Introduction

In 1995 we published *Winds of Change* to treat the key question for transition countries: 'How to reform?' In the meantime we can look back on more than ten years of transition experience. No country was able to jump-start its economy on market-based principles and converge rapidly. In all transition countries production fell after opening up. In some countries this fall was short-lived, but in most it lasted several years. In some the level of production is, twelve years after opening up, still below the level of 1989. There is no simple explanation of the diversity in transition performance, but starting conditions did play a central role.

Today, therefore, the question is no longer 'How to design reforms?' Rather, it is 'Why have certain approaches worked and others not?' This will be a major theme of this book. By implication, in many countries a lot still needs to be done. This is another major theme.

In this book we resist the temptation to produce a complete record of transition experience. We rather select the most significant experiences that may become, over time, classical reference cases. Of course, the overall experience in all transition countries will be presented, but it will not be pursued in depth for each country.

The outline of the book is as follows. In part I we start with a bit of history, an overview of communist experience. Part II summarises the transition process in formerly socialist countries, tests whether or where transition is over and what remains to be done in the lagging transition countries. Part III turns to specific experiences: German unification, the Soviet Union's disintegration, and Russia's complex reforms. Part IV focuses on the institutional architecture of the European Union's eastern endorsement and the specific issues to be addressed for reforms in the Balkan states. The last chapter attempts to assess future possible paths.

The rise and decline of communism

Although we are told that many students in the United States are not interested in learning why communism failed, because, in fact, they have never heard of communism, we still think this is an important question, to which part I is devoted.

Today, communism appears to many as a historic stupidity and, without a shadow of a doubt, capitalism has victoriously emerged as the dominant paradigm. However, such a view is too short-sighted and conditioned by the recent demise of communism. It neglects at least two points. First, the realisation of any theory always differs from the theoretic model, which, at any rate, captures only part of societal organisation. History and the distribution of social and political values interfere with the economic model. For example, only under very restrictive assumptions could it be claimed that, say, colonial capitalism was superior to Soviet communism. Second, because the working class suffered from unbearable misery during the take-off phase of the now successfully developed capitalist countries – a misery still prevalent throughout the developing world – the Marxist vision gave hope to large fractions of society of both developed and developing countries, a hope that capitalism was unable to provide. And, despite the current universal popularity of capitalism, we can be sure that the capitalist paradigm will again be challenged at some point in the future.

There were times (before the Second World War and during the Cold War) when the West did not feel totally assured about its superior economic and military force and when a communist brush fire in poor parts of the world was feared. Western Europe, for geographic reasons, was concerned about Soviet aggression and its democracy felt internally weakened by Moscow-supported communist parties.

The Soviet view of communism was the prescribed model everywhere in the Soviet bloc. The need for incentives was, however, sometimes recognised and temporary concessions were granted; for example, in Catholic Poland, where farming largely remained in private hands and dissidents met with more tolerance than in other East European countries. Hungary, too, was allowed, after its abortive revolution in 1956, to embark on a more relaxed economic policy, which included incentives for workers and greater powers for middle management in agriculture and industry. But when Czechoslovakia seemed to be heading towards the dismantling of single-party rule in 1968 and to be espousing other ‘bourgeois democratic’ heresies, Soviet and Warsaw Pact troops marched in and restored communist order.

In all countries where communist parties took over government, single-party ‘democracy’ with dictatorship by the proletariat was the final outcome. But even in Western countries with strong democratic traditions and mature economies, Moscow-sponsored communist parties played a role, although their influence has waned of late. Figure I.1 summarises the situation in Western Europe in the 1970s at the height of that influence. At that time there were about 60 million communist party members in some ninety countries across the globe. While the party was not allowed in all countries in the West, it nevertheless achieved a membership of 3 million and more. The largest Western communist parties were those in Italy (1.8 million) and France (0.6 million).

