

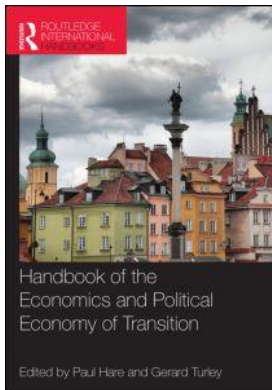
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4

IS THE TRANSITION OVER?

A definition and some measurements

Oleh Havrylyshyn

Introduction¹

While many observers thought it was premature for Czech Prime Minister Václav Klaus to suggest in 1995 the transition was over except for fine-tuning,² nearly 25 years after the fall of the Berlin Wall it is worth asking the question again. The main contribution of this chapter is to show that, for all practical purposes, the post-communist transition is over in most of the early reformers of Central Europe and the Baltic states; but it is *not over* for other transition countries – though many are well advanced, and only three or four remain far behind. The reasons why some are still lagging behind are not investigated, save for a few telegraphic remarks.

Earlier studies addressing this question did not define the end of transition rigorously, but were more often qualitative judgments.³ Here, a precise definition of transition and its end point is proposed, as well as some practical ways of measuring it. Coverage is for the period 1990–2010 in post-communist Europe and Eurasia, excluding China and Vietnam as they are not only still communist regimes, but the transformation they faced was different, more akin to an economic development problem for a still agricultural economy.

The next section defines transition theoretically as the attainment of an efficient market allocation equilibrium. Then the end point is defined as the correction of socialism's main distortions to arrive at a position similar to properly functioning market economies. To assess this, a number of quantitative indicators are presented. The final section summarizes the evidence on completion of transition, noting the differences across countries and measures used.

Defining the end of transition

The meaning of transition and its aims differs for different individuals. For citizens of the former communist countries, transition was seen as a way to overcome the backward economic conditions of the socialist world, and its end was catching up to income levels of the EU; define this as *POP1*. The transition was also viewed as the return to 'civilized European society' with democratic and personal freedoms, *POP2*, with more or less equal weight given to each element. For academics, views differed but overlapped; political scientists and historians focused more on democratization and freedoms: *POL*. These political aspects of transition are not discussed further below.

Economists were most interested in the transition to a market economy with private ownership, comprising two steps which form the focus of this contribution: achieving market rules (*MRULE*), and attaining optimal efficiency (*MEFF*).⁴

A theoretical definition of economic transition and its end point

Two main schools of thought developed on how to do transition: the rapid or big-bang reforms, versus gradual reforms. In the early years of the transition many said that knowing exactly how to proceed was difficult because ‘when the Berlin Wall fell there was no theory of transition’ (Roland, 2001, p. 9). The concern that one needed more time to think it through and do it right was itself an argument for gradual reforms, but the main rationale was to avoid the social costs of high unemployment during the time it took for new efficient industries to develop. Paradoxically, both big-bang and gradualism proponents based their arguments on the same theoretical principles of efficient resource reallocation. However, neither school explicitly specified a comprehensive model of transition, whence the contentious view, ‘there is no theory’.

For the present purpose of defining an end point of transition, it is proposed here that a sufficient theoretical basis is provided by combining Kornai’s (1994) partial definition (changes of rules and incentives by eliminating the central plan, price liberalization, allowing private ownership and imposition of hard-budget constraints), with Blanchard’s (1997) also partial

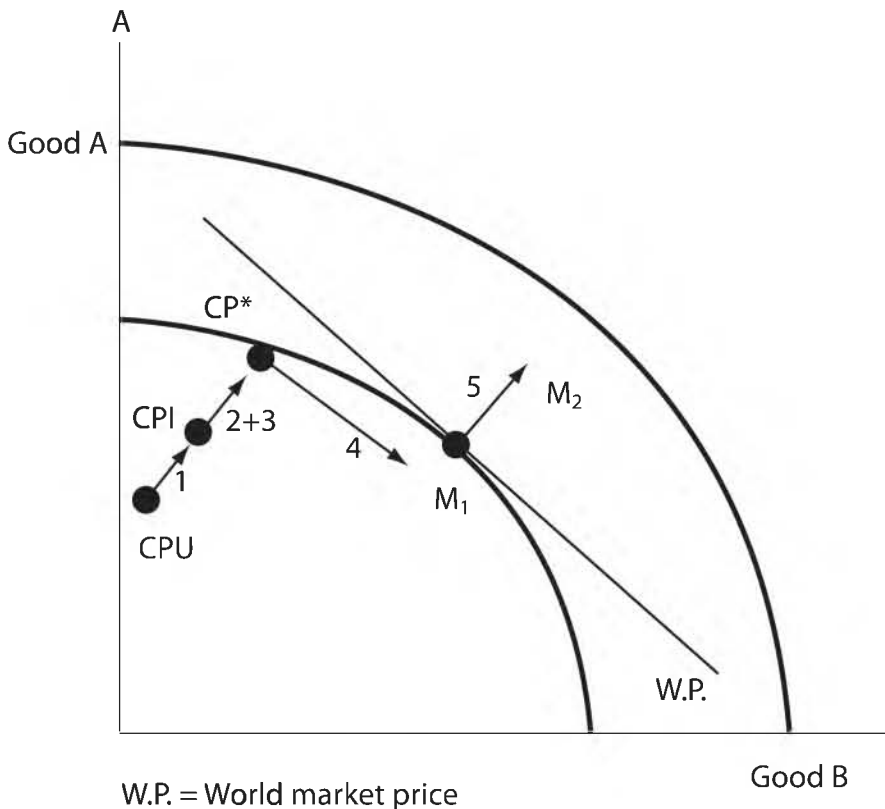


Figure 4.1 How the PPF defines transition and its end
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definition (resource reallocation and efficiency improvements in response to new incentives). Call this the KB theory of transition and define Kornai's changes as the *MRULE*, and Blanchard's as *MEFF*. Broadly, most writings on transition, whether espousing big-bang, gradualism or institutions first, all implicitly worked in this theoretical context: *change the rules, then reallocate resources to achieve efficiency*.⁵

This KB theory can be represented in a simple Production Possibility Frontier (PPF), Figure 4.1 showing the conventional production trade-off between two goods, say A, machinery, and B, consumer goods, assuming full and efficient employment of all resources, and world prices WP. A second PPF is shown further out from the origin; this represents the basis for new growth after transition has been completed.

