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Transition to a Market System: Gradualism *versus* Radicalism

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Ladies and Gentlemen,

Thank you very much again for this honorary degree. The subject of today's lecture is "Transition to a Market System: Gradualism *versus* Radicalism". Interestingly enough, several years after the beginning of transition in East Central Europe, the former Soviet Union and China, this issue – more radicalism or more gradualism? – is far from settled among economists, and the debate continues. I think an answer to the question of who is right: the "gradualists" or the "shock-therapists", can only be given if we have the proper definition of the process we are discussing. My definition is that transition to the market system is a long-lasting, historical process of shifting from centrally planned economy, based on the dominance of state property and bureaucratic control, to an open, free-market economy, based on market deregulation and the dominance of private property. Such a definition implies that the process consists of several indispensable sub-processes.

It was clear already at the beginning of transition in Poland and East Central Europe fifteen years ago, when we discussed the political and economic issues of transformation at the Round Table (as the negotiations between the then government and opposition were called), that the process consisted of several threads. First, liberalization and stabilization; second, institution building; and third, microeconomic restructuring. Only if these three component processes take place simultaneously, can we talk about a system in transition, or about transition from one economic system to another. If only some of these processes have been set in motion, this is a case of reform of the old system, rather than transition to a new one. This gives rise to the first very interesting theoretical question with political implications: "What is the difference between transition to a market system and reforms of a socialist system?" The answer is that reforms of the socialist, centrally-planned economy are aimed at sustaining the old system, while making it more efficient and competitive or – from a social view point –

investing it with a "more human face". It remains, however, the old system. The term "transition" implies that we are getting rid of the previous system, which is being replaced, in a radical or gradual way, by a new one. Fifteen years ago, when we started the transition process, some people raised the question whether we should do it in a radical way – overnight – or in a more gradual manner.

The debate about reforms and so-called "shock therapy" (the radical way) went very wrong right from the beginning. First of all, "shock therapy" is a game of words. It is pronounced together at one breath: "shock therapy", like, for instance, "happy marriage" – which implies that whoever is married must be happy. Yet a marriage does not always have to be happy any more than a shock has to signify therapy. One may call the radical approach to systemic change a "shock therapy", if one wishes so, but only if it indeed delivers the therapy.

The case, however, is that there are three simultaneously going processes:

1) liberalisation and stabilisation;
2) institution building;
3) microeconomic restructuring.

And all these three processes cannot be managed in a radical way. A radical approach is only feasible – if necessary and under certain circumstances – *vis-à-vis* liberalisation-cum-stabilisation. These indeed can be pursued in a very radical way, as has been attempted in some countries. The justification for a radical, shock approach towards liberalisation and stabilisation depends on the level of economic and financial disequilibrium prior to the whole exercise. The deeper the disequilibrium is, the more justified is the radical approach. Yet, much more important than liberalisation and stabilisation is the process of institution building which, by its very nature, is always gradual and long lasting.

What are the institutions? Institutions comprise the rules of the economic game, the laws or customs which enforce compliance with the rules, and the organisations which make the rules perform the way we wish. From both theoretical and practical points of view, as we have seen in some countries of East Central Europe and the former Soviet Union, it is possible to dismantle or destroy the institutions of the old socialist economy very rapidly, but there is no way to build the new institutions in an equally radical fashion. It takes time. And it costs money too. So the naïve, as it happens, belief that it is possible to introduce market economy and the supporting institutions in a short period of time, in a radical or "shock" way, proved very costly for the economies of East Central Europe, including Poland. All of these countries, with one exception, incurred very high, yet perfectly avoidable financial and social costs, because of their failure to recognise the significance of institution building. This mistake has definitely been avoided thus far in China and Vietnam in the course of their market reforms and transition.

If all the institutions of the old system, such as the Central Planning Commission, the Price Commission, or particular industries and organisations which control the centrally-planned economy, are deliberately destroyed, while the new institutions have yet to be put into place, we experience a kind of systemic vacuum: a nightmare of neither plan nor market. Consequently, the unleashed forces of supply and demand, and the unleashed energy of entrepreneurship, are hardly working because of the lack of proper rules. Thus plenty of effort of the economic agents is wasted, although in a different way than it was the case under the centrally planned and over bureaucratized socialist system.

