Strategies for Growth: Central and Eastern Europe

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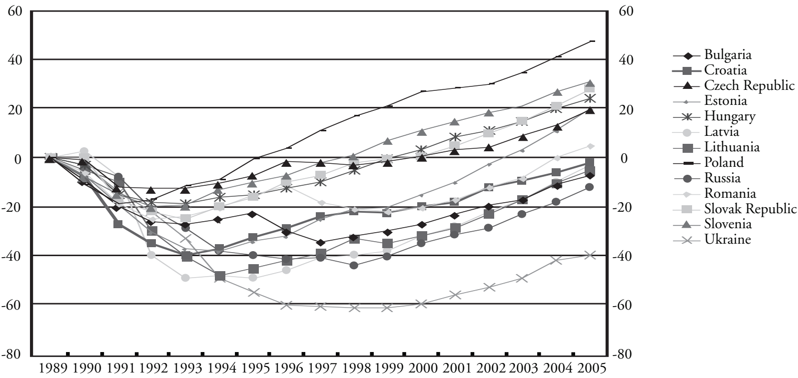
The collapse of the Soviet Union's political and economic system, epitomized by the fall of the Berlin Wall in 1989, started the transition from central planning to a market economy. From a historical perspective, the transition economies have undergone an unprecedented transformation, which has been difficult, but increasingly successful. In particular, these countries have converted their state-owned economies into vibrant, albeit often still imperfect, market economies based primarily on private ownership.

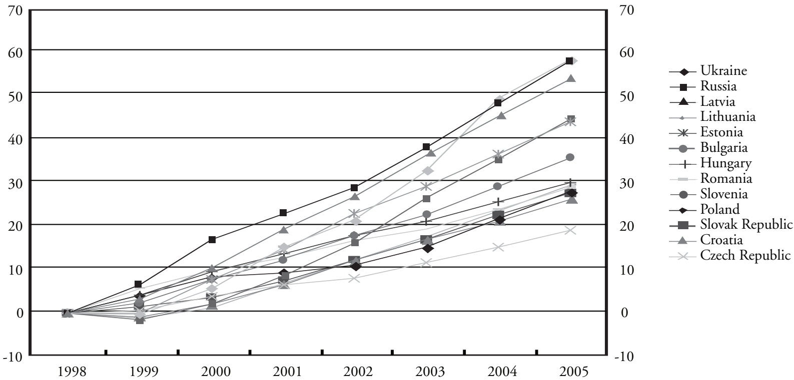
There are two key features related to performance of these economies in terms of their gross domestic product (GDP). First, as may be seen from Chart 1, which captures the evolution of GDP in selected countries since 1989, there was a large decline in economic activity in the first several years of the transition. The decline was unexpected, given that the transition economies were substituting a demonstrably inferior economic system with a superior one. Second, there has been a different pattern in GDP evolution between the central European countries in the west and those in the former Soviet Union (the Baltic and Commonwealth of Independent States, CIS, countries) further east. In particular, the more western transition economies stopped the decline and started growing sooner, and they also grew faster in the 1990s. Charts 1 and 2 together indicate that the more eastern countries in the Baltic and CIS areas experienced a

Chart 1
Real GDP (Base 1989)



Source: *EBRD Transition Report 2005*

Chart 2
Real GDP (Base 1998)



Source: *EBRD Transition Report 2005*

deeper economic decline, turned around later, and have grown faster since 1998. Key questions are: What accounts for this pattern, can the fast rate of GDP growth be sustained, and how can it be done?

In these remarks, I provide an overall assessment of the strategies and outcomes of the first decade and a half of the transition, outline the principal challenges faced by these economies, and propose elements for a growth strategy. In presenting data and examples, I will refer broadly to the experience of the five central European countries (Czech Republic, Hungary, Poland, Slovakia, and Slovenia), the three Baltic countries (Estonia, Latvia, and Lithuania), the Balkan or southeast European countries (especially Bulgaria, Croatia, and Romania), and the CIS, which is made up of countries other than the Baltic States that were formerly republics of the Soviet Union. Within the CIS, I will focus most on Russia and Ukraine.

Strategies for transition

The policymakers in the transition economies formulated strategies that focused on macroeconomic stabilization and microeconomic restructuring, along with institutional and political reforms. The nature and implementation of these strategies varied across countries in speed and specifics. A major debate took place about the merits of fast versus gradual reform, but, as it turned out, almost all the transition governments carried out rapidly what I call "Type I" reforms. However, significant policy differences existed across countries in what I term "Type II" reforms.

Type I reforms focused on macro stabilization, price liberalization, and dismantling of the institutions of the communist system. The macroeconomic strategy emphasized restrictive fiscal and monetary policies; wage controls; and, in most cases, also initially currency devaluation and a fixed exchange rate. The institution governing the Soviet bloc trading area, the Council for Mutual Economic Assistance (CMEA), was abolished, and many countries opened up to international trade. Most countries also gradually opened up to international capital flows. The micro strategy relied primarily on price liberalization.

