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Development and Transition: Emerging, but Merging?

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I. Introduction

It is unclear who first classified countries that are attempting to develop market economies into a single group of 'emerging markets' or 'emerging market economies.' The Economist for example regularly uses this term. These countries can be divided into at least two sub-groups. Both aspire to become modern (democratic) market economies, but have different starting points. One group of countries, in Asia, Africa and Latin America, is presently emerging from underdevelopment (DEs) while the other group is composed of 'transition economies' (TEs), at various levels of economic development, which are emerging from the communist economic and political system. These countries extend from Central Europe through East Asia, with the former Soviet Union at the center.

The main goal of this paper is to investigate to what extent the different heritage and therefore initial conditions are distinct enough to justify the separate treatment of these two groups. We need to ask how much do they have in common and to what extent each group can learn from the experience of the other. Or, per contra, to what extent are the two groups characterized by different economic paradigms and therefore? Or at least, to what extent the heritages are different enough to call for different growth strategies and distinct policy packages?

As an illustration of glaring differences is the observation that industrialization and modernization in DEs follow a gradual evolution from small, family businesses to larger scale enterprises, mostly starting from food and light industry toward more sophisticated production processes. TEs, on the other hand are 'over-industrialized', concentrated in producers goods and lack small businesses. There are many policy implications to this difference, direct ones: the pace of reform, and, how to develop small businesses, how to restructure big industry in TEs. And there are indirect policy differences related to the role of the banking and financial sectors, on fiscal and public expenditure policy. More examples on similarities and differences are discussed as we go along.

The interaction between the two fields of study did not begin with the fall of the

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Berlin Wall and the emergence of 'transition.' When economic development was still in its early stages as a field of study, the industrialization of the Soviet Union since the 1930s was perceived as highly successful and served as a model for DEs and students of economic development. The socialist model emphasized the importance of generating domestic savings to finance investment, especially in industry and particularly in the capital goods sector. The basic idea of self-sufficiency and autarky followed by 'import substitution' and the preference for intensive and direct government intervention and planning (McKinnon, 1991, Ch. 1; Srinivasan, 1997, 1998; Meier, 1998; Krueger, 1993; Rodrik, 1996). A number of non-communist countries in Asia, Africa and Latin America, in particular India, adopted many elements of the communist economic model, (Srinivasan, 1998). Over the past decade, following the acknowledged failure of the Soviet economic approach, the question now asked is whether the TEs which have emerged from the Soviet system, can benefit from the experience of the DEs?

During the last half-century DEs have struggled with many of the problems now faced by TEs. These include the effort to create monetized market economies and to stabilize them in order to avoid or reduce inflation; to develop a solid financial sector that will serve the real economy without destabilizing the macroeconomy; to establish a modern fiscal system; open up to global competition after periods of heavy protection and price distortions; privatize state-owned enterprises; to deregulate and free the economy of heavy direct government intervention (and even planning); and to limit the opportunities for and incidence of opportunistic behavior and improve the quality of government.

These problems are, of course, also confronted by TEs. Joseph Berliner, among others, agrees that at the start transition created unique problems for the TEs due to the scope of the needed changes and the difficult starting points. But he then claims that, following the initial period, TEs face similar problems to those of other countries at a similar level of development and therefore have to be addressed as such (personal discussion). In this vein, Dani Rodrik discusses issues of economic policy for DEs and TEs together, not even including the latter in the title of his survey (1996). Bill Branson, on the other hand, claims that the former Soviet republics in Central Asia "have to make an intensive effort over a period of years in order to qualify as DEs." And from a different angle Tom Friedman (New York Times, April 30, 1999. op. ed.), claims that Japan has been the most successful communist regime (sic) in view of its level of external protection, heavy subsidization of industry and direct government intervention, lifelong job security and safety net.

Finally, the experience of transition during the last decade has prompted economists and policy makers to focus attention on areas that, although crucial for successful transition, are also important for DEs. These include institutional economics, the political economy of opportunistic behavior and corruption, the restructuring of government, large-scale privatization and the speed and sequencing of reforms. The most notable example is the evolution of the 'New Washington Consensus' and the special emphasis on the reform and improvement of government, as seen in recent papers by Stiglitz (1997, 1999), the survey by Rodrik (1996), the official policy pronouncements of the IMF (1997) and the World Bank (Wolfensohn, 1998), Kolodko (2000) and many others. The co-existence in TEs of relatively modern production structure alongside weak market institutions and governments further exposed the weaknesses of the old paradigm and underlined the need for the new elements. Of course, the so-called 'East Asian Miracle' and the recent financial crises in a number of DEs also contributed to the change.

The TEs can be thought of as countries that have traveled for a long time along a distinctly different road than the DEs. However, since the late 1980s when a dead-end was reached, they have changed course and are attempting to join the road that the DEs are traveling on towards full economic modernization. The distance from the main road, reflecting a different economic and institutional configuration, requires that the TEs follow a different and previously non-traveled road until convergence is achieved.[2] Although DEs also experienced periods during which they detoured from the main road and which required a stage of 'restructuring' in order to return, the detours were relatively short detours. For this reason, the issue of speed, scope and sequencing became so important for TEs (McKinnon, 1991). Thus, while there is much in common between TEs and DEs, on both the theoretical and applied levels, and the two groups can benefit from each other's experience, the different routes traveled by the two groups deserve special attention.

The paper proceeds as follows: In the next section we survey the main issues of economic development and their relevance to transition. Section III contains a survey of the structural and institutional differences between TEs and DEs, based principally on empirical comparisons between groups of countries in the two groups at 'similar' levels of economic development. The discussion in section IV summarizes the similarities and differences between transition and development. Section V focuses on the main problems of transition and how the experience of economic development can suggest strategies and policies to deal with them. The paper ends with a short concluding section.

II. The Evolution of Economic Development Theory[3]

The initial, post World War II paradigm of economic development was based on capital investment in manufacturing (and infrastructure) financed by increasing saving and assumed an 'unlimited' supply of labor. In order to ensure the initial success of industrialization, the import-substitution strategy (IS) based on protection, as formalized in the 'infant industry' argument, was adopted. Manufacturing was considered crucial due to its potential to generate a permanent stream of technological changes, scale effects and other externalities and, as a result, sustained productivity growth. The production and export of primary goods was plagued by price instability along a declining long run trend. The successful record of Soviet industrialization clearly influenced this way of thinking. The literature discussed various models, which explained how to achieve the 'critical mass' required for a growth takeoff, but didn't fully internalize them into the main growth model. The models were based on the firm belief in the existence of serious market failures and therefore advocated active government intervention, up to virtually full planning and the establishment of a large public production sector. Foreign aid was considered important to enable the transfer of technology and to reduce the trade deficit or the gap between investment needs and the level of saving. Equity was usually considered a competitor to efficiency and economic growth and the Kuznets curve served as confirmation.

A number of major additions and changes to the theory and policy of economic

[2] The same idea of a road not traveled before is expressed more recently by Shleifer and Triesman in their book "*Without a Map*".

[3] This section is based on a number of recent surveys of economic development: Krugman, 1995; Srinivasan, 1996, 1997, 1998; 1999; Meier, 1998; Bardhan, 1995; Berry and Stewart, 1999; The World Bank, 1993; and specific references in these texts.

development evolved over time in response to lessons from experience, the development of economic theory and changes in the global economy. We consider them in turn, though not necessarily in chronological order. Development and growth theory expanded to include many additional factors as important contributors to growth of DEs, some of which were included in the formal models which came to be known as 'endogenous growth' models. Technological change, the main vehicle of economic growth was moved from being a part of The 'residual', to an integral part of the model. In order to make it possible these models had to depart from the normal assumptions of constant returns to scale and perfect competition and to internalized formally increasing returns, positive externalities and complementarities, and monopoly power and imperfect competition (Romer, 1993). By doing so at least some 'market failures', as well as the intrinsic advantages of manufacturing over primary production were accepted, leading to a theoretical justification for some degree of market intervention and government regulation, possibly including IS type policies as well (Lucas, 198X; Romer, 1993; Krugman, 1995). The new factors appearing in the models included first and foremost human capital, as well as various measures of quality of life, distributional variables, such as the level of poverty and distribution of income, the active 'participation' of all segments of the population in development efforts and 'sharing' in its fruits, and a vector of factors grouped under the heading "social capital." The distributional variables were introduced more aggressively following the experience of the 'East-Asian Miracle' (1993, see more on the EAM below) although their significance was recognized long before (See discussion in Bardham, 1995, Stiglitz, 1998).

The developing difficulties in the application of the radical IS strategy and the success of countries (mostly in East Asia) that chose the alternative strategy of 'export-lead growth', lead to its gradual discontinuation. The issue of whether IS strategy was wrong from the start or was justified for an interim period has been debated in the development literature (Krueger 1993, Bagwati 1963 and later, Srinivasan 1996, 1999; Ranis, 1998). Ranis and others believe in its importance at an early stage, and in its replacement later with a "second stage IS with export promoting" (SIS/EP), the strategy of the Asian Tigers (World Bank, 1993). In any case IS was strongly criticized already in the early 1960s by Krueger, Balassa (for example. 1977, pp. 7-9), and many others on three major points: the forgone advantages of free trade, including the transfer of technology, further enhanced by the 'new trade theory'; the failure of governments to properly manage IS and the increase in opportunistic behavior; and the tendency to postpone the switch in strategy and open their economies until long after it became warranted. In addition to the obvious benefits, openness provided more effective discipline than most governments could achieve in the spheres of macroeconomic fundamentals, budget constraints, 'genuine' restructuring and production efficiency. The global economy had also been opening up and the volumes of trade and capital flows were increasing rapidly, further enhancing the advantages of an open economy (Srinivasan, 1999, p. 168).

'Government failures': In many countries, the experience of government intervention in the economic sphere was rather disappointing. Attempting to rectify market failures, governments caused no less harm through a long list of resulting 'government failures' (Krueger, 1993). In many cases the government remedies failed while in others, they brought with them negative side effects. The main failures can be classified (following Rodrik, 1996) into two major categories: Preserving macroeconomic stability and pursuing

optimal 'industrial policies.' The side effects included the spread of 'opportunistic behavior', rent seeking and corruption. Only governments can maintain macroeconomic stability, and therefore the thrust of the theoretical and policy literature was to assist governments in fulfilling this function. This is the essence of the so-called "(old) Washington consensus".

As to 'industrial policy', the accepted view was that governments should shy away from 'picking winners and losers', which they had failed at in many cases. The great success of the Asian Tigers, achieved with a certain degree of government intervention, gave renewed support to the advocates of intervention in this area. There is a continuing debate over the optimal extent and form of 'industrial policy' in these countries, and its effect. It was possibly the combination of government intervention and the 'disciplinary budget constraint' of an open economy that provided the formula for success. One of the principal forms of intervention consisted of support for successful exporters, (through, for example, exports tenders; see Srinivasan, 1998), but imports were also restricted for extended periods (Ranis, 1998).[4]

Rodrik (1996) made the distinction between the two aspects of the IS strategy, claiming that it is the difficulties with respect to the goal of macroeconomic stabilization, that caused most of the problems, while 'industrial policy' was in some cases responsible only for some static inefficiencies. The main difficulties were the defense of an overvalued exchange rate, and an artificial creation of cycles. Rodrik agrees that the two aspects are not completely independent of each other, but even so this distinction is of crucial importance when considering policies in TEs.

The spread of opportunistic behavior as a side effect of government intervention generated a large volume of literature on theories and policies of the 'second best' (Srinivasan, 1996 and many situations of Bagwati and others there), political economy and public choice and the new institutional economics (Oliver Williamson, 1994). As a result new paradigms for optimal government intervention emerged: 'fundamentals friendly', 'market enhancing' and 'market friendly', whereby varying degrees of complementarity are preferred over substitutability (Srinivasan, 1997; Aoki, 1997; Stiglitz, 1998). The study of the interaction between government and the market, is an important contribution to economic theory and to the general agenda of economics.

The renewed emphasis on institutional economics and political economy was motivated not only by 'opportunistic behavior'. It was also a response to a more general observation that in DEs merely changing the rules of the game, whether in respect to macroeconomic stabilization, industrial policy, or managing the financial sector, didn't have the intended effect. In order for a change in rules to achieve the desired outcome, an appropriate institutional infrastructure is required. This is in addition to economic players that understand the rules. Policies that may achieve (nearly) perfect competitive and efficient markets under one set of institutions may bring an economy to anarchy and inefficiency under different ones. Ann Krueger (1993) makes the point that if the problem in DEs was, of non-response to incentives, then development should be considered a separate field. But if they only suffer from lack of the right incentives then development can qualify only as an empirical application of normal theory. The experience of economic transition seems to reinforce the view that the truth is somewhere in between: the 'right' incentives in a

[4] Srinivasan (1998) and others believe that it is openness and not any kind of government intervention that was chiefly responsible for the economic success of the Tigers.

distorted institutional environment may encourage the wrong response.

It is now acknowledged that in some cases the failure of macroeconomic stabilization efforts had to do with the narrow framework of the Washington Consensus. In countries with inadequate institutional infrastructure it simply didn't work. This has been the motivation for the development of the so-called "new Washington consensus". While still adheres to the same goals of macroeconomic stability and competition, it searches for the best means to achieve them, with a special emphasis on the kinds of institutional development required in order to do this (Stiglitz, 1998, Kolodko, 2000). This was the claim of the "structuralist school" all along (Taylor, 1994).

In his paper Stiglitz (ibid.), pays special attention to the role of the financial sector in economic development and advocates, among other things, a somewhat less competitive, more industrially concentrated sector, with fewer, larger banks. Such a financial sector will be better able to assemble the required management and professional skills and know-how and will be easier for the government to regulate and control. Furthermore, the monopoly profits create 'franchise value' for the banks that encourage them to self regulate. The benefits extend to the macroeconomy as well as to better oversight and control of credits to the production sector on a micro level (pp. 18-21). A banking sector organized along these lines will fulfill the role undertaken by governments in many DEs, i.e., to directly allocate credits to the production sector.

