On the relevancy of institutional economics for international economics

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11.1 INTRODUCTION

After the fall of the Berlin Wall on 1 November 1989, in Central and Eastern Europe one country after the other broke away from the dominance of the Soviet Union and started a transformation process from a centrally planned economy into a market economy. In this process, most countries followed the often-used recipe that the IMF and the World Bank had formulated for developing countries (Taylor, 1993). This recipe was aimed at a rapid macroeconomic stabilization and the introduction of a liberalization process in which old planning institutions would disappear and new market institutions would arise. Implicitly, this recipe assumed that the market institutions would spontaneously arise the moment the old planning bureaucrats disappeared.

The economic results of the reform process were disappointing. Most countries were hit by a severe depression. Indeed, real GDP in 1999 surpassed 1989 levels in just two of the 25 transition countries, and in the most severe cases, in the countries that belonged to the Soviet empire, the observed cumulative output fall was more than 50 per cent of 1989 GDP (Campos and Coricelli, 2002). Moreover, one can perceive that especially in those countries that were formal Soviet republics an important part of the economic transactions took place on the basis of
barter trade and other non-monetary forms of trade such as promises. In this chapter we will explore the causes of the recession. In addition we will search for an explanation for the fact that the disappearance of the old planning relations was not a sufficient condition for the rise of a full-fledged market economy.

An important thesis of this chapter is that the reform process in Central and Eastern Europe is based on an insufficient theory about the functioning of a real market economy. For the underpinning of this thesis we will abandon the formal, neoclassical definition of a market economy in Section 11.2 and formulate the building blocks of a market theory with a more substantive content, namely a market as an institutionalized process (Polanyi, 1992). In Section 11.3 we will describe the real transition process in three different countries, namely East Germany, the Czech Republic and Russia. These descriptions reveal that the rapid demolition of the old planning institutions did not result in the building of a full-fledged market economy. It is true that East Germany imported the formal institutional structure of West Germany, but the informal institutions and routines of the past survived for a long time. In the Czech Republic the building of formal institutions took more time and also in this country the informal institutions of the past did not disappear quickly. In Russia, at this moment the country is still muddling through to a hybrid form of a market economy where the exchange relations often take the form of barter trade and other non-monetary forms.

From our analyses we can conclude that the creation of market relations might be a necessary condition for economic recovery, but not a sufficient one. Also the content of the pursued macroeconomic policy and the scope of manoeuvring of the medium and small-scale enterprises play an important role. We can ask ourselves the question whether or not these empirical revelations will give some indication for a more integrated theory about a successful transition process. This problem will be discussed in Section 11.4.

11.2 INSTITUTIONAL ECONOMICS

In contrast with orthodox economics, which maintains that the central economic problems are the allocation of resources, the distribution of income, and the determination of the levels of income, output and prices, institutional economics asserts the primacy of the organization and control of the economic system (Samuels, 1988: 865). As in the other social sciences, institutional economists
focus on the dependency and power relations between (groups of) human beings. These relations in an economic system originate from the division of labour. In a system characterized by division of labour, human beings need other human beings for their survival. Thus, where orthodox economists tend to identify the economy solely with the market full of independent subjects, institutional economists argue that the market coordinates dependency relations and that the market itself is an institution, comprised of a host of subsidiary institutions, which is interactive with other institutional complexes in society. The fundamental institutional position is that not the market but the organizational structure of the larger economy – including the market – effectively allocates resources. In short, institutional economists argue that orthodox economists have a too simplistic theory of the functioning of an economy in general and a market economy in particular.

The misconception regarding the functioning of a market economy stems from the orthodox formalization of Adam Smith’s argument of the ‘invisible hand’ which induces self-interested agents to serve the common good. Orthodox economists investigate the conditions (taste, endowment, technology, and market structure) necessary for the existence of competitive equilibria that are Pareto-optimal. These conditions are summarized in the First Fundamental Theorem of welfare economics stating that if there are enough markets, if all consumers and producers behave competitively, and if an equilibrium exists, then the allocation of resources in that equilibrium will be Pareto-optimal (Ledyard, 1991: 407; Stiglitz, 1994: ch. 3). Moreover, by assuming that contract disputes are settled in court in an informed, sophisticated and low-cost way, the economic models have implicitly a ‘legal centralist’ point of view (Williamson, 1985: 20).

In these Pareto-optimal general equilibrium models power relations are defined away. The assumption of Pareto-optimality guarantees that the economic subjects participate voluntarily in the economy (assuming there is no jealousy effect), and the assumption of perfect competition guarantees that large corporations cannot set prices in a one-sided way.

The possible existence of an optimal, Pareto-efficient solution in a market economy is often cited as evidence against the functioning of a real planned economy. However, from a methodological point of view, it is only legitimate to compare the properties of ideal systems, or real systems. We cannot condemn the properties of a real existing economy by comparing it with the ideal properties of the alternative to it. In practice, however, this ‘nirvana approach’ is often adopted
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(Demsetz, 1969). When the properties of an optimally functioning market economy are compared with the properties of an optimally functioning planned economy, both based on utility maximizing individuals, it can be shown that under appropriate assumptions both regimes will lead to the identical allocation of resources (Pareto, 1966: 364). Following a different line of argument, Samuelson came to the same conclusion: ‘under perfect competition workers can rent capital goods or capitalists can rent workers’ (1972: 237). Hence, a competitive balance between market and planning can only shift to one side if we take a non-allocative efficiency point of view.

These general equilibrium models have several flaws. These models are only interested in the possible existence and properties of an equilibrium. The difficulties of what would happen if prices were not at the equilibrium level are often glossed over. When they are not glossed over the theory runs into trouble. When the economy is in disequilibrium it is often assumed that the equilibrium can only be restored with the help of a ‘Walrasian auctioneer’. This solution can be criticized both from a theoretical and an empirical perspective. First, from a theoretical perspective, the market theory, using the auctioneer metaphor, is not self-sufficient. It needs an argument exterior to the market in order to stabilize the market. Secondly, when we think about the real content of the auctioneer on the level of a national economy, it can be argued that the orthodox equilibrium models are not models of a market economy, but models of a hybrid economy where central pricing agencies allocate resources of firms based on private property (De Vroey, 1998). Actually, orthodox economics provides a rudimentary theory of the state, imposed ‘from above’ on the economy.

