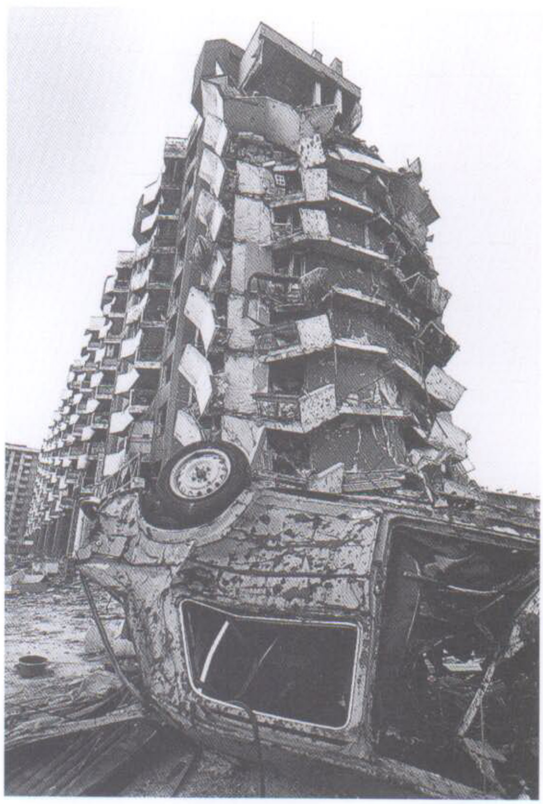
EUROPE and the BALKANS INTERNATIONAL NETWORK

POST-COMMUNIST TRANSITION TO A MARKET ECONOMY. LESSONS AND CHALLENGES

Edited by Domenico Mario Nuti and Milica Uvalic



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Cover Illustration: *Working-class houses on the front line in the Grbavica area (Sarajevo)*
(Courtesy of: Mario Boccia)

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Contents

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TWELVE YEARS OF TRANSITION TO A MARKET ECONOMY

1. *Premise*

This book contains sixteen essays, in addition to this introductory chapter, on the twelve years of transition to a market economy in Central and South Eastern Europe. It focuses primarily on the experience of those transition countries which today are members of the Central European Initiative (CEI). Promoted by the Italian government in 1989 and originally known as the *Quadrangolare*, the Central European Initiative was launched in order to promote regional strategies in this part of Europe. At a meeting in Budapest in November 1989, the Ministers of Foreign Affairs of Austria, Hungary, Italy and SFR Yugoslavia signed a declaration setting up the *Quadrangolare*. Since then, the initiative has changed its name several times before adopting the current one – Central European Initiative – while membership increased rapidly under the impact of important events on the international scene. After the fall of the Wall of Berlin in 1989, many other East European countries, in addition to Hungary and SFR Yugoslavia, decided to join the initiative, while the disintegration of former Yugoslavia in 1991 led to its later replacement by five successor states – Croatia, Bosnia and Herzegovina, Macedonia, Slovenia and FR Yugoslavia. By the beginning of the new millenium, CEI membership increased to seventeen countries. In addition to the two founding states from Western Europe, Italy and Austria, CEI today embraces fifteen countries from the former communist world: seven from Central Eastern Europe – Bulgaria, the Czech Republic, Hungary, Poland, Romania, the Slovak Republic, and Slovenia; five countries from South Eastern Europe – Albania, Bosnia and

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Herzegovina, Croatia, Macedonia, and FR Yugoslavia; and three countries from the former Soviet Union – Belarus, Moldova, and Ukraine.

This introductory chapter has a double function: to present the overall results of the research undertaken by the economic experts involved in this multidisciplinary project on post-communist transition; and to summarise some of the main arguments on the lessons learned from twelve years of economic reforms in CEI countries.