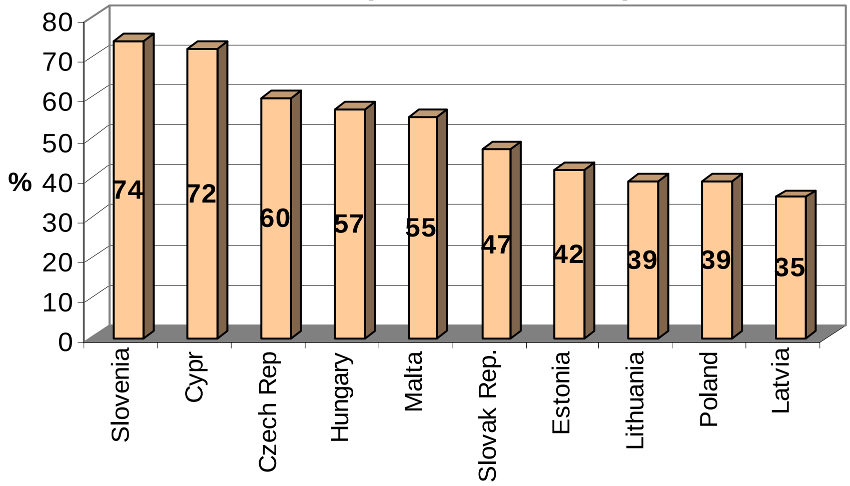
An even longer-lasting process than institution building is that of microeconomic restructuring of the existing production capacities. It takes a lot of time and money to close down certain non-competitive industries, or to retrain and redeploy the labour to more productive endeavours. It is a very painful process which has been experienced in all transition countries. Even now, fifteen years after the commencement of the journey to market economy in the countries of East Central Europe, which were followed by the former Soviet republics, the process of institution building is not concluded.

Going from case to case, from country experience to country experience – whether we talk about Hungary or Macedonia, Croatia or the Czech Republic – we can see that in each case some elements of the radical approach were mixed with some elements of gradualism. From a certain perspective we can say that at least eight of these countries (the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia) are about to complete the transition, as they are joining the European Union. Yet even in these countries – the leaders in transition – a lot remains to be done to build full-fledged market economy, as it exits and performs in the old European Union members or in North America.

Without analysing the differences between the countries in too much detail, we may say that today they are all at the finish line, although they did not all run at the same speed at all segments of the race. This is especially true in the context of institution building, as all these countries had to comply with the rules of the game applicable in the European Union. Other countries in transition do lag behind, to a varying degree, not only from the point of view of their level of development and standard of leaving, but in terms of institutional advancement too. This pertains to a lesser extent, for instance, to Bulgaria, Romania or Russia and more so to Georgia, Tajikistan or Uzbekistan.

But even though some of the countries under discussion – say, Hungary and Poland, Estonia and Slovenia, or Czech Republic and Lithuania – due to the convergence with the European Union, are similar from the institutional point of view, despite the differences at the starting point fifteen years ago, they do differ in levels of output, investment and consumption *per capita*, because of the different paths of economic development over the last decade and a half (see Figure 1).

