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“Lessons and Challenges in  
Transition” Seminar

September 22, 2000

# Introduction

Two dominant 20th Century economic events:

- Socialist/Communist experiment--clear lessons
- Post-Socialist transition--controversial lessons

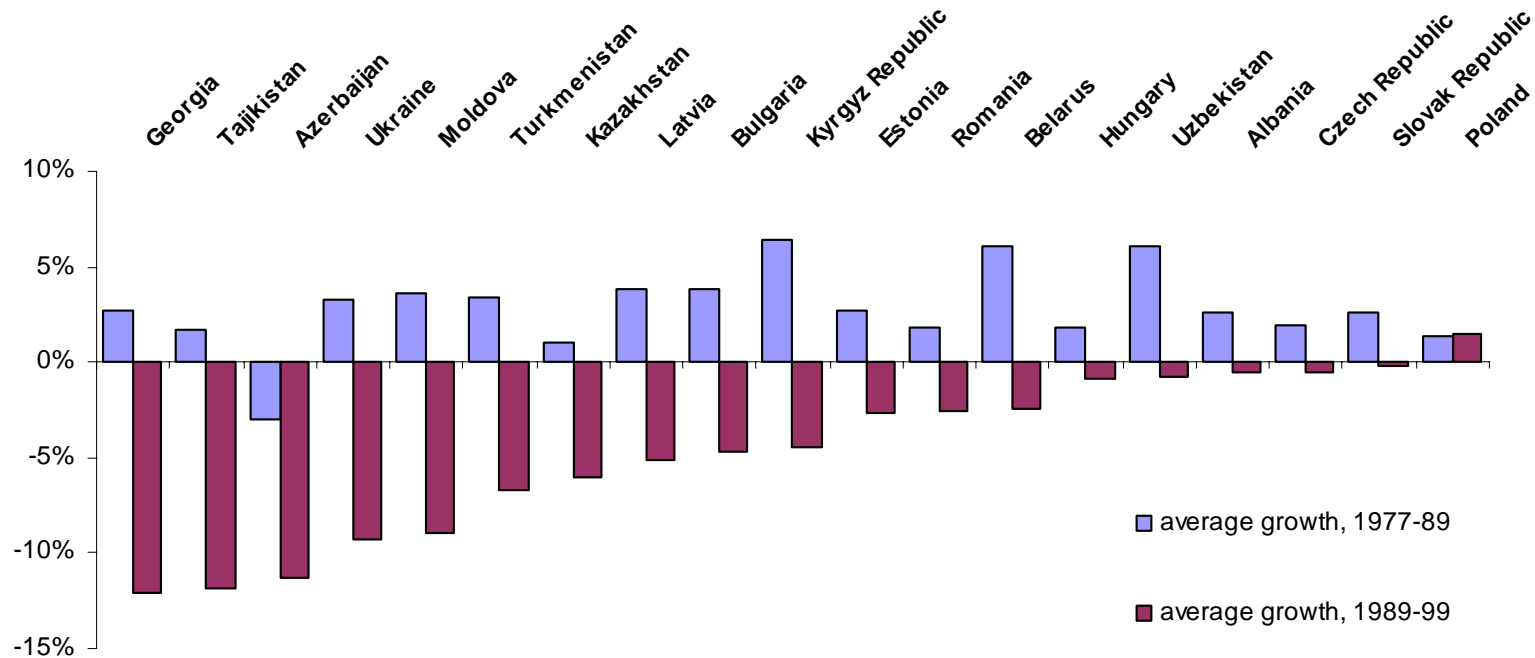
# Two Anomalies

- End of Socialism/Communism was supposed to increase GDP and living standards by allocating resources more efficiently:
  - Eliminating of central planning, substituted by decentralized market system
  - Eliminating of huge distortions through liberalization
  - Providing incentives through privatization
- Creating movement outward towards production possibilities curve
- Expected increases in standard of living greater than increase in GDP, as military expenditures are cut
- Expected benefits in long run greater than in short run as investment was reallocated
- In process of reallocating resources might be small downturn transition

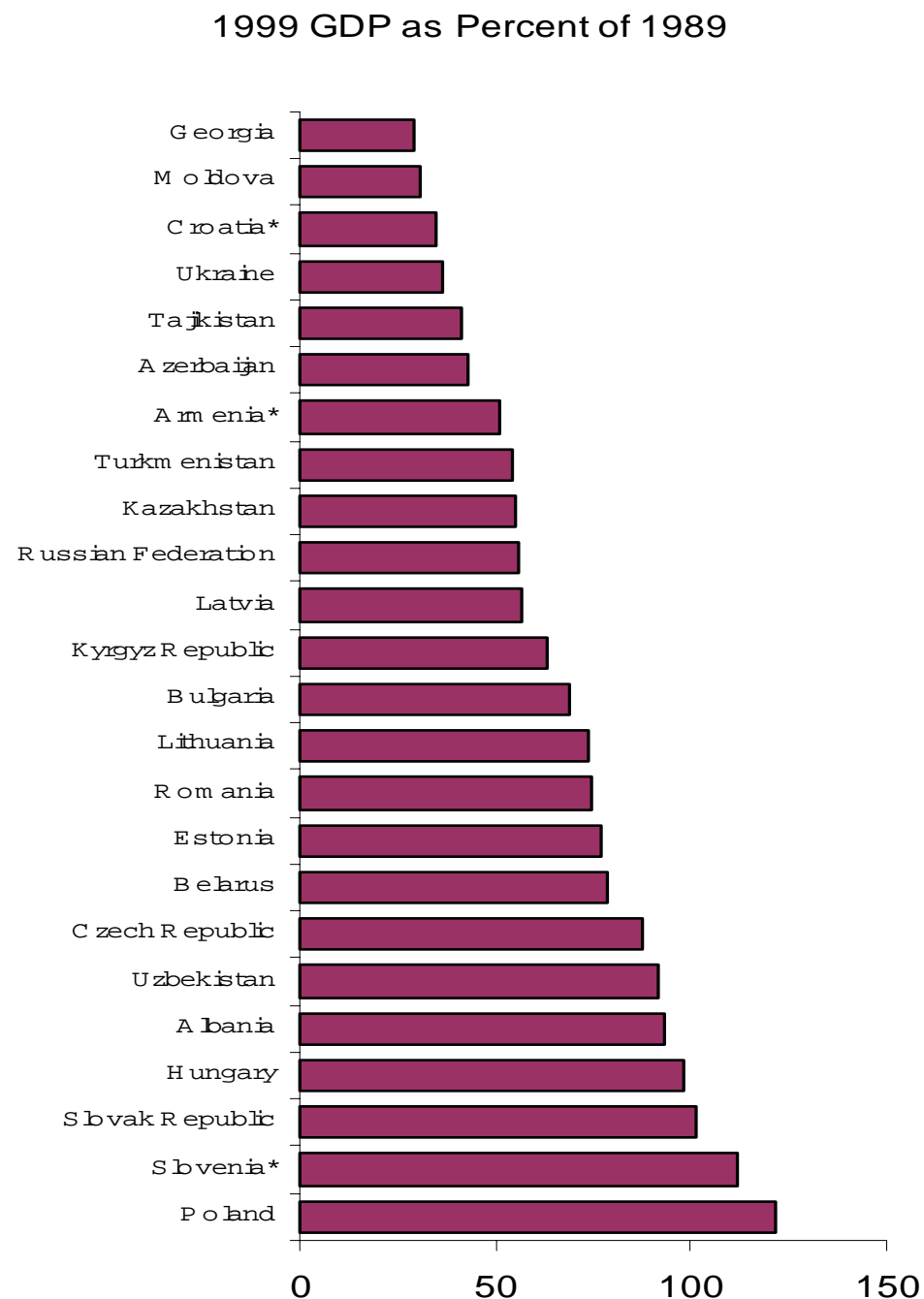
# Jarring Facts Inconsistent with Predictions

- Only a few countries have surpassed '89 GDP
- Most countries' growth rates have worsened during transition
- To regain where they *were* will take a long time
- Let alone to regain where they *would have been*, had previous growth been maintained
- Other social indicators have been broadly in line with these results
- But there are serious data problems

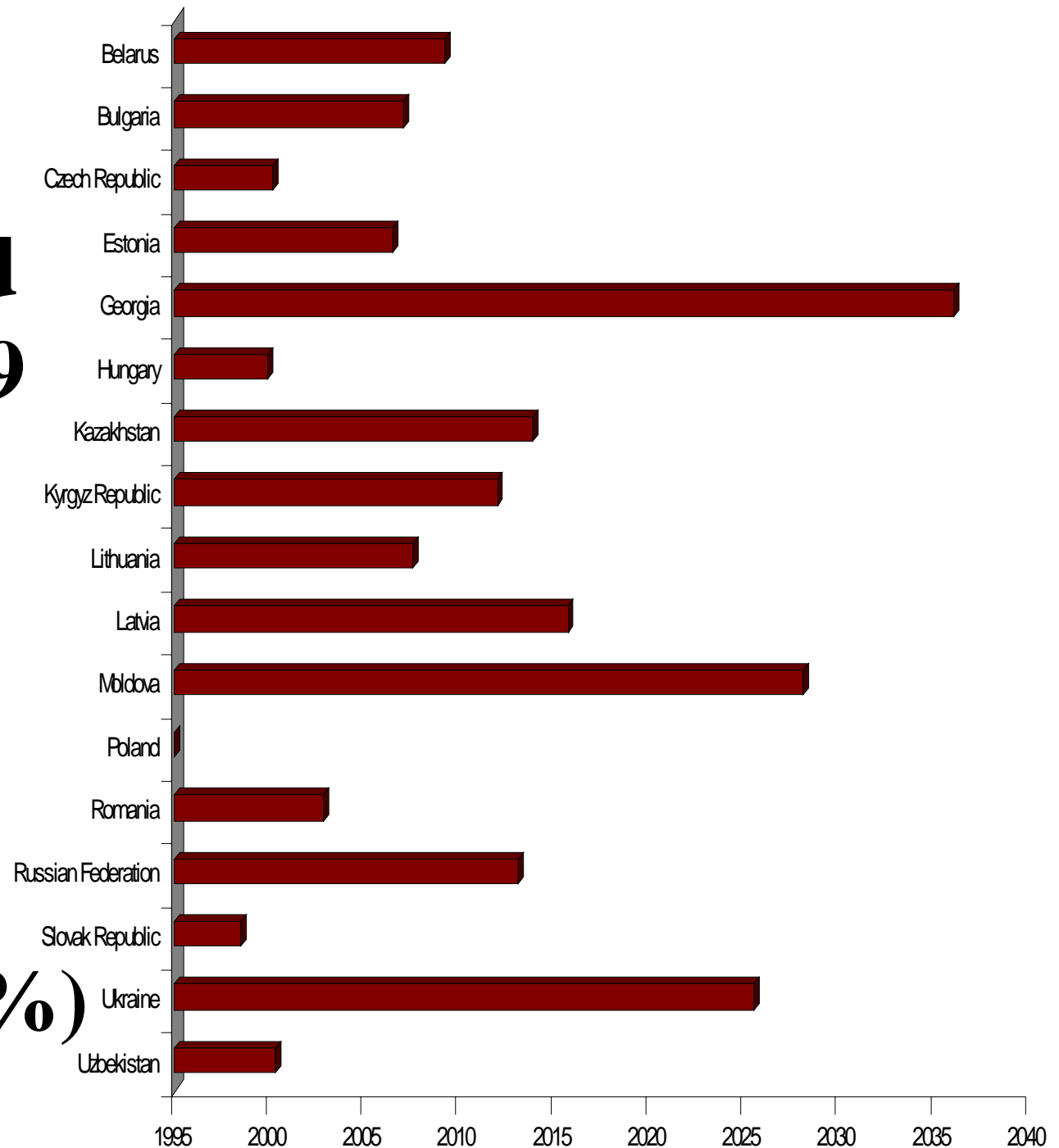
# Figure 1: Most countries' growth rates have worsened during transition



