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Transition from plan to market – a PIE analysis – 2011

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Niels Mygind, CIBEM/CBS, March 2011

Abstract

This paper gives an overview over how far transition has proceeded and what is still lacking in the process. The analytical framework – the PIE model for Politics, Institutions, Economy – is introduced. The model is first used to point to the main reasons for the fall of the command economy. Then it is used to identify the barriers for transition of the institutional system and the restructuring of the economy. This includes an analysis of the different factors behind the steep fall in production in the first years of transition. It is shown that countries implementing a tough stabilization and a comprehensive and consequent liberalization have been most successful in the process. A fast and comprehensive privatization, on the other hand, has not been sufficient for the necessary restructuring of enterprises. Decisive for success in transition has been transformation of the state as a crucial part of the development of new political and economic institutions implementing well functioning, clear and stable rules of the game for private enterprises. The institutional development has been important for the attractiveness of foreign investments - important for restructuring enterprises as part of a positive circle for the transition process.

1. Introduction - some key questions

The transition in Eastern Europe (including the former Soviet Union) has been much more difficult than expected both by experts and the population. Why has transition been so difficult? Why did production fall steeply in the first years of the transition process? These questions will be answered in the following. It will be shown that countries implementing a tough stabilization and a comprehensive and consequent liberalization have been most successful in the process. A fast and comprehensive privatization, on the other hand, has not been sufficient for the necessary restructuring of enterprises. Decisive for success in transition has been transformation of the state as a crucial part of the development of new market institutions implementing well functioning, clear and stable rules of the game for the private enterprises. Building up the new structure of institutions is still in process in all transition economies, but there are huge differences in the stages of development. The front-runners are: The Czech Republic, Estonia, Hungary and Poland closely followed by Latvia, Lithuania and Slovakia. The institutional development has been important for the attractiveness of foreign investments and these FDI have been important for restructuring enterprises as part of a positive circle for the transition process.

This paper gives an overview over how far transition has proceeded and what is still lacking in the process. First the PIE-framework is shortly introduced. Then the barriers for transition will be identified. This includes an analysis of the different factors behind the steep fall in production in the first years of transition. Then, a short discussion follows of the necessary policies of stabilization, liberalization and privatization. The effect of the current financial crisis on the countries in transition is analyzed. The importance of a well functioning state will be emphasized and it will be explained how international cooperation and FDI have had great impact on the development in some of the frontrunner countries.

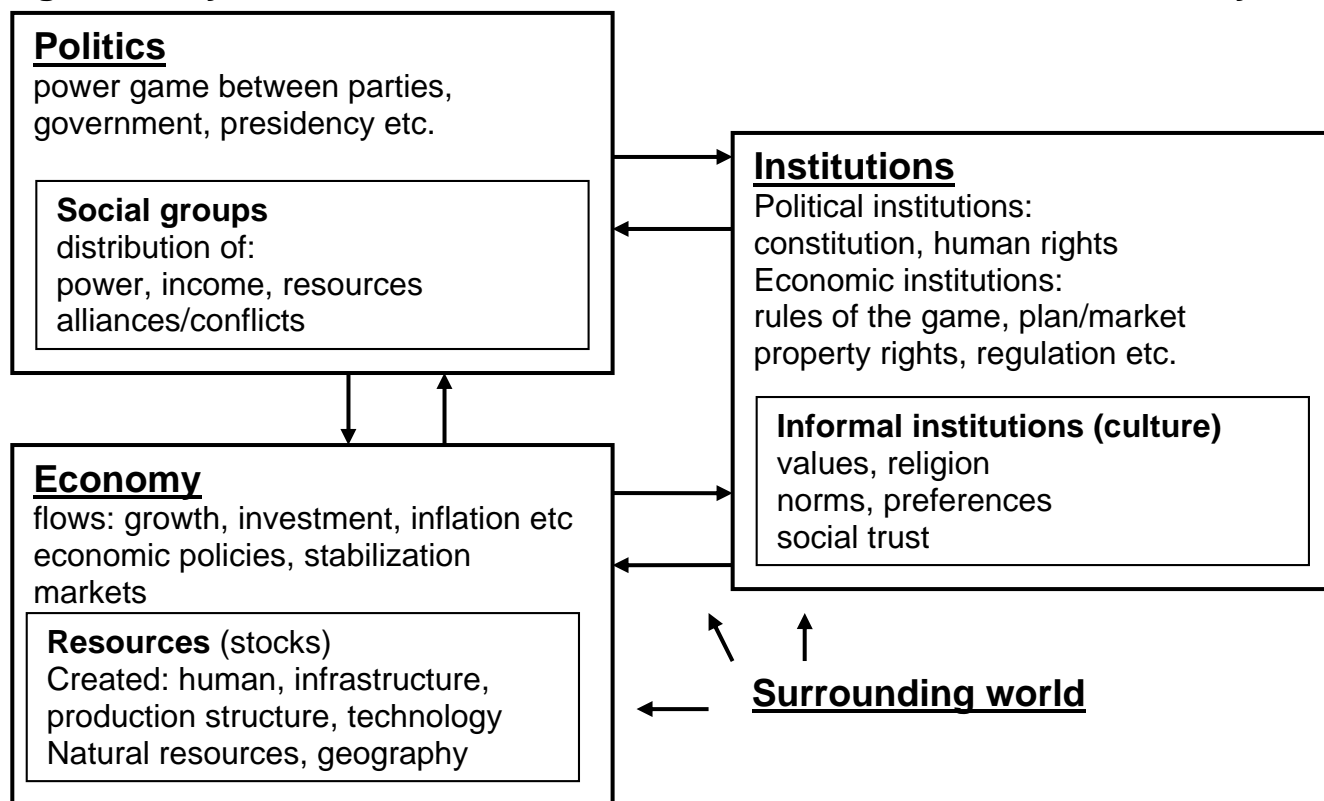
2. The PIE model: *Politics – Institutions – Economy*

This model has been developed as a simple model for dynamic analysis of societal change and to describe the business environment in a given society (see Mygind 2007) – It has also been used as an analytical tool for analyzing the growth prospects in China (Mygind 2008).

Human beings devise institutions as constraints on human behavior to shape human interaction (North 1990). The political and economic institutions of a society define the rules of the game for its citizens. In recent years, it has been widely recognized that high institutional quality is a main driver for growth and high per capita GDP (IMF 2005, Porter and Schwab 2008). This is the reason why *institutions* – both formal and informal – are included as a main box in the model of society given below (see Mygind, 2007 for further details). The *political institutions* define the rules for how the political system functions through the constitution. The *economic institutions* set the framework for the rules of the game in the economy. The *informal institutions* in the culture set unwritten rules both for politics and for the economy. The change of formal institutions is done through the political process – thus, arrows point in both directions between *politics* and *institutions*.

The political process is based on the distribution of power, income, and resources to the citizens. Citizens can be divided into different *social groups* in relation to this distribution. Different cultures can also play a role e.g. in relation to different ethnic or religious groupings so there is also a connection between informal institutions and social groups.

Figure 1 – Dynamics of the PIE-Model: Politics – Institutions – Economy



The economy is divided in two parts: flow variables, such as GDP, investments, consumption, inflation etc.; and stock variables, such as human resources (i.e. size and quality of the workforce), capital equipment in the production structure, technological quality of this capital, infrastructure, natural resources and geography. The economy is strongly influenced both by the economic institutions and by the decisions for economic policy determined in the political process. At the same time, the economy lays the foundation for distribution between different social groups. The level of development in the economy also feeds back to the development of institutions. Therefore, Figure 1 includes arrows in both directions between the economy and the boxes of politics and institutions.

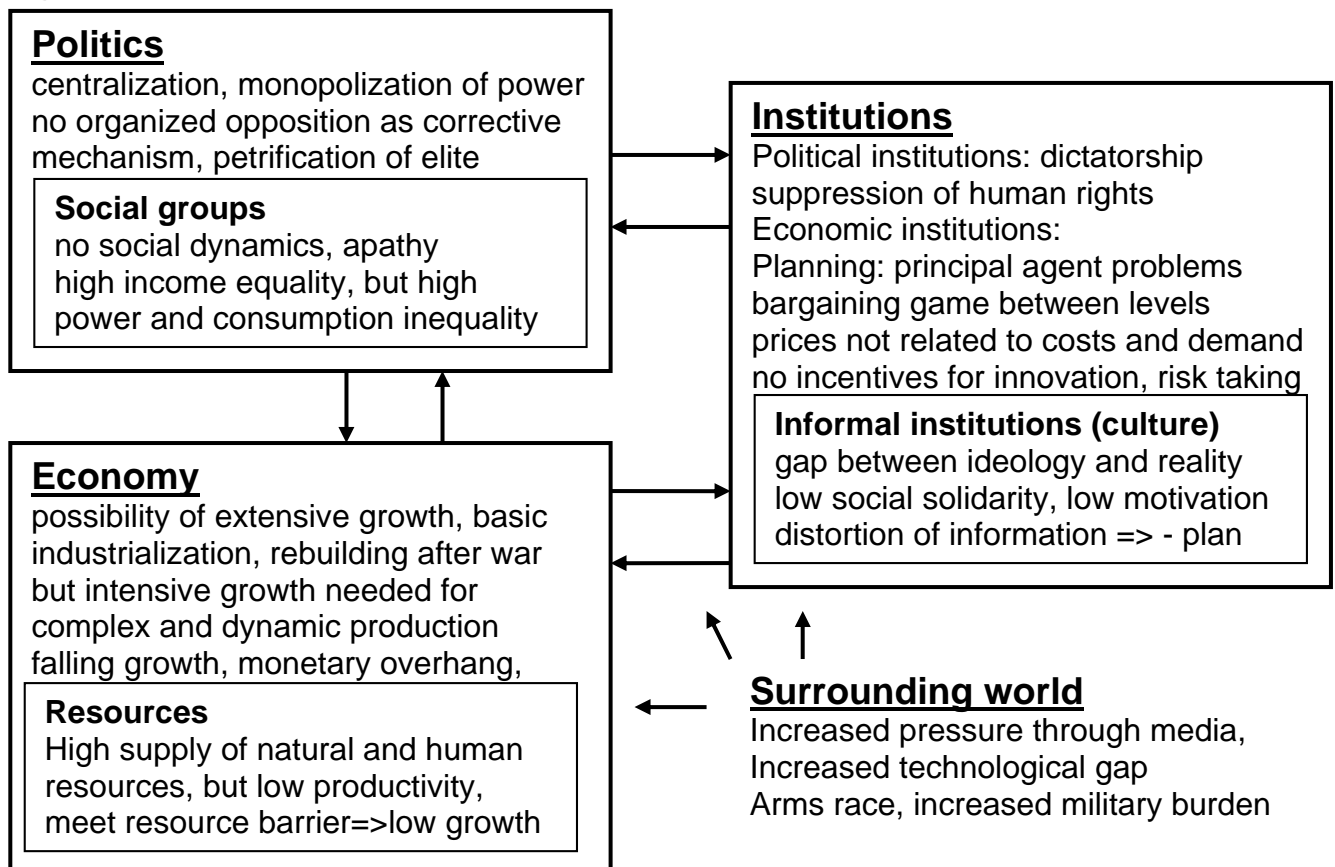
Finally, it is important to include the influence from the surrounding world on all three boxes: International coercion and alliances influence politics. International pressure, benchmarks, and supervision influence institutions. International interaction through trade, FDI, and other types of economic cooperation strongly influences the economy.

