REFORMS IN THE TRANSITIONAL ECONOMIES OF ASIA

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Foreword

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Abbreviations

CMEA - Council for Mutual Economic Assistance
DMC - Developing Member Country
FSU - Former Soviet Union
GATT - General Agreement on Tariffs and Trade
GDP - Gross Domestic Product
GNP - Gross National Product
IMF - International Monetary Fund
IRS - Internal Revenue Service
LAO PDR - Lao People's Democratic Republic
NTB - Nontariff Barriers
PRC - People's Republic of China
SLORC - State Law and Order Restoration Council
TEAs - Transitional Economies of Asia
VAT - Value-Added Tax
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Abstract

Virtually all the world’s formerly planned economies have recently undertaken systemic reforms with the ultimate objective of replacing central planning with reliance on market mechanisms. The proposed reforms have been fundamental and have had significant impact on all sectors of the economy. Implementing these reforms has proved difficult for a number of reasons, including the lack of historical precedents from which to derive lessons.

To date, the results of the liberalization efforts in Eastern Europe and the former Soviet Union (FSU) have been disappointing. While some signs of economic recovery have started to emerge in Poland, the former Czechoslovakia and Hungary, output has generally fallen. The decline has been most rapid in the countries with the most ambitious liberalization programs. In contrast, output in the transitional economies of Asia (TEAs)—comprising the People’s Republic of China (PRC), Lao People’s Democratic Republic (Lao PDR), Mongolia, Myanmar and Viet Nam—has generally continued to grow after liberalization at more or less the same rate as during the pre-reform period. Price stability has also generally been maintained in the TEAs.

Initial conditions and exogenous circumstances account for much of the difference in economic performance between the TEAs and Eastern Europe and FSU, but different approaches to design and sequencing of reforms have also been important. The "Asian approach" to design and sequencing corresponds mainly to the approach of the PRC, but it is also largely consistent with the experiences of Lao PDR, Myanmar and Viet Nam. Mongolia, which is following the Eastern European approach, is the sole exception.

The Eastern European and Russian approach to reforms, frequently described as the big bang approach, has involved sweeping transfers of property rights, sudden price decontrol, and trade and foreign exchange liberalization. The basic objective of this approach is to convert the centrally planned system into a free market economy in the shortest period of time. In such a context, the question of how to sequence reforms is relatively irrelevant. The gradual approach of the TEAs has made the question of sequencing more important.

The "standard approach" to sequencing reforms, generally associated with the International Monetary Fund and World Bank, places macroeconomic reforms ahead of microeconomic ones. The "Asian approach" is "bottom-up" and has put most microeconomic reforms (including institutional reforms—agricultural and industrial enterprise reforms, and reforms of the legal framework under which enterprises operate—and price reforms) earlier than most macroeconomic reforms (including fiscal, monetary and foreign trade reforms). This has been instrumental in developing relatively efficient commodity markets and eliciting quick supply responses. It has also made it possible to control inflation and to reduce the social costs of adjustments.

The TEAs and Eastern Europe have also taken different approaches in such areas as enterprise, price, exchange rate and financial reforms. In designing enterprise reforms, the TEAs have encouraged the development of the nonstate sector while improving corporate governance of state enterprises by increasing autonomy and accountability. This contrasts with the Eastern European approach, where outright privatization has been given increasing priority on the reform agenda. The TEAs have also generally recognized that a certain
amount of industrial dualism (where the traditional "soft budget" enterprises—that is, enterprises that receive subsidized credit from state banks—co-exist with newly liberalized "hard budget" enterprises) is inevitable during the initial stages of reform, and that different price, exchange and financial arrangements are required for the liberalized and nonliberalized sectors.

This gradual and cautious approach is very different from the big bang price decontrol implemented by the Eastern European countries and Mongolia, in which state enterprises with soft-budget constraints could suddenly bid and negotiate prices freely for all goods and services. This resulted in a price explosion at the producer level and very rapid inflation.

Without denying the great importance of the difference in initial conditions among countries, the findings of this study still contain valuable lessons for the TEAs and transitional economies in Eastern Europe and Central Asia. These lessons are:

(i) The dominance of agriculture and light industry is a definite advantage to reform. When a producing unit is a household or small enterprise, profit and income maximization comes about more or less naturally.

(ii) The presumption that a free market will emerge overnight if the infrastructure of central planning is eliminated and the market is freed—is wrong. Scrapping the central planning system is a necessary condition for the evolution of a market system. Unless, however, there are rudimentary institutions that can be readily converted to effective market-based structures that facilitate production and distribution, the transition process will be difficult and lengthy.

(iii) Creating opportunities for nonstate enterprises (including small-scale private businesses) and improving corporate governance of state enterprises is more important than privatization as such.

(iv) Outward-oriented trade policies increase competitiveness and efficiency and also probably increase growth and investment prospects.

(v) Unless the political situation dictates otherwise, gradualism can work. Government regulatory intervention has an important role to play during the transition period. Also, during the transition period, different price, exchange and financial arrangements will be required for the liberalized and nonliberalized sectors.

