Introduction and Overview:
Economics, Institutions, History and Geography in the Transition Process

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1. Introduction

The accession to the European Union by eight formerly centrally-planned countries in 2004 signals that transition is over, or should be. Fifteen years is a short span to restructure an economy. The new EU members are still much poorer than the older members; yet, they are catching up and there is little doubt that they will eventually reach similar standards of living as further West. By and large, they have established all the basic institutions seen as a precondition for sustained growth. The other formerly centrally-planned countries, on the other hand, are not yet there. They are generally poorer, their institutions are not always fully reformed and many of them still debate about the appropriate economic framework. Some are even hardly reformed. Most, however, are now growing and hopefully converging towards the higher standards of living of the more developed countries.

Economic transition is chiefly about growth. Growth theory describes economic convergence as a spontaneous process of capital accumulation and technology adoption that allows a country to shift resources to productive activities. For convergence not to occur, and for countries to remain poor, there must be some forces at work that prevent this spontaneous process from unfolding. Considerable theory and evidence has also shown the crucial importance of property rights (Coase, 1960; Buchanan and Tullock, 1962; North, 1990): wars, corruption, lawlessness and, in general, poor governance and the absence of adequate institutions prevent growth spontaneously to occur. Trade restrictions, which inhibit the adoption of better existing technologies, are another blocking factor.

Central planning was the epitome of a growth-stunting economic organization. Its abrupt end was a golden opportunity to trigger spontaneous growth. Yet, it could not be fully spontaneous. For a start, new property rights had to established, which raised the politically complex question of who would take possession of national wealth (firms, land, retail shops and more); it also required the adoption of adequate legislation and its enforcement. Then, for structural change to take place, old firms had to be closed down and new firms had to be born. New skills had to develop, trade relationships had to be established and new political leaders had to emerge. Meanwhile, people caught with the wrong skills n the wrong economic activities – including the bureaucracy – had to be taken care of. Triggering economic transition could never be entirely spontaneous, in fact disorganization was the first effect of the collapse of central planning. To make things even more complicated, some countries broke apart.

For all these reason, economic transition was bound to be deeply divisive. As a consequence, the politics of transition was bound to be divisive as well. Debates immediately erupted and are still raging on in many countries. Political parties were created, often with short life spans. Governments were elected, soon voted out of office. While some people became quickly wealthy, some hugely so, a large part of the population became instantaneously poorer. It took nerves and courage to avoid deep civil disorder.

In the end, each country crafted its own path. Fifteen years down the road, the transition countries have reached different situations. These experiences are a fascinating field of observation and study. Of course, there were huge differences among the transition countries in terms of economic and social development, education, history and social cohesion, but the initial challenge was the same and there were some general recipes to be adopted. Why did some countries rapidly promptly manage to allow 'spontaneous' growth to occur while others are still grappling with the same issues? This is the question taken up in the present chapter.

Obviously, economics alone cannot hope to provide a complete answer. History, political science, social psychology and many other disciplines each have to contribute to the analysis. Yet, the economics of transition remains a lively field, which has already produced a massive amount of detailed studies. This chapter does not attempt to offer a survey of this rich literature. Its objective is to review and interpret the main macroeconomic features of the evolution observed since the early 1990s. The emphasis is comparative. It does not try to explain individual country experiences but hopes to shed light on why things have been different across all transition countries, and to draw some useful conclusions.

The chapter proceeds systematically. It takes up one by one the key macroeconomic variables – GDP growth, inflation, unemployment, budgets and external balance – and asks what can explain the differences in outcomes. To do so, it looks at traditional economic factors but also considers the role of institutions, making use of new datasets produced by various researchers.

It is surprising how much of cross-country differences can be explained by a few factors. It is also reassuring to see that the economic growth theory principles briefly outlined above go a long way towards explaining the varied achievements of the last fifteen years. The overwhelming impression that good governance is crucial may make for a trivial conclusion. Still, it is amazing that so little was predetermined by deep initial conditions such as education or location.

The next section sets the plot by presenting the basic evidence on the evolution of living standards. The following ones then take up, one by one, the other macroeconomic indicators. The final section draws the conclusions.

2. Living Standards: Is Convergence Occurring?

Growth theory predicts convergence. In this chapter, convergence is meant to describe the catching up living standards in the transition countries with Western Europe.[1] PPP-adjusted real GDP per capita is taken to measure living standards. There are many known limitations to this measure, but there is no better alternative.

