

SHOCK THERAPY VERSUS GRADUALISM RECONSIDERED: LESSONS FROM TRANSITION ECONOMIES AFTER 15 YEARS OF REFORMS¹

Vladimir Popov²

ABSTRACT

This paper starts by separating the transformational recession (reduction of output in most transition economies in the first half of the 1990s) from the process of economic growth (recovery from the transformational recession) in 28 transition economies (including China, Vietnam and Mongolia). It is argued that the former (the collapse of output during transition) can be best explained as adverse supply shock caused mostly by a change in relative prices after their deregulation due to distortions in industrial structure and trade patterns accumulated during the period of central planning, and by the collapse of state institutions during transition period, while the speed of liberalization, to the extent it was endogenous, i.e. determined by political economy factors, had an adverse effect on performance. In contrast, at the recovery stage the ongoing liberalization starts to affect growth positively, whereas the impact of pre-transition distortions disappears. Institutional capacity and reasonable macroeconomic policy, however, continue to be important prerequisites for successful performance.

¹This paper is the logical continuation of my earlier article in *Comparative Economic Studies* Vol. 42, No. 1, Spring 2000, pp. 1-57. The arguments of this earlier article, however, are reconsidered in light of new research and evidence.

² New Economic School, Moscow, Russia (vpopov@nes.ru) and Institute of European and Russian Studies (EURUS), Carleton University, Ottawa (vpopov@ccs.carleton.ca).

SHOCK THERAPY VERSUS GRADUALISM RECONSIDERED: LESSONS FROM TRANSITION ECONOMIES AFTER 15 YEARS OF REFORMS

1. Introduction

This paper starts by separating the transformational recession (reduction of output in most transition economies in the first half of the 1990s) from the process of economic growth (recovery from the transformational recession). It is argued that the former (the collapse of output during transition) can be best explained as adverse supply shock caused mostly by a change in relative prices after their deregulation due to distortions in industrial structure and trade patterns accumulated during the period of central planning, and by the collapse of state institutions during transition period, while the speed of liberalization had an adverse effect on performance, if any. In contrast, the latter process (recovery) should be treated as a normal growth process and could be modeled with the tools of conventional growth theory: it could be expected that in the sufficiently long run it would be possible to capitalize on liberalization due to the increase in factors efficiency that would lead to better performance.

Based on previous literature (see Popov, 2000 for the review) the following framework for explaining the collapse of output during transformational recession is accepted. First, transformational recession was caused by the adverse supply shock that resulted from deregulation of prices and change in relative price ratios that created the need for reallocation of resources due to distortions in the industrial structure and external trade patterns that existed before transition. Second, by another adverse supply shock associated with the collapse of state institutions (understood as the ability of the state to enforce its rules and regulations), which occurred in the late 1980s - early 1990s and which resulted in chaotic transformation through crisis management instead of organized and manageable transition. And third, by poor economic policies, which basically consisted of macroeconomic mismanagement and import substitution, no matter whether the pursued reforms were gradual or radical. Fast speed of reform *per se* (shock versus gradual transition) at the initial stage of transition probably aggravated the reduction of output because immediate deregulation of prices caused the need for

restructuring (reallocation of labor and capital) that exceeded the investment potential of the economy.

In the first approximation, economic recession that occurred during transition was associated with the need to reallocate resources in order to correct the industrial structure inherited from centrally planned economy (CPE). These distortions include over-militarization and overindustrialization (resulting in the underdevelopment of the service sector), perverted trade flows among former Soviet republics and Comecon countries, excessively large size and poor specialization of industrial enterprises and agricultural farms (lack of small enterprises and farms). In most cases these distortions were more pronounced in former Soviet Union countries (FSU) than in Eastern Europe (EE), not to speak about China and Vietnam, – the larger the distortions, the greater was the reduction of output. Transformational recession, to 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 defense industries.

The additional reason for the extreme depth and length of the transformational recession was associated with the institutional collapse – here differences between EE countries and FSU are striking. The efficiency of state institutions, understood as the ability of the state to enforce its own rules and regulations, resulted in the inability of the state to perform its traditional functions – to collect taxes and to constraint the shadow economy, to ensure property and contract rights and law and order in general (crime rates and corruption increased dramatically during transition as compared to the communist past). Naturally, poor ability to enforce rules and regulations did not create business climate conducive to growth and resulted in the increased costs for companies.

It is precisely this strong institutional framework that should be held responsible for 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 strong state 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.

What led to the institutional collapse and could it have been prevented? Using the terminology of political science, it is appropriate to distinguish between strong authoritarian regimes (China and Vietnam and to an extent – Belarus and Uzbekistan), strong democratic regimes (Central European countries) and weak democratic regimes (most FSU and Balkan states). The former two are politically liberal or liberalizing, i. e. protect individual rights, including those of property and contracts, and create a framework of law and administration, while the latter regimes, though democratic, are politically not so liberal since they lack strong institutions and the ability to enforce law and order (Zakaria, 1997). This gives rise to the phenomenon of “illiberal democracies” – countries, where competitive elections are introduced before the rule of law is established. While European countries in the XIX century and East Asian countries recently moved from first establishing the rule of law to gradually introducing democratic elections (Hong Kong is the most obvious example of the rule of law without democracy), in Latin America, Africa, and now in CIS countries democratic political systems were introduced in societies without the firm rule of law.

Authoritarian regimes (including communist), while gradually building property rights and institutions, were filling the vacuum in the rule of law via authoritarian means. After democratization occurred and illiberal democracies emerged, they found themselves deprived of old authoritarian instruments to ensure law and order, but without the newly developed democratic mechanisms needed to guarantee property rights, contracts and law and order in general. No surprise, this had a devastating impact on investment climate and output.

There is a clear relationship between the ratio of rule of law index on the eve of transition to democratization index, on the one hand, and economic performance during transition, on the other. To put it differently, democratization without strong rule of law, whether one likes it or not, usually leads to the collapse of output. There is a price to pay for early democratization, i.e. introduction of competitive elections of government under the conditions when the major liberal rights (personal freedom and safety, property, contracts, fair trial in court, etc.) are not well established.