The main issue addressed in Part I is whether communism failed because it was based on a model, in some sense inappropriate, or whether the particular Soviet incarnation was at fault. We shall argue that the model serves not too badly in special circumstances, such as the economic take-off in the terminology of Rostow (1960), but fails hopelessly in a mature economy. Moreover, the Soviet brand of communism suffers from the weight of Russian history and particularities that would have dragged down any approach – as witnessed by the current difficulties in reforming the Russian economy and introducing capitalism.

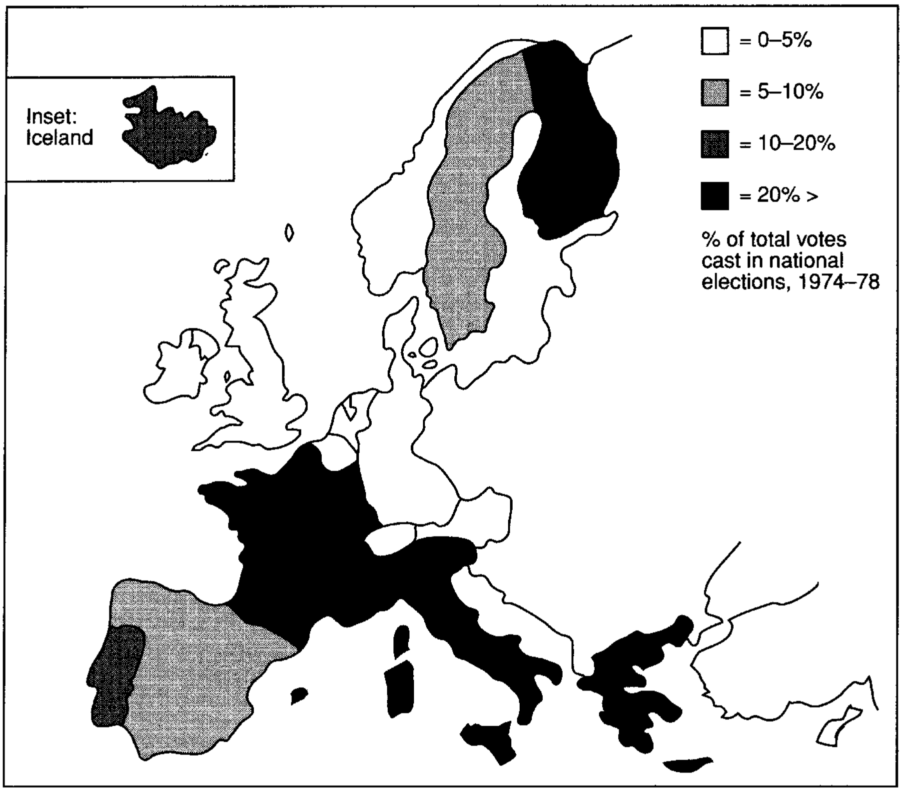

Figure I.1 Communists in non-communist Europe: Western communist parties' strength in national elections, 1974–8
Note: *The lowest number of seats held by communists in national parliaments, 1974–8 was 0 (UK, Ireland, West Germany, Austria, Norway, Denmark). The highest, with 228 out of 630, was Italy.*

Chapter 1 elaborates those features of communist rule which were inherited from tsarist Russia: the centralisation of power and the need for ideology, the key role of the military and the imperial aspirations, the emphasis on heavy industry and the neglect of agriculture, and so on. In fact, according to Marxist theory, the socialist revolution should not even have occurred in Russia but instead in a more developed country such as Germany. The very start therefore contradicted theory, as did much in the later evolution. Chapter 1 shows, moreover, that the new regime was not equipped with a blueprint for running a communist society and instead had to proceed by trial and error, up to the very end.

What, then, was the basic equipment of the new regime? Marx provided both a critique of capitalism and a vision of a communist future in the 'long run', but not much for the interim period.