Many countries also quickly reduced direct subsidies to state-owned enterprises and allowed them to restructure. They removed barriers to the creation of new firms and carried out small-scale privatizations. Moreover, most governments broke up the "monobank" system, whereby a single state bank functioned as a country's central bank as well as a nationwide commercial and investment bank, and they allowed the creation of independent banks. A final feature was the introduction of some elements of a social safety net. The Type I reforms proved relatively sustainable.

Type II reforms involved the development and enforcement of laws, regulations, and institutions that would be conducive to the functioning of a market economy. These reforms included the privatization of large enterprises; establishment and enforcement of a market-oriented legal system and accompanying institutions; an in-depth development of a viable commercial banking sector and the appropriate regulatory infrastructure; labor market regulations; and institutions related to public unemployment and retirement systems.

Type II reforms were designed and implemented differently across countries. For example, in the strategy of privatizing large- and medium-sized firms, Poland and Slovenia moved slowly, relying instead on "commercialization"; Estonia and Hungary proceeded effectively by selling state-owned enterprises virtually one-by-one to outside owners; Russia and Ukraine opted for rapid mass privatization with a reliance on subsidized management-employee buyouts; and the Czech Republic and Lithuania carried out equal-access voucher privatization by distributing a majority of shares of most firms to citizens at large.

Similarly, in the development of the banking system, Russia allowed spontaneous growth of new banks, resulting in a bottom-up creation of hundreds of banks virtually overnight, while in central Europe the process was much more government-controlled. The banking systems differed in various ways, but they shared two discouraging patterns. First, many of the small banks quickly collapsed. Second, in most countries, the large banks started with a sizable portfolio of nonperforming enterprise loans and, upon restructuring, they rapidly

accumulated new nonperforming loans. The need for repeated bailouts of banks since the mid-1990s has led most central European and a number of the Balkan countries to privatize virtually all domestic banks to western banks.

While some countries did better than others, virtually no transition country succeeded in rapidly developing a legal system and institutions that were highly conducive to the functioning of a market economy. Many policymakers underestimated the importance of a well-functioning legal system, many newly rich individuals and groups in the transition economies did not desire a strong legal system, and corruption was rampant. The countries that have made the greatest progress in limiting corruption and establishing a functioning legal framework and institutions are the central European and Baltic countries. Interestingly, since the mid-1990s, an important impetus for carrying out legal and institutional reforms in many of these countries has been the need to develop a system that conforms to that of the European Union (EU) as a prerequisite for accession to the EU. In this sense, the central European and Baltic countries benefited from both favorable initial conditions as well as propitious "terminal" conditions. The impact of the terminal conditions associated with EU entry is currently observed in the Balkan states.

Performance of the transition economies since 1989 economic growth

In reporting economic growth in Charts 1 and 2, it is important to emphasize that in the early 1990s it was difficult to calculate the evolution of GDP. With this caveat, the official data suggest that all of the transition economies experienced large declines in output at the start of the transition. The decline varied from 13 percent to 25 percent in central Europe; more than 40 percent in the Baltic countries; as much as 45 percent or more in Russia; and even more in many of the other nations of the CIS, such as the drop of almost 65 percent in Ukraine. The central European countries reversed the decline after three to four years,[1] but in Russia and most of the CIS, the turnaround did not occur until the late 1990s. Russia's GDP, for instance, declined until 1996, showed signs of growth in 1997, but then declined again during Russia's 1998 financial crisis.

Most central European and Baltic countries have generated sustained economic growth since the early to mid-1990s. The CIS countries started growing in 1999, but since then their rate of GDP growth, together with that of the Baltic countries, has exceeded that of the central and east European economies (Chart 2). Since 1999, all the transition economies have, thus, been growing at a relatively rapid rate.

The depth and length of the depression was unexpected, and a number of competing explanations have been advanced: tight macroeconomic policies (Bhaduri and others, 1993; Rosati, 1994); a credit crunch stemming from the reduction of state subsidies to firms and rise in real interest rates (Calvo and Coricelli, 1992); disorganization among suppliers, producers, and consumers associated with the collapse of central planning (Blanchard and Kremer, 1997; Roland and Verdier, 1999); a switch from a controlled to uncontrolled monopolistic structure in these economies (Li, 1999; Blanchard, 1997); difficulties of sectoral shifts in the presence of labor market imperfections (Atkeson and Kehoe, 1996); and the dissolution in 1990 of the CMEA, which governed trade relations across the Soviet bloc nations. While each explanation tells part of the story, none has strong empirical support across the board.

What factors account for the early turnaround in central Europe and the subsequent upswing in all the transition economies? No single explanation suffices. Geography provides part of the explanation. The central European countries, located farthest to the west among the transition economies, have historically shared the same alphabet and religions, had similar educational and bureaucratic systems, and intensively traded and otherwise interacted with countries in western Europe. They, together with Bulgaria and Romania, were under the Soviet system for only four decades, as compared to five decades in the case of the Baltic countries and seven decades in the CIS countries. Finally, the central European and Baltic countries quickly shifted trade from the CMEA area to western Europe and were the first to prepare for and enter the EU. The physical proximity and historical belongingness to Europe have, hence, provided an important advantage for the "western" transition economies in the

first phase of moving from the Soviet-style to a democratic and market-oriented system.

