

### Economic transformation: state of art and some theoretical reflections

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**LÁSZLÓ CSABA**

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**Economic Transformation: State of Art  
and Some Theoretical Reflections**

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## **Economic Transformation: State of Art and Some Theoretical Reflections<sup>1</sup>**

Gone are the days when those specialising on Central and Eastern Europe were forced to rely on sporadic information released by the authorities and complemented by fanciful jigsaw-puzzle-playing by Kremlin watchers and other outside analysts. By now reporting has become standard, methods mostly come up to international standards, and international organisations as well as prestigious research centres and banks regularly cover current developments in the area. Information has become abundant rather than scarce. Decisionmakers and analysts alike tend to face the opposite problem, namely how to filter out relevant pieces of information from the flood.

It seems senseless to make an effort at recapitulating data on two dozens of countries. Instead, after commenting on some of the regional data (cf. appendix) first a comprised evaluation is attempted from the comparative perspective, trying to figure out one or two of those features which may be seen as truly new. Then, part II attempts to present a functional analysis on the base of the theoretical knowledge accumulated so far. Part three addresses the newly discovered problem of deregulation versus setting new rules of the game as a major new theme for transformation studies and policies alike. Finally part four tries to address those new subjects which are likely to replace the trinity of stabilisation, liberalisation and privatisation as main concerns for the post-transition phase of systemic change in the postsocialist world. In a way the analysis is bound to remain fragmentary, as the scope of the subject is better suited for a book - but even then it is unlikely to cover the entire subject in toto.

### **What's New?**

First and foremost the differentiation of the country group has become more pronounced than ever. Whereas post-Soviet states except the Baltic's continued to decline, Central Europe entered a new growth path. Recent econometric evidence (Fischer et al. 1997; Gelb et al. 1997) has demonstrated: whatever the method in use, whatever the way one tries to measure liberalisation, it is absolutely clear that disinflation and also liberalisation (both in the domestic and the external sectors) do constitute a vital precondition for growth to resume. Not only the alternative of softer approaches, exercised by the Ukrainian and Romanian governments in the 1992-96 period failed. The stabilisatory medicine, if not taken for long enough, could not help, as the softening up of originally very tough Romanian (Daianu

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1994) and Bulgarian (Houbenova 1994) stances amply demonstrated. By contrast, not only Croatia and Lithuania demonstrated, that sound policies do breed fruits, even if later started. Even in Russia as long as the presidential power has been strengthened, the cooperation of monetary and fiscal authorities ensured, and coherent economic policies not only promulgated (as under Gaidar in 1992) but practised, major breakthroughs in terms of disinflation, capital flows, exchange rate stability and enterprise plus banking behaviour could be observed (Csaba 1997). This settled the once much disputed issue, viz. that Keynesian growth generating policies could have alleviated the costs of economic change. Contrasting Polish and Ukrainian, or Estonian and Belorussian experience may suffice to prove the opposite. There is no way to escape from stabilisation, meanwhile these policies do generate growth, whereas postponing liberalisation and disinflation only lengthens the pain. The latter, not the former road leads to depression.

As far as the famous inflation versus unemployment trade off (Philips-curve) is concerned, this does not seem to hold, except for a brief introductory period when bankruptcies and layoffs first occur. Not only the Czech, but Polish, Hungarian, Slovak, Ukrainian and Bulgarian figures seem to defy this conventional wisdom. Unemployment seems to be closer correlated to labour market arrangements and overall socio-economic inertia (or the lack of it). East Germany, too, fits into this landscape.

Inflation, by contrast proved to be much harder to fight than most economic models forecast. It is remarkable, that even in the champions of price stability, the Czech and Slovak Republics, Slovenia and Croatia price increases exceed OECD levels and dangers of sticking in higher levels seem imminent. Detailed analyses of the Czech and Slovak cases (Frensch 1997) name gradualism in price liberalisation, informal wage equalisation practices (quasi-indexing) and problems of managing money supply with a fixed rate of exchange as the main causes. In Slovenia the small size of the country leads to a very strong push of the money supply due to the inflow of foreign capital, as the domestic money base is small. In Croatia, by contrast, keeping prices down coexists with the practice of de-facto credit rationing (Kraft 1996) thus a liberalisation of financial market, abolition of credit allocation and introducing the recoupment criteria (and international accounting standards) for banks may fundamentally change this picture in the future. In Hungary the 1995 adjustment package used a 10 per cent increase in inflation to suppress domestic uses of GDP in order to correct the current account. This, in turn, sustained inflationary expectations and renders attempts at fast disinflation, as currently contemplated by the government (to single digit levels by 1999) fairly unlikely. Also in Poland seems to have stuck in a high growth-moderate inflation scenario, typical of the developing (rather than of advanced) economies. Resumption of growth in the Baltic's also took place while inflation is still double digit. Finally

Balkan countries present cases for temporary rather than fundamental cures to this illness. In Serbia-Montenegro, the Avramovic-reforms could not be sustained, as the intertwined political and economic structures resisted the economic pressures for adjustment, that have been stemming from the monetary sphere. Fiscal overspending - partly due to defense expenditures, partly due to sustaining "core industries" - simply undermined exchange rate stability in a textbook-like manner in about 9 months. With 60 plus per cent inflation in 1996 the next attempt to stabilise will be even more costly and - less credible. In Albania, the improvements in macro-stabilisation - one much hailed in Washington - proved to be illusory and based on rather unconventional methods of management of both savings and cash-flows, which triggered an outbreak of social protest. Finally the new government of Victor Ciorbea has uncovered the malpractices of its predecessor in misreporting actual economic performance in 1994-96, and was forced to institute a Balcerowicz-type of stabilisation package. Even more severe measures had to be adopted by the centre-right Kostov administration in Bulgaria, where the toughest stabilisatory instrument available, the currency board (previously used successfully in Argentina, Estonia and Lithuania) was introduced from April 1997.

