THE ECONOMICS OF TRANSITION

The Economics of Transition

**From Socialist Economy
to Market Economy**

Second Edition

MARIE LAVIGNE

palgrave
macmillan

© Marie Lavigne 1995, 1999

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

No portion 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, Saffron House, 6-10 Kirby Street, London EC1N 8TS.

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

The author(s) has/have asserted his/her/their right(s) to be identified as the author(s) of this work in accordance with the Copyright, Designs and Patents Act 1988.

First edition 1995

Reprinted twice

Second edition 1999

Reprinted 2008

Palgrave Macmillan in the UK is an imprint of Macmillan Publishers Limited, registered in England, company number 785998, of Houndmills, Basingstoke, Hampshire RG21 6XS.

Palgrave Macmillan in the US is a division of St Martin's Press LLC, 175 Fifth Avenue, New York, NY 10010.

Palgrave Macmillan is the global academic imprint of the above companies and has companies and representatives throughout the world.

Palgrave® and Macmillan® are registered trademarks in the United States, the United Kingdom, Europe and other countries.

ISBN 978-0-333-75416-0

ISBN 978-1-349-27313-3 (eBook)

DOI 10.1007/978-1-349-27313-3

This book is printed on paper suitable for recycling and made from fully managed and sustained forest sources. Logging, pulping and manufacturing processes are expected to conform to the environmental regulations of the country of origin.

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

A catalog record for this book is available from the Library of Congress.

Copy-edited and typeset by Povey-Edmondson
Tavistock and Rochdale, England

Contents

<i>List of Tables, Boxes and Figures</i>	ix
<i>Preface to the First Edition</i>	xii
<i>Preface to the Second Edition</i>	xvii
<i>List of Abbreviations</i>	xix

PART I THE PAST: REAL SOCIALISM

1 The Bases of the Socialist Economic System	3
THE PARTY CONTROL OF THE ECONOMY	3
The Ideology	4
The Nomenklatura	4
The Economic Administration	5
Local Government	6
Self-Management	7
COLLECTIVE OWNERSHIP OF THE MEANS OF PRODUCTION	7
Socialist Ownership	8
Non-Socialist Ownership	9
CENTRAL PLANNING	10
Planning Techniques	10
A Non-Reformable System	12
Plan versus Money	13
2 History	15
THE USSR: THE STALINIST MODEL	16
The Beginnings: From War Communism to the NEP and from NEP to Stalinism	16
The Stalinist Era	20
Post-Stalinism	23
THE CREATION OF THE PEOPLE'S DEMOCRACIES IN EUROPE	23
The First Measures	24
The Shift to the Soviet Model	25
Was Yugoslavia a Different Model?	25

THE VARIANTS OF THE SOCIALIST MODEL IN THIRD WORLD COUNTRIES	27
3 The Reforms: Experiences and Failures	29
THE APPARENT LOOSENING OF PARTY CONTROL	29
New Relations between the Centre and the Enterprise	30
A Limited Autonomy	31
The Illusions of Participation	32
A DWINDLING OF THE STATE OWNERSHIP MONOPOLY?	33
State Ownership	33
Cooperative Ownership	35
Non-State Ownership	36
COMBINING THE PLAN AND THE MARKET	37
The Principles	37
The Stalemate	39
Could Any Reform Succeed?	40
The Pervading Parallel Economy	41
4 The Performance	44
THE STRATEGY OF GROWTH	44
The Measure of Performance	44
The Aim and the Model	49
VARIANTS AND ALTERATIONS OF THE MODEL	50
The Eastern European Variants	50
The Non-European Variants	55
THE CRISIS AND THE QUAGMIRE	57
The Economic Crisis	57
The Assessment	62
5 International Economic Relations	65
'FUNCTIONAL' AUTARKY	65
State Monopoly of Foreign Trade	66
Foreign Trade Planning	67
Inconvertibility of the Socialist Currencies	68
COMECON	72
How Comecon Worked	72
How the East was Won	76
TRADE AND COOPERATION WITH THE CAPITALIST WORLD	79
The South: A Costly Partnership	79
East–West Relations: War or Peace?	82

