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Postsocialist Transition and the Integration to the World Economy. Economic Prospects and Social Challenges

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Summary

Transition to a market economy is a lengthy process comprised of various spheres of economic activities. The naive belief that a market economy can be introduced by "shock therapy" has been evidently wrong since the beginning, and in several cases, when attempted, has caused more problems than it was able to solve. Because market economy requires adequate institutional structures and appropriate behavior of all involved, transition can be executed only in a gradual manner, since these are very gradual processes based upon new organizations, new laws, and the changing behavior of various economic entities.

In 1989, influential western financial organizations, political bodies, and professional economists seemed to agree upon main points for economic policy reform. This was termed as "the Washington consensus". Despite the fact that the economic policy of the Washington consensus was initially developed without any concern for postsocialist transformation, it has happened that these ideas have significantly influenced the path of thought and action in Eastern Europe and the former Soviet Union. However, because these policies were not intended for the overhaul of post-socialist countries, they have failed. Besides, these policies have hardly worked elsewhere, including Latin America and South East Asia, what can be seen form the series of recent crises – from Indonesia through Turkey up to Argentina. Yet a new, post-Washington consensus is developing, as it should, based on the lessons learned from experience thus far.

Thus 10 major policy conclusions can be drawn. Hopefully, they will be seriously taken into consideration in the future and hence will facilitate economic growth and social development.

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Postsocialist Transition and the Integration to the World Economy. Economic Prospects and Social Challenges

It is true that the course of events in postsocialist economies has been under great influence from policies based upon the Washington consensus, i.e. the policy option insisting mostly on broad liberalization, fast privatization and tough financial stance. But it is also true that the transformation to a market economy and occurrences accompanying this process have had significant impact upon the revision of these policies. On the one hand, the line of thought typical for the Washington consensus has important meaning for the directions of systemic reform and policy attempts in Eastern Europe and the former Soviet Union. On the other hand, the fact that suggested and executed policies did not bring expected results has led to a search for alternative policy means.

Actually, the range of issues upon which there is a consensus among the major partners on the global financial, economic, and political scene, has expanded over the recent years. The postsocialist transformation has contributed to this evolution of attitudes. There is a wide agreement that the institutions matter as much as the free markets and liberal capital flow. There is a consensus that if growth supposed to be durable, it ought to be to a larger extent than so far an equitable growth.

Nevertheless, several new issues and problems have emerged together with the emerging postsocialist markets, and hence there are new concerns, toward which the views differ and are far from being agreed. However, there are numerous symptoms of an urgent need for a new consensus. Additionally, several new elements must be emphasized in what has been agreed in the past.

Due to thus far experience and certain theoretical considerations **10 major policy conclusions** can be drawn:

1. The main policy conclusion – and the key implication of the post-Washington consensus – is that the **institutional arrangements** are the most important factor for progress toward durable growth. The institutions threes are:
- the rules of the market economic game;
- the law;
- the organizations, which by the means of "stick and carrot" support and enforce the compliance with these rules.

What is taken for granted in some market economies, i.e. an institutional set up sufficient for far going liberalization and free market performance, must be created (often from outset) in countries moving from statist, centrally planned economies. If there is a choice between developing these institutional arrangements spontaneously (by chance) or in a way directed by the government (by design), than in the case of postsocialist countries the latter option is more suitable.

A good example here is the capital market, which can emerge and evolve spontaneously, in rather chaotic way – as for example in Russia – or in the government-led manner, managed from above in a well designed and executed way – as for example in Poland. The choice with this regard depends on both theoretical assumptions on the issue of capital market performance and political commitment of the ruling elites, which must be decisive to fight the conflict of interests, especially when the creation of capital market is strongly linked to simultaneously going privatization and investment of foreign capital.

Yet initially the governments of industrial countries and international organizations must assist postsocialist governments in these attempts.

Those countries, which, due to strong government commitments, were able to take care of such design, are doing much better. Of course, "strong government" works here only if it is at the same time a "wise government", since one can use also his strength for the wrong purpose, as seems to be the case of Belarus. Yet if "strong" and "wise" are going together, then – as in Estonia in early 90s, or in Poland in 1994-97 during the implementation of program known as "Strategy for Poland",[1] or in Slovenia in late 90s – recovery is coming sooner, growth is robust and there are better prospects for sustainable development.