The argument that geography provides only part of the explanation is based on the fact that the western-most transition economy, the Czech Republic, grew slower than others in central Europe in the first decade and a half of the transition (and was the only one to go into a recession in 1996-1998), as well as the fact that the transition economies lying further east have recorded faster rates of growth since 1998 than those located farther west.

Policies and other factors, such as resource prices, clearly matter as well. In particular, the extent to which countries pursued a combination of key Type II reforms provides some explanatory power. With the partial exception of the Czech Republic, the central European transition economies pursued in the early to mid-1990s a relatively complete set of reforms, including the establishment of relatively clear property rights, legal system, and corporate governance. In contrast, the privatization experience of the Czech Republic, Russia, and Ukraine in the 1990s suggests that mass privatization in the absence of a functioning legal system has strong negative effects on performance. In the 1990s, the economic situation in Russia and other CIS economies also was aggravated by the political and economic disintegration of the Soviet Union, a greater presence of organized crime, and the spread of aggressive rent seeking and corruption.

The strong rebound in economic growth in the 2000s is attributable to more fundamental reforms being carried out in most countries; increases in domestic consumption and in a number of countries' foreign investment; growth in credit to consumers and small- and medium-sized firms; growth in exports; and, for a number of countries, including Russia, Azerbaijan, and Kazakhstan, the rise in raw material (especially oil) prices.

Inflation

As may be seen from Table 1, a number of the transition economies experienced high or hyperinflation as the communist system

Table 1
Consumer Price Inflation
(Annual Percentage Change)

	1990	1992	1994	1996	1998	2000	2002	2003	2004	2005*	2006**
Czech Rep.	9.7	11.1	9.9	8.8	10.6	4.0	1.8	0.2	2.8	1.9	2.7
Hungary	28.9	23.0	18.8	23.6	14.3	9.8	4.8	4.9	6.7	3.6	2.0
Poland	585.8	43.0	32.2	19.9	11.8	10.1	1.7	0.7	3.5	2.2	1.2
Slovak Rep.	10.8	10.0	13.4	5.8	6.7	12.0	3.3	8.5	7.5	2.7	4.2
Slovenia	549.7	207.3	21.0	9.9	7.9	8.9	7.5	5.6	3.6	2.5	2.5
Estonia	23.1	1,076.0	47.7	23.1	8.1	4.0	3.6	1.3	3.0	4.1	3.4
Latvia	10.5	951.2	35.9	17.6	4.7	2.6	1.9	3.0	6.2	6.7	6.0
Lithuania	8.4	1,020.5	72.1	24.6	5.1	1.0	0.3	-1.2	1.2	2.7	3.0
Bulgaria	26.3	82.0	96.3	123.0	22.2	9.9	5.9	2.3	6.1	5.0	6.5
Croatia	609.5	665.5	97.5	3.5	5.7	6.2	2.2	1.8	2.1	3.3	3.2
Romania	127.9	210.4	136.7	38.8	59.1	45.7	22.5	15.4	11.9	9.0	7.7
Russia	5.6	1,526.0	311.4	47.8	27.6	20.8	15.7	13.7	10.9	12.7	10.5
Ukraine	4.2	1,210.0	891.0	80.0	10.6	28.2	0.8	5.2	9.0	13.5	10.5

* Estimate
**Projection
Sources: William Davidson Institute; *EBRD Transition Report 2004*; IMF *World Economic Outlook*, April 2003; OECD *Economic Outlook*, Vol. 72; Economist Intelligence Unit

disintegrated. Sometimes inflation arose after the countries lifted price controls; in other cases, it grew out of financial sector crises. Yet, by the late 1990s, most countries had shown that they could reduce inflation with speed and effectiveness. In the 2000s, inflation continued to decline steadily in most of these economies, driven in large part by relatively tight monetary policies of the central banks. There were temporary surges of inflationary pressures in some economies as they were joining the EU (alignments of excise taxes). But, by 2005, consumer price inflation was below 3 percent in all of central Europe, except Hungary; 4 percent to 6 percent in the Baltics; 0 percent to 9 percent in the Balkans, except for Serbia and Montenegro, where it was 16.2 percent; and 0 percent to 14 percent in the CIS, with Russia and Ukraine being at 12.8 percent and 14.1 percent, respectively. At present, inflation is an issue in the Baltic countries where there have been rising wages and increases in food and administrative prices, and it continues to be an issue in Serbia (for similar reasons) and in the resource-rich CIS countries, with booming commodity exports and incomplete sterilization of the resulting increase in base money.

In June 2004, Estonia, Lithuania, and Slovenia joined the Exchange Rate Mechanism (ERM) II system as a first step to adopting the euro, and Latvia followed in January 2005. Slovenia, with a 2.5 percent inflation in 2005, qualified for entry into the euro zone and is expected to adopt the euro in January 2007. Other Baltic and central European countries are expected to follow suit over the next five years.

