Keynote Address

20 Years of Economic Transition
- Successes and Failures

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1. Introduction

This study takes stock of the experiences of 20 years of economic transition and attempts to identify successes and failures with regards to both, theory and policy. The motivation for the study is driven by the prospect that lessons might be learned for the future not only for transition countries but for emerging markets in general. In the presence of the current global economic crisis policy relevance even for the mature capitalist societies are expected.

From an analytical point of view the current global crisis makes it easier to identify shortcomings of transition. Some general observations are that growth slowdown is accelerating with sharp adjustments in some countries and even collapses. Even

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1 Notes prepared for conferences at the EU Institute of Japan, Hitotsubashi University, Tokyo and the Institute of Economic Research, Kyoto University (KIER) in February 2009.
though transition as such has progressed over the past 20 years a slowdown in general is unavoidable and even reversals are likely, particularly in the areas of finance and trade. All transition countries are facing fiscal difficulties, which are a threat to much-needed growth-inducing investments in education. Like in mature capitalist countries increased government intervention is unavoidable, although sector-specific industrial policy is risky.

This study proceeds by looking at concepts of transition with the benefit of hindsight. As there is widespread agreement now that the original concept of the ‘Washington Consensus’ has failed to fulfil expectations of growth and development, the state of the art seems to be confusion (Rodrik 2006). Chapter two will discuss theoretical approaches and confront them with some observations. Chapter 3 outlines major social consequences of transition taking into account recent studies on happiness and health. Then the impact of the post-2007 economic crisis is analysed and long-run challenges for economic development in transition countries are addressed. Tow snapshots look at the economies of Russia and Hungary. Then conclusions are drawn.

2. Concepts of transition

The Washington Consensus approach relates to the specific combination of shock-like transformation and macroeconomic stabilization. ‘Stabilization’ was meant to achieve price stability as a pre-requisite for (long-term) growth. The Washington Consensus was a common understanding of the Washington based institutions IMF and World Bank and some American think tanks to solve the structural balance of payment problems. Most socialist economies suffered from severe macroeconomic imbalances: a mismatch between supply and demand, trade deficits and high foreign debt – an additional gloomy heritage for the transformation. These imbalances were explained as being the combination of price controls and invisible and visible fiscal deficits, financed through printing money by a national bank, serving as a government agency. The result was the vanishing of commodities from official markets and their trading on black markets at uncontrolled higher prices. The lifting of price controls
without the abolition of the causes of imbalances might rather lead to hyperinflation and make the free price system ineffective.

The policy recommendations were:
First of all: Fiscal discipline, implying the redirection of public expenditure priorities toward fields offering both high economic returns and the potential to improve income distribution, such as primary health care, primary education, and infrastructure.

The elements were:

- Tax reform (to lower marginal rates and broaden the tax base)
- Interest rate liberalization
- A competitive exchange rate
- Trade liberalization
- Liberalization of inflows of foreign direct investment
- Privatization
- Deregulation (to abolish barriers to entry and exit)
- Secure property rights

These are often summarised in the definition: Economic transition equals privatisation, liberalisation and stabilisation.

The starting point for macroeconomic policy was to transform the dependent national bank into an independent central bank and then to control money supply by financial programming. If direct credit of the central bank to the government was forbidden, and money was held short, the government would be forced to avoid fiscal deficits. Missed commodities would return to the official markets. Aggregate demand would be cut by its excess component and fall to the level of potential output. The instruments to that goal were (a) control of money supply (sometimes coupled with a currency reform), and/or (b) high nominal interest rates exceeding the rate of inflation (= high real interest rate), and/or (c) a competitive exchange rate (a fixed exchange rate after a sharp depreciation). The elimination of excess demand would not seriously harm output and employment. A ‘transformational recession’ could be
expected for a period of about 1 year, not exceeding some moderate 5%, due to structural effects of the adjustment of relative prices.

