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Twenty Years of Economic Transition: Successes and Failures[1]

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Abstract: This study takes stock of 20 years of economic transition amidst a global economic crisis. The period from the fall of the Berlin wall up to the present day is reviewed to identify successes and failures. In general**,** the high hopes and expectations at the beginning of the system transformation have been disappointed. There has been some progress in Central and Eastern Europe; this stands in stark contrast to the social costs incurred by rapid mass privatization in countries of the former Soviet Union. In addition, the Washington consensus is found to be flawed and partly responsible for the failures. With economic theory in self-consideration, the transition countries call for an institutionalist approach that includes historical time.

Keywords: transition, economic systems

JEL Classification Numbers: p20, p51, f02

1. Introduction

This study takes stock of twenty years' experience of economic transition and attempts to identify successes and failures with regard to both theory and policy. The study is motivated by the prospect of lessons to be learned for the future, not only for transition countries but also for emerging markets in general. In the current global economic crisis, policies might even be relevant to mature capitalist societies.

From an analytical point of view, the current global crisis makes it easier to identify shortcomings of a transition. As a general observation, the slowdown in growth is accelerating with sharp adjustments and even collapses in some countries. Although transition as such has progressed over the last twenty years, a general slowdown is unavoidable and reversals are in fact 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 investment in education. As is the case in mature capitalist countries, increased government intervention is unavoidable, although sector-specific industrial policies are risky.

This study examines concepts of transition with the benefit of hindsight. Since there is widespread agreement now that the original concept of the Washington Consensus has failed to fulfill expectations of growth and development, a state of confusion seems to be prevalent (Rodrik 2006). Section 2 discusses theoretical approaches and confronts them with some observations. Section 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. The economies of Russia and Hungary are also examined briefly. Finally, conclusions are presented.

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 among the Washington based institutions including the IMF and World Bank and a number of American 'think tanks' aiming at solving 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—not a promising basis for transformation. These imbalances were explained as being a combination of price controls and invisible and visible fiscal deficits, financed by a national bank printing money and serving as a government agency. The result was the disappearance of commodities from official markets and their trading on black markets at uncontrolled higher prices. It was thought that the lifting of price controls without the abolition of the causes of imbalances might lead instead to hyperinflation and make the free price system ineffective.

The policy recommendations were as follows:

First: Fiscal discipline, implying the redirection of public expenditure prioritizing 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 as follows:

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 summarized by the definition: Economic transition equals privatization, liberalization, and stabilization.

The starting point for macroeconomic policy was the transformation of a dependent national bank into an independent central bank, followed by control of the money supply by financial programming. If direct credit from the central bank to the government was forbidden, and money was held short, the government would be forced to avoid fiscal deficits. Missing 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 employed to attain that goal were as follows:

(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

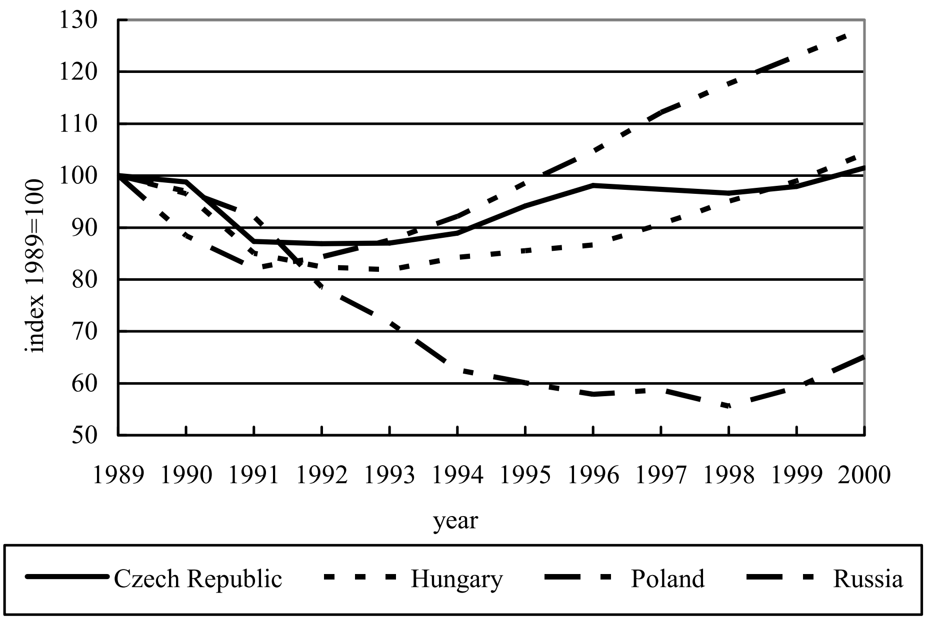
(c) A competitive exchange rate (a fixed exchange rate after a sharp depreciation).