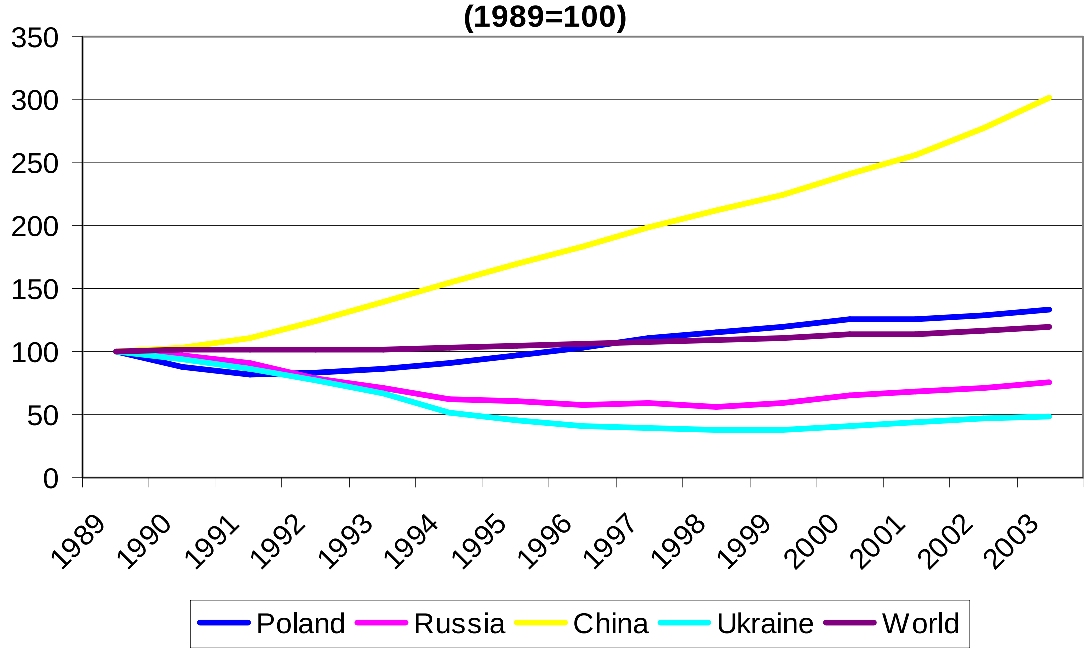
Figure 1. GDP per capita (PPP) in New European Union Members (2003 EU 15 =100)



Source: European Commission.

Poland seems to be the leader within this group, and not only from the institution-building perspective. This country also had got rid first of the transition recession and was able to increase its GDP more than any other country in the region. In 2003 the GDP *per capita* in Poland was hovering over 130 per cent of the level of 1989. In other countries, like Russia or Ukraine, it was, respectively, a meagre 75 and 50 percent or so. Against this background China has dome much better (see Figure 2).

Figure 2. GDP growth in 1990-2003 (1989=100)



Source: World Bank.

Where does this difference come from? Does it have anything to do with the issue of "radicalism *versus* gradualism"? It definitely is connected with the "more radical or more gradual" alternative. I would say that those countries which started at a lower level of development, but at the same time were strongly committed to push ahead with necessary structural reforms and institutional changes, are doing better in terms of output level or long-term growth rate. Consequently, Poland's relative economic success (as it is still relative) compared with other countries of the region during the last fifteen years of transition to market economy came about not because of, but *despite* the so-called shock therapy, which caused very numerous problems, excessive pain and costs which would otherwise have been avoidable. By all means there had been too much of unnecessary costs and shocks and not enough of gains and therapy.

To gain a better understanding of the Polish experience, so as to be able to learn from it, one must take a closer look at how the situation has evolved over the past fifteen years, which can and should be subdivided into several distinct periods. I am referring to the first of these as "shock without therapy" (1989-93). We hardly managed then to stabilise inflation at the lowest possible level and, at the same time, unfortunately the GDP had contracted by about 20 percent during the years of transitional recession (mid-1989 until mid-1992), which marked the beginning of massive unemployment – and many other problems which still encumber the Polish economy.

The second period, most often referred to as “Strategy for Poland”, covers the years 1994-97. A different approach was adopted, much more focused on government-led industrial and trade policy, social equity and fair income distribution, on a re-definition of the role of the state, and on gradual yet sustained institutional building. These four years resulted in 28 per cent growth of GDP *per capita* (which may not be so remarkable from the Chinese perspective but definitely was from our point of view). Unemployment was reduced from the very high level of almost 17 per cent to less than 10 per cent, and inflation decreased by about two thirds – from 38 to 13 percent. Then, unfortunately, a third period of overcooling (if not overkilling) the economy ensued (1998-2001) and the rate of growth decreased to a very low level of around 1 per cent in 2001 and first half of 2002.

Only then did we move on to the fourth – current – period, marked by accelerated rate of growth since the second half of 2002. Ongoing recovery results from improved corporate governance and the restructuring of public expenditure, as well as convergence due to integration with the European Union. Special role in boosting the economic growth has been played by the restructuring of nonperforming debt of enterprises. In exchange for a fraction of outstanding debt and on the basis of presenting a suitable business plan of microeconomic restructuring, a part of the old debt has been written off. I would say that in the second and the fourth periods, unlike in the first and the third, the gradual approach predominated over the radical one. Consequently, if the Polish economy has attained some measure of success compared with other economies in our region, this is much more due to ”gradual therapy” than to ”shock failure”.

