

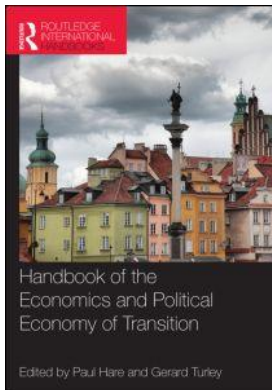
This article was downloaded by: 10.2.97.136

On: 23 Mar 2023

Access details: *subscription number*

Publisher: *Routledge*

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Handbook of the Economics and Political Economy of Transition

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Did We Go About Transition in the Right Way?

Publication details

<https://test.routledgehandbooks.com/doi/10.4324/9780203067901.ch3>

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Published online on: 25 Apr 2013

How to cite :- D. Mario Nuti. 25 Apr 2013, *Did We Go About Transition in the Right Way?* from: Handbook of the Economics and Political Economy of Transition Routledge

Accessed on: 23 Mar 2023

<https://test.routledgehandbooks.com/doi/10.4324/9780203067901.ch3>

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DID WE GO ABOUT TRANSITION IN THE RIGHT WAY?

D. Mario Nuti

The transformation recession

The post-socialist transition that began in 1990–92 in central-eastern Europe and the former Soviet Union (FSU) was widely expected to lead to early significant improvements in the level and growth of people's consumption and income.

It was a plausible expectation: leaving aside its authoritarian drawbacks, the old system – with dominant state ownership and enterprise, central planning and broad insulation from foreign trade and investment – was notoriously inefficient. It neglected consumers' preferences, input substitutability in production, and the opportunities and stimuli of the international division of labour. The system had an autarkic bias, which facilitated central planning but was a source of gross inefficiency, even within Council for Mutual Economic Assistance or Comecon (CMEA), the bloc of socialist countries engaged in a process of planned integration since the end of the 1950s (Lavigne, 1991). For instance, Hare and Hughes (1991) showed that on the eve of transition in Czechoslovakia, Hungary and Poland, between one-fifth and one-quarter of manufacturing production exhibited negative value added at world prices (using 1988–89 data on inputs, outputs and exchange rates). Japan bought Soviet machinery for scrap, and aluminium from the socialist bloc was sold internationally at less than the international price of the energy it embodied.

The Soviet-type system (for short, leaving aside national differences and repeated incomplete attempts at reform, only partly successful) was also unstable and imbalanced, marred by internal and external imbalances, both open and repressed. Endemic excess demand, for both consumption and production goods, prevailed at administered prices artificially held below market-clearing levels and disconnected from opportunity costs in production and trade. Excess monetary balances in the hands of the population resulted in shortages, queues, waiting lists and black markets. So much so that Kornai (1980) could entitle his two-volume treatise on that system, *Economics of Shortage*. Such repressed inflation had doomed to failure the frequent attempts at reform of the system in the direction of 'market socialism'.

The system had achieved rapid industrialization and growth, built military might and conquered space, but in the end it was unable to provide basic necessities to the population, had wasted the windfall of price increases enjoyed by its vast natural resources in the 1970s, accumulated unsustainable foreign debt, and in the 1980s stagnated and often declined. The new

system would generate market-clearing prices in domestic and international transactions, revive the incentives to follow them thanks to the appropriation of profits by owners of private enterprises, and unleash and discipline entrepreneurship. The few practitioners of the transition who did contemplate some disruption (e.g. Leszek Balcerowicz in Poland in 1990), anticipated at most a one-digit temporary decline followed by accelerated growth and catching up with other market economies.

Instead of that, the transition process was accompanied by a deep and often protracted 'transformation recession' (Kornai's label). Poland experienced the shortest and smallest fall in income (17 per cent of 1989 GDP in just under three years) recovering its 1989 level in 1996 and moving rapidly ahead, while Georgia had the largest and most prolonged fall (75 per cent by 1994 before reversing, and still below the 1989 level in 2011) – leaving aside the transition countries that experienced war (with Bosnia and Herzegovina at over 80 per cent GDP decline and by 2012 still not fully recovered).

Three reactions: denial, necessity, cock-up

This unexpected statistical record provoked three contrasting reactions: disbelief to the point of denial, belief coupled with acceptance of its necessity, belief coupled with rejection of its necessity.

The initial response, which to this day is still held by a few observers (e.g. Åslund, 2000) is that the transformation recession was by and large a statistical illusion, owing to changes in conventions and enterprise behaviour. In the old system there was universal reporting by enterprises that had an incentive to exaggerate gross production achievements, to avoid penalties involved by failure to reach planned targets and to reap the bonuses deriving from plan over-fulfilment. In the new system there was incomplete sample coverage of producers under-reporting net results in order to avoid tax. Also, a significant amount of production activity took place in the black or grey economy, simply going unreported. And people benefited from an increase of their consumer surplus, simply from having access to a broader range of goods, while price increases were to some extent justified by quality increases.