The papers included in this volume cover a variety of topics on the transition, with several common themes and messages. They can be classified into three broad groups:

- Discussion of general issues in a comparative framework. This section includes the papers by Kolodko on globalisation and catching up, Franicevic on post-socialist entrepreneurship, Daianu on specific problems in South East European countries, Stanchev on regional interdependencies in South Eastern Europe, and Bruzzi et al. on environmental problems in transition economies.

- Assessment of achieved results in individual CEI countries. Most authors discuss overall results of the transition: Muço and Minxhozi in Albania, Stojanova in Macedonia, Labus in FR Yugoslavia, and Pavlik in the Czech Republic, while a few focus on more specific issues, with emphasis on Bosnia and Herzegovina: Tihi and Bahto on obstacles for the development of Small and Medium-sized Enterprises (SMEs); and Stojanov on industrial strategies.

- Analysis of issues directly relevant for integration processes and European Union (EU) Enlargement. Again, the papers focus either on a specific problem, such as Segrè's paper on the reform of the Common Agricultural Policy (CAP) in relation to EU Enlargement, or on the position of an individual (or a group of) countries in European integration processes and vis-à-vis the EU. This second group includes papers by Liargovas and Chionis on trade integration between CEI countries and the EU and the main determinants of Foreign Direct Investment (FDI); Réti on Hungary's trade relations and capital flows within the Central European Free Trade Agreement (CEFTA); Otachel on EU-Polish trade in recent years, and Mencinger on EU Enlargement and convergence.

There are a number of lessons to be learned from over a decade of transition, that are particularly important for those countries which today are lagging behind others in the transition process. As Kolodko puts it, what was not known then, but is known now?[1]. Despite the different topics treated, there is a degree of consensus emerging on some of the most important issues, which can be synthesised as follows.

[1] Grzegorz Kolodko, «Globalisation and catching-up. From recession to growth in transition economies», in *This volume,* pp. 64-5.

2. *Diverging paths*

Over the last twelve years there has been a growing differentiation among transition economies. Economic systems and economic performance in Central and Southeastern Europe today are much more heterogeneous than in 1989, or even five years ago. Some countries have progressed faster and gone further towards a market economy than others. Twelve years on, some countries are approaching the finishing line and are about to join the EU; a few are barely off the starting point; others are somewhere in between, at various points along the track. Whereas in 1989 the exports countries from the communist world that today are members of the Central European Initiative had many features in common, today we can distinguish at least three distinct groups, primarily on the basis of their status vis-à-vis the EU:

- the seven associated countries in Central Eastern Europe which – together with the three Baltics, Cyprus and Malta – today are slated for EU accession, including the five forerunners – the Czech Republic, Hungary, Poland, the Slovak Republic, and Slovenia – envisaged to join the EU on 1 May 2004, and the two laggards – Bulgaria Romania – scheduled to join in 2007;

- the five non-candidate countries in South Eastern Europe – Albania, Bosnia and Herzegovina, Croatia, Macedonia and FR Yugoslavia – which today are all included in the EU's 1999 Stabilisation and Association Process, that has opened the prospect of possible EU membership at a future date;

- the three countries from the former Soviet Union belonging to the area under consideration – Belarus, Moldova, and Ukraine – which are not, and are unlikely to be in the near future, anywhere near the prospect of EU membership.

3. *Changing perceptions*

Clearly in 1989 the perception of the transition process was very different from that of today. In particular:

- a number of issues were overemphasised in 1989 (such as the importance of speedy privatisation);

- a number of problems were underestimated (such as the costs of transition, as expectations were generally too optimistic);

- a number of problems were neglected or simply ignored (such as the importance of private and public governance); and finally,

- a number of new problems have emerged as a by-product of the transition, which initially were not anticipated (such as financial pyramid schemes, or diffused corruption).

The transition strategy initially suggested and actually implemented by the majority of countries included the following elements[2]:

- Liberalisation of prices and foreign trade;

- Macroeconomic stabilisation;

- Privatisation;

- Capacity restructuring, treated as a simple by-product of privatisation;

- The creation of a viable financial sector, also treated as a by-product of privatisation; and

- Legal and institutional reforms.