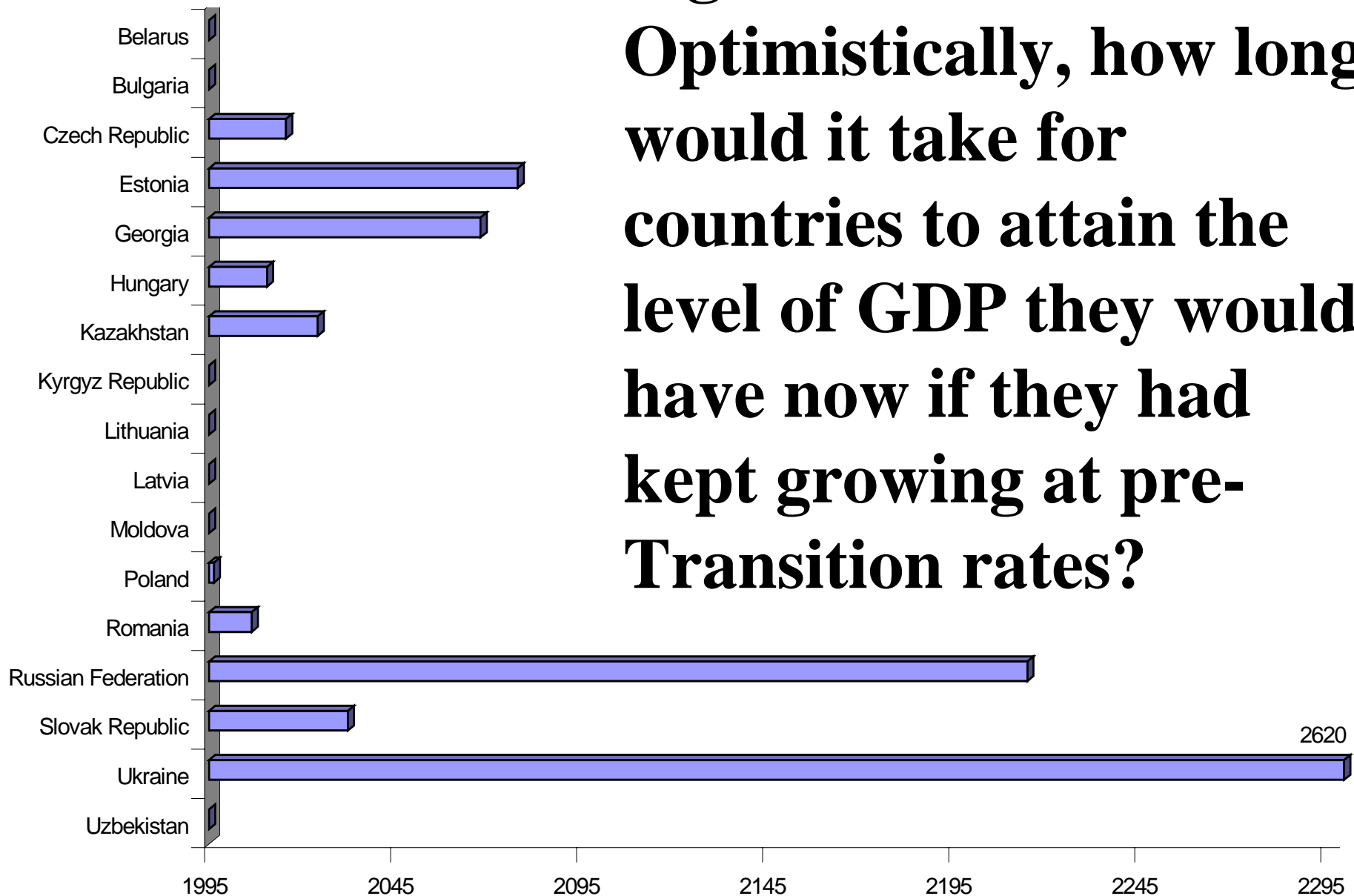
**Figure 2a: Only  
a few countries  
(e.g., Poland  
and Slovenia)  
have surpassed  
'89 GDP**



**Figure 2b:  
Years needed  
to attain 1989  
GDP  
(assuming  
optimistic  
growth rate  
equal to  
Poland's 3.3%)**



**Figure 2c:**  
**Optimistically, how long**  
**would it take for**  
**countries to attain the**  
**level of GDP they would**  
**have now if they had**  
**kept growing at pre-**  
**Transition rates?**



Life Expectancy Changes, 1989-1999

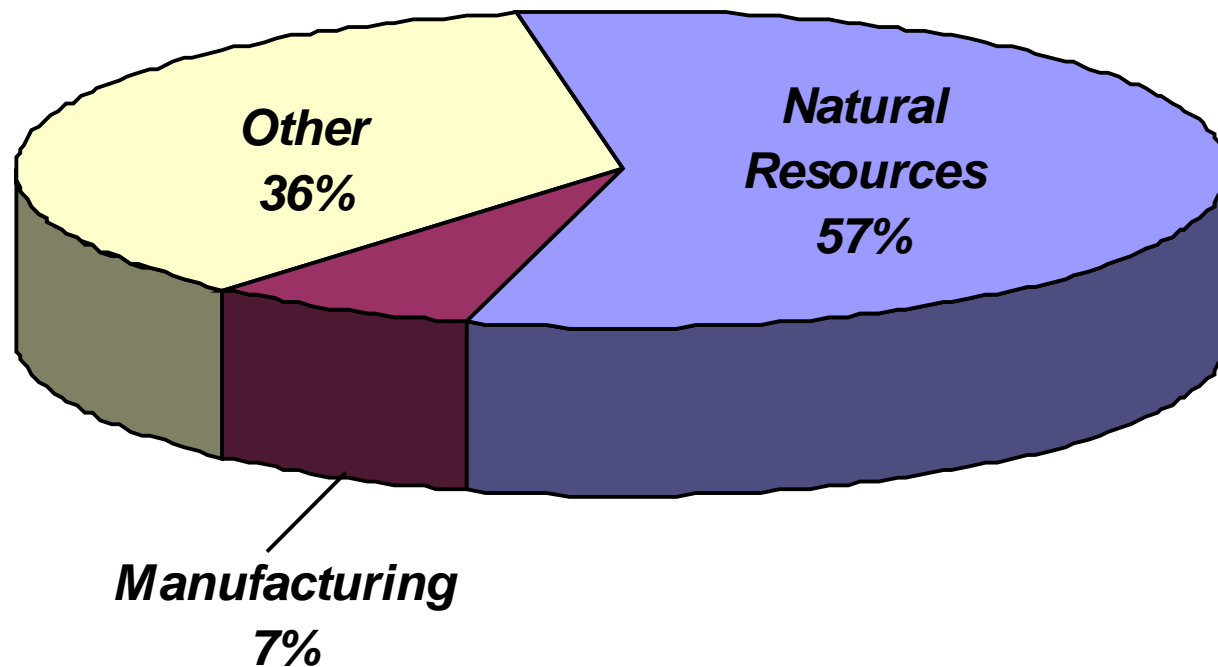
- **Figure 3: Life expectancy in many countries has fallen, even though world average is up 2 years**



# Russia

- Expectations dashed in 1998
- Problems already apparent
  - Little foreign investment, little domestic investment, huge capital flight
  - Investment mostly in natural resources
- But reformers turned blind eye
  - 1996: *The Coming Boom in Russia*
  - 1997: *How Russia Became a Market Economy*

# Figure 4: 1994 composition of total foreign investment in Russia

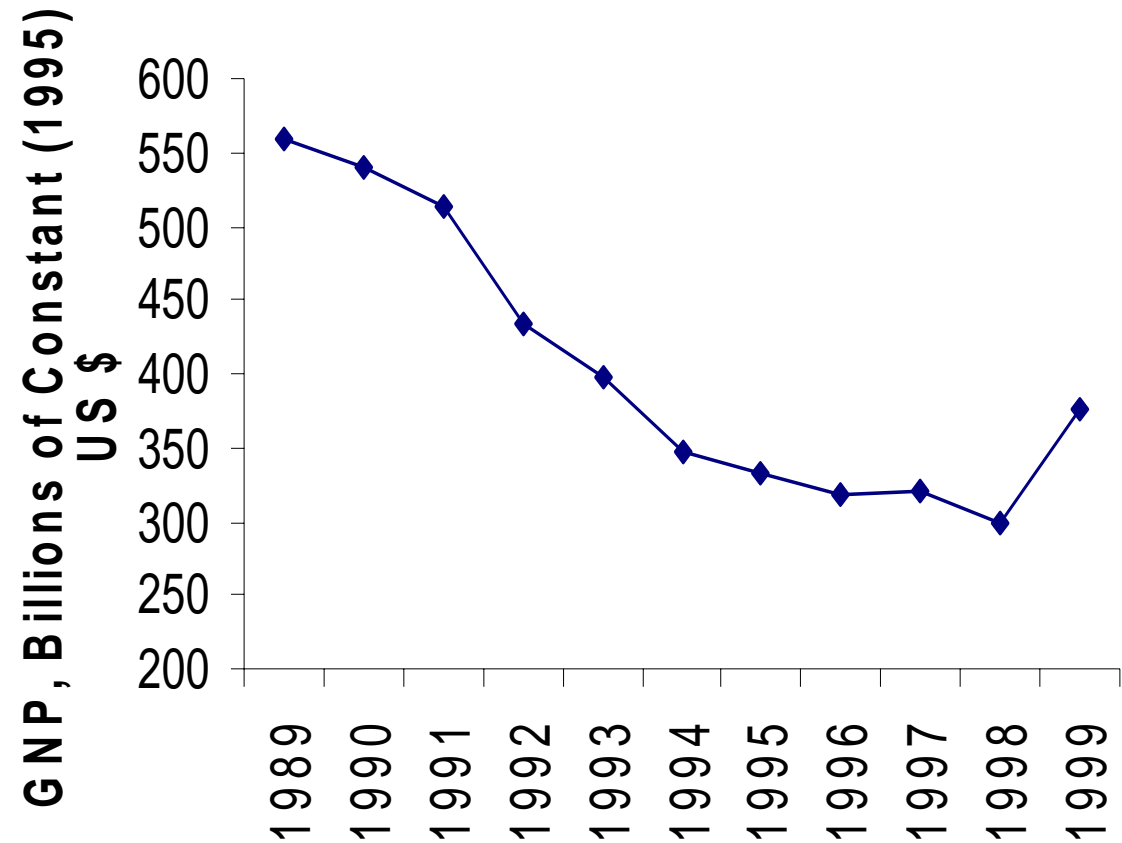


Natural Resources include fuel and energy, ferrous metallurgy, non-ferrous metallurgy, logs, wood, cellulose, and paper. Manufacturing includes the chemical & petrochemical industry, machine-building & metal-processing, construction materials, and light industry.

Source: Goskomstat.