Take CP* as the Central Planner's optimum combination of A and B, which historical consensus agrees was not achievable in practice owing to various socialist inefficiencies. With the actual position inside the PPF at CPI (inefficient), Kornai (1994) argued the first step in transition – *MRULE* – will create a transition recession with output declining to CPU (underemployment). Whether one starts here or at CPI does not materially affect the argument, for in either case the system is under-producing relative to potential, and is generally biased towards a high ratio of machinery to consumer goods. Once *MRULE* is achieved, corrections take place reducing socialist inefficiencies and underutilization of capacity, i.e. recovering from the transition recession and moving towards the PPF.⁶

The actual steps taken by the economy in reaction to *MRULE* may be simultaneous but are usefully distinguished as follows: (1) output decline due to hard-budget from CPI to CPU; (2) recovery of output with socialist capacity back to CPI; (3) efficiency improvements to move economy towards PPF; and (4) movement along PPF, reallocating resources among goods to reflect preferences and comparative advantage in an open economy. Thus, the ultimate end of transition is market equilibrium, and it is reached at M1.⁷

MRULE, involves changing the rules from central planning to competitive market decision-making and allowing private ownership. Popularly, this is often described as creating capitalism, which can be misleading and the source of disagreements about outcomes. Formally, capitalism refers only to the 'ownership' aspect, with state-guided capitalism, monopoly capitalism or competitive capitalism all possible. In this spirit, it has been said that capitalism has now been achieved in Russia or Ukraine, suggesting transition is over. But in fact their non-competitive 'oligarch' capitalism is an incomplete transition relative to the open and competitive market rules benchmark. An alternative interpretation for such countries is that transition is frozen part-way towards a competitive and open market economy.⁸

From the economist's perspective, achieving *MRULE* is just the first step, a necessary but not sufficient condition for the end of transition. The end point and sufficient condition is *MEFF* (at M1); once it is achieved it must have been the case that *MRULE* was also achieved. Nevertheless, it is very useful to track achievement of the *MRULE*, as is done by the EBRD's annual Transition Indicators, as shown below.

Deriving measures of the MEFF end point

Direct measurement of the PPF is not possible, and even efficiency frontier estimates for a single product require a massive econometric exercise. Here proxy indicators for M1 are proposed, *measuring how far the well-known faults of socialism have been corrected relative to the benchmark, average value for 'similar' market economies*.

It is widely agreed that the main shortcomings of economies based on Soviet-type central planning were: (1) anti-consumer bias as seen, for example, in the very low level of automobile

and telephone ownership; (2) over-industrialization and its mirror image, a very low share of services activity in GDP; (3) a relatively closed economy with low ratio of trade to GDP; (4) inward orientation of trade within the socialist bloc; (5) goods-specific allocations that were not reflective of comparative advantage. For the first four the consensus is strong; but less so for the comparative advantage issue; furthermore, it is very difficult to determine a country's comparative advantage and judge how much correction there has been, hence this measure will be treated more qualitatively and conclusions will be less certain.

Considering what each of these faults implies about the correction allows one to derive a practical measure of the end point. Correcting the anti-consumption raises the share of personal consumption in GDP, and the most sensible benchmark is middle-income market economies. Data on major consumer goods like automobiles are also available for illustration.⁹

Correcting the over-industrialization means that the GDP share of manufacturing or industrial sectors should fall over time. The benchmark for M1 here can be more rigorous than a simple comparison with similar market economies: it is well known in development theory going back to Clark (1940) that this share at first increases as an economy develops with the counterpart share of agriculture declining. At some middle-level of income the manufacturing share begins to decline, with agriculture continuing to decline but services increasing. Econometric cross-country analysis of this relationship was done by Chenery, Robinson and Syrquin (1986), and recent estimates for transition countries will be summarized in the next section.

The closed and inward-oriented economy of the socialist period should become more open during the transition, so that its trade/GDP ratio rises, and each country's trade should become more geographically diversified, with the share of exports outside the (former) socialist bloc rising. Openness ratios are readily calculated and cross-country comparisons are summarized below. For geographic diversification, the benchmark is based on available gravity model estimates for transition countries.

Finally, there is the product misallocation fault, not being at the comparative advantage equilibrium on the PPF at world market prices. Most outside experts held this view, but some were less sure suggesting that, for example, the concentration of Eastern European satellites on small and medium manufactures, while the USSR concentrated on natural resources and heavy industry, was not altogether wrong. This is also far more difficult to measure, short of the extensive factor endowment estimates as in Leamer (1984), which do not appear to exist for transition countries, hence prudence might suggest omitting this indicator. However, it has become a central policy issue in many CIS countries (Russia, Ukraine, Kazakhstan) with concerns that transition has 'hollowed out' the strong manufacturing capacity of the socialist period and pushed countries backward to the status of resource-based economies. Therefore some analysis of this is attempted here, but warily and less rigorously than for other measures.

Evidence on completion of transition

MRULE: CEB completed, others advancing, a few laggards

Before assessing attainment of *MEFF*, it is useful to ask how close countries are to completing the first step, *MRULE*. The EBRD provides a widely used set of annual transition indicators (TIs), each assessed on a scale running from 1.0 (indicating next to no change from central planning) to 4+ (often interpreted as 4.3, representing a fully functioning market economy). The indicators comprise three groups: market liberalization (*LIB*), market institutions (*INST*) – the EBRD labels these second-generation measures – and infrastructure reform. Here, the

average of the first two is used to indicate the extent of attainment of *MRULE*. Since the EBRD does not score existing market economies, it is a little unclear what the top score of 4.3 really represents. Hence, here the attainment of *MRULE* is considered more or less complete at indicator values of 4.0.