The fact that social order can only be organized around an external point of reference is not satisfactory. Especially Hayek has tried to close the system with the help of his ‘spontaneous social order’. This order arises from within, but remains nonetheless ‘external’ to the individuals who make up that order (Dupuy, 1996). Hayek’s fundamental assumption is the unlimited variety of human gifts and skills and the consequent ignorance of a single individual of most what is known to all members of society taken together. On the basis of his limited knowledge the individual takes actions. When his perceived actions are in accordance with the actions as expected, he has no incentive to change his plans. When nobody’s expectations are falsified, nobody has an incentive to change his plan and the plans of all individuals are consistent with each other. In other words, they are coordinated and the system as a whole is in equilibrium.
When the perceived actions are not in accordance with the expectations, the individual has to change its course of actions. By taking actions, structures emerge because successful interactions will be repeated more often than less successful ones. According to Hayek these efficient structures will stabilize themselves and form constraints to other individuals who have to adapt their plans. In this learning process, rules emerge which memorize behaviour that has proven beneficial over time. Hence, these spontaneous social orders are the result of human action but not of human design. By relying on these emerged structures, rules and institutions, individuals increase their capacities for actions without appropriating the logic of the combined knowledge these orders mobilize. It is in this sense that the system ‘knows’ more than the individuals of which it consists (Birner, 1996).

Unfortunately, Hayek’s spontaneous social order has a teleological undertone. For Hayek the evolutionary process leads to the best rules, those of liberalism. He ignores the fact that his spontaneous order consists of persons that might have an interest to conspire against his best rules, or have an incentive not to obey these rules (Bianchi, 1994). However, Hayek’s main improvements to the orthodox equilibrium models is his view that life is permeated by fundamental uncertainties and that the spontaneous collaboration of free men often creates things which are greater than their individual minds can ever fully comprehend. These institutions, which are characteristics of the system as a whole, are capable of performing tasks that are far too complex for individual human minds. Hence, rationality does not exist in the singular, as the rationalist approach seems to assume, but is a property of the system as a whole.

When we summarize our criticisms of neoclassical economics, we see that an economy is a hierarchical system. The properties of the system as a whole may be imposed by the state or induced as an unintended outcome of a spontaneous process. Moreover, at all levels of the economy life is permeated by uncertainties and many problems are too complex to be solved by standard optimizing techniques. Therefore, in order to get a more reliable picture of an economy, we have to study these uncertainties and complexities not only on the level of the individuals but at all levels of the economy.

In principle, there are two ways to deal with uncertainty and complexity (Knaack, 1996). First, we can try to reduce uncertainty and complexity by creating stabilizing institutions and organizations. Second, we can create more structural flexibility. Both ways are used at all levels of the economy.
At the micro level, Heiner (1983) has discussed the problem resulting from the gap between the competence of an individual and the complexity of the decision problem to be solved. He develops a Reliability Condition which states that individuals must ignore actions which are appropriate only for rare or unusual situations. This Reliability Condition resembles Simon’s satisfying behaviour. It is also much more in line with biological research stating that our thinking is constrained by the structure of our neuron system (Maturana and Varela, 1984). With regard to firms, Alchian and Demsetz (1972) have advocated the monitoring of the workforce in order to minimize opportunistic behaviour. The problem of ‘disciplining the labour force’ can also be solved by other strategies. Modern organization theory stresses the importance of trust and loyalty for the efficiency of the firm (Simon, 1991). Many authors suggest that the relative efficiency of Japanese firms stems in part from long-established relations of give-and-take and trust (Imai, 1986). At the micro level the structural flexibility can be improved by building stocks and by learning new techniques.

At the meso level, many problems can also be solved by creating uncertainty-reducing institutions. Some of these institutions deal with asset specificity. Consumers will be protected from bad behaviour of firms by good inspectors, consumer agencies and quality marks. Firms are brought into contact with each other by chambers of commerce, auctions and fairs. Prices are published in newspapers, on radio and on television. Many firms work together on joint research projects. Also trust and personal relations are uncertainty-reducing devices. The structural flexibility can be improved when firms aim successfully for diversification and product innovation.

At the macro level too, there is a need for uncertainty-reducing institutions. In general, the need for coordination at the macro level stems from the ‘fallacy of composition’ (Hodgson, 1988: 233). In macroeconomics, relationships might be the reverse of the corresponding relationships at the micro level. For example, wage reduction may increase a country’s competitiveness on the world market. But if every country follows this policy the overall demand for products will fall; this will lead to reduced business expectations, and a general decline in economic activity will ensue. Policy coordination, both national and international, might avoid these unintentional developments. On the other hand, also on the level of macroeconomics, structural flexibility can produce favourable outcomes. For example, the government can create more flexibility by stimulating schemes for \textit{éducation permanente}, by improving the infrastructure and by deregulation.
Strangeley enough the existence of uncertainty and complexity creates not only an impetus for the creation of uncertainty-reducing institutions, but also for growth and technological development. As a result uncertainty and complexity might increase again. Without these ‘imperfections’, entrepreneurs have no incentive to take risks. An incentive to invest, for example, depends in part on the belief that others do not possess information regarding the opportunity open to the investor. A profit opportunity which is known to everybody is available to nobody in particular. Hence markets have a double function. They are instruments for the coordination of activities and for the transmission of impulses to change (Kaldor, 1972: 1240).

From our analyses we may conclude that an efficient functioning market economy requires the stability and support of an overall institutional framework. Order and stability at the macro level are mainly brought about by stable political rules and by the norms set forth by tradition and culture. Order and stability at the meso level are realized by the stability of the organizational forms. Stability on the micro level is created if economic agents behave in an orderly way. This orderly behaviour is brought about by the permanent durability of the structure of human perception and behavioural rules (Nelson and Winter, 1982). The institutional forms on each level are not independent of each other. They have to ‘fit’. The overall ‘fit’ is the result of an evolutionary process.