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”. Weak state institutions usually imply import substitution and populist macroeconomic policies (subsidies to noncompetitive industries, budget deficits resulting in high indebtedness and/or inflation, overvalued exchange rates), which have devastating impact on output. On the other hand, strong institutional capacity does not lead automatically to responsible economic policies. Examples range from the USSR before it collapsed (strong import substitution and periodic outburst of open or hidden inflation) to such post Soviet states as Uzbekistan and Belarus, which seem to have stronger institutional potential than other FSU states, but do not demonstrate substantially better policies (macroeconomic instability, for instance).

Regressions tracing the impact of all mentioned factors are reported in table 1. If the rule of law and democracy indices³ are included into the basic regression equation, they have predicted signs (positive impact of the rule of law and negative impact of democracy) and are statistically significant (equation 1), which is consistent with the results obtained for larger sample of countries⁴. The best explanatory power, however, is exhibited by the index that is computed as the ratio of the rule of law index to democracy index: 83% of all variations in output can be explained by only three factors – pre-transition distortions, inflation, and rule-of-law-to-democracy index (table 1, equation 2). If liberalization variable is added, it turns out to be statistically insignificant and does not improve the goodness of fit (equation 3). At the same time, the ratio of the rule of law to democracy index and the decline in government revenues are not substitutes, but rather complement each other in characterizing the process of the institutional decay. These two variables are not correlated and improve the goodness of fit, when included together in the same regression: R^2 increases to 91% (equation 5) – better result than in regressions with either one of these variables. The liberalization index, when added to the same

³ The **democracy** index is the average of political rights index for 1990-98, taken from Freedom House (<http://www.freedomhouse.org/rankings.pdf>), but inverted and calibrated, so that complete democracy coincides with 100%, whereas complete authoritarianism with 0%. The rule of law index is taken from (Campos, 1999) and for China, Vietnam and Mongolia – from International Country Risk Guide, 1984 to 1998, and calibrated, so that 100% corresponds to the highest possible rule of law.

⁴ For a larger sample of countries (all developing and developed countries, not only transition economies), the result is that there is a threshold level of the rule of law index: if it is higher than a certain level, democratization affects growth positively, if lower – democratization impedes growth (Polterovich, Popov, 2005).

equation, only deteriorates the goodness of fit, is not statistically significant, and has the “wrong” sign.

Table 1. Regression of change in GDP in 1989-96 on initial conditions, policy factors, and rule of law and democracy indices, robust estimates

Dependent variable = log (1996 GDP as a % of 1989 GDP)

For China - all indicators are for the period of 1979-86 or similar

Equations, Number of Observations / Variables	1, N=28	2, N=28	3, N=28	4, N=28	5, N=28	6, N=28	7, N=28
Constant	5.3***	5.4***	5.2***	5.4***	5.4***	5.5***	5.7***
Distortions, % of GDP ^a	-.005**	-.005**	-.003	-.006**	-.007***	-.007***	-.007***
1987 PPP GDP per capita, % of the US level	-.009**	-.006*	-.007**	-.007**	-.009***	-.008***	-.008***
War dummy ^b				-.19 ^c	-.36***	-.37***	-.45***
Decline in government revenues as a % of GDP from 1989-91 to 1993-96					-.011***	-.011***	-.011***
Liberalization index			.05			-.02	.03
Log (Inflation, % a year, 1990-95, geometric average)	-.16***	-.20***	-.18***	-.17***	-.13***	-.13***	-.14***
Rule of law index, average for 1989-97, %	.008***						
Democracy index, average for 1990-98, %	-.005***						-.003**
Ratio of the rule of law to democracy index		.07***	.07***	.06***	.05***	.05***	
Adjusted R ² , %	82	83	83	85	91	91	90

*, **, *** - Significant at 1, 5 and 10% level respectively.

^aCumulative measure of distortions as a % of GDP equal to the sum of defense expenditure (minus 3% regarded as the 'normal' level), deviations in industrial structure and trade openness from the 'normal' level, the share of heavily distorted trade (among the FSU republics) and lightly distorted trade (with socialist countries) taken with a 33% weight – see (Popov, 2000) for details.

^bEquals 1 for Armenia, Azerbaijan, Croatia, Georgia, Macedonia, and Tajikistan and 0 for all other countries.

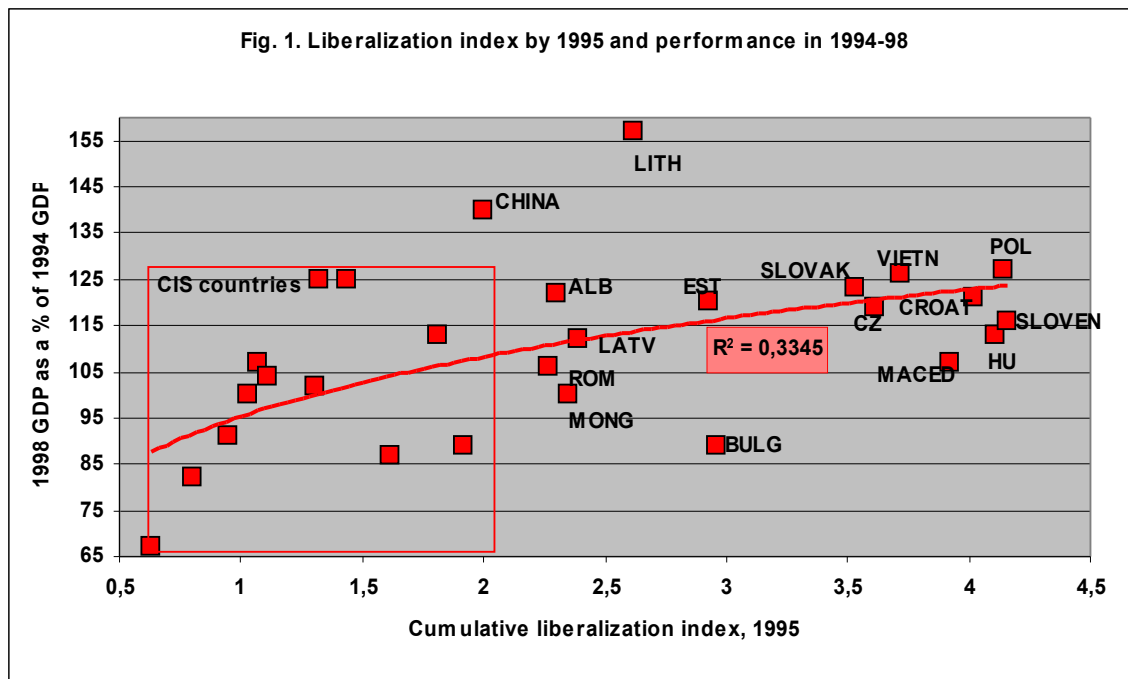
^cSignificant at 13% level.

