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Growth and Institutions in the Transition. How do Belarus, Russia, and Ukraine Compare to Others

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1. Introduction[1]

Early growth theory from the time of the Solow model focused on factors of production and their productivity , and led to econometric estimates of the sources of growth measuring just these factors. Revived interest in growth as exemplified by Barro and Sala-i-Martin (1995) attempted to inquire about a much wider range of conditions which contribute to greater factor accumulation and productivity. Johnson and Subramanian (2005) note that to answer this question "attention has turned increasingly to institutions"; their paper provides a useful recent survey of the links between growth and institutions. This link has also received considerable attention in the transition literature starting with the ex ante debates between gradualists and big-bang proponents , which may be most usefully seen as a debate on the on the sequencing of stabilization, liberalization and institution building. This vast literature is reviewed in Kolodko, 2004. So far only a small number of empirical studies of this link have been done and generally at a fairly broad level. (Moers 1999,Havrylyshyn and van Rooden 2002, Beck and Laeven 2005).

This paper builds on the latter addressing three aims: describing the path of institutional development followed in three transition countries, Belarus, Russia and Ukraine;[2] situating their achievements in comparison to other transition economies in the region; and providing a tentative assessment of the role that institutions have played in the CIS growth recovery. The paper is structured as follows. Section 2 reviews the empirical literature on determinants of recovery in transition, including in particular macrostabilization, liberalization, and institutional development. Section 3 provides some measures of institutional progress in the three countries and compares them to trends in other groups of transition economies, while Section 4 addresses the relationship between growth on the one hand and the three key determinants noted. The issue of the post-2000 surge of growth in the CIS is discussed here as well. Finally Section 5 summarizes what is known and what remains unclear on the institutions-growth link for transition economies.

2. Main Determinants of Growth in Transition

[1] This paper was originally prepared for presentation at the Seventh Annual Global development Conference , St. Petersburg, Russia, Jan.19.2006. I am grateful to Lucio Vinhas de Souza and Marek Rohozynski o for suggestions .

[2] Havrylyshyn(2006) provides a similar comparison of 27 transition countries, but with less detail.

Recent surveys of growth in the transition (Havrylyshyn (2001), Campos and Coricelli (2002), and Ofer and Pomfret (2004)) conclude: standard factor input variables are not important; prior financial stabilization is virtually a sine qua non; liberalization and structural reforms are key explanatory variables; unfavorable initial conditions affect negatively growth prospects but this effect declines with time; and good institutions are important but complement rather than substitute for liberalizing policies. Consider each of these conclusions.[3]

Factor inputs continue to play a large role in explanations of growth in most countries even as other explanatory variables have been added (Barro and Sala-i-Martin, 1995). But transition economies growth is different. As Havrylyshyn et. al (1999) noted, the dynamics in this period are not a matter of moving the economy to a higher production-possibility-frontier (PPF) rather, but correcting the large inefficiencies of the communist period and moving from inside the PPF to the PPF allocation reflecting international comparative advantage. Therefore it is not surprising that econometric studies including capital show insignificant and often negative results.

This does not mean investment is not needed in the process of reallocating resources. To the contrary, at the enterprise level a lot of new investment is taking place, but in the aggregate, the amount of new investments in early phases of the transition may not exceed replacement levels. Campos and Coricelli (2002) list as one of seven stylized facts of growth in the transition that in the aggregate "capital shrank." If old industries are inefficient, a shift to more efficient ones can take place in an environment of negative net aggregate investment.

That financial stabilization is a prerequisite for growth recovery is not a surprising result, nor indeed was it a controversial issue; even critics of the Washington Consensus agreed on the need for stabilization. Some observers argued for the use of exchange rate anchors as the centerpiece of any stabilization strategy, and the econometric evidence on the effectiveness of an anchor tells different stories.[4] Some countries achieved stabilization using an anchor (currency boards like Estonia, Lithuania, Bulgaria). But a large number of Central European and later most CIS and SEE countries achieved it without this anchor, though some had crawling/adjustable pegs (Poland), and some maintained a de facto proximity to a peg

[3] Much of this section is based on the survey of Havrylyshyn (2001); some of the key writings will be separately referenced.

