A History of Transition to Market in the CEE

Lecture 9

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Outline

Transition: 7 Stylized Facts

Campos and Coricelli (2002)

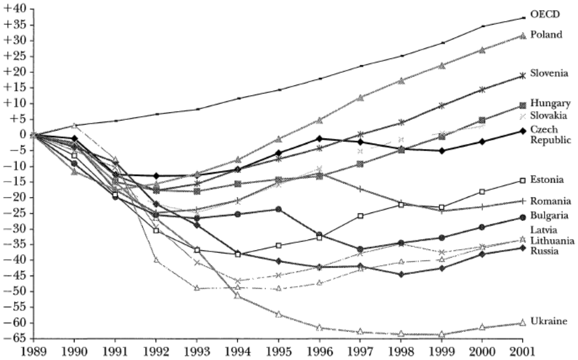
Economic Transition in the CEE

A process of transforming a planned economy into a competitive market economy

1. output fell
2. labor declined and moved
3. the stock of physical capital shrank
4. a rapid and intense trade reorientation to the West
5. the structure of the economy changed
6. collapse of institutions, institutional vacuum
7. large social costs: worsening income inequality, mortality, and poverty rates

Transition: the first 10 years
GDP declines

Figure 1
Real GDP Percentage Change Index *(1989 = Base)*



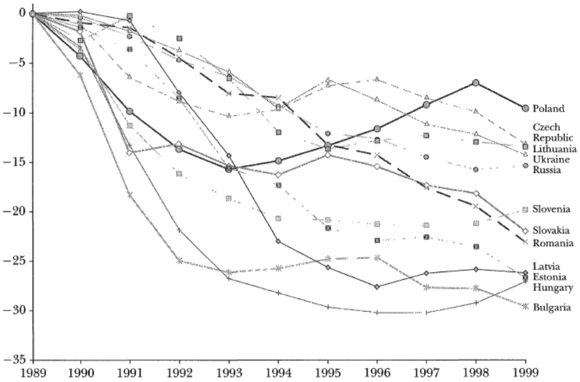
Sources: William Davidson Institute, based on OECD *Economic Outlook,* July 2001; EBRD *Transition Report 2001 Update;* and Davidson Institute staff calculations.

Initial recession at the start of transition; occasional double-dips.

Transition: the first 10 years

Employment declines

Figure 3
Employment Index
(1989 = base)



Source: William Davidson Institute, based on U.N. Economic Commission for Europe, Statistical Division.

Employment declines; what about investment?

Transition: the first 10 years

A comparison of the initial recession with the Great Depression

Countries	*Consecutive years of output decline*	*Cumulative output decline (percent)*	*Real GDP, 2000 (1990 = 100)*
CSB[a]	*3.8*	*22.6*	*106.5*
Albania	3	33	110
Bulgaria	4	16	81
Croatia	4	36	87
Czech Republic	3	12	99
Estonia	5	35	85
Hungary	4	15	109
Latvia	6	51	61
Lithuania	5	44	67
Poland	2	6	112
Romania	3	21	144
Slovak Republic	4	23	82
Slovenia	3	14	105

Note the differences across countries; the average decline

Transition: the first 10 years

A comparison of the initial recession with the Great Depression

Table 1.1.

The Transition Recession

Countries	*Consecutive years of output decline*	*Cumulative output decline (percent)*	*Real GDP, 2000 (1990 = 100)*
CIS[a]	*6.5*	*50.5*	*62.7*
Armenia	4	63	67
Azerbaijan	6	60	55
Belarus	6	35	88
Georgia	5	78	29
Kazakhstan	6	41	90
Kyrgyz Republic	6	50	66
Moldova	7	63	35
Russian Federation	7	40	64
Tajikistan	7	50	48
Turkmenistan	8	48	76
Ukraine	10	59	43
Uzbekistan	6	18	95
Output decline during the Great Depression, 193034			
France	3	11	n.a.
Germany	3	16	n.a.
United Kingdom	2	6	n.a.
United States	4	27	n.a.

Compare the GrDepression w/ the first 10 yrs of transition

TABLE 1.2.

Composition of Output, 1990–91 and 1997–98

	Percentage of GDP		
Regions and periods	*Agriculture*	*Industry*	*Services*
CSB			
1990–91	13.7	45.1	41.2
1997–98	13.9	33.0	53.1
CIS			
1990–91	27.5	39.7	32.8
1997–98	18.7	31.2	50.1

Source: World Bank country office data.

Industry shrank, services grew

TABLE 1.3.

