disinflation, or was it excessive? And the question is valid regardless of whether or not those who pose it understand or accept the implications of the foregoing considerations.

A concept of a credit crunch in the state enterprise sector was advanced (Calvo and Coricelli, 1990) to explain why enterprises reduced output due to the lack of resources to purchase necessary inputs. The explanation implies that output was driven in Poland (although it could apply elsewhere as well) below the level of demand. But Castberg (1991), for example, points out that the concept of a credit crunch cannot explain the state of generalised excess supply dominant on the Polish market.

The present writer takes an intermediate position between those who maintain, along the Calvo-Coricelli line, that reflation would accelerate recovery, and those who say, with the prevailing orthodoxy, that although severe recession was engineered on the demand side (macroeconomic restraint), it must be overcome by supply side measures (structural adjustment).

The Calvo-Coricelli explanation applies to a limited extent in industries that were caught in a period of seasonally high credit demand at the start of the transition. Facing initially extremely high interest rates, they reduced output below demand level (with the differential filled by imports). This dilemma is typified by the food industry.

Furthermore, a markedly larger output fall in consumer goods industries indicated that other forces were at work besides the inventory drawdown. For it was SOEs, rather than households, that needed to adjust more in the shift from excess demand to excess supply (given their larger inventories due to "soft" budget constraints). Therefore, a more nominal "anchor", that is wage controls, might have affected the level of money wages, demand for, and consequently output of, consumer goods industries. Thus, some room existed for relaxation of restrictive macroeconomic policies, including wage controls.

This is not intended to be a criticism of decision-makers but rather a support for the thesis that the very limited knowledge of the structure and behaviour of the economy in transition, from the centrally-managed STE to a market-type one, leaves much room for mistakes. In such circumstances the use of nominal "anchors" is of limited value, to say the least (on this point see Murrell, 1992).

One of the most important – and strongly adverse – developments has been the impact of an unhealthy nexus of state-owned banks and state-owned industrial enterprises on the performance of economies in transition (Winiecki, 1991c). "Nobody's" banks that did not care about the creditworthiness of their clients and the riskiness

of submitted projects tended to lend on an inertial basis to those to whom they lent in the past, that is, first of all to largest SOEs. They were also sensitive to political pressures to support "important" enterprises. On the other hand, "nobody's" enterprises borrowed almost regardless of the level of interest rates. This applied to a much greater extent to the largest SOEs that were more accustomed to being bailed out of trouble by communist regimes than other firms.

These problems highlighted the neglected role of the financial system that would also entail the search for a solution to the bad debt incurred by SOEs under the old regime. Without cleansing the balance sheets of the banks of bad loans made under central planning, simultaneously with a similar procedure with respect to industrial enterprises, restructuring and privatisation turned out to be almost impossible. In fact, even the expected impact of macroeconomic policy would become doubtful. Few analysts seemed to have been aware, however, of the necessity of early and rapid reform of the financial system (for exceptions, see Brainard, 1990; Marer, 1990; and Rybczynski, 1991).

In fact, it transpired that monetary policy applied within the framework of the standard stabilisation programme in countries with strikingly different property rights structures generates outcomes that are at odds with textbook-based expectations. Not only did adverse outcomes of monetary policy come as a surprise, but also the spillover effects that affected the state budget strongly – and again adversely – surprised both practitioners and theorists.

As explained briefly in Winiecki (1992), a not unreasonable assumption of monetary policy under the standard stabilisation programme is that each post-STE enters the transition in a state of greater or smaller disequilibrium, and restrictive monetary policy is therefore called for. An even better reason in post-STEs is to send a signal to economic agents that the era of persistent excess demand has come to an end. A shift to an excess supply regime is generated through the monetary squeeze.

What is conspicuously missing in this reasoning is the typically neoclassical neglect of consequences of a monetary squeeze in economies where the property rights structure is drastically different from that in the textbooks. For there is a huge difference between situations where SOEs generate 10% or even 30-40% of GDP, and those where they produce 90% to 100% of the product (as in the case of Czechoslovakia at the start of transition, for example).

The consequences were similar everywhere. Due to the already stressed unhealthy nexus between "nobody's" banks and "nobody's" industrial enterprises, the extended monetary squeeze has produced largely unorthodox results. Not only, as already stressed, did output fall somewhat more than necessary, but its structure also got worse. Contrary to textbook expectations that monetary squeeze eliminates the least efficient firms, under the overwhelmingly dominant state ownership the reverse has been true.