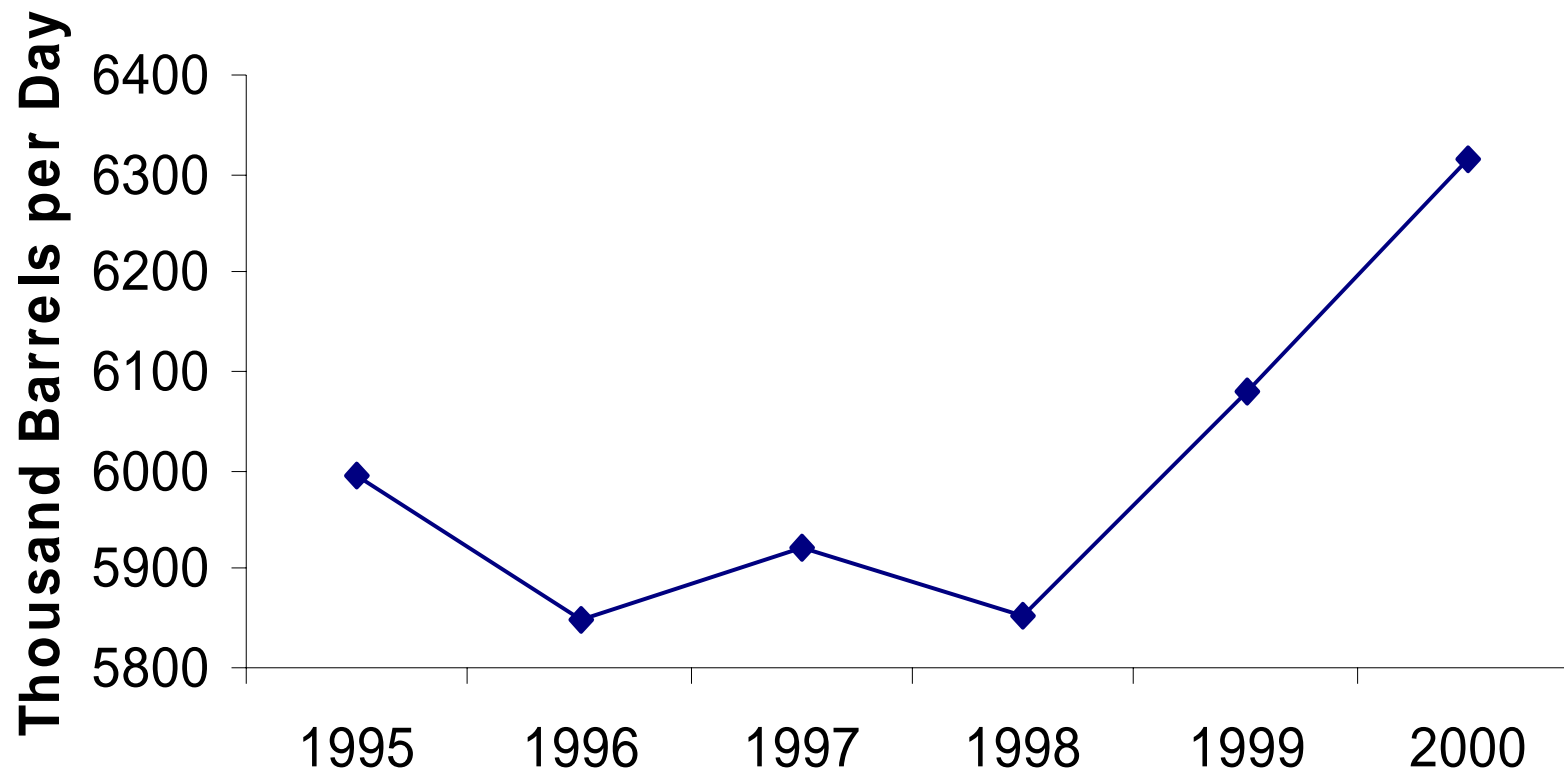
# Figure 5: Russian GNP over the Decade

- 1998 GNP was 54% of 1989 GNP
- 1999 GNP was 67% of 1989 GNP



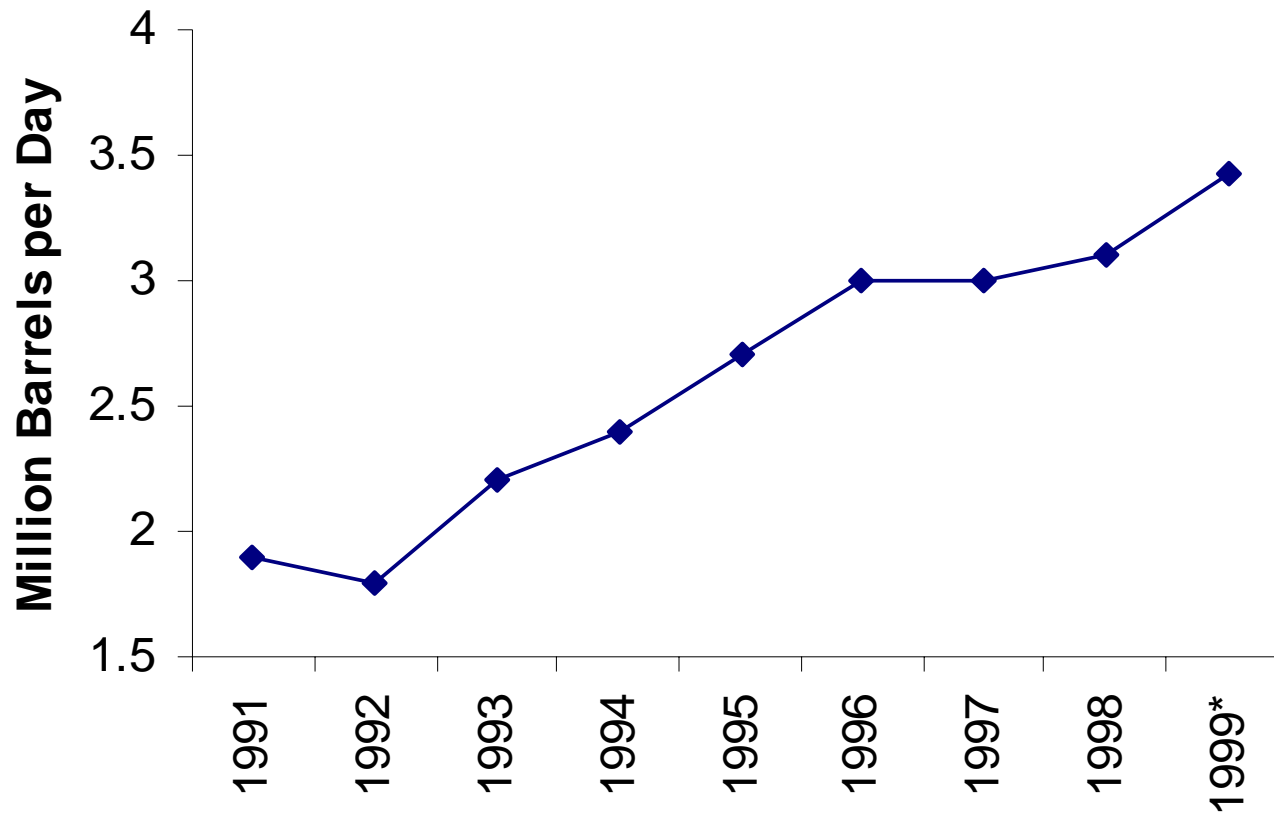
Source: World Development Indicators 2000 and World Development Report 2000-2001

# Figure 6a: Russian Crude Oil Production



Source: Goskomstat

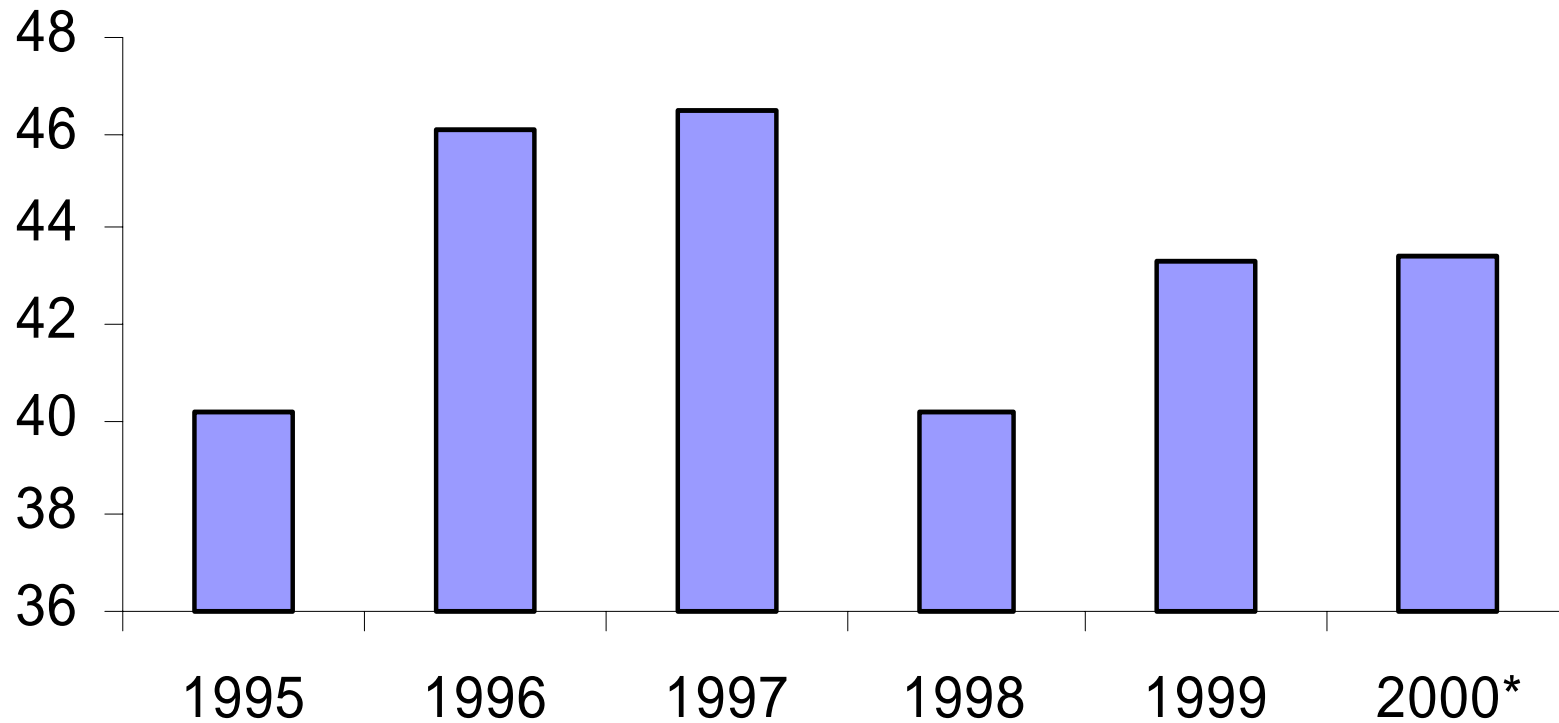
# Figure 6b: Russian Oil Exports to non-FSU Countries