Private Sector Growth, 1990s

	Percentage of GDP		
Countries	*1990*	*1994*	*1999*
CSB	*11*	*50*	*68*
Czech Republic	12	65	80
Estonia	10	55	75
Hungary	18	55	80
Romania	17	40	60
CIS	*10*	*20*	*50*
Armenia	12	40	60
Belarus	5	15	20
Russian Federation	5	50	70

Source: EBRD (2000).

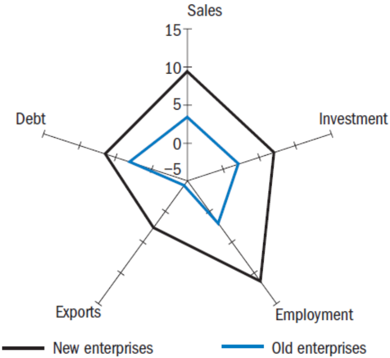
Rapid growth of the private sector

Transition: the first 10 years

Private sector growth: New VS Old Firms

FIGURE 3.2.

Performance of Old and New Enterprises, 1996–99
(percentage change)



Source: Hellman, Jones, and Kaufmann (2000).

New private firms much more productive than the old ones

Transition: the first 10 years
Export Reorientation

Export Growth and Destination, 1990s
(percent)

	Real export growth	Share of exports to industrial countries	
Countries	*199398*	*199293*	*199899*
CSB	*8.8*	*35.8*	*67.5*
Albania	22.0	62.9	94.1
Bulgaria	4.3	55.1	59.0
Czech Republic	10.4	29.9	69.3
Estonia	10.8	25.9	71.3
Hungary	11.1	67.4	81.5
Macedonia, FYR	7.3	22.2	65.5
Poland	12.9	71.6	75.5
Romania	8.7	44.3	71.0
Slovak Republic	6.9	15.9	59.2
Slovenia	5.7	33.7	70.7
CIS	*3.2*	*28.0*	*29.0*
Armenia	–8.6	9.4	34.9
Azerbaijan[a]	14.0	4.2	20.0
Belarus	–3.2	15.3	11.0
Georgia[a]	10.3	2.3	25.9
Kazakhstan	3.4	43.8	29.6
Kyrgyz Republic	–2.4	24.7	44.0
Moldova	4.8	6.2	31.3
Russian Federation	4.7	59.3	49.4
Ukraine	5.8	18.1	23.3

Export grew, went West

Transition: the first 10 years
Poverty and inequality

Changes in Inequality during the Transition, Various Years

	Gini coefficient of income per capita		
Countries	*198790*	*199394*	*199698*
CSB	*0.23*	*0.29*	*0.33*
Bulgaria	0.23	0.38	0.41
Croatia	0.36	—	0.35
Czech Republic	0.19	0.23	0.25
Estonia	0.24	0.35	0.37
Hungary	0.21	0.23	0.25
Latvia	0.24	0.31	0.32
Lithuania	0.23	0.37	0.34
Poland	0.28	0.28	0.33
Romania	0.23	0.29	0.30
Slovenia	0.22	0.25	0.30
CIS[a]	*0.28*	*0.36*	*0.46*
Armenia	0.27	—	0.61
Belarus	0.23	0.28	0.26
Georgia	0.29	—	0.43
Kazakhstan	0.30	0.33	0.35
Kyrgyz Republic	0.31	0.55	0.47
Moldova	0.27	—	0.42
Russian Federation	0.26	0.48	0.47
Tajikistan	0.28	—	0.47
Turkmenistan	0.28	0.36	0.45
Ukraine	0.24	—	0.47

Inequality growing; more so in countries w. deeper output declines

Janos Kornai (1999): communist parties have lost their monopolies; private sector accounts for the majority of GDP; market is the coordinator of economic activities.

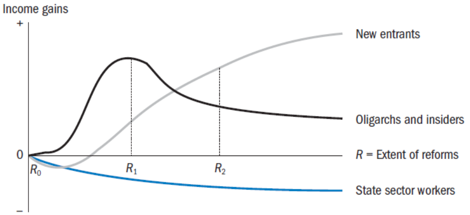
Svejnar (2002): an economy replaces its central planning system by a functioning market system; a rapid and sustainable growth rates; interaction w/ more advanced market economies without major forms of protection.

World Bank: the economic issues and problems policymakers must deal with are no longer specific to transition: no difference in productivity of old, restructured, and new firms

Winners and losers from transition

FIGURE 1.