PART II THE PRESENT: TRANSITION IN THE MAKING

6 The End of the System	91
THE CAUSES OF THE COLLAPSE	91
The Roots	92
The Start	94
THE FIRST STEPS OF THE TRANSITION: CENTRAL EUROPE	96
The GDR: A Merger	96
The PHARE Countries	97
TRANSITION THOUGH BREAKING UP	102
The Collapse of Comecon	102
The Disintegration of the Multinational States	107
THE RESISTANCE TO TRANSITION IN NON-EUROPEAN SOCIALIST COUNTRIES	111
7 Macroeconomic Stabilisation	113
THE STABILISATION POLICIES	114
The Package	114
Tactical Choices	116
THE OUTCOME OF THE STABILISATION MEASURES	120
The Main Features of the Stabilisation Programmes	121
The Achievements in the Monetary–Financial Field	121
The Achievements in the Real Field: The Fall in Output	150
8 Privatisation and Structural Reforms	162
PRIVATISATION	162
Definitions	162
The Aims of Privatisation	163
The Mechanisms of Privatisation	165
Post-Privatisation: Restructuring and Governance	179
OTHER AREAS OF STRUCTURAL TRANSFORMATION	186
The Banking and Financial Sectors Reform	186
The Tax Reform	194
Building a New Social Safety Network	195
Labour Market Policies	196
Agriculture in Transition	197
9 Reintegrating the World Economy	203
HOW TO RECONSTRUCT REGIONAL ARRANGEMENTS IN THE EAST	204
Is there a Rationale for a Central and Eastern European Regional Grouping?	206
Trade and Payments Arrangements in the CIS Space	210

THE REORIENTATION TO THE WEST	218
The First Stage of Reintegration: The Europe Agreements	218
The Accession Process	228
The 'Outer' Circles	239
International Migration Issues	241
PARTICIPATION IN THE GLOBAL ECONOMY	244
The Initial Stage: Western Assistance to the Transition	244
Globalisation and the Countries in Transition	254
10 When is Transition Over?	264
TRANSITION FROM WHAT? THE REAL NATURE OF 'REAL' SOCIALISM	264
A DEAD END: MARKET SOCIALISM	267
Oskar Lange and the Market Socialism Blueprint	268
Objections and New Suggestions	269
Could Market Socialism Offer a Workable Post-Transition Model?	271
THE END OF THE JOURNEY: WHEN IS TRANSITION OVER?	272
Is Transition an Identifiable Stage, or State, or Process?	272
What is To Be Done?	273
When is Transition Over?	276
11 Conclusion	278
A SMALL ECONOMIC IMPACT	278
THERE IS ONLY ONE WORLD	280
<i>Statistical Appendix</i>	281
<i>Suggestions for Further Reading</i>	294
<i>Bibliography</i>	299
<i>Index</i>	320

List of Tables, Boxes and Figures

Tables

1.1	Simplified scheme of material balance	11
2.1	The beginning and end of the socialist economic system	26
4.1	The Soviet growth rates, 1922–85	45
4.2	GNP levels: East–West comparisons	48
4.3	Structure of production in the socialist economies by sector and by final use, and structure of employment, 1950–89	53
4.4	Growth rates in the Soviet Union and Eastern Europe, 1950–90	58
5.1	The issues of the ‘subsidy debate’	78
5.2	Eastern Europe and the USSR: commodity composition of trade with the West in 1990	85
6.1	The stages of the political revolution in Central and Eastern Europe, 1989–91	98
6.2	The countries of Central and Eastern Europe: official names, population and territory	100
6.3	The collapse of Comecon: ruble/dollar cross-rates, end-1989	104
6.4	The former USSR and its successor states	109
7.1	The initial building blocks of the stabilisation-cum-transformation programmes in Central and Eastern Europe, 1989–94	122
7.2	The main instruments of the stabilisation programmes, 1990–7	130
7.3	Exchange rates, purchasing power parities and real product wages in selected countries in transition, 1991–7	145
8.1	The main issues of the privatisation process in the countries in transition	167
8.2	Mass privatisation schemes	175
8.3	Progress in structural transformation: the EBRD indicators	200
9.1	Patterns of foreign trade in the countries in transition: initial changes in direction (1991–3), and shares in 1990, 1993 and 1997	205
9.2	The status of the currencies in the successor states of the USSR	216