Source: Energy Information Administration, Dept of Energy

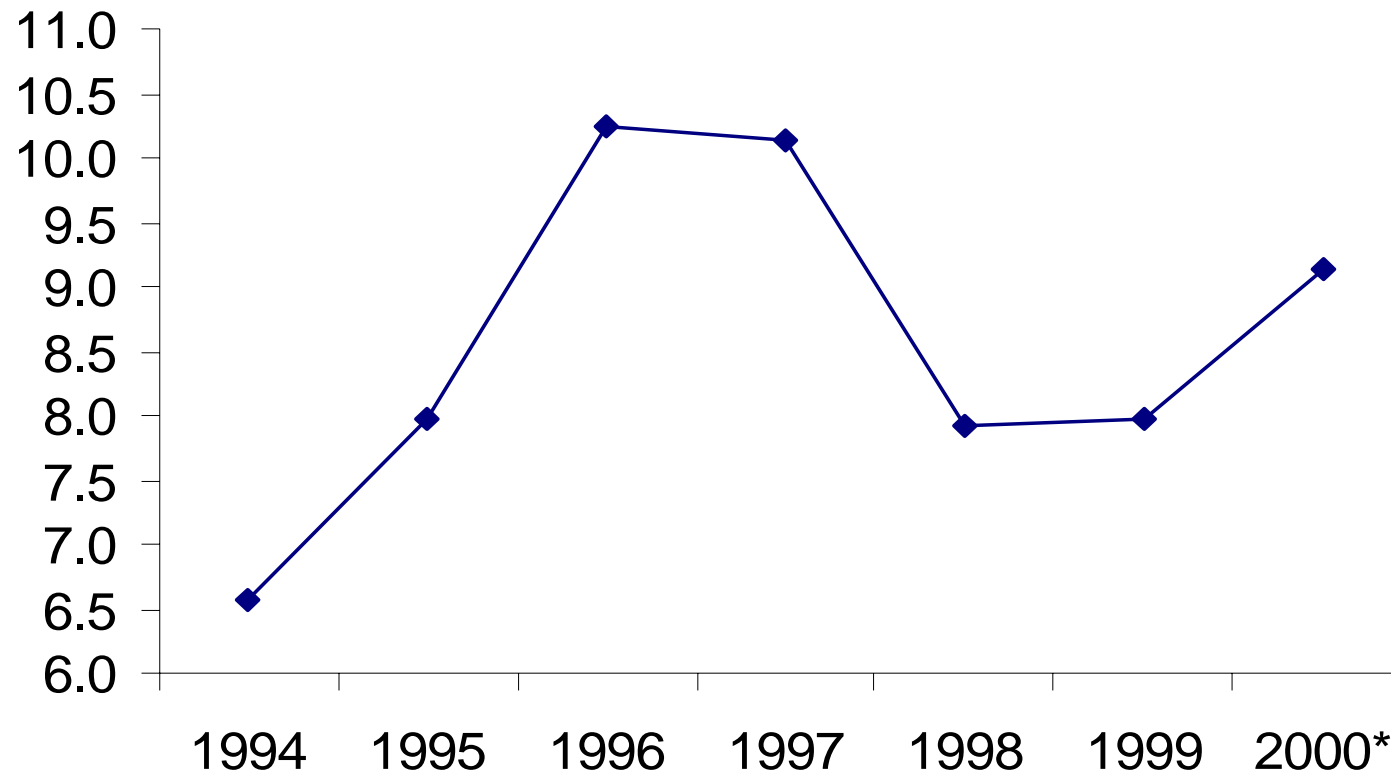
\*Linearly Projected Value

# Figure 6c: Mineral Products as a % of Total Exports



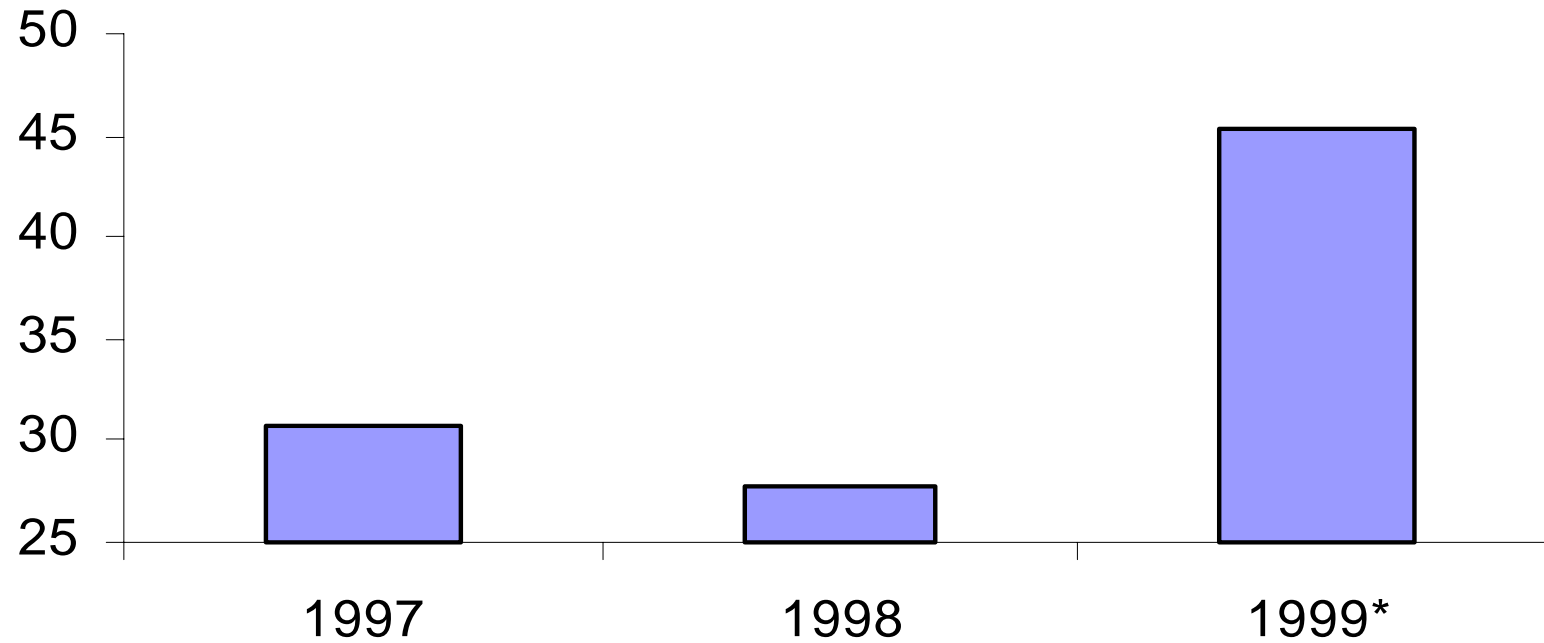
\*Linear Projection from source (Dept of Energy)

# Figure 6d: Mineral Products as a % of GNP



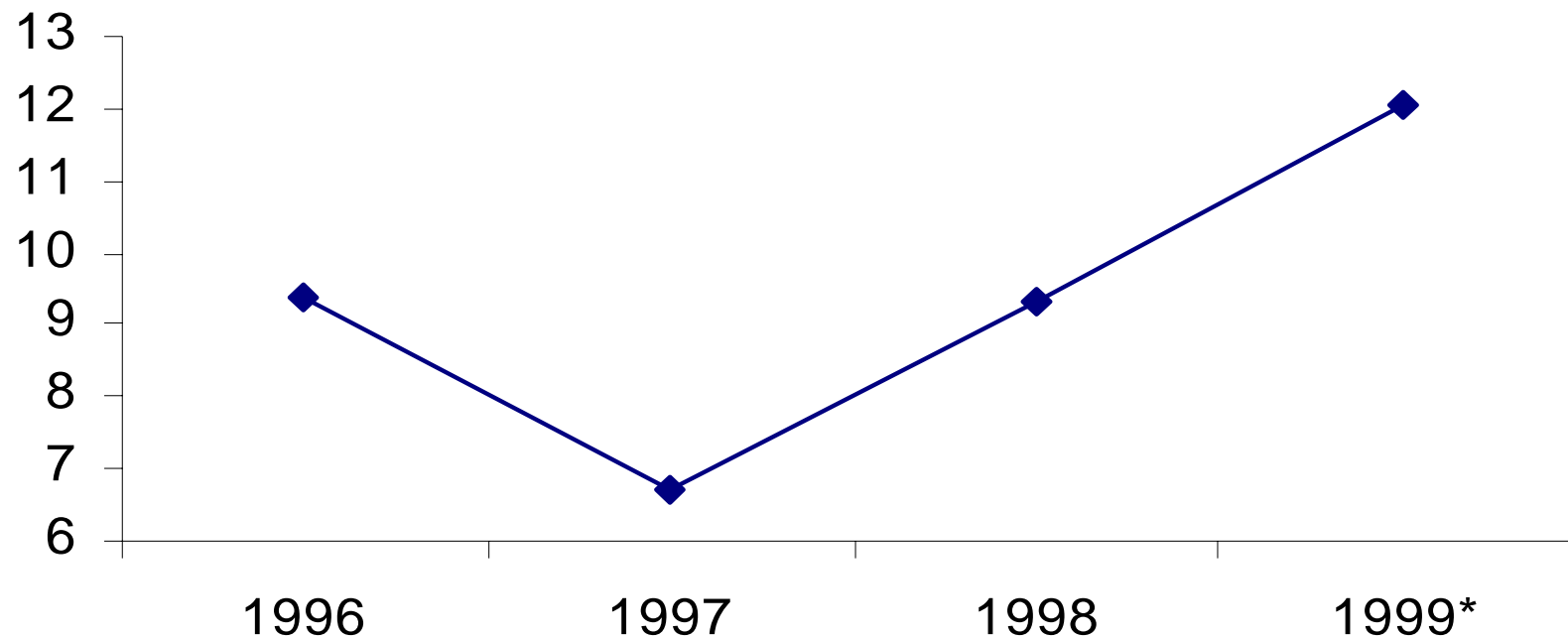
\*Linear Projection from source (Dept of Energy)

# Figure 6e: Petroleum as a Percent of Total exports



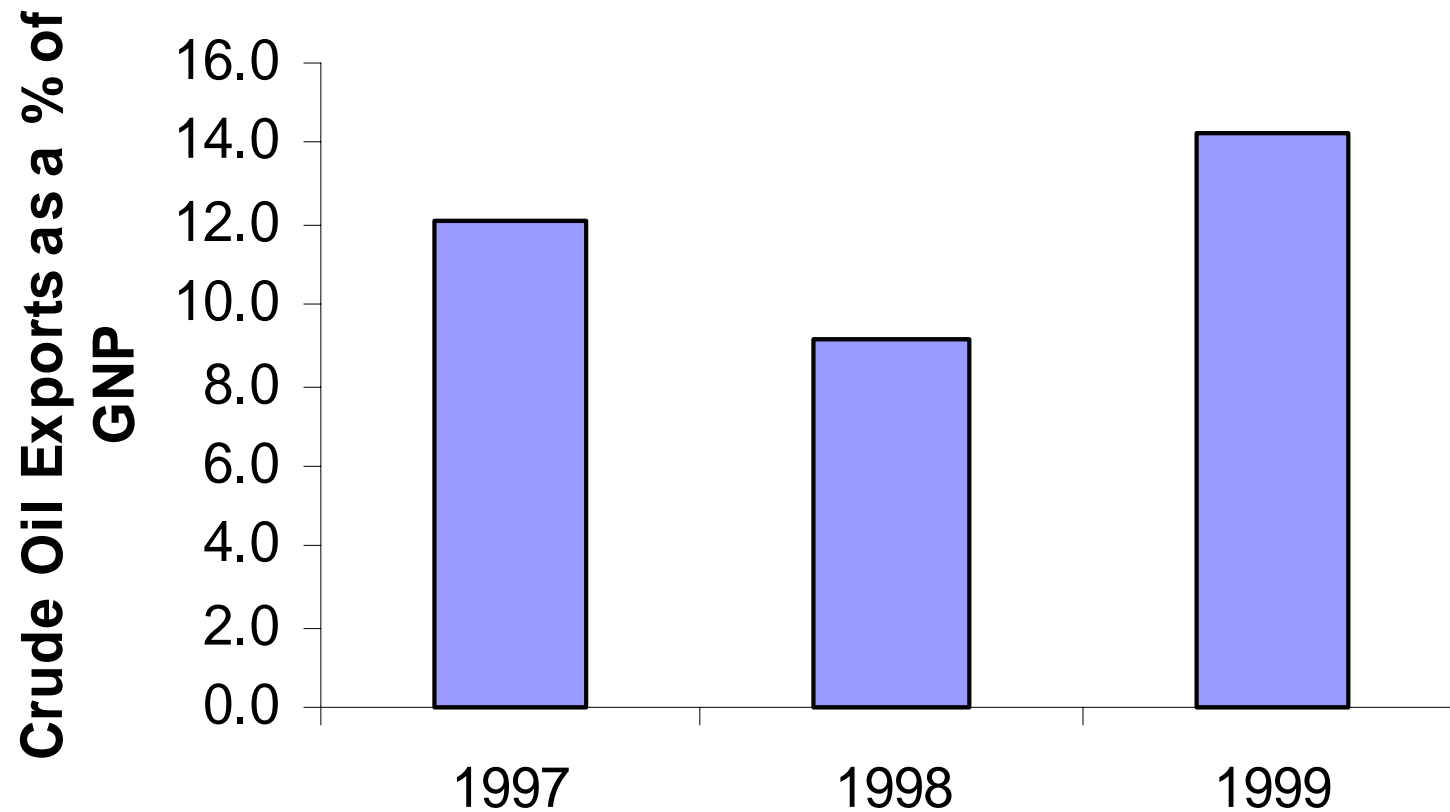
\*Estimated with price and export data from Goskomstat