[4] Williamson (2005) discusses to whether anchors should be seen as part of the Washington Consensus -or not.

(Croatia). Russia had arguably a peg until 1998 (see Owen and Robinson, 2003, and Esanov, Merkl and Vinhas de Souza, 2005), with limited success in stabilization. Ukraine's stabilization came without a clearly defined regime.

An unresolved detail is whether budget tightness or inflation control are the determinant variables, or both. The attempts to sort this out are mixed: there is a strong consensus that lower inflation stimulates growth, but separate effects of inflation vs. budget deficits are not easily established. In the econometrics, this may be due to two factors. First, almost all these models are ad hoc and not derived from structural equations; in studies where inflation is separately determined (De Melo et. al. 1997) deficits do show positive and significant correlation with both inflation and growth. Second, fiscal deficits may have been too narrowly measured, excluding off-budget transfers, and central bank directed lending.

Liberalization of markets and related structural reforms also show up as one of the main determinants of growth during the transition (see Bakanova et al., 2004, and Vinhas de Souza, 2004), though this is true for broader measures of market reforms such as the EBRD transition index, less so for individual components. Thus, price liberalization alone is significant in only a few studies; privatization also comes out insignificant in most but occasionally significant in a few specifications.[5] This suggests it is the combined effect of several policies that matters in creating new opportunities for private sector activity. There emerges a clear consensus on one point: transfer of ownership alone has some small positive effects, but significant benefits come only with the complementary development of competitive market institutions. This supports the view that some threshold of institutional development is needed alongside private sector development before growth starts.

Initial conditions have been measured variously as degree of over-industrialization, share of defense industry, years under communism (a proxy for market memory or "mental" distance from capitalism), distance from European markets, war or civil conflict, etc. Because the possible number of measures of initial conditions is so large, the results vary according to choice of variable, choice of period, econometric specification. A strong role of initial conditions is found by De Melo et. al. (1997). However ,Havrylyshyn et. al. (1999), using the same measures with additional years of data, point out that even if this was true in early years, the statistical significance of initial conditions declines over time (Bakanova et al., 2004, finds the same results). In the same spirit, Zinnes et. al. (2001) distinguish immutable initial

[5] While many surveys of privatization effects exist , this particular point is perhaps most thoroughly explored in the econometrics of Zinnes, Eilat and Sachs (2001).

conditions (geography, history) from changeable ones (degree of industrialization, share of defense), and also find the latter matter little after a short period of time.

Perhaps, the strongest argument against the path-determinacy effect of initial conditions has not been tested in the literature: some of them may have either negative or positive effects on growth. Thus for example, the high share of defense industry in some countries (high in Ukraine and Russia, very low in Baltic Republics; high in Slovakia, lower in Czech Republic) can be both a drag on the reallocation to new industries, but also, given that it contained the highest level of human capital and technology, an opportunity for generating a lot of new growth under the proper incentives. This is analogous to the common arguments about natural resources, which in principle under good policies should benefit the country, but in practice they lead to complacency and bad policies turning out historically to be a negative influence.

3. Institutional Progress in Belarus, Russia and Ukraine

It is widely agreed that institutions are important for sustained growth, though Johnson and Subramanian (2005) note there remains a critical unanswered question: is there any way one can effectively promote good institutions? There are many writings on the role of institutions in non-transition economies, starting with the pioneering contributions of North (1993), (1995), and ending with the most recent revival of his ideas for developing countries. We note only a few points most pertinent to transition. Only a handful of econometric studies on growth include institutional quality as a variable. Moers (1999), Havrylyshyn and van Roeden (2003), conclude that institutions contribute significantly to growth, but especially in the later phase of sustained growth, while liberalization, stabilization and initial conditions are more important in the early recovery. Beck and Thorsten (2005) show econometric results that attribute almost all the explanatory power to institutional quality alone, a puzzling result for the short term, though consistent with the ‘deep explanation’ school of thought, as Johnson and Subramanian (2005) labeled it, that is, in the long run since good institutions lead to good policies, they alone fully explain growth.