The different links in the model have different weights depending on the specific analysis, as exemplified in the following section.

2. Background – why did the command economies break down?

We can make a short analysis of the break down of the command economies by using the PIE-framework (for a deeper analysis, see Mygind 1994 ch. 5):

Figure 2 – Factors behind the break down of the command economy



The core of the problem is to be found in the institutional system. Decision-making were centralized in the planning-bureaucracy which send directives to the enterprises. In the ideal model these decisions would be based on detailed and correct information from the enterprises. The plan would reflect this information and the preferences of the customers, and finally the firms would in a loyal way follow the directives from the center. However, the reality turned out to be completely different. The information flow was distorted first of all because enterprises when reporting to the top had an interest to exaggerate their need of inputs and underscore their production possibilities. In this way they would get an easy plan for the next period. There were conflicting interest not only between enterprises and planners, but also within different sectors and ministries – so the whole process is a classical principal-agent situation with asymmetric information. It was a negotiation game based on distorted information and conflicts of interests. It may be argued that for simple choices in relation to the basic industrialization process – such as building up the electrification of the Soviet Union – the system functioned to some extent. However, in the dynamic and complex economy of the 1970es and 1980es – this kind of central planning with conflicting interests between different levels had increasing problems.

The problems were intensified because of the rigid political institutions where the communist party had the monopoly of power. In this dictatorship there was no organized opposition and no critical press who could point to the deficiencies in the system, criticize abuse of power and corruption and suggest alternatives to improve the institutions. Thus, the system lacked effective corrective mechanisms and lost its dynamics. There was no drive from the political system for institutional change. Attempt of reforms were in the Soviet Union stopped within the system and the same happened in most of the Soviet controlled East European countries in some cases after direct military intervention from the Soviet Union like in Hungary 1956 or Czechoslovakia in 1968. An important exception was the former Yugoslavia where especially the northern parts – now Slovenia and Croatia – introduced reforms with market orientation already from the 1960es.

In spite of hard suppression many basic cultural element e.g. connected to religion survived in the informal institutions. The strong Catholic Churches in Poland and Lithuania are good examples. The communist party tried to develop a new culture – to create the communist man. But instead there was an increasing gap between the official ideology about solidarity, social consciousness, and equality and the reality of people working for their own individual interest and the actual inequality between the elite of leaders with power and high consumption possibilities and the broad group of people without influence and personal freedom and relatively low material standard of living.

Citizens in East Germany could contrast their substandard living conditions with relatives in West Germany, and Estonians who before the Soviet Occupation had a standard of living higher than their Finnish counterpart could see their level falling much behind the prosperous northern neighbor. This kind of benchmarking was part of the pressure from the surrounding world which was part of the social background for the break down of the command economies. IT-technology and new mass media decreased the possibility for censoring information from the rest of the world. At the same time there was a military competition in the cold war which forced the Soviet

camp to use a huge proportion of their scarce resources for rearmament. The best quality of goods, researchers, workers etc. went into military production and increasingly starved the rest of the economy. The economic problems meant that even the conservative parts of the party connected to the military and the military-industrial complex had to face the need for some deeper institutional change – and thus, their resistance against reforms was weakened.

The pressure from the outside world explains part of the timing for the fall of the command system. However, another factor connected to the economy must be emphasized. The command economy could to some extent work in a world of simple technological and economic choices like the basic industrialization process in the 1930es (Do not take this as a defense of Stalin's brutal collectivization of the Soviet agriculture which caused millions of lives) and the fast rebuilding of Soviet after the second world war. It was possible to make *extensive growth* where free resources of labor were moved from unemployment or low productive agriculture to industry. The plan could handle building one power station, then ten and then hundreds and electrify the country. In this way the plan could mobilize the resources not only of labor, but also of raw materials in the world's most resource rich country. However, the extensive growth started to meet its limits in the 1960es and this explains the lower growth rates in the 1970es and the stagnation in the 1980es. The marginal cost of extracting an extra barrel of oil or an extra ton of metal increased. Also, most of the labor reserve was employed – agriculture made up a smaller proportion of the population and most women were employed. The increase in productivity could not be based on adding more resources to industry. The only way was to use the existing resources more effectively – that is through *intensive growth*. However, this type of growth based on innovations, higher motivation, and improved organization needed an institutional framework which could function with complexity and foster dynamic changes. Such a framework should be built on decentralization and flexibility – institutions which characterize the market mechanism.

In short the stagnation was caused by the rigidity of the institutions of the command economy which hindered the change to intensive growth – that is the economic institutions connected to central planning. However, the petrification of the society was also strongly connected to the political institutions with the monopoly of power to the communist party. This rigid power structure hindered for many years the change of economic institutions. The early attempt for change in Eastern Europe was stopped brutally by the Soviet forces. The former Yugoslavia could make an exception because it was not under the control of Soviet Union. However, at a certain point the need of change was so strong even within the Soviet Union that the reform-minded Gorbatsjov came to power. He started first a gradual attempt of economic reforms (Uskarenie) acceleration. However without change in the power structure the intended decentralization did not succeed. Instead he started the policy of Perestrojka (transformation), including Glasnost (openness) and Demokratisatsia. This included an opening of criticism of the traditional command model and started a gradual change of the political structure in democratic direction. It also implied that new reform tendencies first in Poland and Hungary were not met by the earlier veto from Soviet – instead the conservative Honecker in DDR was criticized by Gorbatsjov for not joining the train of reforms. In 1989 a wave of reforms spread from Poland and Hungary to include all East European countries. The Iron Wall fell and in the following years the move went also inside the Soviet Union with democratic elections in each of the republics. An

attempt from conservative forces of stopping this movement in August 1991 failed and instead the process was accelerated and led to the dissolution of the Soviet Union. (See Mygind 1994 ch. 7, for a more detailed description of these revolutionary changes in Eastern Europe and the Soviet Union).

This process is an example of how a small change in the political institutions led to a change in the power structure in the political system which again led to further democratic reforms in the political institutions. At the same time it is an example of interaction between different countries within the Eastern European bloc.

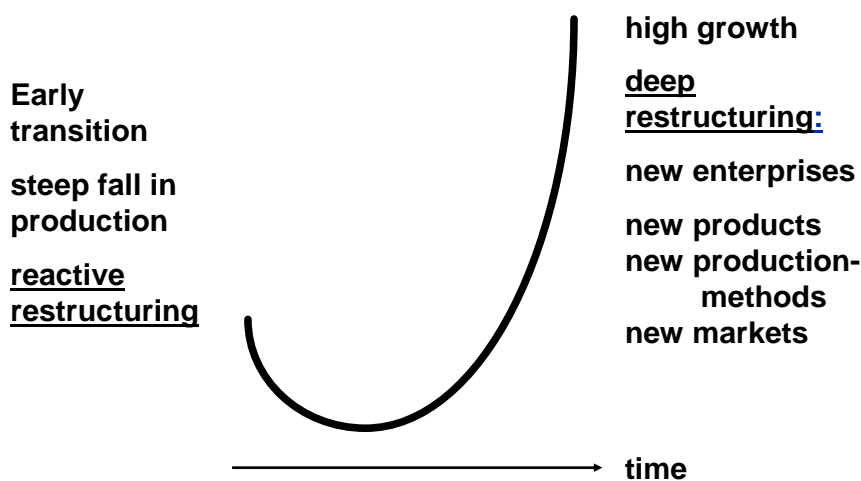
3. Barriers for transition

The political revolutions 1989-91 in the Eastern Europe marked the start of comprehensive transitions of the economic institutions from command to market mechanism and a transition of the economy with fundamental restructuring of production. The transition also included the creation and development of new democratic political institutions with new rules of the game for politics and a cultural liberation with deep changes in the informal institutions of habits, norms and values (Mygind 1994, ch. 6).

3.1. Barriers in the economy – the J-curve as explanation of the fall in production

The dissolution of the old system, the breaking up of most economic networks between enterprises and between countries and steep cuts in production took place in a rather short period. On the other hand, building up new links, new products, and new production methods demanded huge resources - time, capital and human qualifications. Lack of these resources caused bottlenecks for the transition process.

Figure 3 - The production J-curve



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Before transition, production was determined by direct orders from central planners. In a market system it is the demand by the customers and market based costs, which determine what

enterprises shall produce. Calculations for the early stage of transition based on world market prices showed that around one third of production had a negative value added. In these enterprises the value of inputs such as oil and other raw materials were higher than the market value of outputs, which could only be sold at quite low prices. Labor and capital in these enterprises were not used for production, but destruction! (Hare and Hughes, 1992). The other two thirds of production were either produced with losses or with a very low return on assets. The transition to world market prices meant that much of the huge physical capital stock and much of the human capital built up in the command economy turned out to be of very low value measured with the world market as benchmark.

Adjustment to market conditions resulted in a drastic fall of production and after a period also a *reactive restructuring* with cuts in employment in the old industrial enterprises. Employment was cut much faster in Central Europe compared with CIS-countries (Commonwealth of Independent States covering the former Soviet Union minus the Baltic countries) where the workers stayed in the large failing industrial enterprises although they had cut down most of the production. All over Eastern Europe labor productivity fell in the first years of transition. The turnaround based on cuts in employment happened earlier in Central Europe compared to the CIS countries (EBRD 1999, World Bank 1996, for more details on the J-curve see also Mygind 1994, ch. 8).

