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Globalization and Catching-up. From Recession to Growth in Transition Economies

by

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Abstract

The transitional recession in Eastern Europe and the former Soviet Union has lasted much longer than expected. It has been the result of both the legacy of the past and policy mistakes. Due to structural reforms and gradual institution-building, the postsocialist economies have started to recover, and some leading countries have been able to build up a certain amount of momentum towards fast growth. There is a possibility that, within the wider context of globalization, several of these emerging market economies will be able in a matter of one or two generations to catch up with the more advanced industrial countries.

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I. INTRODUCTION

Historical endeavor of transformation from statist-controlled economy to new institutional arrangements of free market is a unique undertaking. Ongoing transition in the former centrally planned economies of Eastern Europe (EE) and the former Soviet Union (FSU) is indispensable part of globalization. Without this transition the globalization would fall short of its full dimension, comprehensiveness and dynamism.

Leaving aside the political and ideological concerns, the main argument in favor of transition to a market system has been a wide conviction that the introduction of market economy should improve competitiveness and efficiency. Hence – after some short period of transitional contraction – the new system supposed to lead to recovery and, later, to fast growth. However, for a number of reasons it has not occurred.

Transitional recession lasted much longer than expected, contraction was deeper than assumed earlier, and the recovery was not – and in several cases still is not – as smooth as envisaged both by the relevant governments and the international organizations. Actually, instead of soon coming recovery and robust growth, the lasting recession turned to be rather the Great Transitional Depression, continuing in some countries over whole decade of the 1990s. Moreover, it is important that such great depression happened to full extent in two biggest transition economies, i.e. Russia and Ukraine, with the population of about 200 million, or a half of all countries in transition.

While after the first decade of transition, i.e. 1990-99, the index of average (weighted) GDP for 25 countries of EE and CIS stands at around 65 percent of pre-transition output, it is as low as around 54 percent for the CIS economies and still below the level from 1989 in the case of the EE economies. By all means that was not expected at the onset of transition. Furthermore, the surprise stemming from these unforeseen developments causes significant differences vis-à-vis the interpretations of occurring events. It is true both as far as the explanations of the causes of so long lasting contraction and, later, the sources of fast growth (in these countries where it has indeed happened) are concerned. Thus it is worth to take a look for the patterns of underlying roots of these processes in transition economies, especially from the viewpoint of policy options for the future and their political and technical constraints.

Consequently, after the Introduction, Section II briefly discusses the links and feedback between globalization and transition to a market economy. In Section III the scope and dynamism as well as the general causes of deep transitional recession are presented. Section IV describes various paths of recession, recovery and growth, because these processes evolve along quite different routes in particular countries and regions of the EE and FSU. Section V elaborates on policy responses towards the challenge of prolonged transitional depression, while especially stressing the meaning of institutional vacuum and importance of institution-building. In Section VI the implications of globalization and external shocks for recovery and growth are discussed as well as the chances and mechanisms of catching-up with high-developed industrial economies are examined. Section VII presents alternative growth paths and the long-term passive scenarios reaching until year 2050. Section VIII examines the active policies options and provides certain advice aiming for growth acceleration and its sustainability in the long-term. Finally, in Section IX, the policy conclusions are presented for the further debate.

II. GLOBALIZATION AND POSTSOCIALIST TRANSFORMATION

The last decade of 20th century has been marked by the immense changes in the world economy. The new phase of technological revolution and far going internationalization of capital flows have changed the patterns of economic performance. Broad trade liberalization, accompanying by growing liberalization of financial and capital markets, has brought the new prospects and new challenges. These challenges must be tackled not only by the governments and various international organizations, but to still growing extent by the private sector and non-governmental organizations (NGOs). Hence, on the eve of the new century, there are not only mounting old structural problems, but also several new issues that must be addressed properly by theoretical considerations and particularly by sound policy response.

First, the private sector ought to be not only the main beneficiary of the fruits of globalization and transition, but must be engaged more than so far in the crisis management. The role of private business is growing worldwide, both in advanced market economies and in developing and formerly centrally planned economies – in the latter mainly owing to vast privatization. Hence private sector must bear larger responsibility for the outcomes of the crises, when they hit. Private sector from the advanced industrial countries – including various financial intermediaries, investment banks, the hedge funds, and multinational corporations – while getting more involved in business on the global scale, must also be more concerned about sharing the responsibility and the costs, when the international flow of capital fails to deliver positive results.

Second, the international organizations – including regional development banks and institutions dealing with particular aspect of international and global economic activities (i.e. IMF, WB, WTO, UNCTAD, ILO, etc.) – must coordinate their actions in well-orchestrated way. Despite advancing liberalization, or in some sense just because of it, there are certain intertwined processes monitored by different organizations, yet the latter are not capable to coordinate their policies in a sufficient way. Many problems on the global economic scene, including its postsocialist theatre, evolve just because of lack of such coordination. The good example here is too risky exposition for unregulated flow of short-term capital, which can help and facilitate economic growth in emerging markets, but it might also make it more difficult. Unfortunately, in the recent years the latter was often the case. If the risk evolving from rampant trade liberalization is augmented by the risk coming from radical financial liberalization, then these risks are critically escalating, particularly in the economies with weak institutions. This is often the case of emerging markets, especially among the postsocialist countries.

Third, the international NGOs are going to play much more important role than thus far. They must be seen as a strategic partner for private sector, the governments and their international organizations. The recent case of coordinating the actions regarding the debt reduction for highly indebted poor countries (HIPIC) is good example of such work and may turn to be good message for the future. If the leading developed countries from the G-7 group as well as the International Monetary Fund and the World Bank work out the challenge of debt burden jointly with certain NGOs, like Oxfam and Jubilee 2000, then the effects are visible. The future will bring definitely more initiatives of similar characteristic, in particular regarding investment in human capital and natural environment protection, on the one hand, and counteracting poverty and inequality, on the other. Transition economies will be also increasingly involved in these types of endeavors. It will work on the behalf of their ability to develop faster, since these activities are linked to the learning process and to more favorable participation in the global economic interchange.

Fourth, the systemic transition to market economy has *per se* significant meaning for globalization. Some of these countries are clearly on the path towards full-fledged market economy. Some others, while still attempting to reform their existing economic system, e.g. China, will most likely join this process soon. All three aspects of transition, that is liberalization-cum-stabilization, institution-building, and the restructuring of industrial capacity, are related to the internationally and thus also globally occurring processes (Kolodko 1992b).

Liberalization-cum-stabilization is linked to the process of opening up previously relatively closed economies. That is reflected not only in the fact that, due to higher participation in international division of labor, their imports and exports are growing faster (or, during contraction, falling slower) than overall output. It means also free entry to and exit from liberally regulated businesses for both domestic and international entrepreneurs. Additionally, capital flow has been liberalized as well, thus making very quick the infant capital markets of those countries a part of the global integrated financial and capital markets. International investors penetrate particularly the financial and utilities sectors. It is causing not only a progress as far as quality of services provided by these sectors is concerned, but also creates a risk of surfacing a kind of 'dependent capitalism' (Poznanski 1997). Such risk is stemming from the asymmetry between the scope of capital being invested by transnational corporations and foreign investors in these countries, on the one hand, and the lack of ability of these countries to raise enough capital to invest into foreign markets, since they are even short of capital to meet their own needs, on the other hand. This challenge can be overcome only in the long run, assuming that financial stabilization is accomplished, the fundamentals are sound, and the growth is fast.

Institution-building, especially through new law and organizations facilitating the market-based allocation of recourses, is linked to globalization too. There are several institutional arrangements, which at the same time are a part of international and global institutional order, e.g. regulation vis-à-vis trade liberalization agreed within the framework of WTO, or standards and policies aiming at protection of natural environment. Indispensable part of globalization – and not contradiction to it – are the processes of various regional integration, e.g. with (and later within) the European Union and, after initial disintegration, within the CIS. During globalization the national economies' institutional arrangements are getting more similar to each other and the more similar they become, the easier it is to enhance the process of integration and globalization.

All these reforms lead to microeconomic restructuring of the existing industrial capacity (Lavigne 1999). To quite large degree it takes place simultaneously with the expanding involvement of multinational corporations. Thus growing part of the production and distribution processes in transition economies can be simply seen as a fraction of the global economy. Increasing inward foreign direct investments (FDI) are contributing to this process importantly. Nonetheless, the crucial meaning for future growth will have higher than achieved so far propensity to save and, consequently, higher capability for domestic capital formation (Kolodko 1999b).

From this perspective, sustained inflow of FDI must be seen only as an addition to healthy flow of domestic capital. Owing to globalization it should continue, even after the privatization process attracting so much of the inward FDI expansion in the 1990s, will be completed. Hence it should be expected that also in the future the FDI will be targeting at microeconomic restructuring and thus will contribute to rising competitiveness in the long run. All these ought to enhance the growth ability in transition economies still further.

III. TRANSITIONAL RECESSION AND THE GREAT DEPRESSION OF THE 1990S

Before the historic endeavor of transition to a market has been launched, the formerly centrally planned economies were growing. Indeed, they were growing fast. Over the four decades preceding the 1990s the annual rate of growth had averaged from 4.8 percent in the former Czechoslovakia to 8.2 percent in Romania.[1] With such pace of growth the national income was doubled in 16 years in the former case, and in less than nine in the latter. However, growth under centrally planned system had numerous specific features. At least five of them are worth to be mentioned in the context of the way of reasoning relevant in these considerations.

First, despite stubborn attempts of the governments – or indeed quite often just because of their intervention in economic matters and owing to the bureaucratic allocation of resources – there were specific growth cycles (Bauer 1978, Kolodko 1976). Although the output was growing systematically, the medium-term rate of growth was fluctuating. There were the periods of accelerated growth, and then the periods of correction, during which the growth had slowed down. Later, another expansion was launched and the sequence, by and large, was repeated (Table 1). These two features – that is the endogenous mechanism of periodical fluctuation and relatively regular character of these changes – justify the interpretation of those processes as of a cyclical nature.

Second, the growth was of a ‘bad quality’, since even in relatively better performing economies the shortage syndrome was never eliminated entirely. That in turn was causing serious economic and political stress. Price distortions were leading to additional obstacles to sustain high and stable rate of growth. At the later stage, in some countries the shortages became accompanied by open (i.e. price/wage) inflation. Thus so-called ‘shortageflation’ syndrome had emerged (Kolodko and McMahon 1987). Consequently, growth was associated with lasting disequilibrium. Under the central planning allocation that was just opposite to what was expected by the authorities.

Third, despite high rate of growth the living standard was not improving fast enough. The socialist (communist) model of development was based on expansion of heavy industries and the investment drive, so consumption was growing always slower. Owing to the cyclical nature of growth, the rate of consumption growth did fluctuate too, yet the highest variation was vis-à-vis investments. Nevertheless, too slow (at least from the people’s expectations perspective) improvement of standard of living was causing increasing social dissatisfaction, what in turn was leading to the further momentum losing. This factor, together with discomfort of shortageflation, explains why the sociopolitical system was getting out of balance despite not that low rate of overall production growth.

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[1] There should be doubts about the reliability of data from that period. Yet if there are certain errors involved, it should make neither the long-term analyses, nor the comparisons between particular countries impossible. Just the conclusions drawn from these analyses must be taken with a proper care and reservations. So they are.

Table 1: Economic Growth Cycles in Centrally Planned Economies, 1950-89

	Years/Growth rate in net material product, percent											
Bulgaria	na	1953-56	1957-59	1960-63	1964-67	1968-71	1972-75	1976-80	1981-85	1986-88	1989	
		6.5	14.0	6.0	9.1	7.4	8.3	6.4	3.5	5.2	0.5	
		–	+	–	+	–	+	–	–	+	–	
Czechoslovakia	1950-52	1953-56	1957-61	1962-65	1966-69	1970-75	1976-78	1979-84	1985-88	1989		
	10.0	6.5	7.4	0.8	7.2	5.3	4.7	1.8	2.4	1.9		
		–	+	–	+	–	–	–	+	–		
GDR	1950-52	1953-56	1957-59	1960-63	1964-69	1970-75	1976-86	1987-88	1989			
	18.0	6.7	8.7	2.2	5.0	5.7	4.4	3.3	2.5			
		–	+	–	+	+	–	–	–			
Hungary	na	1951-53	1954-56	1957-60	1961-65	1966-69	1970-74	1975-78	1979-85	1986-88	1989	
		9.3	2.0	11.0	5.4	7.2	6.2	5.0	0.9	1.6	0.4	
			–	+	–	+	–	–	–	+	–	
Poland	1950-53	1954-57	1958-63	1964-68	1969-70	1971-75	1976-78	1979-82	1983-85	1986-88	1989	
	9.8	9.1	5.4	7.1	3.7	9.8	4.9	6.5	4.9	3.9	0.2	
		–	–	+	–	+	–	+	–	–	–	
Romania	na	1951-53	1954-56	1957-59	1960-62	1963-66	1967-70	1971-76	1977-79	1980-84	1985-88	1989
		17.0	5.0	10.6	7.6	10.5	7.0	11.5	7.7	4.0	5.4	-5.8
			–	+	–	+	–	+	–	–	+	–
Soviet Union	1950-51	1952-53	1954-56	1957-63	1964-68	1969-73	1974-78	1979-88	1989			
	16.0	8.2	11.6	6.0	8.2	6.5	5.0	3.3	2.6			
		–	+	–	+	–	–	–	–			

Sources: Central Statistical Office (GUS), Warsaw, various years, and author's calculations.
'+' - acceleration. '–' - slowdown.