The structure of the financial sector may also be appropriate for the production sector, i.e. larger, vertically integrated production organizations, with or without the participation of banks. The first systematic treatment of such a model was offered by Alexander Gerschenkron with respect to the process of industrialization in Europe (1962, see more below). The same model has also been a major element in the development strategy of most of the East Asian Tigers, including Japan, and no doubt has been a very important element in their success. The Japanese Zaibatsu, the Korean Cheabols, etc., were created with the support and guidance of government. Such an organization shields itself from some competition in less-developed markets and also performs, in a private sector environment, some of the functions that government would have had to, such as micro-managed industrial policy. In this way these large organizations partly compensate for weakly organized markets on the one hand, and weak governments on the other. Such large trusts also provide a better response to openness; they develop capability to create indigenous R&D capacity and to meet the competition of multinational corporations that are at least as large as they are.[5]

Like every second best solution, also here there is a danger of misuse of power by these large conglomerates. The extra market power can be misused as well as internal decision making, resulting in lack of transparency, conflict of interest, inside trading and opportunistic behavior. Furthermore, institutional arrangements tend to survive much longer after their usefulness expired. They should have been replaced much earlier. The above mentioned observation by Tom Friedman (1999) on Japan expresses this well; the financial crises in some of the Asian countries also provide evidence of this tendency.

The 'dual' economy model of development: As we have seen both the theory of economic development and the development process itself, have undergone many changes in strategy, policy and perception. One paradigm that seems to have survived throughout this process is the concept of the dual economy (Srinivasan, 1998; Stiglitz, 1996; Meier, 1998).

[5] This argument is fully recognized by the 'new' trade theory.

The development process can be observed as a sand-clock in which economic players gradually pass from the traditional sector into the modern one. The passage between the two sectors is narrow, allowing some interaction, and allowing the two parts of the economy to coexist in the same country but in two separate economic ages, with differing technologies, services, factor prices and even prices of goods and services. Originally the separation was geographical, between country and town, but later the two sectors coexisted within the same metropolises of the DEs. The dual structure has numerous deficiencies, especially inefficient allocation of resources (Stiglitz, 1996). The principal advantage of the dual economy process is its 'piecemeal', gradual nature of change, allowing sufficient time for institution building, the accumulation of experience and the education and transformation of the population. The transition literature is dominated by the debate between the advocates of a Big-Bang approach and the gradualists, a debate that has only vague precedents in the development literature. One big difference between the concepts of dual economy and of gradual reform is that in the first the gradualism happens by a piece-meal process of applying 'development' to an increasing share of the economy, while gradualism under transition is usually understood as gradual changes in individual aspects of the old system across the entire economy. Even so the study of the dual economy model may have interesting implications for the dual strategy in TEs, possibly also in its original pattern. If it does, this may land additional support to at least one approach of the gradual school.

In summary, the process of development is, to be sure, far from smooth; it is characterized by crises, ups and downs in performance, periods of retreat and of 'restructuring' and shifts from one strategy or stage to another. There are some DEs that haven't yet 'taken off.' DEs frequently found themselves moving away from the turnpike of economic development; they had to stop and make corrections to their course. Corrections were frequently expensive in terms of lost growth and welfare and of time (Ranis, 1998; Ranis and Mahmood, 1992; Rodrik, 1996; Stiglitz, 1996). Such corrections were, however, smaller and different in character than the changes involved in the transition of TEs to a market system. Let us therefore model the development experience as a journey along a winding uphill road, where travelers move ahead at different speeds, sometimes retreat or stop on the side; sometimes they err and travel for a while on dead end side-roads, only to return after a while. In the context of this framework let us think of the TEs as countries that deviated from the main road not far from the start and traveled in a different direction, sometimes at high speed, only to discover the dead end at a late stage. Even worse, the distance leading to the main road is unpaved, never traveled before and full of obstacles. The metaphor emphasizes two points: the enormity of the required changes and the lack of experience for their implementation. Many of the development problems and strategies discussed above are applicable to the transition. The study of transition extensively utilized the development literature and later contributed to it in many areas. However, the intensity and nature of the problems in TEs are very different due to the different route traveled and thus the different starting point. Likewise solutions and their implementation require new ways of thinking. Finally, not all TEs traveled the same road or distance and therefore the economy may pass over different terrain 'at a different stage of development.' Furthermore, TEs also differ in other attributes. There may be therefore TEs that are less distant from the main road, with a lesser demanding gap to travel, and that are equipped with somewhat better off-road vehicles to make the journey. We turn now to examine the characteristics of

the TEs in the early stages of the transition process using the 'normal' process of development as observed in the DEs as a benchmark.

III. The impact of the socialist heritage[6]

The former socialist countries arrived at the starting line of the transition with a common core of characteristics of the old economic, social and political systems that separated them from countries pursuing economic development through a market system. While these core 'socialist' characteristics were largely similar in nature, they differed to some extent between the TEs in composition and intensity and in their relative influence on the transition. Such differences emerged partly from variations of the socialist model among the TEs, and partly as a result of other conditions that affected one or more of the TEs. The most important of these factors is the level of economic development, a summary variable that reflects the work of the systemic, as well as other factors. The latter include the stage of economic development and heritage at the time of the socialist takeover, the length of the period under the socialist regime, the endowment of natural resources and a number of other variables, some mentioned below.[7]

In this section we compare the economic structure and characteristics of TEs with DEs along the latter's path of economic development. The differences in development characteristics between the two groups along this path are observed and used to define the problems involved in the transition of TEs, assuming that the TEs are indeed converging to the 'normal' pattern of development followed by the DEs. In addition to a general comparison of the two groups of countries, subgroups of TEs and DEs at similar stages of development are also compared in order to study specific stage-dependent transition problems. As an illustration, over-industrialized socialist countries at a relatively advanced stage of development, must concentrate on restructuring their manufacturing sector and will have a greater need for a well-functioning financial sector at a time when it is particularly weak. Low-income TEs entering the transition process with a relatively high stock of human capital and with well-established public services will have a difficult time finding ways to put them to a good use and will find it even more difficult to preserve and finance these services.

Based on the data and earlier studies, TEs can be arranged into 6 groups plus the Russian Federation and China, organized in order from higher to lower income levels and geographically from Northern-Central Europe to Southeast Asia. As can be seen these two criteria result in almost identical ordering.[8] The groups are as follows: the advanced countries in Central Europe, a group in South Europe, former Soviet republics in the European part of the FSU with Russia as a separate entry, the Caucasus and Central Asia (including Mongolia), and socialist countries in Southeast Asia. Correspondingly the market economies are grouped into 9 clusters according to level of income and continent. All but

[6] This section is based on The Annual Reports of the EBRD (TR, 1997, 1998), The World Development Report, 1996, de Melo et al., 1997, Bosworth and Ofer, 1995, and specific references mentioned in these texts.

[7] There is a vast literature on 'initial conditions'. Among others see World Development Report, 1996; De Melo et al., 1997; Bosworth and Ofer, 1995.

[8] This geographical pattern is also consistent with the levels of the transition index as compiled by the European Bank of Reconstruction and Development (EBRD) for the European TEs. See a diagram in the Transition Report (TR), 1998, Chart 2.3, p. 29.

the two groups of high-income countries are DEs. The classification of all non-TEs corresponds to the classification of countries by the World Bank (1998, pp. 250-51). The group classification can be seen in Table 1 and the country composition of the groups in Appendix Table 1. The classification is based on per-capita income levels, PPP based, for 1996.

As can be seen from Table 1, the highest TEs income group within the Central European group has a somewhat higher income than the two highest income Latin America and Africa DEs groups, but a much lower income than the that of the High Income Countries groups. Even lower than that of a lower income group among high-income countries made up of mostly South-European countries. The next 2 TEs groups, and the Russian Federation, and China, have income levels similar to lower level DEs groups of Latin America, and East Asia.[9]

[Table 1 around here]

Finally the FSU-Central Asian group of TEs (which includes also the Caucasus), have income levels similar to those of the less developed countries of South Asia, India and Africa. Income comparisons are made on the basis of PPP estimates in order to reflect real standards of living and avoid distortions in official exchange rates. Table 1 shows how the comparison groups have similar ratios between the two measures of per-capita GDP.[10] In 1996 many TEs (with the exception of the central European and one or two Baltic countries) still hadn't reached their higher pre-transition GDP levels. While this fact is taken into account in discussing comparisons, it is not clear how much of this decline has real 'recoverable' production potential and how much should be considered lost. We use this group comparison approach between countries, rather than regressions, so that related typical characteristics and development patterns may be taken into consideration.

In what follows we discuss the main deviations of TEs from the 'normal' patterns on two levels: deviations between all TEs and market economies in general and between specific groups of TEs and DEs at similar level of development. We first discuss general deviations and the variations among groups of TEs. Data on some of the structural differences are presented in Tables 1- 9 and the corresponding charts. Other differences are qualitative and in some cases other references are cited. The order of discussion is as follows: the economy, the market infrastructure, the government, society and polity.

One. Different Economy

TEs are first of all over-industrialized economies which emphasize heavy industry but are equipped with an inadequate physical infrastructure to support this, a functional autarky and distorted foreign trade. They have a more mature population structure, a higher level of human capital with the required social services. They also have a higher level of information instruments.

Economic Structure: TEs followed an extreme strategy of industrialization, with particular emphasize on heavy industry: metallurgy and machinery. The literature brands

[9] Moldova, a member of the European FSU group had in 1996 a per capita income of $1,410, more similar to that of the central Asian FSU countries.

[10] On the basis of the official exchange rates the top group of TEs looks even weaker when compared with the High Income Countries but a bit better when compared with the high-income countries in Latin America. Also Russia had in 1996 a highly overvalued local currency, very large welfare state and public services commitments, and corresponding high tax levels, collected.

this phenomenon as 'over-industrialization', hinting that de-industrialization may be warranted. This phenomenon is especially striking in the composition of the labor force (Table 2). Still in 1996 nearly 40 percent of the labor force was employed in industry in the top three groups of TEs and the Russian Federation, more than any other group of DEs or High Income Countries. Nearly 30 percent of the labor force of the FSU central Asian group was employed in industry, more than in all DE groups. For most TE groups the large concentration of labor in industry came at the expense of the agriculture and service sectors, though some of the advanced TEs still have significant labor forces in agriculture. Most TEs have a higher level of urbanization than the comparator DE groups, and this is despite the fact that the suppression of services should work in the opposite direction (Table 2, last column). Had we been able to break down the employment in services between public services and all the rest, we would most likely see over-employment in TEs in the former and underemployment in the latter relative to the DEs. [11] The corresponding data on the breakdown of GDP by activity (Table 3) is less clear-cut and the low share of industry and manufacturing reflect lower relative prices in these industries following the transition. The observed gap between the labor and output shares of industry in TEs may also reflect lower labor productivity following the transition due to hidden unemployment prior to restructuring. The large share of manufacturing in both imports and exports for all TEs, with the exception of the FSU Asia group, is another testimony to their over-industrialization (Table 4), as is their very high level of electricity consumption (Table 2). The 'functional autarky' of the TEs prior to the transition made possible the extreme internal price distortions, and allowed domestic technology to lag behind that of the rest of the world (Bosworth and Ofer, 1995).

[Tables 2,3,4 and Charts 2C, 4C around here]

Population and human capital: It can be seen from Table 5 and chart 5C that the populations of TEs are further ahead in the demographic transition than the DEs at comparable income levels. Thus, the proportion of children is lower and that of the elderly higher in TEs. The dependency ratios (dependents per person of working age) are lower in TEs than in the comparable DEs. Indeed, the demographic structure of the first three groups of TEs and the Russian Federation is at least as 'advanced' as those of both groups of High Income Countries. Even the groups of Asian FSUs, which are mostly Moslem countries, have a more mature demographic structure than the African groups. These differences are also manifested in slower and often negative population growth rates in TEs as compared with DEs. Population growth rates in the TEs also reflect the pressures of the transition period. The more 'advanced' demographic structure of TEs is a result, under the 'old-regime' of the intensive pressure to modernize, high rates of employment and education levels among women, and poor housing and household services. In theory, this should reduce the demand for transfer payments and social services. However, offsetting this in TEs is the low retirement age. In addition, pension payments and services must now be provided to the entire population given the disappearance of traditional, self-supporting, rural communities in most TEs.

[Table 5 and Chart 5C, around here]

TEs have always invested a higher proportion of their resources in education (Table 6) and health (Table 7). This can also be seen in the shares of total and/or public

[11] This can be deduced from the high expenditures on education and health as percent of GDP in TEs as compared with DEs. See Table 10 below.

expenditures in GNP (see Table 10). We have already mentioned the high level of employment in these sectors. Rates of secondary and tertiary school enrollment are higher in TEs than in DEs, and to some extent the average years of schooling are higher as well, especially among women (data on this is less complete). In the health sector, there are many more physicians and beds per thousand population as well as somewhat higher immunization rates (except in Russia), higher life expectancy at birth (even in 1996) and significantly lower infant mortality rates. The Human Development Index (HDI) calculated by the United Nations, which includes the levels of education and health, as well as per capita GDP, give most TEs a higher rank that their respective GDP per capita rank (UN, 1997, Tables 2.10, 2.11, pp. 40-41).

[Table 6, 7 Charts 6C, 7C,D around here]

Large investments in human capital give TEs a definite potential advantage over DEs, at least in the middle and long term, especially that human capital is becoming a more important driving force of economic growth. The problems that some TEs face with respect to these services are twofold. First, both services suffer from a number of serious deficiencies in content as well as methodology and technology, which must be corrected in order to meet the needs of a modern society and market economy. In education, certain key fields like economics and business for a market economy didn't exist. Likewise, the focus of the health sector lagged behind the changes in health needs. The old paradigm of health-care for infectious diseases predominated despite the alarming increase in the incidence of cancer, circulatory and heart diseases and of illnesses and injuries related to modern technologies. This is true in the areas of public health and prevention and of acute care. Both sectors, but particularly health care, suffer from a lack of modern technology. Second, during the early stages of the transition, and possibly also in the longer run, the continued provision of these services also imposes a heavy fiscal burden on the public sector. It is not clear if all TEs, especially those with lower income will be able to preserve the inherited high level of their human capital.[12]

Infrastructure: The level of physical infrastructure such as transportation, power and utilities is at least as high as in comparable DEs. However, the level of infrastructure probably lags behind the level of industrialization and complexity of the economy. The mass media and communication networks are on a higher level in TEs, as can be seen in Table 8 and Chart 8C. In 1996, TEs had more daily papers, television sets, telephone mainlines and Internet hosts (!) per thousand population. With the exception of telephones, the Central European group is at or above the level of the lower income group within the HICs. The advantage of the lower income TEs is especially impressive and is a result of the high level of education (and urbanization) in TEs.