Three of the indicators comprise the main liberalizing measures (*LIB*): liberalization of prices, trade, and small scale privatization. The other five are akin to institutional rule changes (*INST*): firm governance, entry and competition, financial market development, etc. How good is this measure? Shortcomings of the TIs have been noted by many, but no alternatives are available for the full period. The above definition for *INST* is far from ideal and much less comprehensive than others like the World Bank Governance Indicators or Doing Business Indices. However, its advantage is the full coverage from 1990. Furthermore, Havrylyshyn (2009) shows a very high correlation (0.90 or more) between *INST* and other measures.

Table 4.1 presents data for 27 countries in five groups showing the following: the year *LIB* reached 4.0, the year in which the TIs (*LIB* + *INST*) reached 4.0; if still below 4.0, actual 2010 values are shown in brackets. *INST* values for 2010 are in the last column.

Countries are grouped to reflect similar reform progress,¹⁰ central Europe and the Baltic states (CEB) are the most advanced, with south-east Europe (SEE) now catching up, more reformist FSU countries (CISM) close behind, with Belarus, Turkmenistan, Uzbekistan (CISL) little advanced.¹¹ Table 4.1 suggests *MRULE* for the *LIB* subset was largely achieved in CEB as early as 1992–94, with one exception, Slovenia in 1996. The Baltic countries, starting only about 1992 had completed these by 1994, no later than most of Central Europe. Only Poland and then Czechoslovakia were earlier.¹² *INST* values increased much more slowly for all, and even the fastest CEB countries are still short of a 4.0 value.

Most SEE and CISM countries have by now reached the 4.0 threshold for *LIB*, with Bosnia-Herzegovina, Montenegro and Tajikistan just short. But apart from Bulgaria and Romania (EU members), none has come at all close in the *INST* category, thus these countries, despite considerable policy changes, are far from completing even the first Kornai step. Even farther behind are the three CISL countries, still remaining with socialist rules rather than the market.

Significantly, the broad picture of CEB near completion, SEE and CISM moving forward but still short, and CISL virtually unchanged from the socialist period, presages the results below for indicators of *MEFF* completion.

Indicators for attainment of MEFF

Here we show values by country groups of *MEFF* proxies related to major distortions of socialism. The CISL laggards and SEE are excluded for some indicators; and in CISL the *MRULE* is so little advanced that progress to *MEFF* is hard to judge; SEE are more advanced on the *MRULE*, but political and civil instability through the nineties has doubtless delayed adjustments, especially on the structure of production and exports.

Anti-consumer bias corrected for most

To assess how much anti-consumer bias has been corrected it suffices to observe trends in the share of personal consumption in GDP, as shown in Figure 4.2 and the comparable benchmark Middle Income Countries (MIDINC) as defined by the World Bank.

Both CEB and CISM show an increase in the consumption share within the first five years already from below 50 per cent of GDP to a little under or over 60 per cent, bringing them close to the MIDINC average of about 60 per cent. Lazarev and Gregory (2007), in a study of

Table 4.1 Attainment of MRULE

Country	Year LIB=4	Year TI=4	Inst (2010)
Croatia	1994	[3.7]	3.3
Czech Republic	1992	2007	3.7 (2007)
Hungary	1994	2005	3.8
Poland	1993	2007	3.7
Slovakia	1992	2007	3.5
Slovenia	1996	[3.5]	3.0
<i>Central Europe</i>			3.5
Estonia	1994	2006	3.8
Latvia	1994	[3.8]	3.3
Lithuania	1994	[3.8]	3.5
<i>Baltic states</i>			3.6
Albania	2000	[3.2]	2.5
Bosnia-Herzegovina	[3.8]	[3.0]	2.5
Bulgaria	2000	[3.8]	3.4
Macedonia	1994	[3.4]	2.8
Montenegro	[3.9]	[3.0]	2.4
Romania	1998	[3.5]	3.2
Serbia	2007	[3.1]	2.5
<i>South-Eastern Europe</i>			2.8
Armenia	2001	[3.3]	2.7
Azerbaijan	2007	[3.2]	2.1
Georgia	1997	[3.5]	2.6
Kazakhstan	1997	[3.2]	2.5
Kyrgyzstan	1995	[3.2]	2.4
Moldova	2005	[3.1]	2.5
Russia	2007	[3.1]	2.7
Tajikistan	[3.8]	[2.6]	1.9
Ukraine	2007	[3.2]	2.5
<i>CISM</i>			2.4
Belarus	[2.6]	[2.2]	1.9
Turkmenistan	[2.3]	[1.5]	1.0
Uzbekistan	[2.7]	[2.2]	2.0
<i>CISL</i>			1.6

Source: Author's calculations from EBRD Transition Reports

Russia, also conclude the bias is largely corrected. Some overshoot is seen in 1995 for SEE countries, perhaps reflecting the much greater political and economic instability. Broadly it seems that anti-consumer bias has been quickly and probably completely corrected in most transition countries; in Figure 4.1 this would mean that allocation had shifted to the lower right, with more consumer goods being produced.

A dramatic example for a specific item whose consumption was severely constrained under socialism, automobiles, is shown in Figure 4.3, suggesting fulfilment of consumers' pent-up demand, particularly in the CEB countries where economic recovery came soonest.¹³ A similar story can be told for telephones, housing space, household appliances, and foreign travel. All this is of more than descriptive interest, since such surges in meeting pent-up demand are probably also associated with the excess-credit and overheating in the second transition decade, which resulted in this region being the hardest hit among emerging markets by the global recession.