2. Post-recession recovery

Factors that determine performance in the recovery period, i.e. after the transformational recession is over, are somewhat different from the factors affecting performance during transformational recession. First, cumulative levels of liberalization

achieved by 1995 appear to play a positive role at the initial stage of recovery, 1994-98 (fig. 1). At the subsequent stages the level of cumulative liberalization achieved by the mid 1990s does not seem to be important (fig. 2), but the progress in liberalization (increase in its level during recovery) appears to affect performance positively (fig. 3). This result is confirmed by the regression analysis (table 2) – in most specifications the increase of liberalization during the recovery, in 1995-2003, has a positive and significant effect on economic growth (although the level of liberalization by the mid 1990s is mostly insignificant, except for one specification, where it affects growth negatively).

FIG. 1



Second, pre-transition distortions do not play any significant role in the recovery period – the coefficient of distortions indicator is not statistically significant in any of the specifications⁵. The war dummy variable is always significant, but acquires a positive sign (unlike for the recession period, when it was negative) suggesting that countries that suffered from wars in the first part of the 1990s recovered faster in the second half of the decade benefiting from the effects of post-war reconstruction.

⁵ This is consistent with the result obtained in (Popov, 2000) and Godoy and Stiglitz (2004).

FIG. 2

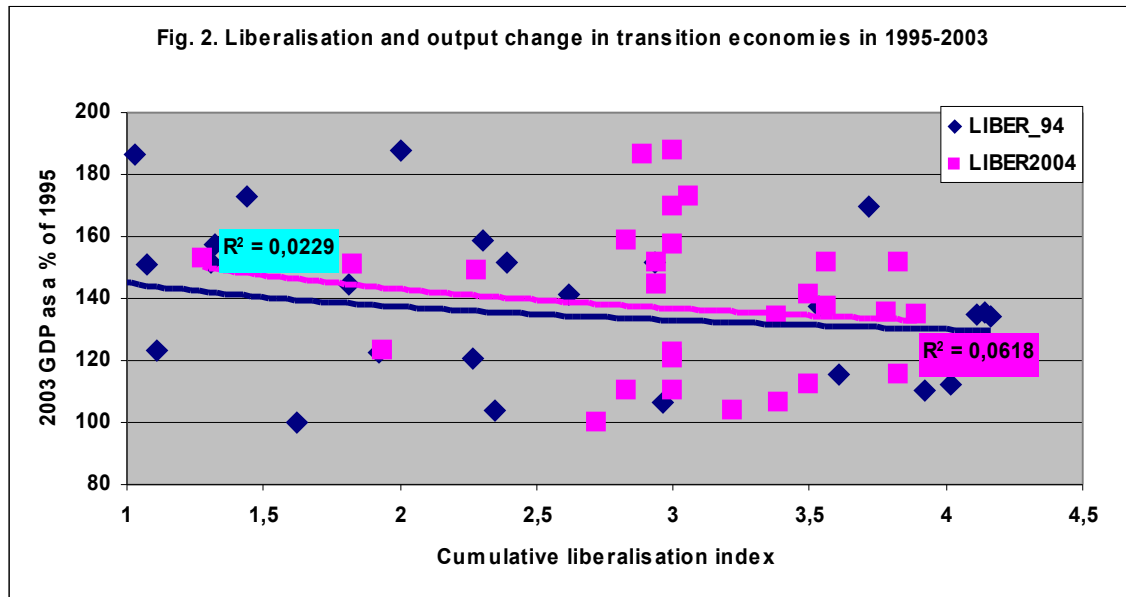
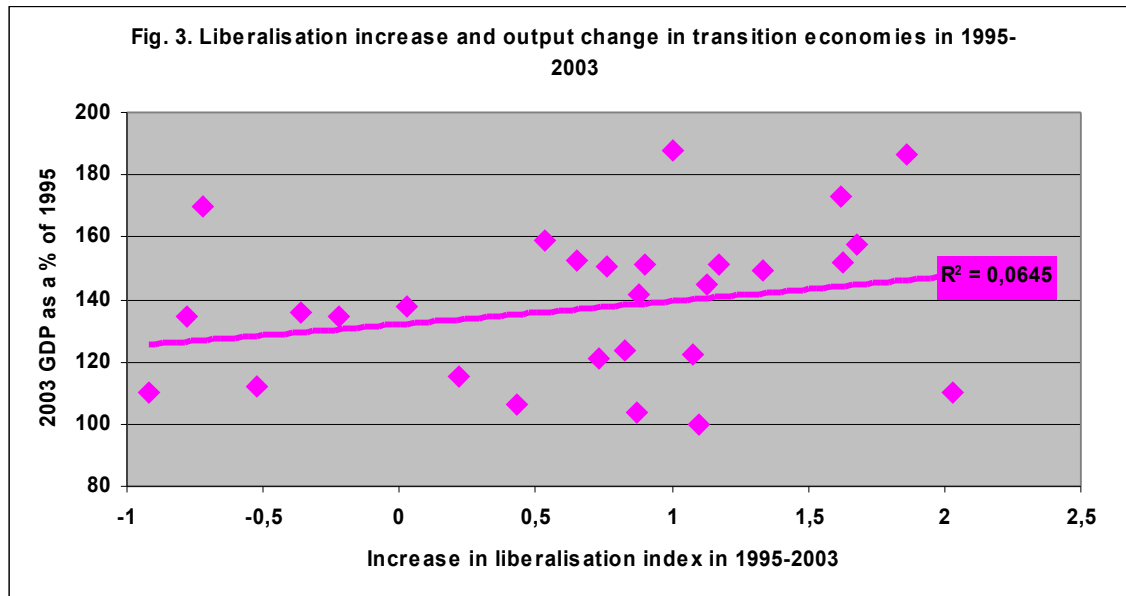


FIG. 3



And finally, third, indicators that determine institutional capacity, such as the rule of law index (positively), the decline in the ratio of government revenues in GDP and democratization (negatively), continue to affect performance during recovery in the same way they affected performance during the transformational recession.

