ANNE O KRUEGER

FIRST DEPUTY MANAGING DIRECTOR, IMF

INSTITUTE FOR THE STUDY OF THE ECONOMY IN TRANSITION: MOSCOW CONFERENCE ON *TRANSITION IN THE CIS: ACHIEVEMENTS AND NEW CHALLENGES*

MONDAY SEPTEMBER 13

A WORK IN PROGRESS: BUILDING ON THE ACHIEVEMENTS OF THE TRANSITION ECONOMIES

Good morning. I am, of course, pleased to be here today. I only wish my visit to Moscow could have taken place in happier circumstances. The recent tragic events in Beslan and elsewhere have cast a long shadow. We are all, naturally horrified by what happened. The Directors and staff of the International Monetary Fund join me in extending deepest sympathies to the people of Russia, and the citizens of Beslan in particular.

I am grateful to the Institute for organizing this important conference. This is a most appropriate moment to take stock of the economic strides that the transition economies have made in recent years, and to assess the challenges they now face.

But first, I must respond to the great honor that the Academy has bestowed on me. Professor Vladimir Mau was typically generous in his remarks; I can do no more than accept the Academy's Honorary Professorship with enormous gratitude. It means a great deal to me in view of my close association with the Academy and with my many friends here at the Institute and elsewhere in Moscow. The warm reception you have given me today will certainly encourage me to try to visit Moscow more often in the future.

This ceremony here today is, in its way, illustrative of the many changes that have taken place in Russia and the transition economies in the past fifteen years or so. So, indeed, is this very Institute. The important role that markets play in creating the conditions for economic growth and poverty reduction is now widely recognized.

The changes that have taken place in this part of the world are truly remarkable. The progress made has confounded the pessimists on more than one occasion. There is still much to be done in many countries, and for some the challenges are formidable. But when we look at all that remains to be done in the future, it should be seen in the context of what has already been achieved.

The nature of the challenge

We should also remember quite what those at the economic policy helm in those early years had to contend with. It is relatively easy to dismantle a market system if you are going to replace it with a command economy. It is also relatively easy to assume ownership and control of ongoing enterprises. But getting those enterprises to continue to function efficiently is more difficult; and achieving the flexibility and responsiveness to adapt to new demands and challenges is even harder. The experience of the transition economies run on Communist lines for much of the twentieth century taught us that.

Command economies found it increasingly difficult to offset falling productivity and inertia with the passage of time.

Yet reversing decades of economic mismanagement is no easy task. Adopting a market-based economic system is a difficult and lengthy process. It takes time for activities to spring up and for people to adapt to new incentives, institutions and constraints. So it is hard to get going. But reforms do become easier over time. As the benefits start to show, and growth begins to accelerate, the momentum for change builds up. This is in sharp contrast to command economies where the outcomes became inexorably worse.

At the beginning, the situation confronting those responsible for overseeing the transition was even more difficult because of the economic collapse that followed the political upheaval. Many of you will be familiar with Egor Gaidar's striking description of what it was like to cope with the aftermath of the collapse of the Communist system, particularly the discovery that the gold reserves had been exhausted, making it difficult to pay for the grain imports on which Russia had become dependent:

In short there was no bread and no gold. And there was no way to pay on credit. And there was noone willing to lend to us. This wasn't a huge surprise to me{Gaidar writes] *though some had retained hopes that many things were a bit better than they seemed, that maybe there were, somewhere, hidden reserves under the rug. But there weren't; there was nothing.*

Dismantling a command economy really did mean starting all over again. What economic assets remained had to be valued and transferred into private hands—and entrepreneurial private hands at that. At every level of activity people had to start thinking for themselves.

Labor mobility was virtually non-existent under a centrally-planned system. People might in many cases have had meaningless jobs, producing poorly-made goods for which there was no real demand. But they did have jobs. The transition to a market economy meant labor mobility —both geographical and between jobs—had to be encouraged. Unemployment was inevitable in the short term as economic activity began to be more efficient. That meant the need for new social safety nets to replace the disguised unemployment so characteristic of centrally-planned economies.

Those in charge of economic policymaking had to learn how to function in a market-based economy. It was soon clear, as Gaidar's account illustrates, that a slow transition would not be feasible. So the basic structures of a market economy had to be put in place as rapidly as possible.

Fiscal discipline was now important, as was monetary policy. Yet the legacy of the centrally-planned system meant that there were now huge fiscal pressures. Infrastructure was often lacking, or in poor condition. Health and education provision needed overhauling. Pension systems needed radical reform. There was thus an urgent need to establish properly-functioning tax systems that would generate revenues and provide incentives to support the transition to the market system

At the same time, the financial sector needed effective regulatory structures. The banking system needed wholesale reform to equip it for its new role as a provider of credit. Financial markets needed to be created and fostered—vital for the efficient allocation of credit and the management of risk.