Fourth, there was a ‘growth fatigue’ (Poznanski 1996). The pace of growth was falling down. Especially at the later stages, after initial rapid growth in the 1950s and 60s, the rate of growth significantly declined. It happened despite investments were growing faster than overall production, what shows that the efficiency was shrinking. As the labor productivity was growing still slower, in the late 1980s growth was coming close to stagnation and in 1989 it became indeed sluggish. Thus the potential for growth was fading away. Later, unfortunately, together with the beginning of transition, the recession had started and inflation accelerated significantly. Thus these countries, although to different degree and for a different period of time, had shifted from one malaise, that is the shortageflation under dying centrally planned regime, to another, that is the slumpflation under emerging market order (Kolodko 1992a).

Fifth, the catching-up process was taking place already under the centrally planned system. Especially in the early years, the countries at relatively lower level of development, e.g. Bulgaria and Romania, were growing much faster that the countries enjoying relatively higher level of production and hence better standard of living, e.g. Hungary and the former Czechoslovakia (Table 2). The same can be said about the pattern of growth within the former Soviet Union, where Caucasus and Central Asian republics were growing significantly faster than the East European republics. Though to a lesser extent similar was situation in the former Yugoslavia republics, where for instance the rate of growth in Macedonia was higher than in Slovenia.

Table 2: Average Rate of Growth (NMP) in Centrally Planned Economies, 1950-89 (percent)

	1950-89	First Phase of First Cycle	Last Phase of Last Cycle
Romania**	8.2	17.0	5.4
Bulgaria*	6.9	>10.0	5.2
Poland	6.7	9.8	3.9
Soviet Union	6.5	16.0	3.3
GDR	5.9	18.0	3.3
Hungary**	5.0	9.3	1.6
Czechoslovakia	4.8	10.0	2.4

Source: Central Statistical Office (GUS), Warsaw, various years and author’s calculations.
* Average for 1953-89
** Average for 1951-89
NMP – Net Material Product

And then the transition recession had begun. It lasted from three years in the best case – i.e. Poland since mid-1989 until mid-1992 – to as many as 10 years in the worst case, i.e. in Ukraine from 1990 until 1999. In the former, GDP contracted by about 20 percent and then started to recover and grow. In the latter, output fell by over 60 percent and has started to grow only in 2000. While only three countries – additional to Poland in 1996, Slovenia in 1998 and Slovakia in 1999 – have been able to recover the pre-transitional output, at the other end of the specter there are countries doing even worse than Ukraine. In Georgia and Moldova GDP in 1999 was at about one third of its 1989 level, and in another four FSU republics it was significantly below a half of that amount. Among the EE economies, in six countries GDP was hovering around or below three fourths of the 1989 output (Table 3).

Table 3: Recession and Growth in Transition Economies. The Rates of GDP Change, 1989-99

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	Real GDP 1999 1989=100
Poland	0.2	-11.6	-7.0	2.6	3.8	5.2	7.0	6.1	6.9	4.8	3.8	121.6
Slovenia	-1.8	-4.7	-8.9	-5.5	2.8	5.3	4.1	3.5	4.6	3.9	3.5	107.6
Slovakia	1.4	-2.5	-14.6	-6.5	-3.7	4.9	6.9	6.6	6.5	4.4	1.9	101.5
Hungary	0.7	-3.5	-11.9	-3.1	-0.6	2.9	1.5	1.3	4.6	5.1	4.2	99.2
Czech Republic	1.4	-1.2	-11.5	-3.3	0.6	3.2	6.4	3.8	0.3	-2.3	-0.3	94.7
Albania	9.8	-10.0	-27.7	-7.2	9.6	9.4	8.9	9.1	-7.0	8.0	7.1	92.5
Uzbekistan	3.7	1.6	-0.5	-11.1	-2.3	-4.2	-0.9	1.6	2.4	3.3	3.0	92.3
Belarus	8.0	-3.0	-1.2	-9.6	-7.6	-12.6	-10.4	2.8	10.4	8.3	1.5	78.2
Croatia	-1.6	-7.1	-21.1	-11.7	-8.0	5.9	6.8	6.0	6.5	2.3	-0.7	77.2
Estonia	-1.1	-8.1	-13.6	-14.2	-9.0	-2.0	4.3	3.9	10.6	4.0	0.0	75.7
Romania	-5.8	-5.6	-12.9	-8.8	1.5	3.9	7.1	4.1	-6.9	-7.3	-4.1	73.0
FYR Macedonia	0.9	-9.9	-7.0	-8.0	-9.1	-1.8	-1.2	0.8	1.5	2.9	0.6	72.0
Bulgaria	0.5	-9.1	-11.7	-7.3	-1.5	1.8	2.1	-10.1	-7.0	3.5	1.4	66.8
Lithuania	1.5	-5.0	-6.2	-21.3	-16.0	-9.5	3.5	4.9	7.4	5.2	0.0	65.4
Kyrgyzstan	4.0	3.0	-5.0	-19.0	-16.0	-20.0	-5.4	7.1	9.9	1.8	0.0	60.4
Kazakhstan	-0.4	-0.4	-13.0	-2.9	-9.2	-12.6	-8.2	0.5	2.0	-2.5	-1.7	60.2
Latvia	6.8	2.9	-10.4	-34.9	-14.9	0.6	-0.8	3.3	8.6	3.6	1.5	60.1
Russia	2.6	-4.0	-5.0	-14.5	-8.7	-12.7	-4.1	-3.5	0.8	-4.6	1.5	56.1
Turkmenistan	-6.9	2.0	-4.7	-5.3	-10.0	-18.8	-8.2	-8.0	-26.1	4.2	17.0	51.2
Azerbaijan	-4.4	-11.7	-0.7	-22.6	-23.1	-19.7	-11.8	1.3	5.8	10.1	3.7	45.2
Tajikistan	-2.9	-1.6	-7.1	-29.0	-11.0	-18.9	-12.5	-4.4	1.7	5.3	5.0	44.1
Armenia	14.2	-7.4	-17.1	-52.6	-14.8	5.4	6.9	5.8	3.1	7.2	4.0	42.5
Ukraine	4.0	-3.4	-11.6	-13.7	-14.2	-23.0	-12.2	-10.0	-3.2	-1.7	-2.5	35.7
Georgia	-4.8	-12.4	-20.6	-44.8	-25.4	-11.4	2.4	10.5	11.0	2.9	3.0	33.8
Moldova	8.5	-2.4	-17.5	-29.1	-1.2	-31.2	-3.0	-8.0	1.3	-8.6	-5.0	30.5
Bosnia-Herzegovina	na	na	na	na	na	na	*-5.7*	*58.9*	*50.1*	*19.4*	*6.6*	x
Yugoslavia	na	na	na	na	na	*2.5*	*6.1*	*5.8*	*7.6*	*1.5*	*-37.3*	x
GDP-weighted average*												
EE-13	-0.2	-6.6	-10.7	-3.6	0.4	3.9	5.5	4.0	3.6	2.4	1.7	99.3
CIS-12	0.6	-3.7	-6.0	-14.2	-9.3	-13.8	-5.2	-3.5	0.9	-3.5	0.3	54.3
EE and FSU-25	0.3	-5.0	-8.1	-9.5	-5.0	-6.0	-0.5	-0.2	2.0	-1.2	1.0	71.3

Sources: EBRD 1999. Data for Russia for 1989 is for Soviet Union; source as in Table 1. Preliminary data and forecast for 1999 also from PlanEcon 1999a and 1999b, and from available national statistics. Data for Bosnia-Herzegovina and for Yugoslavia from PlanEcon 1999b.

*The weights used are the EBRD estimates of nominal dollar-GDP for 1996.

na - data not available.

Thus the great slump is a fact. However, it must be remembered that the data for transition economies is far from perfect too. Of great significance here is the bias stemming from the existence of vast informal, i.e. neither officially registered nor taxed sector. The issue is that informal activities alter upward both output and employment, but not necessary raise the rate of growth, or mitigate the rate of contraction. In another words, it is obvious that in transition economies the factual output and

thus GDP is significantly – in the range between 15 and 30 percent – higher than officially acknowledged. However that changes only the basis from which the pace of growth should be counted, but not the rate of growth as such. Accordingly, at present-day both the overall GDP as well as the GDP per capita (and consequently the GDP absorption, i.e. private consumption and investment) are higher than it may be suggested by official data. The reason is not faster than officially registered growth, but higher output at the point of departure. Hence these observations might change the understanding and interpretation of the absolute level of output, but not the pace of its expansion.

It must be also admitted that in some cases the range of the output fall at the onset of transition was exaggerated. Part of the factual production did not vanish, but simply was transferred, most often together with assets, from official to informal sector. Later such particular form of privatization (since the official sector used to be state-owned and the unofficial became a private one) resulted in faster officially registered pace of growth than indeed it was actually occurring. Output, which did exist before, but was not reported, had turned out to be gradually registered and thus counted in the official statistics.

Therefore the phenomenon of informal sector is bringing two types of bias to the real picture of initial contraction and recovery. It could happen that the real scope of contraction was exaggerated, but later the real growth could be exaggerated as well. Interestingly, in many analyses much more attention has been given to the former case than to the latter. The point is that in the longer run – say, in a period of a decade or two – the balance of these two contradictory phenomena may be neutral.

There was always a belief that growth will come sooner than it indeed occurred. For instance in Poland, at the beginning of transition, the government assumed that contraction would last just one year and the fall of GDP would not exceed 3.1 percent. Actually it lasted three years and was six times more severe. Gomulka (1990) was predicting the rate of growth for 4.7, 8.7 and 7.9 percent in 1991-93. Whereas it should bring sound expansion of about 22 percent over these three years, actually the economy contracted 12 percent in 1990 and further 7.0 percent in 1991. Only then it grew by 2.6 and 3.8 percent in 1992-93. Assuming better policy response, for Hungary and Poland Borensztein and Montiel (1991) foresaw on average 6.5 percent growth in 1991-95 and 3.25 for the former Czecho-Slovakia. Summers (1992) expected the Polish economy turning around already in 1991 (2.0 percent growth) and thereafter soaring by five to six percent. He had foreseen the positive growth in case of Hungary, Poland, Romania, and Yugoslavia since 1992, and in the case of Bulgaria and Czecho-Slovakia since 1993, with the acceleration of non-weighted mean rate of growth for the whole EE going up from 0.8 percent in 1992 to about four percent by the end of decade. Contrary, it shrunk by additional 3.6 percent in 1992 (after drop of about 17 percent in 1990-91) and at the end of decade it was expanding by a mere two percent.

Not only the individual experts were wrong, but so were the governments and respected international organizations. The International Monetary Fund in its *World Economic Outlook 1991* expected the GDP growth for EE already since 1992. After predicting contraction of only 1.5 percent in 1991 (contrary to factual collapse by 10.7) the GDP growth was forecast at 2.8 for 1992 and at 4.4 percent for 1993 (IMF 1991), yet it dropped in the former year by 3.6 and then increased by just 0.4 percent in the subsequent year.

Then the pendulum of expectations shifted to the other extreme. In October 1992 issue of *World Economic Outlook* – under the influence of data showing the 1991 severe contraction – the

forecast was changed significantly. For the EE countries, instead of earlier expectations of 2.8 percent growth in 1992, there was a forecast of 9.7 percent recession. As for the FSU economies, the forecast for that year was minus 18.2 percent, yet actually GDP contracted 'only' 14.2 percent.

There was a number of reasons why the early forecasts were too optimistic and the expectations were not met. During the early transition the range of uncertainty was indeed very huge, hence it was not difficult to be wrong simply because of the substance of the process. Yet the issue is that the true mistakes had been much more vis-à-vis the policies and their theoretical foundation than about the forecasts. The latter were not accurate because the former were wrong (Kolodko 1991 and 1999d, Nuti 1992, Poznanski 1996, Stiglitz 1999). Thus what had caused such deep contraction that in so many cases turned to be a decade lasting depression of economic activity at the very low level?

It is impossible to explain exclusively the Great Transitional Depression of 1990-99 neither by the legacy of the past, nor by the external shocks (Mundell 1997). These factors, of course, play meaningful role, however they are not to be blamed with most of the responsibility for all that misfortune, since a great misfortune indeed it is to lose a half or so GDP over just one decade. The crucial role in these events had been played by the policy, which was often wrong. Among the weakest part of its incorrectness was the negligence of institutional aspects of building the market system. Emerging market economy performance depends much more on the institutional arrangements than simply on an overall economic liberalization.

Therefore, the discussion on the platform 'too fast versus too slow' liberalization and privatization has been led along the lines of the wrong alternative (Kolodko and Nuti 1997, Stiglitz 1998). The theoretical question and pragmatic challenge was not about the pace either of liberalization nor privatization, but about the ways these two processes have been designed and coordinated (or, more precisely, often not coordinated) with the institution-building.[2] If the institution-building was not enhancing the former processes, then there was a lack of compatibility among the elements of multi-track process of transition. In result, instead of growing, the microeconomic efficiency was eroding still further, what in turn had led to output falling for so long and so deep.

IV. DIFFERENT PATHS OF CONTRACTION, RECOVERY AND GROWTH

Although indirect, there is one further argument proving that of critical importance for recession and growth is not the legacy from the past, or bad or good lack, but actually executed policies. The legacy sometime may help, but in the postsocialist economies more often it hinders. Yet whatever is such legacy, the policies decide. The argument is that, despite many structural, institutional, geopolitical and cultural similarities between these countries, they have been moving along quite different paths over the first decade of transition (EBRD 1999, Kolodko 2000a, Blejer and Skreb 2000). These paths have been (and are going to be too) shaped more by the policies than by any other factor. That is the main cause that in certain countries transitional recession lasted just

[2] In the extreme cases of both the large economies, as Russia, and the small ones, as Albania, it had happened that with even larger private sector than in other countries (in terms of its contribution to GDP), as e.g. in Poland or Slovenia, the overall performance was much worse. Not the scope of liberalization and the range of private sector were decisive for the changes of efficiency, but the institutional vacuum in the former countries and relatively sound arrangements and good policies in the latter.

three to five years, but in some others it continued over the entire 1990s. Therefore the current level of output is a function of two occurrences. First, it is the result of the seriousness of output fall during particular years of recession. Second, it is the consequence of the numbers of such years.