[Table 8, Chart 8C around here]

b. Inappropriate institutional infrastructure for a market economy

Centrally planned economies and then TEs lacked the institutions, instruments and know-how required for macroeconomic management, stabilization and inflation control and for the use of money and financial instruments. These deficiencies extend from the central bank and the banking system down to the smallest firm. The lack of macro-management tools also extended to the foreign exchange regime and the management of external transactions,

[12] A more detail discussion on the state of public services in TEs can be found in, WDR, 1996 CHs. 4, 9; Barr, 1994, CHs. 9, 10; Kornai, 1997; Chernichovsky, Ofer and Potachnik, 1996.

capital flows, foreign debt and reserves. A glaring example of these deficiencies is the ability of economic agents to revert to old modes of payments, non-payment and arrears, barter deals and surrogate credit instruments (Hendley, Ickes and Ryterman, 1998; Commander and Mumssen, 1998) as recently occurred in Russia and other TEs. The old macroeconomy of the peculiar division of money into cash and bank money and the old system of payments came alive. This may be thought of as a rejection of the newly transplanted 'market financial organism' by the non-restructured real sector. Similarly, on the fiscal side, there was no market-oriented tax code, no tradition of tax payments and no organized budgetary process. Thus, TEs could not make a clean start; their institutions and traditions actually hindered transition.

Under the old system no market-like financial network existed to deal with the process of creating savings and channeling them to investments and the short-term financing of production. No capital or real estate market existed, especially a banking system capable of distributing and monitoring working capital or medium and long-term loans. A detailed comparative study of TEs and DEs conducted by the EBRD (TR 1998, Ch. 5) found that at any given level of income (also measured by GDP per capita on a PPP basis), the availability of financial and banking services to the private sector in 1996 was significantly lower in TEs. As expected, Chart A (copied from ibid. p. 94) shows that bank credit to the private sector (as a percentage of GDP) was for most TEs well below the regression line for all countries. The exceptions were the Czech Republic, Bulgaria and Croatia. Other Central European TEs had private credit ratios of between 20-30 percent of GDP, and most others for which data were available, had ratios below 10 percent with some countries approaching zero. While most Central European TEs already had normal interest spreads, most former FSU TEs had extremely large spreads (ibid. Chart B, p. 95). As already mentioned, TEs required much higher than normal credit levels in view of their larger 'modern' industrial structure and their need to restructure. Quantitative shortfalls were exacerbated by the low qualitative standards of credit management, the accumulation of bad loans and bank crises. (ibid. chapters 6-8 and references there). Banking crises have recently occurred also in several DEs; during 1997-98 they occurred in a number of East Asian countries and Brazil. Japan is in the midst of a long process of reform of its banking system. It is indicative that in most DE cases there has been a relatively quick recovery, while in FSU countries, notably Russia, much of the banking sector collapsed completely.

[Chart A around here]

Finally, despite these domestic weaknesses in the financial sector, only 4 TEs had higher than 'normal' shares of ownership by foreign banks: Hungary, Armenia, Latvia and Lithuania. However, in the latter two countries, Russian banks held considerable amounts of shares. While the normal level of foreign bank ownership for countries with per capita income above of $4000 is in the 25 percent range, very few TEs achieved more than 10 percent by 1996, (ibid. Chart C, p. 95). We return to this issue in Section V.

At the micro level as well numerous deficiencies existed. The infrastructure for all aspects of contract making and transacting was only rudimentary. There was no legal environment for writing, arbitrating and enforcing contracts, and no culture of negotiations and business trust. Under the old regime, selling, marketing and buying were administrative, almost automatic acts and voluntary trade networks were rare. True, under the "old-regime" there was quite a substantial 'informal' transaction activity in the underground economy, including agreeing on and fulfilling contracts. One wonders to what extent this kind of

activity fits free contracting ‘on the table’ in an open market system. One may even suspect that the culture ‘under the table’ dealing may have spilled-over to the transition period in the different forms of illegal activity. Following the transition, weak regulation and enforcement compounded the lack of business culture, the development of aggressive trade relationships and the spread of business crime. There was even less experience in international trade and finance.

[Charts B and C around here]

Related to the lack of a developed trade network, was the small number of small and medium-size businesses. Small businesses are the backbone of a market economy and provide much of the trade and business services network. They are the incubators for the culture of making transactions, developing new products and services and marketing. It is these firms which educate the population in the mechanism of a market economy. While the growth of DEs was fueled by small businesses evolving into bigger ones, and thereby accumulating market experience, small businesses were almost totally absent from most TEs.

There existed very little experience with the management and administration of modern corporations in a market environment and under a regime of private property. State-owned enterprises (SOEs) were typically managed using bureaucratic methods. Furthermore, privatized enterprises entered into a market without private enterprises to serve as examples; even highly developed economies have had mixed success with privatization. In this respect, as in others, even DEs with large public sectors to be privatized and which have experienced relatively long periods of ‘delay’ prior to reform, possess more experience and know-how than TEs in this area.

In sum, most DEs, whatever their stage of development, were ahead of the TEs. All DEs developed market-oriented institutions to fulfill the above mentioned functions and accumulated experience in their management. The low-income DEs, most of them former colonies, inherited basic macro and micro market institutions and continued to manage them independently during the last half century. Even those among them with dual economies and a large traditional sector or extensive government intervention, developed market institutions and accumulated market experience in their modern sector. In addition large parts of the traditional sector were run along quasi-market lines, especially through a multitude of small businesses. Even if their economies were not yet fully monetized, they were gradually moving in this direction.

Some of the above statements can be observed quantitatively (Table 9) through comparisons of the ‘Index of Economic Freedom’ compiled by the Heritage Foundation (1999, pp. xxx-xxxiv). The index is compiled on the basis of ten sub-indicators ranging from trade, gov’t intervention, taxation, to banking property rights, regulation (also shown in Table 9) and black market. The figures in Table 9 are for 1997 (in order to preserve time consistency throughout). It shows that all groups of TEs are graded at 3 or above (China and SE Asia get 4 and 5) for both indicators shown (only Central Europe scores 2.7 for Property rights and regulation). These low grades (1 is the best) are compared, in many cases unfavorably, even with the bottom income groups in (South) Asia, Latin America and Africa. All other, groups with higher income, are mostly graded 2-3. The contrast is getting even sharper when one compares these grades with the industrial levels of the same groups. Given their higher industrialization and ‘modernization’ TEs need much more than DEs an appropriate institutional base indicated by the economic freedom index and its components.

[Table 9 and Charts 9C,D around here]

Three. Government in Transition

The governments of TEs were ill prepared for the new task of running a market economy — they accumulated extensive experience in managing an economy through central planning. Indeed this was the first lesson that they found hard to learn. Not only did they have to divest themselves of many functions; they had to change their principal mode of operation from one of directive to one of incentive and regulation. They lacked the necessary know-how, experience and culture to accomplish this. The autocratic governments of the old regime imposed their will through strong disciplinary actions and fear. The newly elected democratic governments found it very difficult to replace the old discipline with the rule of law. This was even more difficult in the many newly created TEs, in the FSU, former Yugoslavia and Czechoslovakia, where there was no real central government previously and where most of the functions of government were performed from the center (Moscow, Belgrade or Prague). In these cases the heritage of government was perhaps even weaker than in the post imperial DE states of fifty years ago. The new personal freedom was interpreted by many as unlimited, especially with respect to obeying the government and the law. The growing cynicism, corruption and unofficial activities towards the end of the old regime, continued under the new one. Add to this a large, disoriented and low-paid and therefore frustrated and easily corruptible bureaucracy. In sum, the enormous task of transition was put into the hands of very weak governments.

In a recent paper, Vito Tanzi (1998) presents the latest 1998 corruption perception ranking in 85 countries. All TEs fall below the group of high-income countries and all but two are below the average. Russia appears near the bottom at number 76! However, none of the other CIS countries are included except for the Ukraine, which scored a bit higher, and Belarus. One can readily assume that most of the others wouldn't have done much better. This was corroborated in a study of the size of the unofficial sector in TEs (Johnson, Kaufmann and Shleifer, 1997, p. 183), and from the evaluation of the level of legal reform in TEs (TR, 1998, pp. 42).[13] The only apparent advantage of TEs over DEs is the quality of human capital in the government bureaucracy, as can be inferred from the general advantage of TEs in the level of education (Table 6). This advantage is offset, however, by the work habits inherited from the old regime.

TEs lack democratic traditions and the know-how needed to manage the democratic political processes, organize political parties and operate a parliament. There is a debate in the development literature on the relationship between democracy and successful economic development, and the jury is still out on this issue (Srinivasan, 1998; and references there). However, there is no disagreement on the need for a strong, efficient and credible government, whether democratic or not. The inexperience in TEs with democratic political processes hinders the transition. Unfortunately, the picture is no better among DEs, despite (or because of) their colonial past and nearly 50 years of 'learning on the job.' Only in East Asia there exists a group of relatively efficient governments, although they were far from

[13] Belarus received the highest rank among the CIS countries on both corruption and the size of the unofficial economy, most likely due to the lack of reform and the preservation of some of the old system and discipline.

perfect. In a response to the keynote address by Joseph Stiglitz at a World Bank conference, which advocated a larger role for government, Michael Bruno, citing Stiglitz's experience working for the U.S. government, queried whether he would maintain that view had he worked for a DE government (Stiglitz, 1996, p. 24). The stability of the government in China is being cited as one source of the relative success of the market reform there.

A second related difference between TEs and DEs is the size of the public sector and its ability to raise revenues. TEs entered the transition with much larger public budgets including automatically collected revenues from state-owned enterprises and centrally controlled trade. With the transition to democratic government, the old revenue system collapsed and TEs found it very difficult to create a market-based tax system virtually from scratch. Indeed it was difficult to maintain the previous level of public expenditure under market conditions. While certain defense expenditures, investments and production subsidies could be curtailed, some of the welfare state commitments were further increased by the newly elected parliaments. The resulting fiscal situation was termed by Janos Kornai as a "premature welfare state" (1997) and called for particular solutions (see below). Despite the fact that TEs were able to cut back public expenditures, their budgets remained comparatively high across all TE groups (Table 10, Charts 10C, D). All the European and CIS groups had higher levels of expenditures and government consumption than the other groups in the comparative DE groups. The gaps between TEs and DEs are larger with respect to public expenditures, indicating higher levels of welfare related transfers in TEs. With few exceptions, the same is also true for public expenditures on education and health (Table 10). Tax revenues are higher for the two top groups of TEs although the difference between TEs' and higher income groups are smaller than with respect to expenditures. The gaps are much smaller for comparable groups at lower income levels: the Central Asian countries collect no more taxes than the low-income DEs and Russia has been having particular difficulties in tax collection. While other 'old regime' type sources of revenue close part of the gap between expenditures and tax revenues, lower income TEs have larger fiscal deficits than the comparative groups of DEs. While DEs developed their fiscal capacities gradually in tandem with economic and institutional growth, TEs suddenly found themselves with reduced incomes, large fiscal obligations and the need to develop a new revenue system.

[Table 10 Charts 10C, D around here]

The journal Euromoney (September, 1997, pp. 12-15) compiles an index of 'risk ranking' of countries, including a measure of 'political risk' which takes into account the internal and external political stability as well as the quality of the fiscal system. The average ranking for all country groups of the 'political risk' is presented in Table 9 (column 3). The US has the highest ranking of 25 and all countries are compared to it. Among TEs only Central Europe (and China) receive a ranking higher than 10. The rankings for most other TEs is between 8-9 similar to the lowest income groups among DEs (only the low-income countries in Africa are much worse). Table 9 also present comparative data on the level of 'political rights' and of 'civil liberties' composed by Freedom House (1998). Ranging from 1, best to 10, worse, TEs are ranked quite similar to their DE comparator groups, sometimes even higher. While this is quite encouraging it is not absolutely clear how these achievements relate to the effectiveness of economic transition, at least in the short run. (Srinivasan, 1998).

Four. Differences in society and polity

Most TE societies have a comparatively lower level of 'social capital' (Srinivasan, 1997) and less developed political and democratic cultures. These are the obvious results of the long period under autocratic regimes and the monopolistic position of the state in social activities, as well as the lack of personal freedoms and interpersonal trust. This makes it more difficult for social organizations (in the form of NGOs, for example) to support and/or replace various government functions. It would appear that people in TEs more readily accept and understand the new market institutions and norms (such as the profit motive) than the idea of non-profit societal organizations. As a consequence there may be a need for stronger government intervention in the sphere of law enforcement; TE governments, however, are now less capable of providing this. Most likely there are also important cultural differences between groups of countries in different continents or with different religious heritage (Fukuyama, 1995). Hillman, however, assigns a heavy cultural burden to the socialist heritage itself (this volume). One don't have to fully accept his claim of a 'communist' heritage of 'slave mentality', to recognize at least some effect on behavior and motivation of people living for such a long period under such a regime.

Five. The period of transition

The transition period created additional short-term difficulties on top of the problems of longer-term adjustment, especially during the first few years. The most common phenomenon that emerged upon the abolition of the old regime institutions was termed and modeled as "disorganization" by Blanchard (1997, pp. 35-45), following a vast literature on this problem in earlier years (See among others Murrell, 1991, 1995; Kornai, 1995; Kolodko, 2000; Bosworth and Ofer, 1995, Ch.3). Disorganization enveloped the economy, the polity and society as a whole. It resulted from embryonic institutions having to deal with extreme economic, political and social situations. Internal and external supply networks collapsed while inexperienced new agents attempted to close deals. Attempts were made to correct price distortions before market mechanisms were fully developed. Opportunities arose to exploit price distortions and take advantage of the privatization process for personal gain at a time when legal constraints and sanctions were weak. The government was particularly ineffectual at a time when strong government was in need. There was also the danger of deterioration in the physical infrastructure and public services, such as education and health, due to both 'disorganization' and lack of funds. There was a danger of irreversible damage. The same is true for the financial sector, which was only beginning to restructure itself. This also resulted in macroeconomic and public sector imbalances, inflation and wholesale loss of savings, the collapse of tax collection, the deterioration of public services and a halt in investment. The level of disorganization and its duration depended on the relative balance of power between the disruptive and opportunistic forces on the one side and the ability of the government and other regulating agencies to cope on the other. This balance of power varied among TEs, depending on the exact nature of the 'old regime', the level of economic development and the set of 'initial conditions' as discussed below.

The 'disorganization' during the initial period of the transition is unique to TEs and seldom occurred with such intensity in DEs. This motivated the debate in the literature over how to initiate reform whether through a Big Bang or in a gradual fashion. The issue was a new one, having rarely appeared previously in the economic development literature (Bruno,

1993). The importance of the heritage of the old system as a determining factor was emphasized more by students of the Soviet system, but virtually ignored by general economists (Murrell, 1995). While Erickson believed that the heritage calls for a Big Bang approach (1991), Murrell developed the evolutionary approach to a gradual transition (1992). Over time the transition literature on Big Bang vs. gradual reform also became more sophisticated. It differentiated between the two options, distinguishing between what should be part of the BB package and what must be left for gradual change. It discussed issues of sequencing; and more recently also the interaction between all these elements and the specific conditions prevailing in each TE, by examining which policy package fits the specific conditions in each country (Dewatripont and Roland, 1996).