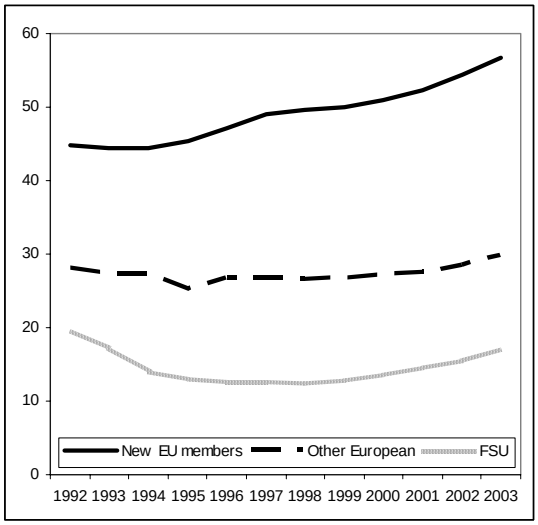
[1] Western Europe itself has been catching up with the US in the postwar period until the mid-1980s. Since then, with a few exceptions, Western Europe's own convergence process has stopped. Throughout the paper, for reasons of data availability, 'Western Europe' is in fact the Euro Area. The Euro Area's GDP represents 78% of the EU-15 and its population accounts for 80% of the EU-15 total.

Out of 26 transition countries, 21 have raised their GDP per capita between 1992 and 2003. With the exception of Macedonia, the five countries that have seen a decline in standards of living are all from the Former Soviet Union (FSU). This suggests separating the sample of transition countries into three groups: the countries of the FSU, with the exception of the three Baltic States, the eight new members of the European Union (EU) and the remaining countries, labeled 'other Europe'.[2] Here and in the rest of the paper, for each variable of interest, we use unweighted averages, which means that each country is taken as an experiment. As a consequence, the data do not represent the situation of each group as a whole, but the average situation across countries in each group.

Figure 1 shows the evolution of GDP per capita, as a proportion of the average of the Euro zone for the three groups. Catch-up is well under way for the eight countries that have joined the EU. The other European countries have only managed, on average, to maintain their distance to the Euro zone; after a decade of falling further away, they have started to close the gap in the late 1990s. The FSU countries, excluding the Baltic states, also went through a deep decline and started to catch up late, not enough to make up for the lost ground.

Figure 1. GDP per Capita (PPP, constant US $)

Average distance from Euro area (%)



Source: *World Development Indicators*, The World Bank, 2005.

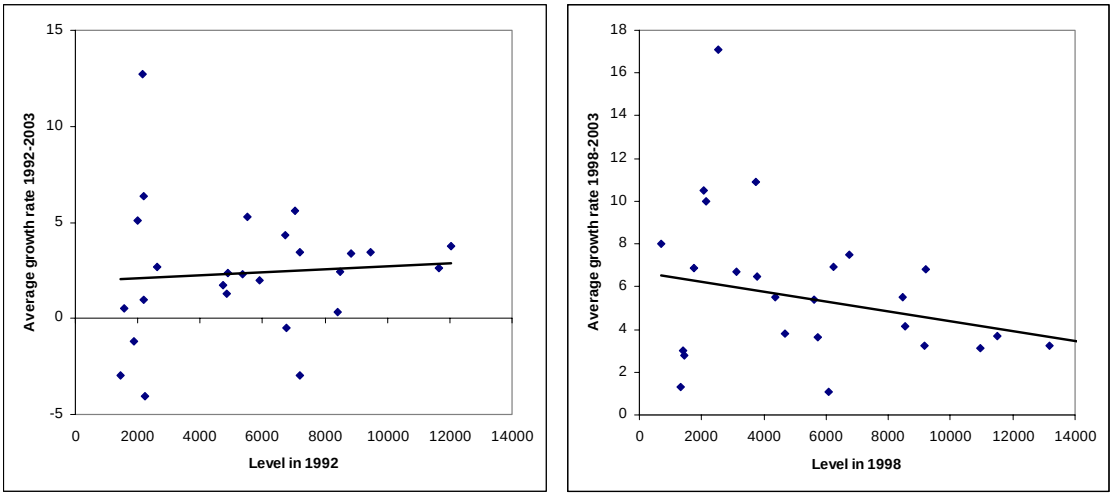
The initial dip in standards of living has been explained by the abrupt end of central planning, before new institutions could be put in place (Blanchard, 1997; Fischer, Sahay and Végh, 1996: Wyplosz, 1999). The speed of growth after the initial disorganization phase is the main object of this chapter.

[2] See the appendix for the list of countries.

Growth theory predicts that catch-up is faster the further is an economy from the technology frontier. The convergence prediction is strongly supported by the empirical evidence, see .e.g. Barro and Sala-i-Martin (2004). The first question is whether catchup has been the main factor driving economic growth. A simple way of checking whether this observation applies to the transition process is to look at a scatterplot that relates the average growth rate of GDP per capita to its level in 1992. The convergence hypothesis implies a negative relationship. The left-most chart in Figure 2 shows the average growth rate for the period 1992-2003. There is no such relationship; the trend line is slightly (but not significantly) upward sloped. The right-hand side chart, on the other hand, which looks at growth rates over 1998-2003, is compatible with the convergence hypothesis.