Marx taught the ultimate and inevitable collapse of the capitalist order and its replacement by a classless, communist one. Under communism, the state itself would be abolished and society would be governed by the principle 'from each according to his ability, to each according to his needs'. But there would be a transitional stage – Marx called it

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Excerpt
More Information

socialism[1] – that would be ruled by the principle 'from each according to his ability, to each according to his work'. Under socialism, the victorious workers, the proletariat, would exercise a form of dictatorship to ensure that socialism could be applied without obstruction from whatever 'capitalist attitudes' society might not yet have succeeded in getting rid of.

Marx had little concrete to say on how this proletarian revolution would come about. That job was left to Lenin – who is the major architect of pre-Stalinist communism (Marxist–Leninist) – and others.

One big controversy throughout most of the seventy years of communist rule in the Soviet Union centred on the 'party of the new type' that Lenin helped to build up. Lenin argued for the creation of a centralised, tightly disciplined revolutionary party. This was criticised by his rival in the Russian revolutionary movement, Leon Trotsky (1861–1940), until he eventually aligned himself with Lenin's ideas.

The Revolution of October 1917 was a watershed. All across Europe, during the late nineteenth century, reformists had been grouping themselves into a body whose direct descendant was the Socialist International. The revolutionaries joined the Communist International (Comintern), which Lenin had set up in Moscow in 1919. Lenin's principle of 'democratic centralism' – or compulsory adherence to central party policy – became the model for communist parties everywhere else. So did the one-party Soviet state established by Lenin and Trotsky and completed by Stalin. The key features of that state were:

- total control of the state by the ruling party, with complete power of political initiative and decisionmaking reserved for the inner leadership and ultimately the party leader alone;
- the absence of any real legal limitation on state power (despite a constitutional façade) with the state identified with the party;
- monopoly party control over all forms of social organisation;
- monopoly party control over all channels of communication, with the right to impose censorship and to mould public opinion.

One lesson of the Stalinistic period is that communism was able to rally forces not only against external threats but also to achieve internal targets (industrialisation), as long as belief in the system was sustained and as long as the target was a simple one (e.g. to double steel output). But this approach was doomed to fail over time. As the system did not allow a shift in supply to satisfy pent-up demands by citizens, support waned. And, equally important, whilst the command system can cope with standard industrial production (steel), it simply cannot evolve into a more modern economy serving complex consumer demands. This inherent contradiction on its own would be enough to explain the incapacity of fundamental reforms unsuccessfully attempted by all successors of Stalin up to and including Gorbachev. But there are also other barriers to reform. The most important is the difficulty of reconciling monoparty communist leadership with a more decentralised incentive and information system.

After this *tour d'horizon* of the history of the Soviet Union from an economic point of view in chapter 1, chapter 2 discusses two permanent policy priorities not dictated by socialism in itself which, perhaps curiously, turned out to be fatal in the end: the goal of autarkic development and the goal of catching up with the West. The first policy choice was dictated by political concerns (a strategy abandoned by China in 1978) and the second by the conviction that socialism could survive and dominate the world only if it could win the Darwinian race in terms of material production. Because it became clear in the 1980s that it had lost the race, a reverse that communists themselves singled out to be decisive,[2] Soviet communism disappeared – but left the sad inheritance of a highly polluted racetrack scattered with industrial junk, and with people so abused that the contest will not be forgotten for a long time. Was it the model? Was it the Soviet incarnation? Certainly, both joined hands to produce disaster. China proves that communism paired with economic reforms and foreign trade can perform remarkably well. But it does not prove that communism can and will survive.

Transition: 1990–2000

When we wrote *Winds of Change*, between 1990 and 1995, the much debated questions concerning transition were what kind of policy and institutional choices were optimal and whether they should be implemented in a gradual way (and, if so, what should come first and what later), or all-at-once (that is, a 'big-bang' approach). After the triumph of capitalism over its main ideological opponent, communism, there was little doubt or debate about the final goals of transition. Only a fool would have questioned the merits of a capitalistic, market-based society.