Those countries in turn, which have tried to trust that major institutional overhaul can occur by itself – that is by chance – or have not been able to lead this complex process adequately, are lagging behind in both transition advancement and the pace of production and standard of living growth.[2]

2. **The size of the government is less important than the quality of its policy and the manner of the changes of government size**, especially if it implies the government downsizing. Yet in transition economies the issue is not just the downsizing of government, but also a deep restructuring of the public finance system and change of the policy targets and means. Basically, fiscal transfers should be redirected from support of non-competitive sectors, such as old industries or agriculture, toward investment in human capital (especially support for education and R&D), hard infrastructure (such as roads and Internet) and the institution building (including behavioral and cultural changes).

As for the revenue side, the attempt to shift the fiscal burden from direct to indirect taxation is advisable. However, it can work successfully and without causing too much of social stress only if implemented gradually and with equitable growth in mind. Otherwise, the resistance to such changes – which suppose to facilitate growth, hence the improvement of the living standard in the long-term – makes social and economic policies still more difficult.

Attempts to downsize the government through cuts of budgetary expenditure can cause more harm than good for launching recovery and growth. Even if small government is sometimes better than a larger one, the issue is that often it cannot be downsized without causing contraction and standard of living deterioration. It must be considered that creative downsizing should occur only when the economy is on the rise, though most often the strongest attempt to do so is undertaken over a period of deep contraction. Thus, the general problem lies in restructuring expenditures rather than cutting them for an illusion of concurrent, albeit unsustainable fiscal prudence.

3. Unlike certain liberalization measures, **institution building by its nature must be a gradual process**. Thus feedback between specific "inputs" to this process and coming from it "output" must be monitored constantly and the policies must be adjusted and corrected. In the process of postsocialist transition there are many uncharted waters where one should not rely on misguided analogies with the experience from distorted market economies.

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[1] See Grzegorz W. Kolodko and D. Mario Nuti, "The Polish Alternative. Old Myths, Hard Facts and New Strategies in the Successful Transformation of the Polish Economy", Research for Action, 33, The United Nations University World Institute for Development Economics Research, WIDER, Helsinki
or http://papers.ssrn.com/sol3/papers.cfm?abstract_id=170889
or http://www.tiger.edu.pl/kolodko/working/wider/WIDER_1997.pdf

[2] More on these issues see: Grzegorz W. Kolodko, "From Shock to Therapy. The Political Economy of Postsocialist Transformation", Oxford University Press, Oxford-New York 2000.

Especially in the 90s the reliance on experiences from certain Latin American countries *vis-à-vis* structural adjustment policy – followed mainly due to the advise stemming form Washington consensus and insistence of the International Monetary Fund and the USA subsequent administrations – have caused serious problems. The implications of this way of policy doing are still difficult to be overcome in East Central Europe and former Soviet Union Republics.

One must consider the specific features of that type of emerging market. Therefore, it is necessary to orchestrate some institution building innovation in a way previously unseen in other places. This is true first regarding privatization and development of capital markets. The capital allocation in a market economy is completely different than it used to be in a centrally planned economy, thus the institutions such as stock exchange, security control commission, investment banks, investment funds, etc. are completely new. Their development has been quite lasting and indeed uneasy process of learning by doing.

For this reason so called shock therapy was ill-advised proposal since the beginning and hence was doomed to fail, as was the case of Poland in the early 90s and much more spectacular failure in Russia in mid-90s. Contrary to the Russian experience, in China the gradual process of building of market institutions, together with wise development policy, has secured durable and high-speed growth already for two decades. Only in the 90s, when Russia's GDP has been cut by half, the Chinese GDP has doubled.[3]

4. If institutional arrangements are neglected and left to spontaneous processes and unleashed forces of too soon and too fast liberalized markets, then **informal institutionalization (such as mafia, organized crime, corrupted bureaucracy, etc.) fills the systemic vacuum**. The best (i.e. the worst) case in point for the most of the 90s had been the Russian "emerging market". The negligence of government's role and its active policy in organizing the market infrastructure is causing situation, in which informal organizations and links take over. The fine art of policy aiming at avoiding such risk is neither too much, not too little of regulation.

The confusing thing is that both, i.e. deregulation of certain forms of activity (for instance, access to business or free trade) and regulation (or re-regulation) of certain other forms of activity (for instance, security trading or bonds issuing) must take place at the same time. In another words, the risk is not "too much" or "too little" of regulation, but "wrong regulation". After all, the American or British economies are firmly regulated, yet rather in a "good" way.