These considerations cannot be dismissed, but can easily be overplayed. There was a grey/black economy, though illegal, already under central planning; its newly found legality in the transition led to at least some of it surfacing, thus unduly boosting the performance of the new system. Consumer surplus is not and has never been included in national income accounting anywhere in the world, and there is no reason to begin accounting for it in the post-socialist transition. Parallel price and quality increases were not necessarily an improvement for all consumers. The availability and quality of public services plummeted. Transition performance was boosted to a great extent by the growth in formerly underprovided and underpriced services, and by real revaluation of the currency from initial gross undervaluation (see below). A single, exceedingly long queue for jobs replaced the many former queues for goods. Both inequality and poverty increased significantly in most transition economies (World Bank, 2000).

The second response to the transformation recession was that it was indeed real, but unavoidable. It was said that the transition was like 'turning a fish soup back into an aquarium', it had to be costly. In Poland the transition was likened to 'turning vodka back into potatoes'. Except that there had been no actual capacity destruction as there had been in wartime to justify this proposition. Others referred to the recession as a form of Schumpeter's 'creative destruction', also implausible since destruction of value-subtracting activities like those mentioned above should have *boosted* national income instead of reducing it, while competition and investment in innovation were missing anyway. Shleifer and Treisman (2000) justify the

recession as due to the unprecedented nature of the transition: they entitle their book on Russian transition *On the Road without a Map*. On uncharted territory we can all easily get lost, but this was not the case. We knew very well where we were, and all the conceivable advantages and drawbacks of the Soviet-type system; we knew what was going increasingly wrong with that system; we had – unlike any earlier transition – complete maps of the alternative points of arrival of the transition, i.e. the various versions of available models of capitalism – from Scandinavian type social-democracy to French indicative planning, from German *Mitbestimmung* to the Japanese neo-corporative model. Therefore we knew what had to be changed to implement the transition from where we were to the target model. What we did not know was the desirable speed of the transition and therefore, in case of a non-instantaneous transition, the appropriate sequencing of the necessary moves.

In one respect, however, the politics of transition rather than its economics necessarily involved disruption and recession to some extent. International trade was greatly disrupted by the economic and monetary disintegration associated with the transition in central-eastern Europe and the FSU. In 1991 the socialist trade bloc, CMEA, disintegrated; the transferable rouble, its purely accounting unit used to register planned trade flows at planned prices and carry over trade imbalances within the bloc for later consensual corrections, was replaced by trade at international prices settled in hard currencies. In 1992 the Soviet Union split into its 15 component Republics, with the rouble being replaced by 15 republican currencies, first as rouble substitutes then as proper domestic currencies. Mundell (1997), who regards the transformation recession as the worst ever, more serious than the 1929–32 recession and even the Black Death recession in the fourteenth century (when population also fell, thus preserving living standards) attributes it to a great extent to such monetary disintegration.

Suddenly, next to the Russian rouble there were Belorussian roubles, Lithuanian litas, Latvian lats, Estonian kroons, Ukrainian hryvnas, Uzbek soms and Kyrgyz soms, Georgian laris, Tajik roubles later followed by the somonis, Azeri manats and Turkmen manats, Kazak tenges, Moldovan leus and Armenian drams – a veritable Babel of currencies. The move to republican currencies, initially with limited convertibility and liquidity, restricted trade to bilateral transactions of balanced barter, or to deficits liquidated in scarce hard currencies. The changeover to international prices, and the end of cross transfers within the trading bloc, were other factors depressing trade and therefore employment and GDP. Should the current eurozone crisis eventually lead to its split into national currencies, the same kind of devastating recession should be expected as a result.

The IMF tried to prevent the FSU monetary disintegration, and was actually accused of holding back the transition. The different target models and stages of transition reached and intended by different republics made the preservation of the Union politically impossible. The same can be said of CMEA: early in 1990 Central-Eastern European members of CMEA had refused to continue planned integration within the trade bloc even if that involved loss of access to oil and raw materials from the Soviet Union at subsidized prices.

Having said that the recession was to some (not very large) extent overstated by national statistics, partly (significantly) the consequence of the politically unavoidable split of CMEA and of the Soviet Union (as well as of the Czecho-Slovak Federation and the Yugoslav Federation), a large residual of the recession was indeed real and due to ‘having gone about transition the wrong way’, to give a summary answer to the question raised by this volume’s Editors.