Despite some differences, the few econometric studies relating growth, and institutions in transition, agree there is a strong important link, and most emphasize that neither market liberalization, stabilization, nor institutions alone have an overwhelming explanatory power, but rather all of them matter, in a complementary fashion. This last econometric result may teach a humble lesson both to big-bang reformers and gradualists. Rapid-reform advocates have by now understood it was not enough to recognize conceptually the role of institutions

— the fact that they developed much more slowly in some countries than others may reflect insufficient weight given to them in policy recommendations.[6] For gradualists this result says it was indeed necessary to move on several fronts at once, and there would have been little effect from starting first with institutional development while delaying the liberalization and stabilization elements.

That institutions matter is not in dispute, but two big issues remain:

- What are the most important market-enhancing institutions needed; that is, is there a minimum critical mass?
- Should they be developed before, during or after the main steps of stabilization and liberalization? Indeed one might ask if it is even possible to complete institutional development before taking some actions on stabilization.

Consider the first issue , critical mass of institutions. There are many relevant institutions hence there is considerable disagreement on relative importance and sequencing. The list of institutions in the World Bank (2002) study suggest there are some that should come early, some that can be developed simultaneously with introduction of specific reforms, and others with can be allowed to evolve over a much longer period. The first category includes elements such as the state's ability to enforce basic law and order, new elements such as a market-oriented laws and government agencies: a Central Bank, a Finance Ministry that enforces budget discipline, a separate Treasury for transparent and uncorrupted implementation of budgets, regulatory agencies for enforcing codes of commercial behaviour, an anti-monopoly regulator.

The second category relates to privatization, freedom of private-sector activity, a legal basis for secure property rights, plus ensured competitive environment. Without property rights, entrepreneurs will be very cautious about engaging in new ventures, or expanding output and employment. In some countries, these were established early, with a reintroduction of pre-communist commercial codes (Poland) or borrowing Western European codes (Hungary, Baltics). In Belarus, Russia, Ukraine and other CIS countries new laws allowing free enterprise coexisted for some years with soviet-period laws deeming it illegal, an inconsistency that of course impeded rapid development of new enterprises. Ensured competition and open entry are needed to avoid monopolistic behaviour which can limit the

[6] International financial institutions –IFI'S-such as the World Bank, IMF, EBRD are often criticized for ignoring institutions; Williamson (2005) and Havrylyshyn (2006) argue this is an imagined straw-man as many of their writings mention institutions being part of the package. A more reasonable criticism is by Moers (1999) that the IFI's recognized institutions but paid too little attention to them in early years.

benefits of the transition from socialist to private ownership. This was much more of a problem, because of delays in introduction of laws, and ineffective application.

The second issue , sequencing , has often been a red-herring in the debates. Earlier work of North and other institutionalists emphasized that institutions evolve over long periods of time. It was surely not possible to delay stabilization and at least some of the liberalization measures (including freedom of de novo private sector development but possibly excluding large scale privatization) until "adequate " institutions were put in place . This paper argues that a simultaneous evolutionary sequencing of institutions with the other two elements was in fact the actual practice in all transition countries. Consider a small example.

"Competitive environment" is itself a general phrase , which includes many dimensions. One of these is a commercial adjudication infrastructure for disputes, and bankruptcy. That this need not be fully in place before private activity begins, is illustrated by the case of Lithuanian judges in new bankruptcy courts who had no experience and no fully developed regulations on how to apportion creditor rights. They proceeded by a combination of trial and error, learning about procedures used in Western Europe, participating in training opportunities offered by technical assistance, and recommending to their government adjustment to the laws on the basis of early experience. An analogous interactive process occurred in all countries with tax reforms and most countries continue with refinements to the present day .

That all countries have been seen significant economic recovery by now regardless of the very low levels of institutional development in some (Table 1 and 2) leads to the conclusion that the process of developing market institutions can be symbiotic with expansion of private market activity and need not precede it.