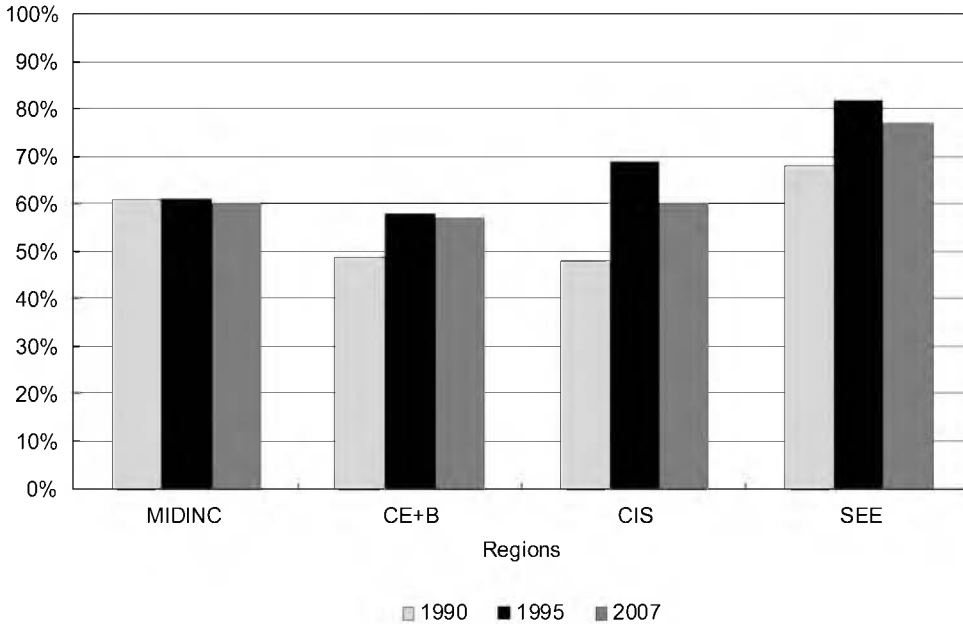


Figure 4.2 Consumption shares in GDP

Source: World Bank, *World Development Indicators*, various years.

Over-industrialization largely corrected in CEB, only partially in CISM

The problem of over-industrialization typically involved an over-emphasis on heavy and military industry compared to light industry and consumer goods, but here only the overall industry share in GDP is analysed. The changes in this share since 1990 are shown in Figure 4.4, for the original EU-15 as a rough benchmark, for the New Member States acceding in 2004 (NMS – the CEB group except Croatia), and Belarus (BY), Russia (RU), Ukraine (UA), Kazakhstan (KZ).¹⁴

Over-industrialization is evident in the 1990 panel: compared to a share of just over 30 per cent in the EU-15, nearly all the centrally planned economies had values of about 50 per cent. Kazakhstan’s 35 per cent reflected its natural resource endowment, which incidentally is consistent with some arguments made that central plan allocations were not entirely out of line with comparative advantage. Within five years these shares fell sharply to levels around 35 per cent, but this may not have been a new equilibrium yet because of the short time for adjustment, and in the case of the CIS countries because their transition policies (*MRULE*) had barely begun. The 2004 values confirm a downward trend for the NMS, and suggest lagging adjustment for the CIS. The NMS countries reached about 32 per cent on average, only somewhat higher than the share for the much higher income EU-15. For CIS countries the share stayed in the range 35–40+ per cent, with some experiencing a slight rebound and Kazakhstan rising to a share even higher than in 1990.

The trend was towards correction, but is it complete, is MEFF attained? The EU-15, with its higher level of development, is not the best benchmark for this: a more rigorous test is provided by estimates of Chenery-type equations as follows:

$$INDSH = a + b.y1 + c.y2 + d.POP + e.SIZE + f.NATRES + g.DUM \quad (4.1)$$

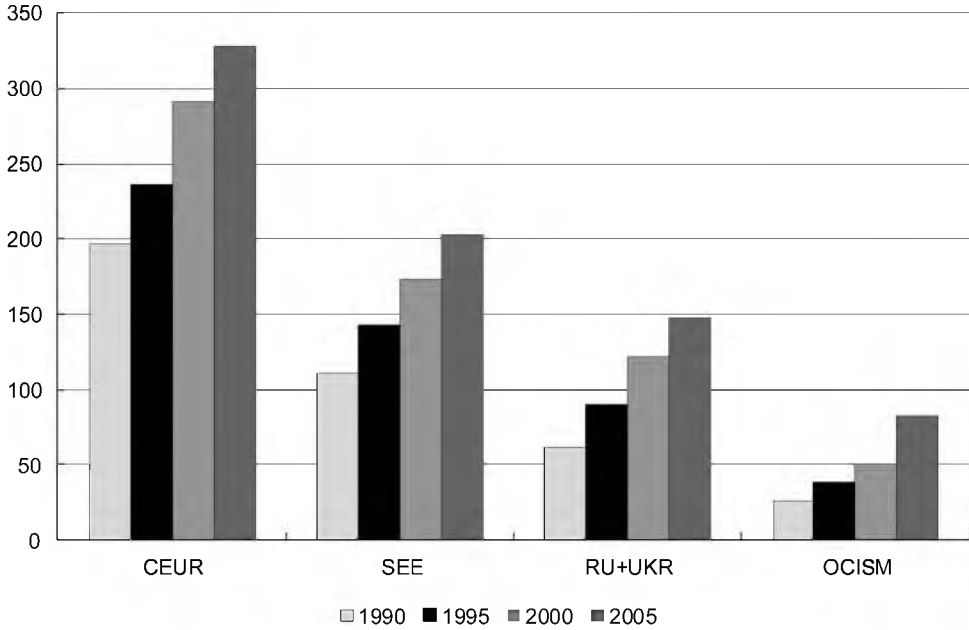


Figure 4.3 Car ownership per 1,000 population
 Source: United Nations, *Annual Statistical Yearbook*, various years.