Table 1 - Growth in GDP 1989-2009

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2009
	1989=100																					
Albania	9.8	-10.0	-28.0	-7.2	9.6	8.3	13.3	9.1	-10.9	8.6	13.2	*6.5	7.1	4.3	5.7	6.7	5.5	5.5	6.0	7.8	3.3	170.3
Belarus	8.0	-3.0	-1.2	-9.6	-7.6	-12.6	-10.4	2.8	11.4	8.4	3.4	5.8	4.7	5.0	*7.0	11.4	9.4	9.9	8.5	9.9	0.5	160.3
Bulgaria	0.5	-9.1	-11.7	-7.3	-1.5	1.8	2.9	-9.4	-5.6	4.0	2.3	5.4	4.1	4.5	5.0	6.6	6.2	*6.1	6.2	6.2	-4.9	108.6
Croatia	-1.6	-7.1	-21.1	-11.7	-8.0	5.9	6.8	6.0	6.5	2.5	-0.9	2.9	4.4	5.6	5.3	4.3	*4.3	4.8	5.6	2.4	-5.8	105.0
Czech R	1.4	-1.2	-11.6	-0.5	0.1	2.2	5.9	4.2	-0.7	-0.8	1.3	*3.6	2.5	1.9	3.6	4.6	6.5	6.8	6.0	2.7	-4.3	135.9
Estonia	8.1	-6.5	-13.6	-14.2	-8.8	-1.6	4.5	4.4	11.1	4.4	0.3	10.8	7.7	*8.0	7.1	8.1	10.5	10.4	6.3	-5.1	-13.9	125.1
Hungary	0.7	-3.5	-11.9	-3.1	-0.6	2.9	1.5	1.3	4.6	4.9	4.2	*5.2	4.1	4.4	4.2	4.8	4.1	4.1	1.1	0.8	-6.7	127.2
Latvia	6.8	2.9	-10.4	-34.9	-14.9	2.2	-0.9	3.8	8.3	4.7	3.3	8.4	8.0	6.5	7.2	8.5	*10.2	12.2	10.3	-4.2	-18.0	96.6
Lithuania	1.5	-5.0	-5.7	-21.3	-16.2	-9.8	3.3	4.7	7.0	7.3	-1.7	3.9	7.2	6.9	10.3	7.3	7.6	*7.8	8.9	2.9	-14.7	104.3
Poland	0.2	-11.6	-7.0	2.6	3.8	5.2	7.0	*6.2	7.1	5.0	4.5	4.3	1.2	1.4	3.9	5.3	3.6	6.2	6.6	5.1	1.7	180.9
Romania	-5.8	-5.6	-12.9	-8.8	1.5	3.9	7.1	4.0	-6.1	-4.8	-1.1	2.1	5.7	5.1	5.2	*8.5	4.1	7.9	6.0	7.3	-7.1	119.7
Russia	0.0	0.0	-5.0	-14.8	-8.7	-12.7	-4.0	-3.6	1.4	-5.3	6.4	10.0	5.1	4.7	7.3	7.1	6.4	7.4	*8.1	5.3	-7.9	101.7
Slovakia	1.4	-2.5	-15.9	-6.7	-3.7	6.2	5.8	6.1	4.6	4.2	1.5	2.0	*3.2	4.1	4.2	5.4	6.0	8.5	10.4	5.8	-4.8	152.0
Slovenia	-1.8	-7.5	-8.9	-5.5	2.8	5.3	4.1	3.7	4.8	*3.9	5.4	4.1	3.1	3.7	2.8	4.4	4.1	5.9	6.8	3.7	-8.1	144.4
Ukraine	4.0	-4.0	-10.6	-9.7	-14.2	-22.9	-12.2	-10.0	-3.0	-1.9	-0.2	5.9	9.2	5.2	9.4	12.1	2.6	7.3	7.6	2.3	-14.8	59.6

Based on EBRD-2008 and 2010. The year when passing the start level marked by *

The deep *strategic restructuring* with development of new products, access to new markets and introduction of new organizational structures and production methods in the enterprises is a much more long term and resource-intensive process. It is much easier and faster to cut production and

employment than to build up new systems which need capital, technological and management expertise as well as developed market institutions. Therefore, the result was a steep fall in production followed by a slow, but in the successful transitional economies, accelerating recovery of production.

There have been important differences in how fast each transitional country has turned around. Poland was the first to show positive growth. In 1996 Poland passed the 1989-production level marked by * in table 1. Slovenia passed the starting point in 1998. Albania, the Czech Republic and Hungary passed the point in 2000; Slovakia in 2001; Estonia in 2002; Belarus in 2003, Romania in 2004; Croatia and Latvia and 2005; Bulgaria and Lithuania in 2006; and Russia in 2007. Ukraine still has some years to go. A weighted average for Central and Eastern Europe including the Baltic Countries shows that the 1989 level was passed in 2000 (EBRD 2000). The 2009 production level for Ukraine is only 60% of the 1989 level, see Table 1. The level for Belarus is somewhat misleading. It is still to a high degree a command economy. If the Belarusian growth is measured in USD the index ends up to be only around 50% of the 1989 level, while the Baltic countries have levels of GDP per capita in USD around the double of this.

3.2 Barriers for political change

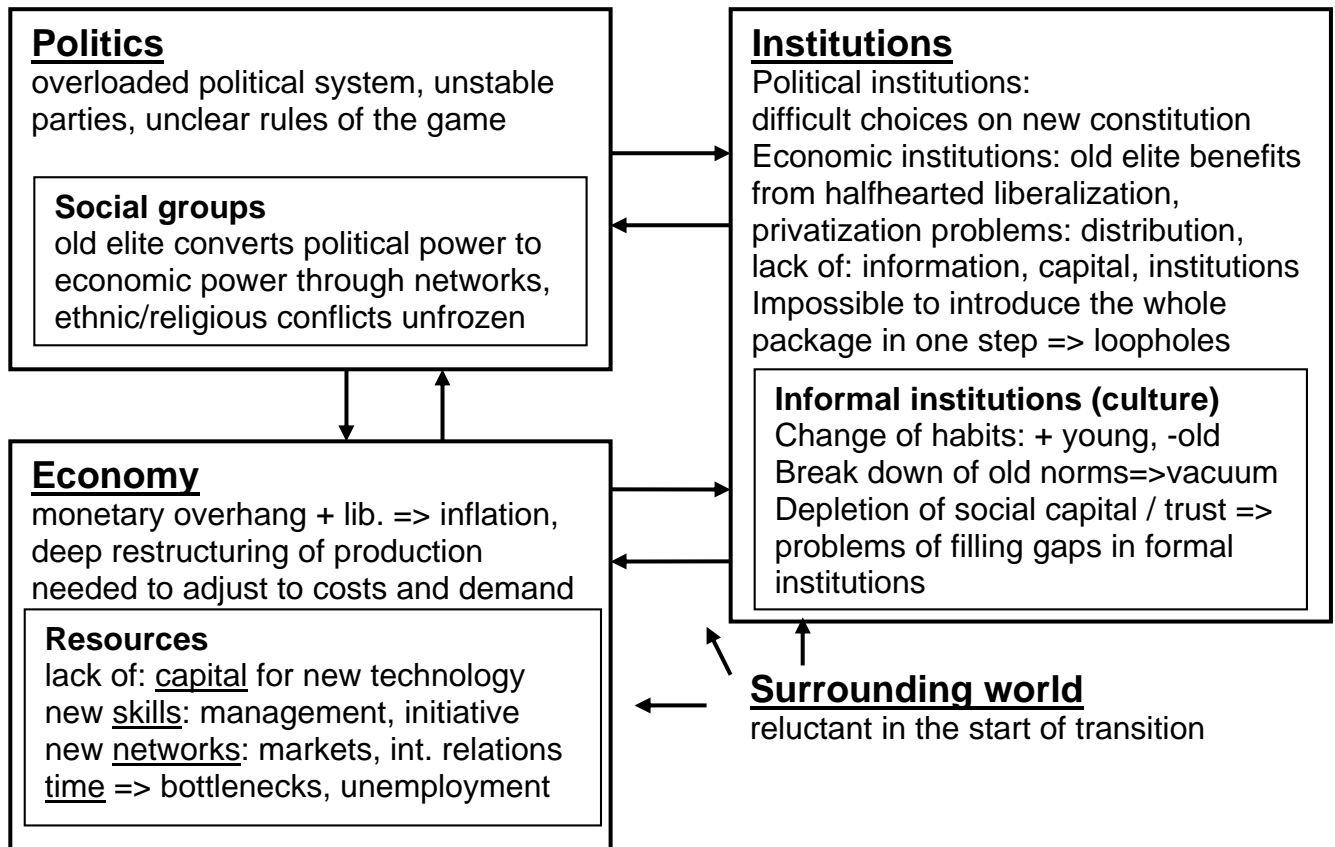
The barriers for the development of the new political system can be found in the risk that the old elite converts its political power to new forms in the new system, and in the lack of democratic traditions and experience. An important barrier is the overwhelming task of consolidating the democratic institutions in a period where new legislation is needed in almost all areas. Many political decisions must be made without knowing the effects of the policies because of the high uncertainty in the early transition. It is impossible to implement the full market model in one step. In most areas a long transitional period will be dominated by “half solutions” leaving a lot of holes to be exploited by corrupt elements. The uncertainty in the political system is an important reason why it took many years to develop stable political parties, because it is difficult to develop and implement stable political programs in an unstable environment. (Mygind 1994, ch. 6)

3.3 Barriers for change of informal institutions (culture)

The barriers for the cultural transition can be divided in two main types. The dissolution of the rigid Soviet system meant that the deep cultural values, that had been suppressed now flourished again. Religion and national consciousness regained importance in many countries. Many of the conflicts cooled down in the Soviet system were unfrozen, and in some areas conflicts heated up further and exploded in ethnic religious wars. Such conflicts seriously delayed the transition process in Caucasus and in the former Yugoslavia.