Winners and Losers from Reform



Note: R_0 = no reforms; R_1 = point at which income gains of oligarchs and insiders are maximized; R_2 = level of reforms that allows the winners of reforms beyond R_1 (new entrants) to compensate for or exercise enough political pressure to neutralize the resistance of oligarchs, insiders, and state sector workers.

State sector workers: drop in income; lack of skill for new entrants

New entrants: significant adjustment costs; gains after a sufficient reform

Oligarchs and insiders: de facto power over assets; links w/ politicians; limited skills to compete in a market economy

Suppose:

1. further reforms are directed not at creating a competitive market framework but at preserving the rents of the oligarchs;
2. the gains for the new entrants are NOT sufficient;
3. the oligarchs do NOT lose rents to be considered part of the past;
4. state sector workers are a large part of the constituency

→ What kind of reforms prefer the three different constituencies?

Two broad sets of policies:

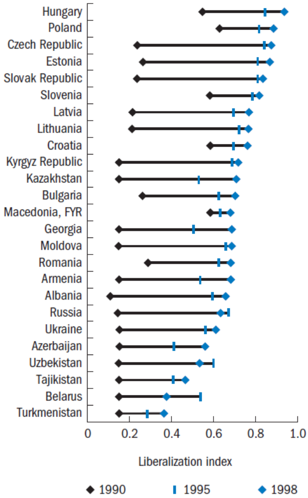
1. Encouragement of the new sector
    - Liberalizing prices, trade; privatization
    - Improving the investment climate
    - Doing business reforms
2. Discipline of the old sector
    - imposing hard budget constraints
    - exit mechanisms for insolvent firms
    - incentives for efficient managers
    - social safety net for the losers among workers

Overall policies to boost growth

Why are they needed?

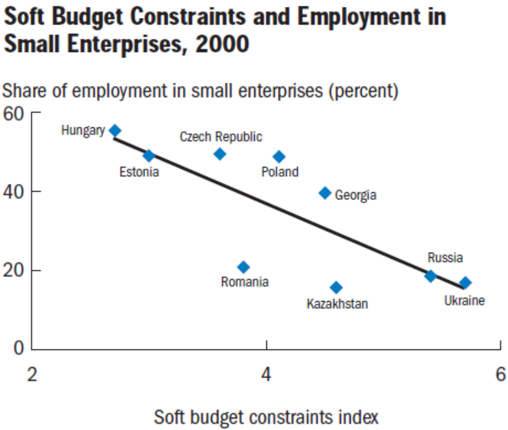
FIGURE 2.1.

Progress in Policy Reform, 1990s



Policies to boost growth

The case for the hard budget constraint

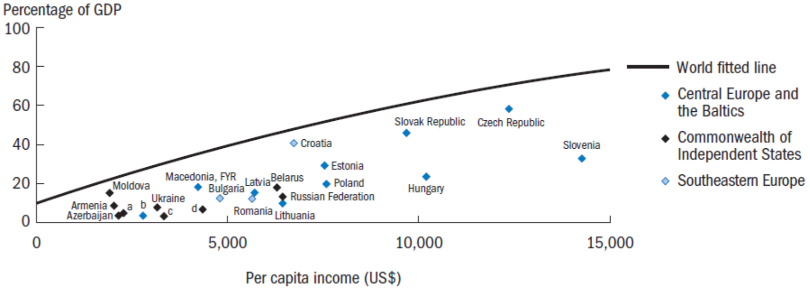


Source: EBRD (2000); World Bank database on SMEs.

The softer the BC, the smaller the share of employment in small firms. So what? –> private sector development

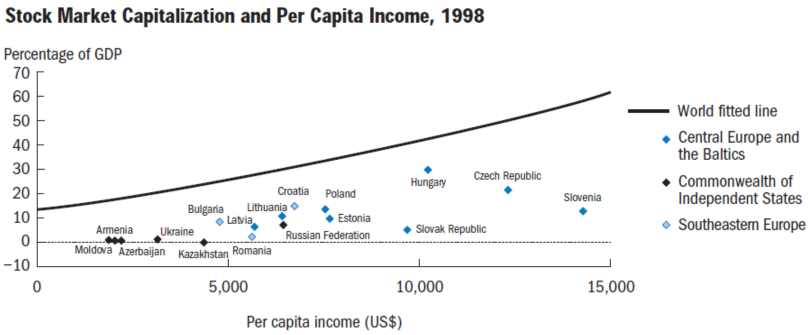
Financial Development in Transition
Banking Development

Domestic Credit by Deposit Money Banks to the Private Sector, 1998



a. Kyrgyz Republic
b. Albania
c. Georgia
d. Kazakhstan
Note: The world fitted line represents the average of all countries in the world in that per capita income range.
Source: Eichengreen and Ruehl (2000).