On the other hand, the new stability might not lead to rigidity. Entrepreneurs and the government must be able to adapt to changes in their environment. It is important to realize that these two kinds of response may contradict each other. Too much control may lead to gigantic principal-agent problems; too much flexibility may create a lack of coordination between the various parts. In short, in each economy there is a dialectic relation between the need for both flexibility and rigidity. This dialectic relation can be found on all levels of the economy.

The foregoing analysis leads to the conclusion that a dynamic and innovative economic system will require a structured combination of variety and rigidity, of statics and change, of centralized guidance and decentralized autonomy. Neither the liberal ideology of the free market nor the state power of Marxism-Leninism lends themselves to this type of conclusion (Hodgson, 1988: 169).

This conclusion has also some relevancy for institutional economics. Institutional economics must both have a theory about economic coordination and a theory about economic change. The institutionalist theory of economic change is worked out especially by the French Regulation School (Boyer and Saillard,
They start from the widely-held view in social sciences that for an economy to function well, all parts of the economic system must be integrated. The parts must correspond to each other, they must support each other. The Regulationists assert that in order to obtain a harmonious development of society, the institutional structure and the technology structure must be fine-tuned to each other and both to the environment. They explain the ‘golden age’ of capitalism, the period 1950-73, as resulting from the ‘functional fit’ between the parts of the economic system and between the system and its environment.

As consequences of changes in particular subsystems or the environment, functional misfits may arise in the system as a whole. The changes stem from different sources (Lin, 1989). The institutional choice set may change (for example, privatization in Eastern Europe), the technology may change (the introduction of ITC), and the environment may change (for example, increasing share of elderly people). These changes may be the outcome of ‘accidents’, of economic laws, or of deliberate action. However, whatever the source may be, the question is whether or not they will induce adjustments in other subsystems.

As a result the institutional arrangements in society will change. However, these institutional changes may develop slower than expected. As a result, they may lag behind (Holesovski, 1977: 33). This delay might be very long because of inertia. Individual behaviour, the institutional arrangements among individuals, and technology may be ‘locked’ into formal and informal networks of social interaction from the past. The prolonged functional misfit among the subsystems is one of the major explanations for so many frustrated reform movements and defeated revolutions.

The fact that each subsystem has a different adaptation time may lead to the hypothesis that an economic reform that seeks to minimize transaction costs can only be an evolutionary process, one of learning-by-doing, of trial and error. What is needed is ‘piecemeal social engineering’, incremental improvements which can be continually improved upon.

In the next section we will demonstrate the dialectical relation between the institutional theory of economic stability and the institutional theory of economic change on the basis of the experiences of three transition economies, namely East Germany, the Czech Republic and Russia.
11.3 THE TRANSITION PROCESS OF THREE FORMERLY CENTRALLY
PLANNED EUROPEAN ECONOMIES

11.3.1 Introduction

On 1 November, 1989, the Berlin Wall fell. From that moment on in Central and
Eastern Europe one country after the other broke away from the Soviet dominance
and started a process of conversion from a centrally governed economy to a
market economy. On 30 June, 1990, the two parts of Germany were reunited and
the German economic, monetary, and social union was created. In
Czechoslovakia the Velvet Revolution brought the rule of the Communist Party to
an end in November 1989. The new government of Prime Minister Klaus
introduced a series of measures as from 1 January, 1991, aimed at the integration
of the Czechoslovakian economy into the world economy. Also the Soviet Union
was contaminated with this spirit of the time. After the breakdown of this
country’s economic system the new rulers strived for a rapid transition towards a
new system characterized by market relations, private ownership, and a liberal
democracy. On 2 January, 1992, the Gaidar administration brought a series of
measures in that direction into force, which inflicted an enormous shock on the
Russian economy.

The processes of change in Central and Eastern Europe were not based on a
blueprint showing how a formerly communist country ought to be restructured as
a capitalist country. According to prevailing opinion that was not necessary. Due
to German unification, East Germany took the West German legislation and rules
over at a stroke and East German enterprises were privatized at a quick pace.
Other countries had the possibility to copy the existing and often-approved recipe
as applied earlier by, for example, Spain at the access to the European Union and
developing countries at their integration in the world economy. It was the recipe
developed by the IMF and World Bank (Taylor, 1993) and is dubbed the
‘Washington Consensuz’. The liberalization process was mainly oriented towards
removing the old institutions. One fully trusted that many of the problems would
resolve themselves naturally. Markets would develop as soon as the planning
bureaucrats disappeared.

The economic results of the process of reform were considered to be very
disappointing. Most countries experienced a severe depression. In one country it
lasted longer than in another. In literature a lot of discussion was stimulated on
the causes of this depression and of the growth differentials between the countries. Particularly, this tried to relate the growth differences to the intensity of economic reform.

The World Bank in its World Development Report 1996, for example, linked the pace of the stabilization and liberalisation processes and the economic results in the years 1989-95. It used a liberalization index constructed as the weighted average of the extent of liberalization of the internal and external markets and the extent of privatisation of state enterprises. On the basis of this index the World Bank distinguished four categories of transition countries and determined the scores per category on economic criteria, such as economic growth and inflation, and social criteria, such as average age and child mortality. On all the criteria the countries with a high value on the liberalization index scored best on average. In this research the World Bank left East Germany aside. Without any doubt this country would have had the highest score on the liberalization index in the period studied.

For individual countries and specific criterion variables however, the relation to the liberalization index appears to be much more differentiated. We will substantiate this view in the next sub-sections by means of a closer analysis of East Germany, the Czech Republic, and the Russian Federation, which endured very different transition processes.