As to sequencing among types of institutions , there may not be clear examples of institutions that are postponable until after the basic reform steps are done; a more useful view of sequencing is to begin with a basic and simplified legal-regulatory framework that is comprehensive but not deep, and follow with refinements of these regulations over time. It is therefore a judgment call what the basic minimum may be, and how soon the refinements take place; this has surely varied across countries. In retrospect, it is clear that most of these economies proceeded along such a path, albeit at different speeds. The Central Europe group moved fastest, the countries of the CIS – with some exceptions such as Armenia's land laws – moved much more slowly, intermittently introducing new laws and abolishing Soviet ones.

But this speaks only about the laws on paper, not about the effectiveness of their implementation. It was a widely held view of Kremlinologists that in soviet states informal rules were far more important than the paper laws. For example, private economic activity was largely banned, but as Handelman (1994) elucidates, the existence of underground economic activity and a 'soviet-mafia' speaks volumes about what the real law was. Until recently, economists have paid limited attention to the informal institutions which political scientists have long studied; but in the transition debates it has come to be recognized the key issue is effectiveness of implementation.

Recognizing this, indices of institutional development rely on subjective perceptions. Early compilations of such synthetic indicators of market institutions come from Freedom House, the Heritage Foundation, and Transparency International with its broad Corruption Index. More recently, a comprehensive compilation of various sources and some new indicators have been put together by the World Bank (Kaufman, Kraay and Zoido-Lobaton, (2004) and continue to be updated in annual surveys of the business or institutional climate, the so-called "BEEPS" exercise. The appropriateness of such measures can be questioned, however any analysis wishing to have some quantitative purchase on the issue, cannot but rely on these data sources. The major criticism made is that measures of institutions may not capture the quality or effectiveness of implementation. This is addressed in great detail in the above work of the World Bank. A related problem concerns informal institutions which develop and subvert the original policy intentions.[7] The criticisms are most acute for indicators that simply list existence "yes-no" of certain laws or regulations that . Indicators that use subjective assessment by experts or panels of experts, or opinion surveys of practitioners ("how easy is it to do business", "how much is bribery a problem") , suffer from the inaccuracy of subjective measures, but paradoxically in this case may get at the important issue of implementation and effectiveness better that hard quantifiable measures.. In depth qualitative case studies are an important complement in assessing the effectiveness of institutions, but there is no other recourse for quantitative analysis than to use the available statistics.

Weder (2001) used such data to assess the degree of institutional development in the region, and Table 1 summarizes the results. Clearly, only Central Europe and the Baltics are beginning to approach the levels of advanced market economies, but many of the countries in

[7] This problem is defined by Alina-Pisano (2006) as "institutional facades."

South East Europe and the CIS were by the late 1990s already comparable to developing market economies in the middle and lower range of institutional development.

To get some view of the actual sequencing between institutions and other transition reforms over time, the more detailed indicators noted above cannot be used, as they are available only for very recent years. The best available proxy is in the well-known EBRD transition indicators. The ten dimensions given can be grouped in two parts: those indicators which measure market liberalization (EBRD's initial phase reforms) and those that involve institutional changes (their second phase reforms). The details are seen in Table 2 showing values for LIB (liberalization) and INST (Institutions)-respectively what the EBRD defines as 'initial phase' reforms, and 'second-phase' reforms. The first includes price liberalization, foreign trade liberalization and small-scale privatization, while the second comprises the EBRD remaining indicators (excluding infrastructure) which can be thought of as 'institutional' reforms. Indeed in its own analysis the EBRD (2003) more or less equates second phase reforms with institutional development . The EBRD analysis emphasizes the following trends. For the average of all countries there was an early surge of liberalizing policy changes from 1989 to about 1994, a somewhat slower but still steady pace to 1996, then a virtual flattening at a level of about 3.2 to 3.3. This is still well-below the top value of 4.3 representing a fully functioning market economy, but importantly the reason for this flattening turns out to be the difference between the advanced countries and the slower reformers .