Unsurprisingly consumer price inflation has been closely interrelated to exchange rate developments. In this respect the choice of the exchange rate régime, as well as the congruence of this choice with fiscal and monetary policies has been of paramount significance. Discretionary and large devaluations though do improve the current account position, however they fuel inflation. Anchoring the rate of exchange, by contrast, may prove unsustainable, as was the case with the rouble and in 1994-96 with the dinar and the leu. Moreover fixed exchange rates, or alternatively real effective appreciation of the currency even under a crawling peg régime, like it is the case in Poland, produce sizeable trade imbalances. Recent Czech current account adjustment measures, which are comparable in size with the 1995 Hungarian package, do indicate that even large and regular invisibles may only partly offset trade deficits, if the latter are recurring. The same applies to Romania. In sum, transforming countries seem to have been pushed into a tricky balancing act between the need to ensure exchange rate stability (in order to foster foreign investments and domestic price stability) on the one hand, and keeping their current account equilibria in order, on the other. Not only institutional rigidities and inertia, but probably also the size and scope of those truly historic rearrangements may explain why these conflicting goals could not be so simply reconciled as econometric models in international trade theory would suggest. Structural, institutional, trade and employment changes have been compounded with inexperienced administration working under conditions of extreme uncertainty. To name but a few of these: frequent changes in government, unforeseen behaviour of major economic agents, including the state, households and the corporate sector, the type of relevant assumptions regarding fundamental macroeconomic variables,

problems inherent in managing new techniques; ambiguous signals arriving from the major point of orientation, the EU.

By contrast, it is worth recalling some problems, which used to figure high on the agenda but has not proved to be decisive. Stabilisatory policies did work even if the institutional infrastructure of their application was imperfect. The technology of privatisation mattered relatively little against the revealed preferences of the government. For instance, Hungary proceeded not only faster, but also deeper in scope while relying on standard methods (cf. the evaluation of *Neue Züricher Zeitung*, 10/11 May 1997), whereas reliance on vouchers could not help a basically disinclined Bulgarian government. Recovery has not been conditional on external financing. Bulgaria, Romania and the Ukraine were running debts in vain, whereas the net position of Baltic states even improved while growth resumed. Debt and growth are no longer fellow travellers, as once development economics used to postulate. On the contrary: the quickly growing debt is likely to put a brake on the previous government-lead dynamics of the Slovak economy as well (Altmann 1997) - a lesson Hungary, Romania and the Czech Republic had to recapitulate quite recently. Finally the interrelationships between stabilisation and systemic change could also be better understood by now. Stabilisation is clearly possible without any systemic change, as the economy of Ukraine and Belarus<sup>2</sup> recently indicated. However, such a stance can not be sustained short of systemic change or massive external financing. The union treaty of March 1997 is an obvious attempt on the Belorussian side to find a bridging solution to a trade deficit which runs regularly at a tenth of its GDP. One wonders, whether Russian economic interest matches this, or even if a strategic wish were there to do so, real possibilities would probably still be lacking. But the story can, indeed, be reversed: Russian, Croatian and Baltic experience indicates, that systemic progress in change positively requires stabilisation.

In sum, even a rudimentary overview of basic statistic is indicative of transformation being an excellent subject of conventional economic analyses, where some of the basic assumptions of economic theories could be tested. Empirical evidence could, indeed, be interpreted on the base of available knowledge, fitting quite well into well established oretical frames. Thus frequent outcries calling for brand new theories, of questioning the use of available economic framework seem poorly founded, indeed.

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<sup>2</sup> The best source of information on this matter is Belarus Economic Trends of the EU Tacis programme, edited in Minsk. The doubts of German economic analysts do not extend to the figure of price increases, as these are largely administered steps.

## **New Perceptions of Transformation**

In a way transformation studies have been catching up with the international literature on policy reform (cf. e.g. Williamson 1994) in so far as sustainability rather than systemic design or technologies of implementing particular policies has become the top item on the agenda. Similarly to Latin American experience, problems of backlash and regressions into past practices have captured the attention of analysts. These turns produced a new trend in dynamic modelling as well as new policy suggestions - a development yet to take place in transformation studies. This is a problem, as early expectations of quick fixes, of fast emergence of „natural“ capitalist institutions never materialised. In the transitory period these and some other qualitative issues have come to the fore. In a way, front runners have been confronted with some problems that are quite familiar to those faced by advanced societies. This, indeed, may be taken as a sign for the transitory phase being over, or an indirect success indicator (Bönker 1995, 203-204) if lobbying, rent-seeking and building of redistributory coalitions, i.e. OECD-normalcy starts to replace the heroic ideological controversies and grand projects of the early years.

Sustainability gains in importance as long as it is appreciated, that at the policymaking level, the convenient assumptions of economic theory on instantaneous adjustment simply do not apply. Thus one of the most demanding tasks of both analysts and policy advisers is to orchestrate support for sensible policies and launch measures that set into motion virtuous rather than vicious circles and synergies. A fair degree of policy continuity may well emerge spontaneously, as was the case in Poland in 1991-97 as well as in Slovakia since 1993, in Estonia since 1991, in Hungary and in Slovenia since 1989. This is both good news and bad news. Good news as all sustainability rests on institutionalisation<sup>3</sup> and self-propelling processes, which did seem to come about. It's bad news insofar as spontaneously evolving policies may remain half-hearted, inconsistent or simply running out of steam. East Germany may be a point in case. Though researchers have been recurrently cautioning against the neglect of bottom up entrepreneurship and the whole related issue of SME, this problem is beginning to be taken seriously only recently, with the five institutes forecasting truly „Western levels“ of growth for the Eastern provinces, 2 p.c. in 1997 and 2.5 p.c. for 1998 (cf. Neue Züricher Zeitung, 23.04.97). This implies that 1996 was not a mere derailment. In the Czech Republic the governing coalition seems to have had a sure bet for its repeated victory, thus slowed down structural reforms. The emergent impasse in 1996, with the opposition calling for a further go-slow (which was the practice, not the platform of the Klaus administration) may exacerbate the problem by the lack of support for privatisation and foreign strategic ownership in the

