Institutions and Diversification of the Economies in Transition: Policy Challenges

Paul G. Hare, Heriot-Watt University, Edinburgh, UK

E-mail: p.g.hare@hw.ac.uk

Web: www.sml.hw.ac.uk/ecopgh and www.ippg.org.uk

Contribution to UNECE conference on 'Strengthening integration of the economies in transition into the world economy through economic diversification', Geneva, April 2-4, 2008.

Outline

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  - Why is it a good idea?
  - How to achieve it in practice
- The role of institutions
- Implications and challenges for economic policy

Introduction – SEE and CIS

- Focus on the SEE region (8 countries, incl. Romania and Bulgaria that are now EU member states) and the CIS (12 countries).

- Very diverse region in terms of:
  - Country population
  - Geographical size
  - Income per head and recent growth experience
  - Resource endowments
  - Access to markets (e.g. whether landlocked)
  - Progress with market-oriented reforms
  - Political configuration, incl. key alliances

Introduction (2)

- Given this diversity, we cannot expect to find uniform policy advice that would suit all countries, but we can develop a common approach/methodology.

- Such an approach will build on:
  - Ideas about general requirements for sustained economic growth
  - Ideas about engaging with the world economy, including desirable degrees of diversification
  - Analysis of the institutions needed to support growth with diversification
  - Analysis of the accompanying policy tools and measures

Sustaining economic growth

- Most SEE and CIS countries had a very bad decade economically in the 1990s – post-communist recessions, exacerbated by civil and/or international wars.
- Since 2000, performance in terms of real GDP growth generally better and exhibiting lower variance.
- The strongest performers have had several years of GDP growth faster than 9% p.a., e.g. Armenia, Azerbaijan, Kazakhstan, Tajikistan.
- Some SEE countries are still growing quite slowly, too slowly to bring down unemployment rapidly, e.g. Macedonia, Bosnia and Herzegovina, Montenegro, Serbia.
- Most of the region already has inflation down below 10% p.a. or on track to achieve that.

- General government balances are mostly manageable, and on average healthier than those of the new EU member states.
- Faster growing countries have lower shares of government in GDP

Growth (2)

- Few countries grow for long unless they ensure:
  - Sound macroeconomic conditions (low inflation, manageable budget and external deficits, credibly manageable debt, etc.)
  - Moderate to high rates of investment (i.e. typically in excess of 20% of GDP), allocated efficiently and credibly funded (from domestic and external savings)
  - Established business activities should not be protected
  - Good business environment, and most new activity in private sector
  - Openness to world economy – both trade and FDI
  - Improving labour force quality.
- Note: Sustained GDP growth is generally the most effective way of reducing poverty

Integration in the world economy

- Until 1990, share of socialist bloc countries in world trade was falling steadily, and of their total trade, most was with each other.
- This lack of engagement with the world economy was a symptom of these countries' poor economic performance.
- Generally expect exports as a share of GDP to be lower in large, already diversified economies, than in small economies with a narrow domestic production base.
- Thus in a small economy, exports can easily exceed GDP, while in a large one they may only be 20-30% of GDP. Expect growth often to be export led.

Integration in the world economy (2)

- Integration involves a mix of elements:
  - Trade in goods
  - Trade in services
  - Income flows: profits, dividends, remittances
  - Aid and other external support (grants and loans)
  - Capital flows – FDI
  - Capital flows – financial (short term and long term)
  - Flows of people: inward and outward migration

Integration (3)

- Countries usually start by liberalising trade, then later liberalise the capital account – this was the path followed by transition economies, for instance.
- Liberalisation usually means: (a) removing old controls and restrictions; (b) rationalising, simplifying, lowering tariffs on imports; (c) export promotion.
- Capital account liberalisation usually starts by encouraging FDI (often linked to privatisation).
- Migration flows depend on economic opportunities and the immigration policies of partner countries.

Integration (4)

- Liberal trade is supported by WTO membership
- From SEE and the CIS, WTO applications are in progress for: Russia, Azerbaijan, Belarus, Bosnia and Herzegovina, Kazakhstan, Montenegro, Serbia, Tajikistan, Uzbekistan; Ukraine's accession has just been approved.
- Other countries already WTO members except for Turkmenistan, which has not yet applied.
- Whether WTO members or not, countries mostly belong to a variety of Free Trade Areas (FTAs) and, in a few cases, Customs Unions (CUs)

Integration (5)

- Most existing FTAs and CUs in the region are badly designed, badly administered, and economically ineffective; too many opportunities for corruption.
- Too many bilateral agreements, giving rise to a ‘spagetti bowl’ of trade agreements.
- Restrictive rules of origin in most agreements.

- If the region wants FTAs, they should be simple, with broad commodity and country coverage, with liberal rules of origin, and with few exclusions.
- E.g. such an agreement has been discussed for the SEE countries for some years, but is not yet fully in place.

Diversification

- Need to consider: (a) What it means; and (b) Whether it is desirable.

- **Meaning**
  - ***Simple notion*** – produce, and presumably export, a wider range of products than in the initial position;
  - Strictly, this includes diversification into exportable services such as medical care, education, tourism (in such cases, customers come to get the service);
  - ***More complex notion*** – produce for export a wider range of goods and services, with the emphasis on high-tech, higher value-added, 'modern' items.

