

## The Successes and Failures of Economic Transition

*Also by Hubert Gabrisch*

EU ENLARGEMENT AND ITS MACROECONOMIC EFFECTS IN  
EASTERN EUROPE  
(with Rüdiger Pohl)

*Also by Jens Hölscher*

THE GERMANY CURRENCY UNION OF 1990: A Critical  
Assessment (with Stephen F. Frowen)

50 YEARS OF THE GERMAN MARK: Essays in Honour  
of Stephen F. Frowen

GLOBALIZATION OF CAPITAL MARKETS AND  
MONETARY POLICY (with Horst Tomann)

GERMANY'S ECONOMIC PERFORMANCE:  
From Unification to Euroisation

*Within Studies in Economic Transition series*

General Editors: Jens Hölscher and Horst Tomann

EAST GERMANY'S ECONOMIC DEVELOPMENT:  
DOMESTIC AND GLOBAL ASPECTS (with Anja Hochberg)

FINANCIAL TURBULENCE AND CAPITAL MARKETS IN  
TRANSITION COUNTRIES

MONEY, DEVELOPMENT AND ECONOMIC  
TRANSFORMATION (with Horst Tomann)

# **The Successes and Failures of Economic Transition**

**The European Experience**

Hubert Gabrisch and Jens Hölscher

palgrave  
macmillan



© Hubert Gabrisch and Jens Hölscher 2006  
Softcover reprint of the hardcover 1st edition 2006 978-1-4039-3493-2

All rights reserved. No reproduction, copy or transmission of this publication may be made without written permission.

No paragraph of this publication may be reproduced, copied or transmitted save with written permission or in accordance with the provisions of the Copyright, Designs and Patents Act 1988, or under the terms of any licence permitting limited copying issued by the Copyright Licensing Agency, 90 Tottenham Court Road, London W1T 4LP.

Any person who does any unauthorized act in relation to this publication may be liable to criminal prosecution and civil claims for damages.

The authors have asserted their rights to be identified as the authors of this work in accordance with the Copyright, Designs and Patents Act 1988.

First published 2006 by  
PALGRAVE MACMILLAN  
Houndmills, Basingstoke, Hampshire RG21 6XS and  
175 Fifth Avenue, New York, N.Y. 10010  
Companies and representatives throughout the world.

PALGRAVE MACMILLAN is the global academic imprint of the Palgrave Macmillan division of St. Martin's Press, LLC and of Palgrave Macmillan Ltd. Macmillan® is a registered trademark in the United States, United Kingdom and other countries. Palgrave is a registered trademark in the European Union and other countries.

ISBN 978-1-349-51752-7      ISBN 978-0-230-62658-4 (eBook)  
DOI 10.1057/9780230626584

This book is printed on paper suitable for recycling and made from fully managed and sustained forest sources.

A catalogue record for this book is available from the British Library.

Library of Congress Cataloging-in-Publication Data

The successes and failures of economic transition: the European experience / edited by Hubert Gabrisch and Jens Hölscher.  
p. cm.

Includes bibliographical references and index.

1. Europe, Eastern – Economic policy – 1989– 2. Free enterprise – Europe, Eastern. 3. Post-communism – Europe, Eastern. I. Gabrisch, Hubert. II. Hölscher, Jens.

HC244.S775 2006

330.947—dc22

2006043163

10 9 8 7 6 5 4 3 2 1  
15 14 13 12 11 10 09 08 07 06

# Contents

<i>List of Figures</i>	viii
<i>List of Tables</i>	x
<i>List of Boxes</i>	xi
<i>List of Abbreviations</i>	xii
<i>Acknowledgements</i>	xiv
<b>Introduction</b>	<b>1</b>
<b>1 The Meaning and Measurement of Transition</b>	<b>4</b>
What transition means	4
How transition is measured	7
An alternative measure: economic and social effects	11
Appendix A: the Gini coefficient and the Lorenz curve	17
<b>2 Two Competing Concepts of Transition</b>	<b>20</b>
The ‘Washington Consensus’ approach	20
The evolutionary–institutionalist approach	23
Fundamental differences in transitional issues	26
The dispute over stabilization policy	31
A country taxonomy of transition	35
Appendix 1: the Lipton–Sachs model of combining liberalization and stabilization	36
Appendix 2: IMF financial programming	38
<b>3 Financial Institutions, Stability and Growth</b>	<b>42</b>
The core of the monetary economy:	
the central bank	42
Financial systems as stabilizers	44
Financial fragility	45
The relevance of financial systems for stability and growth	47
The strategy of ‘semi-liberalization’	53
The evolution of financial institutions	55