9.3	Membership of Central and East European countries and of the former Soviet Union countries in regional and international economic organisations (as of beginning of 1998)	219
9.4	Trade in sensitive products between the EC countries and five countries in transition in 1992	223
9.5	Convergence criteria for reaching Stage 3 of EMU and compliance by the CEEC	234
9.6	The costs of enlargement of the EU, 2000–6	239
9.7	Assistance to Eastern Europe and to the former Soviet Union, 1990–5	246
9.8	Borrowing from the IMF by the Eastern European countries and the CIS, 1990–5	247
9.9	IMF involvement in some countries in transition by end-December 1997	252
9.10	Foreign direct investment in countries in transition, 1991–7	255
9.11	Net capital inflows into countries in transition, 1995–7	262

Boxes

2.1	Chronology of the USSR	17
7.1	The reform plans devised for the USSR/Russia	126
7.2	The Bulgarian crisis of 1996–7	141
7.3	The ‘Washington Consensus’	160

Figures

4.1a	NMP: annual rates of change: Bulgaria, Romania and GDR	58
4.1b	NMP: annual rates of change: Czechoslovakia, Hungary and Poland	59
4.1c	NMP: annual rates of change: USSR	59
5.1	Eastern Europe and the USSR: exports and imports by direction, 1975 and 1989	73
5.2a	Eastern Europe and the USSR: commodity composition of trade	86
5.2b	Eastern Europe: exports to the West, 1990: share of sensitive products	86
7.1a	Consumer prices, 1991–7: Russia, Ukraine	134
7.1b	Consumer prices, 1990–7: Central European countries	134
7.1c	Consumer prices, 1990–7: East-South European countries	135
7.1d	Consumer prices, 1991–7: Baltic countries	135
7.2a	Budget deficit, 1991–7: Russia, Ukraine	138
7.2b	Budget deficit, 1990–7: Central European countries	138

7.2c	Budget deficit, 1990–7: Bulgaria, Romania	139
7.2d	Budget deficit, 1992–7: Baltic countries	139
7.3a	Real exchange rate index, CPI-based, in national currencies per USD, 1991–7	146
7.3b	Ratio of nominal to PPP-based exchange rate, in national currencies per USD, 1991–7	146
7.3c	Average monthly wages in USD, at nominal exchange rate, 1991–7	147
7.3d	Real product wage index, PPI-based, 1991–7	147
7.4a	GDP index, 1989–97: CIS (overall), Russia, Ukraine	151
7.4b	GDP index, 1989–97: Central European countries	151
7.4c	GDP index, 1989–97: East-South European countries	152
7.4d	GDP index, 1989–97: Baltic countries	152
7.5a	Unemployment as per cent of labour force, 1991–7: countries with high unemployment rates	153
7.5b	Unemployment as per cent of labour force, 1992–7: countries with medium to low unemployment rates	153
7.6a	Real wage index, 1991–7: Russia and Ukraine	155
7.6b	Real wage index, 1990–7: Central European countries	155
7.6c	Real wage index, 1990–7: East-South European countries	156
7.6d	Real wage index, 1990–7: Baltic countries	156
9.1	CEECs: Unit labour costs, PPP-adjusted, Austria = 100, 1991–7	227

Preface to the First Edition

Until recently the world was divided into the first, second and third world. The notion of the second world is now losing its substance. What remains is a huge amount of debris and ruins which is a combination of the first and third worlds: by its aspirations and longing to create a democratic political system and prospering market economy it relates to the first world, a part of which it would like to become; however, by the state of the economy and the types of national and social problems it often resembles the third world. (Vaclav Havel, President of the Czech and Slovak Federal Republic, 4 September 1991, Prague, opening speech of the International Forum for Culture and Democracy)

Since the Berlin Wall was breached on 9 November 1989, the former socialist countries have remained on top of the agenda in the Western media, not only because of dramatic political developments such as the anti-Gorbachev coup and the collapse of the USSR in 1991, or because of the lingering state of war in the former Yugoslavia and in parts of the former USSR. Economic developments make headlines as well. The transition to the market arouses public interest out of proportion to the share of these countries in the world economy. Western governments, firms, international organisations and ordinary citizens, are eager to keep informed, to understand, to help, to advise, to trade, to invest, to be involved in one way or another.