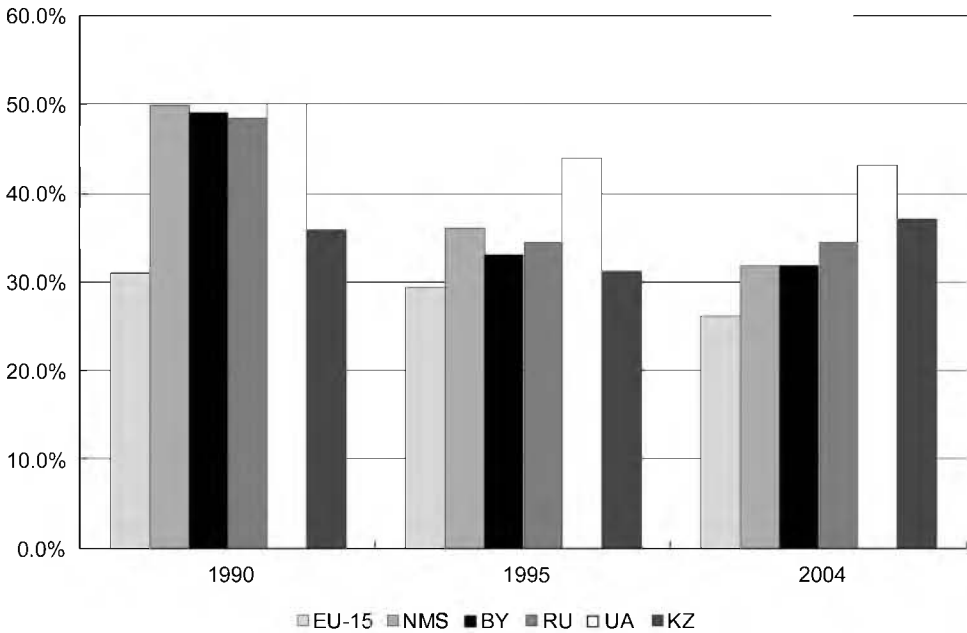


Figure 4.4 Industry and construction as percent of gross value added (Years 1990, 1995, 2005. Selected countries and country groups)

Source: Calculations of WIIW INDEUNIS Project: see note 14.

where y = per capita income, POP = population, SIZE = geographic area, and NATRES = some measure of natural resource endowment; some estimates use DUM for special country characteristics.

The available literature generally agrees there has been correction, and more so in CEB, but some find that by 2005 it is not yet complete even there. Gros and Steinherr (2004), using 1997 data, concluded already that in ‘Central Europe the transition is nearly over’. More recent estimates for CEB in Döhrn and Heilemann (2005) and Thiessen (2004) find the correction was virtually done. Note that this means it took between 10 and 15 years after *LIB* values reached 4.0. Thiessen and Gregory (2005), looking at the employment share in ten NMS and using a fuller Chenery equation with proxies for resource endowments and institutions, confirm a clear correction trend, but conclude ‘transition is not over’ as only four of them have reached the MEFF point.

No Chenery estimates for the CIS appear to be available, though Lazarev and Gregory (2007) conclude that ‘Russia ... a low-middle income country ... is structurally similar to higher income economies’. They infer that either Russia is approaching high-income status, or past distortions remain; the latter seems more likely, as argued below.

Table 4.2 summarizes the available estimates of Chenery predictions for CEB – shown as a range – while for Russia, Ukraine and Kazakhstan, the values are the author’s ‘reasoned guess’ based on the following assumptions. All three have lower income than CEB, hence shares should not be lower. Ukraine, with limited natural resources save for agriculture, whose exports are constrained by EU policies, is likely to be at the top of the range, say 35 per cent. Russia, with a comparable level of development, is likely to be lower given its strong natural resource endowment, as is Kazakhstan. If the ‘reasoned guess’ shares are taken at face-value, the three CIS countries are far from completing this part of the transition, with actual share values considerably in excess of the norm for countries at that level of development, and in the cases of Russia and Kazakhstan far more industry than their natural resources would suggest.

*Trade orientation: all very open, geographical re-orientation complete for CEB,
nearly so for CIS*

In the socialist period there was much trade within the Council for Mutual Economic Assistance (CMEA), but standard trade-GDP ratios were far below ‘normal’, with very little trade outside the bloc save for Russian energy exports. ‘Normal’ means the expected ratio drawn from a cross-country regression where the trade ratio is a function of income, size, landlocked status, etc. Several such studies have been done with results briefly summarized here. Virtually all transition economies very rapidly opened to trade beyond the old bloc, trade ratios for the smaller countries quickly reached 100 per cent and more by 2005, and on the whole ‘fit’ well in such regressions.¹⁵ Turkmenistan is an exception, but interestingly the other two CISL laggards have very high openness ratios. The evidence, while incomplete, is enough to conclude that the trade-opening aspect of adjustment is essentially complete.

Table 4.2 Industry shares of GDP, actual and predicted (selected years and countries, groups)

	<i>Actual: 1988–1990</i>	<i>Chenery: predicted</i>	<i>Actual: 2005</i>
NMS	50	32–35	32
RUS	48	(30? Res)	38
UKR	50	(35??)	43
KAZ	35	(30? Res)	38

Source: As in Figure 4.4 plus author’s compilations.

Equally important was the substantial outward shift of trade. A good indicator of this is the share of a country's exports to the EU-15;¹⁶ Figure 4.5 shows the trends from 1990 to 2005, with a dramatic shift evident in all countries and groups. It was most immediate for Central Europe, jumping from 20–40 per cent in 1990 to over 60 per cent by 1995, then stabilizing at about 65 per cent. For the Baltic states it was even more dramatic, from less than 5 per cent to well over 50 per cent. With the exception of Russia, all USSR republics had very limited exports to EU (though some of this was accounting, attributing to state-trading firms in Moscow exports from other republics). It is thus not surprising that the biggest jump was in the Baltic states, followed then by the Ukraine which increased more slowly from 5 per cent in 1990 to about 25 per cent in 2005. Russia started much higher at 20 per cent, and this doubled to more than 40 per cent, however some of the increase was not a volume but a price effect, as the dominant export was energy (mostly oil and gas). The same sharp reorientation is seen in SEE. However, is the reorientation complete?