In assessing the choices, economists took their inspiration from theory and concrete experiences in Western European post-war reconstruction, China's reforms after 1978, the emergence of Asian tigers, the instability problems in South America and many localised events. Of course, now, ten years later, the question is no longer how one should go about transition, but instead what has worked and why.

In chapter 3 we go over the key elements of a reform programme, as laid out, for example, in chapters 4–9 of *Winds of Change*. In the early 1990s most economists were fairly optimistic about the rapid reforms of transition economies. Taking these views as a benchmark, we can only be disappointed ten years later. Nobody would have expected that successor states of the former Soviet Union (FSU) would within a decade have an official GDP some 50 per cent of its 1989 level, with very unequal distributions of income and a rule of crime. Clearly, the reforms in these countries were not carried out as planned. But the real question is: Why?

Chapter 4 gives the answers. Some countries, in line with some academic recommendations, opted for a gradual reform process. At times gradual meant only very limited reforms. Hindsight confirmed our initial strong support for a 'big-bang' approach. Unsuccessful transformation is always the result of limited, partial reforms in the political, administrative and economic domains. Lack of democratic institutions, problems with law and order, corrupt and inefficient bureaucracies and poor economic performance all go together.

We then examine the question whether or where transition is over. It is not sufficient to look at economic performance because transition means moving from a socialist to a market-based economy; catching up with mature Western economies is a problem of economic development that takes a bit longer. We conclude that in Central Europe and the Baltic states the vestiges of socialist economies have been largely shed. In South-East Europe success has been only partial, and in the FSU even more efforts are required.

In chapter 5 we address some of the issues to be tackled to advance transformation in the laggardly transition countries. The major job consists in institution building. We analyse the need for more political reforms and for establishing a more reliable and efficient public administration. We show the possibility of two equilibria, a good one and a bad one, mainly depending on initial conditions. This analysis suggests that once a bad equilibrium is established, characterised by a high level of corruption and crime, it becomes very difficult to move to the good equilibrium. Even in the West we know these difficulties: once a mafia is powerfully established and connected, it is almost impossible to eliminate. Many weak reformers have experienced difficulties in maintaining a social safety net, in creating a monetised economy with financial intermediaries collecting the savings and financing enterprises. The result has been losses to the economic victims of transition (the retired and the unemployed), and therefore waning support for reforms, and a lack of normal finance for commerce and investment. Substitute mechanisms with low efficiency and little scope for improving the economic situation, such as barter trade and inter-enterprise credits, have developed. We discuss means to deal with such problems on the way to the establishment of a properly functioning financial market.

Extreme cases for reform: scope for disagreements

Part III deals with the disappointments. With immediate EU membership and massive institutional and financial support, East Germany was thought to be a sure winner. Chapter 6 shows why it turned into a curse. Chapter 7 analyses the splitting up of the Soviet Union and chapter 8 the difficulties in reforming Russia. Much of what applies to Russia is also valid for the other successor states of the FSU.

East Germany is clearly apart from the rest because it has ceased to be an independent country, receives full financial and institutional support from former West Germany and has become a member of the European Community. This was expected to make the reconstruction of East Germany much easier and faster than that of neighbouring eastern countries. Yet, quite to the contrary, industrial production in East Germany has fallen more than in the Czech and Slovak Federal Republics, Hungary and Poland. What is the reason for this reversal of initial expectations? Is currency union the culprit? Or was wage convergence to the West German level unavoidable under any scenario and the main factor of the collapse of East German industry? Or could it be that, whilst collapse was more pronounced there than elsewhere, it is only a matter of speed of adjustment (massive Schumpeterian creative destruction, high speed of building up a market economy)?

Currency union spared East Germany from macroeconomic destabilisation and the need for a stabilisation policy. East Germany does not have macroeconomic problems, only microeconomic ones: how to attract private investors and generate jobs with unit labour costs above the US level.

