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1 November 2001

Press Release

The launch of *Transition and Institutions*
will be held at the President Hotel, Library, 24 B. Yakimanka str. 103134, Moscow
5 November 2001, 19:30–22:00 hours.

Ten Years of Transition

Where do we Stand a Decade After the Collapse of the USSR?

Transition and Institutions: The Experience of Late Reformers (edited by Giovanni Andrea Cornia and Vladimir Popov, Oxford University Press, 2001, xiv+273pp) discusses the reasons for differing performance of transition economies.

Vladimir Popov

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Ten Years of Transition

Moscow — After a decade of transition there has been marked progress, but the price is still too high, say two specialists – a Russian and a UN leader – in a book launched Monday evening (5 November) by the World Institute for Development Economics Research (UNU/WIDER Helsinki) together with the New Economic School (NES) here in Moscow. Leading Russian economist Vladimir Popov, who together with Shmelev wrote the influential *The Turning Point* (*Na Perelome*) a bestseller even in the United States in 1989, has just published a remarkable study of how transition has been working, with Giovanni Andrea

Cornia who has spent his life as a practicing economic leader in the United Nations system, and is author of the world-famous *Adjustment with a Human Face*.

The two editors of this book were supported by the World Institute for Development Economics Research of the United Nations University in Helsinki, of which Cornia was then Director. He is now a Professor of Economics in his native Tuscany, and remains an initiator of literally dozens of international projects, many connected with transition Europe. Professor Popov spends half his academic year in Canada, and is now also an active professor, researcher and teacher, at the New Economic School which was founded at TsEMI as an internationally collaborative event to bring modern economics back to Russia.

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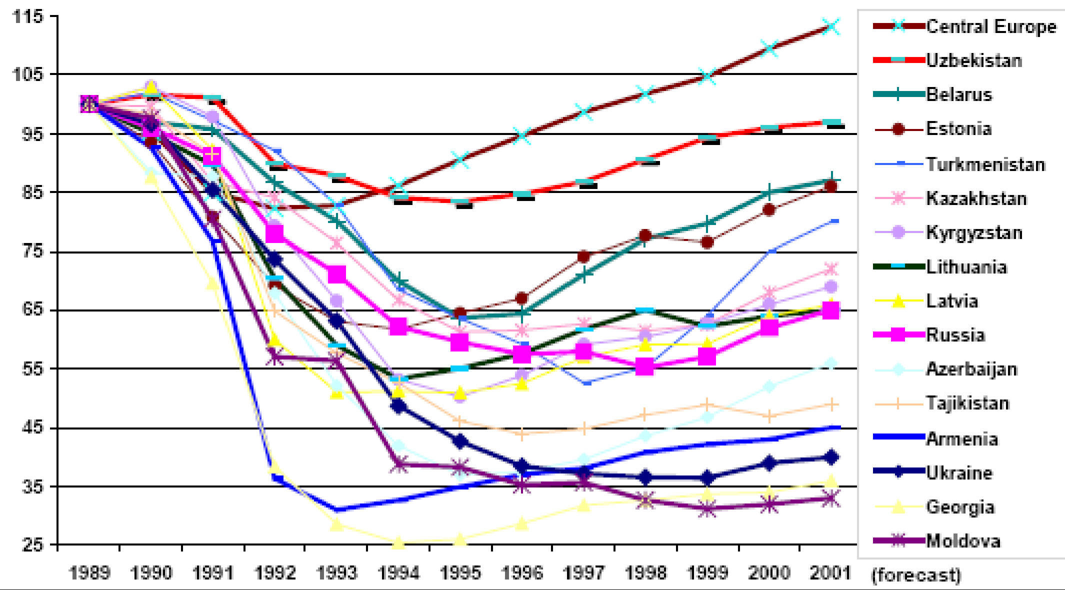
After the Soviet Union collapsed (December 1991) and market reforms were initiated, the economic performance of the successor states was more than disappointing. By the end of the 1990s output (GDP) fell by about 50% as compared to the highest pre-recession level of 1989 (Fig. 1), investment dropped even more, income inequalities rose greatly so that real incomes declined dramatically for the majority of the population, death rates increased by about 50%, whereas life expectancy declined markedly. In Russia output fell by 45% in 1989-98, death rates increased from 1% in the 1980s to 1.5% in 1994 and stayed at this high level thereafter, which was equivalent to over 700,000 additional deaths annually. Over the period of several years such population losses could be likened to the impact of a big war. By way of comparison, during the second world war national income in the USSR fell by only 20% in 1940-42, recovered to its 1940 level in 1944, fell again by 20% in 1944-46 during conversion of the defense industry, but already exceeded its 1940 level by nearly 20% in 1948. In some of the FSU states that were affected by military conflicts (Armenia, Azerbaijan, Georgia, Moldova and Tajikistan) GDP by the late 1990s was only 30 to 50% of its pre-transition levels; in Ukraine even without the military