(vi) In terms of sequencing policy reforms, fiscal and monetary policies are less important in the near and medium term than what standard policy prescriptions make them appear. Institutional reforms and price reforms are more important at the early stages. At a later stage, however, as macroeconomic instability develops, effective fiscal and monetary policies will have to be in place.
While the initial success of the TEAs is laudable, the process of reform is far from complete. Reforms have lagged in Myanmar, and Mongolia has adopted a big bang approach to liberalization. The road to reform is long and arduous even in the more successful TEAs.

While state enterprise reform and macroeconomic adjustment have proved difficult for all the TEAs, most have achieved considerable success in reforming agriculture and small industrial enterprises. Success in reforming large state enterprises has been modest. There is an urgent need for a comprehensive restructuring program for state enterprises. A proper legal framework that establishes and regulates the exchange of property rights, enforces contracts and bankruptcies, and sets the rules governing the entry into and exit from productive activities is also required.

PRC, Lao PDR and Viet Nam have reached a stage in their reform process where a failure to move expeditiously on macroeconomic reform could place at risk the successes achieved so far in the microeconomic areas. The most urgent need is fiscal reform, followed by improvements in the finance, foreign exchange and commercial sectors. Specific recommendations and policy agenda which could be considered by the TEAs are summarized in the paper.
I. Introduction

Virtually all the world’s formerly planned economies, perhaps with the notable exceptions of Cuba and North Korea, have recently undertaken systemic reforms with the ultimate objective of replacing central planning with reliance on market mechanisms. The proposed reforms have been fundamental and have had impacts on all sectors of the economy. The impetus has come from the early success of reform in the People’s Republic of China (PRC), the adoption of perestroika (restructuring) in the former Soviet Union (FSU) and the increasingly apparent inefficiency of the planned economy model. Implementing the reforms has, however, proven to be more difficult than was originally anticipated. These difficulties have reflected a number of factors: (i) the formerly planned economies lacked many of the institutional characteristics necessary for the effective operation of a market economy; (ii) there were fears among policymakers that the unavoidable short-term costs of reforms would result in serious political problems; and (iii) there were few historical precedents from which the former planned economies could derive lessons of experience. By and large, the transitional economies of Asia (TEAs)—comprising PRC, Lao People’s Democratic Republic (Lao PDR), Mongolia and Viet Nam—have been more successful than Eastern European countries and FSU in liberalizing their economies.

The specific objectives of the paper are to: (i) compare the economic performance of the TEAs and Eastern Europe and the FSU in the post-reform period; (ii) account for the differences in economic performance; and (iii) develop recommendations on policies and operational steps for future economic reform in transitional economies, including the designing and sequencing of reform measures.

II. Comparative Economic Performance: TEAs vs. Eastern Europe

After the economic reform measures taken in the PRC in 1978, including the dissolution of agricultural communes and the development of township and village industries outside the web of official price controls and state planning, output grew rapidly (see Figures 1-3). Inflationary pressure during this economic transformation was negligible for the first few years (see Figure 4). These successes, together with the generally recognized inefficiency of the centrally planned model, encouraged Mikhail Gorbachev in 1985 to embark on perestroika. This in turn led Viet Nam and Lao PDR to adopt gradualist reform programs in 1986. Myanmar followed suit in 1988, although its reform program (including some price reforms and the formation of public-private joint ventures) has been slowed by the interventionist bias of the State Law and Order Restoration Council (SLORC). By 1989 the transition from central planning to greater market orientation had become a political imperative throughout Eastern Europe and the FSU. In mid-1990 Mongolia embarked on a big bang privatization and price reform program following the advent of multiparty government.

The initial results of the liberalization attempts in Eastern Europe (including the FSU) have been disappointing. While some weak signs of recovery have started to emerge in Poland, the former Czechoslovakia and Hungary, output has generally fallen; the drop has
Figure 1: Growth of GDP in TEAs and Eastern Europe
Pre-Reform and Post-Reform
(per cent)

TEA

Eastern Europe

Note: t = year when the reform process started: China = 1978; Lao PDR and Viet Nam = 1986; Myanmar = 1988; Eastern Europe = 1989; and Mongolia = 1990.

Figure 2: Growth of Agriculture in TEAs and Eastern Europe
Pre-Reform and Post-Reform
(per cent)

TEAs

Eastern Europe

Note: $t$ = year when the reform process started: China = 1978; Lao PDR and Viet Nam = 1986; Myanmar = 1988; Eastern Europe = 1989; and Mongolia = 1990.

Figure 3: Growth of Industry in TEAs and Eastern Europe
Pre-Reform and Post-Reform
(per cent)

TEAs

Eastern Europe

Note: t = year when the reform process started: China = 1978; Lao PDR and Viet Nam = 1986; Myanmar = 1988; Eastern Europe = 1989; and Mongolia = 1990.

Figure 4: Inflation Rate in TEAs and Eastern Europe
Pre-Reform and Post-Reform
(per cent)

Note: t = year when reform process started: China = 1978; Lao PDR and Viet Nam = 1986; Myanmar = 1988; Eastern Europe = 1989; and Mongolia = 1990.

been most rapid in countries with the most ambitious liberalization programs (see Figure 1).\footnote{Recent International Monetary Fund (IMF) data indicate that real gross domestic product (GDP) in Eastern Europe fell by 13.7 per cent in 1991 and by 10.4 per cent in 1992. The average growth rate is, however, expected to be slightly positive in 1993. Inflation also continued to surge, from 135 per cent in 1991 to nearly 800 per cent in 1992.}

As expected, industrial production has suffered more than agricultural output (see Figures 2 and 3). Some commentators believe the Eastern European economies are following a "J" curve, with output inevitably falling before a long-term growth path can be established. In most countries, however, this upturn has not begun as quickly as anticipated, and the decline in output has been accompanied by severe economic disruptions and high inflation. This is particularly evident in Poland and Bulgaria (see Figure 4), and recently in Russia.