It was hoped that liberalisation and macroeconomic stabilisation could be undertaken fairly quickly, as well as privatisation of small-scale enterprises. The privatisation of large-scale enterprises and legal and institutional reforms were expected to take longer and be implemented more gradually, hence the rush to mass privatisation in order to speed up the process. What has been the actual outcome?

In most cases liberalisation and macroeconomic stabilisation have been implemented successfully. However, some of the consequences have not been perceived or anticipated correctly. The transition and the overshooting of stabilisation led to a dramatic fall in output and labour productivity; the incidence of absolute poverty, unemployment and inequality (as measured for instance by the Gini coefficient) have seriously increased; there were other negative social and demographic trends, such as morbidity, mortality, worse access to education, pensions and welfare[3]. Actual experience, of course, has been different in different countries. Poland, for example, did experience a substantial increase in inequality of labour earnings but, at the same time, social transfers played an important role in mitigating this shift so that the rise in income inequality was relatively modest[4]. The increase in mortality rates is a phenomenon limited to the FSU, and so on.

Initial debates on privatisation and restructuring mainly concentrated on the

[2] See, for example, International Monetary Fund, «Transition economies: An IMF perspective on progress and prospects», Washington, International Monetary Fund, IMF Publications on Transition, 2000, (http://www.imf.org/external/np/exr/ib/2000/110300.htm), or World Bank, Transition, *The First Ten Years – Analysis and Lessons for* Eastern Europe *and the* Former Soviet Union, Washington, World Bank, 2002.

[3] See John, Eatwell, Michael Ellman, Mats Karlsson, D. Mario Nuti, Judith Shapiro, *Hard Budgets, Soft States – Social Policy Choices in Central and Eastern Europe*, London, Institute for Public Policy Research, 2000.

[4] See IMF, *op. cit.*

choice of privatisation methods, giving particular importance to speed. Advocates of mass privatisation, through the free or subsidised distribution of vouchers to the population, did not anticipate that this method would not resolve other equally important issues, such as enterprise restructuring or more efficient corporate governance mechanisms, access to better management and technical know how or additional investment funds. Actual experience has clearly demonstrated some of the negative features of vouchers privatisation, especially if other ingredients are lacking, such as a proper legal framework[5]. More gradualist approaches to privatisation based on a combination of various methods, as those pursued in Hungary, Poland or Slovenia, proved to be more effective and more conducive to enterprise restructuring and good governance.

Within the context of privatisation strategies, a controversial issue which is still being debated regards the role of the new private sector. Many authors have advocated the creation of new firms as the focal point of privatisation of transition economies[6]. But as rightly stressed by Franicevic[7], too high expectations were initially placed in *ex novo* firms. In order to have the expected spill-over effects from new firm creation, the economic environment has to be particularly favourable; governments need to establish a supportive legal, financial and institutional framework, which in many countries is still lacking and without which SMEs cannot survive over time.

While privatisation was undoubtedly an important part of initial reforms, other important complementary conditions also need to be met in order to increase enterprise efficiency, including the introduction of hard budget constraints, competition, effective mechanisms of corporate governance, a legal structure to protect property rights, and so forth. Indeed it turns out that these conditions on their own can deliver many of the advantages expected of privatisation.

The last group of transition issues includes legal and institutional reforms[9]. These reforms have generally been somewhat neglected and slow to implement, irrespective of the country considered, since institution-building takes time. In the late 1980s, only a few countries possessed some form of market-type institutions (Hungary, Poland, former Yugoslavia), while in most countries they had to be built from scratch. Measures aimed at introducing efficient institutional change did not, in many cases, bring the expected results.

[5] See Petr Pavlík, «Economic transformation in the Czech Republic. What went wrong?», in *This volume*.

[6] See also World Bank, *op. cit*.

[7] See Vojmir Franicevic, «Some considerations on post-socialist entrepreneurship», in *This volume*.