The big question, however, is: why is China so successful in terms of economic growth, compared with the former Soviet Union and East Central Europe? What is it that accounts for this difference?

Some commentators may point at cultural factors, others at geopolitical position, others still at political institutions, but does it have anything to do with the “radicalism *versus* gradualism” dilemma? I am positive that there is a link between gradualism and performance in terms of economic growth in China, and that the correlation between the two is positive. Nevertheless, although institutions are very important, there is also the question of policy. A situation is possible when improving institutions acting in concert with good policy give the economy a powerful boost. This is to quite an extent the case of China. Conversely, a mistaken, ill-advised policy, mixed with a wrong institutions, will not take one very far. And this had been for most of the 90s the case of Russia.

This leads us to the question of development policy, which has been so successful in China thanks to its very good coordination with the policy of market-oriented systemic change. The "shock therapy" was based on a naïve, ideological – indeed, so to speak, almost religious – belief that there is no need for development policy. I am referring here to the built-in assumption that actually it is the market system *per se* that acts as the radical development force and a substitute for development policy. This is indeed a grossly mistaken assumption, since one should not believe in something that does not exists, as is the case with the "invisible hand of market" acting as a mean of development. Development needs guidance of government-led strategy and policy. And again, this has been the case of China for last quarter of a century.

We can also come to appreciate the importance of policy – in particular, development policy or growth policy – studying the experience of the countries which are joining the European Union, with largely similar histories of institution building and systemic change. Some of them are doing much better in terms of output, employment and standard of living, while others are lagging behind. This is because they have followed different policies over the past fifteen years. Hence, the lack of orientation towards a long-term development policy resulted in far less favourable developments in Russia, Ukraine or Kazakhstan than in Poland on the one hand and China on the other.

Therefore, one needs to distinguish the ends of one's actions from the means. In the economy, as well as in economic policy and policy-making – and this is true not only in the postsocialist countries in transition, but also elsewhere, especially in so-called emerging markets – there is often much confusion about the ends and the means of economic policy. China has avoided mistakes of the kind committed in East Central Europe and the former Soviet Union, where the ends of the policy have been confused with the means at its disposal. The aim of a policy is development, while everything else is the means to achieve this aim. Unfortunately, in policy-making, stable exchange rates are sometimes taken for the target of economic policy. The lowest possible inflation, whatever the cost, is sometimes assumed to be the ultimate policy aim. The same goes for accession to certain international organisations – the OECD, the European Union, or the WTO. Such developments, however, should never be seen as the end of the policy. They must always be viewed as a means and instrument thereof, since what we are supposed to aim for is long-lasting, durable, sustainable development.

Systemic change, or the shift to the market, is very important for long-term development. In this perspective, transition to market economy should be seen as an instrument to achieve the principal aim, which is development. This is my understanding of the Chinese way to the market over the last 25 years. This is also the theoretical foundation of my policy-oriented research in economics and policy as well as advisory work. Such an approach, viewing everything as instruments subordinated to the aim of socio-economic development, was also a guideline for myself when I was, twice, Deputy Prime Minister and Minister of Finance in the Polish government: first in 1994-97, when we implemented successfully the “Strategy for Poland”, and then recently, in 2002-03, when the economy started to grow fast again. In a matter of less than two years the rate of growth was brought up from 0.5 percent to over 5.0 per cent.

Fifteen years ago, we liked to joke in Eastern Europe that moving from capitalism to socialism was like making out of an aquarium a fish soup. This was meant to imply that it was actually impossible to go the opposite way, that is from socialism to capitalism, what suppose to be as difficult as converting fish soup back into aquarium. However, if a gradual approach is used to advantage, if the economic policy is based on a sound economic theory, if one is not confusing the means with the ends of the policy and sees systemic change and institution building as tools to foster socio-economic development – such a “miracle” may turn out to be possible and a performing market economy can be established in place of the abandoned old system.