The list of urgent reforms needed went well beyond what we used to think of as the economic policy arena. The experience of the 1990s, especially in the transition economies, made it clear that the establishment of a proper commercial code, properly enforceable property rights, a fully-functioning independent judiciary, bankruptcy laws—all mattered. By their presence or absence they can all contribute to the success or failure of a smooth transition. But that was something we learned by doing.

This would be a challenging reform agenda for any country. For countries with no recent experience of operating in a market-based economy, it is an intimidating list. I'm sure everyone here remembers that essentially we were talking about rolling back decades of central planning—and doing so almost overnight. Even now we are reflecting on the progress made over a relatively short period in geopolitical terms.

A challenge met?

You will all, no doubt, recall, as I do the many dire predictions made in the early 1990s. There was a widespread belief that many of the CIS and Comecon countries would face economic catastrophe. There was talk of prospective failed harvests, food shortages. For a time it did not seem possible that such a disparate group of countries could cope with the geopolitical upheavals and the economic shakeout that was inevitably to follow.

But the catastrophes predicted so confidently did not, by and large, occur. Yes, the citizens of many countries endured great hardship in the early years. But the outcome was markedly better than most forecasts, even though the recovery from the initial shock was often delayed. Poland, for example, suffered a much sharper contraction in GNP than expected in the first two years: but by 1993, there were already signs that the economy was beginning to rebound. By the mid-1990s, growth resumed in many of the transition countries, and in others the decline in GDP was gradually reversing.

The fact that some countries fared worse than others is hardly surprising—that phenomenon is not confined to the transition economies. But it is worth noting that those transition countries that experienced the most rapid structural reforms have, by and large, experienced more rapid growth. This is true, for example, of the Baltic States. In recent years, Russia has also seen higher rates of growth—a result, in large measure, of reforms that were implemented in the 1990s.

And it is important to remember that there are good reasons to suppose pre-transition output had in any case been overstated. Leszek Balcerowicz, now Governor of the Central Bank of Poland, has argued that the output decline in the early years of transition was overstated: partly because much of what had been produced under the old system had been worthless and partly because the opponents of reform wanted to exaggerate the hardship and the distress ordinary citizens were experiencing.

Balcerowizc says that the official—uncorrected—figures for output decline were

"used by opponents of the [reform] program to demand its radical revision, by way of a decisive relaxation of monetary policy, widespread state intervention and protectionism".

He notes that these arguments were supported by the majority of Polish economists and some foreign ones.

It was a similar story after the Russian financial crisis of 1998. That was the trigger for another series of dire predictions, both about the economic impact of the crisis and about the economy's ability to recover.

Yet even the August 1998 crisis was not as deep as in many other crisis countries, nor as had been predicted for Russia. And, counter to most observers' expectations, growth from the initial dip was both quicker and stronger than in other crisis countries. Indeed, the recovery was remarkably rapid and in recent years the Russian economy has been expanding vigorously.

Short-term prospects

In the short term, the outlook for most transition economies is favorable. As a group they showed surprising resilience during the worldwide downturn of 2001-2002 and as the global recovery has gathered pace, so the prospects continue to be for reasonably buoyant growth. This is particularly striking given the sluggish pace of recovery in some of the industrial countries.

Coming challenges

Sustained rapid growth is essential in the transition economies if governments are to complete the process of transition started in the early 1990s. The challenge now is to build on what has been achieved so far in the countries that have adjusted more successfully, and, where success has so far proved elusive, to benefit from the experience of others in developing an economic framework that can foster growth. Growth, sustained over a long period, is the best ,indeed the only way to combat poverty and raise living standards.

Sound macroeconomic policies are the prerequisite for sustained growth, and some countries have made substantial progress in this regard. But, as the Fund has noted on several occasions, some countries have quite a way to go to achieve macroeconomic stability. In this latter group, in consequence, sustained rapid growth that will deliver **lasting** reductions in poverty has, thus far, proved elusive.

But much remains to be done, even in the countries that have, in recent years, seen growth start to accelerate. Further reforms are needed if economies are to develop successfully and if growth rates are to be maintained and accelerated.

It is vital that progress made thus far is not undermined because the reform process falters. The more soundly based policies are, the more resilient will be economies to external shocks and global downturns. And now is the time to act. The relatively benign environment provides the opportunity to undertake further reforms that will enhance the prospects for growth and reduce vulnerabilities to external shocks.

The best response to a global upturn is to use it to advance reforms that address outstanding problems—not to relax because some of the short-term economic pressures have eased. A worldwide economic recovery, while welcome, is no substitute for the adoption of sound economic policies.

Lessons learned

What makes for sound economic policies? The experience of the transition economies during the 1990s, coupled with what we learned from crises in Asia and Latin America, forced all of us to redefine what we mean by the term. A framework that provides and fosters macroeconomic stability is essential. Expansionary fiscal policy neither cures structural problems nor generates growth—especially in the absence of structural reform. Indeed, the evidence is mounting that inflation constitutes a significant drag on growth.

And the 1990s also taught us that structural reforms must include institutional and legal reforms as a high priority. These are an essential prerequisite for macroeconomic stability and growth. Effective property laws, a strong independent judiciary, a commercial code—all these help to create the right framework in which entrepreneurial activity can thrive.