At the same time, after several years of transition, frustrations and even a kind of fatigue develop in the West. Though transition to the market is now acknowledged as a longlasting process which might extend to a whole generation, structural transformation seems very slow. While growth has resumed in Eastern Europe, there are only a few signs of the possible ending of a protracted recession in Russia. Along with this gloomy assessment, the West increasingly feels the impact of the East, in many ways. East and West are now parts of the same world. In the past, following the usual international classification, one could divide the world into three parts: the developed market economies, or, in the parlance of the East, the capitalist world; the 'second' world of the centrally planned economies, which used to call itself socialist; the Third World of the developing economies. Now there is just an economic division between rich and poor countries. There is no longer a systemic division. The market economy has won. What is the price of this victory? Will the Western model succeed in the East? Will the rich Western countries be able to go on supporting the South

and at the same time pull the East up to their average level of development? What does this imply in terms of assistance, market liberalisation, and increased immigration? Are our recipes and programmes really suited for the transition process? If these programmes do not work as they should, is the model to be blamed?

Much has already been written on transition. Reports, conference materials, collective books, guides for businessmen, and scholarly articles in specialised and non-specialised journals, have flourished. It is fairly impossible to follow this surge in the literature, and to avoid being overtaken by events. It looks therefore provocative to offer a textbook by one single author on such a fast-moving subject. The purpose and the approach need to be clarified.

The author of this book has been studying Soviet and Eastern European economies for over thirty years. Thus, I belong to the professional world of what used to be called 'sovietology'. This profession is feeling very frustrated lately. Since the beginning of the transition many new experts have come into the field, from various backgrounds, mainly from an experience in developing countries. Many of the former 'sovietologists' have lost credibility, because none of them had predicted that the system would collapse when it did, or the way in which a collapse would occur, and also because they were suspected of bias due to their involvement in the study of a now dead system. Personally I do not feel guilty of lack of foresight. We all were wrong: both those who year after year predicted that the system was bound to collapse, and those, more cautious, who thought it might go on muddling through for many years. Many of us believed that the system might last longer if reformed, and we had even devised the categories of 'modified' or 'reformed' planned economies. The sudden end of the system took everybody by surprise, as well as the radical shift to the market, which excluded any 'third way'. Does this mean that we may now dispense with any understanding of the past? The present transition process has no historical equivalent or precedent, such as the situation of the Western European countries after the Second World War, or the evolution in the developing countries. The transition is burdened with the legacies of the past. This past has to be assessed, especially as history is being rewritten due to new information and new statistical data now available. Slowly, 'the figure in the carpet' reveals itself. Knowledge of the past helps to understand the inertia of the present. History also evidences that the fruit was rotten, through dozens of signs that we know how to decipher only now; thus the present provides us with keys to explain the past.

This book is concerned with economics. Is there such a thing as 'transition economics'? In the past there was a wide debate in the profession as to the relevancy of mainstream economics to the analysis of centrally planned economies. Whatever the answer in theory, in practice it was very difficult to

use any sophisticated econometric model for lack of reliable data. Now there seems to be a wide consensus on the theory. In the East, while communism has been discarded politically, and even outlawed in some countries (for instance, in the Czech Republic), economists and policy-makers alike endorse the fundamentals of neo-classical economic science. Their Western advisers eagerly support this attitude, especially as the standard adjustment and stabilisation packages which they recommend are based on the same theoretical assumptions. I believe that the disillusion in the transition process will lead to a more complex approach, closer to the 'political economy' concept. This concept is generally considered with suspicion both in East and West. It is reminiscent of Marx, more than of Ricardo. It suggests at best a reluctance, at worst an inability to use mathematical formalisation. Beyond such simplifying views, one may find an inspiration in new approaches such as the institutionalist one, and in the combination of economics with political science and history. The last chapter of this book explores these alternative approaches.