However, there was one exception to the rule, hence the recent history has seen just one success story of a radical transition to market economy, or indeed a “shock therapy“, if one wants to call it in this way. This is the unique case of former East Germany – the German Democratic Republic – now the five eastern lands of united Germany. Its special circumstances made it possible not only to liberalise and stabilise the economy literally overnight, but also to introduce the necessary institutions in a relatively short period of time. The third process, however – that is, the microeconomic restructuring of the existing production capacity – has taken even there many years and actually is still under way.

The more I work on the issues of development policy in transition economy, liberalisation and integration of our economies into the world economy, the more I see that there are many political – rather than strictly economic – issues which influence the economy. My thesis is that, in the long run, democracy and democratisation reinforce the shift to market economy and improve the performance of the market, once this process has been set in motion. However, this issue really calls for much more debate. If we are talking about the market, the question must pop up inevitably: "But what about democracy?" I am not sure whether this is the most accurate question, though. While talking about transition to the market, we may point to countries with fewer democratic institutions and less democratic practice, but a much better policy and economic performance, in contrast with those which have more democracy and democratic institutions, but, unfortunately, follow a wrong economic policy and are less successful. Democracy is a value itself, yet not necessarily – and for sure not automatically – supportive of economic development. The latter needs more than just democracy, because it does need sound strategy which must be based on proper economic theory and strong political commitment towards the ends the development is aiming to.

Democracy – and the road leading to it from a non-democratic system, that is democratisation – are also about institutions and institution building. It is lasting and difficult process, involving serious efforts and social costs. Therefore, we observe in some countries of East Central Europe – I think Poland is quite a good example – that people may sometimes be more satisfied with what has been delivered by the market economy than with what has been delivered by democracy. In a sense, market works better than democracy. How come? Why does it happen that way? How is it possible? I would say that, alongside institutions and policy, there is also a third ingredient – the culture. Again, I am neither a psychologist, nor an anthropologist, but as I work on economics, I constantly find out that more depends on culture than, for instance, on perfecting or fine tuning the financial market.

I am referring to culture in the sense of civilisation and culture as a set of rules of behaviour, which makes it possible to talk about business culture, market culture, fiscal culture, and also political culture, bureaucracy culture, or local government culture – pertaining to the selfgoverning bodies which, again, seem to be lagging behind in comparison with change of a strictly economic character. If there is an imbalance between market institutions, market structures and market instruments on the one hand, which are somewhat better developed, and market culture on the other, problems arise – the system is not working the way it should. Hence, if certain changes have been introduced en route to market economy in a faster, more radical way, then market culture is lagging behind, resulting in an incompatibility between various parts of the system one of which falls behind because of its underdevelopment.

And again – the situation in China in this respect is much better than, say, in Russia, because of gradualism in institution building, liberalisation and privatisation. At the same time the process of market culture building has gained momentum. Consequently, compatibility is ensured across the system, unlike in Russia. From this perspective, certain East Central European countries also enjoy a greater degree of compatibility, although for a different reason, as they had embarked on market-oriented reforms before the actual transition started. Therefore, we must see transition as a gradual process of learning by doing and getting familiar with a new style of thinking, working and performing. It is not enough to build a bank from fine steel, glass and marble in the centre of Chengdu or Cracow or St. Petersburg and boast that now we have market economy. We also need people who know how to behave in the bank and outside the bank, rather than gangsters who know how to rob the bank, or the crooks that know how to cheat the clients. This knowledge takes a long time to develop.

In the future we will see that some regions, businesses, industries or countries will be more successful than others. I do not doubt that, seen in this perspective, China will remain, if not the most successful country, then one of such countries. I also hope that Poland will be doing well as a new member of the European Union.

We need commitment and determination – and we need to look forward, but without rushing too much, because it might do more harm than good. On an expedition in Africa, the famous 19th-century explorer Sir Henry Stanley wondered why his African servants were so slow and asked them whether they were sick or tired. Neither, they answered: they could walk much faster, but their souls could not catch up. Let us, therefore, keep going forward, but not at a neck-breaking speed, because otherwise we risk losing our souls – and that would be a very severe malady.

Thank you for your attention.