Table 2. Regression of change in GDP in 1995-2003 on initial conditions, institutional capacity, liberalization and rule of law and democracy indices, robust estimates

Dependent variable = 2003 GDP as a % of 1995 GDP

For China - all indicators are for the period of 1979-86 or similar

Equations, Number of Observations / Variables	1, N=28	2, N=28	3, N=28	4, N=28	5, N=28
Constant	105***	91***	99***	78***	99***
1996 GDP as a % of 1989 GDP	.33***	.45***	.46***	.24**	
1987 PPP GDP per capita, % of the US level					
War dummy ^a		22.9**	42.3***	32.0***	19.4*
Liberalization index in 1995			-19.9***		
Increase in the liberalization index in 1995-2003	15.3***	16.7***		17.6***	17.6***
Decline in government revenues as a % of GDP from 1989-91 to 1993-96 ^a				-.8***	
Rule of law index, average for 1989-97, %			.8**	1.0***	1.2***
Democracy index, average for 1990-98, %				-.6***	-.8***
Adjusted R ² , %	25	38	45	52	55

*, **, *** - Significant at 1, 5 and 10% level respectively.

^aEquals 1 for Armenia, Azerbaijan, Croatia, Georgia, Macedonia, and Tajikistan and 0 for all other countries.

These results are very consistent with intuition and previous explanations. During the transformational recession the reduction of output was determined by the magnitude of the pre-transition distortions and by the collapse of institutions, whereas the speed of liberalization did not have any significant impact on performance. In fact (see appendix), the impact of the speed of liberalization was very likely negative, if any – rapid deregulation of prices caused an adverse supply shock that was beyond the ability of the economy to reallocate resources. The reason, why this negative impact of immediate deregulation of prices does not show up in regressions is that indices of liberalization only partially reflect the speed of price deregulation and, besides, there was in fact only one country (China) that carried out price deregulation gradually via the dual track price system. The other possible reason is the endogeneity of liberalization variable – the issue is dealt with in the next section.

During the recovery stage, after the inefficient enterprises were shut down in the course of the transformational recession, the pre-transition distortions do not affect

performance any longer, but liberalization increases start to matter and to pay off. Controlling for the country effects via introducing the indicator of previous performance (GDP change in 1989-96), we get positive correlation between increases in liberalization and performance in 1995-2003. This result is fully consistent with theory (marketization dividend), but it is observed only at the stage of recovery, when the decline of the inefficient sectors of the economy comes to a halt.

And the impact of institutional capacity of the state on performance is the same at both stages – during transformational recession and during the post-recession recovery. Democratization without rule of law undermines institutional capacity, which has a devastating impact on output (Polterovich, Popov, 2005). This mechanism of the weakening of the institutional capacity in illiberal democracies is only partly associated with the reduction of the size of the state, i.e. decline in the share of state revenues in GDP. The other part of the process is the decrease in the efficiency of the provision of the public goods – even controlling for the decline in the ratio of state revenues to GDP, the positive impact of rule of law on growth and the negative impact of democratization persists.

3. Dealing with the endogeneity

Many authors (Heybey, Murrel, 1999; Kruger, Ciolko, 1998; Godoy, Stiglitz, 2004) have pointed out to the endogeneity of liberalization variable: not only performance is explained by the speed of liberalization, but also liberalization itself is a function of performance (if performance is poor, it is more difficult for the government to push market reforms further). Krueger and Ciolko (1998) demonstrated through constructing the instrumental variable (by linking liberalization to initial conditions specified only as the pre-transition share of exports in GDP) that the hypothesis of the endogeneity of the liberalization variable cannot be rejected. The worse initial conditions for transformation, the greater the probability of the deep transformational recession, and hence the more likely delays in liberalization. Godoy and Stiglitz (2004) examined the impact of the speed of privatization variable on performance: they instrumented this variable using the variables of pre-transition distortions from Popov (2000) and other measures of initial conditions and concluded that, after controlling for the *level* of

privatization, the *speed* (increment) of privatization adversely affected growth in the 1990s.

If there is endogeneity in the regressions presented in previous sections, the estimates cannot be considered correct, so it is necessary to resort to 2SLS estimation. So, first, the impact of liberalization on performance during recession (1989-96) is examined, and later – the impact of the level and change in liberalization indices on performance during recovery (1995-2003) is analyzed. Liberalization index in 1995⁶ is strongly correlated with the level of democracy in 1990-98 (R=60%), while the level of democracy itself is not correlated with GDP growth in 1989-96 (R=5%), so liberalization can be instrumented with the democracy level variable. Economic meaning of this correlation is rather obvious – it is well established that economic market type reforms went hand in hand with democratic reforms in post-communist countries (EBRD, 1999, chapter 5). The results are presented in table 3.

The surprising result here is that the coefficient of liberalization level in 1995 is negative and statistically significant in most specifications: the more liberalized was the economy by 1995, the larger was the reduction of GDP in 1989-96, during the transformational recession. This result is different from the previous regressions: when liberalization variable was not instrumented, it turned out to be insignificant.

On the contrary, for the recovery period, instrumentation of the liberalization variable does not lead to different conclusions, but only strengthens previously obtained results. Here it is the *increase* in liberalization during the recovery that needs to be instrumented, because the *level* of the liberalization in 1995, before the recovery, becomes just one of the initial conditions.

Table 3. 2SLS robust estimates – regression of change in GDP in 1989-96 on initial conditions, institutional capacity, liberalization and rule of law and democracy indices (Liberalization index instrumented with the democracy level variable)

Dependent variable = Log (1996 GDP as a % of 1989 GDP)

For China - all indicators are for the period of 1979-86 or similar

⁶ This liberalization index is constructed as explained earlier by De Melo et al. (1996) as the sum of liberalization “flows” for 6 years (1989-94 for all countries, except China, for which the period in 1979-84). Assuming that before transition the level of liberalization in communist economies was negligible, the 1995 liberalization index can be interpreted as the cumulative “stock” of liberalization by 1995 or as the total “flow” of liberalization in the first six years of reforms.