The distinction between what is appropriate for the European TEs as opposed to China appeared earlier, simply because the two different models of transition were a reality and 'had' to be discussed (McKinnon, 1994, Sachs and Woo, 1993). Only recently, when the gaps between the more and less successful European TEs widened, and the classical reform model seemed to have failed in some TEs, most notably Russia, more attention has been paid to the above interaction (de Melo et al., 1997; Ickes, 1996). A new line of investigation examines situations of multiple equilibria in which there exists some positive (negative) critical mass which is large enough to tilt the equilibrium from its unstable knife's edge position in the direction of the stable 'good' (bad) and stable equilibrium. The 'critical mass' can generally be thought of as 'strong enough institutional pre-conditions'. Some of the models that are offered are based on 'numerical dynamics' in which a small numerical advantage of the 'bad' or the 'good' guys can determine the fate of the system (Johnson, Kaufmann and Shleifer, 1997). Other models allow the government, to proceed gradually, according to its resources and institutional ability at any stage if it lacks the capabilities to take control over the entire economy in one step (Rodrik, 1996; Dewatripont and Roland, 1992; 1996; Roland, 1999, presentation at the AEA meetings in NY). Litwack and Qian (1998) use a similar argumentation and model in explaining the motivation and impact of 'free (Special) trade zones' in TEs in general and in China in particular. We return to discuss this later. Suffice it is to say at this point that such gradual models of transition resemble the dynamics and evolution of economic development under the dual economy models (see Meier, 1998; Stiglitz, 1999). In these cases gradualism is defined as the evolution of covering an increasing share of the economy rather than as changing in a step-wise fashion individual aspects of the 'old' system across the entire economy.

Six. Classifying TEs

In view of the above characterization of TEs, and taking into account different initial conditions, it is possible to classify TEs in the framework of the above mentioned multi-equilibrium model. The classification is based on the intensity of three clusters of influences affecting the transition. They are the institutional heritage (H) of the 'old system', the level of institutional infrastructure for a market economy and democracy (II), and the degree of structural 'over-modernization' (OM). OM refers to the advance of the industrial structure, the level of urbanization and the public sector to positions beyond the normal development pattern. High OM, however, also means more qualified labor and better public services, i.e., the 'premature welfare state'. If successfully maintained with a reasonable fiscal burden, this is a potential jumping-off point to more advanced modes of production. H creates barriers to change; II creates positive initial conditions for transition; and OM complicates structural

and technological adjustment, but holds a potential capacity for future growth. The balance between the three influences determines the optimal transition strategy and can predict its success. In terms of the ongoing road metaphor used in this paper, H represents the distance traveled away from the main road for a given level of development, II the quality of the vehicle available to cross the ragged gap. OM signifies the stage of development at which the transition occurs: overshooting results in a longer distance to be covered, but also by a potential to join the front runners.

There are a number of 'stylized' categories and possibly a few hybrids. The first group of countries is characterized by a relatively low level of H, a high level of II, inherited from the socialist period and prior regimes, and a moderate to high level of OM. This first group consists of the Central European countries (the first group). Most of them had accumulated experience with economic reform prior to transition and had allowed more a flexible economic system. They had a relatively recent and reasonably strong tradition of market and democratic institutions and their level of OM was offset somewhat by a more sophisticated trade composition, both inside and outside the socialist block. In addition, they were highly motivated to 'Westernize'.

The second group, consisting of the European FSU countries, including Russia, epitomizes the model characterized by intensive H, lack of II and a high level of OM, 'socialist' industrial production and trade structure as characterized above. It has to be mentioned that all of the countries in this group other than Russia even lacked a national government for a long period. The Baltic states, which we classified in the FSU group in accordance with their levels of income, comprise an intermediate case between the two groups. They experienced strong H (though for a shorter period), have a somewhat stronger II and a much more intensive motivation than the FSU group, and a somewhat weaker OM. They in fact supply the Soviet Union with higher-level food products and somewhat more sophisticated industrial products.

A third group of the Balkan countries is actually a sort of a hybrid. Bulgaria and Romania with high level of H, though through a relatively short period, lower level of II and, especially Romania with high OM. Croatia, on the other hand has a lower level of H and of weak OM and relatively good initial conditions, II.

The fourth group of TEs, the FSU former republics of the Caucasus and Central Asia, are characterized as suffering from an extreme level of H, and even the total absence of a national government, no tradition whatsoever of II, and a relatively weak but mixed case of OM. These former republics had only a moderate, level of industrialization, which in many cases was based on mineral resources, principally oil and gas and precious metals, or industrial agricultural crops (cotton and sugar). They are major suppliers of agricultural products and raw materials to the FSU, and in this respect have maintained a more familiar DE structure. These countries require less restructuring of the manufacturing sector and can opt for a relatively normal industrialization and modernization process as in other DEs. The further development of a private industrial sector can be accomplished in the traditional branches of DEs to some extent by initially drawing on labor resources in agriculture before full restructuring and privatization of state-owned enterprises is accomplished. In most cases, agriculture was to a large extent industrialized, thus eliminating much of the traditional sector of the 'dual' developing economy. They are also faced with an extreme case of 'premature welfare state': they possess a highly qualified labor force and good public services, but are unable to pay for them. They also have the option of postponing the

attempts to establish a full-fledged democratic regime. In a sense they may attempt to follow a variant of the Chinese or Asian model of transition. Finally, China and the other South Asian TEs, which are at low levels of development, are less burdened by either H or OM and enjoy a more normal industrial structure from which to start or continue 'transition' or indeed, a development process.

We now know that the initial conditions, together with the type of policies that were pursued and some luck, made it possible for members of the first group, the Baltic hybrids, and one or two of the Balkan countries, notably Croatia, to make the jump. We also know that the FSU groups, with few exceptions, didn't quite make the jump, or hesitated before jumping. In these cases the balance of forces described above veered the transition toward a lower level equilibrium, and left policy makers in search of alternative strategies.

IV. Development and transition: similarities and differences

The recent experience of economic development and the elaboration of development theory with its policy implications seem to converge to the following principles. First, development should take maximum advantage of the dynamic global economy, in trade (export-lead growth), direct foreign investment and the transfer of technology (Coe and Helpman, 1995; Romer, 1993). The standards established by the world markets must be the benchmarks for internal efficiency and must guide 'industrial policy'. Achievements in the export sector can serve as a solid base for domestic industrial development. The new trade policy, however, also recognizes the need for measured interventions during the initial stages of the emergence of new industries. One policy option for accomplishing this is through large industrial or financial-industrial corporations. Also, the fast movement and large volumes of global financial flows require measured restrictions on such flows, at least in the case of institutionally weaker economies, (Tobin, 1998).

At the same time that these lessons were internalized, the global economy has also been moving ahead, especially toward a much heavier emphasis on trade and investment in trade and services, information technology, finance and business and professional services. These services moved from the non-tradable to the tradable category and the comparative advantage of the developed countries has shifted to these areas.

Now, countries that aspire to join the leaders must orient their production in this direction. This development is of special importance to TEs that suffer, in various degrees, from a comparative disadvantage in trade and networking, as well as financial and other business services. TEs, more than DEs also have a greater demand for such services, given their highly developed production sector. While in the old days, countries had to develop their own services now they can be imported or brought through FDI on the global market.

Second, there is an increased appreciation of the role of human capital in modern economic growth. Human capital contributes directly to growth a much higher share than in the past. This is supported by experience and theory and, by the nature and pace of technological changes (the 'new economy' included). In addition, (non-discriminatory) investment in education is found to increase active social participation of all segments of society, to reduce inequality, poverty and social tension, and thereby to increase political stability and, indirectly also economic growth.

Here too, the special advantage of TEs over DEs, have to be mentioned. Future economic growth, concentrated in various 'knowledge sectors', is going to be even more

dependent on human capital than in the past, and TEs are well situated to take advantage of this. By restructuring their industries in this direction, (in some cases by the conversion of their military industry), they may be able to more easily position themselves at the leading edge of this global development graduates and a superior educational infrastructure in comparison to most DEs. However, they now face a problem similar to that faced by DEs all along: how to secure enough public resources in a market environment to preserve and improve on that level. Most DEs recognized long ago the importance of education but failed to mobilize enough public financial and institutional resources to do the job. The second problem faced by TEs is to adjust the content of their education, and the methods of delivery to meet the new needs. While is most cases (economics and business excepted) there is a good general human capital base, there is a deep deficiency in certain key specific elements. As to equality and social cohesion, TEs are facing a sharp rise in inequality, despite the high level of human capital, and almost no social capital fit for a free society. If they will be able to preserve their educational infrastructure, they may eventually reach a normal level of equality. The building of the necessary social capital and social solidarity is a longer process.

Third, there is now a much greater recognition of the importance of well-developed market institutions and regulatory infrastructures, as well as a properly functioning government. This is the essence of the 'new Washington consensus' and the subject of much of the more recent development literature. A special place in this new body of inquiry is devoted to the structure, function and development of the financial sector. A well functioning financial sector can partially replace government in economic development. A poorly functioning financial sector can destabilize an economy and lead to opportunistic behavior of all kinds (McKinnon, 1991, TR, 1998 and references there). We already mentioned the comparative disadvantage in and the acute demand of TEs for market institutions and services, as compared with DEs. Unfortunately for both groups it is difficult to import or transfer government services. In most cases government services are still non-tradable and have to be provided internally, possibly with some 'technical assistance'.

Finally, there is less agreement on the optimal nature and extent of government intervention in microeconomic activities through 'industrial policy' and regulation of the 'real' sector. Interestingly, there is a guarded but growing recognition of the need for measured intervention even among scholars who earlier opposed it. The most glaring example is the paper by Joseph Stiglitz (1998) that has been frequently quoted here. As mentioned above this gradual shift in opinion emerged as a result of the successful development of the Asian Tigers and China, and the experience of the TEs during the last decade.

The experience accumulated during the last decade with TEs contributed much to the shift of the development literature in the direction of institutional changes, enterprise privatization and governance, of the relationship between markets and governments, political economy and restructuring of government, opportunistic behavior and corruption. The specific experience of the TEs was influenced by the lopsided development during the Communist period and by the necessity of a major multi-dimensional change over a short period of time. In the wake of the collapse of central planning there was little spontaneous development of market infrastructure in most TEs and institutions and the services that accompany them. Most governments, some virtually brand new, were unsuccessful in their efforts at transition. The fact that there existed large 'modern' production sectors in need of

restructuring and of market services made the task, at the same time more difficult and more urgent. While in DEs production developed more or less in tandem with the required market institutions, in TEs a modern production sector already exist but with no market or government infrastructure. Following a long period of 'functional autarky' and distorted prices, market guidance was even more crucial. Thus, the transition process had to deal with a non-continuous, non-marginal, bulky change. TEs are in greater need of market institutions, but they face higher barriers in developing them. A perfect example is that of the financial sector. While in DEs some people advocate a slow development of the financial sector, in order to assure macroeconomic stability, in TEs this may not be an option, given the heavy need for funds for restructuring and the financing of a modern sector.

Faced with this situation, various forms of government intervention were tried and/or advocated, but the special 'balance of mutual weakness' of both the markets and governments motivated the debate over the degree of gradualism and posed a dilemma to students and policy makers alike. The more advanced TEs, which possessed a better institutional base and a less distorted structure, may have been able to make the change. They had the advantage of greater external assistance (Table 4 and TR 1998, Chs.4, 5). The least developed TEs, mostly in Central Asia, face a much greater institutional challenge, although will most likely embark on a more or less 'normal' route of economic development along the path of equally developed DEs.[14] The TEs in the middle, most European FSU republics and a few others, face the greatest challenge; it is in these countries that the transition is largely stalled and where new strategies are being sought. In the next section we concentrate on these countries using Russia as an example; however, the discussion applies to all TEs in varying degrees.

Finally one have to bring in the feature of the dual economy. The evolution of modernization and industrialization of most DEs was dual in the sense that an initially created small modern sector expanded gradually to encompass increasing shares of the economy. The traditional sector, at the same time, 'experimented' and accumulated experience, on a smaller scale and with less competitive pressure, with patterns and institutions of a market economy. DEs, per contra, emerged to the transition process with a highly dichotomical structure, of fully 'modern', large-scale production sector, but with no accompanying market institutions and services. Hence the inclination toward a Big Bang. At least some of the TEs, especially the former Soviet states, seem to have failed in this approach. The literature on the 'virtual economy', barter and arrears and on the Russian 1998 crisis documents the problems (Gaddy and Ickes, 1998; Guriev and Ickes, 2000). This experience may raise the option of a dual economy strategy also for TEs. In this case too there will be traditional and modern sectors but unlike in DEs the former will comprise of segments of the formerly centrally planned enterprises that find it more difficult to restructure. We come to this again in the next section.

One way to summarize or stylize the differences between TEs and DEs and the problems they face is through a terminology proposed by Paul Romer in a 1993 paper: TEs are endowed with a many more objects both material and human, but many of them embody wrong ideas. Such inappropriate ideas also pervade the inherited institutional infrastructure, thereby radically limiting the absorption capacity of ideas from the outside. Romer seems to

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[14] See Yelena Kalyuzhnova, 1998; David, Jay and Armis Bauer, 1998 Boris; Rumer, (Ed.), 1996; IMF, 1998; Richard Pomfret, 1999.

separate the notion of ideas from that of the ‘absorption capacity’. In the transition from a centrally planned to a market economy, the main missing ideas are those of the institutional infrastructure of markets, like property rights, contract law and culture and contract enforcement etc. Being immersed in a body of wrong ideas makes it more difficult to incorporate the right ones than when starting from a smaller stock of the right ideas. It is more important for TEs to concentrate first on the importation of the ideas that will create a better absorption capacity. When this bottleneck is somewhat widened, then the relative abundance of objects, especially in the sphere of human capital, may make it even easier to expedite the importation and the capacity to self generation of ideas.

V. Elements of a reform strategy for a ‘typical’ TE

In what follows I would like to consider a stylized development strategy for TEs that draws on the rich experience of DEs, yet tries to deal with the special problems, needs and opportunities of TEs. The emphasis is on stylized, key elements that seem to follow from the previous discussion in the paper. Each one of the elements is a subject to vast literature, in some cases there is no full agreement in the literature on the proper policy implications. The strategy combines the following elements:

One. Openness but with emphasis on extensive external involvement.

Two. The main focus of the foreign involvement is in the importation and FDI of market services, the most important among them being banks and financial services.