Events since 1989 have shown that the reforms have been less successful the further one goes east. While the Central European countries have put the first phase of reforms behind them, most countries in the FSU still have to undertake some of the basic reform steps. The main reason for this difference in behaviour is that the Central Europeans had ‘only’ to return to Europe. And their populations and politicians decided that they would do whatever was required to achieve this goal. The newly independent states in the FSU area are in a different situation for obvious historical reasons. Each of these states would merit a separate analysis, but we concentrate on the most important one, namely Russia. Developments in Russia will affect all of Europe, for better or for worse, whereas the developments in other successor states of the FSU matter only to the extent that they provoke a reaction by Russia. Our focus on Russia is also justified by the fact that the problems in all successor states of the FSU are similar.

In relating events after the fall of the Soviet Union, we therefore concentrate on two aspects: the economic consequences of rapid disintegration and the lost decade for reforms in Russia.

The first basic fact of the FSU is its sudden disintegration, despite very intensive internal trade links. We do not pretend to offer any insights into why the political elites in most former Soviet republics (including Russia) suddenly chose to go for independence. The main factor behind this political development was certainly a reawakening of national feelings. On top of that came the unwillingness of the Union government under Gorbachev to consider radical economic reforms. We leave these political factors aside and concentrate on the economic aspects of the disintegration of this huge unified economic area that took place in 1991–2.

It is difficult to analyse the disintegration of the FSU dispassionately because opinions, inside and outside the FSU, about this issue tend to one of two extremes. One school of thought (prevalent among the radical reformers in Russia and some of their Western advisers) maintained that the economic links between the former Soviet republics were artificially created by central planners. The newly independent states should have introduced national currencies immediately in 1992 and terminated all preferential trade arrangements among themselves. The opposite extreme (prevalent among Western official institutions until the end of 1992) argued that the former Soviet republics were so tightly integrated that they should have stayed together in the economic sphere even after they became politically independent.

The analysis of this chapter suggests that both extremes were wrong and that serious policy mistakes were made during the transition. If the transition had been managed carefully, taking into account both the trade structures inherited and their likely future evolution, the economic costs of the collapse of the FSU could have been mitigated. The virtual breakdown of intra-CIS (Commonwealth of Independent States) trade could have been avoided, and even Russia’s output decline could have been less severe.

We first show that, once reforms had started, it did not make sense to keep the former Soviet republics together in an economic and monetary union, as was often suggested in 1991–2. But we also do not agree that the FSU really had, during its last years of existence, ‘the worst monetary constitution one can imagine’. In a similar vein, we also argue that the strange rouble zone that survived until late 1993 cannot be considered a cause of inflation in Russia and elsewhere, as has often been argued.

We argue that the transition to separate currencies should have been managed more carefully, with the aid of a multilateral clearing system. A treaty to that effect was actually signed, ratified and . . . never implemented. A missed opportunity!

While the disintegration of the FSU is a fait accompli and irreversible, despite the periodic attempts by some Russian policymakers to resurrect some imperial system through bilateral agreement, or through the CIS, the fate of reforms in Russia has not been totally decided yet. The experience of reforms in Russia is a sobering tale.

We do not pretend to give a complete picture of Russian reforms. This would be impossible, not only because the situation continues to change rapidly, but also (and mainly) because in Russia few things are really as they appear at first sight. For the first years of reform we concentrate on three specific issues that came up during the crucial initial reform efforts in 1992–3 to illustrate this general point. The three issues more closely examined are price liberalisation, trade liberalisation and the link between fiscal policy and macroeconomic stabilisation.