Equations, Number of Observations / Variables	1, N=28	2, N=28	3, N=17	4, N=17
Constant	6.4***	6.3***	6.0***	6.0***
Pre-transition distortions, % of GDP	-.01***	-.02***		-.004
1987 PPP GDP per capita, % of the US level	-.007**	-.01***		
War dummy ^a	-.45***	-.29 ^b		
Liberalization index in 1995	-.18**	-.39*	-.19***	-.19***
Decline in government revenues as a % of GDP from 1989-91 to 1993-96	-.02***	-.02***		
Log (Inflation, % a year, 1990-95, geometric average)	-1.7***	-.22***	-.22***	-.19***
Rule of law index, average for 1989-97, %		-.01 ^c		
Increase in the share of shadow economy in GDP in 1989-94, p.p.			-.02***	-.015***
R ² , %	86	77	88	90

*, **, *** - significant at 1, 5 and 10% level respectively.

^aEquals 1 for Armenia, Azerbaijan, Croatia, Georgia, Macedonia, and Tajikistan and 0 for all other countries.

^bSignificant at 12% level.

^cSignificant at 16% level.

Two variables are good candidates for the instruments – the FSU dummy (membership in the former Soviet Union) and the preceding level of liberalization, i.e. liberalization in 1995. Both variables are strongly correlated with increase in liberalization in 1995-2003 (R is equal to 0.76 and -0.86 respectively), but not correlated with the GDP change in 1995-2003 (R is 0.24 and -0.28), so they could be used as an instruments for the change in the liberalization index in 1995-2003. The economic interpretation of this correlation is that countries of the former Soviet Union in general liberalized their economies more slowly than other (East European) transition economies, so that liberalization index by 1995 was rather low and the bulk of liberalization occurred later than in EE countries, i.e. in 1995-2003; besides, the more liberalized were transition economies by 1995, the shorter was part of the way to achieve full liberalization, so the relationship between liberalization stock by 1995 and subsequent liberalization increment is, as expected, negative. The results are in table 4 and are no different from those reported in table 2, describing regressions without the instrumentation of liberalization change variable: in fact, the coefficient of instrumented liberalization change variable is higher and no less significant than without instrumentation.

Table 4. 2SLS robust estimates – regression of change in GDP in 1995-2003 on initial conditions, institutional capacity, liberalization and rule of law and democracy indices

Dependent variable = 2003 GDP as a % of 1995 GDP

For China the indicator is for the period 10 years earlier.

Equations, Number of Observations / Variables	1, N=28	2, N=28	3, N=28	4, N = 28
Instruments for liberalization change in 1995-03 variable	LIBER95	FSU	LIBER95 and FSU	LIBER95 and FSU
Constant	97.8***	95.8***	97.7***	79.5***
1996 GDP as a % of 1989 GDP				.18*
War dummy ^a	19.5*	19.8**	19.5*	25.0**
Increase in liberalization index in 1995-2003	18.2***	19.2**	18.3***	22.9***
Decline in government revenues as a % of GDP from 1989-91 to 1993-96	-.76***	-.78**	-.76***	-.65***
Rule of law index, average for 1989-97, %	1.24***	1.28***	1.25***	1.13***
Democracy index, average for 1990-98, %	-.76***	-.76***	-.76***	-.62***
R ² , %	55	54	55	56

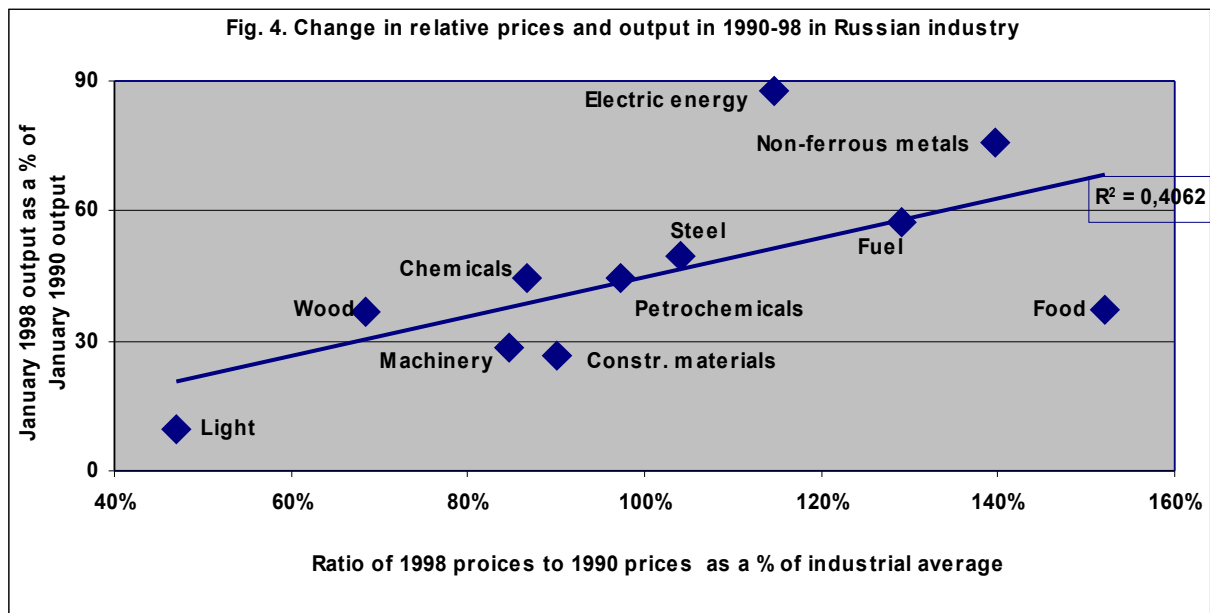
*, **, *** - significant at 1, 5 and 10% level respectively.

^aEquals 1 for Armenia, Azerbaijan, Croatia, Georgia, Macedonia, and Tajikistan and 0 for all other countries.