Two points are clear from the data of Table 2. First, throughout the region no matter how quickly or slowly liberalization proceeded, institutions lagged behind. Secondly, there was not a single instance of a country following the theoretical path of an institutionalist-gradualist strategy with institutions preceding or at least moving in parallel with market liberalization.[8] This strongly suggests that where there was the will and capacity to move fast on liberalization, there was an equal ability to move fast on institutional development, and vice-versa.[9]

[8] The table's group averages are calculated from individual country values as in EBRD, but are not shown here to save space.

[9] One can think of this in terms of the recently popular notion of "policy ownership" or commitment: where the overall commitment to a liberal market and liberal democracy was strong, institutional development proceeded as fast as possible, though this often meant not as fast as liberalization simply because the latter *could* be faster.

It is evident that in all regions institutional reforms lagged behind liberalization and in general with less of a surge than seen for liberalization in the early 1990s. This pattern is consistent with the hypothesis I have posited that institutional reforms cannot be implemented as quickly as many components of liberalization, but it may also be consistent with the criticism aimed at the Washington Consensus, that they were not given enough importance early on. This debate cannot be easily resolved, as there is no benchmark to define the phrase of Vaclav Klaus 'reform as fast as possible'. The evidence is therefore easily used by both gradualists and big-bang proponents in support of their arguments. However, a great deal can still be inferred by comparing the time patterns across country groups.

By 1994 the Central European and Baltic countries (CEB) had reached the very high LIB level of 3.7, broadly comparable to many mixed economies with some state ownership, and price regulation of a few basic goods (housing, some staples). By 1999 this had increased substantially, and by 2005 had reached the maximum 4.3 rating of the EBRD index. It is particularly notable that the Baltics, starting later than the others, already caught up to them by 1994 and kept pace in the final liberalization drive.

South-East Europe lagged somewhat behind, though not nearly as much as the CIS group which in 1994 was far below the level of SEE (no 1994 data available for conflicted Bosnia-Herzegovina and Serbia-Montenegro). Indeed, at the mid-1990s point, the gap between the CISM and CISL is not visible. That quickly changes, however, and by 1999 the CISM group's progress is evident, as it surges ahead in liberalizing measures to achieve about the same position that the CEB countries had five years earlier. I argue below that it is not just a coincidence the CISM output recovery began after reaching about the same level of TPI as had been reached by the CEB countries when their recovery began. What is striking is that by 2005, though the CISM countries had not yet caught up to the liberalization levels of Central Europe, they were very close to the 4.0 mark, reflecting reasonably well-functioning market mechanisms, if not institutions. The nearly stagnant process of liberalization for CISL countries including Belarus is particularly evident in Table 2.

Finally, what do the values of Table 2 imply for the debates about the relative importance and sequencing of stabilization, liberalization and institutions? First, note that the degree of institutional reform reached before growth started was not that high in the CEB. Indeed, even by 2003 the level of development of institutions still had a long way to go in the advanced countries, yet no major damage to the performance of the economies appears to have occurred. Johnson and Subramanian (2005) propose that, generally, good economic policy alone can give growth a start, but sustained growth requires improved institutions. The case of Central Europe appears to fit this hypothesis particularly well. In the first recovery phase 1993-98, GDP grew after the surge of liberalization but then slowed as institutional reform lagged. As these picked up, stronger growth returned after 1999. Second, there is not a single instance of slow liberalizers moving ahead more rapidly (or even at the same pace) with institutional reforms as a true institutionalist -gradualist strategy implies. To the contrary, those that liberalized fastest also moved fastest on institutional reforms, albeit with a lag.

The EBRD makes the point that partial liberalization creates 'winners…who block further progress in reforms' (EBRD, Transition Report 2000, p. 30). Perhaps the most important inference is that the slow reformers were not slow reformers for the reasons often given by internal proponents of gradual liberalization-'the economy is not ready for market operations'-else they would have speeded up institutional reform to prepare the economy for subsequent market liberalization; significantly, nowhere is this pattern visible. This may help one understand the main problem with gradualist arguments. Recall they were motivated by the notion that liberalizing too fast ahead of institutional developments would be less effective and create more dislocation and pain. Many countries did move slowly on liberalization but none did what gradualist theory recommended, move faster on institutional development. The explanations lie in the political economy of vested interests, rent-seeking, and state capture, explored in Havrylyshyn (2006).

