I. OVERVIEW

A transformation in pictures

In 1989, the Stalin-era Palace of Culture stood almost alone on the Warsaw skyline. Now it is joined by a host of modern skyscrapers.

Public transport in Romania in the late 1980s...and now

Shopping in Bulgaria, early 1990 and today
A. Political Transformation

In the mid-1980s, few would have imagined the dramatic changes that were about to engulf Central and Eastern Europe, notwithstanding the initial steps towards modernization introduced in the Soviet Union by the programs of glasnost (openness) and perestroika (restructuring). Nor would they have guessed the speed of these changes: by the end of 1991 the political landscape was unrecognizable from just three years earlier.

In some cases, the fall of communism broke the bonds that had held countries together, with the dissolution of the Soviet Union and Yugoslavia followed in 1993 by the “velvet divorce” of the Czech and Slovak republics. Conversely, less than a year after the Berlin Wall came down, East and West Germany were reunified. Eventually more than 20 countries emerged from the process. The violence that took place in parts of the former Yugoslavia, and also in Romania and Moldova, stood in marked contrast to the major achievement in almost all other cases, that a transformation of such momentous scale was effected peacefully.

Rapid political changes have continued throughout the quarter-century since 1989. Most notable has been the reintegration with Western Europe. Partnerships with the EU strengthened through the 1990s, culminating with the accession of eight former socialist economies in 2004, followed by Bulgaria and Romania in 2007 and Croatia in 2013. Four of these have joined the euro area, with Lithuania also set to join in 2015. Looking forward, the remaining countries of the Western Balkans all have EU candidate or potential candidate status.

Prepared by James Roaf.
Political and economic integration has not only involved the EU. When the Soviet Union was dissolved at the end of 1991, the Commonwealth of Independent States (CIS) was established, comprising most of the former Soviet republics. Recently this region too has moved towards closer integration through the development of the Eurasian Economic Union, to become operational in 2015 with initial members Belarus, Kazakhstan, and Russia.

**B. Economic Transformation**

**Macroeconomic development**

All the transition countries went through recessions with the initial economic dislocation and trade disruption stemming from the collapse of the Soviet-era Council for Mutual Economic Assistance (Comecon). The scale of these recessions varied across countries but were extremely deep and prolonged in some cases—even if the official statistics available at the time tended to overstate the output losses. The 1990s saw diverging growth rates as countries struggled to achieve macroeconomic stabilization and lay the foundations of a market economy. Initial conditions were important to how countries fared in this period: some countries, especially in Central Europe and Yugoslavia, had already experimented with market reforms in the 1980s, while others entered the transition with central planning still fully intact and little familiarity with market systems. External factors mattered too, with countries most dependent on trade with or within the former USSR most affected by its collapse, and countries closest to Western European markets benefiting most from new investment and trade. But after taking account of these factors, policies were critical to outcomes. Countries that took bolder and more front-loaded reforms—notably in Central Europe and then the Baltics—were rewarded with a faster return to growth and stability, including avoiding the series of crises that hit the region in 1997 and 1998.
The initial transition recessions were accompanied by high or hyper-inflation in most countries, as prices moved to market levels and as governments resorted to monetary financing of gaping fiscal deficits. But through the 1990s countries successively brought fiscal deficits and inflation under control, albeit only after false starts in some cases.

In contrast to the turbulence and divergence of the 1990s, growth patterns in the early and mid-2000s were uniformly strong. With favorable global conditions and increasing confidence in rapid convergence with Western Europe, average growth for the region was 6 percent, with no country growing at less than 3 percent annually—a faster rate than most countries have consistently managed before or since. However, while soundly based at the start, growth in this period became increasingly imbalanced, driven in many countries by large-scale borrowing for consumption and construction. The resulting vulnerabilities combined with the effects of the global financial crisis with devastating effect: output declines in 2009 averaged 6 percent and ranged up to 18 percent, a more severe impact than in any other region of the world. The ensuing euro zone crisis and slow global recovery have weighed on growth since—and rising geopolitical tensions further cloud the outlook looking forward.