conflict GDP fell by nearly two-thirds (Fig. 1). By way of another comparison, in East European countries (EE) the reduction of output continued for 2-4 years and totaled 20 to 30%, whereas in China and Vietnam there was no transformational recession at all – on the contrary, from the very outset of reforms economic growth accelerated. *Post factum*, the reduction of output that occurred in the FSU during the 1990s should be considered as the exceptional case in the world economic history. Never and nowhere, to the best of my knowledge, occurred such a dramatic decline in output, living standards and life expectancy without extraordinary circumstances, such as wars, epidemics, natural disasters. Even during the Great Depression (1929-33) GDP in Western countries fell on average by some 30% and by the end of the 1930s recovered to its pre-recession levels.

Fig. 1. GDP change in FSU economies, 1989 = 100%



Why has the reduction of output and incomes in FSU been so deep and so long? To what extent was this collapse caused by the initial conditions and circumstances, i.e. predetermined and hardly avoidable, and to what extent it was "man made", i.e. the result of poor economic policy choices? If it is the wrong economic policy that is mostly responsible for the collapse, future historians may refer to the FSU transition as the biggest "man made" economic disaster on record. The ubiquitous and virtually universal feeling is that "things went terribly wrong" and that with different policies it could have been possible to avoid most of the misfortunes

that struck the former Soviet republics in the 1990s. After all, most other transition economies did better that the FSU states and it is difficult to accept the idea that the exceptional length and depth of recession in post Soviet states was predestined and inevitable. However, when it comes to the discussion of particular policies, there is much less agreement among scholars. The question of why FSU had to pay a greater price for economic transition is answered differently by those who advocate shock therapy and those who support gradual piecemeal reforms. Shock therapists argue that many of the costs of FSU reforms should be attributed to inconsistencies of policies followed, namely to the inability of the governments and the central banks to fight inflation in the first half of 1990. On the contrary, the supporters of gradual transition blame the attempt to introduce a conventional shock therapy package for all the disasters and misfortunes. The alternative explanation of the collapse of output in the FSU accepted in a WIDER produced monograph "*Transition and Institutions: The Experience of Late Reformers*" (edited by G. A. Cornia and V. Popov, Oxford University Press, 2001) is that the speed of reform *per se* (shock versus gradual transition) did not matter a great deal. The unique magnitude of the recession was caused primarily by three groups of factors.
First, by greater distortions in the industrial structure and external trade patterns on the eve of the transition.
Second, by the collapse of state and non-state institutions, which occurred in the late 1980s–early 1990s and which resulted in chaotic transformation through crisis management instead of organised and manageable transition.
And **third**, by poor economic policies, which basically consisted of macroeconomic instability and import substitution, no matter whether the pursued reforms were gradual or radical. The economic recession that occurred in FSU states was associated with the need to reallocate resources in order to correct the industrial structure inherited from the centrally planned economy (CPE). These distortions include over-militarisation and over-industrialisation, perverted trade flows among former Soviet republics and Comecon countries, excessively large size and poor specialisation of industrial enterprises and agricultural farms. In most cases these distortions were more pronounced than in Eastern Europe – not to speak about China and Vietnam – the larger the distortions, the greater the reduction of output. The transformational recession, put in economic terms, was caused by adverse supply shock similar to the one experienced by Western countries after the oil price hikes in 1973 and 1979, and similar to post-war recessions caused by conversion of the defence industries.

The additional reason for the extreme depth of the transformational recession was associated with institutional collapse – here differences between EE countries and FSU are striking. The adverse supply shock in this case came from the inability of the state to perform its traditional functions. State institutional capacity in a broad sense is the ability of the government to enforce rules and regulations, including its ability to collect taxes and to constraint the shadow economy, to ensure property and contract rights and law and order in general. Naturally, poor ability to enforce rules and regulations did not create a business climate conducive to growth and resulted in increased costs for companies. It is precisely this strong institutional framework that should be held responsible – both for the success of gradual reforms in China and shock therapy in Vietnam, where strong authoritarian regimes were preserved and CPE institutions were not dismantled before new market institutions were created; and for the relative success of radical reforms in EE countries, especially in Central European countries, where strong democratic regimes and new market institutions emerged quickly. And it is precisely the collapse of the strong state and institutions that started in the USSR in the late 1980s and continued in the successor states in the 1990s that explains the extreme length, if not the extreme depth of the FSU transformational recession. The exceptions in the former