In some countries, the contraction lasted for relatively shorter period, yet it was altogether deeper owing to more severe fall of output during that time. In some others, the recession lasted for a longer period, yet it was milder because production dropped to a lesser degree in those years. In two countries mostly affected by the Great Transitional Depression – that is in Moldova and Georgia – in 1999 GDP stood at about one third of the pre-transition level. Whereas it is the outcome of eight years of contraction and two years of growth in the former case, in the latter it is the result of six years of contraction and four years of growth. Whereas there are countries, like Armenia, suffering recession only for a period of four years, yet that was enough to bring their national income down to about 40 percent of pre-transition level, there are also countries like Romania, where the output had been falling for seven years, nevertheless in 1999 it was at 76 percent of the 1989 amount (Table 4).

Table 4: Duration of Recession and Growth in 1990-99 (in number of years)

	Transitional Recession	Recovery	Second Generation Contraction	Growth	Total Number of Years of Contraction	Total Number of Years of Growth
Albania	3	4	1	2	4	6
Armenia	4			6	4	6
Azerbaijan	6			4	6	4
Belarus	6			4	6	4
Bulgaria	4	2	2	2	6	4
Croatia	4	5	1		5	5
Czech Republic	3	5	2		5	5
Estonia	5			5	5	5
FYR Macedonia	6			4	6	4
Georgia	5			5	5	5
Hungary	4			6	4	6
Kazakhstan	6	2	2		8	2
Kyrgyzstan*	5			4	5	5
Latvia*	3	1	1	4	4	6
Lithuania	5			5	5	5
Moldova	7	1	2		9	1
Poland	2			8	2	8
Romania	3	4	3		6	4
Russia	7	1	1	1	8	2
Slovakia	4			6	4	6
Slovenia	3			7	3	7
Tajikistan	7			3	7	3
Turkmenistan*	7			2	7	3
Ukraine	10				10	0
Uzbekistan*	5			4	5	5

Source: Author's compilation based on data from Table 3.
In countries labeled with * there was growth until 1990 and recession started only in 1991.

Transition is a unique process by its very nature and substance, so even more is the transitional recession, depression and recovery. There are extreme examples of annual drop of GDP in excess of 50 percent (Armenia in 1992), and of growth of about 17 percent (Turkmenistan in 1999). It is possible to spot to huge differences between the highest rates of contraction and growth for the same year. In the most extreme case such gap exceeded 55 percentage points and that was in 1992. Even in the tenth years of transition, i.e. in 1999, this difference was still larger than 20 percentage points. Altogether there are as many as 57 cases of the years with two-digit rate of contraction, but not surprisingly only seven cases of the years with two-digit rate of growth. To be sure, after the initial collapse of output, later the more the transition process had been advanced, the lower had been the fluctuation of these rates of growth.

The worst of all those years was 1992. Then only Poland, due to recovery which took off already in the middle of that year, had modest (2.6 percent) rate of growth. All other countries were suffering contraction within the range from 2.9 in Kazakhstan and 3.1 percent in Hungary to as much as ruinous 44.8 in Georgia and 52.6 percent in Azerbaijan. For the whole group of countries the recession at that year was fairly deep and accounted for 9.5 percent. That occurred when the transition was going peacefully and only in certain minor regions were local military conflicts. Of course, in the latter case the explanation of such dramatic contraction is obvious, since those conflicts did contribute to further distortions, thus to the output still dropping further.

So far the best year was 1997, when the early fruits of structural reforms had started already to ripe, but still before the East Asian contagion and the fallout from the Russia's financial crisis were making their negative impact upon the region's economic activity (Montes and Popov 1999). In that year the production fell only in five countries (including unusual for this stage of transition drop of 26.1 percent in Turkmenistan), whereas it was growing in remaining 20. The highest rate of growth was recorded in Georgia and Estonia, that is 11.0 and 10.6 percent, respectively. On average, for the entire region, the rate of growth of weighted GDP was 2.0 percent. And then, in 1998, it fell again by 1.2 percent. It is possible and even most likely that that was the last year when contraction was reported for the whole region of both the EE and the FSU economies.

There is not any clear pattern of the sequence of contraction, recovery and growth in transition economies. The first decade of this endeavor must be seen as very untypical period, which neither has a parallel to anything in the past, nor should be expected to be repeated in the future. Number of specific factors have been influencing the developments with these regards.

First, the moment the output begun to fall was different in particular countries. In a few of them, e.g. in Latvia and Uzbekistan, it was feasible to postpone the beginning of transition contraction until the end of 1991 and beginning of 1992 through postponement of liberalization. However for the same reasons, that is due to the delayed structural reforms, production started to fall already in 1989 in countries like Turkmenistan (within the FSU), or in Croatia (within the former Yugoslavia), or in Romania (within the former Comecon). Thus the initial impulse triggering off the contraction was not identical in each of transition economy. In some of them it happened because transition was just initiated, whereas in certain others it happened because it was not launched yet.

Second, the deepness of recession was different owing to initial distortions associated with centrally planned economy, on the one hand, and to the applied policies, on the other. The more severe were those distortions – e.g. the burden of non-performing foreign debt, rate of open inflation and shortages, range of price subsides, array of inefficient state companies, etc. – the deeper was the following contraction. But, during the early years, the range of contraction was also larger in the

countries that tried to exercise too radical liberalization policy. If both these occurrences had taken place simultaneously – and that was precisely the case in e.g. Poland in 1989-90 and Russia in 1992-93 – the early contraction was relatively deeper.[3]

The reverse example, that is the case without distortions typical for reformed statist economy and with gradual shift towards liberalization, does not exist. However the Chinese and Vietnamese experiences of the 1990s show that, if there is not too much of the first characteristic and not too little of the second, the growth can be fast and, at least for the time being, sustained.[4]

Third, the duration of transitional contraction was shorter in these countries, which were able to reform their economies under the previous system. The more the economic and financial mechanism of centrally planned economy was reformed, the shorter was the introduction of critical mass of new arrangements. Consequently, it had taken less time to improve allocative efficiency and hence to return to the path of growth. This is clearly the case of Hungary and Poland as well as Slovenia. This claim is also supported by the experience of Estonia, where certain market-oriented reforms were also executed relatively earlier, if compared with other FSU republics.

Such observation is not contradictory with conclusion that those limited reforms did contribute to growing financial destabilization too (Kornai 1986). Such mixed outcome was causing also mixed impact upon first contraction and then expansion. Again, the best examples here are Hungary and particularly Poland. In this country, on the one hand, the inconclusive reforms of the 1980s led to fiscal and monetary instability. Yet on the other hand – and that in the longer run has been proved to be of much greater importance – these changes contributed to higher flexibility and better ability to adjust. Thus the derivative of these contradictory tendencies for the future growth turned to be positive: the recovery came sooner and the growth was faster.

Fourth, even when there is recovery following the period of contraction, it does not mean that transitional depression is over. During the decade of 1990s there were at least 10 cases of returning contraction after the economy had already bottomed up. So far, six cases of such ‘second generation transitional contraction’ have lasted for more that just one year. These events are not caused solely by the external shocks, but are happening too due to the lack of both sound fundamentals and strong institutions that supposed to uphold growth when it eventually comes. In another words, in transition economies, even more than in the matured markets, the growth never is given just because it has already taken place. It must be maintained by good policy, and also that might not be enough, if good institutions do not support good policy. Undoubtedly just for that simple reason it must be expected that also the future will bring the instances of falling output. Some of them will result from the policies’ failures, some form the business cycle mechanism. However, as far as the cases of the ‘second generation transitional contraction’ are concerned, they have been mostly the results of wrong policies or negative external shocks, or the coincidence of both. The business cycle

[3] Of course, the Russian case is quite different from Polish. In the former, GDP fell by 8.8 percent already before substantial liberalization took place, i.e. in 1990-91. In the latter, there was growth until mid-1989, when the pace of liberalization was fundamentally accelerated, and only since then the output started to fall.

[4] The opposite tendencies vis-à-vis recession and growth in China and Russia should be seen as the most striking event in the world economy in the last decade of 20th century. Whereas during this time in China GDP was doubled, in Russia it was halved. That has also significant geopolitical implications.

mechanism in postsocialist countries has not yet been set fully in motion, since it is a function of the strength of market mechanism, which is just being introduced.

Fifth, it must be remembered that if the national income was lost in the past due to the policies' failures, its current and future growth is not a compensation for such loss. Only in the instances when the later growth is coming because of the previous fall in output caused by structural reforms, such contraction can be seen as a specific 'institutional investment'. If not, recession and depression simply mean the unrecoverable lose of welfare (Nuti 1992).

The first decade of transition came to the end with the aggregate GDP for the whole region matching barely about 70 percent of the pre-transition level. With this evaluation in mind always particular countries are compared from an angle of their current output in relation to their output at the onset of transition and, of course, to the other countries' relative production (see Table 3). However, it may be very revealing to take a look at their aggregated output over the whole decade of 1990s. If certain country has accomplished to recover pre-transition level of output and another country has not been able to do so, most often it is interpreted that the former is doing better than the latter – at least as far as the growth process is concerned. But it may happen that in the latter case the output, in relative terms, was higher over the entire period of 10 years than it was in the former country.

Consider the hypothetical sequence of four years of recession, recovery and growth in two countries. In first of them output fell by 10 percent during second year of that sequence and then, during the third, returned to the previous level. In the fourth year it was still growing, but only by 2.0 percent and hence was overcoming pre-transitional level by this amount. Thus the sum of output over a period of four years is equal to 392 units (100+90+100+102). In the second country the output contracted only by one percent and then again by one percent, and then again by one percent. So, at the end of that period it stood at 97.03 percent of the level of starting year. The sum of output over period of four years is 394.03 (100+99+98.01+97.02). It means that, despite that currently, i.e. at the end of the whole sequence of contraction–recovery–growth, the production (one year flow) is larger in the first country (i.e. 102 units), the total aggregated production for the whole time span is larger in the second country, where the current production (again one year flow) stands at about 97 units. In the latter, with current output smaller by five units (102 minus 97), the sum of the total four years output is by two units larger (394 minus 392).

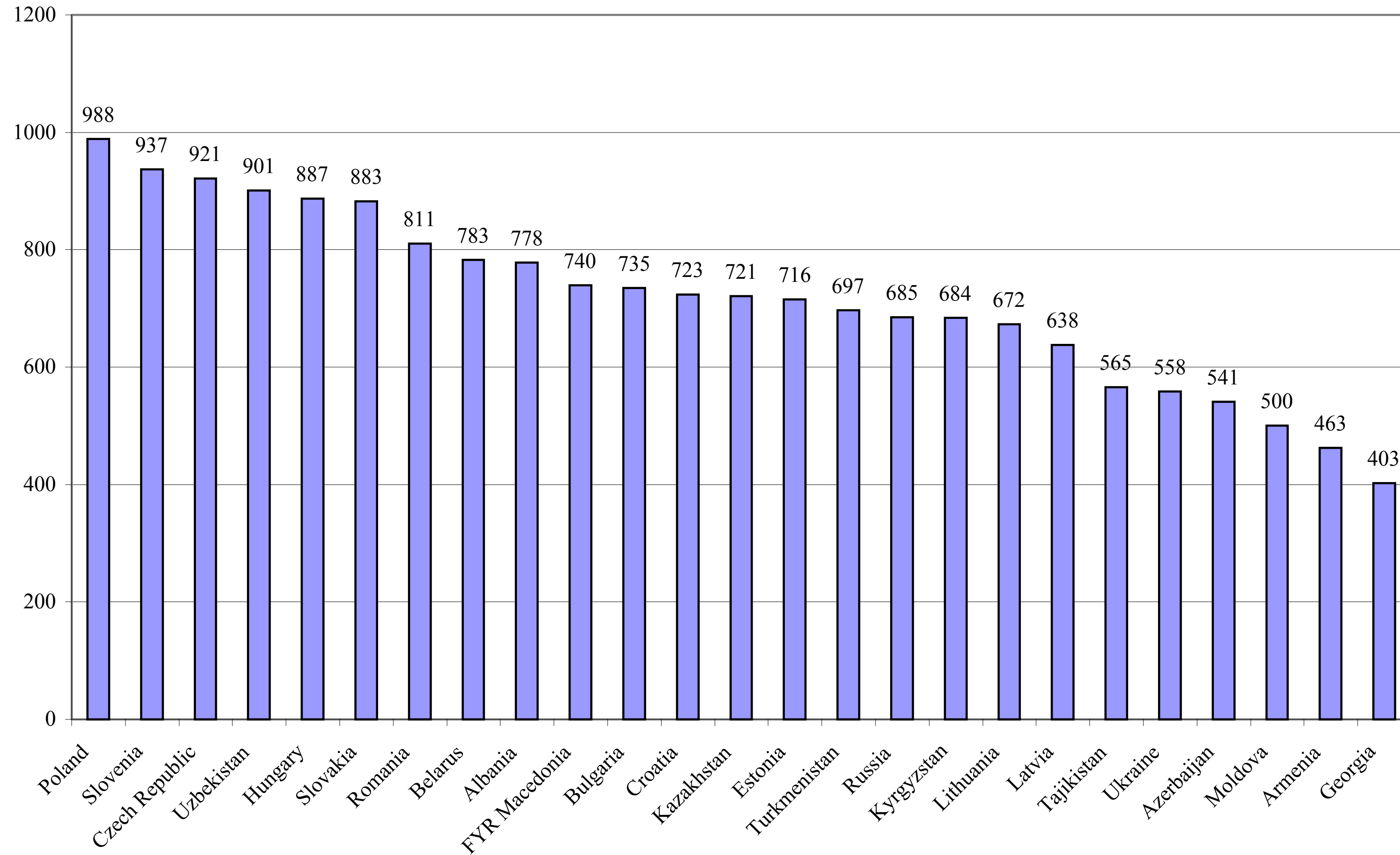
For instance this was the case of Slovakia and Uzbekistan. The index of 1999 GDP, while compared with 1989, is equal to 101.5 and 92.3 percent, respectively. However, in the former the GDP combined for the whole decade is equal to 883 percent of the 1989 GDP, whereas in the latter to 901 percent of the output from that year. The illustration of relevant sums of the GDP combined over the period of entire decade 1990-99 for 25 transition countries is shown in Figure 1.