For the three western CIS countries, progress on institutions varies. At one end are Russia and Ukraine with a relatively advanced TPI-INST value in 2004 of 2.3, slightly above the average for CISM countries and not very different from the progress seen in SEE. It is noteable that no CISM countries have higher values, and half of the SEE countries (Albania, Serbia-Montenegro and Bosnia-Herzegovina in that order) have values even lower. At the other end, Belarus is far behind with a value of 1.7; only Turkmenistan is lower with a value of 1.0 in effect virtually unchanged from a command economy in EBRD's scaling.

4. The Links between Growth and Institutions.

The econometric studies of growth generally cover only the nineties, given data availability. Unfortunately they miss a key turning point in the recovery, that is the surge in growth rates after 1999 for CISM countries (Table 3). The lagging CISL who had, on official data, grown much faster in late nineties, experienced a slowdown. The simplest and most popular explanation has been the sharp increase in oil and gas prices, which benefited directly

Azerbaijan, Kazakhstan, Russia, and Turkmenistan and was thought to benefit indirectly others in the region through the spillover effect of increased imports. But the spill-over argument is not enough to explain the equally high or even higher growth rates for major energy importers such as Ukraine—surely the terms of trade loss should have kept their rates lower. Furthermore, the import effect was declining over time, as the diversification of trade away from intra-CIS trade continued and for many in the region the share of exports to Russia had fallen from well over 50 percent in the nineties to a third or less by 2002 (see Elborgh-Woytek, 2003).

The first alternative explanation is the achievement of macro stability, and particularly control of inflation. As demonstrated in Vinhas de Souza and Havrylyshyn (2006) for Belarus, Russia, Ukraine, an increasingly sensible fiscal and monetary policy began to be implemented from the mid-nineties. Table 4 shows that by 1999 inflation in CIS countries, especially the CISM group, while still high, had fallen to about the same level Central Europe had at the time of their recovery about 1993-94.

Second, Owen and Robinson (2003) demonstrate that even for Russia oil was not the whole story—at least as important was the beneficial side-effect of the 1998 financial crisis of a real exchange rate devaluation, initially about 50 percent. The primary role of energy exports was not just due to the high prices, but also to a large increase in production volume. Furthermore, there was substantial growth in other sectors of the economy, some but not all of which was a spillover effect from energy exports.

Most of the other CISM currencies eventually followed the Ruble devaluation, hence also benefited from this effect on growth of export and import-substituting domestic production. Berengaut et. al. (2003) provide a good analysis of the various possible factors behind the growth surge in Ukraine, and include, besides the above two, the simple possibility that Ukraine (and others) had hit such a low point in the decline, that the rebound was bound to be strong. It is useful to recollect the very high growth rates (5-10 percent) in mid-nineties, when war and internal conflicts subsided in countries such as Albania, Armenia, Georgia, Tajikistan. Berengaut et. al. (2003) also include a policy variable in their explanation for Ukraine: a distinct hardening of the budget-constraint, especially as it relates to implicit energy rents and subsidies, under the more reform-minded Prime Minister Yuschenko and his Deputy for energy Yulia Tymoshenko. Owen and Robinson (2003) describe a similar hardening in Russia under President Putin, with regional budgets subordinated to the federal one, tax-collections greatly increased, and oil revenues prudently used to pay off substantial portions of the external debt, which fell from over 60 percent of GDP in 1999 to about 17 percent in 2005.

Does this surge in growth conform to the econometric consensus described in Section 2? In one way it is contrary to expectations: the Central European countries, much more advanced on structural reforms, have now seen growth decline to an average far below that of the CISM, as seen in Table 3, though the average for the Baltics remains high and comparable after a sharp dip in 1999 reflecting the Russian crisis. However, this is too static an interpretation of the relation between level of market progress attained and growth. Consider the EBRD measure of market reforms, the Transition Progress Indicator (TPI), for the CEB countries, which by this time had values in the range 3.4 to 3.8 or very close to a well functioning market economy. The short-term factors that explain recovery in transition, begin to be replaced by conventional explanations. This is not the place for a detailed analysis of that sort, but note that the much faster growing Baltics have kept their public deficits well under 3 percent, while those of Central Europe have exploded well beyond 5 percent.