The concept of the ‘Washington Consensus’ was stylised by the so-called ‘J-curve’ of economic transformation. Its’ message was that after a little dip of ‘transformational recession’ growth of income would multiply. These expectations of Washington economic academics were widely share by the people undergoing the transition. The reality however looked very different:

Figure 1: The first 10 years of transition

[Graph showing real GDP growth in the Czech Republic, Hungary, Poland and Russia over the first ten years of economic transition]

Source: Hölscher 2006

Figure 1 shows real GDP growth in the Czech Republic, Hungary, Poland and Russia over the first ten years of economic transition. The figure does not display any curve with a J shape. There is modest growth in Central Europe over the first ten years, with Poland as the frontrunner having achieved about 30 per cent growth in the decade. Russia experienced a sharp recession ending with lasting stagnation at 60 percent of the former socialist level of income. Confronted with these facts, it was no wonder that the Washington Consensus concept was abandoned.

In contrast to the Washington Consensus stabilization concept, the evolutionary-institutional approach linked the problem of price stabilization with the development
of credit and money relations, particularly obeying the effects on real output, employment and income distribution. The development of proper institutions would include: law enforcement, sufficient capacities of the central bank to supervise the banking sector, or well-established corporate governance schemes in the relationship between the financial and non-financial sector of the economy. The proposal would include the protection of some collateral for private households (a flat, or shares of privatised enterprises, or money savings) and small enterprises. Money savings could be protected by the resign from a confiscating currency reform or a ‘corrective inflation’. The inherited monetary overhang should be changed into illiquid assets to be used as collateral for investment credits. The fundamental differences of the two approaches are analysed in depth by Gabrisch/Hölscher (2006) and summarised in table 1 in the appendix.

3. Social consequences of transition

This section will look at the social consequences. The update of the figure one results for 2007 are:

<table>
<thead>
<tr>
<th>Country</th>
<th>GDP in 2007 (1989=100)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Czech Republic</td>
<td>130</td>
</tr>
<tr>
<td>Hungary</td>
<td>134</td>
</tr>
<tr>
<td>Poland</td>
<td>158</td>
</tr>
<tr>
<td>Romania</td>
<td>113</td>
</tr>
<tr>
<td>Russia</td>
<td>93</td>
</tr>
<tr>
<td>Source: EBRD 2008</td>
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</tr>
</tbody>
</table>

The table shows that even after 19 years of economic transition growth rates are modest and income has certainly not multiplied. Despite high oil prices Russia has caught up to the 1989 levels and late comers to the European Union like Romania catch up very slowly.

The perceived impact of economic transition is even worse. A survey ‘Life in Transition’ carried out by the EBRD and the World Bank in 2006 (see EBRD 2007), for which 29000 households in the region were interviewed, shows that in general there are more happy than unhappy people in the region, but on significantly lower levels than in Western Europe and North America, where typically 80 – 90 per cent report themselves as happy or Satisfied. In Eastern Europe this proportion is 50 per cent with the exception of Hungary, where only 30 per cent were satisfied. Levels of unhappiness are particularly high in South East Europe and in parts of the Commonwealth of Independent States (CIS) such as Armenia, Azerbaijan, Georgia and Moldova.

The views on changes in household wealth are even more striking: In all countries a majority of respondents responded that their relative position compared to 1989 had deteriorated, in spite of the growth rates experienced in most of the countries. This is particularly pronounced in South East Europe and the CIS, but also in Latvia and Hungary, despite the fact that statistically increased by more than a half. Albania, which started from very low income levels of a special version of socialism, is the only exception.
To some extent this perception can be explained by rising income inequality in particular in Russia and other CIS countries. There are two different sets of experience in transition from socialism to capitalism as far as income development and income distribution is concerned. At first glance the European countries seem to follow a convergence path well in the range of EU income distribution, although slightly below the German benchmark Lorenz curve. All the three EU accession countries followed a gradual path of increasing inequality. In sharp contrast to the European transition experience Russia stands out as a case of dramatically rising inequality leading to polarisation between lower and top income classes and a hollowing out of the middle classes (see Hölscher 2006). The Lorenz curve below shows the dramatically increasing income distribution over the 1990ies. Even in communist times the level of inequality was higher than in other European socialist countries and it was also higher than in Germany. Also there is a sharp increase in inequality from 1991/1992 to 1995/1996, which went along with declining GDP. Thirdly, the winners are clearly the people in the top deciles. There is a shift from the deciles 1 – 7 up to the top deciles creating the class of the so-called ‘super rich’. The bottom decile received 1.4 % of income (see tables), which is only half the value in the other countries, including the benchmark. This suggests more extensive poverty in
the course of transition in Russia. Also the distance to the 45-degree line for the middle classes has widened indicating a further shift towards the ‘super rich’.