# Figure 6f: Petroleum as a Percent of GNP



\*Linear Projection; Source: Goskomstat

# Figure 6g: Crude Oil as a Percent of GNP



\*Estimated with price and export data from Goskomstat

# Czech Republic

- In early days of reform, viewed as “star” performer in Eastern Europe

But:

- Weak economic performance
- Capital market not working
- Corruption, tunneling

# Inequality was expected to increase

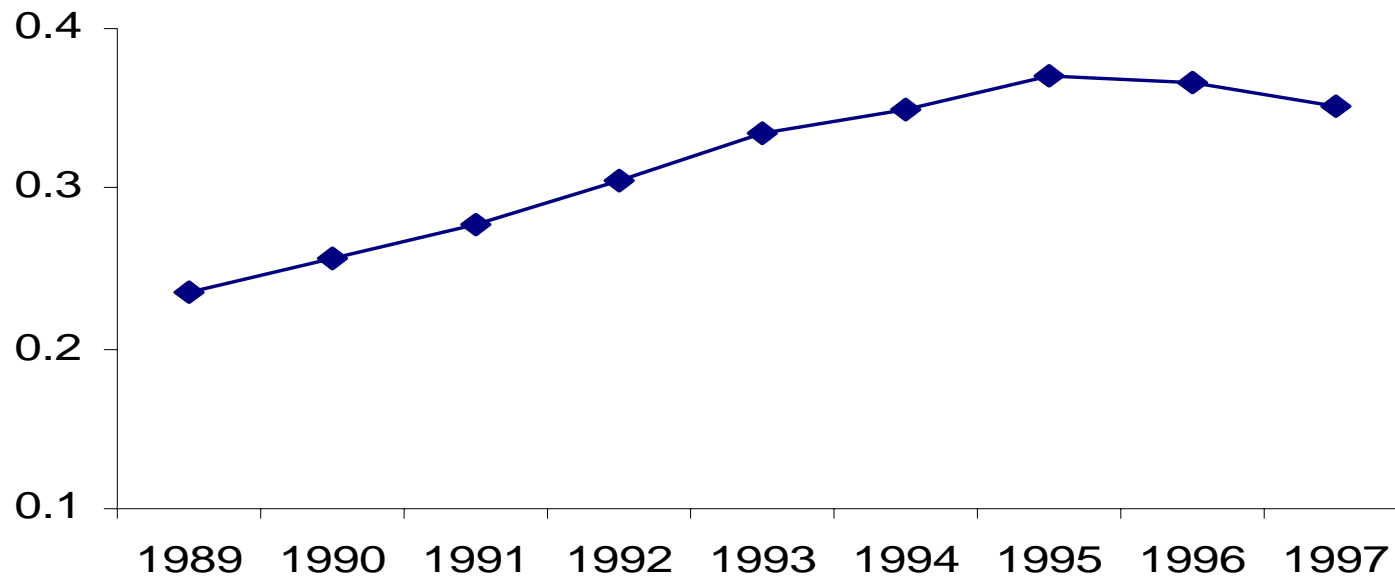
- Under Communism, wage structure was artificially compressed
- Often an incentive/inequality trade-off

But starting from more equal distribution meant that inequality should be less than in West, where there remains some feudal overhang

- Inequality has soared
- Poverty has soared
- In Russia, number of children under 6 below poverty line increased to 56%
  - overall poverty in Russia close to 50%

# Figure 7: There has been a huge increase in inequality

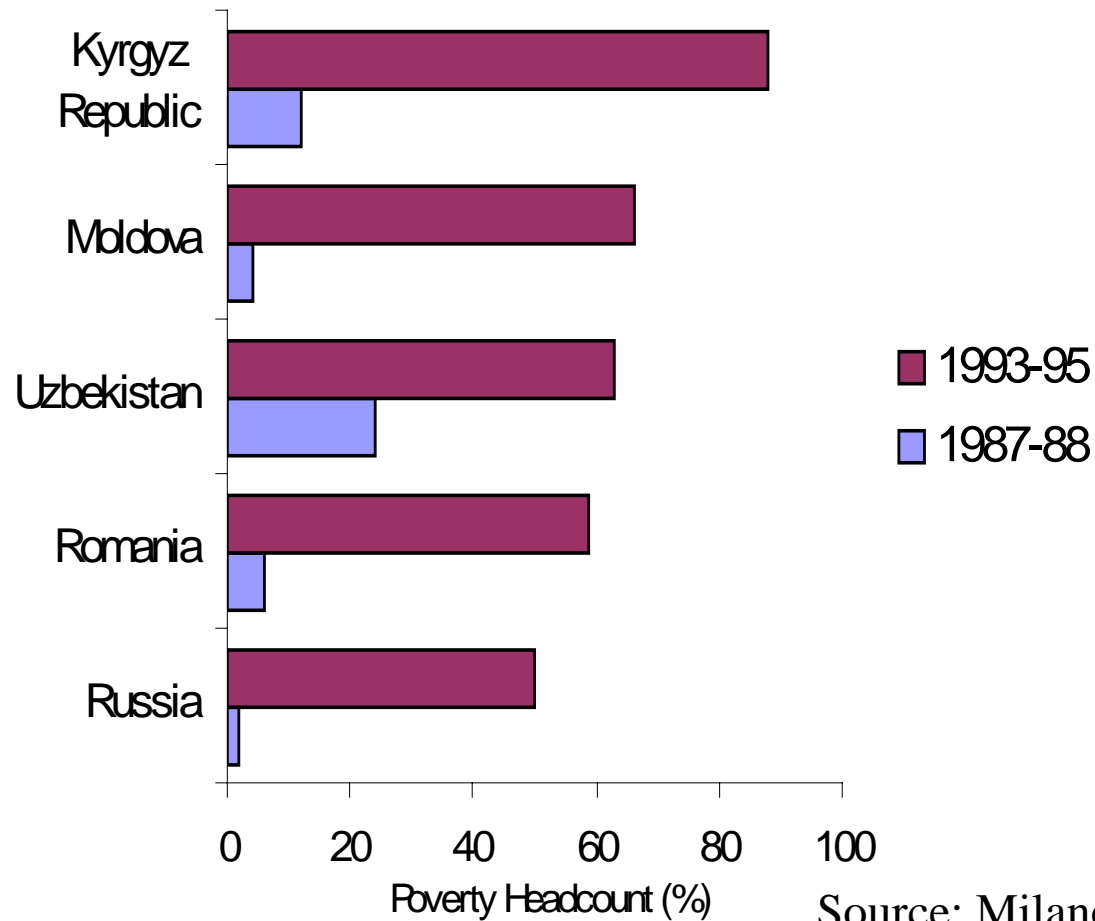
Gini coefficient in transition economies



Source: TransMONEE Database, UNICEF, 2000.

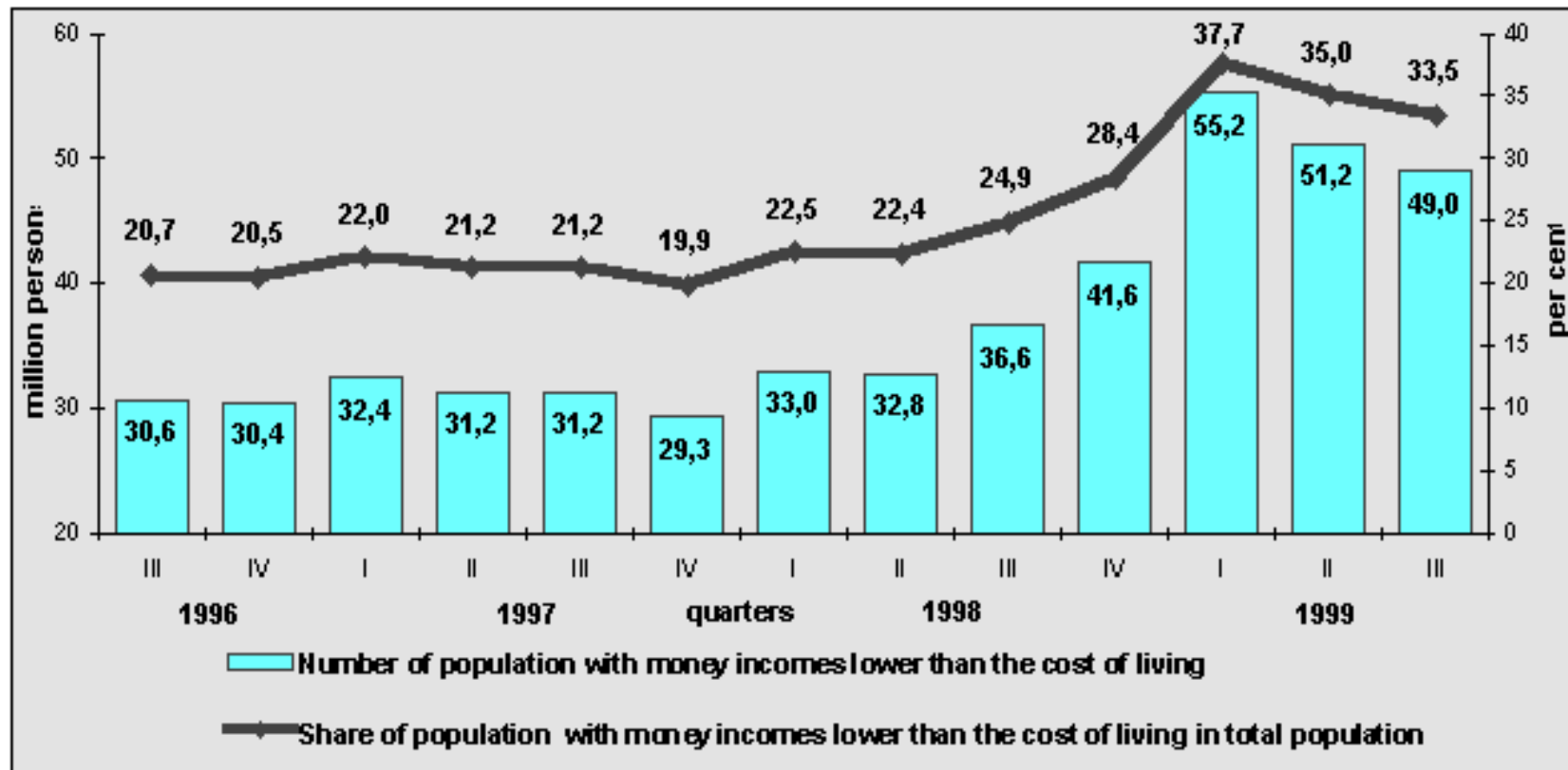
# Figure 8a: In 18 countries with data, poverty increased from 4% to 45% with \$4/day poverty line

Russia: Number of children under 6 below poverty line increased to 56% by 1998.