11.3.2 East Germany

As already mentioned, the two parts of Germany were reunited on 30 June, 1990, after a separation of no less than 45 years. The Ostmark was replaced by the Deutschmark. Wages and a large part of savings in East Germany were converted from Ostmarks into D-marks at an exchange rate of one-to-one. The legal system, as well as the social security and tax systems, was adapted to the existing systems in West Germany. The latter had already proven their value. Moreover, all barriers to unrestricted capital and labour mobility were abolished. In this way, East Germany was spared a long process of economic stabilisation and erection of market institutions (Knaack, 2000: 179).

At first glance the economic results of this ‘big-bang’ were disappointing: between 1989 and 1991 real GDP in East Germany declined by as much as 35 per cent (Von Hagen and Strauch, 2000: 2). The quick restoration of economic growth is noteworthy. While real GDP still fell by 23 per cent in 1991, one year
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later the East German real GDP already displayed an impressive increase by almost 8 per cent, followed by a growth in the next two years of 9.8 and 10.4 per cent. Despite that, at the end of 1998 the level of real GDP was only 96 per cent of the level ten years earlier. One cause was the return of disappointing economic growth, in 1997 and 1998, at a level of 2 per cent, even lower than West German growth rates of 2.3 and 3.9 per cent in these two years.

The adjustment pattern consisting of an initial steep fall and subsequent quick recovery of economic growth, after which a period of near stagnation sets in, seems to have been characteristic for East Germany and, in any case, differs from the reform processes in other Central and East European countries. The Czech Republic, for example, encountered a stagnation of real GDP in the two years 1992 and 1993 – after a fall of ‘only’ 11.5 per cent in 1991 (EBRD, 1999: 213). In the Russian Federation real GDP fell every year of the period 1991-96, with an annual average of 8 per cent, although the decline in 1991 ‘only’ amounted 5 per cent. End-1998 real GDP in the Russian Federation was 58 per cent of the end-1990 level. For the Czech Republic the corresponding outcome is 96 per cent, exactly equal to East Germany’s percentage.

Paradoxically the unification of Germany resulted in a dichotomy between East and West Germany. In order to prevent a huge migration to the west, the decision was made to strive for a rapid upward convergence of the eastern wage level towards that in the west, although the low labour productivity in the eastern part did not give room for that. Soon after the unification a substantial unemployment came into being in East Germany and, partly as a consequence of that, a large and prolonged western financial support for the eastern part of the country appeared to be absolutely necessary.

The sky-high unit labour costs are mainly responsible for the near collapse of industrial production in the east. In 1990 labour productivity in East Germany was only 30 per cent of that in West Germany. Wages, however, were set at 50 per cent of West German wages. In the period until 1995 this percentage rose to 72 per cent, while labour productivity increased to 53 per cent of the West German level. This rise was substantial, but nevertheless not sufficient to compensate for the wage increase in production costs. While relative real wage rises in the period 1991-97 kept more or less in step with the growth of labour productivity in West Germany, in the east real wages doubled in value whereas labour productivity only increased by some 50 per cent (Von Hagen and Strauch, 2000: 4). With these high and increasing labour costs, the East German enterprises were not capable of
competing successfully on the world market. For that reason, production in the east part declined and so did employment, principally in the industrial sector. In 1990, already, industrial production fell by more than 50 per cent. The light industrial and technological-intensive sectors suffered most. The share of the construction sector in East German production rose steeply, from 18 per cent to more than 34 per cent. The share of the services sector substantially increased too.

In the years 1990-94 almost four million jobs were lost through rationalization processes. An important part of these dismissals used an early retirement option. The remaining part of redundant workers became unemployed. In 1993 the unemployment rate was 16 per cent and in 1997 it was more than 20 per cent. Besides that, 20 per cent of the labour force had involuntarily accepted a reduction in working hours.

To prevent a movement of unemployed from east to west in Germany, the unemployment benefits were set high in the east. This combination of high unemployment and high unemployment benefits triggered huge social transfers from west to east (Von Hagen and Strauch, 2000: 11). Total gross financial transfers amounted to DM139 bn in 1991 and increased to DM189 bn in 1998. Between 40 per cent and 50 per cent of these annual amounts consisted of social security benefits. These financial transfers created a large difference between production and disposable income in the east. As an illustration: in 1995 the former was only 60 per cent of the latter.

In line with the data for 1997 and 1998 presented earlier, the more recent figures about production and unemployment in East Germany (until 2003) point to a more or less stagnating economy with the unemployment rate continuously at a high level of almost 20 per cent (Datastream). This situation and the preceding outline of German economic development since the reunification give support to the early suggestion of a ‘German Mezzogiorno problem’ (Hallett and Ma, 1993). Could this Mezzogiorno problem have been prevented?

First, the conversion at parity of the Ost into the D-mark can be criticised. It made wages in East Germany at one strike much higher than in other Central and Eastern European countries. In contrast to those countries, East Germany could not take advantage of a cheap currency. Neither did the area have the policy autonomy to devalue its currency in order to counter the negative effect of an initially high inflation on the country’s competitiveness. In the years 1991-95 the consumer price index rose by one third! (Datastream). A more realistic conversion value would have strengthened East Germany’s competitiveness, but would
probably also have intensified the migration of people from east to west in the country.

Second, the government could have subsidized the production factor labour more intensively. In the years 1991-98 subsidies to East German firms in general were only 5 per cent to 10 per cent of the total financial transfer flows to the east. One can, however, question the effectiveness of this support instrument for, for example, shipyards in Mecklenburg-Vorpommern, mining in Thüringen or the Trabant factory in Saksen. Instead the government preferred to carry out a high wage/high tech policy. It tried to maintain an independent base for research and development in East Germany. It also spent a lot of money in the development of infrastructure. In the process of privatization however, most Eastern enterprises were sold to West Germans. They were not interested in the research and development departments of these enterprises. Their only interest was better access to the eastern market and reduction of their existing overcapacity. The number of employees in East Germany who dealt with research and development declined from 86,000 to 16,000 (Fleischer and Hornschild, 1999: tables 8.3 and 8.4).