Banks continued to lend first of all to their traditional clients, that is larger SOEs, with the consequence that smaller, usually more efficient ones, were crowded out of the credit market. The political clout of the enterprises also ensured that they remained least affected by the squeeze. As, historically, the least efficient, largest firms continued to have easiest access to credit from equally dominant state-owned commercial banks, their output losses were relatively lower. And since the smaller and better SOEs faced the toughest credit squeeze, their output often fell by a larger percentage. Output structure got progressively worse. This is best explained in Winiecki (1991c) and Walters (1991).

The worsening output structure under prolonged monetary restraint generated yet another surprise, namely fiscal crisis, in the second year of the transition. This came about in the most dramatic way in Poland, but budget deficit increased in Hungary in 1991 and this author's assessment is that it may also materialise in Czechoslovakia.

I stressed in Section II that the pattern of fiscal developments has so far been the opposite to that found in earlier cases of stabilisation. The budget was balanced relatively easily at the start of stabilisation in each case, while over time the situation grew progressively worse.

This surprising result is also rooted in the legacy of the past. SOEs historically maintained large input inventories: accelerating inflation and aggravating disequilibria in the last years of STE regimes accentuated the tendency (see Shmelev and Popov, 1989, for the USSR and Winiecki, 1990a, for Poland).

The new rules of the game then freed prices at which products were sold, while inputs to these products had been bought earlier at much lower, controlled prices. Therefore, although output fell and capacity utilisation was low, profitability remained high. As budget revenues depended to a large degree on the already existing tax on

state enterprises' profits, the stream of revenues was sufficient to cover expenditure. This is what happened in Poland, Yugoslavia and Hungary in 1990, and in Czechoslovakia in 1991.

But the prolonged monetary squeeze, with its perverse effect on the enterprise sector, undermined the SOEs' profitability. On the one hand, profits of more efficient SOEs fell sharply. On the other, wasteful giants, living on subsidies and never-to-be-repaid credits, rarely contributed much to state coffers. In fact, the opening up of these economies generated some competitive pressures and resulted in further worsening of their financial performance. Thus, their contributions also declined.

As revenues declined, budget deficits began to increase. The relatively least affected has been Hungary, which already began reforming its tax system in late 1980s. It entered the transition with a more diversified tax system that also included personal income tax and VAT. Therefore, the fall in the SOEs' profitability that occurred there did not affect aggregate budget revenues so strongly.

All these countries have so far tried to avoid re-igniting inflation by printing money, therefore adjusting their budgets downward to keep deficits within manageable limits. An unintended, but nonetheless surprising, consequence of these developments has been a fast decline of budget-to-GDP ratios in all the countries concerned (again except Hungary, where the decline has been much less pronounced for reasons already given).

There are, however, limits to the decline of budget-funded activities. The resistance increases and shifts the issue from the economic to the political arena, undermining the whole transition process (since there is also a lot of bitterness in the industrial sector not least because better, rather than worse, SOEs are pressed against the wall).

Alongside the emerging urgency of the reform of the financial system, reform of the tax system transpired as another urgent priority. Both came largely as a surprise, since neither stabilisation nor liberalistion were seen as strongly dependent on financial or tax reform, least in the shorter run (on tax reform see, however, Kaminski, 1989, and McKinnon, 1991).

V. Unexpected and unnoticed

A set of unexpected developments considered in the preceding section has been more extensive than that of expected developments, whether they happened or not. Unexpected developments are, however, even more numerous. For one should take into account the fact that the section presented only surprising developments that had already received recognition.

On the other hand, some developments that the present writer did not consider have, in his opinion, taken place, but the economics profession seems to continue arguing about them as if nothing had happened. In other words, certain developments were not only unexpected but have also so far passed unnoticed. They belong to the class of unexpected developments that happened (whether noticed or not).

At least two debates continue with much fervour, although developments in post-STEs so far seem to have already decided their outcomes. The first debate centers on whether the return to the capitalist market economy is the only game in town. Market socialism, a long-cherished left wing alternative, has been one of the choices debated, while preference for the labour-managed firm – a variation on the theme – has had not only intellectual but also political support, both in some post-STEs and elsewhere.

This overview of expected and unexpected developments in the post-STE transition to the market is not the proper place to discuss the merits and demerits of alternatives to capitalism (the present writer has done so; see Winiecki, 1990b and 1991e). What is worth noting here is that the gist of the debate seems already to have been decided on the basis of post-STEs' 1990-1991 experience.