Exchange rates and current account

Most countries adopted a fixed exchange rate after devaluing their currency as a means of encouraging and increasing the competitiveness of exports, as well as to provide competitiveness to domestic producers vis à vis imports. However, as domestic inflation exceeded world inflation in the 1990s, the fixed exchange rates often became overvalued, in some cases leading to substantial current account deficits. For instance, most countries in the Baltics, Balkans, and the CIS had at least one year in the 1990s when the current account deficit was 10 percent of GDP or more. Most countries responded by

devaluing their currencies again and adopting more flexible exchange rate regimes, although Bulgaria, Estonia, and Lithuania, for instance, fixed their exchange rate through currency boards.

In the early 2000s, most transition economies succeeded in reigning in current account deficits, and a number of them have since further reduced their deficits (for example, Poland and Slovenia) or even turned them into surpluses (Kazakhstan and Uzbekistan). However, by the mid-2000s a number of countries have experienced increased current account deficits, brought about primarily by rising consumption and investment fueled in a number of instances by expanding credit and rising imports. The problem is especially pronounced in the Balkan and Baltic states. In contrast, a number of commodity-exporting countries in the CIS have been recording strong current account surpluses as world prices have risen in the past several years.

External debt and fnancial crises

A number of transition countries started the 1990s with high foreign indebtedness. In Bulgaria, Hungary, and Poland, external debt exceeded 50 percent of GDP, while in Russia it was 148 percent of GDP. Other transition economies, such as Romania, Slovenia, the Czech Republic, and Slovakia, had conservative regimes where foreign debt was less than 20 percent of GDP in 1990.

In the 1990s, most of the highly indebted countries reduced their debt relative to GDP, while a number of the less indebted countries raised theirs. But in the mid- to late 1990s, foreign indebtedness rose in some of the relatively more indebted countries, and Russia, in fact, defaulted on its sovereign debt in 1998. By the mid-2000s, most transition economies have external debt in excess of 25 percent of GDP, but few (Croatia, Estonia, Latvia, and the Kyrgyz Republic) have external debt higher than 70 percent of GDP. Unless accompanied by other destabilizing factors, such as a high proportion of short-term debt that may suddenly not be refinanced as investor sentiment shifts (as was the case in Russia in 1998), this level of debt is not especially alarming.

Government budget and taxes

Under communism, the government owned almost everything, with taxes and expenditures being transfers among centrally determined activities. During the transition, governments had to develop new fiscal institutions for collecting taxes. This institutional development was one of the hardest reforms to achieve. While tax collection was relatively effective in central Europe and the Baltic States already in the early 1990s, Russia and the other CIS countries faced significant shortfalls in tax revenue as many producers operated through barter and accumulated tax arrears. At the same time, the governments faced numerous transition-related public expenditures, including those on infrastructure and the new social safety net. The initial relative inability of Russia and the CIS nations to collect taxes is one reason why their social safety nets, and the implementation of Type II reforms in general, were much weaker than those in central Europe and the Baltics.

A number of transition economies, particularly those in central Europe, quickly established relatively high tax rates, especially in comparison to other countries at a similar level of GDP per capita. Yet, many of the transition economies have been running budget deficits. Thus, Albania, Bulgaria, the Czech Republic, Hungary, Lithuania, Kazakhstan, Russia, Slovakia, and Ukraine in a number of years have had annual budget deficits in excess of 5 percent of GDP. Table 2 shows the evolution of government budget balance as a share of GDP in selected economies. As may be seen from the table, a number of countries managed to reduce the initial budget deficits by the late 1990s or around 2000, but some (especially in central Europe) have witnessed increasing deficits in the early to mid-2000s. A number of factors account for this development, including the tax harmonization with the EU, compensating for the economic slowdown in the EU with domestic expansionary fiscal policies, expenditures related to electoral cycles, and the growing burden of social transfers. The deteriorating fiscal situation and inability to carry out fiscal expenditure reforms have led the Czech, Hungarian, and Polish governments to

Table 2
General Government Balance
(Percent of GDP)

	1990	1992	1994	1996	1998	2000	2002	2003	2004*	2005**
Czech Rep.	8.2	-3.1	-1.2	-1.7	-4.2	-4.5	-6.4	-11.6	-3.3	-4.5
Hungary	0.5	-6.1	-7.5	-5.0	-8.0	-3.0	-9.3	-6.5	-5.4	-6.0
Poland	0.4	-4.9	-2.2	-3.3	-2.3	-1.8	-3.7	-4.8	-3.9	-3.7
Slovak Rep.	0.1	-11.9	-1.5	-1.4	-5.0	-12.3	-5.7	-3.7	-3.3	-3.3
Slovenia	-0.3	0.3	-0.2	-0.2	-2.2	-3.4	-2.4	-2.0	-1.9	-2.1
Estonia	na	na	1.4	-1.9	-0.4	-0.3	1.8	3.1	1.8	0.1
Latvia	na	na	-4.4	-1.8	-0.7	-2.7	-2.7	-1.5	-0.8	-1.7
Lithuania	na	na	-4.8	-4.5	-3.0	-2.6	-1.6	-1.9	-2.5	-2.6
Bulgaria	-8.1	-2.9	-3.9	-10.4	1.0	-1.0	-0.6	-0.4	1.8	1.0
Croatia	na	-3.9	1.2	-1.0	-1.0	-6.5	-5.0	-6.3	-4.9	-4.5
Romania	-0.4	-4.6	-2.2	-3.9	-5.0	-4.0	-2.6	-2.0	-1.4	-1.0
Russia	na	-18.9	-10.4	-8.9	-8.2	2.7	1.4	1.1	5.0	7.6
Ukraine	na	-25.4	-8.7	-3.2	-2.8	-1.3	0.5	-0.7	-4.6	-2.9