For the CIS countries, the most relevant question to ask with the background of earlier econometric studies may be whether they had by 1999 reached the same level of structural reforms, that one saw for the CEB at the time of their first recovery This threshold level for Central Europe and Baltics in the year preceding first positive growth was on average =2.55 for the overall EBRD index (TPI) as seen in Table 4 . It is critical to the argument here that CISM countries by 1999 had reached something close to the same magnitude of TPI values as the threshold level in the Central European and Baltic recoveries. In most CISM countries this level was actually reached about 1997 when the fist signs of the turnaround began to be seen (negative growth rates but only slightly below zero) , but the beginning of the recovery trend was halted by the financial crisis in Russia. However the delay was not long, with the recovery even picking up additional momentum from the post-1998 factors mentioned above. Therefore, one can conclude that the recent surge in growth, while attributable to several factors, not least of which energy prices (and volumes in Central Asia) , is at least in some part a reflection of having finally reached a sufficient degree of progress towards a market economy to stimulate local economic activity.

The brightest spot on the policy record is to be found in the area of macro-economic policy and stability, especially for CISM countries. While Russia, and Ukraine may still experience inflation of about 10 percent, the trend is clearly downward, reflecting vastly improved management of fiscal and monetary policies. Budget balances have been in surplus for energy exporters, and the oil windfall has been prudently used to reduce debt and/or accumulate reserves in various forms. Even energy importers have had occasional budget surpluses, or at least relatively low deficits of 1–2 percent of GDP. The evolution of monetary policy management is described in Vinhas de Souza and Havrylyshyn (2006); what comes out clearly is the conclusion that in most CIS countries, prudent basic macro-management has become commonplace, allowing the emphasis to move to more micro, structural reforms. This does not mean a problem-free future, as populist pressures for social spending are, if anything, higher, while non-transparent subsidy, tax privileges of the past decade are far from entirely cleansed.

In summary, we see that Russia and Ukraine have achieved considerable progress on all three of the growth-sustaining elements. Stabilization still needs attention, but budgets, monetary policy and inflation levels are broadly under control. Liberalizing reforms are far behind those of a full market economy seen in most of the CEB, but even by 1999 had already surpassed the levels attained in CEB when this region first experienced recovery. The same can be said for institutional development—still a long way to go, but well beyond the historical threshold for recovery seen in the CEB.

Belarus, which had growth recovery earlier than the other two remains somewhat of a puzzle. While it has achieved a modicum of stabilization, inflation has tended to increase well beyond 10% in recent years while it has fallen steadily in other CIS countries. Even more puzzling is that growth remains strong with such low levels of progress in both the liberalization and institutions indices—among the lowest of the twenty-seven EBRD countries. Answers to the puzzle are beyond the scope of this paper, (see IMF 2005 for some discussion) but possibilities include: overstatement of level and rate of growth due to vestiges of soviet accounting methods, “overstatement of the value of exports due to de facto barter pricing for energy imports; and the related fact of continued implicit support by under-priced imports of energy from Russia.

5. Conclusions

This paper analysed institutional development and the link to growth in CIS countries, specifically its largest three western economies, Russia, Ukraine and Belarus. Experience has clearly demonstrated that three elements are needed for sustained growth: stabilization, liberalization, and –perhaps with a short lag–institutional development. Almost a decade and a half since the break up of the Soviet Union, most of these economies are experiencing robust growth rates, and in most cases this has been the situation for several years. Reasonable macro stabilization has been reached by most of them, laying the foundations for growth. But, macro stabilization is a necessary, not sufficient condition for growth, and certainly it is not sufficient for growth sustainability in the middle to long run. For most CIS countries, liberalization of market operations is also highly advanced albeit not complete. Therefore, the reform agenda of most governments in the region now must shift more towards structural, institutional, regulatory, market-discipline enhancing nature. The exceptions are the CISL group of countries including Belarus, where only one of the three elements for sustained growth is reasonably well in place-macro stabilization. Both market liberalization and institutional development lag far behind. But the experience of other transition countries clearly helps show the way, perhaps allowing a faster, smoother and more closely symbiotic progress in the two lagging elements.