Three. Large foreign banks and other major corporations will form the leading core of a financial sector and of large financial- industrial groups. Local banks and producers will belong to these groups as joint ventures or as independent organizations. composed of a relatively small number of major banks.

Four. The fourth element is the dual economy concept, involving a gradual process of expansion of this ‘modern sector’ (MS) resembling that of the modern sector in a dual developing economy.

Foreign involvement will bring with it the know-how and management practices of financial (and production) institutions and will complement, supplement and retrain the existing human capital. This will expedite institutional change, the entry into the global economy and the resumption of growth in advanced industries. The strong financial sector will achieve a critical mass of economic capacity and high level management skills, enabling it to provide credits and governance to the production sector. The production groups will be financially strong enough to restructure and to compete in the global economy. Whether or not there will be banks in the groups; they will be managed with world class business and administrative practices. The MS will encompass only those parts of the economy which qualify and that it can include without loosing efficiency. It will be governed by a modern and advanced legal system that while applied to the entire economy, full observance and enforcement will become a condition for joining. Foreign investors may be granted some privileges, in order to create incentives for others. The MS will expand gradually at a speed to be determined by the availability of resources, material and human, and the pace at which new qualified firms emerge. The government will control and regulate both the financial and the production sectors, and may be involved in strategic issues, but at arm’s length. The rest

of the economy will operate as well as possible, and the process of improving market institutions and the effectiveness of the government will continue.

This line of thinking is motivated by the lessons from the East Asian experience and that of other DEs, and from the recent literature on reforms in the financial sector (Stiglitz, 1998 and earlier work, TR, 1998 and references; see also Bertero, 1997). An additional inspiration is Gerschenkron's classic paradigm of the correlation between the level of relative backwardness and the nature of the institutions needed for takeoff (1962). The high level of financial accumulation in England prior to the Industrial Revolution, allowed banks to provide only ordinary short term services, while the lack of savings and capital in France and Germany, forced the banks to become long term investment banks, and later on, especially in Germany, direct owners of much of the production sector. For pre-revolutionary Russia, Gerschenkron thought that even the banks, including foreign banks and foreign investors, were too weak to accomplish the needed change and that direct government intervention was needed. Eventually Russia received more than its fair share of such intervention. Can the present-day TEs, with weak governments, utilize a potentially stronger institutional innovation in the form of foreign banks and industrial groups?

Inspiration for the dual economy idea can also be drawn from an early proposal to reform TEs, especially such as large a country as the Soviet Union. In late 1988 George Soros initiated a project called "open sector" (1990, pp. 18-20) which envisioned the creation of a 'club' of firms, on a functional rather than geographical basis, that would undertake to behave according to the rules of a market economy. There were very serious negotiations on the project between a delegation brought in by Soros and one sent by the Russian government under Rizhkov. The main obstacle encountered by the group was how to create rules for the 'border' between the two sectors. The project was discontinued in the spring of 1989.[15]

The main justification for large foreign involvement in TEs is the extreme mismatch between the advanced structure of the economy and the lack of market institutions and norms. A model of such intensive involvement was prepared by this author in 1992, as part of the large three volume study by the World Bank, the IMF, the EBRD and the OECD of the economic legacy of TEs (Ofer, 1991). In that model, the main foreign link was through the domestic (retail) trade sector. It was proposed that foreign investors be attracted to the retail trade, a key industry with a strong socialist comparative disadvantage. The retail sector can act as a bridgehead from which to penetrate deeper into the production sector through backward linkages and into the global market, through forward linkages (ibid.). All these in addition to the potential contribution of foreign investors to bring cutting edge technology, efficiency and honesty.[16]

The key element in the above scheme is the (re-)creation of the banking sector. It can stand alone or as part of the above-mentioned stylized design. There is an urgent need to create a credible credit system that will allow production firms to restructure and a control system that will ensure that loans are well-spent and repaid, and thus improve the management of firms. The nesting of this function in properly functioning banks is a better alternative than to leave this function to the government. The banks will be independent in

[15] See also Litwack and Qian, 1998 and Romer, 1993.

[16] For a more general exposition of the potential use of FDI of 'networking' and financial services to help TEs fill their gap in market services see Keren and Ofer, 2000.

their lending and investment decisions. In order to perform their functions, the banks need to be financially strong and stable. In order to achieve this, the banks should be relatively large and their number limited. This will limit somewhat the competition in the financial sector, allow the banks to make higher than normal profits, and concentrate in keeping their reputation (Stiglitz, 1998, 2000). The banks will lend to the business community but not to the government. They must be managed and operated in accordance with strict and acceptable market economy norms of professionalism and administration, risk control, on sight supervision, proper settlement arrangements etc., and transparency, which means that their staff must be capable, well trained, well paid, highly motivated and honest. The constraint on the supply of such highly trained personnel, and of qualified foreign partners, is another reason to keep the number of banks small. In order to achieve this goal, even in a small number of banks, it seems necessary to involve highly reputed foreign banks as co-investors and possibly even international banks such as the EBRD. Such joint ventures are the best way to import and disseminate sound banking practices, to attract and channel foreign investments to the production sector and to represent local businesses abroad. It is also likely that such banks will be able to better attract domestic savings. A small and highly qualified banking sector will have an incentive to self regulate itself and can also be more effectively regulated by the central bank. Strong well-established local banks will also be able to participate, if they are able to meet similar standards. The main importance of foreign banks is thus in the transfer of the technology of banking and the provision of services needed in order to establish a market economy (Romer's 'ideas') and only in a far second place their ability to raise resources ('objects') abroad. A professional credible bank will be able to attract the domestic recourses that local banks were not able to due to mistrust.

The main obstacle to such a project seems to lie in the formal and informal Restrictions on the operation of foreign banks in most TEs (Buch, 1997; TR 1998, Chs. 7-8; but observe Hungary as a counter example, Bonin and Wachtel, this volume). Following the financial crisis in Russia in August of 1998 Russia has been moving in the opposite direction, of raising the barriers to external economic activities. Capital Renaissance (2000) describes the poor state of the Russian banks before and following the 1998 crisis, in great detail in a report. This state further underscores the need for external involvement. The restrictions on entry are more severe in countries that need foreign banks the most. The local banks are the main lobby against opening up. They thrive on weak regulation and on dated legal framework. They may even be able to attract opportunistic foreign banks to join them in "capture the state" (Hellman, Kaufmann and XX, 2000). Reputable foreign banks can thus turn the tide in favor of"good" market equilibrium and against a bad one.

Opening up for competition in services in general and in financial services in particular is a new concept even for the industrialized market economies. There is a legitimate fear among governments of the loss of freedom of action and the repatriation of large profits. However, in this case where TEs have such a strong comparative disadvantage in financial services along with an acute need for foreign banks, they should be ready to put aside old concepts and be ready to pay the high price. This is a commercial deal in which the two sides have a lot to gain. Foreign banks, on their side, should be willing to restrict themselves in sensitive areas, including net short term borrowing abroad in order to make the deal more acceptable to local governments. They should, however, be offered as much encouragement as it takes to bring them in.

There is a debate in the development literature on whether banks should restrict

themselves to credit financing of production enterprises or whether they should be allowed to also own shares and even become active owners and members of financial- production groups. The latter had been the case in Japan and other East Asian countries and, for that matter, also Germany since the 19th century and in Russia since before the revolution. The advantages of banks as owners, i.e., secure lines of credit and assistance in management, may be offset by the banks' conflict of interest as supervisor-agent and as owner. In most TEs, where the financial markets are not yet well developed, and credit and good managerial practices are in short supply, the direct involvement of banks in such groups should not be excluded. Especially if the banking sector is structured along the lines described above.

The support expressed here for the formation of large production groups, composed of newly privatized and new private firms, with varying degrees of bank involvement, is more qualified and is based largely on the experience of East Asia. Such groups can economize, as in the case of the banks, on the meager management skills available in TEs and can better take advantage of the benefits derived from FDI and foreign partners. They can more efficiently assemble the needed resources, establish larger R&D projects required for restructuring and as a base for confronting world market competition. The larger market power of such groups can substitute for elements of direct government intervention as part of 'industrial policy', and eliminate the need for restrictions or taxes on trade during the initial period. Such groups can better deal with the threats of economic crime groups and other initial market disorders and can be more efficiently supervised and controlled by the government. There exists the danger that they will take advantage of their market power in unfair competition, in shoving competitors, lobbying the government, inside deals and improper use of credits. There are many examples of this in East Asia. The short history of the Russian FIGS, both industrial ones and those led by banks, seems to corroborate some of the above points (Johnson, 1997; TR 1998, p. 143 Brown, Guriev, Volchkova, 1999; Volchkova, 2000). For example, groups shielded their enterprises from restructuring; the group used large amounts of resources in lobbying the government for favors, etc. Indeed, the establishment of such groups in TEs embodies the danger of reverting to the behavioral patterns of the old regime, or joined hands with the Mafia. There is also the danger of perpetuating these institutions beyond the time of their usefulness, as is the case in Japan. In order to minimize the dangers, groups will have to go through a stringent qualifying process. There will have to be legislation that determines qualifications, privileges, including those of foreign investors if needed, and control mechanisms. This is also why it is so important to include well-reputed foreign investors in such groups as part owners. A controlling body that will overseer all of these will have to include non-interested public figures and, most importantly, also international representation. The development of FIGs in Russia was spontaneous and all could 'join'. The selection mechanism is designed to prevent the penetration of the wrong agents. Let's emphasize again, the advocacy for external involvement is motivated by the weakness in the lagging TEs of both the market and the government. It comes to strengthen the market infrastructure and to replace, rather than support, more government intervention.

There is also a debate in the literature on whether the foreign involvement should be in the form of independent, "Green-Field" FDI or in the form of joint ventures. The advantages of joint ventures are very clear as main tools of transfer and dissemination of "ideas" (Romer, 1993). Like as with respect to FIGs, here too the recent experience in TEs and in particular in Russia, demonstrated the pitfalls and downside of this approach (Brown,

Guriev, Volchkova, 1999; Volchkova, 2000). Joint ventures seem to be especially vulnerable in the case of banks and financial institutions. Yet the approach that is advanced here hope to allow for a selection process that will benefit from the advantages and will leave the sinister motivated out. The process may start with foreign firms that will gradually take in qualified domestic partners.

The advantage of this entire approach is that it positions the leading agents of the transition in a competitive market (though somewhat protected), but does not place them at the mercy of the government or the Mafia. Transition can move ahead despite the weakness of both the government and the market. In order to keep these agents efficient and honest, a major role must be played by foreign involvement which will bring institutional know-how, technical aid and investment. Despite the constraints on the number of players in the open sector, more efficient competition is assured by better regulation, more effective government regulation and more qualified players.

VI. Concluding Comments:

Since DEs and TEs share a common target, they need to eventually develop similar institutions and employ basically similar policies. But, since they come from two different heritages, the mix of policy instruments their exact shape and emphasis and the pace and sequence may differ. In this way, while liberalization of markets and openness to the global economy proved themselves to be major growth vehicles, DEs demands mostly ordinary technological transfers, TEs require mostly and more urgently massive importation of modern market and corporate governance services. They need them to help restructure their highly developed production sector. The recent development of global production and trade in such services, come just in time. With higher level of Human Capital, TEs are also in better position then DEs to absorb the new market services and also the technologies of the "new economy". They have to make efforts to adapt this human capital to market technologies and culture, and to assure stable financing for the preservation of the inherited educational (and health) infrastructure. While the lopsided economic structure of TEs calls for a faster transition, the enormity of the task in the weaker countries among them may suggest a resort to the gradual dual-sector model of transition, following the experience of many DEs. The nature of the "traditional" sector is different but the basic mechanism may help them to overcome a low level equilibrium trap. The main obstacle for sustainable growth in many DEs and TEs, is the low quality of government institutions, and the prevalence of rent seeking, opportunistic behavior and corruption. TEs also suffer from a deep deficit in social capital. In a way, this deficiency of governance is more harmful in TEs, again due to their highly developed production sector. The emergence of the governance and institutional crisis in many TEs, encouraged economists and political scientists to focus more intensively then before on these aspects as influencing sustained economic growth. In a way this may turn out one contribution of Transition to the study of economic development.

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[Appendix Table 1 here].
[Selected Tables and/or charts here]

Table 1, Gross Domestic Product: 1996					
Country Name	GDP ($US billion)	GDP per capita PPP ($US)	GDP per capita ($US)	PPP GDP/GDP	GDP growth 1995-1996 (annual %)
Transition Economies					
Central Europe	54.3	8,692	5,215	1.76	4.5
Southeast Europe	21.4	4,462	2,235	2.65	-2.0
FSU Europe	13.7	3,478	1,708	2.33	-2.5
Russian Federation	440.6	4,269	2,982	1.43	-4.9
FSU Asia and Mongolia	7.3	2,014	706	3.18	1.6
Southeast Asia	12.6	1,410	352	4.13	8.1
China	815.4	3,364	671	5.01	9.9
Non-transitional Economies					
High Income	940.3	21,398	25,607	0.88	3.1
High Income Low	323.3	13,676	11,917	1.16	3.7
Latin America Mid-High Income	164.6	7,967	4,264	2.07	3.1
Latin America Mid-Low Income	13.0	3,420	1,551	2.59	2.6
East Asia	119.8	5,539	2,279	2.61	6.0
South Asia	28.8	1,503	428	3.89	4.8
India	356.0	1,606	377	4.26	7.5
Africa Higher Income	28.9	7,416	3,517	2.20	4.4
Africa Lower Income	4.7	1,233	366	3.69	5.2

Source for tables 1-10 and charts (unless specified otherwise): The World Bank. 1997. *World Social Indicators.* (Volume and CDROM); The World Bank. 1997. *World Development Indicators.* Washington DC. The charts are based on Tables with corresponding numbers.