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<sup>3</sup> This means a point, when a headline on 'The fate of reforms rests with the election or sacking of Mr. X' becomes not only senseless but also irrelevant.



financial sector.<sup>4</sup> As crises of small banks tended to be covered up by their merging in the large banks, the emergent duopoly of Ceska Stroitelna + Csob versus Komerčni Banka will be hard to privatise, if only for reasons of size (Boland, 1996). The idea of first letting an equity market to emerge and later regulating it, turned out to be counterproductive, with an unregulated but also intransparent market leading to strange concentration of power combined with lasting volatility bearing no relation to corporate performance (Reed 1997).

A similar running out of steam could be observed also in Hungary between July 1992 and March 1995, as well as in Poland in the 1993-95 period. In both cases wide ranging structural reforms were though planned, but their implementation foundered on the resistance of interest groups capitalising on the unreformed arrangements. In this respect economic analysis bumped into one of the evergreens of political science, when the limits to consensual decisionmaking was raised in the context of ever protracting major reforms and rearrangements (Kornai 1995/96). And indeed, some of the rearrangements pertaining to the fundamentals of the previous social contract, like the redistribution of wealth or the retooling of the welfare state will hardly come about if each and every step of it has to pass a referendum. This is not to belittle the need for building up reform constituencies, but the scope of transformation is probably such that traditional buying out compensation corruption techniques are probably incommensurate to this task.

And indeed, when the Hungarian government in 1995 and the Polish government in late 1996 ceased to adhere to the previous unwritten rules of the game, major systemic breakthroughs occurred. In Hungary large scale privatisation of utilities and the banking sector took place. In Poland some of the previously protected large banks, Bank Handlowy and PBK majority shares were sold, and foreigners were entitled to buy fixed assets and non-agricultural land (Wall Street Journal and Neue Züricher Zeitung, both 8 April 1997). In both countries the government decided to introduce a pension system based on three pillars, two of which are managed by investment funds.<sup>5</sup> Also in Russia the highly successful disinflation policies were clearly a result of what may be termed the hijacking of the President's original (populist) electoral economic platform (Glaziev 1997). In Romania likewise, the Ciorbea government seems to have made good use of its original grace period to pass long overdue adjustment measures and launch also restructuring. A list of 10 large bankrupt companies was set up to be closed, and the privatisation agency subordinated to the government to overcome resistance to accelerated privatisation (Máté 1997).

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<sup>4</sup> Roman Ceska quoted in Wall Street Journal Europe, 16 July 1996. The same source quotes also the OECD criticising this stance.

<sup>5</sup> A similar Czech project is in the phase of elaboration.

The major question in all the cases enumerated lays not so much in investigating the peculiar circumstances having lead to these developments, but rather the ways and means of orchestrating these into a sustainable policy line. The answer is non trivial. While in Bulgaria the April 1997 standby and the resultant currency board will probably ensure stabilisation, in systemic arrangements no such anchoring seems feasible. Once privatisation and especially foreign ownership crossed a certain threshold, there is a point of no return. For instance in Hungary the consolidation and following privatisation of the big banks to foreign strategic investors (Balassa 1997) has certainly brought about such a change. In Germany the constitutional form of reunification has solved the problem. In Russia the erosion of state power leaves no other way for the national leadership than to rule by money. Privatised banks and industries seem to favour this too (Dmitriev 1996). In Poland nomenclatura privatisation and the foreseeable threat of an exploding pension system make a continuation of this line highly probable, irrespective of election outcomes. In many other cases, where the intertwining between government and (quasi)privatised enterprises and banks remain intimate, as in Croatia or Slovakia, a different sustainability of a different dynamics of change seems more likely. In other words, while it might be quite a challenge to specify the mechanics and trajectory of systemic changes, there is no reason to accept or forecast a scenario of reform blockage, widely entertained in the political science literature on transformation.

Once we face the fact that a.) systemic change is not a mere transition to a prearranged terminus on a well established trajectory (cf. above), further b.) therefore the shock versus gradualism debate is meaningless and misleading (Hoen 1996), it is the quality rather than the speed, scope rather than radicality of transformatory measures which will be decisive. This also implies that simple, easily accessible and handy quantitative indicators may be of little use if actual progress in systemic change is to be correctly assessed, be that in theory or in policymaking terms. This is bad news: once an economy is liberalised and basically privatised, as the OECD membership of front runner transforming countries testifies, and inflation is also gradually cooling down, a new agenda is required for analyses. By the way quantitative indicators did not foretell Albanian or Romanian changes of 1996/97. With subsidy cuts basically gone the genre of changes is becoming strikingly similar to those in OECD countries: reform of the welfare state, rearranging agriculture, fighting environmental degradation, integrating the lagging behind and the socially inactive in the overall social frame. While transforming economies are becoming gradually more akin to established market systems, their overall level of development compels them to face some of the obvious dysfunction's of current EU economies, rather than purely emulating them. For instance EU economies are saddled with a combination of low growth and high unemployment in a secular manner. In technological change multinational networks create new challenges and new opportunities. Liberalised financial

markets and their strong feedback exert disciplinary pressure on the free imagination of systems' designers. But these challenges also caution the transforming countries of simply copying the existing EU arrangements. As they are in the phase of reshaping their economic order, the way they set the new rules will be decisive for shaping the behavior of millions of agents inside and outside the region. For it is finally of the quality of the new regulatory environment which is to decide what pattern of behavior will better pay: a rent-seeking or a pro-competitive behavior (Csaba 1995). The slowing down of growth in the region in 1996-97 is a warning sign: overcoming transformational recession was a one shot impetus. Conditions for lasting and environmentally tolerable growth do not emerge by themselves: these have to be created. How this can be done will be the subject of future research, but some of its policy relevant elements are covered in the next two sections of this paper.