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Table 1. Quality of Institutions in Transition Economies 1997-98 and 2003

	Weder 1997-98	Developing Countries in Same Range	World Bank 2003
Central Europe[1]	- 6.0	Chile, Korea, South Africa	0.45
Baltics	+ 4.0	Uruguay, UAE	0.34
South-East Europe	- 2.8	India, Lebanon, Pakistan	-0.19
CIS Moderate Reforms	- 6.1	Peru, Burkina Faso, Guatemala	-0.65
CIS Limited Reforms	- 10.3	Kenya, Haiti, Laos	-1.24
Average Industrial Countries	+12.6		n.a.

Source: Weder (2001); and Beck and Laeven, (2005). Note the two use different scales.

1/ Central Europe includes: Hungary, Poland, Czech Republic, Slovakia, Slovenia, Croatia; Baltics, Estonia, Latvia, Lithuania; South East Europe: Bulgaria, Romania, Macedonia, Albania, Bosnia-Herzegovina and Serbia-Montenegro; CIS Moderate Reforms: all CIS except Belarus, Uzbekistan, and Turkmenistan which fall in the group CIS Limited Reforms. The logic of these groupings is based on Havrylyshyn (2006.).

Table 2. EBRD Transition Progress Index, (TPI) Selected Years
Liberalization (LIB) vs. Institutional Development (INST)

		1994	1999	2005
Central Europe	LIB	3.7	4.2	4.3
	INST	**2.7**	**3.1**	**3.3**
Baltics	LIB	3.7	4.1	4.3
	INST	**2.3**	**2.9**	**3.2**
S.E. Europe[1/]	LIB	3.0 (n.a)	4.0 (3.9)	4.1 (4.0)
	INST	**1.7 (n.a)**	**2.2 (1.9)**	**2.5 (2.3)**
CISM	LIB	2.2	3.7	3.9
	INST	**1.4**	**2.1**	**2.2**
CISL	LIB	1.9	2.0	2.3
	INST	**1.4**	**1.6**	**1.5**
Belarus	LIB	1.7	1.8	2.4
	INST	**1.5**	**1.4**	**1.7**
Russia	LIB	3.0	4.0	3.9
	INST	**1.9**	**2.0**	**2.3**
Ukraine	LIB	1.7	3.4	3.8
	INST	**1.3**	**2.0**	**2.3**

Source: Averages calculated from EBRD *Transition Report*, 2000 and 2005, country tables. Liberalization is the average of the following indicators: price liberalization, foreign exchange and trade liberalization and small scale privatization. Institutional reforms comprise: governance, competition policy, banking reforms, financial sector reforms.

1/ For S.E. Europe the first number excludes Bosnia-Herzegovina and Serbia-Montenegro; the number in brackets includes these two.

Table 3. Growth of GDP since 1998

	1999	2000	2001	2002	2003	2004
Central Europe	2.4	3.7	3.5	3.3	3.2	4.5
Baltics	0.1	6.0	7.0	6.3	5.7	6.7
CISM*	4.2	8.8	6.4	5.5	6.7	8.0
CISL*	4.8	9.4	8.2	5.4	5.3	5.3

Source: EBRD Transition Report (2003), Table A 3.1. For 2002 the average excludes Kyrgyz where a gold mine incident caused growth to fall from about 5-6 percent trend to
–0.5 percent.

Table 4. Inflation, Liberalization and Institutions
Threshold Values in Year of Growth Recovery

	CEB Values at Recovery	CISM Values 1999
Inflation (annual percent)	34.0	25.7 (13.1 in 1998)
TPI-LIB (EBRD index)	3.3	3.7
TPI-INST (EBRD index)	1.9	2.0
TPI-All	2.55	2.7

Source: Authors calculations using EBRD *Transition Report*, various years; explanations in text.