Through the 2000s, fiscal positions improved markedly, with revenues boosted by the unsustainably rapid growth. The boom also pushed inflation up somewhat, but demand pressures showed mostly in ballooning external deficits. The underlying fiscal problems were exposed when the global financial crisis hit, with major deteriorations
in budget deficits. Most countries have since embarked on significant consolidation, although many have struggled against the backdrop of slow growth.

Despite the ups and downs, overall the transition period has been one of strong convergence with Western Europe. On average, income per capita has risen from about 30 percent of EU15 levels in the mid-1990s to around 50 percent today. This average conceals large differences between countries, with some, such as the Baltics, making huge advances; and others, such as Bosnia and Herzegovina, Moldova, and Ukraine, getting increasingly left behind. Price levels—along with wages—have also risen as part of the convergence process. To the extent that price and wage increases have reflected productivity increases from investment and better labor skills, these developments are not a cause for concern. But countries where costs are rising faster than productivity risk losing competitiveness.

**Structural reform**

The process of building market economies has been harder than many expected 25 years ago. While reforms have proceeded at very different speeds across the different countries, the sequencing has tended to follow the same pattern. Liberalization of prices, trade, and foreign exchange could be implemented quickly, through legal and regulatory changes. Similarly, privatization of small businesses did not encounter major opposition. Reforms in these areas are mostly complete in all countries except Belarus. But other crucial areas of reform and institution-building have proven much more difficult, chiefly because they involve challenges to vested interests. Large-scale privatization was largely completed in the first decade of transition in central Europe and the Baltics, but remains to be finished in many other countries, especially in the Western Balkans and the CIS. Competition policy, governance reform, and enterprise restructuring have been even more difficult to advance in the face of opposition from insiders benefiting from existing arrangements. Reform momentum has also tended to slow over the years. Countries mostly made rapid progress in the 1990s, but for most, the last decade has seen less change, even in cases where the transition process is still far from complete.
A critical element of the reform process has been to build a sound business environment in which firms can start, invest and expand, and, where necessary, die. Creating these conditions requires far-reaching legal, administrative, and institutional reforms across a broad front. At the start of the transition, these were not in place in any of the countries. Business activity was governed instead by central planning, political decisions, and often corruption. Twenty-five years later, this is an area in which the transition countries differ the most from each other, with important implications for their future growth prospects. In the World Bank survey of ease of doing business, they range from 17th place to 131st out of 189 countries worldwide. The range is just as broad in the latest Transparency International survey of investors’ perceptions of corruption. But in general, there has been a strong improvement: the large majority of transition countries have raised their rankings relative to the rest of the world over the past 15 years, some very markedly, with only a handful falling back.

The development of the financial sector has been important in strengthening conditions for business. Across the region, Western European banks made strategic investments to establish subsidiaries, to the extent that foreign bank ownership dominates most countries’ banking systems. This has facilitated the provision of financing to firms and households (albeit too much, in the mid-2000s boom), but importantly also much needed expertise and technical know-how, and the benefit of arms-length relationships between banks and their customers.

The social impact of the transition has been profound. In moving from a system of guaranteed employment to labor markets governed by supply and demand, and with the closure of unviable firms and industries, unemployment inevitably increased sharply at the start of transition. For most countries, labor market reform and economic growth helped reduce unemployment over time, subject to a continued legacy of long-term unemployment, and the job losses associated with the global crisis. The notable exception has been the Western Balkan countries, which have struggled with extremely high unemployment throughout the transition period. Another stark indicator of the social costs of early transition is life expectancy, which in many countries stagnated or fell for a number of years, most notably in CIS countries.
Governments also found themselves unable to maintain the generous universal benefits of the socialist era, especially given adverse demographic trends. In general, pension entitlements have been scaled back to more fiscally sustainable levels, and other social benefits better targeted towards the needy. But progress in implementing these reforms has varied widely across countries. Inequality has also risen across the board. As with unemployment, in most countries the main increase took place in the initial stages of transition, with smaller rises (or in some cases reductions) in inequality indicators since. On average, inequality in the CEE region is now on a par with that of the EU15 countries—but in both cases there are wide ranges around the average.