Norms and routines from the command economies have prevailed for many groups. Especially the older generations have problems understanding and following the wave of drastic changes. On the other hand the transition gives a lot of opportunities, especially for young people. Therefore, the gap between generations has deepened in many countries of transition. Especially, in the CIS-countries without a positive collective consciousness about the time before the command economy, there is strong inertia concerning the change of norms and habits. This is a main barrier for the development of the new market economy.

Figure 4 – Barriers for transition



3.4 Barriers and elements of the change of Economic institutions

Ideally, the transition of economic institutions should be made in one step. With the exception of GDR, which was taken over by BRD and rapidly enrolled in the German institutional system, it is not possible to implement a real “big bang”. Even in countries performing a tough economic shock therapy like Poland and Estonia there is still something missing in building up and implementing all the necessary market institutions.

The key elements in a market economy are: market based prices as information signals and private ownership with decentralized control and decentralized incentives for the owners. There must be direct correspondence between the right to control and the financial rights to returns and capital gains. The implementation of these elements is done through stabilization, liberalization and privatization. This will be further developed in the next three sections.

4. The necessity of stabilization

In all the command economies there was a “monetary overhang” because of constant prices combined with unbalanced expansion of purchasing power. This overhang was reflected in excess demand of goods. Queues and empty shops were not signs of too low production. They were signs of too low prices in relation to purchasing power. To implement the market

mechanism the prices were liberalized in the start of transition. In countries with a huge monetary overhang the result was an explosion in prices. Hungary, which already had market oriented prices in the 1980es had only small price increases in 1990, see Table 2, while price liberalization in Russia in January 1992 resulted in a 300% jump in prices during only one month.

Table 2 - Inflation 1990-2008 (consumer prices, change in annual average)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Albania	0.0	35.5	226	85	23	7.8	12.7	33.2	20.6	0.4	0.1	3.1	5.2	2.4	2.9	2.4	2.4	2.9	4.0	2.3
Belarus	4.7	94.1	971	1190	2221	709	52.7	63.8	73.2	294	169	61.4	42.6	28.4	18.1	10.3	7.0	8.4	15.3	13.0
Bulgaria	26.3	334	82	73	96	62	123	1082	22.2	0.7	9.9	7.4	5.9	2.3	6.1	5.0	7.3	8.4	12.4	2.5
Croatia	610	123	666	1518	98	2.0	3.5	3.6	5.7	4.2	6.2	4.9	2.2	1.8	2.1	3.3	3.2	2.9	6.5	2.4
Czech R.	9.7	52	11	21	10	9.1	8.8	8.5	10.7	2.1	3.9	4.7	1.8	0.2	2.8	1.9	2.5	2.8	6.3	
Estonia	23.1	211	1076	90	48	29	23.1	11.2	8.1	3.3	4.0	5.8	3.6	1.3	3.0	4.1	4.4	6.6	10.7	-0.1
Hungary	28.9	35.0	23	23	19	28	23.6	18.3	14.3	10.0	9.8	9.2	4.8	4.9	6.8	3.6	3.9	8.0	6.3	4.2
Latvia	10.5	172	951	109	36	25	25.0	17.6	8.4	4.7	2.4	2.6	2.5	1.9	2.9	6.2	6.5	10.1	15.8	3.5
Lithuania	8.4	225	1021	410	72	40	24.6	8.9	5.1	0.8	1.0	1.3	0.3	-1.2	1.2	2.7	3.8	5.7	11.1	4.5
Poland	586	70	43	35	32	28	19.9	14.9	11.8	7.3	10.1	5.5	1.7	0.7	3.5	2.2	1.2	2.5	4.3	3.8
Romania	5.1	170	210	256	137	32	38.8	155	59.1	45.8	45.7	34.5	22.5	15.3	11.9	9.5	6.9	4.8	7.2	5.6
Russia	5.6	93	1526	875	311	198	47.8	14.7	27.6	86.1	20.8	21.6	15.7	13.7	10.9	12.7	9.7	9.0	13.0	11.7
Slovakia	10.8	61	10	23	13	9.9	5.8	6.1	6.7	10.6	12.0	7.1	3.3	8.5	7.5	2.7	4.5	2.8	4.3	1.6
Slovenia	550	118	207	33	21	14	9.9	8.4	7.9	6.1	8.9	8.4	7.5	5.6	3.6	2.5	2.5	3.6	6.1	0.9
Ukraine	4.2	91	1210	4734	891	377	80.0	15.9	10.5	22.7	28.2	12.0	0.8	5.2	9.0	13.5	9.1	12.8	24.8	15.9

Based on EBRD-2010

High and persistent inflation means that the price system sends uncertain signals. The functioning of the decentralized information system and thus the market mechanism is hampered. This is the main reason why stabilization of prices is important. In countries such as Russia and Ukraine too lax economic policy in the first half of the 1990s resulted in a spiral of price increases combined with increasing nominal wages, continued depreciation of the currency, expansion of the monetary supply and soft credits to enterprises. High inflation continued for several years. The Central European countries, on the contrary, implemented tough stabilization policies. This also happened a few years later in the Baltic countries. From Table 2 it can be seen that inflation in these countries fell under the critical level of 40-50% by 1994/95. At this time inflation was still very high in Bulgaria, Romania and the CIS countries. However, through tightening of monetary policy and currency policy with a rather stable exchange rate Russia and most other CIS countries succeeded in stabilizing inflation from 1995. The financial crisis in Russia in August 1998 gave another push to inflation, but the following tough stabilization policy resulted in lower inflation levels, which have not seriously hampered the functioning of the market mechanism.

With the Russian crisis there was a backlash in demand, which limited both growth and inflation in most transitional economies in 1998 and 1999. In the later years inflation has been quite low in Central- and Eastern Europe although with some upward pressure in 2007 and 2008 because of increasing energy and food prices. With relatively fixed exchange rates and an increase in

productivity this leaves room for a real appreciation. In the long run inflation can be a bit higher than the inflation for the most important trading partners - the old members of EU. However, the financial crisis with a steep fall in demand meant a temporary fall in inflation (see section 11).

Comparing Tables 1 and 2 there is a clear connection between lower inflation and growth in production. Countries with fast and consequent stabilization and controlled inflation had, after a few years, growth in production while the fall in production continued for several years in the CIS countries with postponed stabilization. The accession to EU is another element putting pressure on inflation in the frontrunner transition countries. However, increasing excise taxes meant a slight increase in prices in the accession year 2004. With exchange rate fixed to the Euro and a fast catching up of productivity and GDP-levels the Baltic countries will also have a catching up of price levels. In the long trend perspective of the catching up process this may result in an inflation level about 3% higher than the inflation in the Euro-area (see Mygind 2006). This means that the countries with fixed currencies will not be able to fulfill the Euro access-criteria unless they for some years implement tough policies with relatively low growth – see further the discussion on the effects of the 2008-09 financial crisis in section 11.

5. The necessity of liberalization - status for implementation

Liberalization - deregulation through transfer of control and incentives from the state to private decentralized units - is an important element of developing the market mechanism. Successful liberalization also means stable and clear rules of the game for private enterprises and institutions monitoring competition and securing a level playing field.

Price liberalization (except for specific areas such as energy, public transport and housing) was implemented rather fast in most countries. At the same time the frontrunners implemented a fast and comprehensive liberalization of foreign trade. This belongs to what the EBRD calls the first stage of reforms – market enabling reforms (EBRD 2008).

The opportunity for establishing new private enterprises is also an important part of the market economy. However, it is not only important to create access to entry. It is also important to implement the possibility and clear rules for exit from the market. Therefore, a well functioning legal framework for bankruptcy is important. Exit means that non-performing assets are taken over by new owners, who will have the opportunity to make better use of these assets. If exits are blocked by soft credits and subsidies inefficient state supported enterprises can block the entrance of new and potentially more efficient enterprises.

Contrary to price-liberalization which was implemented rather fast and consequent in most countries, opening up for foreign competition showed more variation. Even larger differences could be found in the implementation of bankruptcy procedures. Countries such as Estonia and Hungary implemented tough procedures early in the process while countries such as the Czech Republic and Russia were more reluctantly implementing hard budget constraints for their enterprises.

Table 3 - Status for liberalization 2010

	Price liberalization	Liberalize foreign trade and exchange	Competition Policy	Bank reform liberalize interest rate	Securities market and non-bank finance inst	Overall infrastructure reform
Albania	4+	4+	2 .	3	2 -	2+
Belarus	3+	2+	2 .	2+	2 .	1 .
Bulgaria	4+	4+	3 .	4 -	3 .	3 .
Croatia	4 .	4+	3 .	4 .	3 .	3 .
Czech Rep	4+	4+	3 .	4 .	4 -	3+
Estonia	4+	4+	4 -	4 .	4 -	3+
Hungary	4+	4+	3+	4 -	4 .	4 -
Latvia	4+	4+	3 .	4 .	3 .	3 .
Lithuania	4+	4+	3+	4 -	3+	3 .
Poland	4+	4+	3 .	4 -	4 .	3+
Romania	4+	4+	3 .	3+	3 .	3+
Russia	4 .	3+	2+	3 -	3 .	3 -
Slovak R	4+	4+	3+	4 -	3 -	3 +
Slovenia	4 .	4+	3 -	3+	3 .	3 .
Ukraine	4 .	4 .	2+	3 .	3 -	2+

Based on EBRD-2010, index from 1 (no liberalization) to 4+ (full liberalization)

There is a strong connection between this part of liberalization and the development of market institutions related to the financial system, banks and the capital market, and to the development of institutions securing private property rights. This part of the liberalization process belongs to the second tier of institutional reforms, which takes much more time to implement.

6. Privatization and corporate governance

Privatization of enterprises is necessary for developing decentralized control and decentralized incentives such as financial ownership rights. The owners and managers need incentives to use resources efficiently. This is closely connected to the development of efficient corporate governance systems between owners, managers and other stakeholders related to the enterprise.

However, it is difficult to implement privatization in transitional economies because many market institutions are not fully developed - a developed banking system, a well functioning stock market, reliable information about the economic situation of enterprises etc. It is very difficult to give a fair valuation of the assets because the markets are undeveloped and volatile with high

uncertainty about the future development. The population lacks information and lacks capital to buy the assets. The solution to the last problem has in countries like the Czech Republic, Russia and Lithuania been *privatization through vouchers* - privatization coupons freely distributed to the population. These vouchers were used for auctions of the enterprises to be privatized. Investment funds often played an important role in this process. In this way the problem of lacking capital was solved, and it was possible to have a high equality at least in the initial round of distribution of the assets.