The preceding analysis leads to the conclusion that the potential positive effect of the import of West German institutions for East Germany has been more than fully compensated by the negative effects of the conversion at parity of the Ostmark into the D-mark and the quick upward convergence of the wage rates in east and west in the country. The high growth rates in East Germany in the period 1992-96 are a response to the huge financial transfers from west to east. This money was used for a large part for infrastructure projects, the construction industry and the local government sector. One may fear that if most of these projects will be completed, the economic basis of East Germany will appear to be quite small.

11.3.3 Czech Republic

For a long time, the transition of the Czech Republic towards a market economy was considered to be the example of a successful economic transition process. On 1 January 1991 the government led by Klaus took a number of important measures directed to a quick integration of the Czech economy into the world economy. These measures included the introduction of a fixed and unified exchange rate, liberalization of most prices, abolishment of most foreign trade
controls, and a start of small-scale privatization. These measures covered liberalization, stabilization, as well as privatization of the Czech economy. To a certain extent this scenario reflected the package of measures that the Polish government had introduced one year before (Dyba and Svejnar, 1994: 99).

The substitution of the Ministry of Economic Affairs for the so-called Committee for State Planning was the basis of the Czech economic liberalization process. A direct result was that firms did not need to carry out their tasks assigned by the economic plan any longer. About 85 per cent of all prices were freed and the majority of the state subsidies abolished. The state monopoly on foreign trade was ended step by step. Monetary policy became restrictively aimed at two intermediary goals, namely a prolonged positive real interest rate and a restriction of the growth of bank credits. In order to ease the conversion of Czech exports from the former Comecon countries to the west, the currency was devalued by as much as 50 per cent against the US dollar in 1991.

It was clear that dismantling the institutions of the old planning system and laying the foundation for the institutions of a market economy should preferably be a simultaneous process. The way to realize this seemed to be privatization of state ownership as soon as possible. This privatization occurred in three ways, namely restitution of private properties appropriated after 1948, as well as the so-called ‘small’ and ‘large’ privatizations. The restitution programme delivered an important incentive to the development of the services sector. The small privatization had a similar effect. In a short period of time tens of thousands of shops, restaurants, and small firms were sold. Privatization of large firms was more problematic. Initially, the government tried to realize the ‘large’ privatization by direct sale. An example is Skoda, which was sold to Volkswagen in March 1991 after a tough process of negotiations. Other large state enterprises however, were privatized by means of the voucher system that began in May 1992. In this system the estimated value of the enterprises to be privatized was converted into so-called vouchers, which were sold to the Czech people at a low price. In the first years of its existence the voucher system hardly met any enthusiasm among the Czech population. Only after investment funds entered the market, sometimes offering a tenfold of the value for a voucher, vouchers started to be bought massively and resold to investment funds (Knaack, 2001: 88).

In the first half of the 1990s, all these transformation measures seemed quite successful. Although the Czech GDP declined by 11.5 and 3.3 per cent, respectively, in the years 1991 and 1992, in 1993 it showed a slight recovery of
some 0.6 per cent (EBRD, 1999: 213). After a while, the fight against inflation also proved to be successful. After an annual inflation of almost 60 per cent in 1991, the annual price rise declined rapidly to a level of 11 per cent in 1992. The production slowdown was not associated with a quick rise in unemployment. The Czech unemployment was some 4 per cent end-1991 and even only 2.6 per cent at the end of 1992! In contrast, unemployment in the two other Viségrad countries, Hungary and Poland, was over 12 per cent at that moment. The Czech government’s financial position also remained sound in the first years of the transition period, with an average financial deficit of 2.5 per cent of GDP in the first two years. In these same years, the Czech external sector showed a small trade deficit, on the balance of payments compensated by surpluses in international trade in services and an inflow of foreign direct investments (EBRD, 1999: 213).

The favourable unemployment figures in the Czech republic cannot have been caused by a favourable development in the demand for labour in the industrial sector (Munich and Storm, 1996). To the contrary: between 1989 and 1995 about 25 per cent of workers left that sector. Partly they left the labour process once and for all, particularly the pensionables. Other industrial workers easily found new jobs in the services sector or in the neighbouring countries of Germany and Austria. Many set up one-man firms in the services sector, in particular in trade and catering. Many jobs were also created in the tourist industry. Especially in the Prague area, this industry showed amazing growth.

It was very surprising that in the first years after the change of the economic system Czech international trade did not meet real problems. The business environment had changed dramatically through the collapse of the Comecon. Until 1989, 80 per cent of Czech exports were directed to the Comecon countries. After that year there was a radical fall in this sale of goods, as these countries were unwilling or unable to continue this import flow. It was therefore unavoidable that Czech exports were redirected to the western countries. This adaptation was eased by the substantial currency devaluation and the favourable location of the Czech Republic with respect to rich countries such as Germany and Austria. Mainly the exporters of raw materials and semi-manufactures succeeded in taking advantage of these two assets. Despite that, the Czech trade balance began to deteriorate mid-1990s. Its deficit grew to $3.7 bn in 1995 and $5.9 bn in 1996. In 1995 this deficit could still easily be financed by the surpluses in international services trade and foreign direct investment inflows. However, in
In 1996 this was no longer the case (EBRD, 1999: 213). In 1996 and 1997 the Czech Republic struggled with huge current account deficits of over 7 per cent of GDP. This balance of payments outcome indicates economic problems for the Czech Republic from 1996. In the first half of that year the economic tide turned through a combination of a deteriorated competitiveness and a domestic demand that was too large. The international competition position had mainly been worsened through an inflation that had not fallen since 1992. On the contrary the inflation rate of 11 per cent in 1992 was followed in the years 1993-95 by inflation levels of 21, 10 and 9 per cent, respectively. Due to the deterioration of competitiveness, Czech exports stagnated and the growth of industrial output fell back to the low level of 2 per cent. In particular the large enterprises, privatized under the voucher system, got into trouble in the free market. An important reason was the uncertainty with respect to the privatization programme. From one day to the next the ownership could change. For that reason the owners had a short horizon and concentrated themselves on maximizing short-term profits. Growth of GDP declined further to a low 0.8 per cent in 1997, while there was a production reduction by 1 per cent in 1998 and a weak growth recovery by 0.5 per cent in 1999 (IMF). This recession undermined the trust of the foreign investors in the Czech economy. After an attack on the koruna – since February 1993 the Czech currency – a devaluation of 19 per cent against the US dollar followed. Another consequence of the depression was a large number of enterprises with annual losses. This caused a new wave of enterprise restructuring. Unemployment began to increase quickly to 8.7 per cent in 1999.