In contrast, output in the TEAs has generally continued to grow after liberalization at more or less the same rate as during the pre-reform period (see Figures 1-3).\footnote{Pre-reform average annual GDP growth rates in the PRC, Myanmar, and Viet Nam were 5.5 per cent, -0.7 per cent, and 7.0 per cent, while post-reform growth was 6.9 per cent, 2.2 per cent, and 5.6 per cent, respectively.} By and large, price stability has also been maintained (see Figure 4), although not always successfully in Lao PDR and Viet Nam. The only major exception is Mongolia, where the economy was severely affected by the adverse terms of trade resulting from the collapse of Council for Mutual Economic Assistance (CMEA) trade and financial arrangements in 1990.

Differences in initial conditions account for much of the difference in economic performance between the TEAs and Eastern Europe, but differences in the design and sequencing of policy reforms have also been important. The sections that follow explore these differences.

III. Initial Conditions

The first important difference between the TEAs and Eastern Europe is the relative importance of their rural sectors and heavy industry. Even in the PRC, with its substantial industrial base, the rural sector is dominant. Rural economies are based on relatively labor-intensive technologies and generally operate with a significant degree of self-sufficiency. While Asia's rural economies are technically less advanced and have lower income levels than the industrial economies of Eastern Europe, they possess greater resilience in the face of change.

Despite substantial collectivization, the household has remained an important basic element in Asia's agricultural production systems, and technology has remained consistent with the requirements of family farming. It has therefore proved relatively easy to shift the agricultural systems of the TEAs in the direction of market-oriented family-based farming, something not so readily achieved by the highly mechanized collective farms of the FSU. Moreover, decentralized rural economies facilitate the development of small-scale trading and business activities, which can be the local building blocks of an emerging market system in TEAs.
The relatively smaller role of large-scale heavy industry has contributed to the greater flexibility of the Asian economies. Heavy industry, at the core of the central planning system, was as dependent on allocated inputs and markets in the TEAs as it was in the FSU, and as ill-adapted to the requirements of reform, but it was of much less relative weight. By comparison, light industry, smaller in scale and with technologies much more attuned to the underlying factor endowment, has been far more responsive to the opportunities provided by the market economy.

The second major difference relates to the interplay between political and economic reforms. Among the five TEAs, only in Mongolia was economic reform set in motion by a political transformation as dramatic as those experienced in Eastern Europe. Mongolia, the world’s second oldest communist nation, had been closely linked with the Soviet Union from the early 1920s, and dramatic political change was an inevitable result of the changes that transformed its giant neighbor. While changes in economic policy in PRC, Lao PDR and Viet Nam have been associated with shifts in the balance of political power, there has been substantial continuity in their basic political systems, with profound economic reform being introduced and managed by the existing political regime.

Myanmar is an exception in many ways. Although the country adopted a centralized system of economic management and a commitment in principle to socialist goals, it was never integrated into the international communist system. In most respects it has more closely resembled experiments in nationalist and inward-looking economic strategies undertaken elsewhere in the developing world in the post-colonial era. The limited economic reforms implemented under the SLORC regime have been comparable to structural adjustment programs adopted in a great number of developing economies.

The absence of a definitive political change in four of the TEAs might be taken as evidence that some degree of political continuity can facilitate the implementation of economic reform. Indeed, the precipitate decline in the power of the communist party in most of Eastern Europe was coupled with reduced centralized political control over the economy as a whole, which in turn led to the weakening of newly decentralized control over state-owned enterprises.

The third important difference between the TEAs and Eastern Europe is the relative size of their state sectors and the degree of control of the state apparatus over economic activity. The state enterprise sectors in Lao PDR, Myanmar and Viet Nam were much smaller than those in the Eastern European countries. Indeed, the size of the state sector in these three countries was similar to that in most developing countries. Even in PRC and Mongolia, the share of heavy industry was lower than in Eastern Europe. Economic management in the PRC was centralized and hierarchical, with a network of interlocking material balance tables, specifying sources and uses of commodities. In practice, however, the material allocation system was much less extensive than that of the FSU.

Fourth, in PRC, Lao PDR and Myanmar, the importance of CMEA trade was marginal and its collapse was of little significance. Although Viet Nam was severely affected by the decline of CMEA trade and the cessation of terms-of-trade subsidies from the Soviet Union, it was not as dependent on these arrangements as the heavily industrialized countries of Eastern Europe. Mongolia was an exception.

A final distinguishing characteristic of the TEAs is their geographic location. Adjacent to the fastest growing region in the world economy, most of the TEAs need not look far to find models of economic success. Planners in each country are aware of the potential benefits of the spillover of capital, technology and entrepreneurial energy from their
dynamic neighbors. This has clearly influenced policymakers in PRC and Viet Nam, and could become important for Lao PDR and Myanmar. Conversely, Mongolia faces problems arising from its geographic isolation.