* Estimate / ** Projection
Source: *EBRD Transition Report*

delay the planned entry into the euro zone, beyond the originally planned 2007 date. Among the commodity-exporting countries in the CIS, high commodity prices have generated fiscal surpluses, especially in Kazakhstan and Russia, some of which have been channeled into special long-term stabilization funds. However, there are increasing pressures on the governments to relax fiscal policies.

An especially problematic aspect of the public finances in a number of the transition economies is the increasing strain from the public pension and health-care systems. These economies entered the transition with publicly funded pension systems, almost universal coverage of the population, low retirement ages, a high and growing ratio of retirees to workers, high payroll tax contribution levels, and unsustainably high levels of promised benefits (World Bank, 1994; Svejnar, 1997). Similarly, the health-care systems were by and large fully publicly funded and inefficient. Several countries have already carried out major reforms of pensions and health care, but these reforms are politically unpopular.

Overall, the principal challenge facing the transition economies is how to reduce wasteful expenditures in order to create fiscal space for development spending (especially infrastructure), improving the quality and efficiency of public sector delivery, and increasing the formation of human capital. Moreover, while some economies have already reduced taxes, others still need to reduce tax burdens in order to enhance efficiency, competitiveness, and employment (World Bank, 2006).

Finally, given the fiscal pressure under which most of the transition economies operate, it is interesting that they collected very little revenue (5 percent of GDP, on average) from privatization (Tanzi and Tsiboures, 2000).

Privatization and creation of new firms

In the early 1990s, most transition economies rapidly privatized small enterprises, restructured many large state-owned firms and their management, and allowed the creation of new private firms. However, in most countries, the majority of private assets were generated through

large-scale privatization, which differed in its method across countries. What is remarkable is how quickly most countries generated private ownership, irrespective of the particular privatization methods used. In 1990, the private sector had perhaps 20 percent to 25 percent of GDP in Hungary and Poland, but typically only 5 percent to 10 percent of GDP in other transition economies. But, as may be seen from Table 3, these figures increased quickly. As early as 1994, the private sector was more than 30 percent of GDP in all of the transition economies and represented half or more of GDP in many countries, including Russia. By 2000, the private sector share of GDP was equal to or more than 60 percent in all of the transition economies, and in most of them, it constituted 70 percent to 80 percent.

The effect of privatization on economic performance has not been easy to determine. A large number of early microeconometric studies have found mixed effects, but many of these early studies suffer from a number of serious problems: small and unrepresentative samples of firms; misreported or mismeasured data; limited controls for other major shocks that occurred at the same time as privatization; a short period of observations after privatization; and, above all, not controlling adequately for selectivity bias. Selectivity bias is likely to be a particularly serious problem since better-performing firms tend to be privatized first (Gupta, Ham, and Svejnar, 2001). Thus, comparing the postprivatization performance of privatized firms to the performance of the remaining state-owned firms without controlling for selectivity bias, as many studies do, will erroneously attribute the superior performance of the privatized firms to privatization. Recent studies suggest that in the first decade after privatization, relative performance improved considerably in firms privatized to foreign owners but not (or not much) in those privatized to domestic owners (for example, Hanousek, Kocenda, and Svejnar, 2005; Sabirianova, Svejnar, and Terrell, 2005). This provides sobering evidence because the general expectation was that there would be much improvement in the efficiency of firms as a result of privatization.

Table 3

Private Sector Share of GDP

	1992	1994	1996	1998	2000	2001	2002	2003	2004	2005
Czech Rep.	30	65	75	75	80	80	80	80	80	80
Hungary	40	55	70	80	80	80	80	80	80	80
Poland	45	55	60	65	70	75	75	75	75	75
Slovak Rep.	30	55	70	75	80	80	80	80	80	80
Slovenia	30	45	55	60	65	65	65	65	65	65
Estonia	25	55	70	70	75	75	80	80	80	80
Latvia	25	40	60	65	65	65	70	70	70	70
Lithuania	20	60	70	70	70	70	75	75	75	75
Bulgaria	25	40	55	65	70	70	75	75	75	75
Croatia	25	40	55	60	60	65	65	60	60	60
Romania	25	50	60	70	70	70	70	65	70	70
Russia	10	40	50	55	60	60	65	70	70	65
Ukraine	30	65	75	75	80	80	80	65	65	65

Source: *EBRD Transition Report*, various issues

Domestic and foreign direct investment

The communist countries, like the East Asian tigers, were known for high rates of investment, often exceeding 30 percent of GDP. The investment rates slowed down to about 30 percent in the 1980s in a number of countries. They declined further to about 20 percent of GDP in the 1990s in a number of transition economies (EBRD, 1996), although countries such as the Czech and Slovak Republics maintained relatively high levels of investment. In the 2000s, investment has been maintained at relatively high levels, ranging in most countries between 20 percent and 30 percent of GDP. The issue, outside of foreign-owned firms, has been the efficiency of investment.