Only at the end of the millennium, ownership rights were crystallized sufficiently for enterprises to direct themselves again on the longer term (Myant, 1999). This changed attitude led to an improvement in the economic situation. The Czech economy began to grow again, with 3.3 per cent in 2000 and 2001, and the balance of payments deficit turned into a surplus, mainly through a restoration of confidence of foreign investors. A worrying by-product of this capital inflow was a large current account deficit of 5 and 4 per cent of GDP in the years 2000 and 2001 (IMF). Foreign investments in the Czech Republic are now larger than in the other Central and Eastern European countries. For the entire period 1989-2001 its cumulative inflow of foreign direct investments is second, only to Poland, in the amount of over US$26 bn. (The Economist, 2002: 5). This restoration of the investment climate is to a large extent the result of the drive with which the new social democratic Zeman administration, which succeeded the
Klaus administration, is implementing the *aquis communautaire*, the law of the European Union. This energetic policy stance was rewarded with the EU decision to accept the Czech Republic as a member, effective as from 1 May 2004.

11.3.4 Russian Federation

After the collapse of the Soviet Union and the fall of communism, the way was paved for radical changes in the Russian economic order. On 2 January 1992, the new rulers, under the leadership of president Yeltsin, introduced a series of measures that upset the Russian economy. These concerned a liberalization of foreign trade and trade in foreign exchange, as well as all forms of private trade. Most prices became free market prices. A quick introduction of convertibility of the rouble with respect to the US dollar against a fixed exchange rate was pursued, as well as a swift privatizing of a large part of the state enterprises.

These measures did not generate the desired results. The Russian economy exhibited a massive contraction. As already mentioned in Section 11.3.2, Russian real GDP plunged in the years 1991-98 by 42 per cent. The decline in national income was even larger: 55 per cent in the period 1992-98. At the outset the fall in industrial production even exceeded that high percentage; later on its decline was closer. All in all, the drop of industrial production in the years 1992-97 amounted to 60 per cent. Chiefly the light industry and machine construction sectors were heavily hit. In 1996 their production dwindled to respectively 11.5 and 30.5 per cent of the 1990-level. In contrast, the energy and metal sectors were able to uphold a substantial part of their production. In the same period their production decreased ‘only’ 20-30 per cent. The corresponding figure for agriculture was 25 per cent. The poor economic outlook in that period explains the dramatic reduction in investments, with 80 per cent in the corresponding period.

Developments in domestic production were also reflected in the changing size and structure of foreign trade. Foreign trade fell by about 40 per cent in absolute terms in the period 1990-96. The reduction of imports was larger than that of exports. As a result the Russian trade balance soon displayed large surpluses. The structure of both exports and imports also altered in the first years of the reform period. In effect, trade with the western countries rose to 50 per cent of total Russian foreign trade, at the cost of the trade shares of the former communist countries. The goods composition of Russian exports changed to the benefit of the
energy and raw materials sectors; their share grew to 80 per cent. The export share of industrial goods suffered. On the import side the share of durable consumer goods and food increased to some 60 per cent. It was a vast problem for the Russian economy that the export earnings were hardly used for the import of essential capital goods. Instead, they were used for large-scale capital flight. In the first years after 1991 the foreign assets of Russian inhabitants grew by US$10 bn per year (Chandra, 1995).

These negative economic developments in the 1990s had, of course, serious damaging effects on the living standard and the general well-being of the population. Although the labour force increased by about 1.5 million, the employed labour force decreased by 15 million, or about 20 per cent. Besides a loss of jobs, a part of the employed had to accept an involuntary labour time reduction that occurred in various forms. Unemployment gradually increased from 5.3 per cent in 1994 to 12.6 per cent in 1999 (Datastream). Apparently, firms did not really adjust themselves to the crisis situation by firing superfluous personnel, but by means of labour time reduction and even by late payments of wages or non-payments. Due to these measures average wages declined drastically. Real income of wage earners deteriorated further through a dismantling of subsidies on many products. For products that were supposedly free, such as education and health care, people had to pay informally.

Income distribution became very unequal. This explains, among other things, the steep rises in car sales and imports of durable consumer goods in the 1990s. But it explains too the 23 per cent of households in 1996 that received an income below the poverty line. As a pure survival strategy, the Russian population put much time and energy into cultivating food in the many allotments in the country. This line of food production is even estimated to be 43 per cent of Russia’s total food production.

Through the economic contraction the nature of domestic trade changed. The role of money diminished, which was perceivable in the increase in barter trade and the rapid accumulation of payment delays (Ledeneva and Seabright, 2000). This also held true for government and businesses. There was a shift of transactions from the formal to the informal economy and in addition, an increase of self-supporting activities. All in all, in the first years of transition there were clear signals of a kind of ‘primitivization’ of the Russian economy (Hedlund and Sundström, 1996).
The phenomenon of ‘privatization’ has several possible explanations. First, a much-used argument is the inability of firms to attract loans, due to both the high interest rates and the uncertainty about the Russian economy. Second, the various forms of barter trade give businesses the opportunity to evade tax payments. Besides the usual reason for tax evasion, the non-transparent range of different taxes and the various tax exemptions are additional incentives. Tax evasion is further stimulated by the frequent change of taxes. Third, bankrupt enterprises usually continue producing. Mostly, a Russian enterprise is a link in a large production network, often of a regional nature (Boeva and Dolgopiatovo, 1994). Disappearance of a link may threaten both the entire network and the balance between management, workers and local government. In view of the economic uncertainties and the tight technological and economic ties between enterprises, the networks furnish individual firms a bigger chance of survival relative to an independent position of the enterprise in the economy (McDermott, 1997).