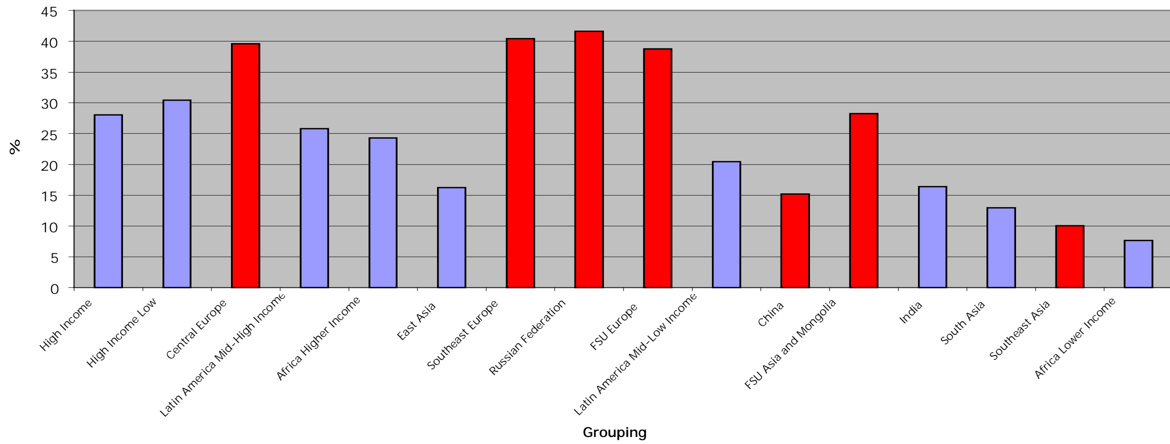

Table 2, Labor Force Structure, 1996

Country Name	Economically Active Population (%) Agriculture	Industry	Services	Women	% Women in Industry *	Urban Population (%)
Transition Economies						
Central Europe	14.2	39.6	46.0	46	33	63.6
Southeast Europe	20.1	40.4	39.5	45	34	63.3
FSU Europe	20.1	38.7	41.2	49	33	68.5
Russian Federation	13.6	41.6	44.8	49	35	73
FSU Asia and Mongolia	30.3	28.3	41.2	46	23	51.2
Southeast Asia	74.9	10.1	15.0	48	8	21.5
China	72.2	15.2	12.7	45	13	30
Non-transitional Economies						
High Income	5.1	28.0	62.9	42	17	77.5
high Income Low	13.7	30.4	51.7	39	20	64.8
Latin America Mid-High Income	16.4	25.8	56.2	34	18	75.7
Latin America Mid-Low Income	37.9	20.5	42.0	33	17	53.3
East Asia	49.4	16.2	32.3	40	14	38.6
South Asia	60.4	13.0	21.6	36	12	22.3
India	63.8	16.4	19.8	32	15	27
Africa Higher Income	40.4	24.3	35.4	40	18	42.2
Africa Lower Income	74.0	7.6	18.4	44	3	30.9

* Out of total women active population.

Table 3, Economic Structure, 1996					
	GDP (%)				
Country Name	Agriculture	Industry	Manufacturing	Services	Electric power consumption (kwh per capita)
Transition Economies					
Central Europe	5.8	34.9	24.5	59.3	3,689
Southeast Europe	14.3	33.0	19.9	52.6	2,364
FSU Europe	18.0	32.4	20.3	49.5	2,212
Russian Federation	7.3	39.1		53.6	4,172
FSU Asia and Mongolia	32.0	28.9	14.2	39.1	1,707
Southeast Asia	39.5	25.6	18.5	34.8	146
China	20.6	48.4	37.6	31.1	637
Non-transitional Economies					
High Income	2.0	29.1	20.2	69.0	8,311
High Income Low	4.3	37.2	23.3	57.8	3,329
Latin America Mid-High Income	9.0	30.4	16.8	60.6	1,643
Latin America Mid-Low Income	20.1	27.5	17.2	52.5	585
East Asia	17.5	40.2	23.8	42.3	938
South Asia	30.1	22.5	13.0	47.5	152
India	27.8	29.2	20.1	43.0	339
Africa Higher Income	7.8	40.5	14.0	51.7	2,305
Africa Lower Income	36.0	23.1	10.8	40.9	201

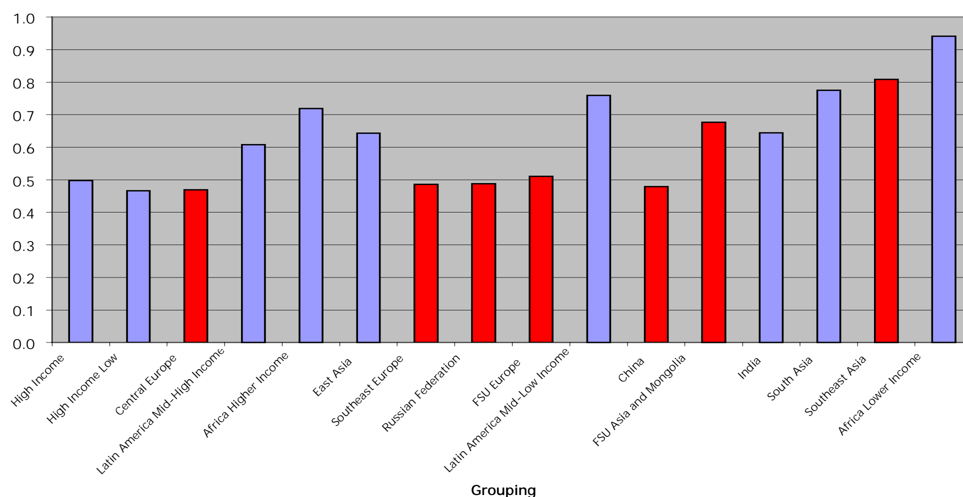

Table 5, Demographic Structure				
	% of Population			
Country Name	Population aged 0-14	Population aged 65+	Age dependency ratio	Population growth 1995-1996 (annual %)
Transition Economies				
Central Europe	19.7	12.2	0.47	-0.04
Southeast Europe	18.6	14.0	0.49	-0.32
FSU Europe	21.2	12.5	0.51	-0.76
Russian Federation	20.6	12.2	0.49	-0.31
FSU Asia and Mongolia	33.9	6.1	0.68	1.04
Southeast Asia	40.4	4.3	0.81	2.23
China	25.9	6.5	0.48	1.00
Non-transitional Economies				
High Income	19.5	13.4	0.50	0.78
High Income Low	18.4	13.4	0.47	0.38
Latin America Mid-High Income	31.4	6.3	0.61	1.46
Latin America Mid-Low Income	39.3	4.2	0.76	2.32
East Asia	34.9	4.0	0.64	1.89
South Asia	39.2	4.0	0.78	2.00
India	34.5	4.7	0.64	1.68
Africa Higher Income	37.2	4.4	0.72	1.98
Africa Lower Income	45.6	2.9	0.94	2.79

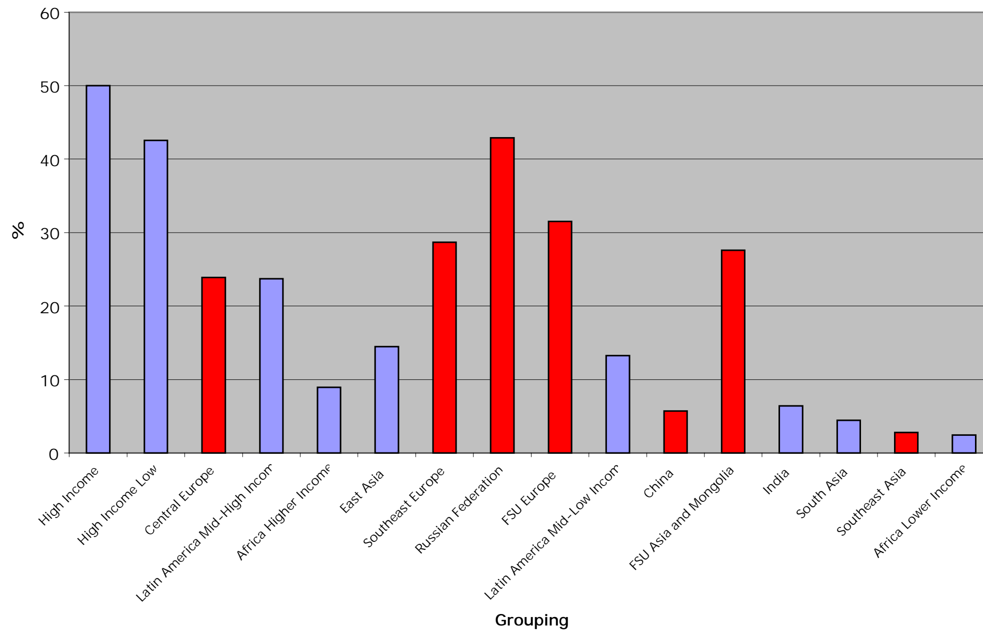

Table 6, Education and Schooling, 1996					
	Gross School Enrollment (%)			Years of Schooling, 1992	
Country Name	Primary	Secondary	Tertiary	Male	Female
Transition Economies					
Central Europe	99	91	24	12	12
Southeast Europe	93	75	29	11	11
FSU Europe	92	85	32	12	13
Russian Federation	108	87	43		
FSU Asia and Mongolia	91	70	28		
Southeast Asia	111	36	3	8	6
China	118	69	6		
Non-transitional Economies					
High Income	104	109	50	15	15
High Income Low	111	104	43	14	14
Latin America Mid-High Income	107	63	24	11	11
Latin America Mid-Low Income	107	45	13	10	10
East Asia	98	51	14	11	10
South Asia	97	46	4		
India	100	49	6		
Africa Higher Income	123	66	9	10	10
Africa Lower Income	75	22	2	5	4

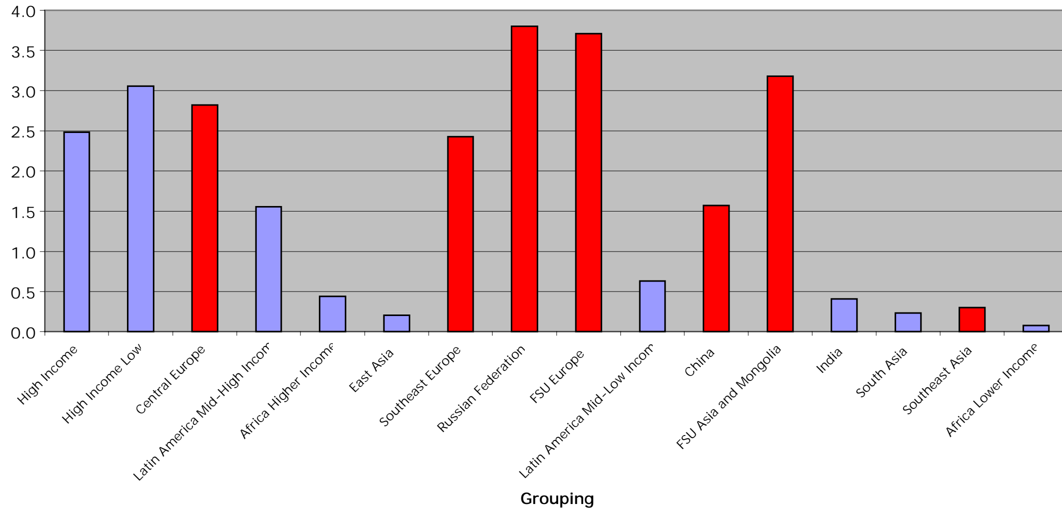

Chart 7 C, Physicians (per1,000people)
4.0
3.5
3.0
2.5
2.0
1.5
1.0
0.5
0.0
High Income
High Income Low
Central Europe
Latin America Mid-High Incom
Africa Higher Income
East Asia
Southeast Europe
Russian Federation
FSU Europe
Latin America Mid-Low Incom
China
FSU Asia and Mongolia
India
South Asia
Southeast Asia
Africa Lower Income
Grouping

Chart 7D, Infant mortality rate (per 1,000 live births)

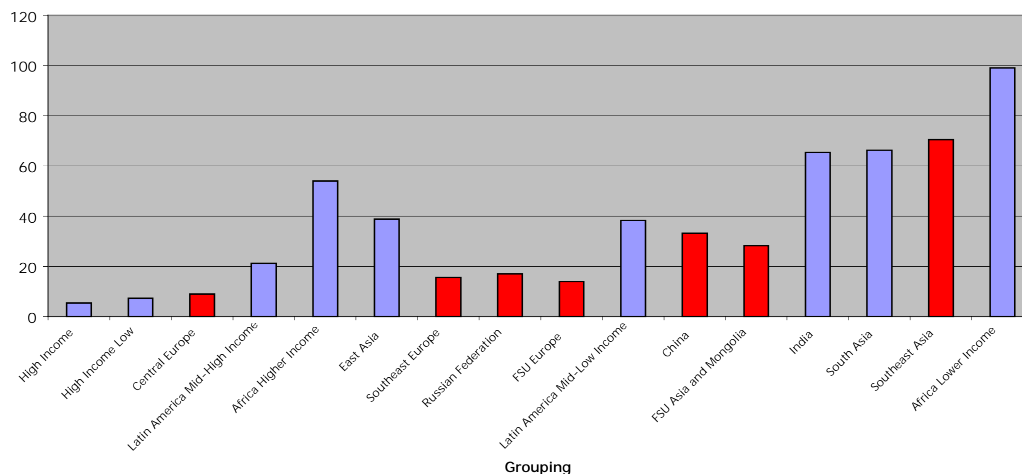

Table 7, Health Indicators, 1996						
Country Name	Health expenditure, total (% of GDP)	Physicians (per 1,000 people)	Hospital beds (per 1,000 people)	Immunization, DPT (% of children under 12 months)	Life expectancy at birth, (years)	Iinfant mortality rate (per 1,000 live births)
Transition Economies						
Central Europe	7.6	2.8	7.0	97.6	72.5	9.0
Southeast Europe	8.5	2.4	8.0	95.0	70.7	15.6
FSU Europe	6.4	3.7	10.9	85.7	68.7	13.9
Russian Federation	4.8	3.8	11.7	72.0	66.0	17.0
FSU Asia and Mongolia	7.3	3.2	9.0	83.9	68.3	28.2
Southeast Asia	3.9	0.3	3.2	74.0	60.5	70.5
China	3.8	1.6	2.4	92.0	69.5	33.2
Non-transitional Economies						
High Income	7.9	2.5	8.2	88.6	77.4	5.4
High Income Low	7.1	3.1	4.4	89.8	75.6	7.3
Latin America Mid-High Income	7.3	1.6	2.9	86.4	72.6	21.2
Latin America Mid-Low Income	5.3	0.6	1.5	81.3	68.5	38.3
East Asia	3.0	0.2	1.9	82.4	65.8	38.9
South Asia	3.2	0.2	1.0	76.3	62.8	66.3
India	5.6	0.4	0.8	86.0	62.7	65.3
Africa Higher Income	5.5	0.4	2.6	71.0	59.5	53.9
Africa Lower Income	3.6	0.1	1.2	56.0	49.7	99.1