In other countries such as Estonia and Hungary the most important method of privatization was *direct sale* to the investor who could offer the best combination of price, and guarantees of future investment and employment. Direct sale favored capital owners, and especially foreign investors played an important role in countries using this method of privatization. In other countries such as Russia, Lithuania and Slovenia *insiders*, managers and other employees, had strong advantages for taking over their enterprises including large and medium sized enterprises. In other countries such insider takeovers were only frequent for small privatization - privatization of small enterprises and subsidiaries of larger enterprises.

Table 4 Privatization status 2010 and method for large privatization

	Private sector % of GDP	Large privatization (large enterprises)	Small privatization (small enterprises)	Governance and enterprise restructuring	Primary privatization method	Secondary privatization method	Peak privatization years
Albania	75	4 -	4 .	2+	insider	voucher	1995-96
Belarus	30	2 -	2+	2 -	not privatized		
Bulgaria	75	4 .	4 .	3 -	direct sale	voucher	1997
Croatia	70	3+	4+	3 .	insider	voucher	1995
Czech Rep	80	4 .	4+	3+	voucher	direct sale	1992-94
Estonia	80	4 .	4+	4 -	direct sale	voucher	1994-95
Hungary	80	4 .	4+	4 -	direct sale	insider	1992-96
Latvia	70	4 -	4+	3 .	direct sale	voucher	1996-97
Lithuania	75	4 .	4+	3 .	insider/voucher	direct sale	1992-94
Poland	75	4 -	4+	4 -	insider/voucher	direct sale	1997
Romania	70	4 -	4 -	3 -	insider	direct sale	1995
Russia	65	3 .	4 .	2+	insider/voucher	direct sale	1993-94
Slovak R.	80	4 .	4+	4 -	direct sale	voucher	1992-96
Slovenia	70	3 .	4+	3 .	insider	voucher	1995-96
Ukraine	60	3 .	4 .	2+	insider	direct sale	1998-99

EBRD 2010 privatization-index: 1=no privatization, 4+=full privatization. Method: own estimate

A fast and comprehensive privatization is not sufficient for developing a system of efficient corporate governance. Also a well functioning state is necessary (see next section) and it is necessary to have strong institutions for securing property rights, a developed capital market, access to reliable information about enterprises for existing and potential investors, and well functioning bankruptcy procedures. There are many examples of fast and comprehensive privatization, which did not lead to efficient corporate governance:

The main part of the large privatization in the Czech Republic was done through vouchers in the

period 1992-94. After the privatization rounds most of the assets were controlled by investment funds again controlled by the large banks. However, state ownership dominated most of these banks. Therefore, it could be questioned whether the assets were truly privatized. The main problem, however, was that the administrators of the investment funds had de facto control with the enterprises in their portfolio. The real owners who had invested their vouchers in the investment funds were outside influence. This gap between control on one side and the financial returns on the other gave the administrators the opportunity to exploit their position of control to tunnel values out of the enterprises to the benefit of other enterprises directly owned by them. Similar ways of inefficient corporate governance systems resulting in tunneling are also known from Russia and other economies in transition.

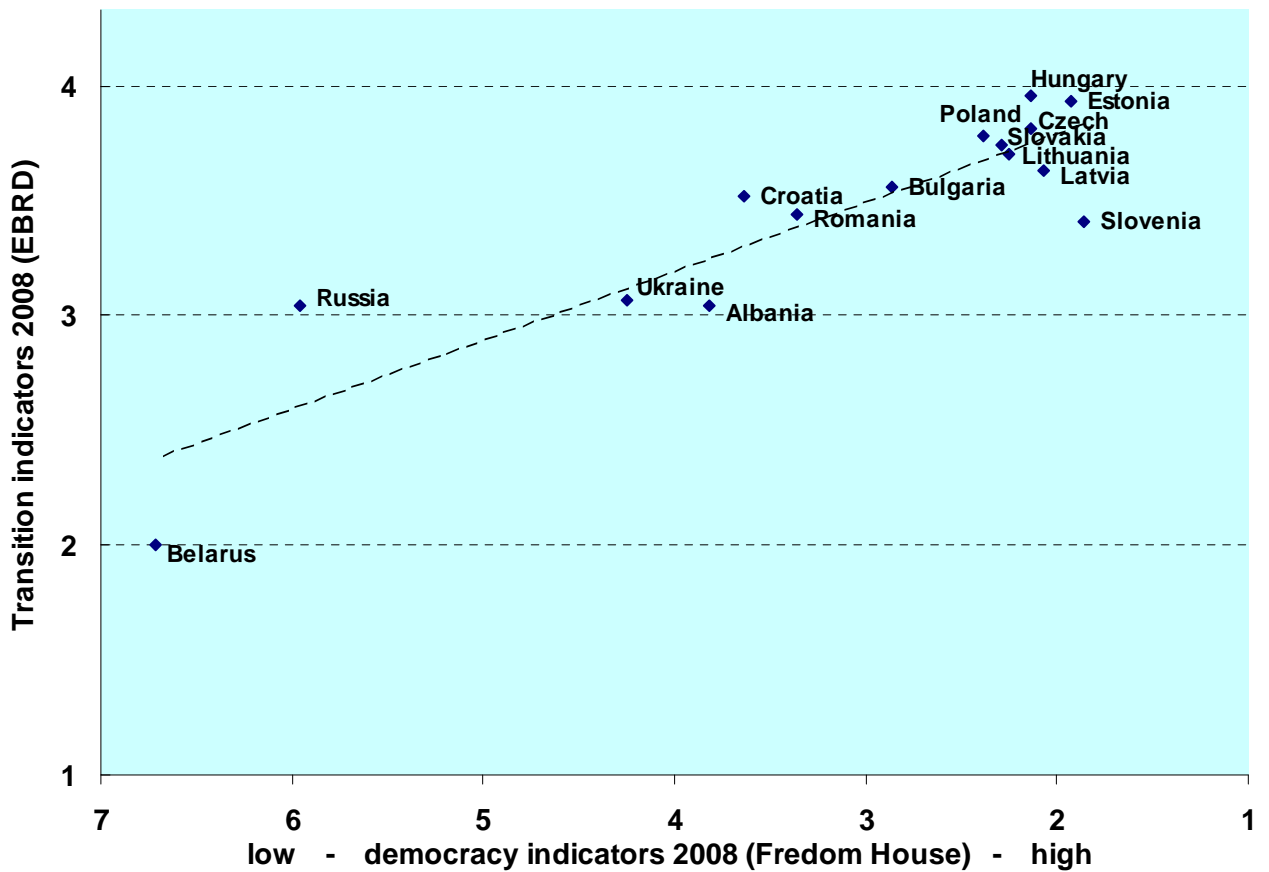
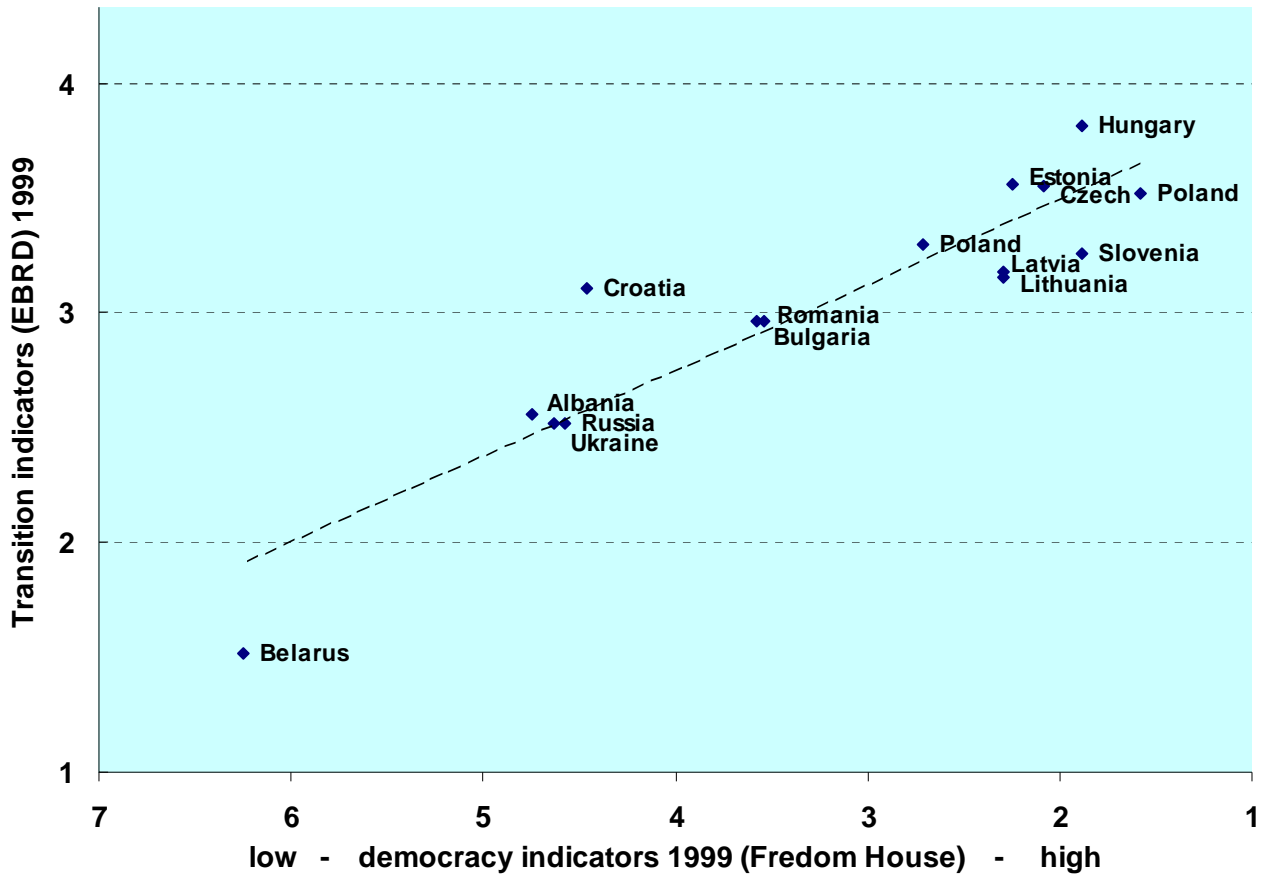
7. The importance of a well functioning state

Closely connected to the quality of corporate governance of the enterprises is the quality of the governance of the state. Clear and stable rules of the game are a must for a well functioning market economy. Here we can distinguish between the development of the political dimension - the development of democratic institutions - and the administrative dimension - the quality of the state bureaucracy closely connected to the economic institutions. The two dimensions support each other and there is a close connection between the development of democratic institutions and the progress in economic reforms (World Bank 2002). Figure 5 shows the relation between the development of democracy as measured by Freedom House on a scale from 1 (full democracy) to 7 (dictatorship) and an average of EBRD's reform indicators from 4.33 (fully developed reforms) to 1 (no reforms). The numbers are based on 1999 and 2008 data. All countries have moved upward on the transition indicators, but the democracy indicators have fallen for Russia and Belarus, while improved for the other countries. In both points in time there is a clear correlation between democratic development and progress in reforms as indicated by the positive trend-lines.