Contrary to pronouncements of decision-makers in some post-STEs about shifting back to the capitalist market economy, what we have seen so far in these countries has been by and large market socialism: state-owned enterprises (banks, *etc.*) affected by market-type policy instruments: interest rates, taxes, exchange rates, and the like. Furthermore, most of the unexpected and strongly adverse developments, as well as the absence of some expected beneficial developments in countries in transition, have been due to the fact that state-owned economic agents behave differently from privately-owned ones (see, *inter alia* Walters, 1991, and Winiecki, 1991c). A version of market socialism with labour-managed firms was also tried in 1990 in Yugoslavia

(and to some extent in Poland in 1990-1991) and registered similar failures.

Thus, failures of the transition are largely due to the market socialism nature of these economies. It is only with progressing privatisation, both through transformation of the state sector and the expansion of private firms, that this market socialism nature will gradually disappear and, at a certain stage, the capitalist market system will become a reality. Discussing alternatives as if they had not already been tried (and failed!) does not seem very realistic.

The present writer is of the opinion that an even more frequent debate on gradual *vs.* rapid transition to the market has already been decided by 1990-1991 developments. What has been called "shock therapy", "big bang", *etc.* – and criticised by "gradualists" – has been a critical mass of stabilising, liberalising and other institution-building measures necessary to obtain a degree of coherence among the rules of the game, ensuring at least a tolerable level of performance in the transition period.

It has transpired since late 1989, however, that what was thought to be a critical mass in fact fell short of requirements in this respect. Most of the problems these economies encountered stemmed not from the fact that they did too much at one moment, *i.e.* at the starting point of the transition, but too little. Even on the basis of this paper's assessment, one could add the immediate need to initiate changes in the financial system (cleansing the balance sheets of state enterprises) and at least short-term modifications in the already-existing tax system (reducing the budget's dependence on the state sector's profits).

As stressed by this author (Winiecki, 1991f), demand for capitalist market economy institutions is great from the start, while supply – in spite of strenuous efforts – necessarily lags behind. Improved performance is the result of reducing the gap between demand for, and supply of, institutions.

Spreading the range of necessary measures over longer period, as suggested by "gradualists", has important implications for performance. It means even less coherence among the rules of the game than that offered by the critical mass approach, for the gap between the demand for, and supply of, institutions will be initially larger, and the time needed to reduce it substantially longer. It also means that improved performance will come later.

It is worth noting that part of the gradual *vs.* rapid transition debate seems to be generated by muddled thinking about the problem. Some commentators tend to confuse two different type of decisions taken at the start of the transition programmes in post-STEs. The first type is a decision about a range of liberalising and other institution-building measures that are to be taken at the start. The second is about a degree of macroeconomic restraint: level of interest rates, extent to which subsidies are to be reduced to narrow budgetary deficit, or extent of exchange rate devaluation. Commentators criticise mostly the second type of measures.

However, this view does not make them "gradualists". In this author's view, recent experience of post-STEs in transition is in favour of a concentrated broad range of stabilising, liberalising and other institution-building measures taken in the shortest possible time span, and against a gradual approach.

On the other hand, decisions on the degree of macroeconomic restraint at the start of the transition are related to the degree of disequilibrium and the strength of inflationary pressures present in these economies. One may, of course, discuss the appropriateness of choosing one or another degree, or length of the time span, of restraint but this, by itself, has little to do with the preference for gradual transition.

VI. In place of conclusions

The stock-taking of expected and unexpected developments analysed against the background of theorists' concerns, however imperfect and selective, yields nonetheless an unambiguous picture with respect to the basics of the transition process. A very large, in fact dominant, part of assessed developments came as a surprise to the economics profession. Either developments expected to take place did not or, more often, unexpected developments affected – strongly and usually adversely – the post-STE transition.

And it must noted that the stock-taking has been selective, not only due to this author's judgement of what constitutes important development, but also due to the omission of some aspects of the transition. One such overwhelmingly important aspect has been privatisation. It was consciously omitted from these considerations for it is a very large issue that deserves a stock-taking of its own, attempted in Winiecki (1992).

In itself the dominance of surprises over developments expected on the basis of the received theory should not be seen as extraordinary. The transition from the collectivist-cum-totalitarian regime, with its special economic-political interface (see Winiecki, 1987, 1991), has been an uncharted path, where no standardised, textbook-based solutions would be expected to apply without thoughtful adaptation.

The fact that they were applied – in the completely different institutional environment of post-STEs – in the form of standardised ("heterodox") IMF stabilisation programmes, created certain expectations that simply could not be fulfilled. In consequence, these programmes became as much part of the problems of transition as that of the solution.

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