Diversification (2)

- **Desirable?**
  - For resource-rich economies, usual argument for diversification is to mitigate effects of Dutch disease (high exchange rate prices out manufactured exports).
  - Also, historically, many resource prices have been highly volatile, so reliance on resource exports can be risky – mitigate by creating resource funds in good times, or by fostering diversification.
  - For small economies, production often narrowly based, with few significant exportables – again, a source of economic vulnerability arguing for diversification.
  - Sometimes argued that natural resource production/ exports benefit from little innovation and productivity gain, so need to diversify into sectors that do benefit from such gains.

Diversification (3)

- **Desirable?**
  - But, no point in diversifying unless the new goods or services are produced to good quality, sufficient to be internationally competitive.
  - Very unwise for the government to dictate/select which sectors to favour – governments are usually wrong!
  - We don't even know in advance which sectors should be regarded as high tech or 'modern' – again, not a good idea for governments to choose.
  - Hence ideally, rely on market mechanisms to 'choose' new sectors in which to develop production/exports.

  - However, to work well, markets often need help. This bring us to the question of institutions.

The role of institutions

- **Various levels**:
  - Social norms and customs
  - Assets and the rights associated with them
  - Institutional forms (organisations); can be formal or informal.

- **3 key functions**:
  - Protecting property rights (both from other private agents and from the state)
  - Supporting transactions (e.g. contract law, improve information flows, accommodate risk, etc.)
  - Facilitating cooperation/coordination

Institutions (2)

- In the context of efforts to diversify an economy, well designed institutions can help in several ways:
  - Provide market information, esp. about new export opportunities (e.g. embassies could do this)
  - Improve flows of technical knowledge and the ability to use it (through higher education, R&D activities – both public and private, manpower training)
  - Facilitate easy entry and exit of firms
  - Institutions to develop, plan, upgrade infrastructure (e.g. transport links, port and airport facilities, border crossings, telecoms, energy supplies, factory and office space, etc.)
  - Provision of credit and other financial services
  - Simple regulatory framework, stable rules
  - Simple, clear, stable tax system, with low tax rates for business

Institutions (3)

- In any economy, institutional conditions are influenced by the prevailing political configuration.

- There are big issues of **credibility**, e.g. how do we know a successful firm will not be taken over by the state? Or whether a failing firm will be protected unfairly due to its political connections? Or whether a regulator will be allowed to perform its tasks without state interference? Or whether banks will be directed to issue credit to firms 'officially favoured'?

- Such phenomena encourage entrepreneurs to direct their efforts to seeking state favours rather than improving their market position.

Institutions (4)

- **Economic diversification** – what should the state do?
  - Aside from the facilitating/supporting approaches of an earlier slide, could argue for doing nothing.
    - Then the market mechanism will stimulate whatever diversification occurs, in the light of perceived opportunities and capabilities.
    - In an already well diversified economy, with good infrastructure and a good quality workforce, this seems the right approach.
  - But if the economy is poorly diversified and there are perceived to be genuine market failures impeding more diversification (and the costs of a narrow production base appear to be high), then may need a more active approach.
    - How to design this without generating economically damaging side-effects?

Institutions (5)

- **Economic diversification** – Designing an active approach.

- ***Key principles***:
  - Identify the main market and institutional failures that are preventing diversification from occurring 'naturally'.
  - Accept that neither state nor private sector can know which new activities will be successful in the market – so if support offered, must expect some failures.
  - Partnership between state agencies and private sector to promote selected new activities (how to select?).
  - Partnership should be based on **competition** (there can be several bids to develop each new activity) and **performance** (i.e. must stop support rapidly for failing activities).

Implications and challenges for economic policy

- Suitable policies will vary enormously between countries, ranging from inaction (in a large, diversified economy with good institutions) to a variety of active measures (in small, narrowly-based economies with relatively poor and weak institutions).

- Some needed policies have little to do with diversification *per se*. E.g. complete trade liberalisation, simplify the tax and regulatory system, ensuring the financial system delivers adequate funding for investment, improve the infrastructure, etc.

- If identifiable market failures are constraining diversification, need policies to alleviate the failures.

Economic policy (2)

- Consider suitable policies for at least three main types of country in the region, namely:
  - Resource rich – Russia, Kazakhstan, Turkmenistan
  - Energy resource poor and large – Ukraine
  - Energy resource poor and small – Macedonia, Bosnia and Herzegovina, Moldova, Armenia, etc.

- Last type is probably the hardest to deal with, so focus on that group here:
  - Vigorous export promotion
  - Efforts to improve access to markets, incl. neighbours
  - Efforts to promote exportable services such as tourism
  - Partnership between state and private sector to support new activities (as outlined above)

Conclusions – Institutions and Diversification

- Economic diversification – important for sustained growth, normally brought about through competition and market mechanism.
- Can be market and institutional failures that ‘lock’ a country into a very narrow production pattern.
- Hence active policies can help to overcome market failures, stimulate more diversification.
- Important that diversification efforts be subject to competition and performance criteria, with little state interference to favour particular firms.
- Diversification is part of successful, sustained growth, so right conditions for growth need to be in place.
- Such growth should then raise incomes and living standards generally, and reduce poverty.