It is worth noting that a well functioning state is not the same as a "strong" state with the head of state in power for a long period. Stability of power is not a guarantee for a positive development. A "strong" state with lack of democratic institutions and lack of political competition means limited possibility for the opposition to criticize and challenge the current head of state. It is important that the government and the administration can be criticized and corrected. The old Soviet system was an example of a stable, but petrified state power, that lacked correction mechanisms and was not able to make the necessary flexible adjustments to exploit the opportunities of the technological development.

A strong opposition performing a persistent and strong monitoring of both the political elite and of the administrative bureaucracy can unveil inefficiencies, corruption and abuse of power. The free press has an important role, but is it also important to have a well functioning legislative system with clear rules and consequent and fair implementation through an efficient and independent court system. Some Central European countries had an advantage in this respect because of their roots in a well functioning court system before World War 2.

Figure 5 Democracy versus transition indicators 1999 and 2008



The EU-integration process supported the institutional development and made it possible to benchmark the quality of the democratic institutions and especially the administrative capacity of the state. This is another explanation why the best functioning transitional states are found among the new EU members. In the accession process the applicants had to strengthen the state functions such as a transparent and fairly implemented tax system, and efficient and fair regulation of enterprises e.g. in relation to environment and safety at the workplace.

8. The dynamics of transition

The gap in consumption level was an important trigger for the revolutionary change in Eastern Europe and the former Soviet Union in 1989-91. After the transition the populations had high expectations about strong improvements of living standards. As shown in section 2 these expectations were not met. On the contrary, the big majority of the population faced steep decreases in real incomes during the first years of transition. At the same time a narrow elite had the opportunity to fill some of the many hole in the new market economy and they earned huge profits of being first movers in different fields. Others made fortunes by using their links to a corrupt state bureaucracy, by tunneling values from state owned firms or by getting assets in the privatization process much below their value. Thus, the inequality increased steeply in most transition countries – especially in the former Soviet Union and the Baltics while it stayed at a lower level in Central Europe – see Svejnar (2002) and EBRD 2007.

This development caused a threat both to the democratic development and to the transition of economic institutions. In some countries we saw elements of a negative vicious circle in the dynamic linkages between the different elements of the PIE-model, see figure 6.

As shown in table 1 all transition countries faced a steep fall in production in the early years. In nearly all countries this led to a political reaction among important social groups which were the losers in this process. In countries such as Lithuania, Poland, Hungary, Romania, Bulgaria the elections in the early 1990es led directly to shifts in government back to parties related to the former communists. However, this did not directly imply a change in policy since in most countries these parties had changed to a Scandinavian style of Social Democratic parties. The exceptions were Russia and the Czech Republic where the communist parties continued their orthodox conservative policies, but here they did not manage to form governments.

This means that there were no direct link from a popular reaction at the elections and a change in the policy although the government was changed back to left wing parties. In a country like Lithuania the old communist leader Brazauskas came back to power, but instead of rewinding the reforms process some of the reform elements were in fact strengthened and privatization was speeded up. Also in Poland the reforms were continued after the socialist party came back to power in 1991.

However, in countries such as Russia, Ukraine, Romania and Bulgaria the reaction led to a slowdown in the reform process implying that the package of reforms did not pass the benchmark which could be called *the critical mass of reforms* – that is enough reforms to motivate enterprise managers to shift behavior to focus on market oriented adjustments e.g. by cutting costs and

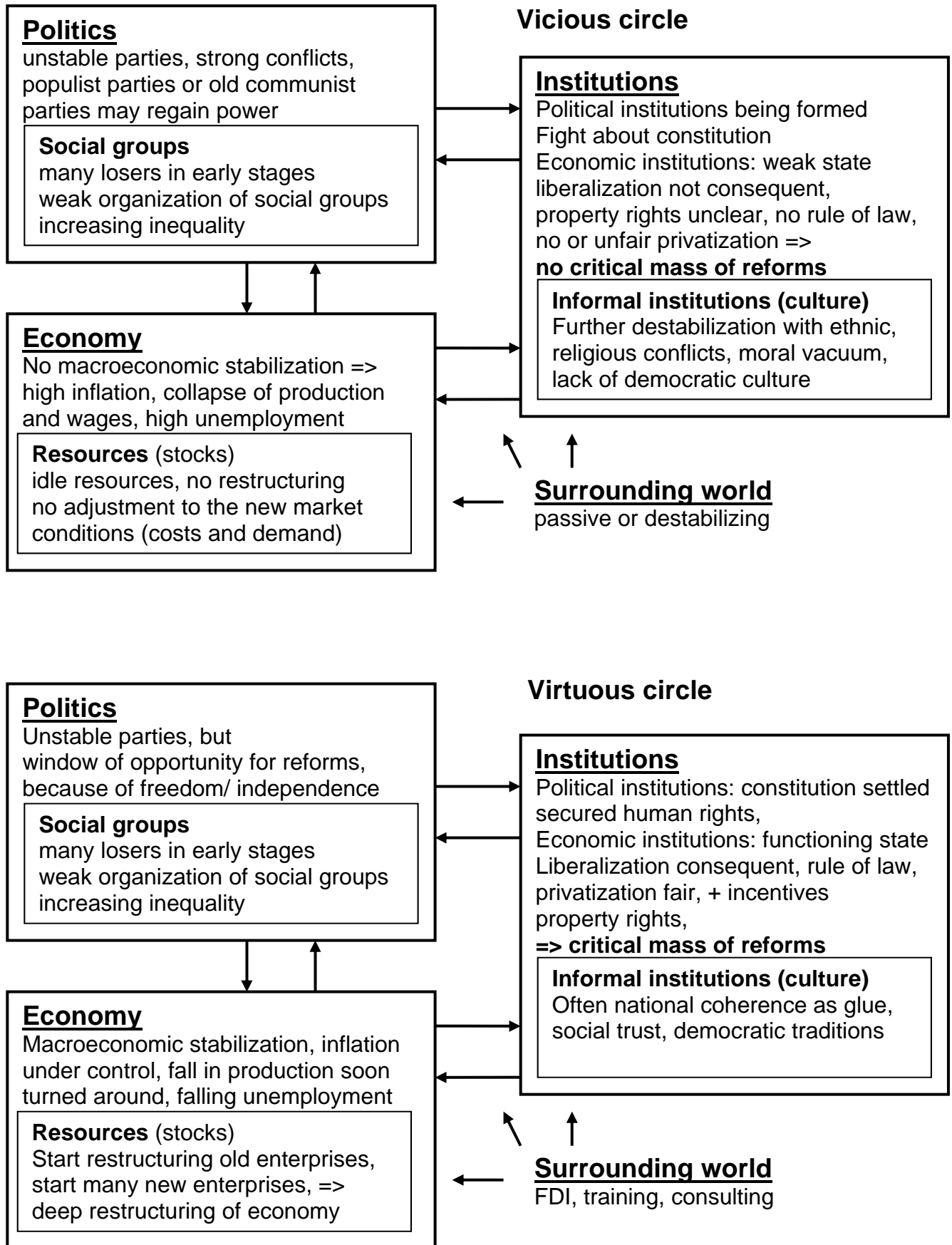
adjusting their products to the preferences of the customers. If the reforms did not pass *the critical mass of reforms* the enterprise managers would continue to use most of their effort on getting support and good deals with the state bureaucracy, and by tunneling values from the enterprises. There were weak states in these countries with high level of corruption, no functioning rule of law, and high barriers for entrepreneurial initiative. The existing vested interests of the elite with strong connections between business and state exploited the long period of halfhearted reforms to built up their fortunes e.g. by using loopholes like: dual prices, skewed privatizations, soft budgets, or direct tunneling of state assets. (Havrylyshyn & Odling-Smee 2000)

At the same time e.g. in Russia and Ukraine, the macroeconomic stabilization was quite weak in the first years. Halfhearted reforms and weak stabilization lead to negative results in the economy. Inflation continued on a high level for several years, existing companies made only little restructuring, and the entry of small new enterprises was low. This meant that the economy fell even deeper and the downturn continued for longer time as seen in table 1. In Russia the problems were made worse by lack of clarity about the political institutions which led to strong confrontations and a second round of violent fight around the parliament in the fall of 1993. Although the clarification of the political institutions and the introduction of a strong presidency like in US stabilized the political system it took some years and a deep economic crisis in Russia in 1998 before the economy stabilized and Putin strengthened the reform process so that Russia although reluctantly passed the critical mass of reforms in the early period of the new millennium. In the Caucasian area and on Balkan nationalist fights reinforced the vicious circle of economic break down and further escalating conflicts.