Two important issues affecting the design of the reform programs in the TEAs are the extent of pre-existing macroeconomic imbalances and the degree of centralized ownership and management of production units. These initial conditions are depicted in Figure 5. While comparative data are difficult to obtain, it is safe to assume that most Eastern European countries would have fallen in the upper right quadrant of Figure 5, with some (e.g., the former Czechoslovakia) falling in the lower right quadrant.

Since prices are rigidly controlled, and budgetary data generally underestimate the fiscal deficit, it is difficult to assess macroeconomic imbalances in most socialist economies. Among the TEAs, however, it is plausible to say that inflation and the overall fiscal deficit/GDP ratios were worst in Mongolia and best in the PRC at the advent of reform. Viet Nam was probably closer to the PRC in this regard, and Lao PDR closer to Mongolia.

The state sector was largest in Mongolia, whose economic system was not only modeled on the Soviet system, but was, if anything, more rigid and centrally controlled. By the end of the 1970s the PRC, too, had a Soviet-type economy, but its material allocation system was much less extensive than that of the Soviet Union in both coverage and content.

Viet Nam and Lao PDR, too, were heavily influenced by Soviet approaches to planning. However, neither was ever as centralized as the Soviet Union. While northern Viet Nam adopted an orthodox Soviet model for a relatively long period beginning in 1954, southern Viet Nam’s experience with central planning was relatively brief, and the private

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**Figure 5: Initial Conditions in TEAs**

![Graph showing initial conditions in TEAs with labels: Mongolia, Viet Nam, Myanmar, Lao PDR, PRC.](image-url)

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Viet Nam and Lao PDR, too, were heavily influenced by Soviet approaches to planning. However, neither was ever as centralized as the Soviet Union. While northern Viet Nam adopted an orthodox Soviet model for a relatively long period beginning in 1954, southern Viet Nam’s experience with central planning was relatively brief, and the private
sector, although illegal, was never fully suppressed. In Lao PDR, where a commitment was made to central planning after 1975, the reality was also very different. Effective state control was largely confined to the country's small modern sector, and the economic situation of much of the population changed little.

Although Myanmar was committed to a socialist path after 1962, there were important differences between Soviet-style central planning and the "Burmese Way to Socialism." Agricultural land was never collectivized; when agricultural land was nationalized in 1948, farmers continued to cultivate their fields as before, only as tenants of the state rather than of landlords. The government did try to direct the type of crops and the area to be sown for each piece of land, at least until the late 1980s. Effective state control of the economy never extended down to the level of the individual farm unit. Beginning in the 1960s agricultural output and exports were adversely affected by government control of procurement, domestic distribution and export; but these efforts to introduce central planning techniques were soon abandoned, in part because data were unreliable and in part because planners trained in Eastern Europe were often marginalized on returning home. Despite much discussion, Soviet-style credit and cash plans were never used.

IV. Sequencing of Policy Reforms

The East European and Russian approach to reform involved sweeping transfers of property rights, often through privatization; sudden across-the-board price decontrol; and trade liberalization. The basic desire among the reformers was to convert the old centrally planned systems completely into free market economies in the shortest possible time—at least in intent, if not always in practice. In such a context, the question of how to sequence reforms was relatively irrelevant. In contrast, the approach of the TEAs (except Mongolia) was more evolutionary and gradual, and questions of sequencing and design were more critical.

The PRC is the leading example of a successful gradualist approach to liberalization. In 1978 the PRC began to reform the agriculture sector with the twin objectives of improving the food supply situation and reducing poverty. Large agricultural communes were replaced with a system of small farm leases, and prices were liberalized in a gradual manner. As a result of these measures, farm output surged by around 8 per cent per annum between 1978 and 1985. In the early 1980s the focus of rapid economic growth shifted to rural light industry, which began to absorb much of the labor force released by productivity improvements in agriculture. Hundreds of thousands of the new manufacturing enterprises (called township and village enterprises) were owned largely by local communities. The township and village enterprises were market driven and outside the web of price and output controls that still dictated activity in the state-dominated heavy industry sector. Meanwhile, partially successful attempts were made to improve corporate management of the state sector. Step by step, the pricing and financial arrangements governing the old state enterprises were rationalized beginning in the late 1980s.

The experience of Lao PDR and Viet Nam in sequencing reforms was very similar to that of the PRC. In both countries, the government began to decollectivize agriculture in the mid-1980s. In Viet Nam, state enterprises were temporarily allowed to market their
output freely under a dual-price system similar to that employed in the PRC. With the abolition of this system in Viet Nam in 1989, and with the 1988 price reforms in Lao PDR, both countries completed the return of agriculture to family farming in a market environment. Efforts to improve corporate management of enterprises and promote the development of nonstate enterprises started in both countries in the early 1980s and strengthened as the decade progressed.