[8] See Boris Tihi and Senada Bahto, «Small businesses in a transition economy: Bosnia and Herzegovina», in *This volume*.

[9] See Stiglitz, Joseph, *Whither reform? Ten years of transition*, paper presented at the Annual

Therefore, from today's perspective, the results of twelve years of economic reforms in transition countries have in many ways diverged from initial expectations.

4. *Recent debates*

In the meantime, emphasis has shifted to related but somewhat different issues, which are for most countries today more important than those discussed in the early years of transition. Some of the problems that have become central in current debates on transition (and post-transition) include the following:

- The issue not only of corporate but also of public governance, and the related need for speedy and efficient reform of the public administration[10];

- Long-term issues including the determinants of economic growth, catching up prospects, conditions for sustainable development, importance of rural reforms, as opposed to the earlier emphasis on liberalisation and stabilisation[11];

- The role of the state and of active government policies, contrary to the initial widespread belief that free markets would take care of everything. Experience has shown that government support for national industries can in many cases be beneficial[12]. In foreign trade many transition countries have opened up immediately and unilaterally, only subsequently to re-introduce restrictions (usually an import surcharge). In recent years, protectionist measures have indeed gained strength in CEFTA countries[13]. In agriculture, trade liberalisation has been implemented to such an extent that farmers in EU countries are today far more protected than those in most transition countries[14]. It may be desirable to implement an active industrial policy also in other cases[15].

- The question of a regional strategy vis-à-vis the EU, which would require efforts towards greater co-operation, rather than continuing competition among transition countries. This is a controversial issue because of different positions of

Bank Conference on Development Economy, Washington, World Bank, 2000.

[10] A problem clearly emphasised for a country like Albania in the paper by Marta Muço and Luljeta Minxhozi, in *This volume*.

[11] See the papers by Bruzzi et al., Daianu, Kolodko, Mencinger, Segrè, in *This volume*; see also European Bank for Reconstruction and Development, *Transition Report 2002 – Agriculture and Rural Transition*, London, 2002.

[12] See Daniel Daianu, «Can further economic decline be stopped in South Eastern Europe?», in *This volume*.

[13] See Tamas Réti, «Hungary's trade and capital export relations with the CEFTA countries», in *This volume*.

[14] In all except Slovenia, see Segrè, «The Common Agricultural Policy reform process and the Central East European countries' accession to the European Union», in *This volume*.

[15] As in Bosnia and Herzegovina, as suggested by Stojanov, «Supply-side industrial strategy

individual countries. Generally speaking, while the more advanced countries are in a good negotiating position and would have less to benefit from such strategies, the less advanced countries would probably gain greatly from a more coordinated approach in their negotiations with the EU. Such a strategy today, for most CEFTA countries, would be of limited use[16]; but the Southeast European countries could benefit from a common regional strategy, precisely because they are not likely to join the EU soon. This could help speed up their future integration with the rest of Europe.

5. *Explaining performance*

The main reasons for the diversified performance of single transition economies is much more controversial, both in the papers of this volume and in the general debate on transition.

One of the main messages of Kolodko's paper[17] is that actual economic policies are central for the success or failure of a given strategy. Others would argue that initial conditions – whether historical legacies or resource endowments – are even more important. Proximity to the West, as exemplified by the distance from Berlin or from Brussels, and other comparative advantages, have also been considered as a determinant of economic performance. In addition, for most transition economies there have been external shocks, such as the disintegration of larger states or of trade blocs (the disintegration of COMECON, of the Czechoslovak Federation, of the Soviet Union, of the Socialist Federal Republic of Yugoslavia), as well as also armed conflicts, international sanctions and the consequent long years of isolation. In Southeastern Europe, these shocks have had not only devastating economic effects for most countries of former Yugoslavia, but have also affected negatively the whole region, clearly confirming the regional interdependencies of the Balkans[18]. In this context, the interaction of economic and political factors should also be mentioned, as in some cases, political objectives and priorities have been crucial for determining poor economic performance, much more than inefficient economic policies (for example in Serbia and in Croatia in the early 1990s).