So what needs to be explained is the negative impact of “liberalization stock”, accumulated by 1995, on economic performance in 1989-96 – this negative impact becomes visible only when liberalization is instrumented via democracy level indicator, whereas without instrumentation this impact is insignificant. The interpretation of this result is quite straightforward. Liberalization is best explained by the democratization process (it pushes liberalization forward) and pre-transition distortions (large distortions force policy-makers to slow down liberalization because they are afraid of the collapse of output). Democratization pushes liberalization forward too much, even accounting for other factors that influence liberalization, such as the negative impact of pre-transition distortions, so liberalization, inasmuch as it is determined endogenously, has a negative impact on performance. The impact of residual liberalization (i.e. inasmuch as it is *not* determined within the specified model) is positive, but insignificant. Including the residual liberalization into the right hand side of the regression equation is equivalent to including actual liberalization together with democracy variable (see table 2, equation 7 – liberalization impact is positive, but insignificant).

The negative impact of fast liberalization is associated with the rapid decline of the non-competitive industries that is not counterweighed by the rise of competitive sectors. The speed of the transfer of resources from non-competitive to competitive sectors is not infinite, it depends on a flow of new investment, so when fast liberalization creates a need for restructuring that exceeds the investment potential of the economy, there is a general reduction of output – a typical supply-side recession that could have been avoided with slower pace of liberalization. Fig. 4 presents the evidence that the reduction of output in Russia during the transformational recession was to a large extent structural in nature: industries with the greatest adverse supply shock (deteriorating terms of trade – relative price ratios), such as light industry, experienced the largest reduction of output. Such a reduction was by no means inevitable had the deregulation of prices been gradual (or had losses from deteriorating terms of trade for most affected industries been compensated by subsidies). The pace of liberalization had to be no faster than the ability of the economy to move resources from non-competitive (under the new market price ratios) to competitive industries (see Appendix).

FIG. 4



4. Concluding remarks

Differences in performance during the initial stage of transition (transformational recession) depend strongly on the initial conditions – pre-transition levels of GDP per capita and distortions in industrial structure and external trade patterns. The higher the distortions (militarization, overindustrialization, "under-openness" of the economy and the share of perverted trade flows), the worse the performance as measured by the GDP change. And the higher was GDP per capita before transition, the greater were distortions embodied in fixed capital stock, the more difficult it was to overcome these distortions (because more investment was needed) to achieve growth.

By focusing on liberalization and macroeconomic stabilization as key policy variables in transition economies the conventional wisdom overlooked the impact of strong institutions. Accounting for uneven initial conditions sheds new light on the relative importance of various policy factors. Macroeconomic stability continues to matter a great deal – the inclusion of the inflation variable improves goodness of fit, but liberalization index in the initial period of transition (during the transformational recession that continued in most countries until mid 1990s) does not appear to be important – the coefficient is not statistically significant and in most cases has unexpected sign. On the contrary, changes in the institutional capabilities of the state have dramatic impact on performance. It follows that the debate about the speed of the liberalization (shock therapy versus gradualism) was to a large extent misfocused, whereas the crucial importance of strong institutions for good performance was overlooked.

In a sense, the importance of preserving strong institutional capacity of the state for ensuring good performance may be considered as the main finding of this paper with strong policy implication. After allowing for differing initial conditions, it turns out that the fall in output in transition economies was associated mostly with poor business environment, resulting from institutional collapse. Liberalization alone, when it is not complemented with strong institutions, can not ensure good performance.

Institutional capacities in turn, depend to a large extent on the combination of the rule of law and democracy: the data seem to suggest that both authoritarian and democratic regimes can have strong rule of law and can deliver efficient institutions, whereas under the weak rule of law authoritarian regimes do a better job in maintaining

efficient institutions than democracies. To put it in a shorter form, the record of illiberal democracies in ensuring institutional capacities is the worst, which predictably has a devastating impact on output.

Moreover, the impact of the speed of liberalization at the initial stage of transition, i.e. during the transformational recession, appears to be negative, if any. If we consider the speed of liberalization as endogenous, i.e. inasmuch as the speed of liberalization was determined by political economy forces, pushing it forward (like democratization) or holding it back (like pre-transition distortions that could have led to the collapse of output during liberalization and hence frightened policymakers), it turns out that the impact of liberalization was negative, rather than positive. The reason for the negative impact is most probably associated with limited ability of the economy to adjust to new price ratios that emerge after rapid liberalization, and in particular – with investment constraints that do not allow to transfer rapidly capital stock from inefficient to efficient industries and to compensate the fall in output in non-competitive sectors by the rise in competitive sectors (see Appendix).

This way or the other, the process of the collapse of output in transition economies is best described by the supply side recession model, where the key determinants are initial conditions and the strength of institutions, whereas the speed of liberalization, to the extent it was endogenous, i.e. driven by political economy factors, had an adverse effect on performance.

At the recovery stage liberalization starts to affect growth positively, whereas the impact of pre-transition distortions disappears. Institutional capacity and macroeconomic policy continue to be important prerequisites for successful performance. Liberalization, which proceeds much more slowly at the recovery stage (and for some countries is even negative – see fig. 3) influences performance positively because it creates market stimuli without causing rapid collapse of output of inefficient industries, which cannot be compensated fully by the rise of efficient industries due to investment constraints.

To be sure, these factors are not sufficient to explain an “economic miracle”, like in China, which remains an outlier in all regressions. Very rapid growth is virtually always associated with the increase in export/GDP ratio, i.e. it is an export-led growth, and it requires export-oriented industrial strategy. The key and most efficient instrument

of this export-oriented industrial strategy appears to be undervalued exchange rate that is maintained through accumulation of foreign exchange reserves (Polterovich, Popov, 2002).

References

Åslund, Anders, Boone, Peter, and Johnson, Simon, "How to Stabilize: Lessons from Post-communist Countries". *Brookings Papers Econom. Activity*, **1**: 217-313, 1996.

Breton, Paul, Gros, Daniel and Vandille, Guy , "Output Decline and Recovery in the Transition Economies: Causes and Social Consequences". - *Economics of Transition*, Vol. 5 (1), pp. 113-130, 1997.

Bruno, Michael, and Easterly, William (1995), *Inflation Crisis and Long-Run Growth*. Unpublished. World Bank.

Bruno, Michael (1995), Does Inflation Really Lower Growth? - *Finance & Development*, September 1995.