The elimination of excess demand would not seriously harm output and employment. A 'transformational recession' not exceeding a moderate five per cent might be expected for a period of about one year, resulting from structural effects of the adjustment of relative prices.

The concept of the Washington Consensus was depicted by the so-called 'J-curve' of economic transformation. Its message was that after a slight dip of 'transformational recession', growth of income would multiply. These expectations of Washington economics academics were widely shared by the people undergoing the transition. The reality, however, looked very different.

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 per cent of the former socialist level of income. Confronted with these facts, it is no wonder that the Washington Consensus concept was abandoned.

Figure 1 The first 10 years of transition



Source: Hölscher (2006)

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, in particular taking into account the effects on real output, employment, and income distribution. The development of proper institutions would include: law enforcement, sufficient capabilities of the central bank to supervise the banking sector, or well-established corporate governance schemes in relationship with the financial and non-financial sector of the economy. The proposal would include the protection of some collateral for private households (e.g. a flat, or shares in privatized enterprises, or money savings) and for small enterprises. Money savings could be protected by withdrawal from a confiscating currency reform or a 'corrective inflation'. The inherited monetary overhang would be changed into illiquid assets to be used as collateral for investment credits. The fundamental differences of the two approaches are analysed policies might even be in depth by Gabrisch/Hölscher (2006) and summarized in Table 1 in the appendix.

3. Social consequences of transition

This section looks at the social consequences. The updated results for 2007 in Figure 1 are as follows:

Country	GDP in 2007 (1989=100)
Czech Republic	130
Hungary	134
Poland	158
Romania	113
Russia	93

Source: EBRD (2008)

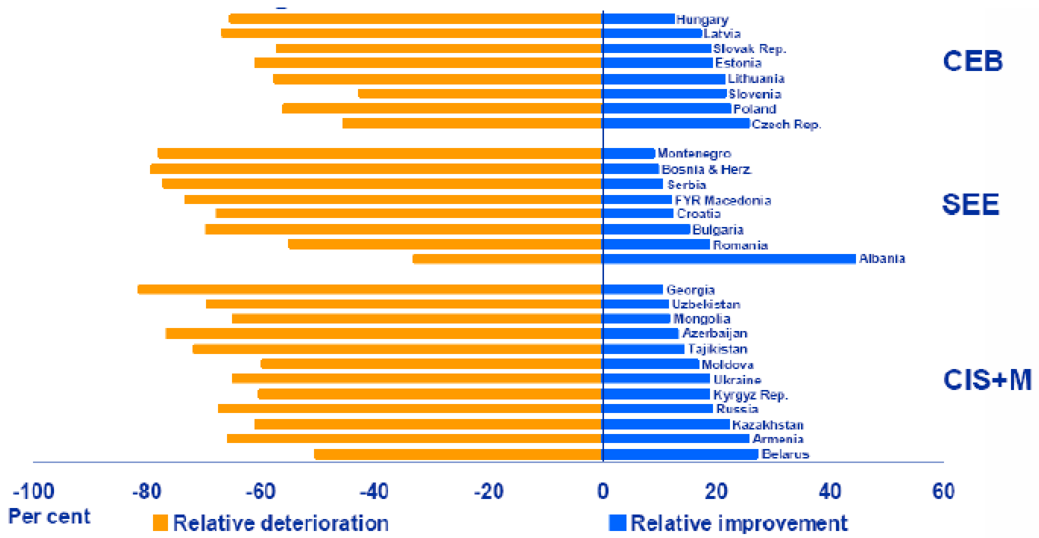
The table shows that even after 19 years of economic transition, growth rates are modest and income has certainly not multiplied. Despite high oil prices Russia has caught up to the 1989 levels, and late comers to the EU, for example Romania, are catching up very slowly.