Among all the twenty seven countries in transition, the three most successful ones arguably are Hungary, Poland, and Slovenia[19]. Despite diverse liberalisation experience, exchange rate regimes, rate and methods of disinflation and

in Bosnia and Herzegovina», in *This volume*.

[16] See Tamas Réti, *op. cit.*

[17] See Grzegorz Kolodko, *op. cit.*

[18] See Krassen Stanchev, «Political economy of interdependencies in South Eastern Europe», in *This volume*.

[19] See Kekic, Laza, «UN Economic Commission for Europe, Spring 2000 seminar, May 2-3»,

privatisation policy, the one common feature is that all three countries had some experience with markets, economic reform and market-type institutions prior to 1990, which left a legacy of greater familiarity with commercial practices and contacts with the West. This is a legacy built up over time that could not have been replicated overnight[20].

Yet legacies are certainly not sufficient, as shown by FR Yugoslavia, where above-average initial conditions have been ruined by a decade of economic mismanagement, postponement of radical reforms, continuous political conflicts and instability. Only after the radical political changes in October 2000, that also opened the doors for Yugoslavia to join major international organisations including the CEI, did the government implement a series of fundamental reforms required by the transition to a market economy[21]. Given the disastrous conditions inherited from the Milosevic regime, Yugoslavia's transition is proving harder than initially envisaged, and is being additionally complicated by unresolved political problems related to undefined borders (uncertainly about the future status of Kosovo and of Montenegro).

In conclusion, economic performance in transition economies is the complex outcome of initial conditions (achieved development level, earlier experience with markets, resource endowment), external shocks of economic disintegration or armed conflict, and economic strategy and actual policies. All of these factors (and probably others) will have to be considered in combination in a systematic analysis which is still incomplete.

6. *Lessons for the laggards*

This analysis has implications for those CEI countries – like Belarus, Moldova, or Ukraine – where the transition is proceeding at a slower pace. The most common view, particularly within the major international financial organisations, is that countries lagging behind ought to follow the same path as the forerunners. Undoubtedly, any economy that relies on market mechanisms of resource allocation, regardless of the scope of state ownership and commands, needs absolutely to use at once market-clearing, single, prices; to abolish state foreign trade monopoly and quantitative restrictions, and to open trade and investment to all; to mobilise entrepreneurship energies through legalisation and encouragement of private enterprise; to seek a stable macroeconomic environment. Any system relying on unrealistic administered prices, multiple prices and exchange rates, inflation tax and/or rising public indebtedness, bureaucratisation or unnecessary

London, Economist Intelligence Unit, 2000.

[20] *Ibid*, p. 3.

[21] As illustrated in the paper by Miroljub Labus, present Vice Prime Minister of the Yugoslav

restriction to private initiatives, domestic or foreign, is a non-starter.

Other aspects of economic policy are open to a much wider choice than it is or was ever contemplated by the so-called Washington consensus of the early "nineties"[22]. The speed of dis-inflation does not have to be fast at all costs; indeed it is no accident that the most successful transition economy, Poland, in spite of its shock therapy reputation, should have dis-inflated over twelve years at an excruciatingly slow pace. Trade opening does not have to be instantaneous, unilateral and total. Central bank independence can be granted without following and exceeding the Bundesbank model. Hard budget constraints should apply to public debt, not necessarily to budget deficits regardless of expenditure composition, unless they impinge on the sustainability of debt.

As we have already noted, the speed of implementation of transition and stabilisation policies should be geared to past experience with the market economy. As observed by Kekic[23], if pre-transition inheritance is a major influence on economic performance, "then the application of orthodox medicine to those countriès which did not possess such an inheritance was necessarily doomed to failure"[24].