However, this vicious circle was not the general experience in the Baltics and in Central Europe. Instead these economies went into much more positive reinforcing dynamics between the different elements in the PIE-model:

In Estonia and Latvia the political reaction on the economic crisis were quite limited because the focus for politics was on the national problem related to the big Russian speaking minority. In other countries like Lithuania and Central Europe the new ruling Social Democratic parties continued the reform process. Therefore, they passed the critical mass of reforms already in the first half of the 1990es and the turn in production also happened quite fast. It has been argued (Balcerowicz 1994) that these countries to a high degree used the “window of opportunity” which was created because of the goodwill in the population toward the change first of all in the political system after the end of the Soviet occupation/dominance and the introduction of personal freedom. These advantages meant that the population was willing to accept some sacrifices at least for a certain period until the economy started to go up the J-curve. In this way they came into a virtuous circle of transition:

Figure 6 – Vicious and virtuous circle of transition



The most important elements of the liberalization and privatization package were implemented implying that the economic institutions passed the critical mass of reforms. Though the initial fall in production was unavoidable the economy turned around within 2-4 years and the positive elements of enterprise restructuring and start of new enterprises made the base for increasing productivity in the economy and increasing wages. This meant in general that the population continued to support market oriented reforms so there was backing behind deepening of the market institutions.

At the same time most of these countries implemented a rather strict macroeconomic stabilization and the initial high inflation fell steeply. The exchange rate was stabilized. In fact in some countries fixed exchange rates or currency boards like in Estonia from 1992, Lithuania from 1994 and Bulgaria from 1997 were important for the stabilization policy bringing down inflation.

9. Restructuring of enterprises

One of the most important problems of the command economy was the insufficient use of the human and technological resources to develop and produce competitive products. The main reason behind the steep fall in production at the beginning of transition was, as earlier mentioned, the gap between the production structure of the command economy and the new structure adjusted to the competitive market economy. This transition of production is directly linked to the restructuring of enterprises. The *reactive restructuring*, cutting away unprofitable production and cutting down the number of employees, was implemented in the first years of transition although it was implemented slower and less consequently in the CIS countries.

Deep strategic restructuring means building up the new structure of production with development of new products, new production methods, new technology, retraining of the employees, implementation of new management methods, new structures of organization, new networks to suppliers, new marketing methods and new markets. Strategic restructuring takes a long time to implement and it demands large capital inputs. At the same time new management skills must be developed – training of old and new managers in strategy, accounting, marketing, organizational behavior etc. has been a persistent bottleneck in all countries in transition.

Strategic restructuring is not only taking place in existing enterprises. Starting up new enterprises is a very important element in building up the new structure of production. This is especially important for sectors like trade and services, which had a low priority under the command economy. Closing down and/or breaking up old giant industrial enterprises and transfer of employees and physical assets to new enterprises is often the most efficient form of deep restructuring. The early success of the Polish economy is closely connected to the very dynamic development of new small and medium sized enterprises. The Polish privatization was rather slow, but new private enterprises contributed to fast growth in the private sector from the early start of the transition process.

Bureaucratic barriers, lack of transparency in legislation, uncertainty in relation to more or less criminal networks, and uncertainty about the market development limited the possibilities and the dynamic development for small and medium sized enterprises in most CIS countries.

The societal framework including the quality of the state is a very important factor for strategic restructuring. At the same time corporate governance of enterprises plays a crucial role. It is important which groups take over the ownership of the enterprises in the privatization process and in the post privatization change of ownership structures. The privatization and lack of regulation of investment funds in the Czech Republic is an example of a bad corporate governance system, which for some years hampered the incentives for strategic restructuring.

The Russian privatization has been criticized for the strong emphasis on insider-takeovers by management and broad groups of other employees. Experts have called this: “half privatization” and some evidence have been presented showing that insider owned enterprises have problems getting enough capital for restructuring. However, there is contradictory evidence showing that insider owned companies often perform better than outsider owned domestic enterprises (Mygind 2000). The delay in restructuring in Russian enterprises can probably not be explained by the ownership structure. Instead, the unfavorable conditions in the institutional framework around the enterprises must be blamed. One of the leading economies in transition, Slovenia, with the highest GDP per capita in Eastern Europe, has a corporate governance system with many employee owned enterprises. Note, however, that there is quite clear evidence that enterprises owned by foreign core investors are in front concerning strategic restructuring. This will be further discussed in the following section.

10. Foreign Direct Investment - importance and development

The explanation behind the strong strategic restructuring in foreign owned enterprises is that foreign investors have strong advantages concerning access to capital, management expertise, new technology and international networks. Usually the foreign investor constitutes a strong core owner with a dominant share of ownership. This means that there are no corporate governance problems under the assumption that the overall institutional framework guarantees the property rights. The countries with the highest foreign direct investment per capita are characterized by advanced transition and a quite well functioning state with clear and transparent rules for enterprises and foreign investors. Czech, Hungary and Estonia are leading measured per capita. Already in the 1980es Hungary had opened up for foreign investments mostly in the form of joint ventures. The high level of foreign investments has been an important reason behind Hungary’s advanced development in relation to strategic restructuring and in relation to the development of a competitive industry. However, some evidence points in the direction that the technological and other positive spin-offs to the domestic part of the industry were rather modest (Hunya, 1997). The fall in FDI for some of the leading countries in the later years is because the acquisitions in relation to privatizations have ended. However, around the membership of the EU in 2004 FDI went up again in the accession countries. Also for Russia and Ukraine we see high inward FDI in the later years. Though, the financial crisis resulted in a steep fall in FDI in 2009.

Table 5 Foreign Direct Investment inflows per year 1990-2009 and stock 2009

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2009	
	millions USD																				stock	%GDP
Albania			20	68	53	70	90	48	45	41	144	206	135	178	346	264	325	662	988	979	3 537	28.7
Belarus	0	0	7	18	11	15	105	352	203	444	104	98	253	174	164	305	354	1785	2158	1863	8 457	17.2
Bulgaria	4	56	42	40	105	90	109	505	537	819	1002	813	905	2097	3452	3923	7507	12388	9795	4467	50 727	107.7
Croatia			13	144	114	108	493	541	941	1452	1051	1313	1071	1989	1179	1825	3468	5023	6140	2605	36 602	58.1
Czech R.	72	523	1003	653	868	2562	1428	1301	3718	6324	4985	5642	8482	2103	4974	11653	5463	10444	6451	2725	115 899	60.9
Estonia			82	163	217	202	151	266	573	303	392	540	289	928	958	2869	1797	2725	1726	1680	16 248	85.1
Hungary	554	1470	1477	2443	1143	5103	3300	4167	3335	3312	2764	3936	2994	2137	4506	7709	19802	71485	61993	5575	248 681	194.3
Latvia			32	45	214	180	382	521	357	348	413	132	253	304	637	707	1663	2 322	1261	72	11 726	44.8
Lithuania			10	31	31	73	152	354	926	486	379	446	725	180	774	1028	1817	2 015	1823	348	13 837	37.4
Poland	88	359	678	1715	1875	3659	4498	4908	6365	7270	9445	5701	4123	4588	12874	10293	19603	23561	14689	11395	182 799	42.5
Romania	0	40	77	94	341	419	263	1215	2031	1027	1057	1158	1141	2196	6436	6483	11367	9 921	13909	6 329	73 983	45.9
Russia			1161	1211	690	2066	2579	4865	2761	3309	2714	2748	3461	7958	15444	12886	29701	55073	75461	38722	252 456	20.3
Slovak R.	93	81	100	179	255	2587	370	231	725	428	1932	1584	4142	2160	3030	2429	4693	3581	3411	- 50	50 258	57.1
Slovenia	4	65	111	113	117	151	174	334	215	107	136	370	1659	302	831	577	648	1514	1924	- 67	15 237	31.4
Ukraine	0	0	200	200	159	267	521	623	743	496	595	792	693	1424	1715	7808	5604	9891	10913	4816	52 021	44.3

Based on UNCTAD (2010) – www.unctad.org

Foreign investments are often motivated by access to the market of the host country. However, there is increasing weight on motives based on the exploitation of competitive factor inputs, especially the cheap highly qualified labor force (Meyer, 1998). Often the two motives are combined. The host country is an important market and at the same time the foreign investor uses the factors of production to build up exports to other Eastern European countries or to export back to the West. This means that in most cases there is a positive connection between foreign trade and FDI.

Table 6 – Current account balances 1990-2009 (in per cent of GDP)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Albania					-14.4	-7.2	-7.3	-11.5	-6.7	-7.6	-4.6	-7.4	-9.5	-7.0	-5.9	-8.7	-6.5	-10.6	-10.7	-14.0
Belarus				-11.9	-9.1	-4.4	-3.6	-6.1	-6.7	-1.6	-3.2	-3.3	-2.2	-2.4	-5.2	1.4	-3.9	-6.6	-7.0	-13.1
Bulgaria	-8.2	-1.0	-4.2	-10.1	-0.3	-0.2	1.7	10.0	-0.5	-5.0	-5.6	-5.9	-2.0	-5.1	-6.8	-12.5	-17.9	-21.7	-21.2	-9.5
Croatia		-3.4	3.4	5.6	5.7	-7.7	-5.0	-12.6	-6.8	-7.7	-2.8	-3.7	-8.6	-7.2	-5.0	-6.3	-7.9	-8.6	-9.9	-5.3
Czech R.				1.3	-1.9	-2.6	-6.7	-6.3	-2.1	-2.4	-4.7	-5.3	-5.7	-6.3	-5.2	-1.6	-3.2	-2.6	-2.9	
Estonia				1.3	-7.3	-4.4	-8.6	-11.4	-8.6	-4.4	-5.3	-5.2	-10.7	-11.4	-11.8	-9.9	-16.8	-18.0	-11.2	4.5
Hungary	0.4	0.8	0.9	-9.0	-5.6	-9.4	-4.0	-4.5	-7.2	-7.8	-8.4	-6.0	-7.0	7.9	-8.6	-7.6	-7.5	-6.4	-5.7	0.2
Latvia					5.5	-0.4	-4.9	-5.5	-9.7	-9.0	-4.7	-7.5	-6.7	-8.2	-12.8	-12.4	-22.7	-23.9	-12.1	8.6
Lithuania				-3.2	-2.2	-10.2	-8.8	-9.8	-11.6	-10.9	-5.9	-4.7	-5.2	-6.9	-7.7	-7.2	-10.8	-13.7	-13.9	4.2
Poland	1.0	-2.6	1.1	-0.7	0.7	4.5	-2.1	-3.7	-4.0	-7.4	-5.8	-2.8	-2.5	-2.1	-4.0	-1.2	-2.7	-4.1	-5.2	-1.7
Romania	-9.6	-3.5	-8.0	-4.5	-1.4	-6.3	-7.3	-6.1	-6.9	-3.6	-3.6	-5.8	-3.4	-5.8	-8.4	-10.2	-11.8	-14.4	-13.3	-4.5
Russia					2.1	1.4	2.8	0.0	0.1	12.6	18.0	11.1	8.4	8.2	10.2	11.0	9.5	6.1	6.4	4.0
Slovakia				-4.7	4.6	2.1	-9.9	-9.1	-9.2	-5.3	-3.5	-8.3	-7.9	-5.9	-7.8	-8.5	-7.0	-5.3	-5.0	-3.2
Slovenia	3.0	1.0	7.4	1.5	4.0	-0.5	0.3	0.3	-0.7	-4.1	-3.2	0.2	1.1	-0.8	-2.7	-1.7	-2.6	-4.2	-3.6	-1.5
Ukraine					-3.1	-3.1	-2.7	2.7	-3.1	5.2	4.7	3.7	7.5	5.8	10.5	2.9	-1.5	-4.2	-6.5	-1.5