Another factor presumably influencing the perception of the transition experience is public health. A recent study by Stuckler et al. (2009) shows that “Rapid mass privatisation as an economic transition strategy was a crucial determinant of differences in adult mortality trends in post-communist countries”. Protagonists of rapid mass privatisation were Russian and some other CIS countries as opposed to Poland and other European countries. The results are shown in Figure 4.
Source: Stuckler et al. (2009)

The causation chain Stuckler et al. are finding is that rapid mass privatisation leads to high levels of unemployment, which then encouraged an unhealthy lifestyle including high levels of alcohol consumption, which ultimately leads higher mortality rates. The authors interpret their findings as an argument against the Washington consensus approach. Given the social costs this way of transition by rapid mass privatisation turned out to be fatal failure.

Finally it is no surprise that asked about perception about the past, the present and the future against the background of this analysis, that across the region just 30 per cent of the respondents think their household lives better than 1989 and only 40 per cent agree With the statement “all thins considered, I am happy with my life now”. The only good observation is that almost half of the respondents belief that their children will have a better life than they have themselves. This seems to indicate optimism for the future.
4. The impact of the global crisis

The short term impact of the current global economic crisis is the accelerated decline of growth rates from the 2nd half of 2008 onwards turning into negative growth rates during the last quarter of 2008 and outright recession from 2009 onwards. Most transition countries suffered from a dramatic decline of capital inflows and even reversals of former investments. Across the region syndicated landing and bond markets have dried up alongside lower agency ratings for sovereign bonds. Also foreign parents bank have been deleveraging in the order to cope with financial distress in their headquarters. The decline in growth, which reached dimensions of 30 per cent in some countries fed back into the financial sector stress resulting in lower confidence. Huge bailout rescue packages added fiscal capital need in addition to the needs of the private sector.
The transition economies were hit by the global crisis at a moment where the economic environment used to look bright. This changed dramatically, as commodity prices are no longer supportive, in particular oil and gas, but also minerals and even manufactured goods. Also the export markets for transition economies deteriorated sharply. For Europe Germany would be the most important export market, but the business climate there hits an all time low. With Germany in recession at a rate about 3 per cent prospects for East European exporters are gloomy.

Short term prospects for transition economies would lie with the regression of financial development. This will affect the Small and Medium size Enterprise (SME) hardest, which experienced difficulties in accessing finance even in “normal” times. There are also signs of reversals of former large-scale privatisations in order to maintain the employment levels. Foreign direct investment is also falling sharply. Under these circumstances private sector participation in large infrastructure projects as advocated by the EBRD and others will be more difficult. The biggest problem however is that trade liberalisation might be challenged, as new protectionism surges.

These short term problems will add to the already existing long term challenges the transition countries are facing. The biggest challenge is that large gaps in labour productivities between mature Western economies and transition economies are still remaining after 20 years of economic transition.
Figure 6: Distribution of number of firms according to productivities

All firms of the panel ranked in 10 classes according to labour productivity. Class I is the group with the lowest labour productivity levels and class X the highest.

Source: IWH firm-specific database.

Figure three describes the distribution of firms ranked according to their individual levels of labour productivity. The picture is clear: whereas the distribution of German firms comes close to a normal distribution with the highest number of firms in the middle-classes of productivity, the distribution of firms in the Central East Europe-panels of Poland, the Czech Republic, and Hungary show a bias towards firms with lower productivity levels. These are the most advanced transition economies in Europe, which have labour productivities double the size of for example Russia. The non-resource rich MIS countries have levels of labour productivities at the extent of about 10 per cent of for example the United States (EBRD 2008).