An important reason why the transition in Russia resulted in a prolonged reduction of production compared to the production in, for example, the Czech Republic is the very delicate position of Russia’s small and medium-sized businesses. In the period 1995-97 employment in Russian businesses with a maximum of 50 employees reduced by 50 per cent! This cannot be explained by a disappointing productivity growth. To the contrary, these small firms often had a good performance (Commander et al. 1996: chapter 8). The true explanation is the behaviour of the Russian Mafia and the unreliability of the Russian government. Small enterprises are compelled to make regular payments to their ‘protectors’. The presence of the Mafia however, also has advantages. As a consequence of the weakened tax morale and the lack of a well-functioning legal system, a frequently used method for settling payments is to call in the help of ‘Judge Kalashnikov’ (Knaack, 1999).

The Russian currency crisis in August 1998 was more or less a watershed for economic development in the Russian Federation. An outcome of that crisis was that the rouble depreciated strongly, from 5.8 roubles per US dollar in 1997 to 24.6 roubles per dollar in 1998. The strong depreciation continued in 1999 to an exchange-rate value of 24.6 roubles per dollar. The concomitant real effective depreciation of the rouble over the two years concerned amounted to 31.3 per cent, despite high and increasing inflation of 15 per cent in 1998 and 55 per cent in 1999. In the next two years inflation remained at a level of some 50 per cent. Although the rouble continued to lose some value against the dollar, the real
effective exchange rate of the rouble appreciated again by 33 per cent. The most
gratifying economic development in Russia was the associated start of economic
growth. The economic growth rate in the years 1999-2002 was between 4 and 5
per cent with an outlier of 9 per cent in 2000. In response, unemployment could
fall, from a peak of 12.6 per cent in 1999 to 9 per cent in 2001. The real
depreciation contributed to huge surpluses of the Russian current account of over
10 per cent of GDP from 1999. It seems that the Russian economy, after a long
transition period with shrinking growth, through the shock of the currency crisis
appeared to be able to find the upward path of transition with substantially
positive economic growth. One remaining worrying feature of this new path is the
alarmingly high inflation.

11.4 INSTITUTIONAL VACUUM

After the fall of the Berlin Wall in 1989, in principle all East European countries
followed a liberalization process directed at the breaking down of the existing
planning systems. It was expected that markets would arise spontaneously the
moment the old planning bureaucrats disappeared. In other words, the policy-
makers hoped that the political and economic institutions necessary for the
functioning of a market economy would be created during a process of ‘organic
growth’. Obviously it was assumed that the fundamental propensities of mankind
to barter and truck as postulated by Adam Smith were not foregone during the
decades of communist rule (Knaack, 1999: 357).

However, this did not take into account the fact that properly functioning
markets require an institutional infrastructure and that it takes a lot of time before
the new institutional system and the persons who have to work in those markets
are adapted to the new circumstances. Not only must new institutions be created,
but they must prove their value during a time-consuming process of trial and
error. Each economic transition process is fundamentally an incremental process,
constant experiments with new forms, which finally keeps that form which is
considered acceptable. In this way the existing institutional structure will be
improved.

The at-a-stroke abolishment of the old planning system without construction of
the new institutions of a market economy will irrevocably lead to an institutional
vacuum. That vacuum has many forms (Knaack, 1999: 363). The old rules lose
their meaning, but the enterprises have not yet learned how to behave in the new situation. Further, the information structure of the old system disappear, while at the same time the new market signals are not yet developed enough. The enterprises find it difficult to find new customers and when they finally succeed it is difficult to find out how trustworthy they are. As a result, the enterprises operate in an environment characterized by an extreme level of uncertainty.

As we have seen, enterprises might react in different ways to the uncertainty, either by creating and/or adopting uncertainty reducing institutions or by creating structural flexibility. In the first case the institutional vacuum is filled. In the case of East Germany, the institutions of West Germany were taken over in one stroke. In the case of the Czech Republic, the country profited heavily from the neighbourhood of Germany and Austria, and learned quickly from the international trade relations. Moreover, from 1995 onwards the Czech Republic adopted the *acquis communautaire*, the jurisdictional structure of the European Union. Russia did not have these advantages. As a large country, its international trade is a much smaller percentage of the national income. With regard to the possibility of the import of institutions it only had to fulfil the requirements of the IMF when it borrowed money. As a consequence, much more so than the small countries, Russia could fill the institutional vacuum on its own terms. Given the fact that the creation of new institutions is a time-consuming process, one can understand that it fell back into its old routines and that, given the weakness of the state, organizations such as the Mafia filled the vacuum.

Although the differences in institutions are important, they alone cannot explain the differences in growth figures. The success of the transition process was also dependent on the possibilities in the countries to improve the structural flexibility. Government policy with respect to the foreign trade and the medium and small enterprises was particularly important. The collapse of the Comecon trade and the resulting loss of jobs in the big state enterprises had to be counterbalanced by an increase of exports to the west and the creation of new jobs by the medium and small enterprises. Only the Czech Republic was successful in both respects. The strong devaluation of the crown resulted in a strong swing of foreign trade to the west and the process of the ‘small’ privatization contributed to the strong growth of employment in the private sector. The Czech Republic also profited from its geographical position and the possibilities of the tourist industry, especially in Prague. Compared to the Czech Republic, East Germany could not profit from devaluation. Given the politically motivated choice of a one-to-one
conversion of the Ostmark for the Deutschmark, the terms of trade of East Germany worsened, creating mass unemployment. On the other hand, many young entrepreneurs could profit from the new circumstances.

Compared to both the Czech Republic and East Germany, Russia opted for the less successful road. It is fair to say that it had few other options. The choice for a fixed coupling of the rouble to the dollar under conditions of high internal inflation led to a strong appreciation of the rouble. This did not lead to a deterioration of the trade balance given the strong export of the gas and oil reserves. These developments resulted in the crowding-out of Russian industrial production. Industry became more and more expensive and lost its possibility to export. The industrial loss of sales became severe because the strong rouble stimulated Russian consumers to opt for cheaper foreign consumer goods. The loss of jobs in the industrial sector was not counterbalanced by a growth of jobs in the medium and small enterprises. Both the government and the Mafia are responsible for the lagging behind of the de novo enterprises in Russia. Both viewed the new enterprises as cash cows instead of centres of new economic initiatives that required stimulation.