The message is mixed again. In certain instances, while the relative aggregate GDP counted for the entire decade is larger, simultaneously the current relative level of GDP is smaller. So, who therefore is better of? Is it the country with higher current level of GDP compared against the pre-transition output, though the sum of GDP for the entire transition period is relatively lower than in an alternative case? Or is it the country where the GDP amassed over the whole transition decade is relatively larger than otherwise, although the current production is still relatively lower if compared to the alternative case? It depends. The issue is that from the formal viewpoint (leaving aside important structural changes), the same category of GDP is concerned. Though from another viewpoint somehow already changed society is taken into account. Once again today's higher income is not

always a compensation of yesterday's loss. This is so, because some other people did lost and some other had gained. Such outcome may cause social stress and political tensions, making the economic policy and facilitating it structural reforms still more difficult. Thus, what is important with this regard, is the fluctuation of the rates of contraction and growth. It seems that more favorable for long-term fast growth and the nations welfare is less hectic and volatile fluctuation of these rates and thus the smoother process of quantitative changes vis-à-vis output.

Totally over the period of last decade the whole group of 25 postsocialist transition economies produced barely 7.6-fold what they were able to produce in 1989. The corresponding index for the CIS stands at 673 and for the EE at 895 percent. It means that in Eastern Europe it takes as many as 11 years to produce the GDP matching the 11-fold 1989 GDP. From the statistical viewpoint it is the same as if there would not be recession, but simply stagnation lasting 11 subsequent years – from 1990 until 2000.

Figure 1: Index of Aggregated GDP for the Decade 1990-99 (1989=100)



V. Policy Response and the Role of Institution-building

At current stage of transition the postsocialist countries have much more in common with other emerging markets than it was the case just a few years ago. Then it was too often believed that these countries supposed to tackle similar structural problems as other regions with distorted economy. That was neither true then nor is now, despite growing similarities between various challenges all these countries are facing. So why considering the policy options from the viewpoint of future growth, the specific features of postsocialist economies still must be taken into account very seriously. Of crucial importance here is the process of institution-building.

From economic perspective the statist centrally planned system had collapsed because of lack of ability to adjust. The changing environment of the world economy became more requiring and thus rigid, inflexible system, enmeshed in numerous distortions, proved to be unable to improve its competitiveness. Whereas on the one hand globalization brought a threat for countries unable to adjust, on the other hand it brought also a chance to overhaul the inefficient economic system. In addition to growing internationalization of economic links and vast political changes, the technological progress happened to be a critical catalyst deciding that the time for comprehensive transition arrived. Otherwise it would be difficult, if at all possible, to adjust to growing development challenges and take advantage of prospects for long-term expansion. Here two issues have emerged.

First, initially the policies must tackle the new challenges within the framework of inherited old institutions. The institutions, i.e. the rules and the organizations that help to comply with these rules, always matter. So the more they do matter during transition (North 1997). But, within the wider concept of the meaning of institutions, also the market culture and behavioral aspects of market economy ought to be seen. Hence in transition countries – even if the law regulating the rules of emerging market economy has been already adopted, and even if the organizations assisting the observance of this law have been established – there still remain the challenge of relatively lagging behind market culture and behavior.

Second, as the time is elapsing, these very institutions must be changed for the purpose of policies' facilitation. It means that while in the long run quality of institutions (thus their short-term ability to support the course of actions, too) is a matter of policy, in the short-term the institutions are given. Hence the policies carried out must be performed within the limits imposed by the existing institutional arrangements. In another words, there were, and to a degree still are, the policies that cannot be implemented in transition economies because of institutional weakness. This claim, so obvious at the end of the first decade of postsocialist transition, was not a common wisdom at the onset. Quite to the contrary.

Not surprisingly, weak institutions – either earlier tailored for the needs of the outgoing statist system marked by the dominance of government sector and vast bureaucratic control, or later only emerging from a naught – were weakening the efficiency of policy. Considering such institutional weakness there were various reactions that should be expected, yet often they were not anticipated, precisely because of the negligence of institutional arrangements. The most important with this respect was the lack of early positive supply response. Many policymakers and their advisors (including international organizations) indeed expected that output should start to grow soon after liberalization took place and if only certain critical mass of privatization was executed.

Conversely; despite quite fast and far going privatization for a prolonged period of time there was not an improvement of allocative efficiency, or it even deteriorated. It would be opaque to

assume that it was happening because private assets are less productive than owned by the government, though there was such coincidence that privatization was followed by contraction. If for that purpose sometimes transitional recession and depression are associated with ongoing privatization, it is a mistake, since it must be linked to the institutional drawback. Emerging private sector to prove its superiority needs a rudimentary institutional streamlining.

Another important observation is that within the same or similar institutional arrangements alternative sorts of policies might be implemented. It means that, regardless the existing at given moment of time institutional arrangements, the policies can be better or worse. The policy response can be more suitable to tackle the issues in one country, or less suitable in another. Therefore though the institutions do not differ, the different policy responses are delivering different results.

It is also possible that even within the framework of weaker institutions the outcomes are better than they might be in other places enjoying stronger institutions. And that is exactly the result of better policies. Thus the institutions do matter, but so do the policies. It may happen that economic performance is healthier in a country with better or worse institutions, or in a country with better of worse policies. To some extent these are complementary matters, to some extent they may substitute each other. As far as economic growth is concerned this explains why some countries, *ceteris paribus*, are doing better than certain others. It also explains why in some of them the performance is more remarkable over one period and worse during another, despite the fact that in the meantime the institutional arrangements have been upgraded and improved.

Fine example of this inter-relation can be the Polish economy. In this country, due to gradual yet committed institution-building and because of sound policy, following the recovery that started in mid-1992 the growth had accelerated profoundly after 1993. However later, since after 1997, the pace of growth did slow down significantly (and much more than expected). It had occurred despite ongoing advancement of institution-building over all those years. To modest extent it was provoked by external shocks, but mainly was caused by the deterioration of policy. The analyses pointing just to the external shocks fall short to explain the drop of the rate of GDP growth from as much as 6.7 percent in 1995-97 to only about 4.5 percent in subsequent three years, i.e. 1998-2000. The quality of policy deterioration does explain it.

Of course, the best combination is to have sound policies and good institutions. And, no doubt, the worst one is to have the opposite, i.e. weak institutions and bad policies. From this perspective, unfortunately, in transition economies the latter alliance has happened more often than the former. Not surprisingly the transitional recession converted into the Great Transitional Depression.

At the early stages of transition there is not any obvious rule with the respect to the combination of quality of institutions and policies. Later, presumably, they start to facilitate vigorously each other. Before that occurs it might happen that relatively better institutions can demobilize the policymakers from taking care of further structural reforms and commitment to continuing institution-building, since it is never easy. These are ever-lasting processes, not just an episode.

Or it may happen to go the other way around. Then the distortions, difficulties, tensions, crises, etc. are pushing the governments to reform the institutional orders still further. Yet of great economic implications, this question too is of great political nature. The answer depends on ability of

the elite to formulate long-term development vision and is strongly involved in a feedback with simultaneously going process of political liberalization, i.e. democratization.

Hence the issues are quite complex. It is excellent when the progress with institution-building is resulting simply from the wisdom of the people and determination of their leaders. It happens. But the experience shows, too, that quite often the institution-building is getting momentum only if the problems are mounting, so ‘the worse, the better’. Then strong pressure appears and the need for structural reforms, especially from business sector, but also from outside, does increase. International organizations, while providing technical advice and financial assistance based upon conditionality stressing proper policies and reforms, contribute to such processes too.

VI. External Shocks and the Catching-up Process

Widespread conviction that a push towards market economy in postsocialist countries must bring better allocative efficiency and higher competitiveness is strong argument behind the rationale to do so. Thus in due time it must bring, too, the growing output and better standard of living. Yet to accomplish such aim not only the pre-transition level of output ought to be recovered, but the return to path of quick and sustained growth must be accomplished. Only then there will be the chance for catching-up, what means gradual and lasting process of diminishing the development gap between transition economies and wealthier industrial countries.

While looking into the future, there is always temptation to presume that it will be fine. Such optimism may seem reasonable from the policymakers’ perspective, especially since they always believe that they do know well what ought to be done and that unfavorable external shocks, making their ambitious plans impossible, will not happen. Unfortunately, quite often these assumptions do not hold. Consequently, the future seldom looks as bright as envisaged just couple of years earlier. Despite such experiences, too optimistic expectations are tended to be repeated time and again. Postsocialist economies and their leaders are not any exception from this rule. It might be added that international organizations have been following this pattern of behavior too, or at least they were doing so for several years (World Bank 1997). Moreover, at least at the outset of transition they have made a strong impact on such excessive optimism in transition countries.

There is nothing wrong with optimistic expectations, if they are only based on knowledge and sound commitment to structural policies, on the one hand, and draw the right conclusions from the historical experience, on the other. Otherwise too much of optimism becomes too much of ignorance, what always acts against growth and its sustainability. Therefore the considerations about catching-up in transition economies should draw from these countries own experiences as well as from the characteristic of growth processes occurring elsewhere.

As for the experience it must be clearly understood why some countries – actually very few – produce in 1999-2000 more that they did in 1989-90 and many of them are still not able to do so. Or, in another words, there is a question to what extent the rate of growth in the future will differ between particular emerging markets in the EE and FSU region? Can it differ as significantly as it did over the last decade? That is hardly imaginable, because there were some unique reasons for such diversification and is very unlikely that they will reappear again.

First, there had been local military conflicts. Countries affected by such misfortunes have obviously lost significant part of their production. Especially Armenia, Azerbaijan, Georgia, Moldova and Tajikistan in the FSU region, and several Balkan countries in the EE region, have been

harmed by heavy loses owing to military operations. It is a disaster to lose during just one year as much as 21.1 percent of GDP in Croatia in 1991, 52.6 in Armenia in 1992, 18.9 in Tajikistan in 1994, or 37.3 in Yugoslavia in 1999. In some places the situation remains unstable and unpredictable. As for the future, all further predictions are presuming that there will not be such type of conflicts, yet it is not granted. If, however, transition process during next decades will evolve peacefully – and all necessary attempts to secure such course must be undertaken – it is reasonable to expect extra growth just for this cause. In the 1990s output started to grow rapidly in certain countries immediately after military conflicts ceased. But if regional conflicts will continue, then sluggish economic performance and depression will last for several more years.

Second, they were external shocks causing additional difficulties. Among them, the shock following collapse of the former Soviet Union was extraordinary. Only for this motive the transitional recession was much deeper in the FSU economies than in the EE countries. The break of the former Yugoslavia became a great shock, too. Meaningful, though with milder implications, was dissolution of the Comecon, i.e. the trade bloc of socialist countries. More recently, the contagion following the 1998-99 Russian financial crisis has shown that especially the FSU republics are vulnerable for crises occurring in these economies among them, with which the others sustain strong links. Nonetheless, owing to diversification of trade partners and directions where capital is flowing from, there is likelihood that this vulnerability will decline. Yet all the time there will remain the risk of external shocks, what can diminish the growth prospect. Hence a shield against negative external shocks ought to be created.[5]

Third, certain events are the good news and the bad news at the same time. There are the economies, mainly among the FSU, that rely to large extent on specific commodity prices. Natural gas and oil for Turkmenistan, oil for Azerbaijan, cotton and gold for Uzbekistan, crude ore for Ukraine, etc., are of big significance for these countries' income. So, of course, is the oil for Russia. Without taking a closer look into the fluctuation of these prices, it is not possible to explain such shifts of rate of growth as from minus 26.1 to plus 17 percent between 1998 and 2000 in Turkmenistan, or from minus 11.8 to plus 5.8 percent between 1995 and 1997 in Azerbaijan. When the prices of oil and gas were plummeting to the lowest level since 25 years, it was negative shock for countries, which revenues depend on export of these products. But for the same occasion it was positive shock for the importers, including majority of the EE economies. Through influence upon their terms of trade such price fluctuations affects their rate of growth in a positive way.

Fourth, in the postsocialist countries not only the market economy is emerging, but democracy rises too. It is a value by itself, though at the same time is inter-linked in complex manner with the process of economic growth. Neither there is apparent relation between market and democracy (Alesina 1997), nor there is between marketization, i.e. the process of transition to a market system, and democratization, i.e. the process of transition to democracy. There are the examples of economies growing fast and durable without much of democracy and of lasting depression under authoritarian regimes. There is plenty of cases of fast growth under democracy as

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[5] During the implementation of structural reforms and development program "Strategy for Poland" (1994-97) there was special task force led by the deputy premier and minister of finance, which was working on early warning and policy response counteracting threat of negative external shocks, especially vis-à-vis risks stemming from financial markets liberalization. This tiny team worked in very discreet manner, out of media spot, what was crucial for its success.

well as the opposite examples, when democracy went along with the sluggish growth. However, even if bumpy process of democratization in certain transition countries did not help economic growth instantly, it does so in the longer run. In such perspective, democracy assists growth, because it corrects the policy excesses. Of course, democracy works better if the market performs well – and the other way around.

Fifth, in certain cases extraordinary output fall was also due to the lack of wise macroeconomic policies. The best examples here are the failure of fraudulent financial pyramids in Albania and the Russian financial crisis, but there were many ill-advised policies and wrong decisions in other economies too. As for the future, in consequence of increasing maturity of both market and democracy institutions, it seems reasonable to expect more responsible policies. So further institutional advancement will contribute to relatively higher rate of growth.