<b>4</b>	<b>Privatization and Competition</b>	<b>60</b>
	From state to private ownership	60
	A taxonomy of privatization methods	64
	A review of anti-trust practices in EU accession countries	70
<b>5</b>	<b>Emerging Labour Markets</b>	<b>79</b>
	Supply- and demand-side liberalization	79
	The unemployment problem	81
	The optimal speed of transition	84
	The Beveridge curve	87
	Growth and unemployment	88
	Appendix: the Aghion–Blanchard model of the OST	90
<b>6</b>	<b>Opening towards the World</b>	<b>95</b>
	The open and the opening economy	95
	Price convergence and aggregate demand	99
	Relative price shocks and value added	99
	The exchange rate as a tool for trade policy	101
	Capital account liberalization	107
	Appendix: trade opening and negative value added	108
<b>7</b>	<b>Rising Income Inequality</b>	<b>113</b>
	Income distribution and convergence in the transition process	113
	The ‘standard explanation’ for rising inequality and its application to transition economies	114
	Macroeconomic aspects of income distribution	115
	Some observations	117
	Cross-country comparisons	128
	Country performances reconsidered	130
	Convergence versus divergence	132
	Appendix: income statistics	133
<b>8</b>	<b>Transition and EU Membership</b>	<b>137</b>
	Competition policy	137
	EMU membership	147
	Fiscal transparency	149
	Fiscal transparency and rules in Poland	150

<b>9 Country Case Studies</b>	<b>158</b>
East Germany: the transfer economy	158
Hungary: the economy of stop-go cycles	164
Russia: the oligarchic economy	171
The 'new rich' and capital flight	174
China: currency undervaluation and economic development	177
Reasons for fixing the exchange rate to the US dollar	178
Does the PBOC waste money?	179
Adjustment of the balance of payments	180
 <i>Index</i>	 185

# List of Figures

1.1	Progress in transition, 2003	09
1.2	Corruption in European countries, 2001	10
1.3	Interpersonal trust	11
1.4	The J-curve and actual GDP development	13
1.5	Real GDP per capita, 2002	14
1.6	GDP per capita and the Gini coefficient	15
1A.1	Income distribution and the Gini coefficient	17
2A1.1	Utility and real income	37
4.1	The private sector's share in GDP in per cent	61
5.1	Participation rates in the labour force	83
5.2	Employment rates, in percent, at 1990 and 2003 participation rates	84
5.3	Job destruction and job creation, Poland, 1990–2002	86
5.4	The Beveridge curve: Poland, 1993–2001	87
5.5	The relationship between unemployment and GDP changes	89
5A1.1	The dynamics of state job reduction and private job creation	92
6.1	Industrial output and external trade, 1990–2002, in transition countries	100
6.2	The real exchange rate of the Zloty and the trade balance of Poland, 1989–2002	105
6.3	The overvaluation of the Zloty, 1993:1–2001:3	106
6A.1	Trade opening and negative value added	110
7.1	Development of real GDP during systemic transition, 1989–2000	118
7.2	Personal income distribution, Czech Republic, 1988, 1992, and 1996	121
7.3	Functional income distribution and transfers, Czech Republic, 1989–1998	122
7.4	Personal income distribution, Hungary, 1991 and 1994	123
7.5	Functional income distribution and transfers, Hungary, 1989–1998	123
7.6	Personal income distribution, Poland, 1986, 1992, and 1995	124



7.7	Functional income distribution and transfers, Poland, 1991–1998	125
7.8	Personal income distribution, Russia, 1991, 1992, 1995, and 1996	127
7.9	Functional income distribution and transfers, Russia, 1992–1998	127
7.10	The Kuznets curve for transition countries	129
9.1	East Germany: GDP growth rates in comparison with new EU members, 1990–2002	159
9.2	Net transfers in relation to East German GDP, 1989–2003	159
9.3	East German unemployment rates in comparison, 2003	160
9.4	Hungary: GDP growth rates in comparison with other new EU members, 1990–2002	166
9.5	Hungary: current account and budget balance, 1990–2004	167
9.6	The Forint in the Hungarian exchange rate, from 2000	169
9.7	Hungary: base rate of the National Bank, 2001–2005	170
9.8	Real GDP development, Russia and EU candidate countries, 1986–2003	172