This conclusion about the importance of the role of medium and small enterprises in the transition process agrees with one of the most important conclusions of a recent report of the World Bank regarding the first 10 years of the transition process (World Bank, 2002). According to this report the key for economic growth in the transition countries is the shift of means of production from the old, capital largely intensive-enterprises to the new, largely labour-intensive, enterprises. The last group consists overwhelmingly of small enterprises (with a maximum of 50 workers). The value added per worker in this group is much higher than in the group of old enterprises. It is interesting to notice that the differences became bigger when the old enterprises were heavily subsidized and protected.

According to the World Bank the transition process gains momentum when the share of medium and small-scale enterprises in the national employment is more than 40 per cent. The group of countries in Central Europe (including the Baltic states) reached this percentage in 1996. This group continued with the reform process. On the other hand, the countries that belonged to the former Soviet Union stayed behind. In these countries the growth of small-scale enterprises seems to have stagnated with devastating consequences for the whole economy. The share of small enterprises did not rise above 20 per cent.
The World Bank explains this stagnation in growth of the small-scale sector in the countries of the former Soviet Union with the help of a public choice type theory. In this theory the results of the transition process are determined by the power game between three groups of players in the former central planned economies: (a) the workers in the state enterprises; (b) the workers and managers who are able to work in the new sectors; (c) the oligarchs and insiders who enter the transition process with a tremendous amount of control over the state properties and close relationships with the old political establishment. An important hypothesis of the World Bank is that the power game between these three groups can result in three possible situations.

The first situation is that there will be no reform at all. At the start of the reform process all workers and managers lose, also those in category (b). Only category (c) wins, although the gain is relatively small. In fact there is no force that is strong enough to change the situation of 'no reform'. The only possibility for change is the prospects for category (c) of additional profits when they strive for a moderate reform. In that situation category (c) can aim for maximal profit. At that moment category (b) also starts to make a profit. In this second situation the joined profit of both categories is more than enough to compensate the loss of category (a). In that situation a moderate reform will end in a stable equilibrium.

The reform process would get a new impulse if the de novo enterprises would get much more room of manoeuvring. The prospect of much more profit can be a stimulus for category (b) to strive for this. But categories (a) and (c) will be opposed. This means that only a government that is strong enough to reform the institutional infrastructure can break through the deadlock. Part of the new situation must be a new coordination mechanism which helps the potential winners – the scattered small, new enterprises – to find each other in a joint effort towards a more radical reform process in which the power position of category (c) will be broken. In this third situation the profit of category (b) is already so huge that the losses of categories (a) and (b) can be compensated more than enough. At this moment the reform process gains momentum. The profits of category (b) increase without further losses to the other two categories. So to speak, the door is wide open for more reforms.

This picture corresponds to the analyses in Section 11.3. The reform process in Russia is stagnant because the oligarchs and insiders, together with the old political elite, are still in command. The Czech Republic had trouble reaching and
passing the third situation in 1996/97. After some hesitation they succeeded and at the moment the country moves freely in the direction of far reaching reforms.

1.5 CONCLUSIONS

After the fall of the Berlin Wall in 1989, one country after the other in Central and Eastern Europe freed itself from Soviet dominance and started a transition process from a centrally planned economy to a market economy. In this transition process they followed the recipe developed earlier by the IMF and the World Bank for developing countries. In each country, the results were disappointing. In 1999, only two of all the transition countries surpassed the 1989 levels. Especially the countries that had belonged to the Soviet empire were struck by a severe recession. The recession was much more profound than expected.

The length and depth of the recession in most of the transition countries can be explained by the fact that the reform process was based on an incomplete theory about the functioning of a market economy. The policy makers were too late in recognizing the precondition for the functioning of a market economy, namely an institutional infrastructure, and the dynamics of the reform process, namely that it takes time for the new institutional infrastructure and the persons who are to work in it to adapt to each other and the new situation. The collapse of the old planning institutions placed the enterprises in an extremely uncertain situation, in which it was difficult to find new customers and decipher how trustworthy they were. From this perspective the length and depth of the recession depended on the time it took to build new institutions, for example the new private property rights, and the time it took for the market players to adapt to them.

This point of view seems to be confirmed by the experiences in East Germany, the Czech Republic and Russia. The depth of the recession can indeed be related to the speed of the introduction of new market institutions. However, our analyses suggest that the institutional infrastructure is not the only factor that can explain the differences in growth figures. Also of importance for the success of the transition process is the increase of structural flexibility in these countries. For example, given the collapse of the Comecon trade, in all Central and East European countries enterprises were forced to bend their trade to the west. A precondition seemed to be a depreciation of the national currency. Only the Czech
Republic was able to do this. This explains why the collapse of industry in East Germany and Russia was much more profound than in the Czech Republic.

Our study also suggests that the speed with which the de novo enterprises can expand is also important for the success of the transition process. Especially in Russia the de novo enterprises were unable to expand. The government was not able to protect the new enterprises against the negative practices of the Mafia and the already existing large enterprises. Also the behaviour of the government itself was counterproductive.

From our story one can conclude that the success of a transition process does not only depend on the building of a viable market sector. It also depends on the existence of a strong government that is able and willing to create the necessary market institutions, fight the trusted interests, and formulate an economic policy that aims among others at a rapid switch in the trade relations with the west.

NOTES
1 In the present analysis we neglect the subdivision of Czechoslovakia in the two autonomous countries the Czech Republic and Slovakia on January 1, 1993. The economic situation in Slovakia was then much more negative relative to the Czech Republic. Unemployment in Slovakia, for example, was over 10 per cent in 1993, whereas it was only 4 per cent in the Czech Republic.
2 The data in this paragraph are derived from IMF and Datastream.

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