Soviet sphere – Uzbekistan, Belarus and Estonia – only prove the rule: the share of government spending in GDP in these countries did not decline as much as it did in the others. To put it differently, the Gorbachev reforms of 1985-91 failed not because they were gradual, but due to the weakening of the state institutional capacity leading to the inability of the government to control the flow of events. Similarly, the Yeltsin reforms in Russia, as well as economic reforms in most other FSU states, were so costly not because of shock therapy, but due to the collapse of the institutions needed to enforce law and order and carry out manageable transition. Finally, performance was of course affected by economic policy. Given the weak institutional capacity of the state, i.e. its poor ability to enforce its own regulations, economic policies could hardly be "good". Institutional capacity depends not only on technical factors (efficiency of public service and government administration), but also on the degree of consensus in society, on the ability of government to carry out policies that are opposed by particular interests groups and lobbies. As a result, weak state institutions usually imply import substitution and populist macroeconomic policies (subsidies to non-competitive industries, budget deficits resulting in high indebtedness and/or inflation, overvalued exchange rates), which have a devastating impact on output. In many CIS states poor macroeconomic policies (exchange rate based stabilisation) led to currency crises in 1998-99, whereas after these crises industrial policies continued to favour energy intensive industries hiding the structural inefficiencies under the carpet. Domestic fuel and energy prices in Russia are currently only 20% of the world level. If these prices are allowed to increase tomorrow to the world level (i.e. if restrictions for oil and gas exports are lifted), there is going to be a painful restructuring leading to a recession. If they are not increased, energy intensity will continue to be the highest in the world. At one point CIS countries will have to seize the hot coal and it will be painful. True, there is some growth in the former Soviet sphere in recent years, after devaluation of 1998: in Russia it was 3.2% in 1999, 7.8% in 2000, and hopefully about 5% in 2001. But if you put this growth into perspective, things do not look that bright: if 1989 Russian GDP was 100%, then by 1998 it fell to 55%, and in 2001 recovered to about 65%. By contrast the Chinese economy was growing at 7-8% in 1997-2001 (and by 10% annually in 1989-96), so Russia is rapidly falling behind. If Chinese GDP was 100% in 1989, now it is close to 240%.

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World Institute for Development Economics Research (UNU/WIDER)
Director, Professor Tony Shorrocks

Through its research WIDER seeks to raise frontier issues and provide new and original insights and policy advice aimed at boosting the economic and social development of the poorest nations. Research is conducted by a Helsinki-based research staff of about 15 senior researchers and visiting fellows, some four PhD interns, with 14 administrative staff. An external network including 6-8 external project directors, each located at their university or institute, and over 400 network members around the world contribute to the ongoing projects. This group includes research staff from the UNU, UN and Bretton Woods institutions including FAO, ILO, IMF, UNCTAD, UNDP, UNICEF and World Bank. This cooperation ensures a broader political constituency and leads to a wider dissemination of policy findings.

The winner of the 2001 Nobel Prize for economics Professor Joseph E. Stiglitz is a WIDER author and five other Nobel Prize laureates as well as several scholars occupying key policy-making positions in both developing and transitional economies have contributed to the Institute's research. The Institute has conducted a large number of research projects on transition economies and Professor Tony Shorrocks is directing a research project on "Micro-simulation of Tax-Benefit Reforms in Russia".

New Economics School

A decade ago, a group of Russian and Western economists shared a vision about the future of economics education in Russia. A selection of the finest graduates from Russia and the former Soviet Union would be offered a chance to study modern economic theories and methods of analysis, with courses given in English and Russian by leading economists from all parts of the world. Afterwards, some of the students would find employment in Russia's embryonic market economy, or help the government develop the framework for future economic success. Others would go on to pursue PhDs at leading universities in the West, returning later to train a new generation of Russian economists and to raise the standard of economic research on Russia. Thus the New Economic School was born. Since that time, more than 100 visiting professors from abroad have joined with Russian professors to provide a rich programme of study in graduate economics, to pursue joint research projects, and to help build a true community of scholars in the Western tradition. Graduates of NES are already making important contributions to Russian economic policy at the highest levels. Others, with their Western PhDs completed, have returned to teach and lead research at a variety of institutions in Russia. In addition to the core two-year Master's degree program, activities at NES have expanded to include a research center, which lies at the heart of Russian research into the problems of the economic transition of emerging market economies, and a sustained attempt to disseminate the teaching of economics to other universities in Russia and the Former Soviet Union.

www.nes.ru

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