Analogously to industry share, a rigorous test is whether destination shares are similar to predictions of the well-known gravity model:

$$X_{ij} = a + b.Y_i + c.Y_j + d.DIST_{ij} + e.DUM \quad (4.2)$$

where X_{ij} is exports from country i to country j ; Y_i is GDP of each country, and $DIST_{ij}$ is the distance (in kilometres or travel costs) between i and j , and DUM are variables reflecting special relations between i and j such as common language, contiguous borders, free trade arrangements and the like. The coefficients b and c are positive and d is negative. Results for available gravity model estimates are summarized in Table 4.3 showing export shares to the EU before transition, the range of predicted values for this share in various gravity model studies, and the range for actual shares in the period 2000–2005.¹⁷

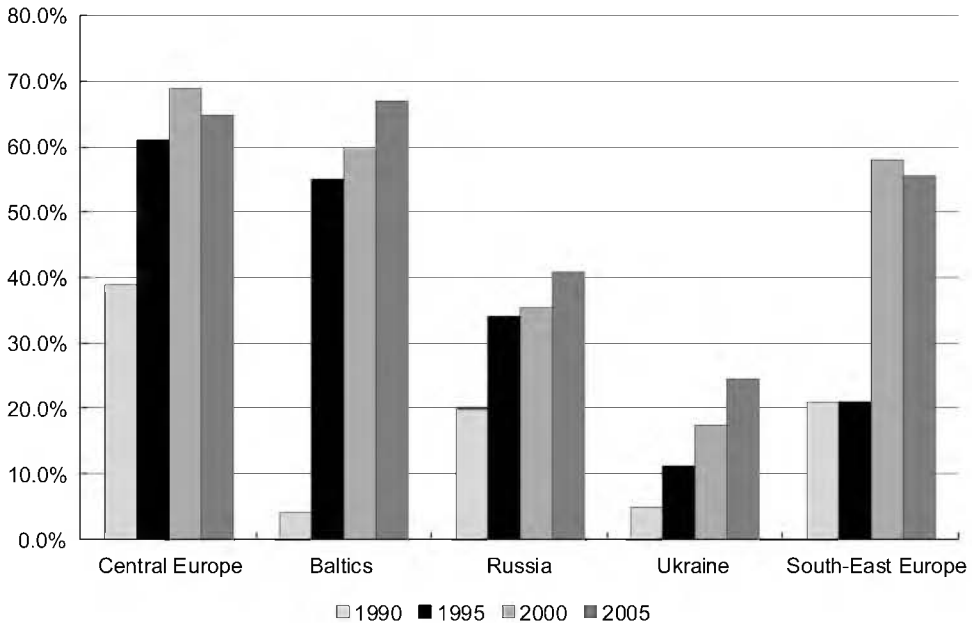


Figure 4.5 Share of total exports to EU (Years 1990, 1995, 2000, 2005. Selected countries and country groups)

Source: as in Figure 4.4.

Table 4.3 Share of exports to the EU: actual and gravity estimates

	<i>EU share: 1987</i>	<i>EU Share: predicted by models</i>	<i>EU share: 2000–05 actual</i>
Central Europe	35	70–80	65–70
Baltic states	4	60–70	55–65
Russia	20	35–40	40–45
Ukraine	5	30–35	20–25

Source: Author's compilations for Column 2; and WIIW INDEUNIS calculations.

Clearly, the CEB countries have essentially completed their geographic orientation towards Europe; Russia exceeds the estimated norm but perhaps only because energy prices have been very high; Ukraine has not yet reached the 'normal' despite its huge shift. There is no hard evidence for other CIS countries or SEE, but it is likely that, as in Ukraine, the shift has been substantial if still incomplete.¹⁸

Has the comparative advantage equilibrium been reached? Maybe, maybe not

As already noted, determining the new comparative advantage equilibrium is far more difficult than for the other indicators. Leamer endowment models are a vast undertaking, and even more feasible measures such as comparisons of RCA (revealed comparative advantage) values is still a large exercise, though some of this has been done.¹⁹ An alternative approach here is to ask two questions: have some countries seen *greater* shifts in export structure; is there evidence of shifting up the technological ladder-of-comparative-advantage? Culling the literature on the above still allows use of the best available quantitative evidence.

Consider first the broad categories, agricultural, natural resource, and manufactured goods. Figure 4.6 shows that for Central Europe (= NMS5 excluding the Baltic states) the manufacturing share has risen steadily, albeit from an already high level over 70 per cent. In contrast SEE, Russia and even Ukraine show a slight decline, offset by the rise for natural resources. For Ukraine natural resource content is understated, included in major exports like chemicals and metallurgy. Kazakhstan is not shown but exhibits the same trend as Russia, based on energy.

The increased emphasis on resources in the large CIS countries has generated heated debates about industrial policy,²⁰ an issue not pursued here. But does this evidence say anything about a new equilibrium? Unfortunately, not definitively. Arguably – and contentiously – one might conclude that the observed movement is *towards* a new equilibrium and not away from it, given the socialist over-emphasis on heavy-industry and the unsurprising outcome that countries with rich natural resources – energy in Russia and Kazakhstan, cotton in Uzbekistan, mild climate in Moldova (suited to fruit orchards).

Having said this, the opposite case can also be made: one should have expected the strong scientific and educational endowment of the USSR to bring about an increasing export of more high-tech products, based on radical rationalization of a large industrial capital endowment, at least after some time. In fact, a sharply increasing sophistication of exports is clearly observable in the CEB countries. Numerous studies have looked at the changed composition in terms of capital-intensity, skill-intensity, low versus medium versus high technology content, and have generally found this very quickly changed in an upwards direction already in the nineties.