### **The Rediscovery of the Regulatory Issue**

As the early transformation stage was concerned with creating the fundamentals of any market economy by stabilisation, privatisation and liberalisation, the subject of the debate was basically the proper sequence among these, and the ways reform constituencies could be built up. Having mastered the triple task of the first stage, at least in the frontrunning countries of CEFTA, but also much of the problems having emerged in those lagging behind, the issue of regulation, including its quality comes to the fore. Let us address some of its dimensions!

1. As the policies of transformation tended to be formulated exclusively in terms of stabilisation rather than in terms of institution building<sup>6</sup>, especially in the early period, it is hardly surprising that the latter tended to be neglected (quite in line with the practices of the predominant formalised neoclassical approach in economic theory). Whereas theories can set their assumptions and levels of abstraction fairly freely, at the level of their application disregard for institutions - and other conditions theorists conventionally assume away - can be a source of difficulties. It is hardly surprising if the lack of the rule of law, the often insurmountable obstacles to contract enforcement and the frequently blurred state of proprietary rights together breed what US theorists call private enforcement techniques, and those in the region refer to as mafia capitalism. Weak state power, poor quality and often changing regulation (that may surface in thousands of decrees trying to address peculiarities that judiciary interpretation of what a stable and transparent law should) and very high profits from rent-seeking practices together created an ideal environment for these. It is worth noting, that not only in Southeast Europe and in the CIS can one observe these features, but

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<sup>6</sup> For reasons and details of this paradox cf. Csaba 1995, ch. 8.

also in the Baltic's, where good macrostatistics sometimes overshadow the twin burden of Soviet legacy and spill over of crisis phenomena from the entire post-Soviet region to these traditional "commercial gates" (Ostrowska 1997). It seems certainly naive to believe that this type of mafia capitalism would spontaneously transform itself into a more civilised edition of the market order purely because mafia bosses wish to secure their property rights. In fact, from Southern Italy to Korea, not to mention some stagnant „developing“ nations, one could observe the stabilisation of rent-seeking rather than competitive structures for historically longish periods of time. This can be explained in terms of standard economic theory. First, if one type of equilibria-emerges, short of external shocks, there is no reason for us do expect a change. Second, if in the years of formation of norms and rules rent-seeking behaviour pays off and the related informal institutions also crystallise, this will be internalised by the successful players and society at large as a role model. The probability of these structures to solidify rather than to be civilised is certainly high. This issue is far deeper in scope than the problem of corruption and of street violence would indicate. It creates a long term economic and security problem both for these states and their partners short of remedial actions. In theoretical terms it also means that the minimalist approach to the state (Aslund 1995; Naishul 1993) proved to be self-defeating as the outcome is - understandably - a long way from any version of a liberal market order. Thus in assessing market maturity of entry candidates both to NATO and EU it seems ill-advised to adopt a narrow technicist focus, as e.g. the 1995 White Book of the Commission did. Advancement in some areas, especially if it is formal, can certainly not make up for some qualitative characteristics that may well have gone under due to the much too technical focus of raising questions. The questionnaire of the Union also suffered from such a narrow approach.

2. It were equally naive to postulate that globalisation per se would tackle the issue. On the contrary, external investors in general, but especially portfolio investors adjust to the prevailing regulatory frame. Although examples of attempts at leveraging state administrations abound, it is fairly clear that the latter have a major responsibility for shaping the regulatory as well as the macroeconomic environment for the individual investor. Merely changing the ownership title, even if it implies a transfer to foreign private proprietor is but one step on the long road towards the market economy. It is worth noting that even this very first step is not always made. Decades of seclusion as well as the obvious interest conflict between national middle class building and transnational considerations of efficiency, as represented by MNCs has already produced a series of conflicts. These are particularly sharp and well publicised in case of the Russian energy and banking sectors, but also Polish, Czech, Slovak, Croatian and until recently Romanian privatisation policies were clearly burdened by the priority of societal considerations over efficiency.

In any economy with a strong tradition of seclusion reinforced by a lack of transparency and a habitual intertwining between banking and the state administration, establishment of a sufficiently high share of foreign ownership in financial intermediation is a *conditio sine qua non* for improving allocative efficiency over and above a trivial level of correcting the distortions inherited from the command economy period. This consideration will gain in importance with the time passing, as a factor decisively shaping long term growth patterns. In the first decade of transformation correcting distortions might well have done for a reasonable macroeconomic performance. By the turn of the century it will surely not be the case. Recent empirical analysis of the Polish and Czech banking reforms (Mizsei and Rudka, 1996) have already indicated some structural weaknesses of the respective sectors due to the lack of this elements. As it seems, the Polish government has made a resolute turn in the right direction in 1997 by accelerating privatisation, whereas the fragility of the Czech government, as well as disagreements with the central bank make similar solutions unlikely for some time to come.

Whereas in Slovakia, Romania, Bulgaria and Russia the role of FDI remained marginal, in Hungary the open door policies sometimes have lead to overgenerous arrangements for foreign investors. Large investors are granted tax holidays way above local SME, which is not in line with international practice (and was rightly criticised by OECD). In selling one of the largest banks BB, the buyer could opt for reselling (an obviously nonperforming) affiliation of this institution, which it did a year later at the cost of Hungarian taxpayers (Mrázik 1997). In other cases foreign investors push for - and often get - undue market protection, as Daewoo in Poland and Deutsche Telekom/Ameritech in Hungary.

In other words relying on more (and more sound) foreign strategic investment and creating an efficient and transparent while non-biased regulatory frame should go hand in hand in bringing about efficient policies of systemic change. It is worth recalling that efficiency and equity considerations are, in this case, mutually reinforcing each other. Estonian, Russian, Polish and Hungarian examples show that strategic investors, especially with greenfield investments often enjoy a very high social acceptance by virtue of their creating employment and paying public dues, that may be particularly relevant for municipalities struggling with chronic unemployment.