The sooner such reforms are put in place, the better—as I said, those countries that made more progress on this front in the 1990s experienced more rapid growth. A sound financial sector is equally important. A strong, well-regulated banking sector has an important part to play in allocating credit efficiently, and managing risk. And, since the extension of credit provides access to the new resources that are vital for growth, widening and deepening the financial sector is also important because it can help strengthen the financial system, increase resilience to shocks, and create new opportunities for growth.

We all knew these things to be true. But the 1990s made us realize that they were even more important than many of us had assumed. The financial crises of the 1990s taught us that with capital account liberalization—itself important in the context of trade liberalization—a weak financial sector or poorly regulated and badly managed banks could be the source of dangerous instability.

Without structural reforms of this kind, markets cannot function well; foreign investors will be reluctant to make long-term commitments and opportunities for more rapid growth will be lost.

The IMF's role

John Odling-Smee, who spearheaded the Fund's work in the transition economies for so long, will be reflecting on the relationship between the Fund and Russia later this afternoon. I am sure Stan Fischer will have observations on the role of the Fund as well.

The transition experience has been a learning process for us all—policymakers in the countries in question, Fund staff and economists around the world. We were, after all, working towards a transformation that had never before been attempted. We still are.

The Fund's principal objective is, as it always has been, the maintenance of international financial stability. That gives the Fund an important role in crisis prevention and resolution—and the past 15 years have provided plenty of opportunities from which I think we have all, ultimately, profited. But we also have an important advisory role. Reform is, in a very broad sense, the Fund's business. When appropriate we can also offer technical assistance on a wide range of issues in order to help governments adopt and implement reforms.

The Fund uses the annual Article IV consultations to draw attention to policy weaknesses and recommend appropriate reforms. But both in our surveillance discussions and in discussion with countries embarking on reform programs with financial support from the Fund, we always seek to remind policymakers that it is **they** who have to adopt reforms and try to ensure their success. It is **they** who have to secure the support of civil society and the various economic actors involved and whose response will contribute to the success or otherwise of the reforms.

Russia

As many of you know, we have recently completed our annual Article IV consultations with Russia. These took place against a backdrop that in many ways is encouraging. Growth has accelerated, and there is every reason to expect that it will remain robust in the short term. The balance of payments is strong. High oil prices have had a significant beneficial impact in the short term, although they make macroeconomic management more difficult.

This backdrop provides the opportunity and the means for Russia to consolidate and advance what has been achieved in the past few years. But labor markets are tightening and there are emerging capacity constraints. In themselves, these are clear signals of a relatively buoyant economy. But they also suggest that stronger inflationary pressures could be building up. This is not the moment to relax fiscal policy and in so doing add to the burdens of those in charge of monetary policy whose aim is something approaching price stability.

So in our staff report, we warned against a further fiscal relaxation, however good the current numbers look. Extra spending would only add to strengthening inflationary pressures.

It is also important to tackle the problems in the banking system, some of which have emerged recently. Postponing reform in the financial sector will only make it far more difficult, and costly, to deal with later.

And structural reforms should be advanced. The job started 15 years ago is still not complete. Many projected reforms have yet to be implemented. And it would be a pity if high oil prices offered an excuse for inaction. After the turmoil of the 1990s, it would be understandable if the current breathing space were used to justify delay that would have considerable costs over the longer term, but that would reduce growth potential and lead to the need for these reforms to be made against the backdrop of slower growth later on.

In fact, the impact of higher oil prices underlines the importance of diversification away from too great a reliance on oil and gas production. The more rapidly the Russian economy can diversify, the less vulnerable it will be to the consequences of rising—and **falling**—oil prices. And diversification would result more rapidly from acceleration of structural reforms.

Conclusion

Let me conclude. This has been a period of intense change for the transition economies. In many cases the hardest part of the reform process has been completed, or is nearing that point. Much can therefore be gained by moving forward with the further reforms need to deliver the benefits that rising growth can bring.

Now is the time to move on. Pressing on now will mean that the full benefits of the reforms undertaken thus far can be realized. It will ensure that the momentum for change is kept up. And it will also make investors—domestic and foreign—more confident about the future.

It is right to take a moment to recognize how far the transition economies have come. But this is, as my title implies, a work in progress—and progress depends on maintaining the momentum. Delay should not be an option.

One advantage for the transition economies is that they came late to economic reform. That meant that they had the example of many countries to follow. It also means that here in Russia, and elsewhere, there are lessons already learned about the need to focus on the right substantive issues, and—most important—not to get too comfortable when there is short-term progress. The benefits of reform take time to feed through, and can be quickly undermined if the momentum is not maintained.

So I urge policymakers, and those who advise them, to seize the opportunity afforded by the currently benign global economic environment. The IMF is ready to do whatever it can to support further change. But the difficult challenges have, first and foremost, to be met here in Russia and in all the other transition economies—not in Washington.

Thank you.