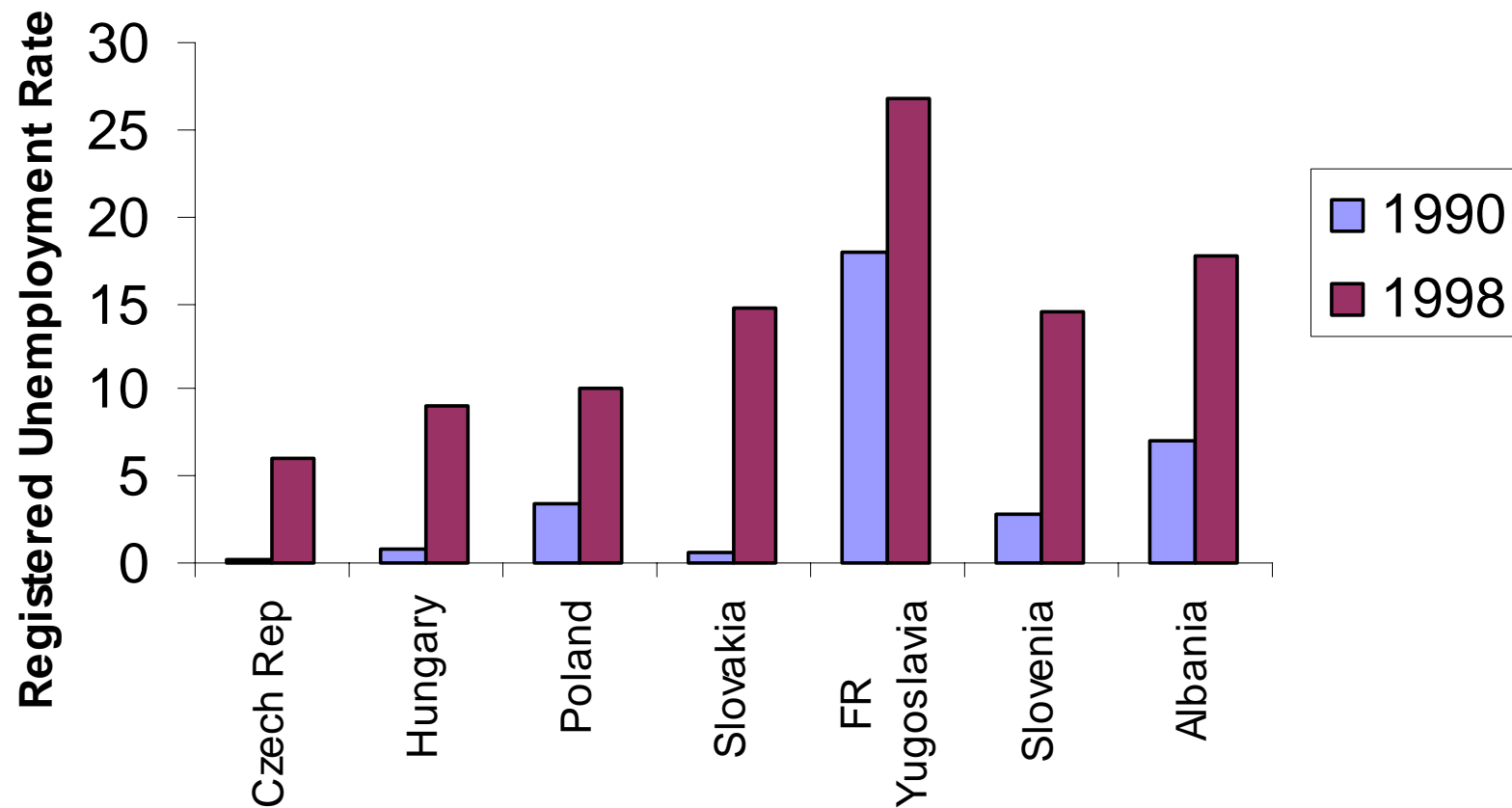
Source: Milanovic [1998].

# Figure 8b: Poverty Level in Russia over the Past 5 Years



Source: Goskomstat

# Figure 9: Unemployment Rates have Increased Dramatically



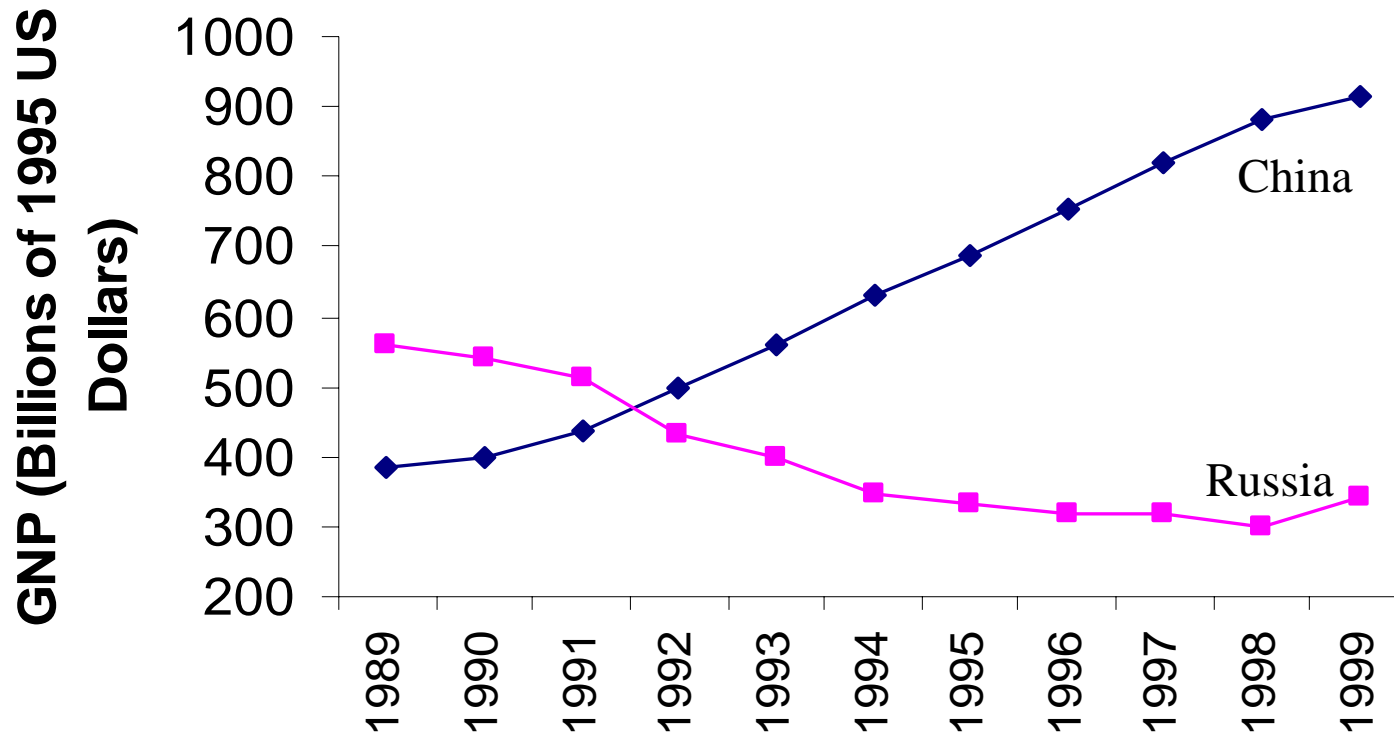
Source: TransMONEE Database, UNICEF, 2000.

# Marked Contrast with China

- China faced double challenge of development and transition
- Most successful developing or transition country
  - Annual growth rate of 9.5%
  - Well over half of increased incomes in poor countries over two decades is in China
  - If you treat provinces as separate countries: top 20 fastest growers over 20 years all in China

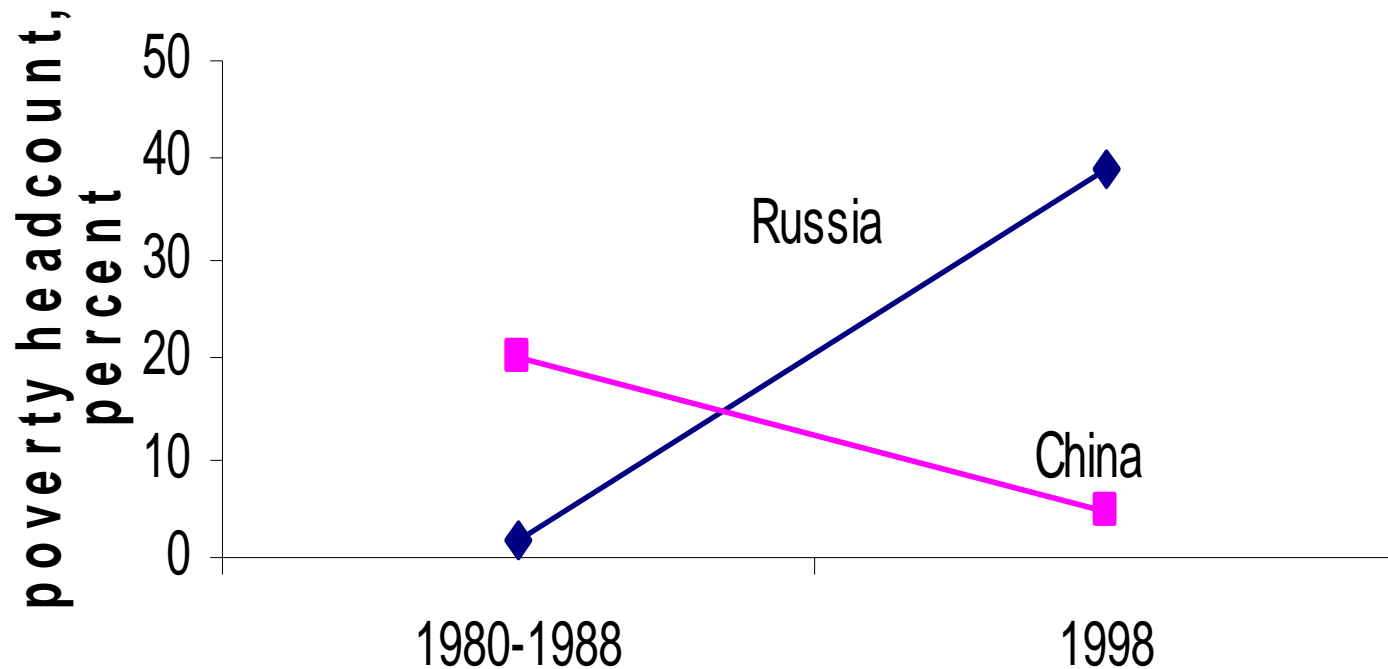
# Russia's and China's GDP compared over the decade:

## Figure 10: The big cross-over



# Russia and China's poverty compared over the decade:

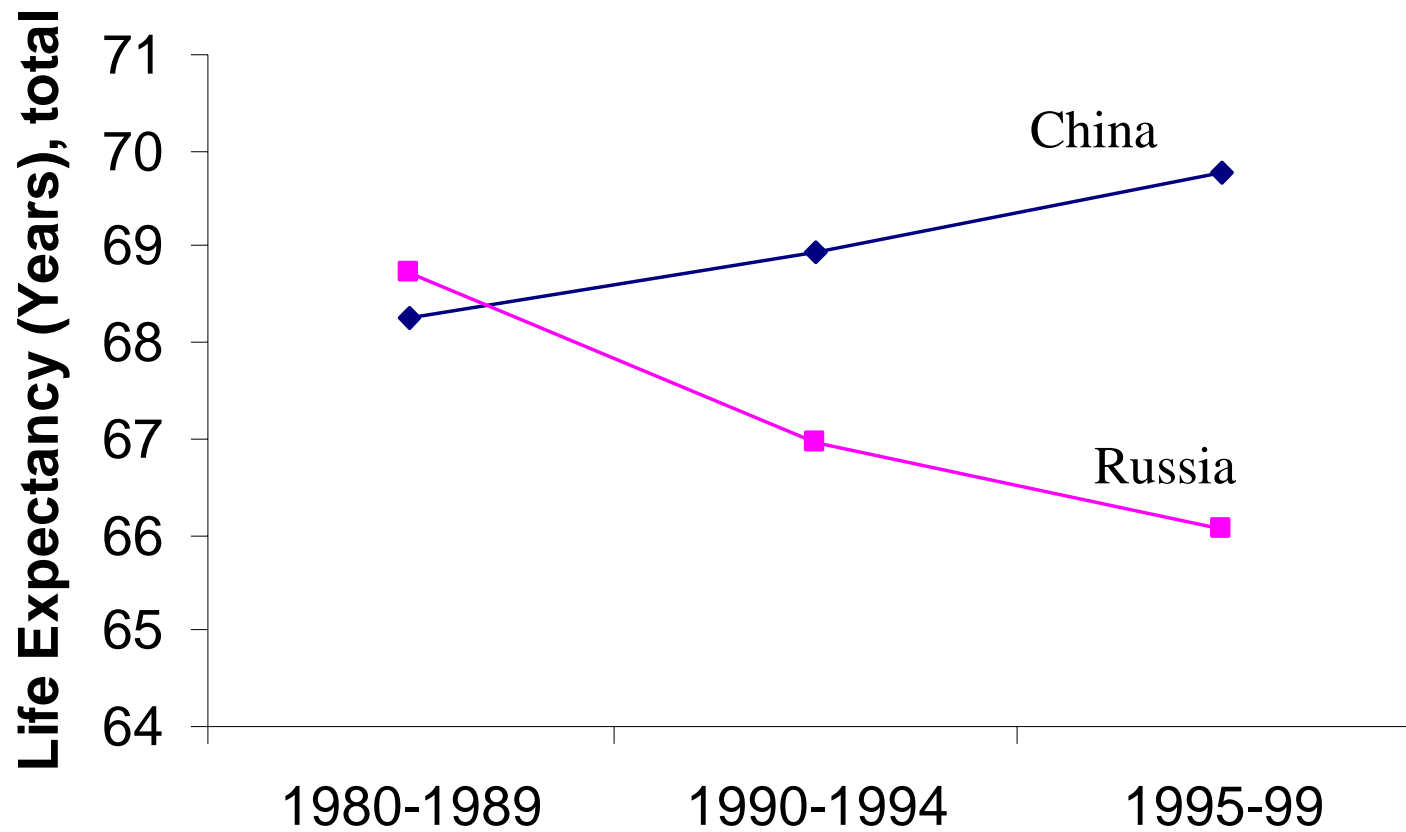
## Figure 11: Another big cross-over



# Russia and China

## Life Expectancy Compared

### Figure 12



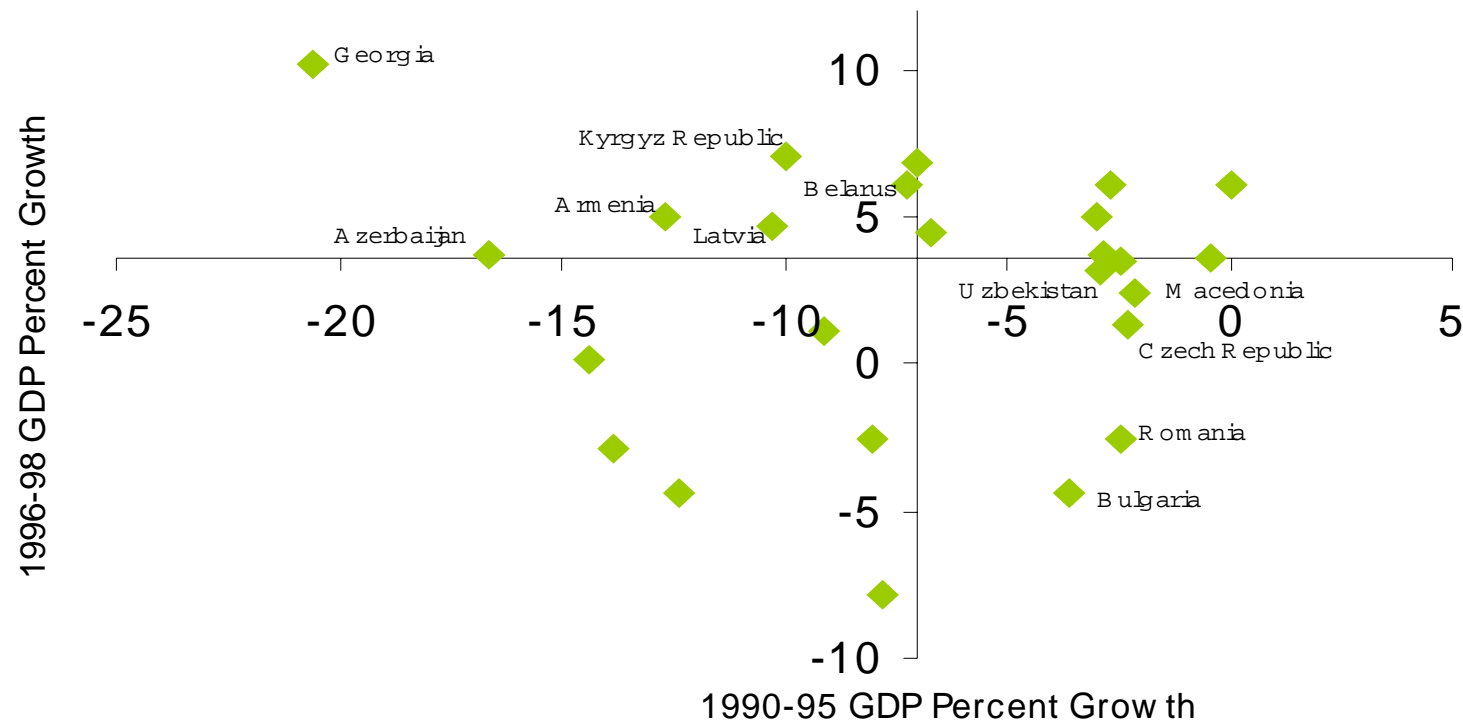
# Russia and China's poverty rate compared over the decade

- Some increase in inequality, but
- Poverty reduced from 30% to 6%

# Reassessing conventional wisdom

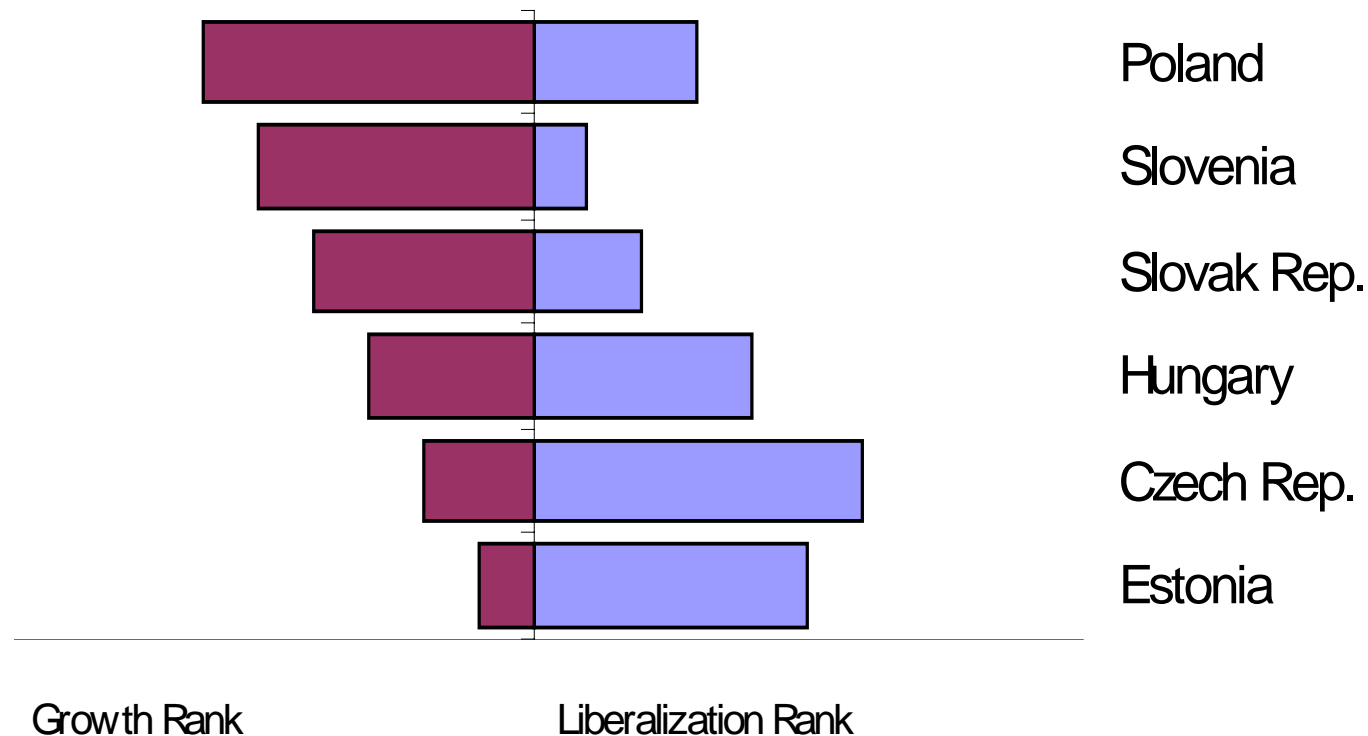
- Growth rates early in decade not good predictor of growth rates now
- No longer clear that fast liberalization leads to faster growth
- While stopping hyper-inflation important, moderate inflation may be better than excessive suppression of inflation

# Figure 13: No correlation between growth early in decade and later



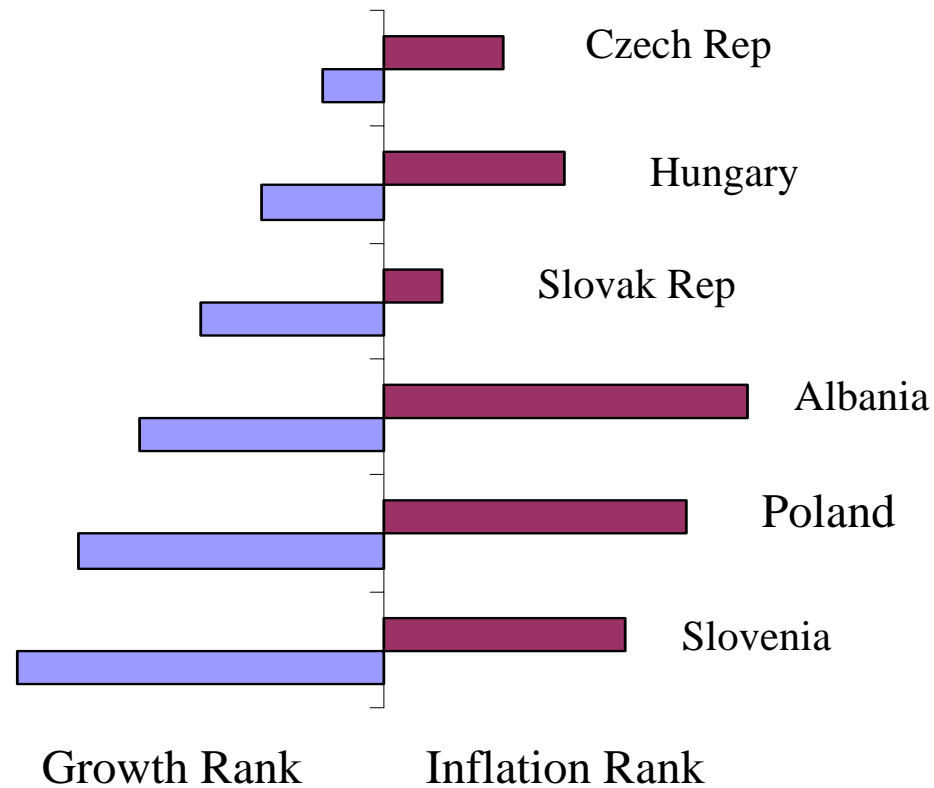
Source: Statistical Management and Information Analysis database, World Bank and EBRD *Transition Report 1998*

# Figure 14: Ranking of Liberalization and Growth in Eastern Europe



Sources: Statistical Information and Management Analysis database, World Development Report 1996.