C. Involvement of the IMF

The IMF has been closely involved with the transition process from the start. In fact, some of the countries had joined the IMF well before 1989, with the Fund providing financial and technical support to early reform steps in Hungary, Romania, and Yugoslavia in the 1980s. But it was after the collapse of communism in 1989 that the main expansion of the Fund’s membership and activities took place, with 25 new members from the ex-socialist bloc joining by the end of 1993. These countries were almost all in parlous economic conditions and in desperate need of foreign financing and advice.

The arrival of the new members was the most significant development in the Fund’s history since the ending of the Bretton Woods exchange rates system two decades earlier. It required a major expansion of all three of the main areas of IMF activity:

- Surveillance, meaning advice on both individual country policies and multilateral issues such as the dismantling of the ruble zone;
- Program lending, by which the IMF provided financing to support countries’ economic stabilization programs, with disbursements conditioned on implementation of key policy measures; and
- Training and technical assistance, whereby teams of experts in a particular field worked closely with the country authorities to help design and implement specific reforms such as the adoption of a value-added tax, establishing new monetary policy frameworks, or strengthening expenditure controls.

IMF staffing was upgraded accordingly, along with expertise in economic and legal issues relating to transition. At least, to the extent that such expertise existed. The problem was that the countries were in uncharted territory; no-one at the Fund, or elsewhere, knew for sure how to create a market economy from scratch after decades of distortions under central planning. Thus, the early programs involved a significant element of “learning by doing,” jointly between the country authorities, IMF staff and other international advisors.
The first of these programs was for Poland in February 1990, only months after the Berlin Wall fell, in support of the “Balcerowicz Plan” for radical, front-loaded reform. This was quickly followed by programs for Hungary and Yugoslavia that same year, with programs for Bulgaria, Czechoslovakia and Romania coming in 1991. With the slew of new countries joining in 1992 after the dissolution of the Soviet Union, the IMF faced a problem: most of the new states lacked the institutional capacity to meet the Fund’s normal lending standards. The Systemic Transformation Facility (STF) was set up in 1993 to provide support to countries as they built up sufficient capacity and policy credibility to move to a full-fledged IMF program. More than half the transition countries used the STF in 1993–94. Financing under the STF was strictly limited, reflecting the risks involved and limited repayment capacity. Indeed the early transition programs were generally not very large, at least in comparison with what came later in the Asian, global and euro zone capital account crises. But many of them contended with output losses of unprecedented scale.

Timeline of IMF membership and programs

1/ Maximum cumulative decline in three years from program inception (or lowest growth if no decline).
2/ Only non-concessional arrangements.
The volume of transition programs remained high through the 1990s. But in the 2000s, the benign global environment and ready availability of market financing meant very few countries were turning to the IMF for financing. This changed dramatically with the onset of the global financial crisis in 2008–09, which saw eight countries in the region returning to the IMF for support. The scale of the turnaround in private capital flows resulted in extremely high financing needs and very deep recessions in some cases—although the programs helped avoid even worse contractions of demand. This period also saw the introduction of new precautionary credit lines from the IMF for countries with sound policies but facing heightened risks, which were used in different forms by Poland and FYR Macedonia.

By 2014 the crisis programs had concluded, generally successfully. But the legacy of slow growth in the aftermath of the global and euro zone crises contributed to persistent fiscal and competitiveness problems in some cases, especially in the CIS and Western Balkans. More broadly, countries continue to face external vulnerabilities. These issues are being addressed by IMF-supported programs in Albania, Bosnia and Herzegovina, Romania, and Ukraine.

Over the full period since 1989, the IMF has provided a total of some 530 person-years in technical assistance to the transition countries. The bulk of this has been for fiscal policy and the financial and monetary sectors, peaking in Russia and the other CIS countries in the mid-1990s. The IMF has provided training in all aspects of macroeconomic and financial sector policy, statistics, and other areas of relevance to the transition to almost 12,000 individuals from the CEE region, mostly via the Joint Vienna Institute.