Whereas all these five arguments are based on lessons from the past, there are certain others, pointing to concurrent processes going in global economy, which can be promising for the prospects of fast and sustained growth (Fischer, Sahay, Vegh 1997). Against this background, it is rational to expect that the process of catching-up with more developed countries indeed will take place.

Here in turn, the first argument is that the course of catching-up with technological progress is taking momentum on the global scale. Transfer of new technologies from advanced economies to catching-up countries significantly contributes to growing competitiveness of all emerging markets. If macroeconomic fundamentals are sound and financial stabilization is accomplished, and if only political institutions performs well, then technology transfer brings major acceleration of rate of growth. On this precise field the catching-up process is going to be most visible and most fruitful. It makes sense to presume that, *ceteris paribus*, in the long-term in transitional economies at least one additional percentage point of growth can be obtained solely due to this factor. Technology transfer is causing faster increase of the labor skills than its costs, i.e. wages are growing. For this reason production placed by developed in less developed countries will grow faster than the global average. It is also true for transition economies.

Such mechanism of catching-up has been set in motion already, however it is difficult to spot it within the complexity of changes influencing the contraction–recovery–growth sequence. If not the current phase of global technological revolution and transfer of know-how, the transitional recession could be even deeper and last longer, the recovery would be weaker, and the growth slower. Such spillover effect, i.e. spreading out new technologies and know-how, upgrades the qualifications of labor. Unfortunately, simultaneously there is harmful process of brain drain, what diminishes the ability to compete and expand. That threat must be counteracted by better compensation for and larger investment in the human capital. Particularly the inward FDI work against the flight of human capital. In countries absorbing most of them, e.g. Hungary and Poland, there is already net inflow of skilled labor, what means that more qualified people are coming into these countries than leaving them. This is good for future growth.

The second argument is related to the process of integration with global economy. Transition is not only indispensable part of globalization, but postsocialist economies have a chance to be one of the major beneficiaries of this multi-track process. However, the picture is mixed here and this time the geopolitical position does matter more. In best situation are the EE countries negotiating their access to the European Union. First the Czech Republic, Estonia, Hungary, Poland and Slovenia, and later Bulgaria, Latvia, Lithuania, Slovakia and Romania, followed soon by Croatia, will get a strong boost for their growth ability because of this integration. These countries upgrade fast institutional

arrangements along the line of the rules observed in the EU, what facilitates growth ability in the long run. They can also count for relatively larger inflow of FDI. Indeed, expectations for their future membership in the EU have attracted already not negligible inward FDI.[6] Net transfer of resources from Western to Eastern Europe works as catalyst of growth and thus the process of integration with the EU should accelerate long-term rate of growth, perhaps for another percentage point or so.

The third argument is linked to progress of wisdom on economic and financial matters. Yet not appreciated in a similar way as technological revolution, this progress too contributes to catching-up, because macro and microeconomic management is more complex challenge contemporary than it used to be in the past (Kozminski 1993). Experience suggests that there is certain lag vis-à-vis adopting such knowledge owing to both cultural and political reasons, yet learning by doing is already very well on the way. Although impossible to measure, by all means this factor enhances pace of growth, too.

And the fourth argument is that the advancement of institution-building contributes to getting rid of systemic bottlenecks and structural distortions both, inherited from the past as well as created at the early stages of transition. This, in turn, boosts labor productivity and overall economic efficiency.

So there is a ground to assume that transition economies will grow faster than the global economy and developed industrial countries, and in due time they might catch up with the latter group. Yet the fulfillment of catching-up theory needs support. Various political, cultural and institutional factors must come into existence and specific conditions must be met to set a mechanism of catching-up fully in motion. After first decade of transition, in several countries, though not yet in all of them, these factors and conditions seem to be at least to certain extent established. Against such background, it seems possible to outline alternative scenarios of catching-up and the policy recommendations facilitating implementation of the optimistic scenarios.

VII. Four Scenarios for long-term growth until 2050

Transition can be seen as a specific endeavor shifting part of global economy from one model of development to another. Before recent recession, though their early expansion went along the pattern of growth cycles distinctive for centrally planned system, all these economies were growing. Until they had lost momentum in the late 1980s, they were catching-up with more developed regions. Now, while assuming that the Great Transitional Depression has come to the end, there will be the growth along the pattern of business cycles distinctive for market system. In further considerations, there is an implicit assumption that long-term growth will evolve around a trend derived from business cycle fluctuations. Hence the postsocialist economies are going through process of changing

[6] Out of about 104 billion dollars of inward FDI over the period 1989-99, about 55 percent was located in the group of five EE countries advanced most in both transition and their accession negotiations with the EU, i.e. the Czech Republic, Estonia, Hungary, Poland and Slovenia. The largest of them, Poland, has absorbed about 20 percent of this amount. As for total FDI placed in the EE region, these five countries received about 77 percent of foreign direct capital, while Poland alone almost 30 percent. It is important to emphasize that in these cases the capital flow actually is a net inflow, because the outward FDI virtually do not exist in these countries. That is, of course, if the capital flight from Russia is disregarded. If it is not, then the net flow of capital to the whole EE and FSU region over the first decade of transition is negative. It implies that more capital has left the region than was invested there – with all harmful implications for recovery and growth.

the substance of their cyclical growth. They do not move from system, where there was not growth (since it was, and not so slow) to a system, where the growth will resumes *per se* and automatically will be of a ‘better character’. That must still happen.

There are various forecasts for forthcoming years. Actually nobody foresees further decline of output for any of transition economies. There are just a couple of cases where drop of output is expected and only for a single year. Of course, presuming that the developments will go peacefully and severe external shocks will be avoided. Yet the misfortunes cannot be ruled out *a priori*. In 2003-04 the GDP index will look less depressing than now, although not as much impressive as one would like to see it. In 2004 only in seven or eight out of 27 countries the output will overcome GDP of 1989. At the other end of the list, in another eight countries it will still remain below two thirds of that standard. That will be altogether after 15 years of transition (Table 5).

Table 5: Real GDP Index. Forecast for 2003-04 (1989=100 and 1999=100)

	Index 1999		Rate	of	Growth		Index 2003(4)*	
	1989=100	2000	2001	2002	2003	2004	1999=100	1989=100
Poland	121.6	4.8	5.1	5.5	5.8	4.9	129.0	156.8
Slovakia	101.5	3.8	4.6	6.4	6.0	6.9	130.9	132.9
Slovenia	107.6	4.0	3.9	4.2	4.1	4.8	122.8	132.2
Albania	92.5	7.0	6.7	8.3	6.9	6.5	140.8	130.2
Hungary	99.2	5.3	5.2	5.4	5.1	5.5	129.5	128.4
Czech Republic	94.7	2.6	3.6	4.8	4.7	4.4	121.8	115.3
Uzbekistan	92.3	3.8	-1.0	2.2	3.8		109.0	100.6
Croatia	77.2	2.6	3.5	4.4	4.8	4.7	121.6	93.9
Romania	73	5.3	5.4	5.3	5.0	4.6	128.4	93.7
Estonia	75.7	5.5	5.5	5.1	4.5		122.2	92.5
FYR Macedonia	72.0	4.8	5.5	5.0	4.5	3.6	125.7	90.5
Bulgaria	66.8	4.1	5.0	5.2	4.7	4.4	125.7	84.0
Lithuania	65.4	5.3	5.3	5.7	5.2		123.3	80.6
Belarus	78.2	-8.1	1.7	3.1	5.7		101.9	79.6
Latvia	60.1	4.9	4.8	5.5	5.3		122.1	73.4
Kazakhstan	60.2	3.3	4.5	5.9	6.1		121.3	73.0
Kyrgyzstan	60.4	4.5	4.1	4.2	4.4		118.3	71.5
Azerbaijan	45.2	7.3	9.1	9.7	9.0		140.0	63.3
Turkmenistan	51.2	5.3	5.1	5.0	6.1		123.3	63.1
Russia	56.1	2.2	2.7	2.0	3.4		110.7	62.1
Armenia	42.5	6.2	6.9	7.1	7.2		130.3	55.4
Tajikistan	44.1	5.0	5.1	5.0	5.9		122.7	54.1
Georgia	33.8	8.0	7.8	7.8	7.5		134.9	45.6
Ukraine	35.7	0.2	3.3	3.9	4.6		112.5	40.2
Moldova	30.5	3.7	4.7	5.6	6.1		121.6	37.1
Bosnia-Herzegovina	na	*6.1*	*4.6*	*3.8*	*3.1*	*3.7*	*123.2*	na
Yugoslavia	na	*15.4*	*13.2*	*10.9*	*8.1*	*5.9*	*165.8*	na

Source: Index 1999 from Table 3. Forecast for 2000-04 from PlanEcon 1999a and 1999b.

na – data not available.

* 2003 for the FSU and 2004 for the EE countries

Sometimes, owing to market exchange rate instability, the change of relative value of national currency may suggest the fall of GDP measured in dollars whereas actually it is growing.[7] For that reason it is justified to take closer look at the evaluation of GDP per capita on the basis of purchasing power parity. This indicator ought to be regarded as point of departure into catching-up process (Table 6).

Table 6: GDP per capita in 1999 and 2003(4), PPP basis*

	1999	2003(4)	Growth (in PPP$)	Growth (in %)
Slovenia	14,267	17,344	3,077	21.6
Estonia	9,096	16,048	6,952	76.4
Czech Republic	9,472	11,442	1,970	20.8
Slovakia	8,395	10,954	2,559	30.5
Hungary	8,063	10,648	2,585	32.1
Croatia	8,284	9,528	1,244	15.0
Poland	7,232	9,255	2,023	28.0
Latvia	6,341	7,877	1,536	24.2
Belarus	5,722	5,737	15	0.3
Russia	4,539	5,087	548	12.1
Bulgaria	3,758	4,796	1,038	27.6
Lithuania	3,680	4,520	840	22.8
Romania	2,962	3,837	875	29.5
Armenia	2,842	3,662	820	28.9
FYR Macedonia	2,897	3,423	526	18.2
Turkmenistan	2,891	3,376	485	16.8
Kazakhstan	2,482	3,028	546	22.0
Yugoslavia	1,828	3,027	1,199	65.6
Uzbekistan	2,612	2,721	109	4.2
Azerbaijan	1,970	2,689	719	36.5
Ukraine	2,348	2,641	293	12.5
Georgia	1,950	2,570	620	31.8
Kyrgyzstan	2,211	2,472	261	11.8
Moldova	1,745	2,104	359	20.6
Albania	1,474	2,025	551	37.4
Tajikistan	748	848	100	13.4

Source: PlanEcon 1999a and 1999b.

* 2003 for the FSU and 2004 for the EE countries.

Interesting phenomenon here, unlike in the EU and other advanced market economies, is that in transition economies there is a large gap between the GDP counted at current, i.e. the market exchange rate, and its evaluation on the basis of purchasing power parity (PPP). The progress of opening up and integration of transition countries with the world economy is diminishing this gap, yet it still remains. For this reason, there is going to be long-lasting process of real appreciation of

[7] For instance, it occurred in Poland in 1999, when GDP estimated in current dollars dropped by 2.1 percent, whereas in the real terms, while measured in constant process in domestic currency, it increased by about 4 percent.

transition economies currencies.[8] Indeed, it already is well under way. If from time to time the currencies of transition economies do depreciate – and indeed sometimes devaluation is quite spectacular event – it is not contrary with such long trend.

These data better reflects actual level of development and living standard. Hence this is too the point where indeed these economies and societies are at the time, and not the GDP per capita measured at current exchange rate. If the latter is taken into account for instance in Russia, than – with her GDP per capita according to market exchange rate at around 1,500 dollars – it stands in 2000 at only 13 percent of the Slovenian GDP. With all drawbacks Russia is not that much behind. In the future, following progress vis-à-vis financial stabilization, such gap subsequently will decrease along the line of the real ruble appreciation and, most likely, also faster rate of growth in Russia than in more advanced postsocialist countries.

So where all these postsocialist countries can be in a time of generation or two? From the perspective of their long-term growth ability, and thus the ability to catch up with advanced industrial countries, four distinct groups of postsocialist economies can be specified.

First can be called 'the gainers' and will consist of economies able to sustain over the very long-term the rate of GDP growth at least two times higher than in advanced market economies. As a benchmark the recent rate of growth in the EU can be used. Though the future growth is not a sure figure in this case too, it seems reasonable to assume that, by and large, it will sustain around the level accomplished in 1997-2000, i.e. 2.5 percent. This implies that over the coming decades annual rate of growth will be about five percent, oscillating mostly between four and six.

Second group, 'the even-runners', will be able to maintain the pace of growth similar or slightly only higher than the EU, so it will oscillate around three percent on average, jumping between two and four. In result these countries will not be catching-up with most advanced part of the European economy, or if doing so it will happen very slowly. Consequently, the relative distance between these two groups will change only very modestly, yet given different bases, the absolute distance will rise still further. Also the development gap between this group and the gainers will increase.

Third group, let us call them 'the laggards' due to the lack of ability to take transition to their own advantage, will grow over the long term even less than the EU economies (and the even-runners). Their long-term growth will not exceed two percent or even can stay below such low level. Thus in the future their relative income, while compared with other groups of transition economies, will lag behind even more than at the turn of the millennium. There are many arguments that all postsocialist region will be the growing economies, yet it would be unwise to assume that, owing to coincidence of unfavorable circumstances and policies, the worst among them will not be driven from time to time into another recession. Accordingly, their long-term growth can happen to be very meager.

[8] The issue of depreciation and appreciation will disappear from policy agenda when certain countries will join the EU and then abandon their national currencies. It will be the easiest exercise in countries currently under currency board regime, e.g. Estonia. In such case it will be simply done by converting from the D-mark (the denomination used under the currency board arrangements as an anchor) to the euro. In the longer run, all new EU members from Eastern Europe will join the euro zone.