Campos, Nauro F. (1999), "Context is Everything: Measuring Institutional Change in Transition Economies", Prague, August 1999.

De Melo, Martha, Denizer Cevdet, Gelb, Alan, and Tenev, Stoyan "Circumstance and Choice: The Role of Initial Conditions and Policies in Transitions Economies". The World Bank. International Financial Corporation. October 1997.

De Melo, Martha, Denizer, Cevdet, and Gelb, Alan, "Patterns of Transition From Plan to Market". *World Bank Econom. Review*, 3: 397-424, 1996.

EBRD (1999). Transition Report, 1999.

EBRD (2001). Transition Report, 2001.

Fisher, Stanley, Sahay, Ratna, Vegh, Carlos, A. (1996), "Stabilization and Growth in the Transition Economies: The Early Experience". – *Journal of Economic Perspectives*, 10 (2), 1996, pp. 45-66.

Fisher, Stanley, Sahay, Ratna (2000), "The transition economies After Ten Years", SSRN Working Paper, February 2000.

Godoy, Sergio and Joseph Stiglitz (2004), Growth, Initial Conditions, Law and Speed of Privatization in Transition Countries: 11 Years Later. Mimeo
(http://www2.gsb.columbia.edu/faculty/jstiglitz/download/website/Growth_Initial_Conditions_Law_and_Speed.htm).

Heybey, Berta and Murrell, Peter (1999), The Relationship between Economic Growth and the Speed of Liberalization During Transition. – *Journal of Policy Reform*, 3 (2), 1999.

Kornai, Janos, Transformational Recession: The Main Causes. *J. Comp. Econom.* 1: 39-63, 1994.

Kruger, Gary and Ciolko, Marek (1998), A note on Initial Conditions and Liberalization during Transition. – *Journal of Comparative Economics*, 26 (4), pp. 618-34.

Naughton, Barry, Economic Reform in China. Macroeconomic and Overall Performance. - In: *The System Transformation of the Transition Economies: Europe, Asia and North Korea*. Ed. by D. Lee. Yonsei University Press, Seoul, 1997.

Polterovich, V., V. Popov (2002). Accumulation of Foreign Exchange Reserves and Long Term Economic Growth. – In: *Slavic Eurasia's Integration into the World Economy*. Ed. By S. Tabata and A. Iwashita. Slavic Research Center, Hokkaido University, Sapporo, 2004. See full version at: <http://www.nes.ru/english/research/pdf/2003/PopovPolterovich.doc>

<http://www.nes.ru/english/about/10th-Anniversary/papers-pdf/Popov-Polterovich.pdf> and
<http://www.nes.ru/english/about/10th-Anniversary/papers-pdf/Popov-charts.pdf>.

Polterovich, V., V. Popov (2004). Appropriate Economic Policies at Different Stages of Development. NES,2004 (<http://www.nes.ru/english/research/pdf/2005/PopovPolterovich.doc>).
The updated version: <http://www.wider.unu.edu/conference/conference-2005-3/conference-2005-3.htm>.

Polterovich, V., V. Popov (2005). Democracy and Growth Reconsidered: Why Economic Performance of New Democracies Is Not Encouraging.
(http://ctool.gdnet.org/conf_docs/PopovDemocracy2004Aug.doc and
http://ctool.gdnet.org/conf_docs/PopovDemocracy-charts%202004.xls).

Popov, V. (2000), Shock Therapy versus Gradualism: The End of the Debate (Explaining the Magnitude of the Transformational Recession). – *Comparative Economic Studies*, Spring, 2000, No. 1, Vol. 42, pp. 1-57.

World Bank (1996), From Plan to Market. World Development Report, NY: Oxford University Press, 1996.

World Bank (1997), The State in A Changing World. World Development Report, NY: Oxford University Press, 1997a.

Zakharia, F. The Rise of Illiberal Democracies. - *Foreign Affairs*, Vol. 76, No. 6, November/December 1997, pp. 22-43.

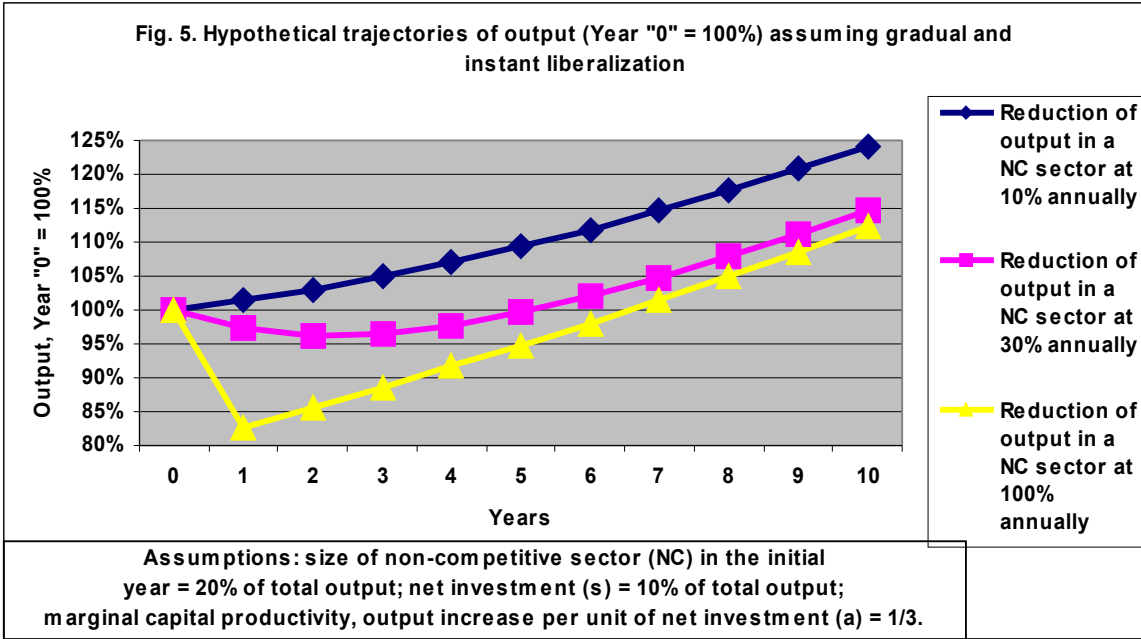
APPENDIX. ADVANTAGES OF GRADUAL REFORMS

Assume for a moment that market-oriented reforms do indeed lead to increased welfare in the longer run in all countries, no matter what is the distance to the technological frontier. The question in this case is whether to proceed with fast (or even instantaneous) reforms or with step-by-step, piecemeal, incremental reforms. The issue was widely debated with respect to post-communist economies in the 1990s; the debate was between shock-therapists that advocated rapid changes and gradualist that favored slower pace reforms, including step-by-step deregulation of prices (Chinese style dual track price system). At least one general conclusion from the study of the experience of transition economies appears to be relevant for the reform process in all countries: *provided that reforms create a need for restructuring (reallocation of resources), the speed of reforms should be such that the magnitude of required restructuring does not exceed the investment potential of the economy.*