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 b), for which 29,000 households in the region of central East Europe and the former soviet Union were interviewed, shows that in general there are more happy than unhappy people in the region, but at 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 are satisfied. Levels of unhappiness are particularly high in Southeast 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 reported 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 Southeast Europe and the CIS, but also in Latvia and Hungary, despite a statistical growth increase of more than 50 per cent. Albania, which started from the very low income levels of a special version of socialism, is the only exception.

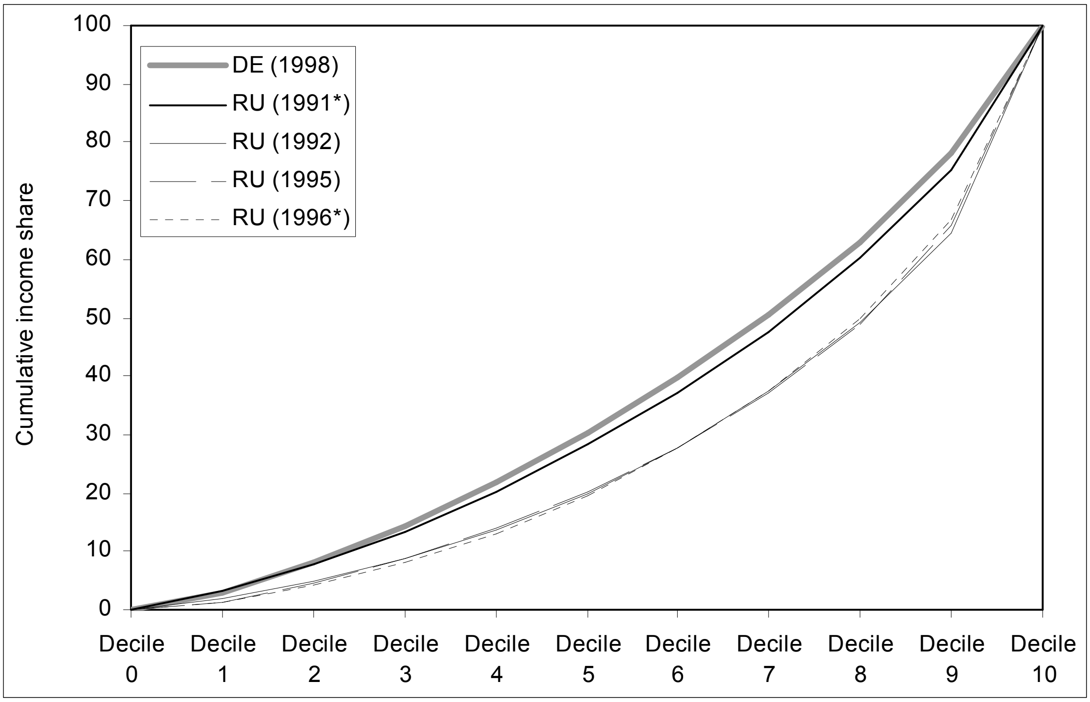
Figure 2 Views on changes in household Wealth



Source: EBRD (2007 a)

To some extent this perception can be explained by increased inequality of income, 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 are concerned. At first glance the European countries seem to follow a convergence path well within 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 that has led to polarization 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 1990s. Even in communist times the level of inequality was higher than in other European socialist countries and it was also higher than in Germany. There is a sharp increase in inequality from 1991/1992 to 1995/1996, which went along with declining GDP. In addition, 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 a class of so-called 'super rich'. The bottom decile received 1.4 per cent of income (see tables)—only half the value pertaining in the other countries, including the benchmark. This suggests more extensive poverty in the course of transition in Russia. Furthermore, the distance to the 45-degree line for the middle classes has increased, indicating a further shift towards the 'super rich'.