As Table 4 shows, in the early 1990s, Hungary was the only transition economy receiving a significant flow of foreign direct investment (FDI) as a result of being the only country that was hospitable to and had well-defined rules for FDI. But starting in the mid- to late 1990s, major foreign investments went to the Czech Republic, Poland, Slovakia, and the Baltic States. In the last few years, FDI inflows have increased dramatically throughout the transition economies, rising from $20 million to $30 million per year in 1998-2003 to $39 million in 2004 and an estimated $48 million in 2005 (EBRD, 2005). Estonia has been the largest recipient of FDI on a per capita basis, but a number of other countries, including Azerbaijan, Croatia, the Czech Republic, Hungary, Kazakhstan, Latvia, and Slovakia, have been receiving considerable per capita inflows of FDI. Even Russia reversed capital inflows and has started receiving significant FDI inflows over the last three years.

The rate of FDI appears to increase with several factors: the proximity of the perceived date of accession of a given country to the EU; the desirability of the country's political, economic, and legal environment; and the availability of attractive privatization projects in the country. At the micro level, FDI is associated with both higher levels and higher rates of improvement in efficiency of firms (Sabirianova, Svejnar, and Terrell, 2005).

Table 4

Foreign Direct Investment, Net Inflows (Millions of U.S. Dollars)

	1990	1992	1994	1996	1998	2000	2002	2003	2004*	2005**
Czech Rep.	132	983	749	1,276	3,591	4,943	8,276	1,895	3,917	8,500
Hungary	311	1,471	1,097	2,279	3,065	2,190	2,590	874	3,653	3,500
Poland	0	284	542	2,741	6,049	9,324	3,901	3,927	5,353	6,431
Slovak Rep.	24	100	236	199	374	2,058	4,007	549	1,259	1,800
Slovenia	-2	113	129	167	221	71	1,489	-139	277	346
Estonia	na	80	212	111	574	324	153	763	781	2,500
Latvia	na	29	279	379	303	400	374	328	538	622
Lithuania	na	8	31	152	921	375	715	142	510	655
Bulgaria	4	41	105	138	537	1,003	876	2,070	1,232	2,697
Croatia	0	13	110	486	835	1,085	591	1,700	898	1,000
Romania	-18	73	341	415	2,079	1,051	1,080	2,156	5,020	5,300
Russia	na	1,454	409	1,657	1,492	-463	-72	-1,769	2,132	5,000
Ukraine	na	170	151	516	747	594	698	1,411	1,711	900

* Estimate / ** Projection
Source: *EBRD Transition Report 2005*, World Bank World Development Indicators

Employment adjustment, wage setting, and unemployment

State-owned enterprises in all the transition economies absorbed the output decline by rapidly decreasing employment and/or real wages in the early 1990s (Svejnar, 1999). In most transition economies, the employment decline reached 15 percent to 30 percent in the 1990s and was followed by stagnation or only modest increases in employment thereafter (Boeri and Terrell, 2001; World Bank, 2005). When combined with the GDP data in Chart 1, the employment data suggest that restructuring in the transition economies involved an initial decline in labor productivity as output fell faster than employment and a subsequent rise in productivity as output grew and employment stagnated. This development has become known as "jobless growth."[2]

Unemployment was unknown before the transition, but it emerged rapidly and openly in the central European countries (except for the Czech Republic), and as both open and hidden unemployment in the Baltic countries and the CIS (Table 5). In particular, in the early to mid-1990s, the Czech Republic was a model of a transition labor market, characterized by high inflows of workers into and outflows of workers out of unemployment. Unemployment, hence, represented a short, transitory state between old and new jobs (Ham, Svejnar, and Terrell, 1998, 1999). Unemployment rose more slowly in the CIS and the Baltic countries, as firms were slower to lay off workers and used wage declines and arrears as devices to hold on to workers.

Over time, the patterns of unemployment have shown considerable differentiation as well as gradual convergence. The Czech Republic, the CIS, and the Baltic countries experienced gradual increases in unemployment as their transition proceeded and, in the 2000s, most countries have had high unemployment rates that are at least as high, and often significantly exceed, those observed in the EU. It is notable that two of the fastest growing economies, Poland and Slovakia, have continued to suffer from chronically high (15 percent to 20 percent) unemployment rates.