Table 4.4 summarizes the widely used measure of Intra-Industry Trade (IIT), usually thought to reflect technical sophistication. In Central Europe, IIT is now in the same range or higher than in 'similar' emerging market economies, Russia and Ukraine are still much lower. This too

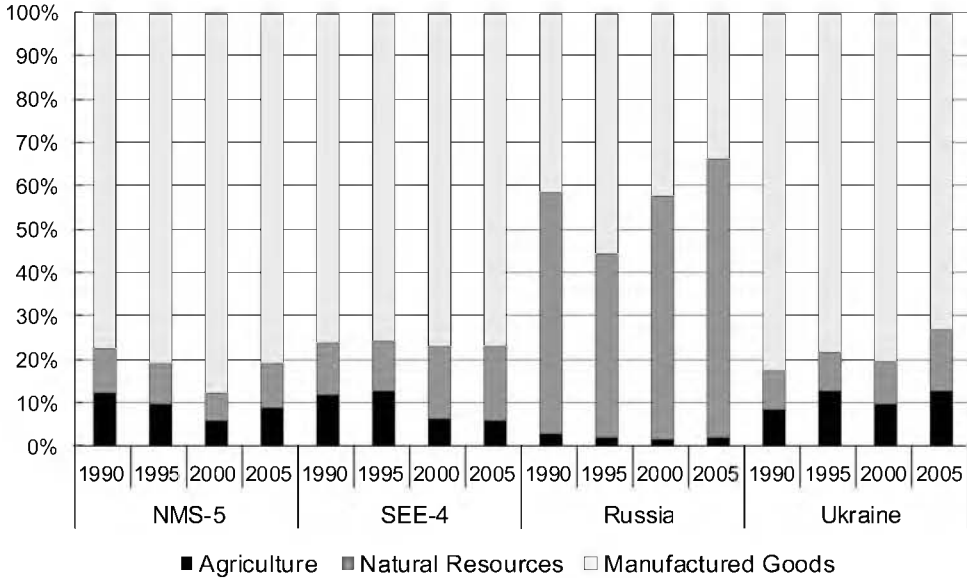


Figure 4.6 Sectoral structure of exports (Years 1990, 1995, 2000, 2005. Selected countries and country groups)

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Table 4.4 Intra-industry trade index. Selected comparisons

Industrial 1978 (1995)	59 (75)
East Asia 1991–94	48
Latin America 1991–94	35
Turkey 1991–94	28
Central Europe 2000–02	55–60
Russia 2000–02	20–25
Ukraine 2000–02	38–40

Source: Author’s compilations.

confirms that there was a much more dynamic structural change in Central Europe, and perhaps an approach to their new comparative advantage equilibrium.

It is not our purpose to seek the causes of the CIS lagging behind CEB in the attainment of the transition end point, but a short remark is warranted. Proponents of industrial policy contend that over-rapid reforms killed off the existing industrial potential. Perhaps more compelling are two other explanations: first the *MRULE* reforms came much later and are still incomplete; second the CIS export patterns may in fact be the new equilibrium given their large natural resource endowments.

Summary and conclusions

To answer the question, ‘is transition over’, it is necessary to define transition; this is best done in the context of a conventional production possibility frontier, as the movement from the socialist inefficiency position inside the frontier towards the frontier and finally to a market efficiency equilibrium point, *MEFF*, the end of transition. Direct measurement of a PPF being impossible,

it is instead proposed to measure how much correction has occurred in the main faults of socialism, with the end point reached when these take values similar to comparable market economies. The first conclusion is that for Central Europe and the Baltic states transition is essentially over, elsewhere some of the shortcomings of central planning have been corrected or nearly so, but many have not, and at least three former USSR republics lag very far behind.

It is important to distinguish between two steps of the transition process: first are the changes in policy to establish market rules, *MRULE*. While this is *not* in itself a measure of the end of transition, it is a necessary condition to motivate the reallocations which lead to the *MEFF* end point. The annual transition indicators of the EBRD show that the CEB group completed the market-liberalizing parts of the rule changes by as early as 1992–94, and the remaining institutional dimensions of reforms were very close to completion by about 2010. SEE countries took much longer just for the liberalization elements, but by 2010 were close to completion. The same is true for nine CIS countries with moderate reform effort; though some achieved this well before 2000, most did so later. However, for both these groups, progress on the institutional elements was much slower, and only two (EU members Bulgaria and Romania) are approaching the CEB. Entirely *sui generis* are three laggards, Belarus, Turkmenistan and Uzbekistan, still scoring much closer to values representative of centrally planned economies. That these rankings are echoed in the measurement of *MEFF* achievement is probably not a coincidence, though the causal relation is not explored in detail.

For two of the socialist shortcomings measured here – anti-consumer bias and low trade-GDP ratios – a strong conclusion emerges that nearly all transition countries have completed this correction, with consumption-GDP ratios rising to levels comparable to middle-income countries, and openness-ratios rising sharply to fit well in cross-country regressions. Only Turkmenistan remains an exception. Over-industrialization, defined as the share of industry to GDP, was largely corrected in CEB before 2000, and may be incomplete but moving downward in most others. This is seen not only in the simple trend values of the ratio, but is confirmed by econometric estimates of the Chenery equation across a large sample of countries. The inward orientation of trade within the bloc has shifted rapidly and dramatically. Gravity model predictions of exports by destination show that CEB had reached a new equilibrium probably before 2000, with the large CIS countries approaching but not all yet at their expected values.