3. Financial sector reform is a subject where the problem of regulation is of paramount significance. This may well sound as a triviality for anyone specialising in financial economics. However in early transition theories and also in cases of certain countries this considerations was disregarded or played down. Especially radical theories of systemic change postulated a quick emergence of

the capital market thanks to voucher privatisation and the thus resultant massive trading of corporate papers on an instantaneously created equity market. By now the dangers inherent in this approach, which lead e.g. in the Czech Republic and Russia large scale trading of equities without any regulation (even registration), have become manifest. Large scale frauds lead to the collapse of investment funds and some smaller banks. Concentration of wealth took place in random fashion, where neither transparency nor efficiency considerations seem to have played a major role. Insider trading, usually prohibited in civilised countries, has become the norm. The Russian government's debt for equity programme of 1995 resulted in a particularly inefficient form of insider privatisation to financial rather than strategic investors, with little interest in or ability for restructuring.

It is interesting, that different techniques of orchestrating similarly conceived mass privatisation<sup>7</sup> have lead to a German-type bank dominated industrial management pattern in the Czech Republic, while the Italian type of political leverage/network seem to emerge in Poland, and even more in Croatia, Russia, Latvia and Slovakia. By contrast in Hungary the large share of foreign ownership as well as the widespread practice of financing via parent company<sup>8</sup> has simply abolished the state side of previous (public) bank-industry interlockage. Banks, as a rule, do not own industrial equities or companies, a feature only reinforced during their (pre)privatisation and the concomitant restructuring.

The problem of ex post regulation is well illustrated by the current endeavours of the respective governments to regulate and enhance prudential regulations. As a result, in Russia a very strong concentration in the banking sector emerged, with hundreds of small banks 'voluntarily' escaping into mergers to large Moscow-based banks. In the Czech Republic the concentration process is less transparent but all local analysts consider it as manifest. Governmental promotion of the earlier discussed duopoly situation and widespread bank ownership of industries via the investment banks though stabilises the system, however decreases competition and hardly bode well for dynamic allocative efficiency.

Lack of regulation took extreme forms in Albania where totally uncontrolled and intrasparent investment funds were positively supported by the governing Democratic Party (in exchange for alleged electoral financing in 1995). The inevitable chain collapse of the funds has created by March 1997 security challenge for the international community on par with Bosnia, as neither external nor domestic coverage for cheated investors emerged.

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<sup>7</sup> For a detailed discussion cf. Wagener (1997).

<sup>8</sup> As a result only half of the 18 bn \$ Hungarian external debt is public sector outstanding, the other half is privately owned, mostly MNC. This is a major sign of the country's having mastered its traditional debt problem.

In these - sometimes extreme - ways transforming societies were forced to rediscover the role of regulation in the financial sector. It also has become an empirical fact by now, that the equity market could not be the major instrument of asset valuation. Quite in line with continental practices the number of corporations whose shares are traded at the stock exchange is limited against those who fall outside of this category. While the some 100 companies whose papers are traded at the Budapest (and sometimes also on foreign) stock exchange constitute the backbone of the Hungarian economy, and with the privatisation of banking, energy and the utilities sector, both their share and their number will grow, the signals of the equity market will be but one among the success indicators of managers and their companies alike. In other words, following the first phase of transformation, equity markets are important as sources for cheap external financing (against the high real rates in the domestic banking sector<sup>9</sup>) as well as instruments of portfolio diversification. But the idea of their replacing the banking sector in generating savings and their controlling the market for managers proved to be far-fetched. On the other hand while the state proved quite dispensable as a provider of funds or a source of subsidies, meanwhile it proved irreplaceable as a regulator, setting rules, enforcing disclosure requirements<sup>10</sup>, check observance of auditing procedures, guarantee the savings (especially of small investors) and the stability of the system as a whole. These far-reaching tasks do not constitute any 'interventionist temptation' against free market ideas, as it was sometimes postulated by some theorists, but boil down to safeguarding the framework in which a competitive game makes sense at all. Lack of regulation plus mass privatisation, favoured by adherents of people's capitalism have invariably lead to more oligarchic structures than standard privatisation plus good quality regulation, even if the latter approach directly favoured large foreign investors. This finding is not so paradoxical, as it sounds, still is not widely appreciated as yet.

4. Privatising utilities and the energy sector is a relatively new phenomenon in the OECD countries as well. More often than not these sectors were organised in a nation-wide monopoly system run on commands. The breakthrough starting from Britain and spilling over to Scandinavia - much less to the rest of continental Europe - has resulted in impressive cost gains for consumers by retaining the stability of supply. In the British case households gained 15 p.c., industrial users 21 p.c. in 1990-96 in real terms, while the two monopoly suppliers' market shares fell from 80 to 54 p.c. (cf. *Neue Züricher Zeitung*, 29.04.97.).

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<sup>9</sup> Currently in Hungary it is about 8 per cent, in Russia about 20.

<sup>10</sup> Even share owners of investment banks might be denied of elementary, information in Russia and in the Czech Republic.

In transforming countries systemic changes offers an opportunity to overcome those structures, that lead to obvious inefficiencies and unjustified high costs in most of Western Europe. This would (have) require(d) a first regulate later privatise sequence. In reality, something else happened. Empirical analysis of the Hungarian energy sector, the largest privatisation deal regionwide of 1995 (Vince 1996) has disclosed the opposite sequence. Large producing capacities were passed over to often publicly owned-foreign investors, who have, of course no interest in breaking up the monopoly structures or introduce the spot market in place of an official formula based on marginal outlays plus 8 per cent guaranteed profit. Such an option, while much praised in terms of ownership change, may become a most serious obstacle to bringing down inflation to lower single digit levels by the time of EU-accession.