Apart from the lack of investment two reasons can be identified for the backwardness of labour productivity in transition countries. First, the level of education measured in PISA scores for enrolment for primary and secondary education lies significantly below the OECD average. Considering that there is a clear relationship between PISA scores and educational expenditure per student the situation is worsened by the fact that expenditure per student in transition countries measured by expenditure on education as percentage of GDP is also lower (EBRD 2008). The effects of the global crisis can be expected to delay the catch-up process.
The second reason for the low level of productivity is the lack of competition (see Hölscher/Stephan 2009). A direct comparison confirms that the effectiveness of antitrust policy is lower in a selection of CEE countries, with levels around 6.0 for Germany as a benchmark in the West and around 4.0 for Poland and slightly more for the Czech Republic and Hungary. The ranking of Germany has even increased in the mid-2000s, further widening the gap between the East and the West. This provides evidence that the implementation of a strong competition policy in post-socialist countries is a process that even may experience steps backward. Possibly, the disciplining effect of the negotiation process in the relevant chapters of the *acquis communautaire* was strongest during negotiations, but lapsed afterwards.

Figure 7: Effectiveness of antitrust policy between 1999 and 2007

![Graph showing effectiveness of antitrust policy](image)

Ranked between 1 and 7, whereas 1 indicates that in the specific country effectiveness is lowest and is highest with 7.

Source: Hölscher/Stephan 2009

Furthermore one would expect that this lesser effectiveness of competition policy enforcement may also result in a lower intensity of competition on markets in CEE. Despite the fact that West and East form an integrated economic area with intense exchange both in terms of trade in goods and services and in terms of Foreign Direct Investment and Joint Ventures, a lower intensity of competition in the East may be the
result of a lesser effectiveness of competition policy. This can be tested empirically by use of the World Economic Forum indicator of Intensity of (local) Competition.

Figure 8: Intensity of local competition between 1999 and 2007

![Intensity of local competition between 1999 and 2007](image)

Ranked between 1 and 7, whereas 1 indicates that in the specific country intensity is lowest and highest with 7. The bars for 2001 do not directly compare with other years due to a change in method.

Source: Hölscher/Stephan 2009

Here, differences between East and West are not as pronounced as for antitrust effectiveness. Still, a clear picture emerges: the intensities of local competition are lower in even the most advanced transition economies and new EU member states in CEE. In 2007, they reach a level of around 4.7 and 5.7, whereas our West European benchmark reaches a level around 6.3. Admittedly, West European countries like Greece (4.8) and Portugal (4.9) are closer to transition countries, but never-the-less, we may conclude that not only competition policy is less developed and less effective in CEE transition economies, also the intensities of competition are lower.

In terms of the development of indicators over time, one again observes that intensities of competition tend to increase in Germany, whereas the trend is more

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2 In 2001, the questionnaire was slightly different: whilst in the other years, experts and practitioners had been asked for the “intensity in the local market”, in 2001, the question was reworded to “In most industries”. Because this change applied to all countries alike, we can still compare across countries in 2001, but across time, we have to exclude the 2001-results.
erratic in CEE which may well be a result of privatisation programmes in the early phase and usual fluctuations of foreign direct investment inflows. Again, we observe a widening of the gap in competitiveness between the ‘old’ member of the EU and Poland as well as Hungary, whereas the Czech Republic appears to catch up. This picture is even more dramatic, if Russia and other CIS countries are included.

In a snapshot this paper looks at the Russia, the biggest economy under review. In proportion to its size the Russian economy was hit harder by the global economic crisis than for example the United States, if measured in stock market decline. In addition Russia suffers particularly from the decline of energy and commodity prices. The first retail chain, which comprised 190 shops in the Moscow region, went bankrupt in May 2008; other retailers received access to government-backed financing. One of the biggest construction sites of the world, supposed to build an international business centre, the Moscow Tower, stands still. Government responses to the financial sector depleted huge sums of foreign reserves, which were accumulated in past times of high oil prices. With 15 per cent inflation and the Rouble sliding by a rate of 40 percent over the last six months, Russia is on the brink of economic collapse, which would have worldwide repercussions.

Before drawing some conclusions this paper will return to Europe, where the fist economic collapses happened last year. The first country European (and European Union member) country to approach the IMF for help in the global crisis was Hungary. Hungary was bailed out by the IMF with 12 billion Euros and further support by the EU. Its debts amount to 97 per cent of GDP and the IMF dependency imposes strict fiscal conditions on the economy. The unhappiness of the Hungarian populations described earlier in this paper seems to have anticipated this “Goulash meltdown”. Latvia followed suit and there are negotiations with the IMF are going on with Belarus and the Ukraine at present. Further candidates are to come.