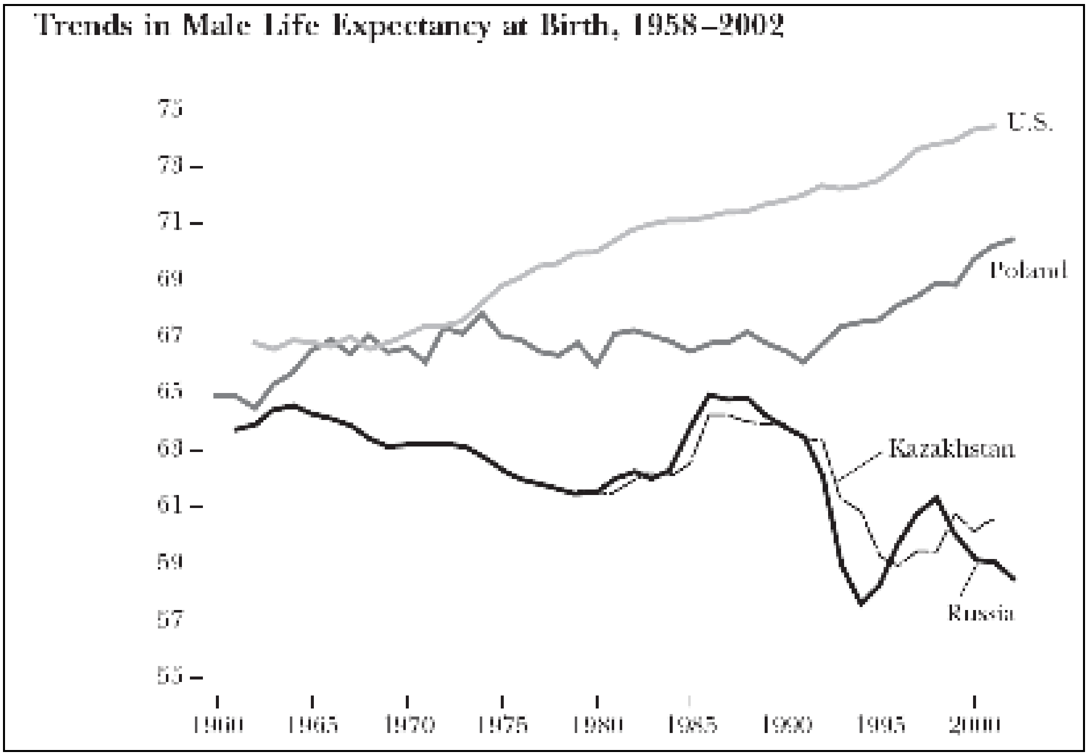
Figure 3 Personal income distribution, Russia 1991, 1992, 1995 and 1996



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 privatization as an economic transition strategy was a crucial determinant of differences in adult mortality trends in post-communist countries'. Protagonists of rapid mass privatization were Russia and some other CIS countries, as opposed to Poland and other European countries. The results are shown in Figure 4.

The causation chain found by Stuckler et al. suggests that rapid mass privatization leads to high levels of unemployment, which then encourage an unhealthy lifestyle including high levels of alcohol consumption, ultimately leading to higher mortality rates. The authors interpret their findings as an argument against the Washington Consensus approach. Given the social costs, this method of transition by rapid mass privatization has turned out to be a fatal failure.

Figure 4 Social Costs



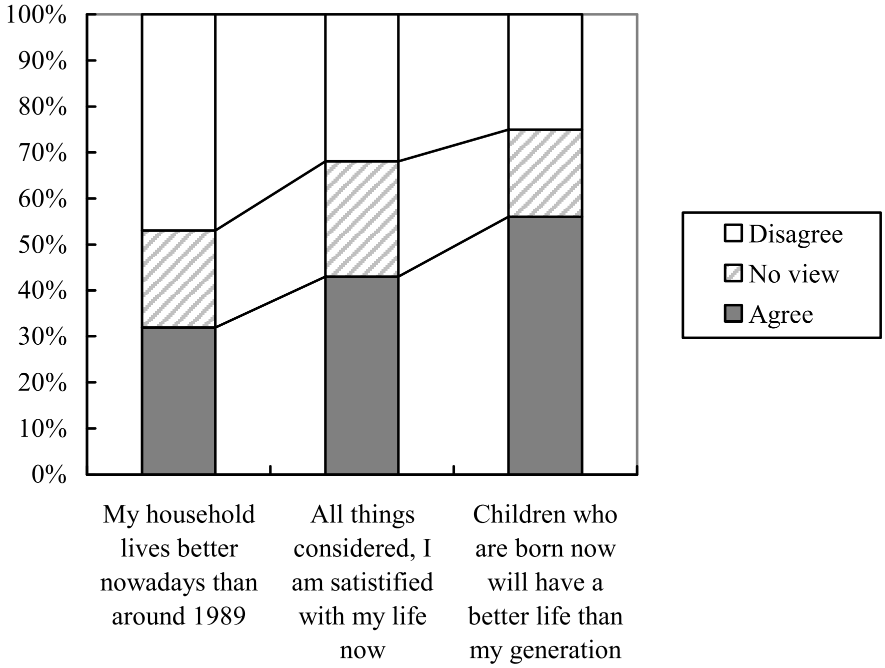
Source: Stuckler et al. (2009)