Table 5

Unemployment Rate

	1992	1994	1996	1998	2000	2001	2002	2003	2004	2005	2006**
Czech Rep.	2.6	3.2	3.5	7.5	8.8	8.2	7.3	7.8	9.8	8.9	8.7
Hungary	9.3	10.7	9.9	7.8	6.4	5.7	5.8	5.9	6.1	7.2	7.1
Poland	14.3	16.0	13.2	10.4	16.4	18.5	19.8	19.2	19.6	18.2	16.9
Slovak Rep.	10.4	14.6	12.8	15.6	17.9	19.8	17.9	17.4	14.3	11.7	11.3
Slovenia	8.3	9.1	7.3	7.6	7.2	5.9	5.9	6.7	10.6	10.1	9.6
Estonia	na	7.6	10.0	9.9	13.6	12.6	10.3	10.0	9.7	7.9	6.4
Latvia	3.9	16.7	19.4	14.0	14.4	13.1	12.4	10.6	8.5	7.5*	7.4
Lithuania	1.3	3.8	16.4	13.3	16.4	17.4	13.8	12.4	6.8	4.8	4.5
Bulgaria	15.3	12.8	12.5	12.2	16.4	19.5	16.8	12.7	12.7	11.5	10.1
Croatia	13.2	14.5	10.0	11.8	16.1	15.8	14.8	14.3	18.7	18.0	17.4
Romania	8.2	10.1	6.5	10.4	10.5	8.8	8.4	7.2	6.3	5.9	6.1
Russia	5.3	7.8	9.9	13.3	10.5	9.0	8.0	8.3	8.2	7.6	7.5
Ukraine	0.2	0.3	1.3	3.7	4.2	3.7	3.8	3.6	3.5	3.1	3.8

* Estimate / ** Projection

Sources: ILO Survey Data, Economist Intelligence Unit, *EBRD Transition Reports*

Note: For most countries, data based on ILO methodology.

Data on income distribution, expressed in the form of Gini coefficients, are summarized in Table 6.[3] The communist countries had highly egalitarian income distributions, but inequality increased during the 1990s, with the Gini coefficient rising from 20 to 25 in the late 1980s to 24 to 32 in central Europe, low 20s to low 30s in Bulgaria and Romania, 23 to 30 in Ukraine, and 26 to 40 in Russia. These coefficients bring inequality in the transition economies into the range spanned by capitalist economies and in line with developing countries, such as India. However, the Russian and Ukrainian data in Table 6 may well understate the extent of inequality. In particular, the data from the Russian Statistical Office (Goskomstat) are based on wages that firms are supposed to be paying to workers, but, until recently, many Russian firms were not paying contractual wages (Desai and Idson, 2000). Inequality calculations based on survey data from the Russian Longitudinal Monitoring of households, for instance, suggest that income inequality in Russia has reached much higher levels—a Gini coefficient of 52—resembling the level of inequality found in developing economies with the most inegalitarian distribution of income. Interestingly, the relatively egalitarian structure of income distribution in central European countries has been brought about by their social safety nets, which rolled back inequality that would have been brought about by market forces alone (Garner and Terrell, 1998). The Russian social safety net has been regressive, making the distribution of income more unequal than it would have been without it (Commander, Tolstopiatenko, and Yemtsov, 1999).

The key finding is that inequality has increased during the transition; the increase has been greater in the east and has depended on the relative importance of changes in the distribution of wages, employment, entrepreneurial incomes, and social safety nets. Unlike in central Europe, in Russia, there has been a rapid rise in wage inequality, which, in turn, has had a strong effect on income inequality dynamics. What seems to have been a dominant common driver of inequality in all the transition economies is wage decompression, resulting from the attenuation of the centralized wage setting and the high return to skills associated with globalization (Munich, Svejnar, and Terrell, 2005; Gupta and Yemtsov, 2005).

Table 6
Income Distribution

	Late 1980s– Early 1990s		1990s		Late 1990s– Early 2000s	
	Year	Gini	Year	Gini	Year	Gini
Czech Rep.	1988	20.0	1992	23.0	1996	25.4
Croatia	1988	28.6	1998	29.7	2001	29.0
Hungary	1987	24.4	1992	26.0	1998	24.4
Poland	1987	25.0	1993	29.8	1998	31.6
Slovak Rep.	1988	19.5	1993	21.5	1996	25.8
Slovenia	1987	19.8	1993	24.1	1998	28.4
Bulgaria	1989	21.7	1993	33.3	2001	31.9
Romania	1989	23.3	1994	28.6	2000	30.3
Russia (a)	1991	26.0	1993	39.8	2000	39.9
Russia (b)	1992	54.3	1994	45.5	1996	51.8
Ukraine	1988	23.3	1996	33.4	1999	29.0

Sources: (a)Based on Russian Statistical Office (Goskomstat) data; (b) Based on Russian Longitudinal Monitoring Survey; other data: World Bank Development Indicators

Attitudes of the population

In many countries, opinion surveys indicate that the majority of individuals feel that it was worthwhile to change the political and economic system. However, in many countries, throughout the 1990s, even more people believed that the losses from transition exceeded the gains than the reverse (Svejnar, 2001). Similarly, in the 1990s, many respondents felt that their "material conditions of living are now a little worse" than the reverse. By 2004, the situation had improved, but in many countries of central Europe and the Baltics, there are still surprisingly positive attitudes expressed toward the old regime (Kornai, 2006). It is likely that the sentiment in the more poorly performing countries is even more pessimistic. The attitudinal survey, hence, provides a sobering assessment of how people in the most advanced transition economies feel about the benefits and costs of the transition.