These are two main maladies in countries that experience liberalization and privatization under institutionally weak governments. Sometimes the governments are too weak not because they are too large, but because they were forced (or unwisely they have chosen to do so themselves) to become smaller too early, that is before the infant market was able to substitute for the state (government). Prematurely or too extensively downsized government is not strong enough and than the market expands in the informal sector (shadow economy), while difficulties mount in the official economy. Therefore, the profits accrue to the informal sector, but the revenues fall in the official sector, with all the negative consequences for the budget and social policy. Thus the market works in a way where profits are privatized, but the loses are socialized in a politically unsustainable way.

5. In transition economies the policies must **transform and streamline the judiciary system to serve the needs of market economy**. The judiciary system must be independent,

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[3] Poland's GDP in 1990-2000 has increased all together by 27 percent (in real terms). However, it was result of decline of 1 percent in 1990-93 and 1998-2000 and growth of as much as 28 percent during the implementation of "Strategy for Poland" in 1994-97.

professional and efficient is this sense, that – on the one hand – it is able to monitor compliance with the law and especially enforce respecting it (including new acts and regulation, just adopted for the purpose of building the institutional foundation of market economy) and – on the other hand – is flexible and fast *vis-à-vis* dealing with court settlements and arbitrage concerning economic and financial matters and disputes between different agents involved in market endeavor.

This is a great challenge, since the old system of contracts' execution under planned allocation has ceased to exist, but new system of contracts implementation under market rules and culture has not yet matured enough. The establishment and development of a new law – e.g. trade and tax code, capital market regulation, property rights protection, competition and anti-trust rules, banking supervision, consumer protection, environmental protection – are even more important and ought to be addressed before privatization of state assets.

Creation and advancement of a legal framework for market economy should be also much higher on the agenda of international financial organizations. It must be put in front, as more urgent and important issue than liberalization and privatization, since the latter can contribute to sound growth only if the former is secured. The course of developments during the 90s has shown clearly that only the countries with steady improving legal system have been able – yet still to a limited extent – take advantage of ongoing liberalization-cum-privatization reforms.

6. A shift of competence and power from central government to local governments is necessary for deregulation of the postsocialist economy. Such shift means **moving the public finance system toward decentralization and streamlining local governments by giving them larger fiscal autonomy**.[4] Otherwise the process of weakening the central government is not matched by enhancing the local governments. The joint position of both levels of government must be seen as an integrated entity needed for the sake of gradual institution building.

If local governments are not enhanced, while at the same time the central government is weakening too much, and the market forces are not yet supported sufficiently by new institutional arrangements, than liberalization and privatization will not necessarily improve capital allocation and will fail to raise economic efficiency. Unfortunately, this has been mostly the case, what can be seen from the results in the sphere of the real economy during first decade of transition and integration of the postsocialist countries with the global economy.[5]

Of course, if decentralization of power and public finance system is implemented in wrong or inadequate way – as, for instance, was the case with the federal system in Russia under the Yeltsin administration, or the experience with 4 so called great reforms (i.e. social security, health care, education and administration) in Poland in 1998-2001 – than, instead of improvement of the quality of service provided to the citizens and growing efficiency of the whole governance, there is just a phenomenon of growing and inflating local bureaucracy. This threat can be overcome only by the proper design and execution of the relevant reforms. They call for full commitment of central government and proper training of local administration staff, but also for true local democracy and development of civic society. Hence, for successful implementation these reforms do need many years.

[4] See Grzegorz W. Kolodko, "Post-Communist Transition. The Thorny Road", University of Rochester Press, Rochester, NY, and Woodbridge, Suffolk, UK, 2000.

[5] Comprehensive analysis of the 90s *vis-à-vis* postsocialist transition is provided, *inter alia*, in "World Economic Outlook. Focus on Economies in Transition", International Monetary Fund, Washington DC, October 2000. See also "Transition Report Update", European Bank for Reconstruction and Development, London, April 2001 and G. W. Kolodko, "From Shock to Therapy…", *op. cit.*

7. There is an urgent necessity to accelerate the **development of non-government organizations** (NGOs). Next to the private sector and the state (government), this is the third indispensable pillar of contemporary market economy and civic society. With the lack of a proper range of the NGOs, which are supposed to take care of various aspects of public life, there is a continued tension between the state and society, and the expanding private sector does not provide sufficient or satisfactory solution to this matter.