High energy prices certainly may be a matter for public choice. A strong emphasis on environmental concerns, or a priority to divest smoke chain industries, may well justify this option. But in this case - which would currently be hard to prove directly for Hungary, or even for Germany for that matter - the appropriate way of attaining this goal would be imposing a levy or an across-the-board environmental tax on energy users, which could feed a special environmental fund on recultivating damaged areas and/or prophylactic procedures. But leaving the fat profits with external investors,<sup>11</sup> or giving way to a corporate strategy aimed at modernising newly acquired assets exclusively from price rises in a traditionally loss making sector, were textbook cases of regulatory failures. In the latter case public policies are directly accountable for the perverse consequences of privatisation conducted on a simplistic unidimensional fashion with disregard for the economic fundamentals and rationale for the entire process.

5. It goes without saying that reforming the welfare state requires utmost attention to regulation. Both the health care and pension reforms are part and parcel of the social contract making the free market economy socially acceptable. Therefore the regulatory role of public policies will remain decisive even if fully funded systems were to replace the current de facto planned economies prevailing in both sectors.

Here several issues require regulation, even without getting down to the (hotly debated) bits and pieces of detailed legislation in the respective countries. First in both areas entitlements resulting from past legislation obviously overstretch financial capacities. This applies a fortiori in countries with low birth rates, high structural unemployment and ageing population. The situation is only

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<sup>11</sup> The point of criticism here is the opportunity cost of the actual procedure, i.e. foregone gains from a hypothetical competitive version of privatisation, not that investors collect their risk premium.



exacerbated by the need to cut social security contributions, currently the strongest disincentive to new employment and taxpaying private activities alike. Second, the employment situation in terms of decreased economic activity is already tough, thus any measure inducing more elderly job-seekers is likely to be rejected by the labour market. Incongruence of skills and jobs as well as decreased learning abilities of the aged make such reforms risky. Though the need to strike a clear dividing line between old-age beneficiaries and unemployed is there, retroactive measures will hardly do. Mistakes of early transition years, having channelled the lion's share of unemployed to the pension sector will be impossible to remedy, which in turn is likely to constrain any new model, which tries to exclude 'unqualified' hundreds of thousands or even millions. Third in health care the problem of cost explosion due to new techniques and new medicines looks insurmountable. Maintaining the equity oriented present systems will likely to accelerate the ongoing spontaneous privatisation. The latter, in turn, will create more divisive differences than a reform of the entire system could have produced. Fourth, good economics in these areas make previously implicit debts explicit and therefore immediately enhance fiscal burdens. This may run counter to a stability-oriented economic course.

A major danger is the lack of efficient regulation, which allows for parallel spontaneous privatisation processes, which in turn may disintegrate Central and East European societies in a way as was the case in the period prior to Count Bismarck's reforms. While life expectancy increased dramatically since then, the large family disintegrated, thus a mass phenomenon of the unattended elderly may create a civilisational problem even if it enhances labour incentives and related incomes.<sup>12</sup> As inflation has already eaten up the savings of much of this state across the region, any market-oriented reform's feasibility rests on the supplementary measures that are meant to cope with those millions whose fate is no longer in their own hands. The latter requires financing, whose costs must be incorporated in the consolidated balance sheet of these rearrangements. Studies currently available to me, including those of international agencies, fall short of addressing these issues in a satisfactory manner, which only reinforces the position of those opposing and obstructing any change in the name of equity. The latter is, as shown above, a sure way sack to a civilisational pattern given up in Europe more than a century ago.

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<sup>12</sup> For such a proposition cf. Sachs and Warner (1996).

### **Posttransition Transformation: from Quantity to Quality?**

What has been said above casts serious doubts over the efficacy of numerous attempts at creating quantitative indices of measurement of progress in systemic change. While in the phase of 'getting fundamentals right', or Transition to those set of arrangements that exist in any edition of a market order these might have made sense, in the later stage this situation changes. When stabilisation, liberalisation and privatisation is mastered, Transition is over. But transforming the system, as EU countries know only too well, is a never ending process. Welfare state reform, but also agricultural, labour market and environmental legislation must be brought up to the standards of the 21<sup>st</sup> century as well as of globalisation. Progress made here, but also advances in mastering the problematique discussed in the five points of the preceding section hardly lend themselves to quantitative assessment. This is particularly bad news for economists trained in formalised approaches. But also decisionmakers may find it embarrassing having to make qualitative value judgements, rather than referring to objective indices, in explaining their choices. In sum, while overall performance will be measurable as before, the usual trouble with the explanatory power of individual established theories of actual developments will haunt transformation studies as well. If such developments as stagnation of the Czech economy in 1997 or successful Russian disinflation in 1996 require major reassessments, the theories in question were not sufficiently sound, not appropriately generalised, or maybe irrelevant to the general subject.

Previous analyses have highlighted the focal role of structural reforms in creating sustainable development in Central and Eastern Europe (World Bank 1996). This also implicates that the decisive issue of the coming years (maybe even decades) will be the quality of governance. This emerges in a series of key areas as a recurring element of conclusions from sectoral studies. Corporate governance, i.e. the institutional arrangements mastering the principal-agent problem between owners and managers of large organisation is certainly one of the points in case. Likewise, the regulatory complex of the financial sector is more comprehensive an issue than it could be reflected in the state of fiscal balances. In fact, both the Albanian and the Czech derailment should lend emphasis to this consideration. Fiscal sector reform, though partly overlapping with welfare reform, is a subject on its own right. Here transparency, accountability, congruity with international accounting practices, as well as the ability to generate regular revenues sufficient to finance public outlays, as approved by legislation (but without) having to recourse extraordinary measures), may serve as evaluation criteria. In terms of legal reform formalistic approaches may prove counterproductive, insofar as similar rules work differently under dissimilar cultural conditioning. Thus more general concepts, as the rule of law or contestability of markets, seem to be better suited to produce

meaningful assessments as the percentage of EU or UN legislation incorporated into the national legal framework.