Finally, it is no surprise that when asked about perceptions of the past, present and future against the background of this analysis, across the region only 30 per cent of the respondents think their household is better off than in 1989 and only 40 per cent agree with the statement that 'All things considered, I am happy with my life now'. The only positive finding is that almost half of the respondents believe that their children will have a better life than they themselves have. 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 second 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 lending and bond markets have dried up in parallel with lower agency ratings for sovereign bonds. In addition, foreign parent banks have been deleveraging in order to cope with financial distress in their headquarters. The decline in growth, which reached 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.

Figure 5 Overall satisfaction in past, presence and future



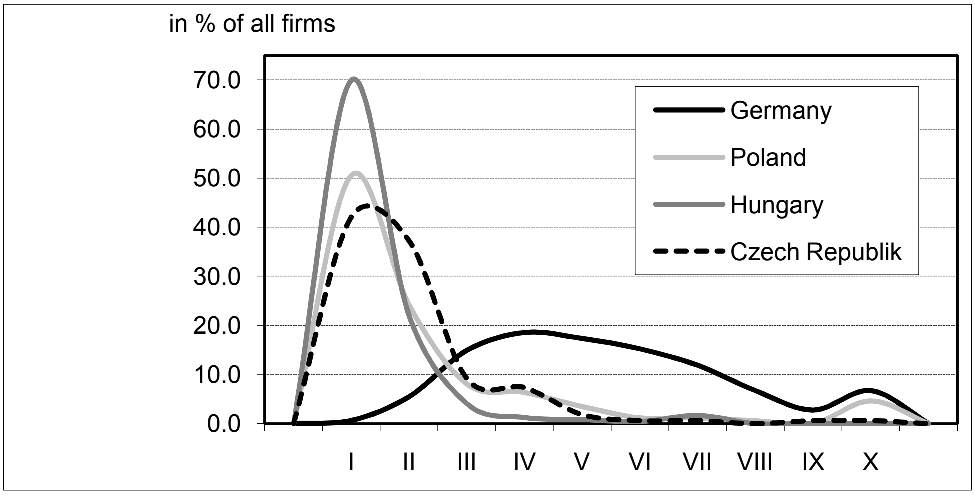
Source: EBRD (2007 b)

The transition economies were hit by the global crisis at a moment when the economic environment had been looking bright. This changed dramatically, as commodity prices were no longer supportive—not only oil and gas but also minerals and manufactured goods. Export markets for transition economies also deteriorated sharply. For Europe, Germany ought to be the most important export market, but the business climate there has hit an all time low. With Germany in recession at a rate of about three per cent, prospects for East European exporters are gloomy.

Short term prospects for transition economies are impacted by the regression of financial development. This has the hardest effect on the Small and Medium-sized Enterprises (SME), which experienced difficulties in accessing finance even in 'normal' times. There are also signs of reversals of former large-scale privatizations in order to maintain employment levels. In addition, foreign direct investments are declining 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 liberalization might be challenged, as new protectionism surges.

These short term problems will add to the existing long term challenges faced by the transition countries. The biggest challenge is that large gaps in labour productivities between mature Western economies and transition economies still exist after 20 years of economic transition.

Figure 6 Distribution of number of firms according to productivities



Note: 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.