And there is fourth group, or at least there a chance that such will appear – 'the frontrunners'. These countries, under a lucky coincidence of favorable circumstances and good policies, will enjoy average rate of growth around three times higher than the EU, i.e. 7.5 percent. While running between six and nine percent annually, they will approach the EU standard, whereas at the same time will distance themselves from all other postsocialist economies.

These are certain general reflections vis-à-vis alternative pace of growth. It does not mean, of course, that each country growing faster will enjoy higher output and, consequently, better standard of living than a country growing at lower rate. In the longer run that must eventually happen. However, for several years it can be just to the contrary, because of the very logic of catching-up mechanism. It means that countries departing from lower level of output in 2000, like Azerbaijan in the FSU region, or Albania in the EE region, although they will report faster growth than, say, Estonia and Slovenia, for a number of years will still have relatively lower income.

In Azerbaijan the GDP per capita at PPP basis was estimated in 1999 at about 1,970 dollars, while in Estonia at 9,096 – almost five times more. Against this background it is assumed that whereas in the former the GDP will increase on average between 2000 and 2003 by 7.0 percent, in the latter it will grow only by 4.1 percent per year, yet the absolute production will remain much larger.

As for Albania and Slovenia, the relevant GDP per capita on PPP basis is 1,474 and 14,267 dollars, whereas expected rates of growth are 7.1 and 4.2 percent. Therefore, while sticking with above categorization, not surprisingly Albania and Azerbaijan can be found among the frontrunners, whereas more developed Estonia and Slovenia among the gainers, and amongst them only at the very end of the league (Table 7).

These predictions must be seen as passive scenarios based on the extrapolation of recent trends and certain assumptions vis-à-vis future policy reforms. The recent forecasts are often less optimistic than only couple of years ago. Such change of the mood results, *inter alia*, from negative external shocks, which have influenced not only the real economy, but even more the ways of thinking and expectations. For this reason it can happen that this time, contrary to the early 1990, there is excessive pessimism.

Yet it is true that the Russian 'crisis within the crisis' and its 1998 financial climax has affected not only several FSU republics, but, owing to large exposition for trade with Russia, also some other economies, including previously faster growing Slovakia and Estonia. In other countries, e.g. Poland and Slovenia, deceleration of growth had occurred more as the result of policy mistakes. As far as active policies are concerned, they can possibly bring back the pace of growth in all those countries close to already accomplished seven percent. Maintaining it at that level for many years will keep these economies among the frontrunners. That is possible and that is likely. Consequently, certain scenarios would change soon in more optimistic direction. The forecasts depend mostly on the policies – not the other way around.

Accordingly, there can be four paths of long-term growth: for laggards, even-runners, gainers and frontrunners. Hence where particular country can arrive, if it would stay the course of specific pace of growth for a given period of time during the next 50 years? (Figure 2)

Table 7: Average Rate of GDP Growth in 2000-03(4)*

Frontrunners	
Yugoslavia	10.7
Albania	7.1
Azerbaijan	7.0
Georgia	6.2
Gainers	
Slovakia	5.5
Armenia	5.5
Hungary	5.3
Poland	5.2
Romania	5.1
FYR Macedonia	4.7
Bulgaria	4.7
Lithuania	4.3
Turkmenistan	4.3
Bosnia-Herzegovina	4.3
Slovenia	4.2
Tajikistan	4.2
Estonia	4.1
Latvia	4.1
Even-runners	
Czech Republic	4.0
Moldova	4.0
Croatia	4.0
Kazakhstan	4.0
Kyrgyzstan	3.4
Ukraine	2.4
Russia	2.1
Laggards	
Uzbekistan	1.8
Belarus	0.5

Source: Author's estimation based on the forecast of PlanEcon 1999a and 1999b.
* 2003 for the FSU and 2004 for the EE economies.

Fig.2.1 Alternative Growth Paths for the Very Long-Term, 2000-2050

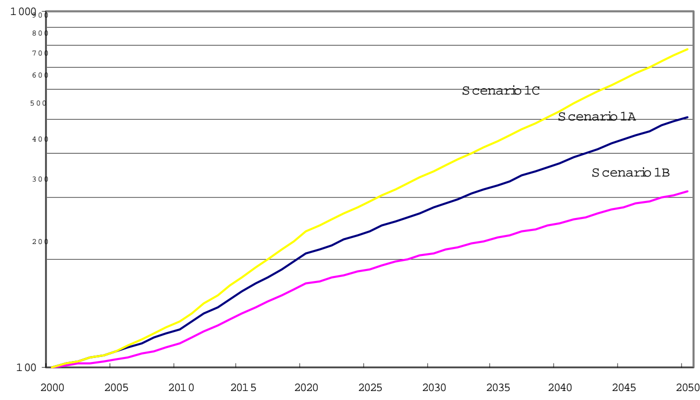


Fig.2.2 Alternative Growth Paths for the Very Long-Term, 2000-2050

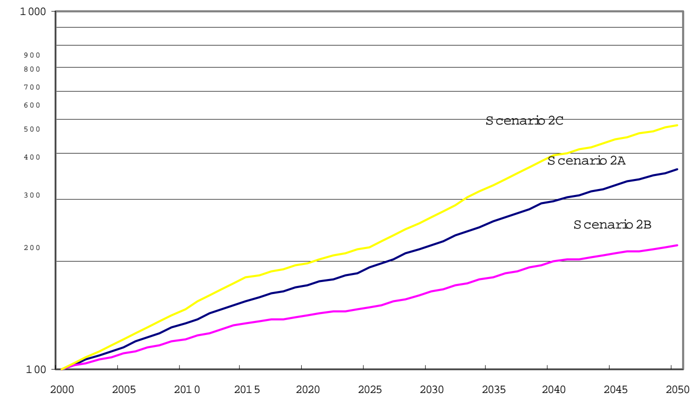


Fig.2.3 Alternative Growth Paths for the Very Long-Term, 2000-2050

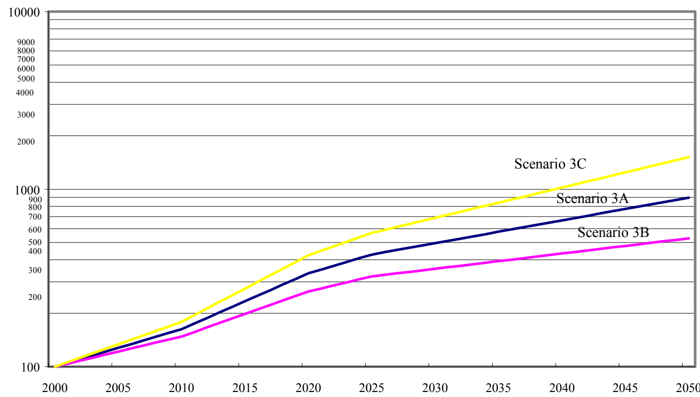
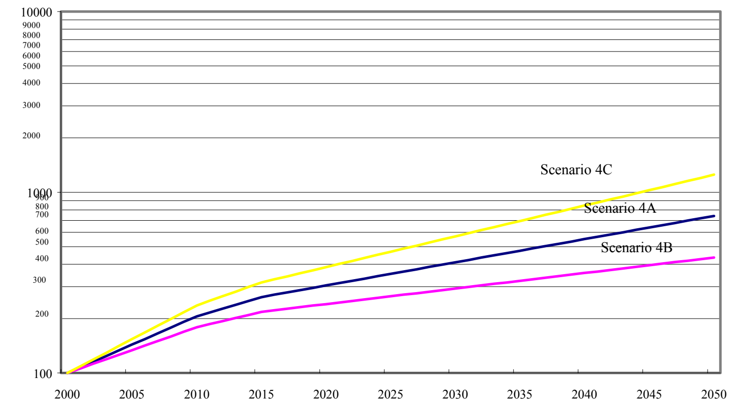


Fig.2.4 Alternative Growth Paths for the Very Long-Term, 2000-2050



Within such four hypothetical scenarios there are three sub-scenarios, i.e. the core scenario A, the minimum scenario B, and the maximum scenario C. The extreme sub-scenarios are based on calculation that over whole half century the rate of growth is either at the minimum or at the maximum end of the band, the center of which is given by the core scenario (Table 8).

Table 8: Catching-up in the Transition Economies in the 21st Century

	1A	1B	1C	2A	2B	2C	3A	3B	3C	4A	4B	4C
	Laggards-5			Even-runners-15			Gainers-10			Frontrunners-10		
Year	Even-runners-5	Min	Max	Laggards-10	Min	Max	Frontruners-10	Min	Max	Gainers-5	Min	Max
	Gainers-10			Even-runners-15			Gainers-5			Even-runners-35		
	Even-runners-30			Laggards-10			Even-runners-25					
2000	100	100	100	100	100	100	100	100	100	100	100	100
2005	110	105	110	116	110	122	128	122	134	144	134	154
2010	128	116	134	134	122	148	163	148	179	206	179	237
2015	163	141	180	156	135	180	234	198	276	263	218	317
2020	208	172	241	172	141	199	336	265	424	305	241	385
2025	242	190	293	192	149	220	428	323	567	354	266	469
2030	280	209	356	222	164	267	497	356	690	410	293	571
2035	325	231	433	258	181	325	576	393	840	475	324	694
2040	377	255	527	296	200	395	668	434	1022	551	357	845
2045	437	282	641	327	210	437	774	479	1243	638	395	1028
2050	506	311	780	361	221	482	897	529	1512	740	436	1250

Source: Author's calculation. See text for the assumptions.

First scenario initially presumes medium-term (five years) period of slow growth due to unstable fundamentals, weak institutions, inadequate policy response, and negative external shocks. Then the growth accelerates for subsequent five years due to continuing institution-building and policy reforms as well as more favorable external factors, e.g. an end of regional conflicts. Later, over a full decade, acceleration is getting momentum owing to institutional advancement and better policies stemming from learning by doing, experience and knowledge. Hence these economies advance to the gainers group, what means that their rate of growth increases to the range of four to six percent. Afterwards, for the long-term of three decades, the growth declines, yet only to the pace of even-runners, i.e. three percent. Thus in a matter of one generation it lifts national income almost twofold and over the two generations time, by 2050, it might increase it about five times. Considering the range of rates of growth, in sub-scenarios 1B and 1C the cumulative growth can be much smaller or significantly larger than in the core scenario 1A (see Figure 2.1). Such sort of scenarios is likely for countries that have weak fundamentals, poor institutions, delayed structural reforms, inconsistent development policies, relatively less favorable geopolitical position, and in certain cases might be directly or indirectly affected by local tensions and conflicts. For instance, countries like Tajikistan in the FSU or Romania in the EE region fit to certain degree in these scenarios. The future will bring a lot of mutations that will make the real picture even more colorful. Nevertheless, these countries can accelerate their rate of growth later too, if only through proper policies they will be able to get rid of various structural and institutional bottlenecks keeping thus far their growth potential in check.

Second scenario is for countries, which will take only limited advantage of the chances brought by introduction of market economy. For this reason they will grow even slower than under centrally planned system. Moreover, a sluggish growth will be accompanied by further increasing

inequality (Milanovic 1998, Kolodko 1999c). For the first, say, 15 years, they will grow at about three percent annually and then even slower – at only two percent. Then, during a period of second generation, such sequence of 15 years as the even-runners and 10 years as the laggards can be repeated. All these are probable for the countries that are still muddling through inconsistent structural reforms and burdened by the institutional vacuum. Old institutions have been already dismantled, but the new ones are not yet in place. Such hybrid system simply contributes to making the growth more difficult and averts the opportunity to catch up in just illusion. If even the geopolitical position helps and the human capital is relatively fine, the weak fundamentals and unstable political situation can discourage domestic capital formation and hinder absorption of flow of foreign savings. Thus such group can be in 2025 and 2050 as far behind the average global income as in 2000, because it will rise only by about 260 percent over the very long-term (see Figure 2.2). What countries can belong to this group, that is left for themselves to decide, since according to the logic of reasoning presented thus far none is doomed *a priori* for such meager growth.

Third scenario reflects situation when over 10 years or so the average rate of growth sustains at five percent, while oscillating between four and six. That might be plausible for the gainers with strong institutions and improving fundamentals as well as reasonable policy response and advanced structural reforms. During succeeding decade the growth may even jump to 7.5 percent and then cease one more time to five percent for a medium-term. After time span of one generation it will slow down to the pace of the even-runners, where it can be maintained for another 25 five years. That would be indeed extremely successful. In such case the catching-up would be complete, since at the end of the journey along such lines the income would be on the par with the standard of developed industrial countries.[9] With luck it may occur, perhaps, for the best performers among countries joining soon the EU. It is barely imaginable that all of them will take such path, yet the best seem to have a chance (see Figure 2.3). If so, realistically looking they should fit close to minimum sub-scenario 3B, because the maximum one, i.e. 3A, is rather on the verge of postsocialist miracle. Of course, it would help, the problem however is that the miracles do not happen neither in Eastern Asia, nor in Eastern Europe.

Fourth scenario (see Figure 2.4) is very optimistic as well. Over sevenfold increase of real income during half century did not happen that often in the course of history. Indeed, it had occurred very seldom (Cohen 1998). Nonetheless, under certain circumstances that can be fulfilled in the case of leading transition economies, on the one hand, and some postsocialist countries that are underdeveloped, on the other. To this first group (similarly as in previous scenario) can aspire economies with strong fundamentals and matured institutions, say, the members of OECD. They must simultaneously manage sound policies and take firm advantage of their integration with the EU as well as attract continuously large inflow of FDI. For instance, for Hungary or Poland among the EE emerging markets, or for Estonia within the FSU region this scenario is not unimaginable. Their favorable geopolitical position and quality of human capital can help too. Yet decisive is going to be the policy, particularly enhancing entrepreneurship. Open product markets, flexible labor markets, and well-developed capital markets make it easier for entrepreneurs to start new firms. This kind of 'venture privatization' and grass-root entrepreneurship have a crucial importance for sustaining high-speed growth (Lavigne 1999, Kolodko 2000b). In the first decade of 21st century these types of

[9] Of course, only the income, that is the flow. As for the standard of living, which is a function of both, the flows and the stocks of assets accumulated in the past, it would be still firmly below the level enjoyed by the most advanced societies.

economies would grow as the frontrunners having average growth rate at about 7,5 percent. In such case GDP would double over 10 years, that is two times sooner than under the first scenario. Later, when catching-up will be somehow advanced, the rate of growth would decline to five or so percent and then would fall to the EU level.