What has been said does not invalidate to use of standard methods and quantitative techniques in measuring various developments in transforming economies. But the subject of the present paper was not to put the performance of Central and East Europe into international perspective. Our task was to assess progress made and yet to be made on the bumpy road of systemic change. In answering the question about how much closer transforming countries have come to creating conditions for an internationally competitive and sustainable development, standard quantitative indicators give only the first clue. Industrial production or trade balance in the first quarter do not reflect our concerns. It may well be - as previously in the case of Chile, France and Britain, currently in case of Hungary or Russia - that sound policies do not breed immediate success. Moreover, they may even have to account for temporarily poor indicators. If, however, a sound analytical frame could be elaborated, that could probably enhance the predictive strength of available knowledge.

The present paper was an attempt to contribute to a better analytical understanding of the state and prospects of economic transformation in Central and Eastern Europe. Having surveyed quantitative and qualitative information, a synthesis was attempted in a comparative perspective. Our findings clearly emphasize the differences in performance in the 1990s. However, they also caution against the so often failed, still reemerging practice of using the past for predicting the future. Transformation studies try to identify, how congruous individual nations to EU are and will be. The outcome is a new research agenda, with an emphasis on qualitative aspects and a de-emphasis of short term indicators. Those relying on extrapolation to save the pains of a comprehensive assessment will, again, find themselves surprised all across the postsocialist region. The heritage of the past as well as the role of specific institutions, i.e. two factors abstracted away by neoclassical growth models will exert a growing influence on the developmental performance of the second decade of systemic change in Central and Eastern Europe, which is to reshape the landscape that emerge in the first phase. It is worth observing!

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**Table 1: Central and Eastern Europe in 1996**

	<b>GDP</b>	<b>Industrial Output</b>	<b>Inflation</b>	<b>Rate of Unemployment</b>	<b>Trade Balance (% of GDP)</b>	<b>Net External Debt</b>	<b>Stock of FDI</b>
<b>Eastern Europe</b>	4,0	7,1	n.a.	11,8	-9,7	71,1	30304
Albania	n.a.	n.a.	n.a.	12,3	-26,7	0,3	258
Bulgaria	-10,0	-1,0	311,1	12,5	2,0	9,4	399
Croatia	4,4	3,1	3,5	15,9	-17,6	2,6	609
Czech Republic	4,4	6,8	8,7	3,5	-11,5	6,1	7371
Hungary	0,5	3,3	19,9	10,5	-6,9	17,9	13377
Poland	6,0	9,1	18,6	13,6	-9,6	23,1	5492
Romania	4,1	9,8	56,8	6,3	-6,5	6,1	1184
Slovakia	6,9	2,5	5,5	12,8	-11,1	2,9	789
Slovenia	3,5	1,0	8,9	14,4	-5,9	1,7	786
Macedonia	1,6	3,2	0,3	39,8	-22,6	0,9	39
Serbia/ Montenegro	4,3	6,8	60,3	26,1	-15,3	n.a.	n.a.
<b>CIS</b>	-5,3	-3,4	n.a.	6,4	6,4	n.a.	n.a.
Russia	-6,0	-5,0	21,8	9,3	8,5	115,7	7519
Ukraine	-10,0	-5,1	39,7	1,5	-3,0	7,8	1245
Belarus	3,0	3,2	39,1	4,0	-4,0	0,9	57
Moldova	-8,0	-8,5	15,1	1,5	-10,1	0,3	167
<b>Baltic States</b>	3,4	1,7	n.a.	6,4	-18,6	-0,1	1787
Estonia	3,5	1,1	14,9	5,6	-26,4	-0,3	752
Latvia	2,5	0,7	13,2	7,1	-17,2	-0,2	775
Lithuania	4,0	2,8	13,1	6,2	-15,2	0,5	261

Source: ECE Economic Survey of Europe, 1996/1997.

**Table 2: Medium term overview of GDP in selected countries  
(real change in % against preceding year)**

	<b>1991</b>	<b>1992</b>	<b>1993</b>	<b>1994</b>	<b>1995<sup>a</sup></b>	<b>1996</b>	<b>1997</b>	<b>1998</b>
Czech Republic	-14,2	-6,4	-0,9	2,6	4,8	4,2	4,5	5,0
Hungary	-11,9	-3,1	-0,6	2,9	1,5	0,5	2,0	3,5
Poland	-7,0	2,6	3,8	5,2	7,0	6,0	6,0	6,0
Slovak Republic	-14,5	-6,5	-3,7	4,9	7,4	6,9	5,0	5,0
Slovenia	-8,9	-5,5	2,8	5,3	3,9	2,5	3,0	3,5
<b>CEEC-5<sup>b</sup></b>	-10,0	-1,5	1,3	4,2	5,5	4,6	4,8	5,2
Bulgaria	-11,7	-7,3	-1,5	1,8	2,6	-10,0	-3,0	---
Romania	-12,9	-8,7	1,4	4,0	7,1	4,1	0,0	2,0
<b>CEEC-7<sup>b</sup></b>	-10,7	-3,2	1,1	4,0	5,5	3,4	3,4	---
Croatia	-19,8	-11,1	-0,9	0,6	1,7	3,5	5,0	4,0
Russia	-5,0	-14,5	-8,7	-12,7	-4,2	-6,0	1,0	2,0
Ukraine	-11,6	-13,7	-14,2	-23,0	-11,8	-7,0	2,0	4,0

<sup>a</sup> Preliminary<sup>b</sup> WIIW estimate

Source: WIIW (1997), 1.