More precisely, much of what did go wrong was owing to (1) the uncritical acceptance of a particular and controversial model of capitalist market economy, namely hyper-liberalism; (2) the extension to transition economies of the Washington Consensus policies applied in the

1980s in Latin America (price liberalization, trade opening, privatization); (3) misplaced emphasis on the relative merits of gradualism versus ‘shock therapy’, neglecting actual policy trade-offs and governments’ preferences; (4) ‘state desertion’ of public enterprises and more generally of its role even in a market economy, and, in particular, the neglect of institutions in the naïve belief that they would establish themselves, develop and regulate themselves automatically; (5) various policies that can be regarded as mistakes even without the benefit of hindsight, mostly rooted in ideological dogmatism; (6) eventually, sooner or later, most transition economies especially those that joined the European Union (in 2004 and 2007, and the current candidates) completed the transition and accelerated their catching up with the rest of Europe, but the same factors mentioned here caused a vulnerability to the global crisis of 2007—to date, and a stronger (though later and shorter) fall (with the exception of Poland, Albania and Azerbaijan) than in other European economies and, above all, a marked deceleration of their growth. The same factors are now standing these countries in good stead for the subsequent recovery.

Hyper-liberalism

The target model adopted almost everywhere in the transition countries was that of an open and liberal (in the European sense) market economy that would reap the benefits of markets and private ownership and enterprise. However, the timing of the post-socialist transition coincided with the general domination of a particular and controversial model of capitalist market economy, namely hyper-liberalism, typical of the Reagan–Thatcher era. Under the strong influence of this ideology, the instigation of most foreign advisors, the conditionality imposed by the IMF and the World Bank, and the acquiescence of the European Union, the most widespread model in the transition was a hyper-liberal model that was more fundamentalist than any modern capitalist model in existence, including American capitalism.

The hyper-liberal character of the post-socialist transition model is confirmed by the dominant adoption of the following policies:

- Immediate unilateral opening of foreign trade, frequently revoked and therefore premature.
- Exceptionally rapid liberalization of capital flows, in contrast to the experience of other European economies after the Second World War.
- An unprecedented mass privatization (a notable exception was Hungary), through the distribution to the population of free or symbolically priced vouchers, convertible into state assets or shares in state enterprises – a macroscopic experiment in social engineering of debatable effectiveness.
- The demotion of the state, that led to delays or gaps in market regulation, especially in financial markets (see the disastrous diffusion of banking pyramids in Russia, Romania, Albania, Serbia, Macedonia and elsewhere), for the protection of shareholders and more generally for corporate governance.
- The dismantling of the welfare state, which in these economies was to a large extent the responsibility of state enterprises, without reconstructing it at the central level.
- A costly reform of the pension system from a Pay As You Go, defined benefits, distribution system (whereby pensioners are funded by the contributions of current employees), to a capitalization, defined contributions or funded system (with pensions paid out of the revenue earned on accumulated past contributions).
- A low and uniform rate of direct taxation (flat tax), therefore mildly progressive, on households and companies, mostly without taxation of capital gains but with higher indirect taxation.

- A flexible labour market, with weak trade unions and a low incidence of collective bargaining; the principle of market sovereignty was not applied to the labour market, frequently subjected to widespread wage ceilings enforced through punitive taxes.
- Lack of consultation and concertation between social partners and with the government.
- A central bank not only independent but exceptionally independent and free from any controls, without co-ordination with fiscal policy, pursuing a strict policy of inflationary containment and high interest rates, aiming at positive real rates even in the presence of currency appreciation (therefore attracting foreign capital but making the sterilization of the ensuing monetary expansion very costly).
- In general, a dominant weight of markets as against institutions.

This list could continue. Usually the IMF and the World Bank have been either praised or blamed for their part in imposing economic policies and institutional transformations in extreme forms, through the conditionality of their financial assistance, whose effects were multiplied by other public and private institutions in turn making their assistance conditional on an IMF programme. Sometimes Western advisors have been blamed for recommending policies that they would not have dared propose to their own governments. However, the ultimate responsibility for the policies actually adopted must be attributed to the sovereign governments that adopted those policies, and that were often only too pleased to conform to the requests of international institutions and the advice of some Western consultants.

The hyper-liberal victory in central-eastern Europe has involved a watering down of the European Social Model (ESM) as a result of EU enlargement to the East that began in 2004 and 2007 and is still in progress. A model somewhat closer to the ESM was adopted in Slovenia and Estonia, while Belarus and a few Asian republics adopted a model still close to an etatist one and to the old system, while under Putin's leadership since 2000, especially during his second mandate, Russia has moved somewhat in the same direction, of something approaching a *developmental state*. In view of the bitter reconsideration of hyper-liberalism that followed the global crisis of 2007–to date, we can say that, had the transition taken place 20 years later, post-socialism would have certainly adopted a very different model and policies.