This book is also the outcome of a personal involvement. I have been travelling in East Central Europe and in the USSR since 1964. I have witnessed the first year of the transition in Prague in 1990–1. I have many personal friends in all these countries. Therefore I cannot look at the transition from a mere scholarly point of view. I want the transition to succeed, and I sense all the sorrows and pains associated with this process, which looked so exhilarating in the beginning. I have a special thought for my Russian friends. Not only are they facing the damages and losses resulting from the past regime, which they had to bear for so long; and not only, in their own private lives, are they looking back at their wasted years, and anticipating an uncertain and difficult future for their children. But also, they are explicitly or implicitly burdened with a collective guilt for what their leaders have imposed upon others. Their native motherland has vanished; its name is associated with infamy, and glorious memories are wiped out. The 900 days during which Soviet Leningrad resisted the enemy sink into oblivion while St Petersburg is born again. Transition is irreversible: nobody wants the communist past to be revived, but should all of it be doomed?

Finally, let me add a few methodological notes. The book is divided into two parts, the first one dealing with the past of the centrally planned economies under 'real socialism', the second exploring the transition in progress. Central and Eastern European countries, together with the former USSR, are mainly considered here; other experiences are mentioned but not elaborated upon.

The book is targeted for students in economics, political science, and history of Eastern Europe. Though designed for undergraduates and not requiring a preliminary acquaintance with the subject, it may also be used

on advanced courses as an introduction to transition economics. For teachers and graduate students, a guide for further reading provides opportunities for a deeper investigation. The book is also meant for the general public wanting a simple and clear approach to the complex issues of the transition to the market. It does not pretend to convey detailed information on all its aspects for all the countries under review. This is why, contrary to almost all the books devoted to this topic, no country studies are presented. The purpose is to offer basic and comprehensive guidance to the essentials, so that the reader may use what he/she already knows about the past of this area, sort out the huge volume of information brought to him or her by the media day by day, and follow up on his/her own through further reading.

A book on such a topic cannot be definitive. The process analysed is transitory by definition. People and governments in the East have to go through and out of transition; international organisations, states, and experts in the West are busy helping, advising, monitoring, and observing the process. The ultimate aim is not to create a new type of society, a new system. The East wants to rejoin the developed West where it stands. To reconstruct a market economy is, however, a long and complex task: we know where we start from, we believe we know how to get there, but we cannot know exactly what the outcome will be. The story is still open-ended.

* * *

I could not have written this book (as well as the shorter French book on which the present volume elaborated and expanded, *L'Europe de l'Est, du plan au marché*) without various favourable circumstances such as fruitful contacts and discussions in several research centres in the beginning of the transition. I would like to acknowledge the research support of the European University Institute (1988), of the Bundesinstitut für internationale und ostwissenschaftliche Studien (BIOST) in Cologne (1989), of the Averell Harriman Institute at the Columbia University and of the Institute for East–West Studies (IEWS) in New York (1990). I had the great privilege of being appointed by the IEWS as the director of its Central European branch, the European Studies Centre in Prague (1990–1), and this gave me the invaluable opportunity of witnessing the first steps of transition in a former communist country, as well as the privilege of working with a team of people enthusiastically dedicated to assisting the transition process. I was associated for two years (1991–3) with the Programme for Strategic and International Security Studies of the Graduate Institute for International Studies in Geneva. With the support of the French Ministry of Education and of my university, I organised in 1992 an international ‘summer school’ on the transition to the market which again allowed me to develop exciting intellectual contacts.

I cannot formally express my gratitude to all the friends, colleagues, specialists and institutions who actually helped me in devising this book, gathering the material, and clarifying my ideas. I earnestly apologise for not mentioning everybody toward whom I have an intellectual debt. Among the few names I want to mention, I shall begin with two dear friends of many years, with whom I have repeatedly discussed the issues of feasible or unfeasible socialism, and who both died in 1994: Alec Nove, Emeritus Professor at the University of Glasgow and father of the British sovietology, and Aleksandar Vacic, the head of the Division for Economic Analysis and Projections at the Economic Commission for Europe of the United Nations in Geneva. Several friends agreed to read the manuscript and to comment; I am especially grateful to Joel Dirlam, Marvin Jackson, Viktor Kuznetsov, Harriet Matejka, and Mario Nuti, for their attention and their remarks. All conclusions and remaining errors are mine.