There are spheres within the public domain that must depend neither on the state, nor on the profit-oriented private sector, e.g. certain cultural institutions (such as operas, galleries and museums) or sport organizations as well as many others. These kinds of activities supposed to be a domain of NGOs, because they cannot perform as profit oriented endeavors, on the one hand, and, if run by the central or local government, the wasteful bureaucracy can overburden them, on the other hand. Additionally, there is plenty of room for the NGOs, which are watching that the governments indeed act on the behalf of human rights protection, or natural environment support. These NGOs are not necessary a substitute for elected bodies, but a kind of complimentary institutions, which should enhance the efficiency of the latter. This is true both on the domestic (local and central) as well as international scale. As for the latter, we have certain good examples of such activities, e.g. Green Peace fight in favor of undertaking a true action against the green house effect, or Jubilee 2000 crusade to write of the debt of 41 highly indebted poor countries (HIPC), most of them (35) form Africa.

Hence, a growing part of international technical, financial, and political assistance must be channeled into enhancing the NGOs activities. Otherwise the infant market economy and democracy in postsocialist countries will not evolve fast enough and the transition will be incomplete. The delay of institutional infrastructure provided by the NGOs becomes a growing hurdle for successful systemic changes and high-quality growth, so much needed in the postsocialist countries looking for their way to catch up with more advanced part of the world economy.[6]

8. During transition to market economy the income policy and government concern for **equitable growth** has great meaning.[7] Whereas inequity increasing to a certain degree is unavoidable during the initial years of transition, the government must play an active role – through fiscal and social policies – in controlling income dispersion. There is a limit of disparity, beyond which further expansion of overall economic activity becomes constrained and growth starts to slow, or recovery is delayed.[8] It is very difficult to quantify this limit *a priori*, yet one must look towards it through the prism of growing social tensions and the workers' strikes, people's demonstrations, etc., as well as growing lack of motivation to improve the labor skills, which become less interested in increasing qualifications, because it doesn't pay back sufficiently.

If disparity growth is tolerated for a number of years during contraction and when the standard of living improves for a few and declines for many, than the political support for

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[6] On the prospects and constraints of the fast growth in postsocialist economies of East Central Europe and the former Soviet Union see Grzegorz W. Kolodko, "Globalization and Catching-up in Transition Economies", University of Rochester Press, Rochester NY, and Woodbridge, Suffolk, UK, 2001.

[7] More on this issue see Vito Tanzi, Ke-young Chu, and Sanjeev Gupta. (eds.), "Economic Policy and Equity", International Monetary Fund, Washington, DC 1999.

[8] Indeed, it has been the case in Poland, where – due to ill-advised policy of overcooling the economy – the annual rate of growth of GDP has been brought from as much as 7,5 percent during the second quarter of 1997 down to a meager 1 percent, or so, in the second quarter of 2001. It must be remembered that already during the implementation of "Strategy for Poland" the average rate of growth in 1994-97 was hovering around 6,4 percent per annum. Thus far, this was the most remarkable period, from the viewpoint of the pace of economic growth, in any of postsocialist countries.

necessary reforms will evaporate. It can be clearly seen recently in as remote emerging market and democracies as Brazil, Indonesia, South Africa and Ukraine.

9. Postsocialist transition to the market is taking place at a time of fast going globalization, hence the **opening and integration with the world economy** is an indispensable part of the whole endeavor. These processes must be managed carefully, with special attention given to the short-term capital flow liberalization. It must be monitored and controlled by the countries' fiscal and monetary authorities with the support of international financial institutions, e.g. the International Monetary Fund (IMF), the World Bank and the Bank for International Settlements (BIS).

It is better to liberalize capital markets later than sooner. First the institution building must be advanced enough and stabilization ought to be consolidated into stability. Only then should financial markets be liberalized, and it should be done rather in a gradual manner. Otherwise – especially against the harsh experience with the aftermaths of the currency and financial crises – the societies of young emerging markets and postsocialist democracies are not going to be supportive of market mechanism introduction or integration with the world economy. Even more – they may become hostile toward such changes.

The growing anti-globalization sentiments – and this is also true in East Central Europe and the republics of the former Soviet Union – are just the expression of erosion for such support. If these countries will not be able to walk soon along the path of high-speed growth, and the growing income inequality will be not contained, than the social tensions will increase and the support for transition to a market will be sharply on the decease. With all the negative consequences for the democracy, too.