A broadly "Asian approach" to reform emerges from the discussion of policy sequencing (see Table 1). This involves a "bottom-up" approach, wherein the implementation of most aspects of microeconomic reform (including institutional reforms—agricultural and industrial enterprise reforms and reform of the legal framework under which enterprises operate—and price reforms) is earlier than macroeconomic reforms (including fiscal, monetary and foreign trade reforms). This approach differs from the "standard approach," often attributed to the IMF and World Bank, which places macroeconomic reforms ahead of microeconomic reforms. Although the "Asian approach" refers mainly to that taken by the PRC, the experiences of Lao PDR and Viet Nam were also similar. While price adjustments and promotion of joint ventures suggest that Myanmar, to some extent, adopted the Asian approach, reforms under the SLOC regime have proceeded very slowly. Mongolia, on the other hand, adopted an Eastern European big bang approach to privatization and price reforms because of internal political changes coupled with the sudden collapse of CMEA trade and financing arrangements; high inflation and recession have resulted. In those countries where it has been adopted, the "Asian approach" has facilitated the development of relatively efficient commodity markets and the encouragement of quick supply responses by helping establish market-oriented enterprises capable of responding to market incentives. It has also reduced the social costs of adjustment by generating supply responses as opposed to the "standard approaches," which advocate belt-tightening measures and demand restraints.

Although the TEAs did not adopt the standard prescription for sequencing, their reform programs have been regarded as fairly successful, particularly with respect to inflation. Why? Like their socialist counterparts in Europe, the revenue share of gross national product (GNP) fell sharply in the TEAs during the early years of reform, and their fiscal deficits increased. Despite heavy government borrowing, the TEAs, except Mongolia, managed to avoid inflation for several reasons. First, while liberalizing and improving the terms of trade for agriculture and promoting the nonstate sector, the governments imposed very hard budget constraints on the liberalized sectors (i.e., little credit was made available by the state banking system). These sectors were expected to self-finance themselves from their improved cash position due to increased output and productivity.

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3 According to the "standard approach" for sequencing policy reforms in developing countries, the first priority is fiscal control. This requires an organized internal revenue service capable of collecting taxes, and involves the introduction of taxes on agriculture and personal income, and of a uniform value-added tax (VAT) on industrial enterprises. After fiscal control, the domestic financial sector can be liberalized. The first step is liberalization of interest rates to make them positive in real terms; decentralization and privatization of the banking system should come later. As for the external sector, the exchange rate should be unified before eliminating centralized controls over who can import or export. While quantitative restrictions on trade should be removed at an early stage, preferably when prices are liberalized, they may temporarily be replaced by tariffs set at an equivalent level. These tariffs should then be phased out over a pre-announced period of a few years. Full capital account convertibility should wait until domestic financial liberalization has been completed and established. This is usually the last stage in the optimal order of economic liberalization.
The second reason for macroeconomic stability in the TEAs was the use of the financial surpluses of the newly liberalized sectors to finance the fiscal deficits. The newly liberalized sectors in both agriculture and industry began to build up their savings which then was made available to the state. The largely successful policy of keeping real interest rates positive also helped this process of non-inflationary financing of the fiscal deficit. Finally, the governments of the TEAs retained price controls and financial support to the traditional soft-budget enterprises at the same time that they were rationalizing and liberalizing prices for the nonstate sector.

V. Design of Policy Reforms

In addition to the differences in the sequencing of reforms between the TEAs and Eastern Europe, there have also been differences in the design of policies in key areas such as enterprise, price and trade reforms.

In designing enterprise reforms, the approach of the TEAs was first to encourage nonstate enterprises, including private businesses, while improving the governance of state enterprises through increased managerial autonomy. In PRC and Lao PDR, enterprise reform included reforming enterprise management through the introduction of a contracting system; privatization of ownership has not yet taken place on a large scale. This contrasts with the Eastern European approach, where privatization was given a high priority on the reform agenda, mainly because of the lack of success with earlier efforts to commercialize state enterprises while retaining state ownership. The indirect approach adopted by the TEAs is similar to the approaches used by East Asian economies, including the Republic of Korea and Taipei, China, and consistent with the idea that the inefficiencies of the state sector become less worrisome as the relative size of the nonstate sector increases. This strategy of first encouraging the nonstate sector and then progressively reforming the public sector allows the growing private sector to absorb laid-off state employees, and is thus a less painful way of reforming the enterprise sector.

The TEAs have generally recognized that a certain amount of industrial dualism (where the traditional "soft-budget" enterprises—that is, enterprises that receive subsidized credit from state banks—co-exist with newly liberalized "hard-budget" enterprises) is inevitable during the initial stages of reform. They have also recognized that traditional enterprises will normally become unprofitable as prices are decontrolled or rationalized. An understanding of the social consequences and economic costs of letting these enterprises collapse has led them to allow for a transitional period involving a two-track pricing system.

This approach has been adopted in PRC and Viet Nam. Once state enterprises satisfied their delivery commitments to each other at centrally controlled prices, they were permitted to sell at the margin any excess production to the rapidly growing nonstate sector at market-determined prices. While the PRC continues with this system, Viet Nam unified and almost totally deregulated prices in 1989. Both governments correctly recognized that price controls are necessary to anchor the producer price level when (i) enterprise budgets are still very soft, and (ii) sufficient competition has not developed in the provision of raw materials or producer goods from a hard-budget nonstate sector.