**Table 3: Overview developments in selected countries (1995 - 1998)**

	GDP real change (% against previous year )				Consumer prices change (% against previous year)			
	1995	1996	1997	1998	1995	1996	1997	1998
			forecast				forecast	
Czech Republic	4,8	4,2	4,5	5,0	9,1	8,8	9,5	8,0
Hungary	1,5	0,5	2,0	3,5	28,2	23,6	19,0	15,0
Poland	7,0	6,0	6,0	6,0	27,8	20,0	16,0	13,0
Slovak Republic	7,4	6,9	5,0	5,9	9,9	5,8	7,0	7,0
Slovenia <sup>b</sup>	3,9	2,5	3,0	3,5	12,6	9,7	9,0	9,0
<b>EEC-5</b>	5,5	4,6	4,8	5,2	---	---	---	---
Bulgaria	2,6	-10,0	-3,0	---	62,2	123,1	45,0	---
Romania	7,1	4,1	0,0	2,0	32,3	38,8	70,0	40,0
<b>CEEC-7</b>	5,5	3,4	3,4	---	---	---	---	---
Croatia <sup>b</sup>	1,7	3,5	4,0	4,0	2,0	3,5	4,5	5,5
FYR Macedonia <sup>c</sup>	-2,0	1,6	4,0	4,0	15,9	4,0	10,0	10,0
FR Yugoslavia <sup>c</sup>	6,0	4,0	1,0	1,0	74,1	95,0	80,0	50,0
Russia <sup>d</sup>	-4,2	-6,0	1,0	2,0	198,0	48,0	18,0	20,0
Ukraine	-11,0	-7,0	2,0	4,0	377,0	90,0	50,0	30,0
	Rate of unemployment (%, end of period)				Current account (US-\$ mn)			
Czech Republic	2,9	3,5	3,8	4,0	-1362	-4200	-4400	-4000
Hungary	10,9	10,5	10,5	10,5	-2480	-1500	-2000	-2600
Poland	14,9	13,5	13,0	13,0	-2299	-1000 <sup>a</sup>	-2500 <sup>a</sup>	-3500 <sup>a</sup>
Slovak Republic	13,1	12,0	13,0	13,0	646	-1500	-1500	-1000
Slovenia <sup>b</sup>	14,5	14,0	13,0	12,0	-36	-150	-200	-250
<b>CEEC-5</b>	12,1	---	---	---	-5531	-8350	-10600	-11350
Bulgaria	11,1	12,5	13,5	---	43	0	100	---
Romania	8,9	6,1	8,0	8,0	-1336	-1900	-1500	-1700
<b>CEEC-7</b>	11,2	---	---	---	-6910	-10250	-12000	-13050
Croatia <sup>b</sup>	17,4	18,0	19,0	19,0	-1712	-1200	-1200	-1200
FYR Macedonia <sup>c</sup>	39,1	42,0	40,0	35,0	-216	-300	-300	-300
FR Yugoslavia <sup>c</sup>	27,0	30,0	35,0	35,0	-500	-1200	-1000	-500
Russia <sup>d</sup>	8,8	9,3	10,0	11,0	12261	10000	8000	6000
Ukraine	0,6	2,0	9,0 <sup>d</sup>	12,0 <sup>d</sup>	-1545	-600	-600	-600

<sup>a</sup> Including net unrecorded exports.

<sup>b</sup> Consumer prices correspond to retail prices

<sup>c</sup> GDP corresponds to Gross Material Product

<sup>d</sup> Unemployment rate according to ILO methodology

Source: WIIW (1997), 12.

**Table 4: Consumer price inflation change in % against preceding year**

	1991	1992	1993	1994	1995 <sup>a</sup>	1996	1997	1998
Czech Republic	56,7	11,1	20,8	10,0	9,1	8,8	9,5	8,0
Hungary	35,0	23,0	22,5	18,8	28,1	23,6	19,0	15,0
Poland	70,3	43,0	35,3	32,2	27,8	20,0	16,0	13,0
Slovak Republic	61,2	10,0	23,2	13,4	9,9	5,8	7,0	7,0
Slovenia <sup>b</sup>	117,7	201,3	32,3	19,8	12,6	9,7	9,0	9,0
Bulgaria	338,5	91,3	72,9	96,2	62,2	123,1	450,0	
Romania	170,2	210,4	256,1	136,8	32,3	38,8	70,0	40,0
Croatia <sup>b</sup>	123,0	665,5	1517,5	97,6	2,0	3,5	4,5	5,5
Russia	92,6	1526,0	875,0	307,0	198,0	48,0	18,0	20,0
Ukraine	91,2	1210,0	5371,0	891,0	377,0	90,0	50,0	30,0

<sup>a</sup> Preliminary<sup>b</sup> Retail prices

Source: WIIW (1997), 4.

**Table 5: Real exchange rates in NCE per DEM (PPI deflated)  
(annual average change in %)**

	1991	1992	1993	1994	1995	1996 preliminary
<b>Czech Republic</b>	-4,4	-6,0	-13,7	-3,8	-1,4	-6,9
<b>Hungary</b>	12,0	1,8	-0,6	5,7	6,5	-4,6
<b>Poland</b>	-21,2	3,4	-4,9	2,9	-2,3	-7,8
<b>Slovak Republic</b>	-3,7	-2,0	-12,2	-2,8	-2,0	-6,1
<b>Slovenia</b>	8,6	0,5	8,2	-0,8	-6,1	2,1
<b>Bulgaria</b>	433,6	-3,3	-11,6	16,1	-7,5	2,7
<b>Romania</b>	-2,7	52,5	-11,9	-7,1	4,7	1,4
<b>Croatia</b>	-13,3	28,1	-21,9	-2,6	-0,2	-1,6
<b>Russia</b>	25,0	589,6	-65,3	-49,0	-32,0	-38,0
<b>Ukraine</b>	32,0	406,7	-52,5	-19,3	-5,9	-24,6

**Note:** National currency units. PPI: Producer price index. Producer price index.

Minus sign indicates real appreciation.

Source: WIIW (1997), 7.



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