The Washington Consensus

The IMF, the World Bank and the US Treasury applied to transition economies the policies implemented in the 1980s in Latin America with relative success: rapid macroeconomic stabilization, liberalization of prices and foreign trade, privatization. The notion that these policies might be replicated in transition economies in the 1990s ignored fundamental differences between the two groups of countries. Latin America in the 1980s suffered from open inflation and hyper-inflation, state enterprises were a minority and were familiar with the market economy including international markets. Transition economies, on the contrary, suffered from repressed inflation (see above); state enterprises were dominant and were not used to a market environment; the bulk of foreign trade was planned and the preserve of state monopoly.

These differences had profound implications. In the transition economies the price increase towards market-clearing level – which was the first necessary step towards a market economy, and indeed would have been necessary for the orderly and efficient running of a planned economy – was naturally bound to overshoot. Faced with a sudden new, unusual state of market balance, at uniform prices higher but necessarily lower than those previously prevailing in the black market, and with expectations of accelerating inflation, economic subjects were bound to reduce their demand for money below its equilibrium level at the new prices. The successive

replenishment of liquid resources therefore had to depress the current demand for goods and services. Latin American consumers, instead, faced with a slowing down of open inflation were induced to maintain higher monetary resources than they would have done otherwise.

Looking at it in another way, repressed inflation could be deconstructed, as was usual in Polish literature, into: an inflationary gap (*luka inflacyjna*), i.e. the price increase that would make the current flow of real goods equivalent to the current flow of monetary incomes; and the stock (*navis*) of accumulated past inflationary gaps. In theory there were ways to eliminate both, in the necessary advance to market clearing. For instance, a confiscatory currency reform at different rates for prices, incomes and cash (as in the late 1950s in the Soviet Union, many central-eastern European countries and China); but this was not politically feasible. Alternatively, a burst of imported consumption financed by foreign loans and aid, but this was not available at the time. Or a front-loaded privatization of state assets, but this was still controversial and a simple announcement would have been hardly credible before the start of the transition.

The choice of price liberalization was the simplest, fastest and most expedient way to clear markets, as a by-product of changing *relative* prices.¹ However, it necessarily involved overshooting: price rises that were practically irreversible had to absorb both the current inflationary gap and its past cumulation; in the following period (defined as the weighted average of the intervals at which markets were restocked) there would be lower demand than sustainable and consequent unemployment (Nuti, 1986).

Overshooting in price liberalization from a repressed inflationary state appears as unplanned fiscal surpluses and massive exchange-rate devaluations with respect to purchasing power parity (PPP) (with the US dollar worth 32 times its Russian rouble PPP equivalent, 20 times its Polish zloty equivalent, eight times its Hungarian forint equivalent when prices were first liberalized). Supply elasticities being low, these devaluations did not always work, but sometimes produced unplanned trade surpluses and reserves accumulation (e.g. in Poland).

This is not a good reason not to undertake price liberalization, for a market economy cannot exist without market clearing. But it makes a strong case for subsequent fiscal and/or monetary stimulus, and parallel price and wage subsidies of the sort introduced in Czechoslovakia and in the early stages of German unification, instead of wage controls and punitive taxation on wage rises (the Polish *popiwek tax*) and the abolition of price subsidies.

Both Latin American and transition economies had inefficient state enterprises, but in transition economies, moreover, they had a dominant position and were centrally planned, without the experience of adjusting to internal and international prices. Thus, the organic growth of new enterprises and the restructuring and commercialization of state enterprises were more important than their instantaneous privatization, and it was unlikely that liberalization could stimulate a rapid supply response, although it was important as a source of greater competition.

Neglect of the *repressed* nature of their inflation caused transition economies significant losses in terms of employment and output, in an economy shifting from supply-side constraints to Keynesian lack of effective demand. The overshooting implied by this approach was aggravated by fiscal and monetary policies more restrictive than intended, and by central controls over wages. The transformation recession was not, or should not have been, a surprise, but a mathematical certainty, although only a Kaleckian economist such as Laski (1990) was able to anticipate it, forecasting correctly a range of 15–20 per cent GDP fall in Poland.