This cautious approach is very different from the big bang price decontrol implemented by the Eastern European countries and Mongolia, in which state enterprises
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<td>Modern Tax System</td>
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<td>Administered rates increased but not</td>
<td>Some adjustments, but system of</td>
<td>Administered rates have been</td>
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<td></td>
<td>sometimes positive. No open</td>
<td>ceiling rates still set by Central Bank</td>
<td>liberalized; open market operation since</td>
<td>administered rates continues.</td>
<td>increased on occasion, but not</td>
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<td></td>
<td>market operation;</td>
<td></td>
<td>1992.</td>
<td></td>
<td>liberalized.</td>
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<tr>
<td></td>
<td>complex.</td>
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<tr>
<td>Trade Reforms</td>
<td>**</td>
<td>**</td>
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<tr>
<td></td>
<td>Reappeared with emergence of swap</td>
<td>1988; small deviation between official</td>
<td>1993, prior to which the deviation</td>
<td></td>
<td>in 1989; the deviation between</td>
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<td></td>
<td>markets after 1985.</td>
<td>and parallel rates high</td>
<td>between the official and parallel rates</td>
<td></td>
<td>official and parallel rate is small.</td>
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<td></td>
<td></td>
<td>Restrictions on trade reduced</td>
<td>Restrictions on trade reduced</td>
<td></td>
<td>Restrictions on trade have been</td>
</tr>
<tr>
<td></td>
<td></td>
<td>significantly.</td>
<td>significantly.</td>
<td></td>
<td>reduced to some extent.</td>
</tr>
<tr>
<td>Controls over imports and</td>
<td>During 1984-1987, controls on trade</td>
<td>During 1991-1995, restrictions reduced</td>
<td>Since late 1988, restrictions on trade</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Exports</td>
<td>management greatly reduced.</td>
<td>on about 3,500 commodities.</td>
<td>reduced significantly.</td>
<td></td>
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<tr>
<td>Replacement of Quantitative</td>
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<tr>
<td>Restrictions &amp; Tariff</td>
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<td>Reductions</td>
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<tr>
<td>Microeconomic Reforms</td>
<td>Price Reforms</td>
<td>* to **</td>
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<tr>
<td>Agricultural Reforms</td>
<td>Two-track system, but more than 70% of retail prices and 85% of output prices of collectively owned enterprises are market determined.</td>
<td>Almost total deregulation since 1988.</td>
<td>Almost total deregulation since 1992.</td>
<td>Some price adjustments since late 1988.</td>
<td>Two-track system until 1989, when almost total deregulation occurred.</td>
</tr>
<tr>
<td>Promotion of Non-State Enterprises</td>
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<tr>
<td>Privatization of Small Enterprises</td>
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<td>Bankruptcy Law</td>
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<td>Anti-Monopoly Law</td>
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<tr>
<td>Foreign Investment Law</td>
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with soft-budget constraints could suddenly bid and negotiate prices freely for all goods and services. This resulted in a price explosion at the producer level, and in very rapid inflation.

A similarly cautious approach was adopted by PRC and Viet Nam in foreign exchange and commercial policy. For example, in the PRC, the central government initially allocated all foreign exchange at the official exchange rate, then gradually allowed an interenterprise swap market to develop at a variable but modest premium over the official rate. Through this policy, export enterprises were provided access to a realistic exchange rate despite the general overvaluation of the local currency. Other export promotion policies adopted by the PRC included the establishment of special economic zones, decentralization of foreign trade companies, and the implementation of export retention and foreign exchange contracting schemes. It was mainly the effective implementation of these export promotion policies that accounted for the dramatic growth of the PRC's foreign trade sector, from 5 per cent of GNP in 1979 to 20 per cent in 1992. The big bang liberalization in Russia, comprising price decontrol and the pursuit of current account convertibility, was followed by a tremendous increase in the ruble price of foreign exchange and a sharp contraction of export volumes.

VI. Lessons and Agenda for Reform

Without denying the great importance of the differences in initial conditions among countries, the findings of this study still contain valuable lessons for the TEAs and transitional economies in East Europe and Central Asia. First, the experience of the TEAs indicates that the economic dominance of agriculture and light industry is a definite advantage to reform. When a producing unit is a household or small enterprise, profit and income maximization comes about more or less naturally. Also, unlike large enterprises, households and small enterprises rarely enjoy soft-budget support. At the early stages of the reform process, the TEAs moved quickly to replace collectivized agricultural units with family farms. This was accompanied by pricing reforms that reinforced the market orientation. Improvements in efficiency and the unleashing of latent energies of the small farm sector contributed to the expansion of agricultural output. Other aspects of the reform process, including trade reforms and the expansion of light industry in the nonstate sector, also indirectly supported the growth of agriculture, and the ready supply of commodities provided a real basis for improvement in farm incentives.

A second lesson is that the presumption that a free market will automatically develop overnight if the infrastructure of central planning is eliminated and the market is freed—is wrong. Scrapping the central planning system is obviously a necessary condition for the evolution of a market system. But unless there are rudimentary institutions that can readily be converted to effective market-based structures to facilitate production and distribution, the transition process will be difficult and lengthy. A major success area of the TEAs has been developing market-oriented institutions and, therefore, eliciting favorable supply responses. Efficient product and factor markets have evolved in the process.