But this scenario can match also characteristic of another type of economies, which are starting from very low income. Despite weak institutions and unstable fundamentals, despite lagging structural reforms and often not the most reasonable policy response, they can take off towards this kind of catching-up too. That is because of coincidence of two specific factors that, at the top of many other features facilitating fast growth, do matter for catching-up. On one hand, the nascent fruits of transition as such, i.e. liberalization and privatization, are contributing to fast growth in countries at very low point of start because of capital inflow and its better allocation. On the other hand, valuable natural resources will attract firm FDI flow boosting for several years very strong growth. For instance, Azerbaijan fits this category well and, to a lesser extent, Tajikistan. Their level of development gives them bigger chance to grow fast, since they are starting from GDP per capita, at PPP basis, at only 1,970 and 750 dollars, respectively. If only other conditions are met, particularly if there will be conclusive end of regional conflicts, then they can indeed take off towards fast growth.

Later, these two different groups of postsocialist economies, after upgrading their development level remarkably over the next 15 years or so, will expand at different pace. The advanced ones should slow down to the pace of even-runners for following 35 years. Most likely then they will be closer to the lower limit within the band of two to four percent of annual growth. The less developed countries will be closer to the upper limit, that is to four percent, or even can match higher rate of growth characteristic for the gainers. In this scenario, alike in scenario two and three, the critical catching-up occurs at the beginning and middle years of the whole period, whereas closer towards its end the rate of growth supposed to be basically on the par with more advanced countries and only for the countries starting currently from very low level it can remain higher.

Yet it can happen that the entire process of catching-up will fail, if structural reforms and institution-building will not be performed profoundly. It can fall short, if political situation switch to adverse. It may be deferred, if globalization will get off course and instead of streamlining transition – will hamper it. The true future of postsocialist economies will be much more complicated than that outlined in these hypothetical scenarios. It is extremely unlikely that any country will stay the unchanged course for the very long run, say for generation or two. Countries may switch often from one path of growth to another. They will do so in both directions, that means up and down, depending on the changing domestic and international conditions. Some will be not able to avoid a threat of recession, when they will get hit by external shocks or by their own policies' excesses. Many of these changes are completely unpredictable at the moment. Many others will be a matter of political decisions that may be taken – or may be not. That in turn will depend on the institutional aspects of development and the democracy performance. Of course, the latter is also capricious, especially in the nations with relatively young democratic regimes, as indeed all postsocialist countries are.

Whereas for some countries worldwide the future development game will be about sustaining the path of growth they have been able to take earlier, for some others the struggle will focus on getting to the path of faster move forward (Lucas 1999). The future of postsocialist economies depends on taking a favorable path of economic growth and their ability to remain for the longest possible time on the desired route. A bulk of scenarios of further development are feasible. In the hypothetical occurrence of the extreme cases – what is simply unlikely – certain postsocialist

economy could expand for the whole period of half century as the frontrunner or can drag as a laggard. That hardly is going to happen, because neither there are arguments that we should expect any country running on average at 7.5 percent until 2050, nor we should be that pessimistic that there will be a country increasing its output by very low margin, say just one percent per year, if at all. It should be expected that these economies will belong to neither of such extreme groups, but rather to the central one, that is to the gainers and the even-runners. It implies that they will manage to stay on the course of rate of growth relevant for these two groups, that is between two and six percent. However, within this very wide band one can expect that most often the growth rate will fluctuate between three and five percent.

VIII. Active Policies for Catching-Up in the 21st Century

While looking into the future, it is necessary to distinguish between passive scenarios and active strategies. Along what path a travel towards the future will go, it depends on many variables. Some of them are given and hence we can only try to foresee them more or less accurately and clearly. However, the critical mass of the growth process is contingent to chosen policies and political ability to follow the lead. Once again the geopolitical position, inherited culture, quality of human capital and skilled labor, number of population and thus the scope of products and service markets, stock of natural resources, the beauty of country and its tourist attractiveness – all these given factors do matter for the growth prospect. Some of them are given forever, some can be changed only over long time and only under the conditions of growing economy. But what does matter most, that is the policy. Without a sound one even comparative advantage given by other factors will not serve the purpose of development well.

Countries with better geopolitical position, having advantage of localization closer to the vast markets, as Estonia to Scandinavia, the Czech Republic to Germany, Bulgaria to Turkey, or even Azerbaijan to Turkey or Kyrgyzstan to China, are founding themselves in relatively better situation to grow faster. Still more do so the countries aiming at integration with the European Union. Countries that with true commitment are taking care of gradual institution-building, as for instance Hungary and Poland, will benefit from this strong foundation in the years to come more than other emerging markets. They do so already.

Combination of these two factors, that is favorable geopolitical position in Eastern Europe and substantial progress vis-à-vis institution-building, are already boosting growth of the candidates for accession to the EU. These countries, even if developed relatively more, as the Czech Republic, Estonia or Slovakia, will grow faster than other countries in the region. That entire group can be foreseen in the next decade or two among the gainers. Some of them, under wrong policies or unfavorable external shocks, might be downgraded to the lower league. Yet before they will catch up with Western Europe – or at least with relatively less advanced southern part of the continent – they should not remain there for too long. It means that even if from period to period they will not succeed to sustain the rate of growth at about five percent annually, they can be back on such path soon afterwards.

As for the countries advancing occasionally to the upper league, they will be coming from two different groups. The first will include the true leaders of transition, which are able to combine sound development strategy with comprehensive structural reforms. These are two different, yet strongly inter-related issues. Healthy institutions brought up by the structural reforms and improving market culture are not the substitutes for good policy and wise development strategy. They are just complementary. In transition economies there is not straightforward causing relationship between

structural reforms and development. At least there is a clear message from the record of the first decade of transition, that for sure not such relation has been set in motion yet. Since this relationship does not work automatically, it must become a candid concern of the government policy.

So far there have been only three cases of high-speed growth, which deserve to be counted as the frontrunners. However, it was that way only for a while. Estonia in 1995-97 and Poland in 1994-97 were growing at average rate of 6.3 percent. Slovakia was able to follow the suit at the latter period of time with 6.2 percent rate. All these three countries, as well as other working out their way to the EU, have a chance to repeat such accomplishments in the future. It calls for good coordination of fiscal and monetary management, well-designed industrial and trade policies, and subordination of structural reforms to pro-growth policy.

The problem is that across the region of both the FSU and EE the governments tend to neglect this latter aspect of long-term growth. It is so because often they are advised (and they tend to follow such guidance eagerly) that just further reforms, particularly full liberalization and privatization, will do the job. Later, when the latter unfortunately is not done, the postponement of structural reforms is blamed for 'unexpected' underperformance. And if there is no way to accelerate those reforms still further owing to political and social constraints, than external shocks are called as an excuse for the failures vis-à-vis growth policy. From this angle the Russian financial crisis in 1998-2000 has come to the rescue to many governments in transition countries, as well as their foreign institutional and individual advisors, because it serves the purpose of a scapegoat extremely well.

The second group advancing periodically to the frontrunners is going to surface from the less developed postsocialist economies, literally catching-up with their more advanced neighbors. If additionally these countries will take good advantage of foreign aid, which in some cases (e.g. in Albania and Bosnia-Herzegovina) is not negligible, they can run forward indeed quick. It did happen incidentally during the first decade of transition, but it will happen more often over the next decades. Bosnia-Herzegovina had unusual, soaring rate of growth of over 40 percent, on average, in 1996-98, but it was due to the post-war recovery entirely financed from external sources, mainly grants. Albania in 1993-96 had the average rate of growth of 9.2 percent. In Georgia in 1996-97 GDP was increasing by 10.2 percent annually. Similarly in Azerbaijan soon later, in 1997-98, the average rate of growth was 7.9 percent.

However, all these processes became unsustainable in the face of too weak fundamentals, poor institutions, inconsistent policies and negative external shocks. Hopefully that is going to change again, this time to the right direction. Already, and not without good reason, for the latter three countries very high rates of growth are predicted for the early 2000s. All of them – plus Yugoslavia recovering from the 1999 war devastation – can turn into the frontrunners for some period of time (see Table 7). Yet if that will happen, one more time it will not mean that fast growth will be guaranteed for very long. It requires that the active policies, coordinating properly the structural reforms with development strategy, must be carried out.

For simple, computation reason small differences vis-à-vis rate of growth become big in the very long-term. When considering next half of century only one point difference between three and four percent annual rates of growth makes as much as 272 percentage points on the cumulative basis. That is enough to catch up and close quite large gap. For instance, if country like Hungary starts from current GDP (on the market exchange basis) of about 5,500 dollars and would be able to sustain for next 50 years four percent rate of growth, it would bring GDP up to as much as 39,000 dollars. That is

more than today's GDP of the United States. If it would grow only by three percent over the next five decades, then in 2050 it will make 'only' about 24,000 dollars.[10] Hardly enough to catch up with moving all the time up the EU average, because then it will firmly exceed 50,000 dollars – even if over next 50 years it would grow by a mere two percent annually. So one percentage point indeed makes the difference. And the higher rates of plausible growth are taken into account, the larger such difference becomes.

What particular country's GDP per capita will be in the future, depends on its value at the point of departure in 2000 and the pace of growth over the next decades. Assuming that the GDP per capita, on PPP basis, in the most advanced industrial countries is approximately 30,000 dollars, how many times the current level of GDP in transition economies must increase to match it? The specter of the multiplying factor with this regard is quite vast: from about two times in the case of the most advanced postsocialist economy, that is Slovenia with GDP per capita at around 14,800 dollars, to about as many as 39 times in the case of the most underdeveloped country, that is Tajikistan with GDP per capita at about 770 dollars. Whereas only for eight countries such ratio is not bigger than five to one, in 12 cases it is believed to be no less than 10 to one (Figure 3).

Actually, many postsocialist countries are not that far behind the countries with the highest GDP per capita as the data on GDP suggest. Gross domestic product is just a flow of current production and does not reflect other important aspects of standard of living. In transition economies – what this time is positive legacy from centrally planned episode – there is high, on the par with the OECD countries, life expectancy. The rate of literacy is very high, secondary school enrollment is similar as in advanced industrial societies, etc. It has significant implications for the future not only because it shows that quality of human capital and hence the growth potential are relatively higher. It also shows that if growth in terms of quantity supplied can be considered as a linear process, it is not so with socioeconomic development. In future the model of development is going to change, so the measures of development will evolve too. They will take more into account the quality of human capital, standard of natural environment, access to culture and nature, density of urban areas and other issues that are omitted in the GDP index. Some of the items that thus far are counted in it, and hence suppose to rise the standard of living, in due time can be considered as an obstacle to this end. Therefore, the catching-up may take a shorter time than it can be seen through the prism of catching-up with the quantity of output.

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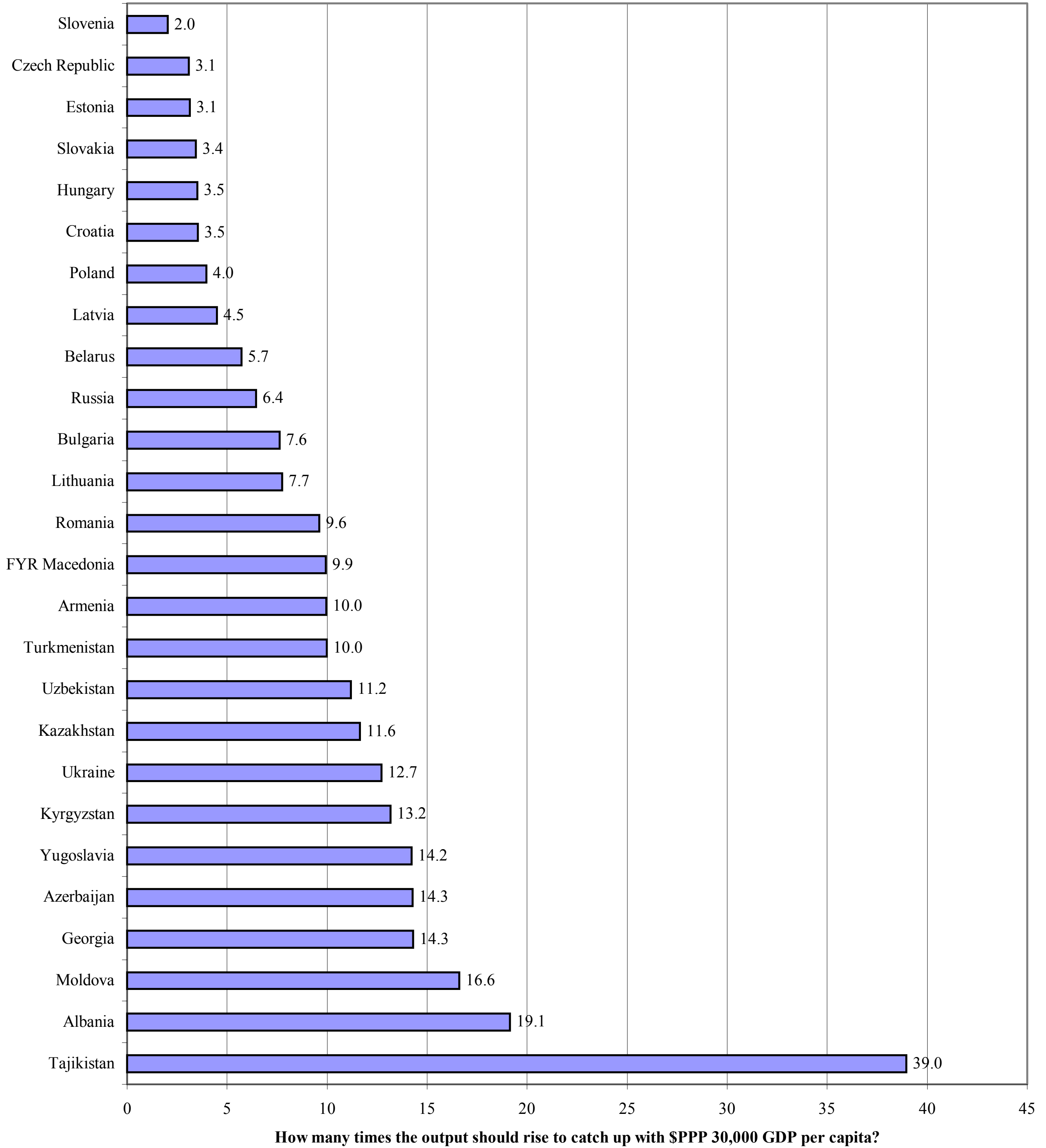
[10] However, it is more rationale to consider for a purpose of catching-up the GDP measured in terms of purchasing power parity. Therefore, in Hungary's example, the respective values would be 57,000 and 35,000 dollars. There are certain methodological concerns about the relevance of the data used for purpose of these comparisons. Always the evaluation of GDP based on purchasing power parity ought to be taken with proper consciousness, and even more it must be the practice vis-à-vis such proxy for transition economies. It must raise some doubts if the evaluation of GDP per capita (in 1995 PPP dollars) suggest that Estonia is on the par with the Czech Republic, or that the Belarus' income is almost twice as much as the Ukraine's, or that Macedonia has GDP per head almost 70 percent larger than Moldova. However, these estimations are agreed on the same methodological ground and are done along the lines of similar assumptions. So if there is – since for sure there is – some error included in those estimations, it still allows to rely, of course with proper reservations, on these data.