Gradualism versus shock therapy

Since the early stages of the transition there have been endless and lively debates on the relative merits of gradualism versus ‘shock therapy’ (Kolodko, 2000; Popov, 2007). In truth the scope for

government choice in the transition is rather narrow in this respect, and the emphasis on this issue was misplaced. In the transition there are measures that can and must be introduced instantaneously and simultaneously, such as:

- Raise prices to market-clearing levels (see above).
- Legalize private ownership and enterprise.
- Allow all economic subjects – individuals and enterprises – free access to international trade.
- Eliminate quantitative restrictions on imports and exports.
- Unify exchange rates.
- Establish convertibility for current account transactions (not yet for capital account transactions) by residents.

All these changes can and should be made by decree, literally from one day to the next, at a stroke. Temporizing is counterproductive. At the other extreme there are measures that need time for their realization and therefore they should be given all the time that they reasonably require. Such measures include to (i) draft and introduce legislation; (ii) establish a properly functioning legal/judicial system separated from politics; (iii) break-up monopolies and establish competition; (iv) restructure productive capacity; (v) create financial markets; and (vi) establish relations of reputation and trust between government and private sector agents. It does not make sense, indeed it is counterproductive, to pretend that these changes could be accelerated, let alone be instantaneous.

The cases where there is a possible choice between shock therapy and gradualism can literally be counted on the fingers of one hand, namely trade liberalization; the elimination of subsidies; privatization; convertibility on capital account; and, especially, dis-inflation. I consider this an exhaustive list of policy areas where there is no absolute superiority of either gradualism or shock. Their relative merits depend on their respective costs and benefits, i.e. the trade-offs that the economy offers between government objectives, and the actual government preferences between those objectives.

For instance, alternative methods of privatization have costs and benefits (World Bank, 1996); mass privatization can be rapid and equitable, but with some associated costs: losing the fiscal revenue that would result from the sale of state assets, establishing weak corporate governance, leaving an unchanged management and poor access to new investment funds. Privatization via sales to employees and managers is less rapid and obtains some additional revenue for the budget, at the cost of less equity, here as well without managerial improvements and access to investment funds (provided not only by buyers but also through credit). Privatization via sales to the public is slower but involves greater revenue for the state budget, better governance, better management and greater access to investment funds. Sales to foreigners have the advantages of a capital inflow, better access to new technologies and investment funds, trade outlets, at the cost of losing national control and the risk of future capital losses via profit repatriation and capital sales at times of crisis. On the other hand, delaying privatization often creates unprecedented opportunities for self-appropriation of state assets by managers and party officials, and straight corruption (see for instance the ‘loans for shares’ scheme that gave a few Russian banks a large stake in privatization at rock-bottom prices).

Similar considerations – of costs and benefits subject to government valuation – apply also to the other four areas indicated above. Thus, dis-inflation, from hyperinflationary rates to single-digit inflation, can be tackled gradually or rapidly; the benefits of price stability must be offset against the costs of associated unemployment. External tariffs can be eliminated rapidly and unilaterally or negotiated more slowly; the positive impact on competition and prices must be

offset against the possible adverse effect on government revenues and unemployment; it is no accident that countries that opened trade fast, as did Poland, Czechoslovakia and Hungary, subsequently backedpedalled and reintroduced tariffs and surcharges. Subsidies can be eliminated gradually (as in the Czech Republic, in spite of Vaclav Klaus's hyper-liberal rhetoric) or quickly (as in Poland); the benefits in term of inflation control must be offset against the claim on government expenditure. Currency convertibility on capital account can be introduced quickly, gaining from capital inflows but risking their volatility, or slowly, avoiding both benefits and risks.

There is perhaps a presumption against instantaneous privatization (in comparison to the birth and growth of *de novo* enterprises), against the rapid introduction of convertibility on capital account (see the Czech koruna crisis of 1997 and the Russian rouble crisis of 1998), against the rapid lowering of trade tariffs (for the resulting loss of government revenue, as lamented even by the then head of IMF Fiscal Affairs, Vito Tanzi, in 1997). And against rapid dis-inflation: Poland's star performance is probably owing among other things to its particularly slow dis-inflation, taking 10 years to go from three digits to single-digit inflation in spite of its shock rhetoric; Slovenia also benefited from slow dis-inflation.

'Clearly a generalised and unconditional "shock therapy" approach is facile and superficial. Just as for Lenin in December 1920, *communism = electrification + Soviet power*, we can say that for the initial Washington Consensus, *transition = liberalization + privatization*. Both equations have a doubtful theoretical foundation and have borne poor results' (Nutti, 2007).

State and institutions

On the rebound from the experience of a totalitarian state, transition leaders went to the opposite extreme of wanting to contain state activity to the minimum and destroy state institutions in order to allow the free play of market forces. Policy interventions appeared as undue interferences with market forces: in 1990 the Polish Minister for Industry and Trade, Tadeusz Syryjczyk, argued that 'The best industrial policy is no industrial policy' (Kolodko and Nutti, 1997). In the still large public sector, pending privatization, 'state desertion' of public enterprises occurred and led to continued inefficiency and to the appropriation of state assets by managers and *apparatchiks*. The weakening of state institutions made it possible for private subjects and enterprises to benefit from 'state capture', effectively a form of corruption.

