Liberalization, stabilization, privatization, and poverty relief are intrinsic to transition. But they are not enough to create vibrant market economies. Building on the early gains of transition will require major consolidating reforms, to develop strong market-supporting institutions, a skilled and adaptable work force, and full integration into the global economy.

The many institutions that support market exchange and shape ownership in advanced market economies—both concrete organizations and abstract rules of the game—largely disappeared under central planning. As Part One showed, even in this weak institutional setting, favorable policy reforms have been able to spur economic growth. But a growing body of evidence on market economies suggests that, for the longer term, if transition economies are to join the ranks of the advanced market economies, they will need not just good economic policies but strong and accountable institutions to support and implement them.
Which institutions are most critical? First are good laws and effective means for their enforcement (Chapter 5). These establish and apply the rules of the game, lower transaction costs, increase commercial certainty, create incentives for efficiency, and control crime and corruption so that businesses can focus on productive activities. Second are strong financial institutions (Chapter 6), to encourage saving and channel it to its most productive uses. Financial institutions also play an important role in corporate governance, complementing that of enterprise owners, by imposing financial discipline and overseeing the activities of borrowers. A third essential institution is government (Chapter 7), but the all-powerful, all-encompassing governments of the planning era need to be completely reoriented toward a smaller, more selective set of activities that support and complement, rather than stifle, private enterprise.

Institutions do not develop in a vacuum. Reformers' top-down efforts to develop strong legal and financial institutions and to change government behavior must be complemented by bottom-up demand for such reform. This demand will not spring up overnight, and it will often require deep changes in incentives, attitudes, and experience. But it will emerge faster if policymakers are vigilant in pursuing macroeconomic stability, open markets, and private sector development.

An extensive body of research shows the importance of human capital for the sustained growth and adaptation of market economies. Many countries enter transition with a strong human capital base, and their rising returns to education already show the importance of skills in the new economy. Nevertheless, thorough reform of education and health systems is needed, both to preserve past achievements and to adapt to the needs of the market (Chapter 8).

Finally, openness to trade and foreign investment has proved an equally robust predictor of strong economic performance across countries. Indeed, both have already had a large positive impact in transition economies. Deeper integration into the institutions of the global economy carries obligations as well as rights, and these can help integration serve a broader purpose: that of locking in reforms against the emergence of pressure groups (Chapter 9).