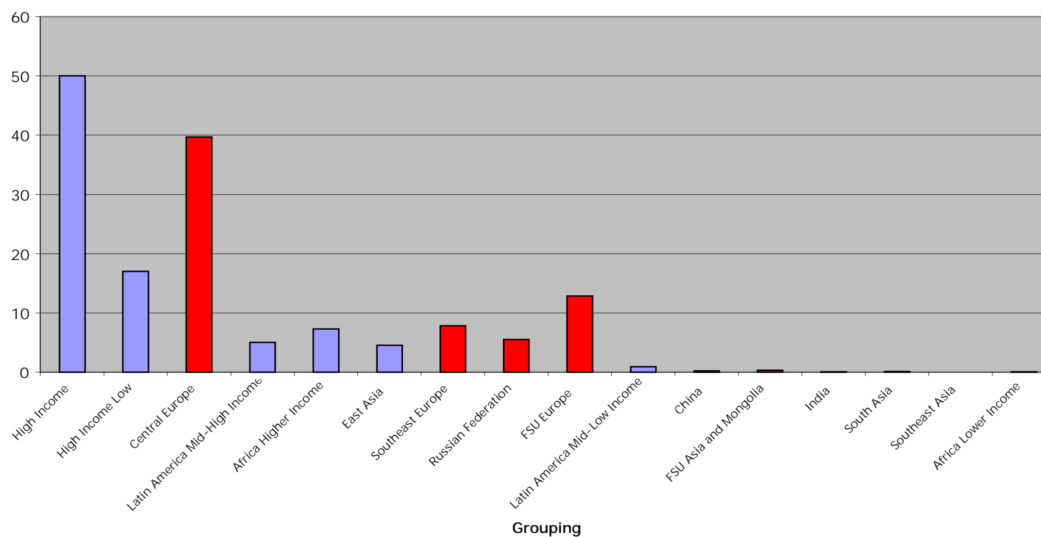

Table 8: Information and Communications

Country Name	Daily newspapers (per 1,000)	Television sets (per 1,000)	Telephone mainlines (per 1,000)	Internet hosts (per 10,000) 1997
Transition Economies				
Central Europe	206	405	254	39.7
Southeast Europe	436	279	254	7.8
FSU Europe	156	394	232	12.8
Russian Federation	267	386	175	5.5
FSU Asia and Mongolia	28	234	85	0.3
Southeast Asia	6	95	11	0.0
China	23	252	45	0.2
Non-transitional Economies				
High Income	338	511	520	214.2
High Income Low	176	411	427	17.0
Latin America Mid-High Income	121	255	141	5.0
Latin America Mid-Low Income	45	150	62	0.9
East Asia	54	151	62	4.5
South Asia	15	29	10	0.1
India		64	15	0.1
Africa Higher Income	49	95	79	7.3
Africa Lower Income	5	29	5	0.1

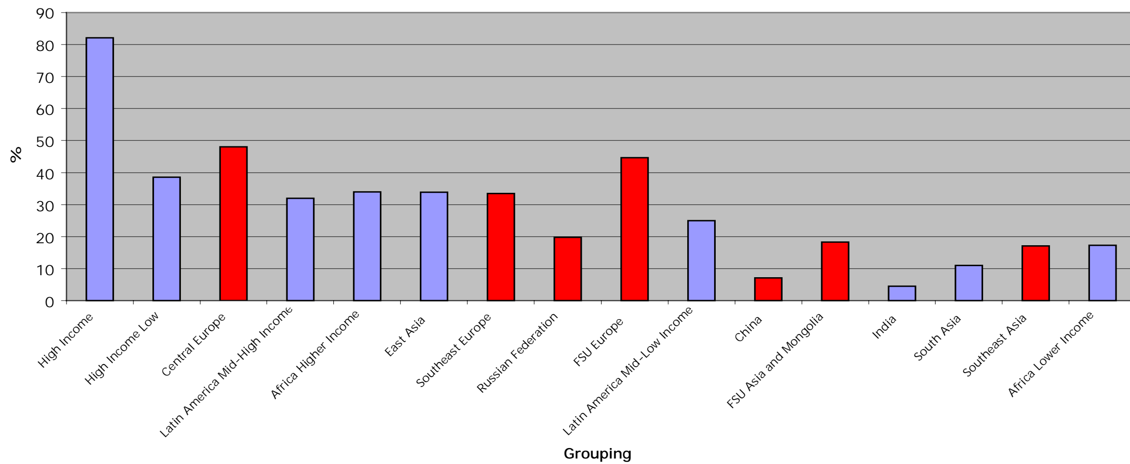

Table 4, External Sector Indicators, 1996					
		Manufactures (% of)		% of GDP PPP	
Country Name	Trade (% of GDP PPP)	Imports	Exports	External debt	Foreign direct investment
Transition Economies					
Central Europe	48.1	72.8	76.8	21.9	1.5
Southeast Europe	33.5	66.6	74.6	18.9	0.8
FSU Europe	44.6	59.	53.0	7.1	1.2
Russian Federation	19.8			19.8	0.3
FSU Asia and Mongolia	18.3	56.3	24.3	8.4	0.8
SoAsia	17.1			30.6	1.5
China	7.1	79.1	84.4	3.2	0.9
Non-transitional Economies					
High Income	82.1	77.2	71.5		-0.2
High Income Low	38.6	70.9	76.3		0.2
Latin America Mid-High Income	32.0	75.4	34.2	21.3	1.6
Latin America Mid-Low Income	25.0	69.4	33.7	26.2	0.9
East Asia	33.9	78.6	57.6	18.6	0.8
South Asia	11.0	61.3	84.8	14.0	0.2
India	4.5	53.8	73.5	5.9	0.2
Africa Higher Income	34.0	73.0	39.7	20.8	0.2
Africa Lower Income	17.4	64.4	18.6	37.3	0.2

Table 9 : Political Freedom and Risk, and Property rights

Country Name	Index of Economic Freedom Rankings	Property Rights and Regulation	Political Risk	Political Rights	Civil Liberties
Transition Economies					
Central Europe	2.8	2.5	14.4	1.4	2.3
Southeast Europe	3.6	3.8	9.1	2.7	3.3
FSU Europe	3.2	3.2	8.2	2.7	3.3
Russian Federation	3.7	3.5	8.3	3.0	4.0
FSU Asia and Mongolia	3.8	3.9	5.5	5.3	5.0
Southeast Asia	4.9	5.0	7.4	7.0	6.5
China	3.8	4.0	16.0	7.0	7.0
Non-transitional Economies					
High Income	2.1	1.9	22.7	1.1	1.5
High Income Low	2.6	2.4	19.6	1.3	2.0
Latin America Mid-High Income	2.9	2.8	12.8	2.1	2.8
Latin America Mid-Low Income	3.1	3.5	8.0	2.9	3.2
East Asia	2.7	2.9	13.9	3.6	4.0
South Asia	3.2	3.8	8.3	3.0	4.5
India	3.7	3.5	13.2	2.0	4.0
Africa Higher Income	2.9	2.5	11.9	2.2	2.6
Africa Lower Income	3.5	3.8	4.0	4.8	4.7

Sources: Indexes of economic freedom and of property rights: Heritage Foundation, 1999. Political risk ratings: *Euromoney,* September, 1997. Political rights and civil liberties ratings: Freedom House, *Freedom in the World, 1996-97.*

Chart 1 9C, Economic Freedom

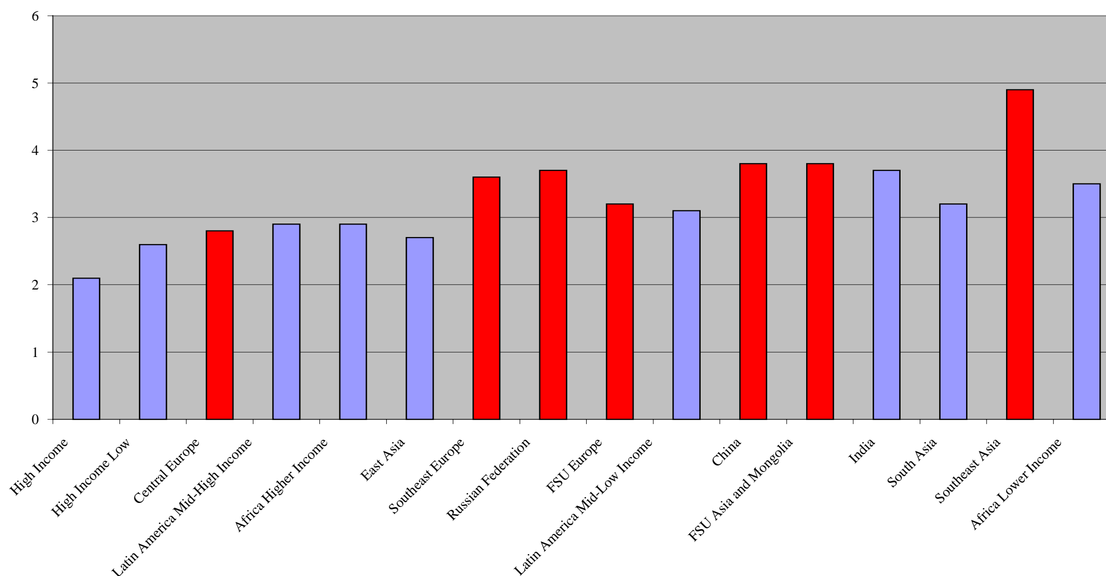

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Chart 9 D, Political Risk

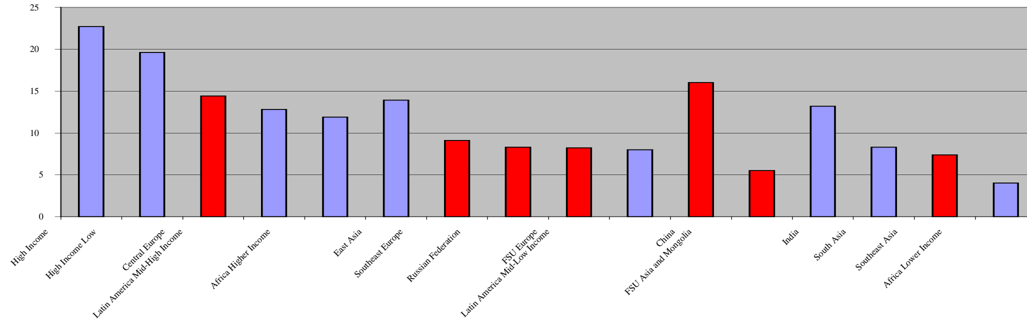


Chart 10D, Tax revenue (% of GDP)

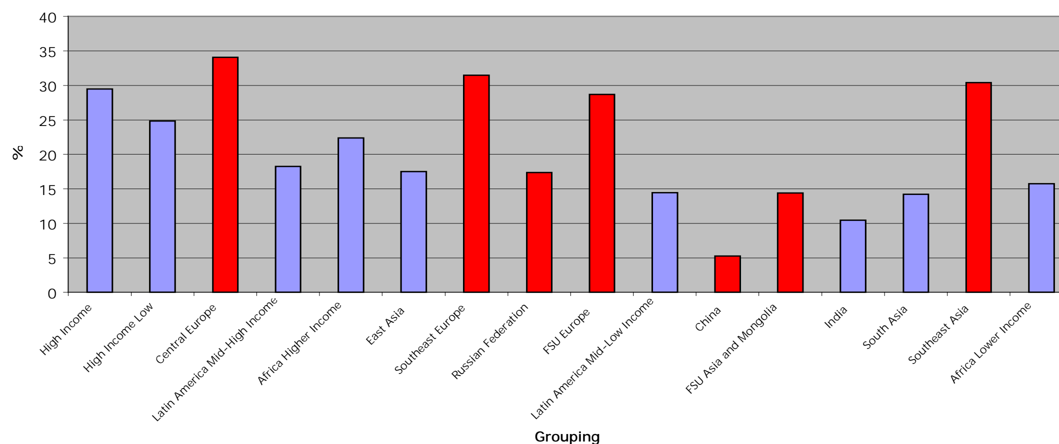


Table 10, Public Sector Finances, 1996 (% of GDP)

Country Name	General government consumption	Current expenditure	Current revenue, excluding grants	Tax revenue	Budget defic
Transition Economies					
Central Europe	19.0	43.2	37.8	34.1	
Southeast Europe	17.7	34.1	36.3	31.5	
FSU Europe	21.3	32.9	28.9	28.7	
Russian Federation	11.2	7.2	18.5	17.4	
FSU Asia and Mongolia	13.8	21.7	24.1	14.4	
Southeast Asia	6.9	35.0	34.1	30.4	
China	11.2	8.3	5.7	5.2	
Non-transitional Economies					
High Income	17.9	33.6	32.9	29.4	
High Income Low	14.9	27.2	27.5	24.8	
Latin America Mid-High Income	11.4	16.0	22.4	18.3	
Latin America Mid-Low Income	10.1	11.3	16.2	14.4	
East Asia	12.8	14.3	20.2	17.5	
South Asia	11.5	19.3	16.9	14.2	
India	10.5	14.6	13.8	10.5	
Africa Higher Income	20.1	23.6	30.6	22.4	
Africa Lower Income	12.3	12.0	18.3	15.7	

Appendix table 1: Basic Income Data by Country and Country Groups

Country Name	GDP ($ billion)	PPP GDP per capita in US $	GDP per capita in US $	PPP GDP/ GDP	GDP growth (annual %)
Transition Economies					
Central Europe					
Czech Republic	54.9	11,006	5,321	2.07	4.1
Hungary	44.8	6,952	4,400	1.58	1.3
Poland	134.5	6,016	3,482	1.73	5.9
Slovak Republic	19.0	7,478	3,549	2.11	6.7
Slovenia	18.6	12,010	9,321	1.29	4.3
e-avg[17]	54.3	8,692	5,215	1.8	4.5
w-avg	95.7	7,231	4,090	1.8	4.9
Southeast Europe					
Bulgaria	9.5	4,455	1,135	3.93	-9.0
Croatia	19.1	4,300	3,999	1.08	-1.0
Romania	35.5	4,632	1,571	2.95	4.1
e-avg	21.4	4,462	2,235	2.7	-2.0
w-avg	27.2	4,546	1,794	2.9	0.3
FSU Europe					
Belarus	19.3	4,393	1,879	2.34	2.6
Estonia	4.4	4,658	2,969	1.57	3.6
Latvia	5.0	3,649	2,018	1.81	2.1
Lithuania	7.8	4,442	2,097	2.12	3.6
Moldova	1.8	1,466	417	3.51	-16.7
Ukraine	44.0	2,259	868	2.60	-10.0
e-avg	13.7	3,478	1,708	2.3	-2.5
w-avg	34.1	2,721	1,129	2.5	-7.2
Russian Federation	440.6	4,269	2,982	1.43	-4.9
FSU Asia and Mongolia					
Armenia	2.4	2,160	630	3.43	6.9