In particular, the role of the state in the establishment, monitoring and regulation of institutions was neglected, in the naïve belief that institutions would establish themselves, develop and regulate themselves automatically. Sachs (1993) typically asserts that 'markets spring up as soon as central planned bureaucrats vacate the field'. Markets are self-regulating (homeostatic) mechanisms in the sense of adjusting prices to demand, supply to prices, actual to desired capacity; but they are not generated automatically, nor are they self-disciplined. They are social artefacts that rely on state authority for their validation and regulation, and often for their very existence. The kind of markets that moved in when central planners left at the beginning of the transition were the wretched people who lined up in Moscow streets to offer a few individual items for sale or barter, not the fabric of a market economy. When central planners move out, unless the state creates and controls markets, they leave a vacuum, and what moves in is disorganization and chaos (Blanchard and Kremer, 1997): former backward and forward planned linkages are broken, and a supply multiplier leads to chain losses of output and unemployed inputs. Unfortunately the importance of institutions (stressed by North, 1990) came too late to influence transition policy-making.

Ellman (2012) stresses 'The need for an effective and accountable state', compared with the Friedmanite notion that 'the state is not the solution but the problem'. He quotes the World Bank's 1997 *World Development Report* recognizing that 'An effective state is vital for the

provision of the goods and services – and the rules and institutions – that allow markets to flourish and people to lead healthier, happier lives. Without it, sustainable development, both economic and social, is impossible’ (p. 1). And the 2002 *World Development Report* was entitled *Building institutions for markets*. Ellman regards the official acceptance of these principles, that were not new, as one of the lessons of the transition, and reviews a number of adverse effects of their earlier neglect, such as the accumulation of payment arrears in the Russian economy, a new institution generated in the transition but actually incompatible with a market economy.

The quality of policies

The quality of transition policies is usually judged by the speed and intensity with which a country has followed the prescriptions of the Washington Consensus, or by the indices of transition progress assessed by the EBRD in their annual *Transition Reports*, or their cumulation over time. It seems necessary, however, to consider instead the consistency and feasibility of policy targets; the choice and intensity of qualitative and quantitative policy instruments and packages with respect to those targets, the co-ordination of policies delegated to different agencies; the continuity of policies, in the sense of their inter-temporal consistency, the possible undesirable side-effects. We have already discussed the necessary overshooting of price liberalization without subsequent fiscal or monetary stimuli. Two other examples are given here: central bank independence and pension reform.

Central Bank independence

The principle of Central Bank independence rests on very shaky theoretical foundations, namely rational expectations. These are supposed to eliminate the trade-off between unemployment and inflation, to the point that inflation can be targeted by an independent Central Bank while the government is supposed to take care of unemployment.

In the transition this principle was implemented with mixed results. Some central bank governors were not really independent (Belarus 1994–98); others followed their own personal political agenda (in Poland in 1995 the Central Bank governor stood for election as President without resigning beforehand and resumed her position after a resounding defeat); others aimed at targets different from price stability, such as the support of state enterprises (Russia 1992).

In the fight against inflation, the Central Bank sometimes fixed real interest rates at usurious levels (Russia 1994, with a real annual rate of the order of magnitude of 200 per cent, or Poland towards the end of the 1990s and early 2000s). Such rates became a residual form of central planning that necessarily caused deflation. There was no co-ordination with fiscal policies, which involved interest rates, exchange rates and fiscal deficits all higher, with less inflation but higher unemployment and lower net exports and lower incomes, than would otherwise have been possible and desirable.

In Russia in 1998 the containment of inflation led to overvalued exchange rates, maintained thanks to high interest rates which were not consistent – given the burden of public debt – with fiscal balance. The bubble exploded in August 1998: the Russian government defaulted in spite of the massive financial support of the IMF, the World Bank and the G8; the banks that had sold credit default swaps to cover investors against the risk of devaluation were unable to meet their obligations; those investors who were not favoured by the government with the early redemption of government bonds lost most of their investment; and the rouble was massively devalued.

A policy of excessively high real interest rates naturally encouraged the postponement of payments of purchases, wages and taxes on the part of enterprises, and eventually the

postponement of all payments (including salaries and pensions) on the part of the government, also in view of the IMF unwisely setting limits on the government deficit in cash instead of on an accruals basis. This form of de-monetization and accumulation of payment arrears, which in Russia reportedly reached something like 40 per cent of industrial transactions, was an unnecessary recessionary factor.

