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Economically blessed are the institution builders

Markets without regulation proving a real shock to capitalism

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> Institution building. It's the new global mantra, chanted by mandarins and moneymen alike, for warding off economic collapse. But these two words have an infinite number of interpretations, from advocates of more non-governmental organizations to capitalist in search of binding contracts to unrepentant communists who dream of a return to complete state control. Is there substance to this mantra, or is it simply code for more bureaucracy?

"SHOCK THERAPY"-- a program of accelerated privatization and severe cuts in the public sector -- is widely credited with setting post-communist Poland on the path to economic recovery. But the program was actually more shock than therapy. It was not until the country shifted to a policy best described as "therapy without shocks" that real progress was made.

This conclusion runs contrary to the conventional wisdom, enshrined in the "Washington consensus", that shifting property rights and allocation decisions from the state to the private sector is, along with fiscal discipline, the key to economic success For the approximately 30 countries trying to remake themselves in the communism's aftermath, however, a new consensus is emerging, one that emphasizes improving government rather than eliminating it and favors gradualism over shock.

A rush to shock

Poland and other East European countries have discovered that a market economy requires not only private property and limited regulation, but also adequate institutions. For this reason, a successful transition must be done in a gradual manner, since institutional building is a slow, incremental process based upon new organizations, new laws and changes in the behavior of various economic entities.

The naive belief that market economy can be induced by a shock is wrong, and in several cases compounded the existing problems. Poland's early transition, for example, was characterized by very severe contraction and spreading poverty. The false assumption that emerging market forces would quickly substitute for government in setting up new institutions, investing in human capital and building infrastructure caused severe economic losses and growing social stress.

The disconnect between the pace of the financial and political changes and the ability of institutions to cope is illustrated in the results posted by most formerly communist countries (see chart). After 7 to 9 years of transition, output in Eastern Europe and the former Soviet Union is at about three quarters of the pre-transition level in 1989 -- the year used as a benchmark -- while unemployment, poverty and income inequality continues to increase.

Policy right, government wrong

Despite these results, the advocates of policies and advice based on the Washington consensus still argue that the policies' design was correct, only the implementation has failed. That is not true. Instead of hastily withdrawing the state from economic activities, policymakers need to redesign its role.

Without an active approach, institutions are created by an informal process characterized by narrow, private interests. The extreme case is the vast corruption and organized crime that has flourished in Russia.

With a government that was starved of resources -- to the point that it cannot pay many government employees -- this vast country has been unable to prevent the informal, black market system from overshadowing its fledgling market economy. Thus, the “market” in Russia works in a way where the profits are privatized but the loses are socialized -- in the long run a politically unsustainable approach.

Based on these lessons and the recent experience with the Southeast Asian crises, the outline of a new, emerging consensus -- the post-Washington consensus -- can be drawn. It stresses both the need for free markets and the new role of the state in developing the institutions needed to make those markets work. Rather than tearing down the old institutions as soon as possible, the new consensus calls for their gradual reform and favors waiting until the transition is complete before paring them back.

Again, based on the Polish experience, countries that do not dismantle their institutions wholesale have recovered sooner, their growth is robust and it is sustainable. Countries that hoped the market would take care of the necessary institutions are lagging behind.

A culture of commercial law

Within this new consensus, there are several important policy considerations. One of them is simple: some institutions are more important than others. Those that govern the public finance system and oversee the legal aspects of the market economy are perhaps the two most important.

FROM ALL STATE TO NO STATE: POST-COMMUNIST TRANSITION ECONOMIES, 1990-97

Countries ranked in order of average GDP growth 1989-97

Country	# of years of GDP decline	did GDP fall again after recovery?	average rate of GDP growth 1990-93	94-97	90-97	1997 GDP Index (1989=100)
Poland	2	No	-3.1	6.3	1.6	111.8
Slovenia	3	No	-3.9	4.0	0.0	99.3
Czech Republic	3	No	-4.3	3.6	-0.4	95.8
Slovakia	4	No	-6.8	6.3	-0.3	95.6
Hungary	4	No	-4.8	2.5	-1.1	90.4
Uzbekistan	5	No	-3.1	-0.3	-1.7	86.7
Romania	4	Yes	-6.4	2.1	-2.2	82.4
Albania	4	Yes	-8.8	4.9	-2.0	79.1
Estonia	5	No	-9.7	4.1	-2.8	77.9
Croatia	4	No	-9.9	3.0	-3.4	73.3
Belarus	6	No	-5.4	-2.6	-4.0	70.8
Bulgaria	6	Yes	-7.4	-3.6	-5.5	62.8
Kyrgyzstan	5	No	-9.3	-2.4	-5.8	58.7
Kazakhstan	6	No	-6.7	-6.0	-6.3	58.1
Latvia	4	Yes	-13.8	2.2	-5.8	56.8
FYR Macedonia	6	No	-12.9	-0.8	-6.9	55.3
Russia	7	No	-10.1	-5.3	-7.7	52.2
Turkmenistan	7	No	-4.5	-12.5	-8.5	48.3
Lithuania	5	No	-18.3	0.5	-8.9	42.8
Armenia	4	No	-21.4	5.4	-8.0	41.1
Azerbaijan	6	No	-14.5	-5.7	-10.1	40.5
Tajikistan	7	No	-12.2	-8.4	-10.3	40.0
Ukraine	8	No recovery	-10.1	-12.1	-11.1	38.3
Moldova	7	No	-12.6	-10.2	-11.4	35.1
Georgia	5	No	-24.1	2.9	-10.6	34.3

CHART COMPILED BY GRZEGORZ W. KOLODKO

The establishment and development of the new laws -- trade and tax code, capital market regulation, property rights protection, competition and anti-trust rules, banking supervision, consumers' protection and environment protection -- is a more urgent need in transition economies than the privatization of state assets. Without a culture for commercial law and a mechanism for enforcing contracts, an economy cannot “take off.”

Speed is another important policy consideration. Institution building is -- and should be -- a gradual process. This is especially true when it comes to integrating with the global economy. It is better to liberalize capital markets after domestic institutions are strong enough to cope with the inevitable ups and downs, otherwise people in post-socialist societies are not going to support market mechanisms and integration with the world economy -- in extreme cases, they may be actively hostile.

Looking beyond the big, national institutions is another key to success. Institution building should not be interpreted simply as the creation of central banks and new national agencies. Money and effort should also go towards accelerating the development of non-government organizations (NGOs), the third indispensable pillar of contemporary market economies and civic societies. There are things government does badly and things the private sector has no interest in doing. Where these things overlap, it is vital that NGOs step in.

Similarly, post-socialist countries need to steer more resources to local institutions which, under the centralized communist system, did little that required initiative or independent action. This means both granting them more authority to make decisions relevant to regional issues and giving them more fiscal independence. Otherwise, the process of weakening the central government creates an institutional vacuum that makes it more difficult for the market to function efficiently.

Finally, the architects of this new consensus must keep in mind that achieving consensus is a process, not an act. The new consensus must be constantly evaluated in the light of outcomes and events and, when it doesn’t deliver, adjusted.

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