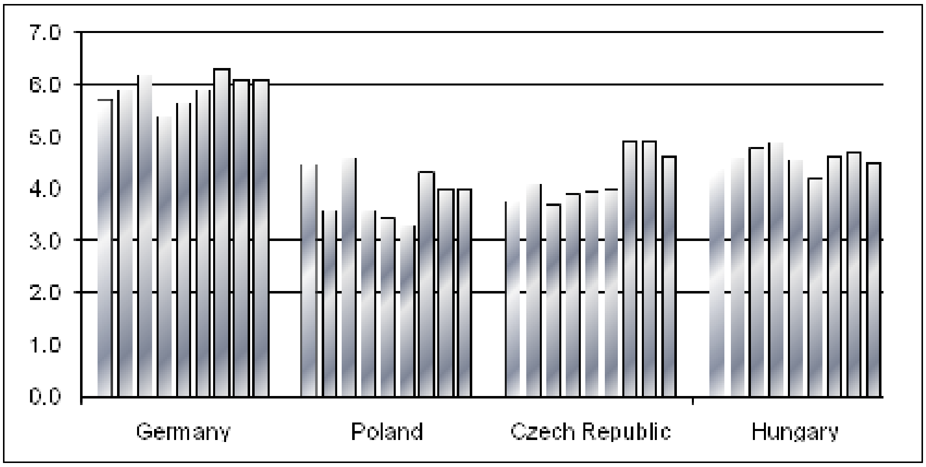
Source: IWH firm-specific database.

Figure 6 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 range of productivity, the distribution of firms in Central East Europe—Poland, the Czech Republic, and Hungary—show a tendency towards firms with lower productivity levels. These are the most advanced transition economies in Europe; for example, they have labour productivities double the size of Russia. The non-resource-rich MIS countries have labour productivity levels of about ten per cent of, for instance, the US (EBRD 2008).

Aside 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 Program for International Student Achievement (PISA) scores for enrolment policies in primary and secondary education lies significantly below the Organisation for Economic Co-operation and Development (OECD) average. There is a clear relationship between PISA scores and educational expenditure per student, and the situation is worsened by the fact that expenditure per student in transition countries—measured by expenditure on education as a 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 productivity levels around 6.0 for Germany as a benchmark in the West, around 4.0 for Poland, and slightly more for the Czech Republic and Hungary. The ranking of Germany has actually increased in the mid-2000s, further widening the gap between East and West. This provides evidence that the implementation of a strong competition policy in post-socialist countries is a process that might even experience regression. It is possible that the restraining effect of the negotiation process in the relevant chapters of the *acquis communautaire* was strongest during negotiations, but lapsed afterwards.

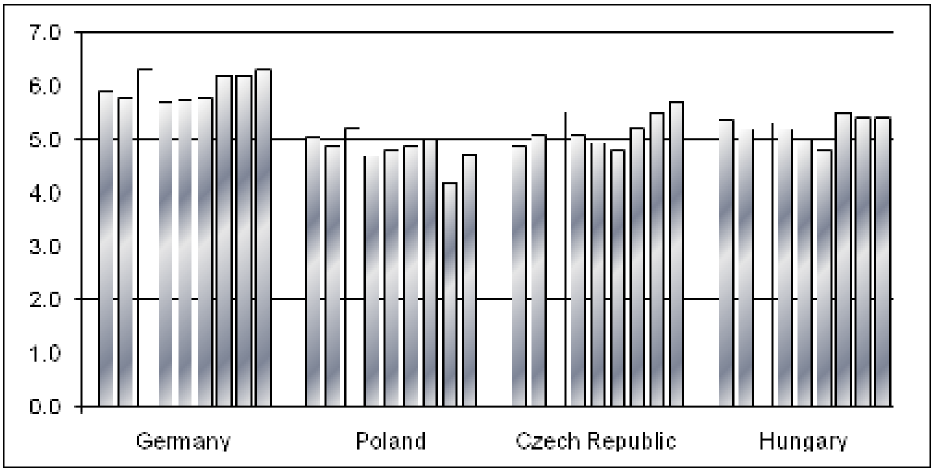
Figure 7 Effectiveness of antitrust policy between 1999 and 2007



Note: 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, this less effective competition policy enforcement might also be expected to result in a lower intensity of competition among 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 could be the result of a less effective competition policy. This can be tested empirically using the World Economic Forum indicator of intensity of (local) competition.