Pension reform

Imagine that a PAYG pension system is introduced where there was none before. Pensions begin to be paid instantly, out of the current contributions of those currently employed, while making sure, however, that the following condition is continuously satisfied:

$$p.P = a.w.L$$

where p is the average pension, P are the old age pensioners, w is the average wage, L are those currently employed, and a is the fraction of their wage that they contribute to the pension system. As long as:

$$a = p.P/w.L = (p/w).(P/L)$$

the system is balanced, does not absorb any resources from the state budget and can be deemed to 'yield' pensioners a rate of return equal to the growth rate of the wage bill. Certainly it is like a Ponzi scheme, in that payments out are funded by payments in. However, it is a *viable* Ponzi scheme, in that there are always new depositors (as long as there are *some* current employees), withdrawals are restricted (to pensioners, monthly) and are orderly (i.e. not exceeding new payments in). Population ageing can be anticipated, dealt with by prior accumulation of reserves, or by raising pension contributions, by lowering pensions or extending the retirement age.

A capitalized, fully funded, defined contributions system, by definition, does not cost anything to the budget – until there is a serious financial crisis in which the state cannot leave the elderly destitute. It yields whatever rate of return is earned by the investment of employee contributions; it promotes 'choice' and the development of financial markets. However, the switch from the first to the second pension system has an *unnecessary cost*, i.e. the emergence of a pension debt that – as long as the equilibrium condition mentioned above is satisfied – could otherwise remain conveniently buried for ever, until the end of the world.

A PAYG system has an implicit hidden debt, equal to the present value of the pension rights already matured by current employees and pensioners, but such a debt only has to be paid if there is a transition to a capitalized, fully funded, defined contribution system (see Chapter 8 of Eatwell *et al.*, 2000, Barr and Diamond, 2008).

Paradoxically, the reversal of such a reform, with a return to PAYG (partial or full, temporary or permanent), would free fiscal resources equivalent to the pension contributions of those currently employed for the entire period during which the reversal lasts (see the recent examples of Poland, Hungary, and other transition economies), without resorting to unnecessary and illegal confiscation of pension funds already accumulated.

The current crisis

The global crisis of 2007 to date struck transition economies in the middle of a process of rapid growth and robust catching up with the rest of Europe. In 2000–07, central–eastern Europe grew

at an average yearly rate of 6.3 per cent, south-eastern Europe at an average of 5.0 per cent, and the CIS at 8.3 per cent, while the EU-15 grew at an average of 2.6 per cent, thus leading to progress in convergence towards average EU-15 income levels, from 39 per cent in 1995 to 57 per cent in 2005 (Connolly, 2010). The crisis hit them: (1) *with a 1-year delay* compared to the global economy, in the last quarter of 2008 after the collapse of Lehman Brothers (simply because of the relative under-development of their financial systems, for they were not involved in the sub-prime crisis); (2) *with particular intensity*, not so much compared to other country groups but rather with respect to their earlier performance before the crisis and especially contrasting with previous forecasts of their performance. Against this background, therefore, the actual income falls (with the exception of Poland in the EU, Albania and Azerbaijan, with positive though slow growth in 2009) are an under-estimate of the impact of the global crisis in the region. What counts is the *deceleration* (i.e. the growth rate decrease) involved; and (3) was followed by a *more rapid recovery* compared to the rest of Europe (though not as fast as other emerging countries), resuming the earlier convergence process with the EU-15 but still with modest and intermittent progress. There has been a great diversity among these countries, depending on their economic policies and in particular their exchange rate regime, their dependence on foreign trade, and their integration in global financial markets.

The Bruegel-WIIW (2010) report gives great importance to the exchange rate regime: floating rates have fared better than fixed. This is true – with two qualifications. First, a floating exchange rate can maintain international competitiveness through devaluation – up to a point, for competitive devaluations make every competitor worse-off. If trade flows are sufficiently elastic and there is appropriate spare capacity, this improves trade balances. However, devaluation raises the value of all debt denominated in foreign exchange – which is most of it in these countries, in view of higher interest rates in a fairly stable domestic currency and the difficulty of borrowing in domestic currency. Thus, devaluation may turn private and public loans into sub-primes, raising both the risk of default and interest rates.

A fixed exchange rate does not have this negative impact on debt, but loses international competitiveness and causes unemployment, and is still exposed to the risk of sudden devaluation, all the more damaging as it is less expected; the very prospect of a possible devaluation may raise interest rate spreads and the price of Credit Default Swaps. Every exchange rate regime has both costs and benefits, but there is no regime that protects a country fully from a crisis.