Third, creating opportunities for nonstate enterprises (including small-scale private businesses) and improving corporate governance of state enterprises is more important than privatization as such. It is not entirely clear why the TEAs have been relatively successful
in getting their enterprises to respond to commercial opportunities. Plausible explanations include the relatively greater importance of light industry, the looser hold exerted by the state planning system, the improved system of incentives including prices, the entrepreneurial skills of the population and the greater emphasis on local control of enterprises.

Fourth, the experience of the TEAs illustrates the advantage to be gained during the reform process from outward-oriented trade policies. Once the TEAs embarked on reform, they moved relatively quickly in the foreign trade area by liberalizing the foreign trade regime, implementing export promotion policies and realigning exchange rates. This resulted in a rapid expansion of exports in most cases. Among the TEAs, only Myanmar has not realigned its exchange rate, which has had a significant cost to the economy. Removal of nontariff barriers and tariff reduction have, however, lagged in all the TEAs.

Fifth, the experience of the TEAs indicates that, unless the political situation dictates otherwise, gradualism can work. Reforms in the TEAs were not doctrinaire, but rather evolutionary and pragmatic. This means that (i) while the long-term objective should be to reduce the role of government, government regulatory intervention can play an important role during the transition period; and (ii) different price, exchange and financial arrangements will be required for the liberalized and nonliberalized sectors during the period in which enterprises with soft-budget constraints and liberalized enterprises with hard-budget constraints co-exist. These include dual pricing and exchange arrangements as well as different fiscal and monetary regimes. The two-track system must be rationalized by taking into account domestic and international conditions. Currently in the PRC, collective and private industries compete vigorously with the old state sector, paving the way for the elimination of price controls without upsetting producer price levels. Still, the old state enterprises need to be constrained from bidding for scarce resources as long as they are recipients of soft loans from the state banking system.

Finally, the Asian experience shows that fiscal and monetary policies are less important in the near and medium term than "standard" policy prescriptions would make them appear. In the long run, however, as macroeconomic instability develops, effective fiscal and monetary policies need to be in place. The sequencing adopted by the TEAs, in which microeconomic reforms have been implemented prior to macroeconomic reforms, has encouraged the development of institutions capable of responding to market opportunities, eliciting quick supply responses and reducing the social costs of adjustment.

While the initial experience of the TEAs has been successful, the process of reform is far from complete. Reforms have lagged in Myanmar, and Mongolia has adopted an Eastern European-style big bang approach to liberalization. Both of these countries need to draw lessons from the more successful TEAs.

While state enterprise reform and macroeconomic adjustment have proved difficult for all the TEAs, most have achieved considerable success in reforming agriculture and small industrial enterprises. It is significant that reform of the latter has been achieved mainly through the promotion of the nonstate sector rather than through rapid privatization. Success in reforming large state enterprises has been modest. In many cases, the steps taken during the early stages were marginal manipulations rather than full-scale attacks on the underlying problems. Later reforms (e.g., the introduction of the contract responsibility system in the PRC and the "socialist business accounting" system in both Lao PDR and Viet Nam) have been more comprehensive. Still, serious problems remain. Comprehensive restructuring programs for state enterprises are therefore needed.