Figure 8 Intensity of local competition between 1999 and 2007



Note: 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 reached a level of around 4.7 and 5.7, whereas our West European benchmark reaches a level around 6.3. Admittedly, West European countries, for example Greece (4.8) and Portugal (4.9), are closer to transition countries, but nevertheless, we can conclude that not only is competition policy less developed and less effective in CEE transition economies, but also the intensities of competition are lower.

In terms of the development of indicators over time[2], again it is apparent that intensities of competition tend to increase in Germany, whereas the trend is more erratic in CEE, which may well be a result of privatization programmes in the early phase and normal fluctuations of foreign direct investment inflows. Again, we observe a widening of the gap in competitiveness between the 'old' members of the EU, for example like Poland and Hungary, whereas the Czech Republic seems to be catching up. This picture is even more dramatic if Russia and other CIS countries are included.

This paper looks at a snapshot of 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 US, if measured in stock market decline. In addition, Russia particularly suffers 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 in the world—the Moscow Tower—meant to house an international business centre, stands idle. Government response to the financial sector crisis depleted huge sums of foreign reserves, accumulated in a previous era of high oil prices. With 15 per cent inflation and the rouble dropping 40 per cent over the last six months, Russia is on the brink of economic collapse, which would have worldwide repercussions.

Before drawing any conclusions, this paper will focus once again on Europe, where the first economic collapses occurred last year[2]. The first European country (and EU member) to approach the IMF for help during the global crisis was Hungary. Hungary was bailed out by the IMF with 12 billion euros and further support by the EU. Its debts amounted to 97 per cent of GDP, and the IMF dependency imposed strict fiscal conditions on the economy. The unhappiness of the Hungarian population described earlier in this paper seems to have anticipated this 'Goulash Meltdown'. Latvia followed suit and negotiations with the IMF are going on with Belarus and the Ukraine at present. More countries are expected to follow suit.

5. Conclusions

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

Finally it should be emphasized that there have been different paths of transition. Overall, Eastern Europe fared better with its more managed approach than did Russia and the other CIS states. EU membership also made a significant contribution. The dissatisfaction of many people in the region could be caused by simply having too high expectations. Even Western economists seem to have forgotten that capitalism develops in fluctuations 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 in thinking about formation of human societies. On this meta level, diversity of 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. Clearly, this will be a lesson for other emerging market economies.

Notes

[1] Prepared for conferences at the EU Institute of Japan, Hitotsubashi University, Tokyo and the Institute of Economic Research, Kyoto University (KIER) in February 2009.
[2] In 2001, the questionnaire was slightly different: although in the other years, experts and practitioners had been asked for the intensity 'in the local market', the question was reworded in 2001 to 'in most industries'. Because this change applied equally to all countries, we can still compare across countries in 2001, but across time, we have to exclude the 2001 results.
[3] The first sovereign default in the current global crisis was Iceland.

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Appendix

Table 1 Fundamental differences between the two concepts

	'Washington Consensus'	**EVOLUTIONOARY-INSTITUTIONAL APPROACH**
Images	'Get over a deep river by one leap': Shock-like liberalisation, macroeconomic stabilisation and downsizing the state	'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
Initial conditions	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	The heritage has a value that should be protected; otherwise the destruction of the society's social capital mutates the nomenclature into mafia
Attitude towards state-owned enterprises	Privatise quickly in order to avoid asset stripping and rent-seeking; close down inefficient enterprises	Gradual downsizing relying on the development of the private sector
Prices	Flexible prices on free markets lead to efficiency and growth; they signal expectations and ensure rational behaviour	Institutions ensure stable expectations, and prices are only one institutions among others; flexible prices are unfair during transformation
Macro economic policy	Price stabilisation through control money supply, cut government expenditure, introduce nominal wage and exchange rate anchors	Output stabilisation; hence control for real economy effects of stabilisation, above all unemployment
The leading question	How to rationalise actions of individual agents = producers and consumers	How human beings gain control over their lives by developing a structure to order their relationship to the environment (North 2003)

Predictability	With rationalised behaviour and under given legal environment = results of individual actions are predictable as well as the result of transformation	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
Transactions in a market economy	Only market transactions are efficient	Market and non-market transactions contribute to efficiency, don't neglect social relations including corporate governance
Property rights	Physical ownership of assets	Ownership + right to contract + control of contract fulfilment
State and government	Minimal state; downsize the state in its share in GDP and in employment	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