Second, the orthodox ‘bi-polar’ view of exchange rates typified by Fischer (2001), namely that a fixed or adjustable peg should be avoided in favour of either a flexible or hyper-fixed regime (Currency Boards, or the unilateral adoption of a foreign currency), has been falsified by the transition countries in the economic crisis. In particular the Baltic states have suffered greatly – from the straitjacket of a hyper-fixed misaligned parity – in terms of output and interest rates, and from the alternative ‘internal’ devaluation in the form of a severe deflation, which was forced upon them as the only remedy to restore competitiveness.

The EU has not allowed its members and accession candidates to adopt unilateral euroization, but has allowed Currency Boards (e.g. Bulgaria, Latvia), inexplicably because their success is subject to the achievement of at least the fiscal and monetary convergence conditions required before adopting the euro. A Currency Board simply reduces the probability of a crisis at the very considerable cost of making the crisis catastrophic if and when it occurs (as in Argentina in 2002).

The adoption of a hyper-liberal economic system, which had partly contributed to the transformation recession, subsequently facilitated their integration in the European economy, their growth and convergence. Openness to trade and dependence on external finance made them particularly vulnerable in 2009, with the collapse of world trade (the first episode of

de-globalization since global integration resumed its course after the last War) and the slow-down and often the reversal of capital flows (often referred to as their ‘sudden stop’). There was also the impact of worsening terms of trade, which on average was almost as large as that of the reduction in trade volume, and worse for primary products exporters (primarily Russia, Azerbaijan and Kazakhstan).

Financial integration promoted growth and convergence, but in the crisis it became a channel for contagion. Large capital inflows (flowing ‘downhill’ in this case, not ‘uphill’ from emerging to advanced economies as is often the case globally; reaching 11 per cent of their GDP before the crisis) made these countries vulnerable to flow reversals. Moreover, the composition of capital inflows in many transition economies was often inappropriate, focusing on real estate and financial services rather than on manufacturing tradeables.

Transition economies on average had a high share of foreign ownership of banks, growing especially in 1999–2001 from an average 40 per cent to over 70 per cent (except Slovenia), mostly by EU-15 groups, approaching 100 per cent in some countries of Central-Eastern Europe. Foreign banks provided personnel, know how, funds, credibility and expanded the volume of credit. At the beginning of the global crisis, however, in a framework of lower capital inflows, these countries suffered initially from the frequent capital repatriation by foreign banks, also because national government support for EU-15 banks was not extended to their eastern operations. This was a typical prisoner’s dilemma, i.e. there was a collective advantage if all banks kept lending, an individual advantage for one bank that did not while all the others did, and a collective loss if all banks withdrew. However, the EBRD and the IMF provided funds and incentives that kept this adverse development under control through the European Bank Co-ordination Initiative (the so-called ‘Vienna Initiative’) between international banking groups, home and host-country authorities, IFIs and the EU (see the EBRD’s *Transition Report*, 2009). The Initiative is being replicated in 2012, with lower prospects of success.

The Bruegel–WIIW (2010) report stresses the need for regulation and supervision of financial markets, such as constraints on leverage, regulation of derivatives, better capitalization, counter-cyclical macroeconomic policies, Glass–Steagall-type legislation, consumer protection, transaction taxes, provisions for systemic risk. That all this was needed was already well known before the crisis, except that the hyper-liberal approach that had dominated the global economy since the late 1980s shaped the financial systems of transition countries even more forcefully than those of advanced countries.

Those transition economies that joined the EU did not – with the exception of Slovenia and to some extent Estonia – adopt the institutions of the European Social Model; it was not part of the institutional convergence required by the EU of new members. This resulted in the inadequacy of social safety nets, to protect the population from unemployment, poverty, illness and old age. Such inadequacy raised the social cost of the economic crisis when it happened and disabled some of the mechanisms that dampen economic decline (they are usually called ‘automatic stabilizers’, improperly because they can slow down the decline but cannot reverse it on their own).

On the positive side, the same deep and possibly premature integration with the global real and financial economy is bound to lead to economic recovery in these countries if and when – sooner or later – the global economy bounces back.

Note

- 1 There were three gradual alternatives, all of them inferior to instant change. First, sequential price rises initially short of equilibrium (involving lower inflation but persistent disequilibrium and expectations of further inflation). Second, a two-track price system (China 1980s, part controlled part free, but in

transition economies imbalances were too large, there was no time and too little administrative capacity). Third, sequential price liberalization of groups of commodities (which would have led to adverse forced substitution). Price liberalization was preferable to the uncertain guesswork of an arbitrary and inefficient system of market-clearing administered prices.

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