Lower banking development in transition –> limited capital accumulation

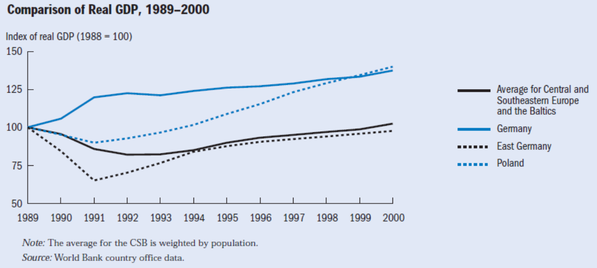


Note: The world fitted line represents the average of all countries in the world in that per capita income range.
Source: Eichengreen and Ruehl (2000).

Weaker stock markets in transition –> lack of efficient allocation of finance

1. a shock adoption of the western institutional framework
2. huge transfers from Western Germany: 40-60 percent of GDP annually, solidarity tax in the West to finance the transfers
3. automatic membership into the EU

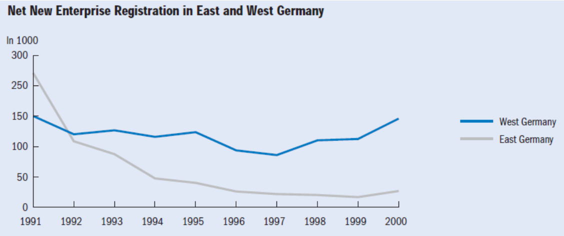
→ Enormous difficulties on its transition path: slower growth



Why the slow growth?

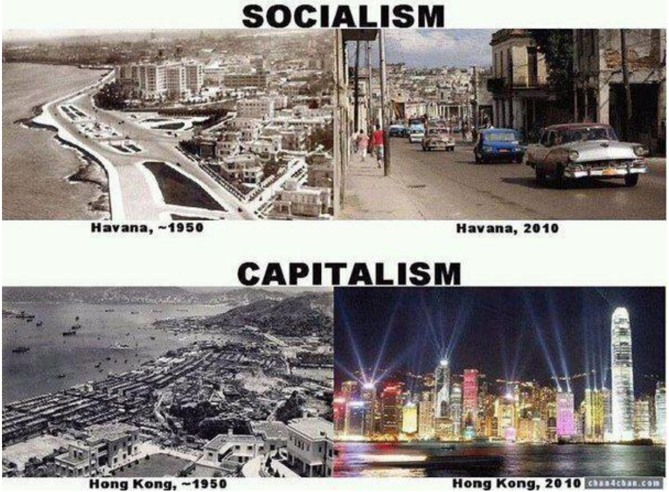
1. A Dutch disease of its own? – think about the transfers from the West as a natural resource. So the policies were not directed at creating new enterprises but rather at redistributing the resource proceeds.
2. exchange rate conversion 1:1 with the DM
3. an attempt to bring up the wages in the East Ű further loss of competitiveness, loss of FDI to Czech Republic, Poland and Hungary for the low wages

→ Slower enterprise creation in East Germany



Main points

1. What is the transition in CEE and CIS?
2. What are the main traits (stylized facts) of transition?
3. Where did the output fall more: in CEE or the CIS? How does this compare with the Great Depression?
4. What is the role of new enterprises in a successful transition?
5. What are the differences in export orientation between CIS and CEE?
6. Patterns of inequality; groups of winners and losers; why the transition process may mutate into facade democracy?
7. Sets of policies to make transition successful
8. The significance of the Soft budget constraint


SOCIALISM
Havana, ~1950
Havana, 2010
CAPITALISM
Hong Kong, ~1950
Hong Kong, 2010

Further reading

1. *** World Bank (2002). *Transition. The First Ten Years. Analysis and Lessons for Eastern Europe and the Former Soviet Union.* (**Overview**)
2. *** Campos, N., and Coricelli, F. (2002). Growth in Transition: What We Know, What We Don't, and What We Should. *Journal of Econ Lit*, XL, 793–836 (**793-818**)
3. Svejnar, J. (2002). Transition Economies: Performance and Challenges. *Journal of Economic Perspectives*, 16(1), Winter, 3-28
4. Murrell, P. (2005). Institutions and Firms in Transition Economies. In: C. Menard & M.M. Shirley (eds.) *Handbook of New Institutional Economics*, Ch. 26, Springer, pp. 667-699.