Mistakes from the early years of transition have been forgotten only too easily in recent years in some of the less advanced countries; an example is the vouchers privatisation scheme in Bosnia and Herzegovina[25], or IMF's stringent conditions recently imposed on FR Yugoslavia, irrespective of the accompanying costs[26]. There is no doubt that macroeconomic stabilisation, liberalisation and marketisation are extremely important, but so are other crucial areas which must not be neglected. These include labour redeployment (finding ways to create jobs for the unemployed), restructuring the capacity and finances of major loss-making enterprises, reforms and re-capitalisation of the banking sector, substantial downsizing of the state sector through the redeployment of assets, radical legal and fiscal reforms, anti-corruption measures, strict implementation of the rule of law. In several transition economies, these areas of reform were initially neglected and have come to the fore only fairly recently.

7. *Integration prospects*

Over the past decade, the EU and CEI countries have become more integrated, both in terms of trade flows and FDI. But these processes have been

Federation, in *This volume*.

[22] See Kolodko, Grzegorz, *From Shock to Therapy: The Political Economy of Post-Socialist Transformation*, Oxford, Oxford University Press, 2000; Stiglitz, Joseph, *Globalization and its Discontents*, London, Allen Lane, The Penguin Press, 2002.

[23] See Kekic, *op. cit.*

[24] *Ibid*, p. 3.

[25] See Stojanov, *op. cit.*

very uneven for different groups of countries[27]. Increase in the volume of EU-CEI trade has been greatly facilitated by trade liberalisation provided through the Association agreements or other preferential trade arrangements with the EU[28]. But FDI inflows in transition economies, with the exception of a few countries, have been disappointing, especially in South Eastern Europe[29].

There are also more fundamental problems related to future integration processes. Mencinger's views[30] well illustrate today's diffused scepticism on the difficulties of the EU Enlargement process. Emphasis is usually placed on monetary and fiscal convergence, in view of the Maastricht criteria for EMU membership, even for the economies that are not current or even future candidates for EMU. EU accession candidate countries already satisfy or are very close to satisfying those criteria – except for the fiscal deficit, which will require a radical restructuring and containment of government revenues and expenditure. Other transition countries, especially in the CIS area, will find those conditions harder to fulfill, but in given time the task is not prohibitive. Institutional convergence is and will continue to be much harder, for all countries including the current accession candidates, that still have to close or in some cases even open chapter 30 of EU negotiations, on Institutions. Real convergence, which only recently has began to be discussed in EU circles and among experts, will be the hardest of all.

Prospects for newcomers to catch up or even narrow their gap with existing EU members are not particularly bright[31]. Gradual convergence of Central East European countries to the EU is often presumed or pretended, but there are strong reasons to doubt that this will happen soon, if at all. The conclusion is that "the existing gap between EU and CEECs might escalate rather than diminish, making a delayed accession even more difficult than a «premature» one"[32].

Reasons behind such scepticism, according to Mencinger, lie in the doubtful criteria that have been used to evaluate performance of transition economies. Macroeconomic performance ought to be judged much more on the basis of the sustainability of growth, in relation to the state of the current and capital account. What we should consider is "intrinsic or inherent economic growth", which an economy can attain without reliance on foreign assistance, foreign loans or sale of assets to foreigners[33].

[26] See Labus, *op. cit.*; Stiglitz, *op. cit.*

[27] See Panagiotis Liargovas and Dionysios Chionis, «Economic integration between the European Union and the transition economies of the Central European Initiative countries», in *This volume.*

[28] For its positive impact on EU-Polish trade, see Bartosz Otachel, «Trade between Poland and the European Union in the 1990s», in *This volume.*

[29] See Stanchev, *op. cit.*

[30] See Joze Mencinger, «Enlargement and convergence? A sceptical view from the East», in *This volume.*

[31] See Grzegorz Kolodko, *op. cit.*

[32] See Joze Mencinger, *op. cit.*

[33] *Ibid.*

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