Azerbaijan	3.7	1,515	482	3.15	1.2
Georgia	4.6	1,810	850	2.13	2.4
Kazakhstan	20.8	3,244	1,260	2.57	0.5
Kyrgyz Republic	1.8	2,065	383	5.39	5.6
Mongolia	1.0	1,855	386	4.80	2.6
Tajikistan	2.0	901	343	2.63	-4.4
Turkmenistan	4.3	1,993	937	2.13	-2.4
Uzbekistan	25.2	2,582	1,085	2.38	1.9
e-avg	7.3	2,014	706	3.2	1.6
w-avg	13.9	2,315	886	2.8	1.3

Southeast Asia

Lao PDR	1.9	1,250	393	3.18	6.8
Vietnam	23.3	1,570	310	5.07	9.3
e-avg	12.6	1,410	352	4.1	8.1
w-avg	22.1	1,551	315	5.0	9.2

China

China	815.4	3,364	671	5.01	9.9

Non-transitional Economies

High Income

Australia	392.5	20,596	21,434	0.96	4.0
Austria	226.1	21,701	28,056	0.77	1.1
Belgium	264.4	22,190	26,026	0.85	1.4
Canada	579.3	22,104	19,333	1.14	1.5
Denmark	174.2	22,695	33,114	0.69	2.5
Finland	124.0	18,837	24,189	0.78	3.3
France	1,540.1	21,585	26,383	0.82	1.3
Germany	2,353.2	21,212	28,728	0.74	
Hong Kong, China	154.8	24,260	24,523	0.99	4.7
Iceland	7.3	22,205	26,976	0.82	5.7
Ireland	69.6	18,684	19,195	0.97	7.3
Israel	90.3	18,520	15,842	1.17	7.0
Italy	1,207.7	20,139	21,047	0.96	0.8
Japan	4,599.7	23,158	36,575	0.63	3.6
Netherlands	392.4	20,503	25,288	0.81	2.7
New Zealand	65.1	17,758	17,909	0.99	2.1
Norway	157.8	23,464	36,020	0.65	4.8
Portugal	104.0	13,535	10,473	1.29	3.0
Singapore	94.1	26,680	30,901	0.86	6.9
Sweden	250.2	19,588	28,298	0.69	1.1
Switzerland	293.4	24,811	41,476	0.60	-0.7
United Kingdom	1,145.8	19,917	19,492	1.02	2.2
United States	7,341.9	28,023	27,676	1.01	2.4
e-avg	940.3	21,398	25,607	0.9	3.1

w-avg	3772.5	23,601	27,286	0.9	2.4
High Income Low					
Greece	122.9	12,476	11,737	1.06	2.6
Korea, Rep.	484.8	13,193	10,644	1.24	7.1
Portugal	104.0	13,535	10,473	1.29	3.0
Spain	581.6	15,499	14,814	1.05	2.2
e-avg	323.3	13,675.8	11,917.0	1.2	3.7
Latin America Mid-High Income					
Argentina	294.7	9,652	8,367	1.15	4.4
Brazil	748.9	6,491	4,641	1.40	2.9
Chile	74.3	12,013	5,152	2.33	7.2
Colombia	85.2	7,000	2,275	3.08	2.0
Costa Rica	9.0	6,479	2,619	2.47	-0.5
Mexico	334.8	7,983	3,593	2.22	5.9
Panama	8.2	7,209	3,083	2.34	2.5
Trinidad and Tobago	5.5	6,678	4,213	1.59	3.2
Uruguay	18.2	7,841	5,676	1.38	4.9
Venezuela	67.3	8,321	3,017	2.76	-1.6
e-avg	164.6	7,967	4,264	2.1	3.1
w-avg	449.4	7,549	4,394	1.9	3.6
Latin America Mid-Low Income					
Belize	0.6	4,355	2,877	1.51	1.7
Dominican Republic	13.2	4,527	1,654	2.74	7.4
Ecuador	19.0	5,099	1,628	3.13	1.9
El Salvador	10.5	2,816	1,802	1.56	2.5
Guatemala	15.8	3,877	1,447	2.68	3.0
Haiti	2.6	1,135	357	3.18	2.0
Honduras	4.0	2,133	657	3.25	3.1
Jamaica	4.4	3,564	1,738	2.05	-1.7
Nicaragua	2.0	2,075	438	4.74	4.7
Paraguay	9.7	3,520	1,952	1.80	1.3
Peru	60.9	4,523	2,509	1.80	2.8
e-avg	13.0	3,420	1,551	2.6	2.6
w-avg	25.0	3,736	1,654	2.5	2.9
East Asia					
Indonesia	225.8	3,456	1,146	3.02	7.6
Malaysia	99.2	10,905	4,824	2.26	8.0
Papua New Guinea	5.2	3,045	1,173	2.59	2.3
Philippines	83.8	3,416	1,166	2.93	5.7
Thailand	185.0	6,873	3,084	2.23	6.4
e-avg	119.8	5,539	2,279	2.6	6.0
w-avg	180.0	4,455	1,693	2.8	7.0

South Asia					
Bangladesh	31.8	1,010	262	3.86	5.3
Nepal	4.5	1,074	202	5.31	5.3
Pakistan	64.8	1,605	486	3.31	4.6
Sri Lanka	13.9	2,324	760	3.06	3.8
e-avg	28.8	1,503	428	3.9	4.8
w-avg	43.6	1,365	390	3.7	4.9
India					
India	356.0	1,606	377	4.26	7.5
Africa Higher Income					
Botswana	4.9	7,663	3,335	2.30	6.2
Gabon	5.7	7,451	5,070	1.47	3.2
Mauritius	4.3	9,109	3,785	2.41	6.1
Namibia	3.2	5,232	2,039	2.57	3.2
South Africa	126.3	7,623	3,355	2.27	3.3
e-avg	28.9	7,416	3,517	2.2	4.4
w-avg	111.2	7,569	3,360	2.3	3.5
Africa Lower Income					
Angola	6.7	2,004	606	3.31	7.0
Benin	2.2	1,254	392	3.20	5.8
Burkina Faso	2.5	954	238	4.01	6.1
Burundi	1.1	597	177	3.37	-8.8
Cameroon	9.3	1,930	676	2.85	5.0
Central African Republic	1.1	1,463	318	4.61	-2.8
Chad	1.2	910	177	5.13	2.8
Congo, Dem. Rep.	6.9	902	153	5.91	1.3
Congo, Rep.	2.4	1,793	883	2.03	4.8
Cote d'Ivoire	10.7	1,724	745	2.31	5.9
Ethiopia	6.0	504	103	4.89	10.3
Ghana	6.3	1,831	362	5.06	5.0
Guinea	3.9	1,788	582	3.07	4.5
Guinea-Bissau	0.3	1,049	248	4.23	5.2
Kenya	9.2	1,162	337	3.45	4.3
Lesotho	0.9	1,713	439	3.90	11.9
Madagascar	4.2	937	303	3.09	2.0
Malawi	2.2	705	220	3.20	14.5
Mali	2.7	727	266	2.73	4.0
Mauritania	1.1	1,908	469	4.07	4.5
Mozambique	1.7	556	95	5.84	6.1
Niger	2.0	934	213	4.39	3.3
Nigeria	32.0	894	279	3.20	3.5
Rwanda	1.3	636	198	3.22	11.4

Senegal	5.2	1,693	604	2.80	5.6
Sierra Leone	0.9	520	203	2.56	4.8
Togo	1.4	1,687	336	5.03	6.2
Uganda	6.1	1,038	310	3.35	9.1
Zambia	3.4	884	368	2.41	4.9
Zimbabwe	7.6	2,298	671	3.42	7.3
e-avg	4.7	1,233	366	3.7	5.2
w-avg	11.8	1,045	300	3.9	5.2

[1] e-avg : simple average; w-avg: weighted average.

Source: The World Bank. 1997. *World Social Indicators.* (Volume and CDROM).

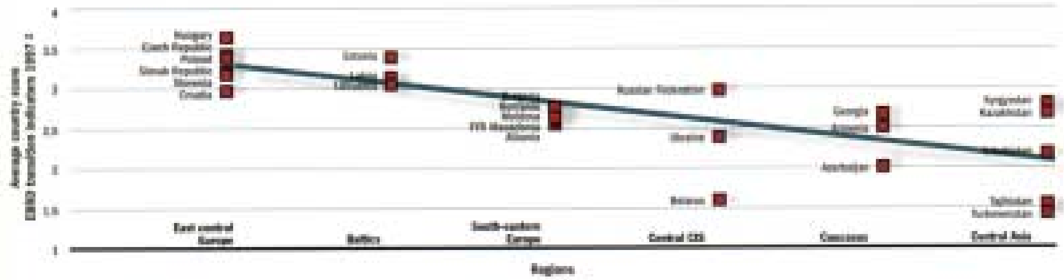
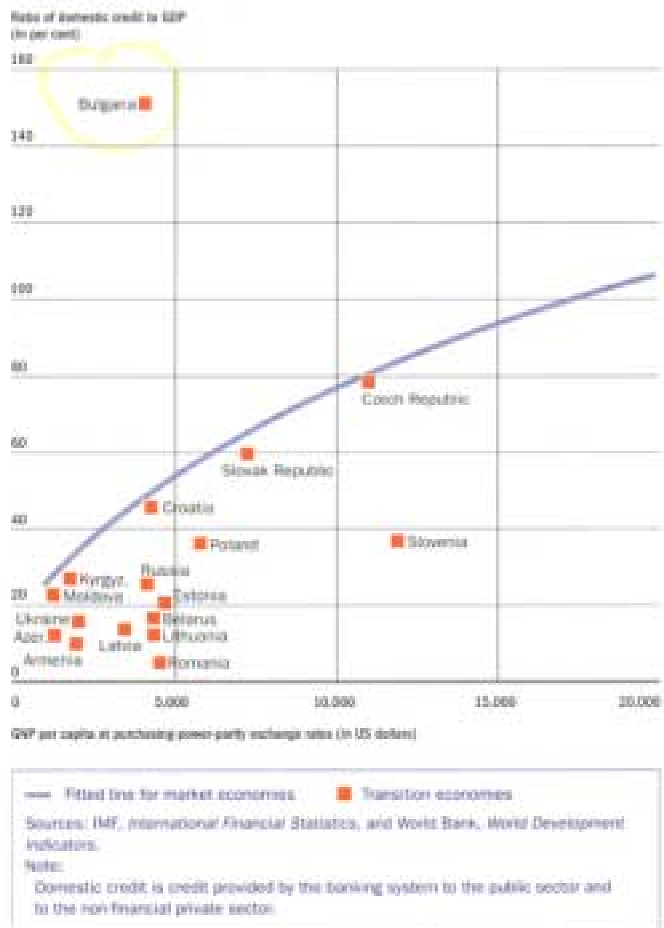


Chart 5.1

Ratio of domestic credit provided by banks to GDP by countries' level of per capita income, 1996



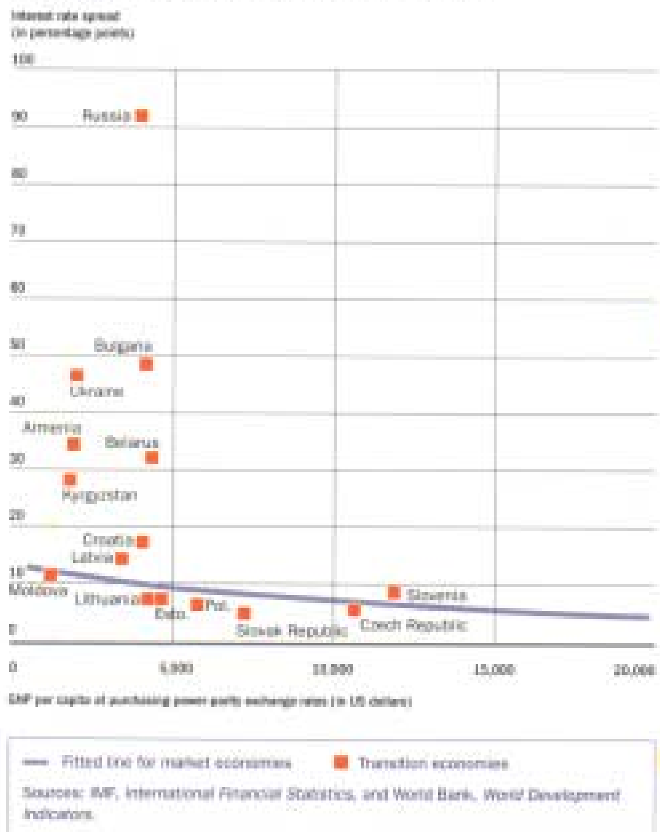
Sources: IMF, *International Financial Statistics*, and World Bank, *World Development Indicators*.

Note:

Domestic credit is credit provided by the banking system to the public sector and to the non-financial private sector.

Chart 5.3

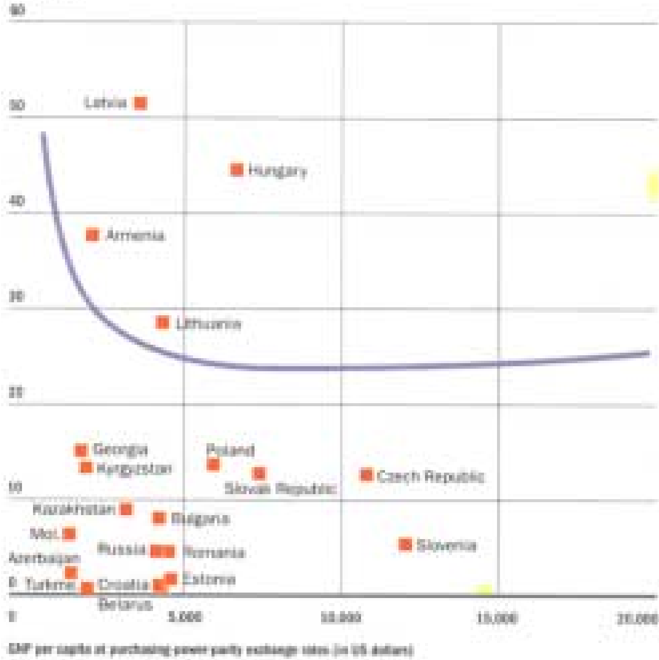
Spread between bank loan and deposit rates by countries' level of per capita income, 1996



Sources: IMF, *International Financial Statistics*, and World Bank, *World Development Indicators*.

Chart 5.4

Share of foreign-owned banks in total bank assets by countries' level of per capita income, 1996



Fitted line for market economies ■ Transition economies

Sources: BankScope, central banks and World Bank, *World Development Indicators*.