10. International organizations should not only support, but also insist on further regional integration and co-operation. If growth is expected to be durable and fast, it requires export expansion, which will depend on strong regional links. Thus it calls for institutional support, as export-import banks, commodity exchanges, credit insurance agencies, and suchlike. This should be the main institution building concern of the European Bank for Reconstruction and Development (EBRD), supported by directed lending from this institution, and by its technical assistance. This type of market infrastructure is still underdeveloped in transition economies, thus regional trade and cross-country foreign direct investment are lagging behind overall changes. What should be one of the driving forces of sustained growth is so far actually one of its main obstacles.

The Bretton Woods organizations should reconsider their policies toward transition economies. If the IMF mainly takes care of financial liquidity, currency convertibility, fiscal prudence and monetary stabilization, the World Bank should focus attention mainly on conditions for equitable growth and sustainable development. For obvious reasons these two kinds of economic policy aims (or rather the means in the former case and the ends in the latter) are often contradictory. There is an inclination to confuse the ends with the means of the policy, to subordinate long-term development policy to short-term stabilization policy.

Yet the record of transition so far has clearly proved that there is neither much development, nor stability.[9] Hence, in the future **the fiscal and monetary policies must be subordinated to development policy – not the other way around**. Such subordination doesn't imply loose fiscal and monetary policies, but calls for not confusing the ends with the means of development policy. The aim is economic growth and social development, and not fiscal balance or money supply.

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9 See the cited reports and outlooks of the IMF and EBRD as well as G. W. Kolodko, "Post-Communist Transition. The Thorny Road", *op. cit.*

For instance, neither "tough" policies in Russia until crisis of summer 1998, nor in Poland until summer of 2001 have even proved to lead to declared fiscal prudence and financial stabilization; just the contrary. Because of overshooting the monetary and fiscal aims and wrong coordination of these two policies, at the end of the day there has been a perverse effect of undertaken attempts. On the one hand, not only the economy was driven in recession (as in Russia in 1999), or in stagnation (as in Poland in 2001), but also the budget was driven into deeper deficit than it was before. In another words, the assumed targets were not accomplished, yet the real financial and social costs of the exercised policies have been much higher than envisaged *ex ante*.

There is a need for the World Bank performance criteria describing socio-economic development as much as there is such need for the traditional IMF fiscal and monetary criteria. The new set of criteria should always stress the implications of suggested policies for growth, capital allocation, income distribution and the social safety net. The World Bank should not accept and support policy reforms and actions that – while aiming at financial stabilization – may lead to social destabilization resulting from lack of growth, spreading poverty, increasing inequality and divestment in human capital.

Hence, the postsocialist transition to a market economy, civic society and political democracy is an interactive process of learning-by-monitoring and learning-by-doing. It will continue and last for several more years. After all, even if there is – as indeed it seems to be – a growing chance for some kind of the post-Washington consensus, this must be seen as a process, and not as an act. Such emerging consensus must be accomplished indeed among many more partners than just the important organizations based in Washington. Simply, there is a need of new world consensus on the new global institutional order, and the coordination of economic policy on the world scale. Otherwise, the policies agreed in Washington will not be able to deliver what they assume elsewhere. And that has been basically the case of the 90s. The beginning of the 21st century has not changed much with this regard. Thus the quest for comprehensive and implementable consensus on policies facilitating sustainable growth must continue.

Policy recommendations

1. The institutional arrangements are the most important factor for progress toward durable growth. Unlike certain liberalization measures, institution building by its nature must be a gradual process.
2. The size of the government is less important than the quality of its policy and the manner of the changes of government size, especially if it implies the government downsizing.
3. If institutional arrangements are neglected and left to the spontaneous processes of too soon and too fast liberalized markets, then informal institutionalization fills the systemic vacuum.
4. The policies must transform and streamline judiciary system to serve the needs of market economy.
5. A shift moving the public finance system to decentralization and streamlining local governments by giving them larger fiscal autonomy are required to improve the efficiency of whole economy.
6. There is urgent necessity to accelerate development of non-government organizations.
7. Income policy and government concern for equitable growth has great meaning, since markets mostly fail with this respect.
8. The opening and integration with the world economy is an indispensable part of the structural reforms aiming at growing efficiency and higher rate of growth.
9. International organizations should support further regional co-operation.
10. Fiscal and monetary policy must be subordinated to development policy – not the other way around.

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