The major elements of such a program should be: (i) the merger and/or liquidation of nonviable enterprises; (ii) the reform of enterprise ownership, including conversion into
<table>
<thead>
<tr>
<th>REFORMS</th>
<th>PRC</th>
<th>LAO PDR</th>
<th>MONGOLIA</th>
<th>MYANMAR</th>
<th>VIETNAM</th>
</tr>
</thead>
</table>
| Fiscal Reforms| 1. Establish National Tax Service to centralize product tax, VAT and business tax collection.  
2. Introduce formula grants to provinces in place of current base number method.  
3. All existing minor taxes to remain under local government revenue.  
4. Prepare invoice method for VAT.  
5. Establish single rate for VAT.  
6. Limit product tax to alcohol, tobacco, petrol, cosmetics and other luxury goods.  
7. Apply domestic turnover taxes to joint ventures and foreign enterprises.  
8. Enterprise taxation to be applied equally on all enterprises.  
2. Introduce central tax collecting agency.  
3. Streamline present income tax structure. | 1. Introduce central tax collecting agency.  
2. Introduce uniform VAT.  
3. Streamline present income tax structure. | 1. Unified individual and enterprise income taxes.  
2. Value dutiable imports at market rates.  
2. Eliminate ad hoc tax breaks for state sector.  
3. Eliminate "special taxes" imposed by local authorities.  
4. Introduce orthodox personal income tax covering farmers as well.  
5. Improve revenue sharing between central and local governments. |
| Monetary Reforms| 1. Streamline representation in Council that sets monetary policy.  
2. Terminate dual leadership of local branches of Central and State Banks.  
3. Consolidate interest; eliminate preferential rates and eventually free interest rates.  
4. Commercialize state banks and allow establishment of branches by foreign banks in more cities.  
5. Integrate secondary market for government bonds and eventually introduce open market operations.  
7. Strengthen the central bank function and develop techniques of indirect monetary management.  
8. Phase out direct credit policies | 1. Reduce burden of nonperforming assets on newly established commercial banks.  
2. Institute system of market-related interest rates.  
3. Address problem of nonperforming assets held by commercial banks. | 1. Institute system of market-related interest rates.  
2. Gradually introduce open market operations.  
3. Address problem of nonperforming assets held by commercial banks. | 1. Institute market-related interest rates.  
2. Gradually introduce open market operations.  
3. Resolve problem of nonperforming assets held by commercial banks.  
4. Develop capital markets including stock exchange. | 1. State Bank should focus only on central banking.  
2. "Commercial" state banks should operate on profit-making basis.  
3. Reduce foreign exchange to improve balance of payments.  
4. Free interest rates in a phased manner.  
5. Reduce burden of nonperforming assets on banking system. |
| Trade Reforms  | 1. Unify exchange rates; eliminate foreign exchange certificates.  
2. Replace non-tariff barriers (NTBs) with tariff equivalents, then reduce tariffs to uniform General Agreement on Tariffs and Trade (GATT)-compatible level. | 1. Unify official and free market exchange rates.  
2. Replace NTBs with tariff equivalents, then reduce tariffs to uniform GATT-compatible level.  
2. Introduce free economic zones and promote border trade.  
3. Introduce new tariff schedule following Harmonized International Tariff Classification system.  
4. Eliminate minimum export prices. | 1. Encourage private sector participation in foreign trade.  
2. Unify exchange rates by lowering import duties.  
3. Introduce tariff schedule following Harmonized International Tariff Classification system. | 1. Develop basis for effective foreign trade sector through creation of competitive internal markets.  
2. Replace NTBs with tariff equivalents, then reduce tariffs to uniform GATT-compatible level.  
3. Eliminate export earnings retention system. |
<table>
<thead>
<tr>
<th>Price Reforms</th>
<th>1. Gradually eliminate remaining price controls.</th>
<th>1. Eliminate state order system so that price reforms can be more effective.</th>
<th>1. Gradually eliminate price controls.</th>
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<tr>
<th>Agriculture Reforms</th>
<th>1. Improve availability of inputs to farmers.</th>
<th>1. Improve availability of inputs (fertilizer, credit, infrastructure) to farmers.</th>
<th>1. Improve availability of inputs (fertilizer, credit, infrastructure) to farmers.</th>
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<tr>
<th>Enterprise Reforms</th>
<th>1. Improve corporate governance of state enterprises by converting into joint-stock companies of establishing asset management corporations.</th>
<th>1. Develop administrative and technical capacity for privatization.</th>
<th>1. Adjust prices (urgent).</th>
</tr>
</thead>
</table>

joint-stock companies and possibly privatization; and (iii) the further improvement of corporate governance. The PRC has recently begun merging enterprises with a view to enhancing their viability; the government is also considering the conversion of state enterprises into joint-stock companies with the state as a shareholder. Under the joint-stock company model, the financial performance of an enterprise and the public assessment of its economic prospects will be reflected in the price of its stocks. Such transparency will promote a more efficient management system.

One important, but difficult, set of institutional requirements in enterprise reform relates to the question of property rights. In the early stages of reform, particularly with many ideological issues unresolved, there may be some virtue in a degree of ambiguity regarding the status of enterprise ownership and control. As the new economy emerges, however, problems can be expected if enterprises operate in a sort of limbo between public and private ownership, with rights and responsibilities of management and ownership unclear in both practice and law. A fundamental requirement of a market economy is a legal framework that establishes and regulates the exchange of property rights; enforces contracts and regulates bankruptcies; and sets rules governing the entry into and, generally more difficult, exit out of productive activities.

The stop-and-go approach to reform in the PRC has led to an uneven growth path, while the high degree of experimentation (e.g., in establishing special economic zones) has contributed to regional imbalances. In the area of foreign trade, a certain amount of decentralization has been achieved. However, exchange rate unification and significant reforms of tariffs and nontariff barriers have yet to occur. In the area of monetary reform, although the banking system is still complex, a two-tiered system has been in place since 1985. Still, despite frequent adjustments, interest rates have not been liberalized, and the tools needed for indirect monetary management have not yet been fully developed.

In the fiscal area, the PRC has made limited progress in implementing reforms. A central government agency to collect taxes has yet to be established, and the decentralized fiscal system is not very efficient. Although a number of direct and indirect taxes including personal income tax and VAT have been introduced, their coverage and implementation need to be improved if they are to serve as a foundation for a modern tax system.

The PRC cannot postpone macroeconomic reforms for much longer. The government cannot rely indefinitely on heavy borrowing from the liberalized sectors, because households are no longer undermonetized and the broad money supply/GNP ratio, which has reached a very high level, cannot continue rising forever. When (or even before) the ratio of household liquid assets to income reaches its peak, there could be a financial crisis that could put the great accomplishments of the reform process at risk.

Both Lao PDR and Viet Nam successfully implemented several important macroeconomic reform measures in the late 1980s and the early 1990s. While these measures were steps in the right direction, they have not gone far enough. Exchange rates have been adjusted and restrictions on trade management reduced, but tariff and nontariff reforms have yet to be completed. In the financial sector, while administered deposit and loan rates have been increased on occasions, deregulation has not yet occurred. In the fiscal sector, a number of new direct and indirect taxes have been introduced, but more needs to be done to extend their coverage, streamline their administration, and improve tax buoyancy and elasticity.

More specific recommendations and policy agenda which could be considered by the TEAs are summarized in Table 2.
References