# Figure 15: Rankings of Inflation and Growth in Eastern Europe



Sources: World Development Indicators (2000) and World Development Report 2000-1

# Reassessing conventional wisdom (continued)

- Privatization key
  - Effect of privatization (by itself, aside from corporate governance and restructuring), not statistically significant
  - It is significant for countries with good corporate governance, restructuring

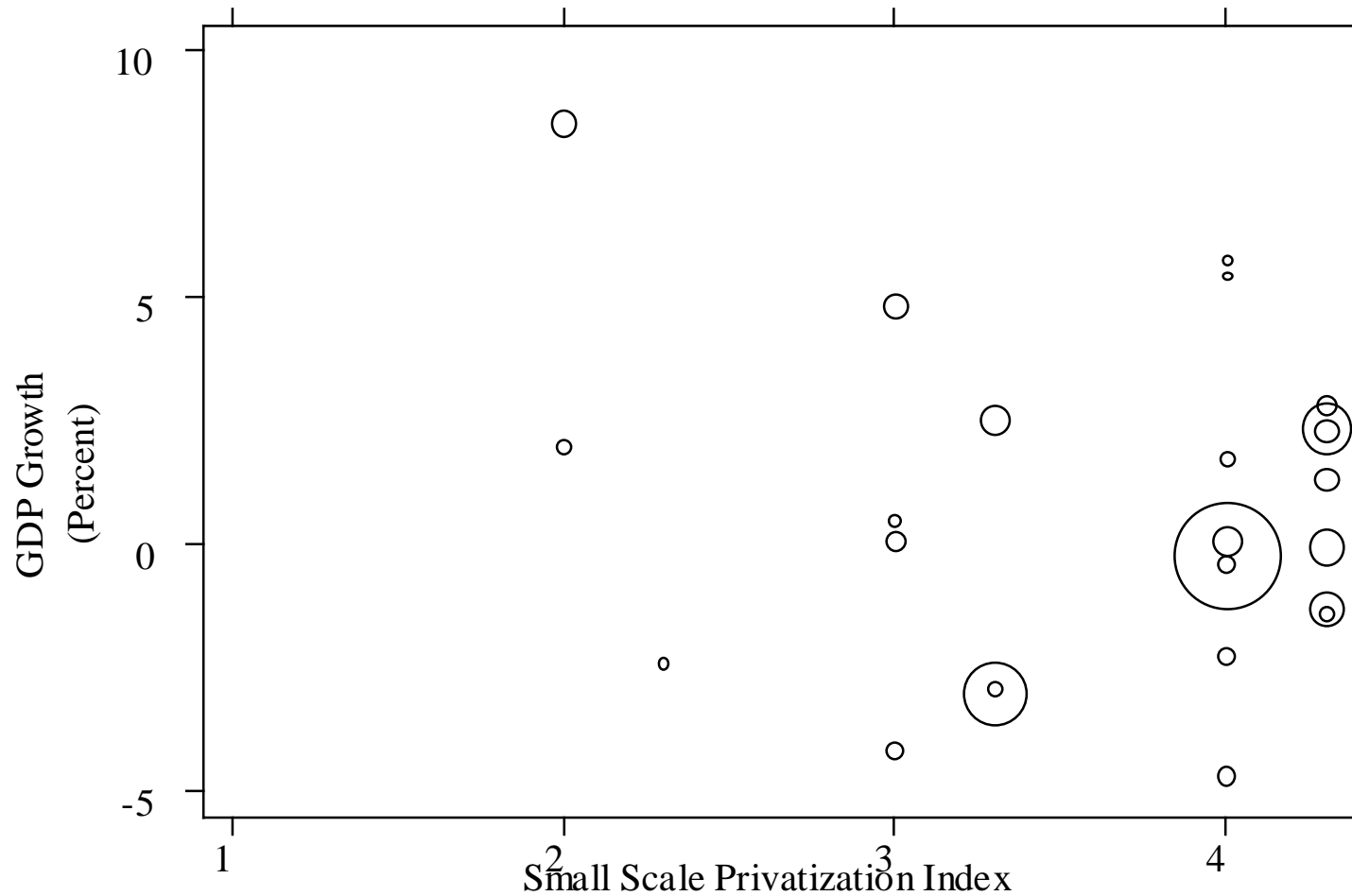
# Regression of GDP Growth on Small and Large Privatization and Restructuring

*Weighted by 1989 GDP*

	Coef.	Std. Err.	t	P> t	[95% Conf. Interval]	
large	.1194704	1.88032	0.064	0.950	-3.790869	4.029809
small	-.8837738	2.213307	-0.399	0.694	-5.486598	3.71905
restruct	5.377377	1.39438	3.856	0.001	2.477606	8.277148
_cons	-13.20642	4.126102	-3.201	0.004	-21.78712	-4.625719



# Figure 17: Correlation of Small Scale Privatization and GDP Growth

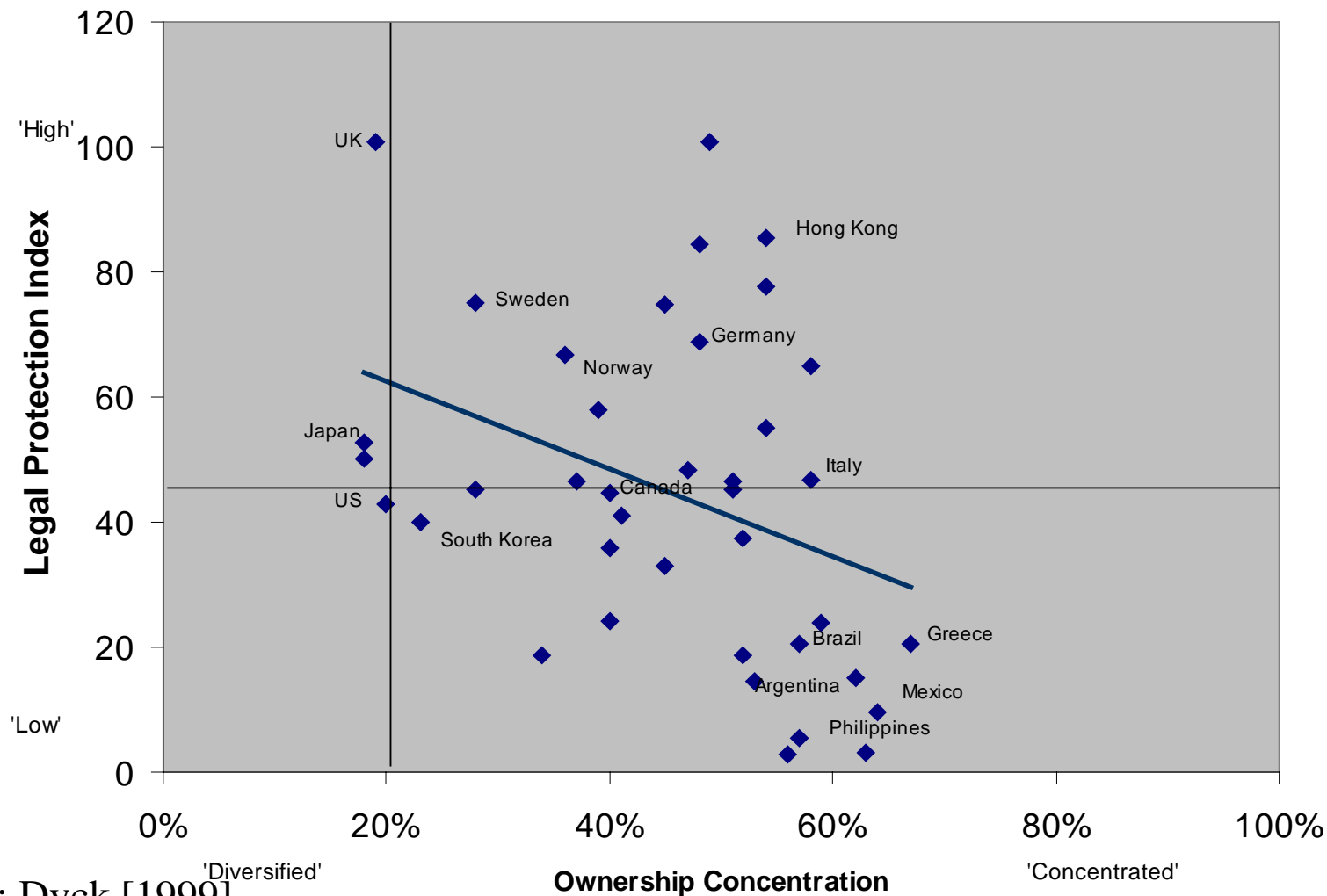


# Regression of GDP Growth on Privatization and Restructuring, With Interaction Effect

Weighted by 1989 GDP Source	SS	df	MS	Number of obs = 25
-----+-----				F( 3, 21) = 15.28
Model	177.018499	3	59.0061662	Prob > F = 0.0000
Residual	81.0809533	21	3.86099778	R-squared = 0.6859
-----+-----				Adj R-squared = 0.6410
Total	258.099452	24	10.7541438	Root MSE = 1.9649

	Coef.	Std. Err.	t	P> t	[95% Conf. Interval]	
-----+-----						
dgdp	.9013996	1.092511	0.825	0.419	-1.370602	3.173401
restruct	-3.539967	2.816531	-1.257	0.223	-9.397264	2.31733
<b>r2  </b>		<b>2.290305</b>	<b>.6654943</b>	<b>3.442</b>	<b>0.002</b>	<b>.9063339 3.674276</b>
cons		-1.868984	4.358989	-0.429	0.672	-10.934 7.19603

# Figure 18: Rule of Law and Ownership Concentration



Source: Dyck [1999].

- Analytic problems caused by multicollinearity and simultaneity problems
  - Differences in initial conditions
    - Geography
    - Land locked
    - Near EU
    - Incentive of EU accession
  - Economic resources
  - Linkages with Russia
    - Trade
    - Taxes/transfers/subsidies
- Differences in time of beginning of transition

# Analysis: Why the failures?

- Shock Therapists:
  - “Patients didn’t follow doctor’s orders!”
  - “Too little shock; too much therapy.”
  - “Right design: Wrong implementation.”
  - “Nothing wrong with laws except non-enforcement.”
  - “Reforms not fast enough.”
  - But implementation is key part of design (CDF).
  - Need policies designed to be robust in face of myriad local problems.
- Deeper problems:
  - misunderstanding of actual market economies.
  - misunderstanding of reform process.

# Key economic mistakes

- Emphasis on privatization over competition
- Emphasis on restructuring existing enterprises over creation of new jobs and enterprises
- Inadequate attention to institutional infrastructure and social capital
  - Inevitable casualties in “Bolshevik” approach to reform

# Key economic mistakes (continued)

- Wrong strategy of privatization combined with
  - capital market liberalization
  - failure to establish institutional infrastructure
    - including corporate governance (and other failures)
  - led to incentives for asset stripping, not wealth creation
  - Incentives do matter!
- Excessive focus on macro-stabilization, not enough on growth
  - Pushed economies to barter—even more distorted price system
  - Made it impossible to create new enterprises