Based on EBRD-2000 and EBRD-2010

The balance of foreign trade and the current account has run through four different stages during the transition process: Immediately after opening up in early transition there was a huge inflow of Western goods based on pent up demand for these goods which before were unavailable for the ordinary consumer. However, the steep devaluations of the currencies made imports relatively expensive and made important constraints on this kind of imports. The third stage is the long restructuring period when the transition countries have to import investment goods to build up their production capacity. Only gradually this has been reflected in increasing exports. This means that most East European countries have had huge deficits on trade and the current account. Only the strong commodity producers like Russia, Ukraine and some of the countries in Central Asia has had positive current accounts in the later years – see Figure 6. The steep contraction of demand following the financial crisis resulted in steep falling imports and trade surplus in e.g. the Baltic countries.

11. The financial crisis and the effect on the countries in transition.

As shown in the earlier sections the integration with the surrounding world has been an important part of the transition process. This has been directly related to the development in formal institutions – most markedly for the new EU member states, and in the restructuring of production, where the steeply increasing trade and FDI have played key-roles including the integration of the East European financial sectors with Western Europe. However, this development also meant that the transition countries were exposed to the risks following a recession in the global economy and especially in relation to their most important trade partners - the old members of EU.

Using the PIE-terminology the main push comes from the surrounding world. However, the vulnerability of each country depends on their specific characteristics in relation to:

- The development of institutions, the degree of openness to trade, FDI and especially to foreign ownership and international integration of the financial sector.
- The stage of development in relation to restructuring foreign trade and competitiveness in the economy, including balance of trade and current account and foreign debt.
- The stance of macro-economic stabilization and exchange rate regimes.
- The resources in the economy, the dependency on the development in commodity prices.
- In the longer run we may see political effects of the crisis. The question is to what extent the economic downturn may result in unrest and strong confrontations which may strengthen some more extreme political forces.

Especially, the most advanced transition countries have had quite open economies with high foreign trade and high level of inward FDI. Still, nearly all the transition countries have a high trade deficit. They are as earlier described in the stage of strong restructuring where they need to import investment goods especially for implementing new technologies. This restructuring means steeply increasing productivity improvement in quality and competitiveness. Exports are increasing fast, however still not fast enough to cover imports. The trade and current account deficits have been covered by FDI and foreign debt, but this external financing means that an

increasing part of income shall be paid in interest and returns to foreign owners. These transfers have not been an important burden for these economies in the economic boom in the later years. Interest rates have been low, refinancing easy, and the returns on FDI have typically been retained in the host countries, thus, counting as additional FDI. The expectations were that in the long run the balance would be reestablished by further restructuring resulting in higher competitiveness and increasing exports. However, when demand fell because of the global recession exports were strongly hurt. At the same time FDI also fell steeply. This meant that financing the current account deficit became a problem and several countries were forced to cut down domestic demand to lower imports.

Few banks in Eastern Europe and Russia have been directly hit by the sub-prime defaults which triggered the financial crisis, but because of the credit crunch refinancing of foreign debt became more difficult and more expensive. The development of the financial sector was an important part of the latest stage of transition, and especially in some countries like the Baltics, Romania, Bulgaria, Russia and Ukraine there was a strong credit boom in the later years.

In Russia the banks were owned by domestic capital and after the 1998 crisis the dominating banks were state-owned. This was not the case in Eastern Europe where most banks were owned by Western banks. The Western owners in general supported their subsidiaries, which often belong to the most profitable parts of their networks (EBRD 2008). However, there was a risk that losses in the mother banks led to cuts or a stricter credit policy in the subsidiaries and in general the flows of credits to Eastern Europe were restricted and made more short term because of the crisis.

In the Baltic countries with fixed exchange rates/currency boards domestic interest rates were nearly down at the Euro level and a high proportion of the loans were taken directly in Euro. At the same time catching up of productivity and production meant a gradual catching up of price levels and thus higher inflation (Mygind 2006).

The credit boom triggered a boom in the real estate sector building up a housing price bubble and this was an important reason for increasing pressures on the labor market. Unemployment fell to very low levels and wages increased steeply causing further pressures on inflation. This meant that the nominal interest rates did not follow the increase in prices and became lower than inflation. This negative real interest rate increased further the incentives to take loans. The credit boom was accommodated by the foreign owned banks which supplied the economies with cheap loans. In this way there was a self-enforcing dynamic circle within the economic system which led to further overheating.

For some years the Baltic economies had record high growth rates, but the boom was accompanied with increasing inflation and very high current account deficits. This was not sustainable in the longer run and already before the melt down on the global capital markets the Baltic economies experienced an economic turn-around and their crisis was further deepened after the global melt down in the fall of 2008. Especially, the Latvian economy was vulnerable because of some years with quite loose fiscal policies and high increases in wages and prices.

One of the biggest banks was rescued by the state and IMF had to step in with a big loan conditioned by a tough fiscal package including direct cuts in public wages. This saved the fixed exchange rate which was part of the Latvian entry plan for the Euro, but at the same time production fell further.

Also Hungary had to implement an austerity package to get an emergency loan from IMF and ECB – the European Central Bank to protect the economy from a full melt down. Unlike the Baltics, Hungary had a floating exchange rate. Still, Euro loans made up a substantial part of many Hungarians' loans. With steep falls in the Hungarian currency this debt burden increased considerably and threatened a further break down of the economy. In this way several countries like Hungary and Latvia had to tighten their economic policies in a period where the fall in demand called for economic stimulus and the crisis was deepened in the short run.

Commodity producers such as Russia had benefitted from the high and increasing prices on oil, gas and metals for several years. They had high trade and current account surpluses, and in Russia they accumulated huge reserves from oil tax revenues in a stabilization fund. This turned out to be a prudent policy when the commodity prices collapsed in the fall of 2008. The development showed the Russian dependency on high oil prices. The Russian stock market experienced one of the steepest fall and there were increasing pressure on the Ruble which depreciated by more than 30%. At the same time the Russian state had to inject high amounts of capital into the financial sector like it was done in many countries in the West.

With the revival of the global economy in 2010 nearly all transition countries turned to positive growth rates after. The crisis meant a set back in growth; but these economies have a high potential for high growth rates in their continuing restructuring process which within a period of the next 20 years may lead to a catch up to the average EU level. The speed of this catch up process depends on the final stages of transition and their ability to consolidate their institutional development. The current crisis has also pointed to weaknesses in some of the transition countries like: dependency on commodity prices, dependency on cheap credits, weak states with high corruption and lacking quality of institutions. This will be further discussed in the final section on the status of the transition process.

12. Status and perspectives for the remaining transition process

Has the transition been too tough? Because of the drastic fall in production and living standards the first answer could be yes. However, there is much variation in the development of production for different countries. The evidence shows that the most consequent reformers have been most successful. The majority of the population in these countries has now living conditions at least as good as before the transition started. This level has been reached after a tough period with high costs for many groups such as retired people, most employees in the public sector, workers in large failing enterprises etc. Many mistakes have been made and a few countries are still below the starting point.

Reforms must be adjusted to the specific conditions in each country. But this argument has often been used as an excuse for slow and inconsistent reforms. It is hardly too tough policies, but

hesitant and contradictory reforms combined with a badly functioning state, which is to blame for the lacking, or hopefully postponed, success in several countries. There is a close connection between the success of the reforms, the quality of the state and foreign investments and opening toward the developed market in Western Europe. The countries most advanced in the transition process are also the countries most advanced in the integration process with EU and they also have the highest level of foreign investments. Foreign direct investment plays an important role in the current stage of transition with focus on restructuring at the enterprise level.

These elements point toward the future transition with further integration with Western Europe and further restructuring of enterprises and integration into international production networks. There is still some potential in restructuring production also in the most advanced transitional countries. Even though these countries have an educational level comparable to most EU countries they still need to invest a lot of capital in infrastructure and a new restructured production base. The qualifications of the labor force must be further adjusted to the new needs. Further development of institutions is crucial especially concerning financial markets, the court system and the development of the administrative capacity of the state.

In the coming years we will probably see an extension of the gap in Eastern Europe between groups of countries with different speeds in relation to transition and EU-integration. In the frontline we have Estonia, Poland, Slovenia, Czech Republic, Slovakia and Hungary closely followed by Latvia and Lithuania and then Bulgaria, Romania and Croatia, while the remaining countries in the Balkans come in the second row. The CIS countries with Russia in front have a more uncertain future and a more peripheral participation in the integration process. Decisive for Russia and other CIS countries is the development of the state. Will they succeed in building up a well functioning democracy with a critical opposition and an independent free press, which can criticize the people in power and present alternatives to corruption and abuse of power? Will they succeed in building up an administrative capacity, which can assure clear, stable and fair rules for enterprises?

The economic slowdown following the financial crisis has hurt the transition countries mainly because they are highly dependent on the Western markets for their steeply increasing exports and dependent on external finance for some of their investment in restructuring production. At the same time the cooling of the economy with falling commodity prices has relaxed the inflationary pressure, which especially hit the overheated Baltic economies. This fall in inflation in fact opened a window of opportunity in relation to Euro accession for Estonia in January 2011. With proper policies and with further upgrading of the quality of institutions and of the functioning of the state bureaucracy there should be good prospects for succeeding in the long catching up process with Western Europe within the next 20 years.

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