# List of Tables

1.1	EBRD transition indicators, 2003	08
2.1	Fundamental differences between the ‘Washington Consensus’ and the evolutionary–institutional approaches	27
3.1	Liberalization and the bad debt solution	54
3.2	Non-performing loans as a percentage of total loan portfolios, 2002	55
3.3	Financial sectors in the CEE accession countries, 2002	57
4.1	Leading methods of privatization	65
4.2	EBRD indicators on institutional reforms and competition policy, selected transition countries, 2001–2002	72
4.3	Anti-trust measures, selected transition countries, 1996–1999	75
4.4	Effectiveness of implementation of competition policy	76
5.1	Employment and unemployment rates 2003	82
7A.1	Cumulated personal income distribution, selected countries and years, and in comparison to Germany	133
7A.2	Change in personal income distribution, selected countries, between selected years	134
7A.3	Distribution of household income according to decile shares	134
8.1	EU accession negotiations: numbers of provisionally closed chapters and dates	143

# List of Boxes

1.1	Social capital	05
1.2	Defective informal institutions: corruption and mistrust	10
1.3	Absolute and relative poverty	16
2.1	The 'Washington Consensus'	22
2.2	Corporate governance	29
2.3	Rent-seeking	30
3.1	The functions of money	43
3.2	Explaining financial fragility: three hypotheses	46
3.3	Anatomy of a financial sector crisis	51
4.1	What is a private sector?	61
4.2	The 'soft' budget constraint syndrome	63
4.3	'Insider' privatization: the case of Gorenje (Slovenia)	66
4.4	Examples of merger control	74
5.1	EU definitions of labour market aggregates	81
5.2	Okun's law	90
6.1	The Marshall-Lerner condition	102
8.1	The components of ERM-II	147
8.2	Exchange rates and monetary policies in the accession countries	148
8.3	The Maastricht criteria	148
9.1	The YUKOS affair	176

# List of Abbreviations

ALMP	Active labour market policies
BT	Balance of trade
CEE	Central and East European
CEEC	Central and East European countries
CPE	Centrally planned economy
EA	European Agreements
EBO	Employee buy-outs
EBRD	European Bank for Reconstruction and Development
ECE	Economic Commission for Europe
EMU	Economic and Monetary Union
EPL	Employment protection law
ERM	Exchange Rate Mechanism
ESCB	European System of Central Banks
FCL	Foreign currency loan
FDI	Foreign direct investment
FEER	Fundamental equilibrium exchange rates
FRG	Federal German Republic (West Germany)
FSU	Former Soviet Union
FTA	Free trade area
FX/forex	Foreign exchange
GATT	General Agreement on Tariffs and Trade
GDP	Gross domestic product
GDR	German Democratic Republic (East Germany)
ILO	International Labour Organization
IMF	International Monetary Fund
JV	Joint venture
LIS	Luxembourg Income Study
LOLR	Lender of last resort
MBO	Management buy-outs
MEBO	Management–employee buy-outs
MoF	Ministry of Finance
MTBF	Medium-term budget framework
NAFTA	North American Free Trade Area
NAIRU	Non-accelerating inflation rate of unemployment
NCA	National competition authorities
NCF	Net capital flows

NGO	Non-governmental organization
NIC	Newly industrialized country
NIK	Supreme Chamber of Control (Poland)
OST	Optimal speed of transition
PC	Personal computer
PPP	Purchasing power parity
REER	Real exchange rate
SBC	'Soft' budget constraints
SEE	South East European
SGP	Stability and growth pact
SME	Small and medium-sized enterprise
SOE	State-owned enterprise
TI	Transparency International
TVE	Township and Village Enterprise (China)
UNCTAD	United Nations Conference on Trade and Development
VAT	Value added tax
WTO	World Trade Organization

# Acknowledgements

We thank Michael Kaser, who provided detailed suggestions and constructive comments on an earlier draft of the book. We gratefully acknowledge the assistance of Silva Globacnik and Pavel Silan in obtaining insights into restructuring and privatization of the Gorenje company. Further, we have to thank the organizers and students of the European University VIADRINA in Frankfurt/Oder, Germany (MBA – Management for Central and Eastern Europe), where we had the opportunity to teach parts of this book. Special thanks go to Peter Kunz and Hans-Jürgen Wagener.

Furthermore we like to thank Éva Katalin Polgár for preparing the case study of Hungary. Mariusz Jarmużek and Johannes Stephan have been collaborating with us in various projects on which this book is based so that is almost impossible to identify the impact they had on this book.

Parts of the article by Jens Hölscher, 'Income Distribution and Convergence in the Transition Process – A Cross Country Comparison', in *Comparative Economic Studies*, (2) (June 2006), Palgrave Macmillan, have been reproduced with permission of Palgrave Macmillan, and parts of the article by Jens Hölscher and Johannes Stephan, 'Competition Policy in Central East Europe in the Light of EU Accession', in *Journal of Common Market Studies*, 42(2) (2004), have been reproduced with the permission of Blackwell Publishing.

Finally, we wish to thank Keith Povey for meticulous editorial support.

HUBERT GABRISCH  
JENS HÖLSCHER