We argue that price liberalisation was unavoidable, but the most important part of it, namely the liberalisation of energy prices, never happened. Trade policy, the showpiece of the reformers, because of the liberalisation of imports, was a disaster area. Initially there were huge import subsidies and, all throughout the initial reform period, large export restrictions. This combination was deadly for Russian trade, which shrank, instead of expanding by 50 per cent as in the Central European countries. Inflation, which was brought partly under control only after two years, was probably due to a large fiscal deficit, but this cannot be proven because the official numbers are close to meaningless. Our analysis shows that the Russian government could have used the substantial foreign aid it received to stabilise the economy if it had conducted a completely different foreign trade policy. However, given the disastrous trade policy followed by Russia, most of the aid that was actually delivered in 1992–3 reduced welfare in Russia. Stabilisation could also have been achieved with a different kind of foreign assistance. Both sides thus contributed to this failure. But the major responsibility remains with Russia: the inability to generate a wide majority in favour of strong institutions that are the *sine qua non* of a well-functioning market economy.

We then analyse privatisation – arguably the most disastrous decision with long-lasting consequences – and the financial crash of 1998. We also answer the question ‘Who lost Russia?’ Where did the billions of dollars go?

The general lesson we draw from all this is that, in the case of Russia, most things are different from what they appear to be at first sight and a number of widespread preconceptions do not stand up to closer analysis. This also applies to the privatisation process. On paper, close to 100 per cent of Russian industry outside the military–industrial complex has been privatised. However, the behaviour of management has not changed noticeably for most enterprises. We suspect that this will continue to be the case and that the large swings in policy which are reported periodically in the Western press do not correspond to reality. Over the first few years there has been only very limited, but nevertheless tangible, progress towards a market economy. One should not expect much more from Russia, but also not much less.

The new Europe from the Atlantic to the Urals

The map of Europe is in the process of being redesigned. In this book we make ample use of gravitational models and, once again, gravity suggests that the Western part of the former communist bloc fits better into the EU.

The EU has already engaged in a process of enlargement, although few people are at ease in assessing the wisdom, the costs and the benefits of enlargement to actual, or future, members of the EU. Chapter 9 deals with these questions. It also raises the issue of the optimal size of the EU and shows that the optimal size depends on the institutions in place and the goals adopted. The importance of goals is obvious: if the goal were simply free trade, the optimum size would be the world. If the goal were direct democracy for every decision, then a household may be the optimal size. This example also illustrates the critical roles of institutions.

Decisionmaking by majority increases the optimal size, as compared to unanimity rules. For these reasons we consider the EU reforms more crucial for successful enlargement than the convergence of applicant countries.

We also look at the costs and benefits of enlargement and find that the costs have been exaggerated.

Europe's catalytic role is not and should not be limited to future members of the EU. The EU must also be a partner of the FSU countries and must help those Eastern European countries not joining the EU (in the near future). These are the Balkan countries.

The EU already provides financial assistance for the Balkans. Chapter 10 argues that, as these countries are small and suffer from weak institutions, they should 'import' strong institutions. Some have already given up their monetary sovereignty by adopting currency boards or by operating on a euro basis. The whole of the Balkans could, and should, become a euro zone. They should also opt for free tade with the EU and any country of the EU free trade zone. They would then have free trade with each other, using the same currency and an optimal basis for creating more efficient and clearer public institutions, the necessary starting point for sustained growth.

In the concluding chapter 11 we assess the chances for future convergence and see three different destinies: Central Europe will soon be part of the European Union and its future is safe; the Balkan countries have much more reform work to do and will become members of the European Union in a second wave; the successor states of the Soviet Union have much more difficult starting conditions, are not favoured by history or geography, do not benefit from an obvious geopolitical future and could as easily end up in heaven as in hell.

Notes

1. In this book we use the terms 'socialism' and 'communism' interchangeably, as has become the custom.
2. In fact, they fell victim to Marx's theory that for a *capitalist* society 'to accumulate is to conquer the world of social wealth . . .' (Marx 1933: 649).

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Excerpt
More Information

Part I

The rise and decline of communism: an overview

'Every year humanity takes a step towards Communism. Maybe not you, but at all events your grandson will surely be a Communist.'

(N.S. Khrushchev, 1956)