Consider a country where deregulation of prices (or elimination of trade tariffs/subsidies) leads to a change in relative price ratios and thus produces an adverse supply shock for at least some industries. Capital should be reallocated from industries facing declining relative prices and profitability to industries with rising relative prices. Assume that 20% of the total output is concentrated in non-competitive industries: this whole sector should disappear either gradually or at once depending on how fast relative prices will change; capital is not homogeneous and cannot be moved to the competitive sector, whereas labor can be reallocated to the competitive sector without costs. Marginal capital productivity in the competitive sector is higher than in the non-competitive and is equal to 1/3. Assume further that all investments go into the competitive sector, and that net investment is equal to 10% of GDP. Under these simple assumptions we get output trajectories shown at fig. 5⁷.

⁷ Total output consists of output of competitive and non-competitive sectors: $Y_n = (Y_n^C + Y_n^{NC})$ and is equal to 1 or 100% in the initial year. Output in the non-competitive sector in the year n, Y_n^{NC} , is equal to the share of the non-competitive sector in total output in the initial year, NC , multiplied by $(1 - \alpha)^n$, where α is the rate of reduction of output in the non-competitive sector determined by the speed of deregulation: $Y_n^{NC} = (1 - \alpha)^n * NC$. Output in the competitive sector in the year n is equal to the output of the preceding year, Y_{n-1}^C , plus the increase in output equal to marginal capital productivity, a , multiplied by the share of net investment in GDP, s , multiplied by total output: $Y_n^C = Y_{n-1}^C + a * s * (Y_n^C + Y_n^{NC})$.

FIG. 5



If reforms are carried out instantly, then output in the unprofitable sector, accounting, say, for 20% of total output, falls immediately and savings for investment are generated only by the competitive sector, so that it takes 7 years to reach the pre-recession level of output. However, assume that reforms are carried out slowly (gradual price deregulation or elimination of tariffs/subsidies), so that every year output in the non-competitive sector falls by 30%. In this case transformational recession is milder, total output recovers by the 5th year.

The best trajectory, of course, is the one with such a speed of deregulation that leads to the reduction of output in the non-competitive sector at a natural rate, i.e. as its fixed capital stock retires in the absence of new investment. If the retirement rate of fixed assets in the non-competitive sector is 10%, so that output there falls by 10% annually, there would be no reduction of output at all. On the contrary, growth rates would increase constantly approaching the steady state 3.4% annually by the year 25. The slower rate of deregulation implying a more gradual output reduction in the non-competitive industries

Solving for total output, we get:
$$Y_n = \frac{Y_{n-1}^C + (1 - \alpha)^n * NC}{1 - as}$$

would require some investment into supporting capital stock and output in the non-competitive sector. This is clearly a sub-optimal option since productivity of this investment in this sector is lower than elsewhere by definition.

The example illustrates that there is a limit to the speed of reallocating capital from non-competitive to competitive industries, which is determined basically by the net investment/GDP ratio (gross investment minus retirement of capital stock in the competitive industries, since in non-competitive industries the retiring capital stock should not be replaced anyway). It is not reasonable to wipe away output in non-competitive industries faster than capital is being transferred to more efficient industries. If there are other factors of production (labor) that can be transferred faster than capital, there is a trade-off between using labor in non-competitive industries, but with high capital/labor ratios, and transferring this same labor to competitive industries, but without much capital (low capital/labor ratios) for the time being. But the same logic that applies to physical capital could be applied to the human capital as well.

Market type reforms in many post-communist economies created exactly this kind of bottleneck. Countries that followed shock therapy path found themselves in a supply-side recession that is likely to become a textbook example: an excessive speed of change in relative prices required the magnitude of restructuring that was simply non-achievable with the limited pool of investment. Up to half of their economies was made non-competitive overnight, output in these non-competitive industries was falling for about a decade and fell in some cases to virtually zero, whereas the growth of output in competitive industries was constrained, among other factors, by the limited investment potential and was not enough to compensate for the output loss in the inefficient sectors (Popov, 2000).

The problem is still there for many transition economies, since many domestic price ratios are quite different from those of the world market. Fuel and energy prices, for instance, in most cases are still way below the world market prices: in Russia electricity tariffs are about 1 US cent per kw-h, whereas in Western and even in Central European countries they are about 10 cents (EBRD, 2001). Meanwhile, the 3rd most important Russian export commodity (after oil and gas) is extremely energy intensive aluminum, produced out of largely imported bauxite. If Russian electric energy prices are increased

to the world level instantly, investment required to create jobs just for the workers from going out of business aluminum smelters may exceed the meager investment potential of the whole national economy.

In short, the speed of adjustment and restructuring in every economy is limited, if only due to the limited investment potential needed to reallocate capital stock. This is the main rationale for gradual, rather than instant, phasing out of tariff and non-tariff barriers, of subsidies and other forms of government support of particular sectors (it took nearly 10 years for the European Economic Community or for NAFTA to abolish tariffs). This is a powerful argument against shock therapy, especially when reforms involved result in a sizeable reallocation of resources. For Western countries with low trade barriers, low subsidies, low degree of price controls, etc. even fast, radical reforms are not likely to require restructuring that would exceed the limit of investment potential. But for less developed countries with a lot of distortions in their economies supported by explicit and implicit subsidies, fast removal of these subsidies could easily result in such a need for restructuring that is beyond the ability of the economy due to investment and other constraints.