Assessment and strategy going forward

The performance of the transition economies was poor in the initial phase, but it has rebounded since the 1990s. The strategies pursued by the policymakers have worked in that recently the transition economies have constituted one of the fastest growing regions of the world.

Geography has been an important factor, with the transition countries farther east, on average, performing worse than their more western counterparts in the 1990s, but better in the 2000s. Interestingly, geography had little impact on whether the countries carried out Type I reforms—macroeconomic stabilization; price liberalization; small-scale privatization; opening up to trade and gradually to capital flows; reduction of subsidies to state-owned enterprises; elimination of the monobank system; removal of barriers to the creation of new firms; and introduction of a social safety net—which all transition economies carried out relatively fast. However, geography did affect the nature and speed of Type II reforms: large-scale privatization; in-depth development of a commercial banking sector and effective tax system; labor market regulations and institutions related to the social safety net; and establishment and enforcement of a market-oriented legal system and accompanying institutions. The reform of greatest importance seems to be the development of a functioning legal framework and corporate governance of firms. Countries that placed emphasis on this reform early on, such as Hungary, Poland, and Slovenia, performed better in the 1990s than those that did not, such as the Czech Republic, Russia, and Ukraine.

What does the experience imply for strategies going forward? The overview provided in this paper suggests that there are six important elements for a successful strategy in the mid- to late 2000s.

1. Maintaining macroeconomic stability is a key element of success for these countries. The central banks have succeeded to bring inflation under control and provide investors with an important sense of stability. In this respect, maintaining a noninflationary environment is a key element of a successful strategy going forward. It is indispensable for those aspiring to join the EU and adopt the euro. The challenge is how to accomplish stability while carrying out important fiscal reforms, especially in the areas of pensions and health (where existing programs are expensive and unsustainable), and infrastructure, education, and research (where investment is needed for growth).

2. Retaining competitiveness and creating "good" jobs is a high-priority item for the transition economies. The record to date is one

of an initial drop in the employment rate, followed by "jobless growth," which may be worse than growth of both output and jobs. But it signals major increases in productivity and is obviously much better than "jobless stagnation" that is observed in a number of other countries around the world. The challenge for many of the transition economies is how to make their labor markets more flexible and less burdened by payroll taxes. Using American-style layoff taxes together with reduction in employment protection would be sensible, since it makes employment protection financial rather than administrative and provides compatible incentives to firms and workers. Combining this with a shift of taxes from payroll to another base would have beneficial effects in discouraging layoffs and encouraging hires.

3. Maintaining or increasing FDI inflows and increasing the efficiency of domestic firms is an important priority. The transition countries have been increasingly attracting foreign investment, and foreign firms have created high-paying jobs and led these economies in innovation and increases in efficiency. They appear to have had positive spillovers on local suppliers, though not on local competitors. In central Europe, the Baltic states, and increasingly the Balkan countries, one observes a major improvement in the efficiency of the economy, with FDI being a key catalyst of the observed change. In Russia and the other CIS countries, one observes a boom driven by a combination of rising natural resource prices and real turnaround of economic activity in industry and services. The latter phenomenon is recent and still somewhat fragile. Ensuring that both foreign and domestic producers become the engine of economic growth is an important element of a successful strategy.

4. Improving the levels and effectiveness of human capital is an important driver of future economic growth. The transition economies historically have had high levels of education relative to other developing countries. Most have failed to invest adequately in human capital (and research and development) during the last two decades, however, as fiscal pressures restricted government expenditures in this area. Yet, at least for the resource-poor economies, specializing in higher-value-added activities based on human capital is a sensible strategy to pursue in the future.

5. Containing the discontent of the population with respect to the transition reforms is crucial. Inequality, poverty, and uncertainty have risen in virtually all the transition economies, resulting in considerable discontent on the part of many citizens. The strategy going forward needs to contain and reduce these phenomena, while addressing the tradeoff between "inequality as a determinant of poverty" and "inequality as a factor that provides incentives for effort and risk taking."

6. Finally, maintaining liberal democracy and protecting human rights needs to be taken as a prerequisite for future development of these countries. The transition economies have been carrying out economic reforms while striving to create democratic systems and protect human rights. (China and Vietnam have pursued a different model.) These aspects of the transition have been widely recognized as being inherently important, despite the fact that they have occasionally made economic reforms difficult to implement. As such, they need to be part of future growth strategies.

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Endnotes

[1]The exception is the Czech Republic, which experienced a recession in the late 1990s and, on average, hence, achieved a somewhat lower rate of economic growth.

[2]With production shifting from large to small firms, the decline in employment (and output) may have been less pronounced than suggested by the official data because small firms are harder to capture in official statistics.

[3]The Gini coefficient, which was invented by statistician Corado Gini, varies from 0 to 100, with 0 representing a perfectly egalitarian distribution of income (every individual or household receiving the same income) and 100 denoting the most inegalitarian distribution (one person or household receiving all income).

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