Pau, France

MARIE LAVIGNE

Preface to the Second Edition

Is it still relevant to talk about the economics of transition when the process is already almost ten years old? When embarking on the update of this book I felt greatly relieved by the statement of Joseph Stiglitz, author of *Whither Socialism?* (1994) and chief economist of the World Bank, upon being asked whether there was such a category as 'transition country': 'Definitely', was the answer (*Transition*, the World Bank's Newsletter, December 1997). True, he said, Central European countries are moving towards less and less differentiation as a category, but many transition countries have still a long way to go.

The approach to these countries has changed. We know increasingly more about them. Attention has shifted away from broad assessments of the macro-economic situation towards micro-economic investigation based upon detailed case studies, often conducted in cooperation with professionals from these countries in the framework of technical assistance programmes. The analyses have focused on branches, regions, enterprises. Large data bases have been constructed and exploited using standard tools. We have now a huge amount of detailed studies, working papers and technical material. It is increasingly difficult to keep track of this information, which is disseminated in journals, conference documents, and updated papers available on numerous Internet sites.

From this increasing mass of information, I have tried to extract the basic trends of change in a comparative approach. My aim is to give the clearest picture of what is happening in the main areas of transformation, and to help the reader to find his or her way in the available sources, should he or she want to go further. This is why I have substantially revised and updated Chapters 7 to 9 to account for the progress in macro-economic stabilisation, micro-economic restructuring and integration in the world economy.

I did not alter the first six chapters, because I have not changed my mind either about the main features of the past centrally planned system, or about the causes of the collapse of communism (though some of my reviewers have criticised me on this latter point). I substantially altered Chapter 10, because I have been convinced that there cannot be a 'theory of the transition' (I am particularly grateful to János Kornai for his advice and comments). We are now heading towards the end of transition. The question is how and when.

What we may be sure of is that the end is not going to be as obvious and clear-cut as the beginning has been.

Bagnères-de-Bigorre, France

MARIE LAVIGNE

List of Abbreviations

BIS	Bank for International Settlements
BSEC	Black Sea Economic Cooperation
CAP	Common Agricultural Policy
CEEC	Central and Eastern European Countries (Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia)
CEFTA	Central European Free Trade Agreement
CIS	Commonwealth of Independent States
CMEA	Council for Mutual Economic Assistance
Comecon	Council for Mutual Economic Assistance
CPI	consumer price index
CSFR	Czech and Slovak Federal Republic
EAs	Europe Agreements
EBRD	European Bank for Reconstruction and Development
EC	European Communities (before 1993)
ECE/UN	Economic Commission for Europe of the United Nations
ECO	Economic Cooperation Organisation
ECSC	European Coal and Steel Community
EEC	European Economic Community (before 1993)
EFTA	European Free Trade Association
EIB	European Investment Bank
EMS	European Monetary System
EMU	Economic and monetary union (within EU)
EPU	European Payments Union
ERM	Exchange rate mechanism (within EEC/EU)
EU	European Union
FDI	foreign direct investment
FTO	foreign trade organisation
FYROM	Former Yugoslav Republic of Macedonia
GATT	General Agreement on Tariffs and Trade
G-7	Group of Seven
G-24	Group of 24
GDP	gross domestic product
GDR	German Democratic Republic
GNP	gross national product
GSP	generalised system of preferences
IBEC	International Bank for Economic Cooperation

IBRD	International Bank for Reconstruction and Development (World Bank)
IGC	Intergovernmental Conference
IMF	International Monetary Fund
MFA	Multi-Fibre Arrangement
MNCs	multinational companies
NIS	newly independent states
OECD	Organisation for Economic Cooperation and Development
OPT	outward processing trade
PHARE	<i>Pologne, Hongrie, assistance à la restructuration économique</i>
PPI	producer price index
PPP	purchasing power parity
SDR	special drawing rights
SITC	Standard International Trade Classification
SMEs	small and medium enterprises
SOE	state-owned enterprise
TACIS	Technical Assistance for the CIS
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme
UNIDO	United Nations Industrial Development Organisation
USDA	United States Department of Agriculture
VAT	value-added tax
WTO	World Trade Organisation