Figure 3: Catching-up with the Developed Countries



It would be more reasonable for the purpose of catching-up to sustain stable yet relatively high rate of growth for the very long period of time, than to attempt at its maximization over certain time, which comes to its limits sooner than expected. In such case, owing to involved risks and likeliness that the economy may get out of balance and consequently slow down, even if only for a couple of years, the final result might be less impressive. In another words, it is better strategy to be the gainer all the time than to be for a while the frontrunner, but at the price that later one becomes even-runner, if not yet the laggard.

As the consequence of all these circumstances, particular postsocialist countries can catch up with the level of output of the developed world in very different years. Of course, the latter countries are the growing economies too, so actually the catching-up should be seen as a running towards target moving forward. Yet just to get only to the current level of production of the world leaders would be quite an achievement. In what year it might happen? It depends on a path of growth: is one going to be more like a frontrunner or rather like an even-runner? The laggards, of course, do not count (Table 9).

Table 9: The Year of Catching-up with the Developed Countries

	GDP per capita in 2000 (in 1995 $PPP)	The Year of Catching-up with the GDP per capita of 30,000 $PPP		
		Frontrunner	Gainer	Even-runner
Albania	1,569	2041	2060	2100
Armenia	3,009	2032	2047	2078
Azerbaijan	2,101	2037	2055	2090
Belarus	5,238	2024	2036	2059
Bulgaria	3,930	2028	2042	2069
Croatia	8,484	2017	2026	2042
Czech Republic	9,699	2016	2023	2038
Estonia	9,606	2016	2023	2038
FYR Macedonia	3,017	2032	2047	2077
Georgia	2,099	2037	2055	2090
Hungary	8,525	2017	2026	2042
Kazakhstan	2,576	2034	2050	2083
Kyrgyzstan	2,279	2036	2053	2087
Latvia	6,681	2021	2031	2051
Lithuania	3,872	2028	2042	2069
Moldova	1,805	2039	2058	2095
Poland	7,575	2019	2028	2047
Romania	3,124	2031	2046	2076
Russia	4,654	2026	2038	2063
Slovakia	8,707	2017	2025	2041
Slovenia	14,802	2010	2014	2024
Tajikistan	770	2051	2075	2124
Turkmenistan	3,004	2032	2047	2078
Ukraine	2,357	2035	2052	2086
Uzbekistan	2,681	2034	2048	2082
Yugoslavia	2,108	2037	2055	2090

Source: The 2000 GDP per capita from PlanEcon 1999a and 1999b. Forecasts - author's own calculation.

All these paths show how long is the distance to be overcome for the sake of catching-up and closing the development gap. This gap had risen not only during the times gone by long ago, but unfortunately deepened even more during just the last decade of the last century. It might happen that in certain cases not a half, but several centuries will be needed to liquidate it utterly. If at all, because the catching-up of transition economies with advanced industrial countries does not mean that it is an imperative. It is only an option and chance, which can be taken or can be lost – as it happened so many times in the history of mankind.

The postsocialist countries must try to find their path of growth that will enable them to advance in the catching-up process as much as feasible. Only this will make sense of the whole transition and can turn it in its ultimate success. Such success is contingent on patience, good policies and years of hard work.

IX. Policy Conclusions

Having said that, there is time to ask one more essential question: are all these analyses and conclusions correct , and especially are the forecasts reasonable, if they happened to be wrong so many times in the recent postsocialist past? The answer consists of three parts. First, there were many warnings and predictions that accurately were pointing to the risks and to the future unpleasant occurrences, yet they were not taken sufficiently into account by the policymakers, including international organizations. Second, theoretical assumptions that the transition countries can become fast growing economies are correct, nonetheless the conditions for such take off were not fulfilled earlier, also due to the policy failures. And third, now there is a time to presume rationally that such conditions can be met, so the growth can accelerate. Yet there are the differences and there are the risks.

One difference between then and now is that now we suppose to know much better than then what works in postsocialist economies and why, and what does not work and why. Although there remain the risk that the false assumption suggesting that unleashed market forces will itself do the development job can still take over, we already should know that they will not. For this reason the governments' sound development strategies and wise involvement of the international community, including official and non-government organizations, must support the market forces.

A second difference between then and now is that at the onset of new century all transition economies are already growing. So the question is not any more how to stop recession and depression, but how to accelerate the rate of growth and sustain it at the highest possible level for the longest possible period. All the time there is a challenge how to do it within the framework of specific institutional and political environment of nascent postsocialist market and democracy. A negligence of this specificity creates the second risk.

Policies exercised during the first decade of transition to large extent have been derived from so-called Washington consensus, though this set of structural reforms was designed for another challenge (Williamson 1990 and 1997). Yet while applied towards postsocialist economies, these policies have greatly influenced the direction of systemic reforms and the course of changes (Stiglitz 1998). However, the transition has also had a significant counter-impact. The policies have not generated the anticipated results, and this has led to a search for alternative measures (Kolodko and Nuti 1997). As the postsocialist markets have emerged, so have fresh issues, problems, and concerns. The reactions to these have differed, and new approaches have been evolved. Following a number of

conclusions and policy options formulated so far, another ten major policy conclusions must be put forward here (Kolodko 1999a).

First, institutional arrangements are the most important factor in the achievement of fast and durable growth. They should be established through a process directed by government (by design) rather than spontaneously (by chance). In those nations in which government has been committed to this approach, recovery has come sooner, growth has been more robust, and there are more prospects for sustainable development. Those countries in which government has relied on the spontaneous appearance of new institutions have not been able to manage this complex process adequately and are lagging behind both vis-à-vis systemic transition and the growth of the real economy. Institution-building must be a gradual process. The effects of specific inputs in this process must be constantly monitored, and policies must be regularly adjusted and corrected. One should not depend on the experiences in distorted market economies, but should understand the special features of the emerging postsocialist markets. This is especially true in privatization and the development of capital markets.

Second, the size of government is less important than the quality of government policies and the manner in which the changes are implemented (Tanzi 1997). In transition economies a profound restructuring of the public finance system is more important than is the downsizing government. Fiscal transfers should be redirected from non-competitive sectors towards institution-building (including behavioral and cultural changes) and investments in human capital and hard infrastructure. Attempts to downsize government through expenditure cuts can do more harms than good in terms of recovery from transitional recession and the achievement of sustained and fast growth. Even if one believes that small government is better than big government (what usually is true), to downsize may lead to economic contraction and deterioration in standards of living. Expenditures should not be cut for the sake of the illusion of fiscal prudence, but should be restructured.

Third, if institutional arrangements are neglected and left to spontaneous processes and liberalized market forces, then there will be a systemic vacuum and 'informal institutionalization' will occur. Spreading corruption and organized crime are extreme examples of informal institutionalization. These are the two principal diseases in countries in which liberalization and privatization have taken place under weak government. Governments may sometimes be too weak because they are too big, but in transition economies they are often too weak because they have been downsized too soon, before the emerging market and the NGOs were able to take over relevant functions of the state. Even if the aim of the downsizing is to reduce the scope of fiscal redistribution so as to encourage capital formation and hence investment and growth, one must not overlook the fact that the struggle against informal institutions is costly in fiscal terms, too. A prematurely or too thoroughly downsized government may not be strong enough to lead in this struggle, and the market may quickly expand within the informal sector, while the difficulties are mounting in the official economy. Thus, profits accrue to the informal sector, while revenues drop in the official sector. Profits are thereby 'privatized', while loses are 'socialized' in a politically unsustainable process full of negative consequences for the budget and for social policy.

Fourth, in transition economies policies must aim at transforming and streamlining the legal system so that it can serve the market economy. The establishment and development of new laws – trade and tax codes, capital market regulations, the protection of property rights, antitrust regulations, banking supervision, consumer protection, environmental protection – are extremely important and ought to be addressed before state assets are fully privatized. The establishment of a legal framework, which is appropriate for the market economy, should be much higher on the agenda of international financial organizations. It must be a more urgent and important issue than trade

liberalization and assets privatization, since these latter can contribute to sound growth only if the former has been assured.

Fifth, a shift in functions from the central government to local governments is necessary for deregulation in the postsocialist economy. This means that some decentralization must be undertaken in the public finance system and that local governments must be given more fiscal autonomy. The process of taking functions away from the central government must be matched by reinforcing local governments. Both levels of government must be seen as two parts of a single entity, which is essential for gradual institution-building. If local governments are not strengthened as the central government is reduced, then healthy market forces cannot be supported by new institutional arrangements, and liberalization and privatization are less likely to improve capital allocation and raise efficiency.

Sixth, the development of non-governmental organizations must be accelerated. More significant international technical and financial assistance must be channeled into the effort to empower non-governmental organizations. Along with the private sector and the state, these organizations are an indispensable third pillar of the contemporary market economy and civic society. A wide range of non-governmental organizations active in various areas of public life is needed to ease the constant tension between the state and society. The expanding private sector alone cannot adequately fill this gap. Certain areas of public life can rely neither on the state, nor on the business-oriented private sector. Without the institutional infrastructure provided by non-governmental organizations, successful systemic change and high-quality growth become more problematic, the infant market economy and democracy in postsocialist nations cannot evolve properly, and the transition will remain incomplete.

Seventh, income policy and equitable growth are very important for the growth sustainability and thus the ultimate success of the transition. Because increasing inequity is unavoidable during the initial years of transition, the state, through fiscal and social policies, must play an active role in managing income dispersion. Beyond a certain limit, income disparities inhibit the expansion of economic activity, delay recovery, and slow down economic growth. Substantial inequities hamper crucial institutional and structural reform.

Eighth, the postsocialist transition to the market is taking place in a context of worldwide globalization. Hence integration with the world economy is an indispensable part of the process. This must be managed carefully. Special attention must be paid to short-term capital liberalization, which must be monitored and controlled by fiscal and monetary authorities and supported by international financial institutions. It is better to liberalize capital markets later rather than sooner. Institution-building must first be sufficiently advanced, and stabilization ought already to be consolidated into stability. Only then should financial markets be liberalized in a gradual manner. Otherwise the populations in the young and emerging democracies will not back the introduction of market mechanisms or integration with the world economy and may even become hostile to these steps.

Ninth, international organizations should not only support globalization, but ought to encourage regional integration and cooperation. Fast and durable growth requires export expansion, which depends on strong regional linkages. In turn, this calls for institutional support through import-export banks, commodity exchanges, credit insurance agencies, and so on. This should be the main focus of the institution-building effort of the EBRD through its direct lending and technical assistance. This sort of market infrastructure is now underdeveloped in transition economies, and

regional trade and direct cross-country investment are lagging behind in the process of changes. What should be a driving force behind sustainable growth is actually now a major obstacle.

Tenth, the Bretton Woods institutions should reconsider their policy approach towards transition economies. While the IMF should emphasize financial liquidity, currency convertibility, and fiscal and monetary stabilization, the World Bank should focus mainly on supporting equitable growth and sustainable development. These two areas of economic policy are frequently at odds. There is a tendency to confuse the means and the ends of policy, to favor short-term stabilization over long-term growth and development. Decisionmakers should not rely only on stabilization policies, but should seek a proper balance between stabilization policies and medium- and long-term development strategies. Fiscal and monetary policies must be subordinated to development policy – not the other way around. The World Bank performance criteria for socioeconomic development are needed as much as are the IMF fiscal and monetary criteria. There should always be an eye on the impact of financial policies in terms of growth, capital allocation, income distribution, and the social safety net.

As conditions change and challenges appear, policies must be revised in the future too. Consequently, the quest for a comprehensive and achievable policy consensus, which facilitates sustained and fast growth, must be ongoing. Especially since there is the occasion to catch up. Such chance should not be lost.

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