3 The first sovereign default in the current global crisis was Iceland.
5. Conclusions

In light of the current global economic crisis the whole process of economic transition appears to be a failure. This however could be stated for almost the whole world. As the nature of the current crisis is of global character, one should not expect the transition countries to solve the problems by themselves. Specific aspects with regards to the transition economies are facing domestic challenges. Like in mature capitalist countries these countries need to attempt to protect their core financial systems by improving its governance and structure. A major challenge will be to maintain access to finance for the growth driving SME sector. The overriding problem will be the fiscal constraint, which was restricting growth in the past and is now leading the region into deeper recession than the rest of the world. Intelligent industrial policy is required in time of a shrinking private sector and a constraint government budget.

Finally it should be emphasized that there were different paths of transition. Overall Eastern Europe fared better with its more managed approach than Russia and the other CIS states. Also EU membership has made a significant contribution. Also the dissatisfaction of many people in the region could be caused by simply to high expectations. Even Western economists seem to have forgotten that capitalism develops in swings of business cycles. What seems clear is that even after 20 years transition is not over, in fact the current crisis of global capitalism is the intellectual challenge for thought on formation of human societies. On this Meta level diversity in time and space is to be expected. With the benefit of hindsight it is also clear that experiments in the spirit of the Washington consensus were extremely expensive in terms of social costs. This will clearly be a lesson for other emerging market economies.
References:


Appendix:

Table 1: Fundamental differences between the two concepts

<table>
<thead>
<tr>
<th>Images</th>
<th>‘WASHINGTON CONSENSUS’</th>
<th>EVOLUTIONARY-INSTITUTIONAL APPROACH</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>‘Get over a deep river by one leap’: Shock-like liberalisation, macroeconomic stabilisation and downsizing the state</td>
<td>‘Build a bridge between both banks of the river’: Gradual and sequenced actions including institution building, competition, support for private business, solving the corporate governance problem</td>
</tr>
<tr>
<td>Initial conditions</td>
<td>The heritage is a burden and represents ‘old’ and inefficient connections, more nomenclature than market; choose the first best 'socially engineered' solution that is not ‘distorted’ by the initial condition</td>
<td>The heritage has a value that should be protected; otherwise the destruction of the society’s social capital mutates the nomenclature into mafia</td>
</tr>
<tr>
<td>Attitude towards state-owned enterprises</td>
<td>Privatise quickly in order to avoid asset stripping and rent-seeking; close down inefficient enterprises</td>
<td>Gradual downsizing relying on the development of the private sector</td>
</tr>
<tr>
<td>Prices</td>
<td>Flexible prices on free markets lead to efficiency and growth; they signal expectations and ensure rational behaviour</td>
<td>Institutions ensure stable expectations, and prices are only one institutions among others; flexible prices are unfair during transformation</td>
</tr>
<tr>
<td>Macroeconomic policy</td>
<td>Price stabilisation through control of money supply, cut government expenditure, introduce nominal wage and exchange rate anchors</td>
<td>Output stabilisation; hence control for real economy effects of stabilisation, above all unemployment</td>
</tr>
<tr>
<td>The leading question</td>
<td>How to rationalise actions of individual agents = producers and consumers</td>
<td>How human beings gain control over their lives by developing a structure to order their relationship to the environment (North 2003)</td>
</tr>
<tr>
<td>Predictability</td>
<td>With rationalised behaviour and under given legal environment = results of individual actions are predictable as well as the result of transformation</td>
<td>With free entry and exit of markets and technological progress the institutional environment changes, and results of individual and collective actions are not predictable as well as the result of transformation</td>
</tr>
<tr>
<td>Transactions in a market economy</td>
<td>Only market transactions are efficient</td>
<td>Market and non-market transactions contribute to efficiency, don’t neglect social relations including corporate governance</td>
</tr>
<tr>
<td>Property rights</td>
<td>Physical ownership of assets</td>
<td>Ownership + right to contract + control of contract fulfilment</td>
</tr>
<tr>
<td>State and government</td>
<td>Minimal state; downsize the state in its share in GDP and in employment</td>
<td>Reform the state and use it for law enforcement and securing property rights; pro-poor and crisis prevention policy in order to support the middle classes</td>
</tr>
</tbody>
</table>