It is generally agreed that central planner's product allocations were not in accord with what world market prices might have implied, though some argued that comparative advantage within the socialist bloc was partially reflected, as evidenced by the concentration of the USSR on heavy industry and resources, and of the satellites on lighter manufacturing – though the latter's global non-competitiveness was revealed immediately at the start of transition and opening up to the world economy. In any event some analysis of changes in export structure is worth attempting, though precise identification of comparative advantage is not feasible. Instead, two less rigorous questions are posed: did some countries or groups show greater changes? And how much shifting occurred up the comparative-advantage ladder (towards higher technical sophistication)? Once again the CEB saw much greater changes with a continual rise of manufactures' share, with increased skill and technical content, while CIS exports continued to have a high resource content, and little movement up the technical ladder. Many different measures have been used in the literature to analyse export content, but one, the share of IIT, reflects them as if a 'tip-of-the-iceberg': CEB with values around 60 per cent, similar to those in East Asia, while Russia and Ukraine (30–40 per cent) remain at or below Latin American values.

Our results do tentatively allow the conclusion that CEB seemed to have reached a new equilibrium in its global trading relations. Many observers both inside and outside the CIS insist that the results also mean, at least for the large countries like Russia, Ukraine, Kazakhstan –

perhaps even Uzbekistan – that they are moving away from rather than towards a new comparative advantage equilibrium, and that supportive industrial policy is needed to overcome the ‘hollowing out’ of the manufacturing sector caused by transition. The available evidence cannot refute this view, but neither does it confirm it. Direct estimates of what is the optimal comparative advantage were not (and cannot) be done, and qualitative interpretations can go either way. On the one hand, given the strong skill and human-capital base of the USSR, and a large, albeit inefficient, capital stock, one might expect eventual export success in many technically advanced areas. On the other hand, the large resource endowments, and the very delayed and still incomplete achievement of *MRULE*, might well explain the actual outcome.

These findings point to a few key areas for further research. First, the issue of what is or is not comparative advantage merits much more investigation in future research, with more emphasis on its dynamics, especially to address the heated debates in Russia and Ukraine about ‘Industrial Policy’ to speed the process of moving up the ladder of comparative advantage. Second, the issue of partial reforms and their sequencing merits considerable research effort, not merely for its historical interest to the transition debates, but also for the valuable lessons it could surely provide for emerging markets with non-socialist but very involved governments, like the new Arab regimes. It is evident in this analysis that movement to *MRULE* involved partial reforms, some more delayed than others, and in all cases even slower implementation of good institutions – yet recovery came early in CEB, elsewhere it was later but did come with a surge, and seems to continue in the post-crisis period with solid if not astronomical growth. The conclusion is inescapable: you do not need the full complement of reforms to get good performance. But then what is it you do need? Is there a *de minimis* combination, or does it vary by country? Last, the fact of different speeds to implement *MRULE* raises a central political-economy question: why? How much was happenstance, historical endowment and memory, the incentive of EU membership, anti-liberal preferences of new vested interests, oligarchs?

As one approaches the 25th anniversary of the opening and dismantling of the Berlin Wall, the amount of data and experience from the transition will be vast, covering a few complete business cycles, and numerous regimes. Economists should not overlook the opportunity this wonderful laboratory provides.

Notes

- 1 A detailed analysis with fuller references but earlier data is in Havrylyshyn (2009).
- 2 The reference is to Svejnar (1999), p. 78 who questioned ‘declarations such as that of the Czech Prime Minister in 1995’.
- 3 I accept that many experts have the ability to make such a judgment and this can be valuable.
- 4 Svejnar (1999) presages these distinctions, which he describes as ‘two conditions’ that must hold for transition to be completed, but does not define them rigorously.
- 5 Roland (2001) makes a similar argument about the underlying aims and concepts of all three schools of thought. He also shows without elaborating the same PPF representation.
- 6 A second-best question, and a key aspect of the sequencing debates is: if all the rule changes are not yet in place what combination of partial reforms gives fastest adjustment? One example of such an analysis is Zinnes *et al.* (2001), who show econometrically that efficiency improvements of privatized firms were greatest where liberalization was accompanied by good institutions.
- 7 Figure 4.1 can also depict the *POPI* definition of transition’s end: a movement to a higher level of production for all goods (the higher PPF and an analogous equilibrium M2), hence a higher per capita income. This is not explored further here.
- 8 Åslund (1997), in my view, misleadingly titles his otherwise excellent book ‘How Russia Became a Market Economy’.
- 9 Others like telephones, housing space and quality, clothing variety, video and audio equipment, could be measured as well, but the results for autos are sufficiently representative.

- 10 The original analysis is in Havrylyshyn (2006). While the rationale for groupings was not geographic, it is not coincidental that the results show regionalism, because there certainly were geography, proximity and historical inertia effects behind the differential progress of countries – not least EU membership incentives.
- 11 Arguably, Tajikistan is more like the CISL group – but this is not material to the present analysis.
- 12 It is likely this is what Klaus had in mind in his 1995 statement; indeed *LIB* for CZ had reached 4.0 as early as 1992.
- 13 Some of the country groups in Figure 4.3 for cars are different because of data availability in the source; Baltic states not shown, Russia–Ukraine shown separately and OCIS (other CIS) does not include all countries.
- 14 Their study compares average industry share averages for the World Bank’s broad income groups.
- 15 Broadman (2005, p. 297, Fig. 11.1); he also gives great detail on other aspects of trade.
- 16 EU-15 exports are, unsurprisingly, given proximity, the predominant share for exports outside the old bloc, and thus serve as a good proxy for the geographic reorientation in transition.
- 17 Actual values and references to gravity model studies are in Grinberg *et al.* (2008), Ch. 2.
- 18 Havrylyshyn (2009) elaborates on causes for a faster or slower adjustment.
- 19 Another difficulty with RCA comparisons is that per capita income similarity is not an adequate benchmark: high RCA for narrow product definitions is due to many factors such as inertia, tradition, specific resources, human capital, and foreign investment.
- 20 Much of Grinberg *et al.* (2008) addresses these debates; it also discusses the most relevant studies from the vast literature on measuring skill-intensity and quality of exports in Central Europe.

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