Figure 2. The Convergence Hypothesis

GDP per capita (PPP, constant US $)



Source: *World Development Indicators*, The World Bank, 2005.
Note: One outlier (Turkmenistan with a 17.1% growth rate) is excluded from the trend line in the right-hand side.

A more detailed analysis reveals a few additional facts. Over the whole period 1992-2003, if we look separately at each of the three country groupings displayed in Figure 1, we observe that convergence occurred within each group but not across groups, essentially because the FSU countries failed to catch up. It is the acceleration of growth in the FSU at the end of the 1990s that changes the picture. Over 1998-2003, the FSU as a group has seen a sharp acceleration of growth and started to converge towards Europe, although convergence within the FSU group has not taken place.

These observations suggest two key issues. First, transition has obviously not been a complete success. Some countries are well on their way to catch up while others have barely started to close the gap. Even in countries that have been catching up, the process is slow. From 1992 to 2003, the new EU members' average GDP per capita has risen

from 44.8% to 56.7% of the EU average, growing at 3.9% per annum. This is far less than the record achieved in fast-growing Asia. Why do these countries, which have a well-educated labor force, fail to catch up at the same speed?

The second issue concerns the acceleration of growth in the late 1990s. As Table 1 shows, this acceleration is general. It is spectacular in the case of the laggard countries, mostly from the FSU but a few elsewhere as well, where Asian-style growth rates have been recorded lately. The standard interpretation is that many of these countries have benefited from the rise of commodity prices. Is this all there is to it?

Table 1. GDP per Capita Average Growth Rates

	1992-2003			1998-2003		
	Average	Min	Max	Average	Min	Max
EU	3.9	2.5	5.6	4.6	3.1	7.5
Non EU Europe	4.4	-0.5	12.7	4.1	1.1	6.7
FSU	0.3	-4.0	5.1	7.4	1.3	17.1

Source: *World Development Indicators*, The World Bank, 2005.

3. Growth

The evidence presented in Figure 2 is partial as it ignores the many reasons other than the initial situation that may have affected growth performance. Conditional convergence copes with this problem by allowing for other factors that may have helped or hindered the catchup process, Growth theory and empirics provide us with a long list of factors that have a role to play, which is the object of a voluminous literature. The results presented in the following table follow the 'standard' list of variables that have been found to be significant, see Sala-i-Martin (1997). Many of these variables are not available for at least some of the transition countries and cannot be used.

Undoubtedly, each country is a special case; the aim here is to generalize and track down the few key factors that allow for a systematic comparison of the transition process across the 26 countries. To that effect, in this section and in the following ones, we report on cross-section regressions. These regressions are meant to detect the factors that explain differences across the transition countries, which is one way of dealing systematically with the questions asked in the previous section.

Table 2 shows the results of regressions that attempt to explain the growth of per capita GDP. It qualifies the graphical impression from Figure 2. The two first columns look at the whole sample period 1992-2003. The convergence effect is highly significant. Importantly, it is much larger than the standard 2.5 estimate that is ubiquitous in the literature. This result, which is robust to specification searches, means that the transition

countries have been converging unusually fast, all other things being unchanged. Why has not growth been faster, then? This is the first question previously identified.

Some answers can be found in the table. Three factors have slowed growth down. First, corruption.[3] The effect is strong and highly significant. In world comparisons, many of the transition countries rank very poorly, especially most of the FSU countries. Corruption is only the visible tip of the iceberg of bad governance; the result generally points toward governments that do not work to promote the social good and fail in a large number of dimensions. This is confirmed by the second factor, the size of government, measured here as the share of general government spending in total GDP.[4] Transition countries have inherited from the previous regime large and inefficient governments. Although the administration size has usually declined, it remains high by international standards, as Figure 4 illustrates. A general feature of international comparisons is that poor countries have small governments. By this standard, governments are oversized in the transition countries. Since, in most cases, their efficiency has not been sufficiently improved, the result is a brake on growth. The third factor that has stunted growth is inflation. It has considerably declined but remains a source of concern in many countries.[5]

The second question raised in Section 2 is the acceleration of growth during the more recent period, 1998-2003. The last two columns in Table 2 correspond to this period. The results deepen the puzzle. While the poorest transition countries of the FSU are among those where growth has risen, the catchup coefficient is found to be much lower over this period than over the whole sample period; it is even lower than the 2.5 standard, and only marginally significant. The result suggests that the recent acceleration of growth is not related to the convergence process emphasized by growth theory, i.e. by the late adoption of better governance. Instead, the two strongly significant variables for this period are oil exports and corruption. The interpretation is that, indeed, the fast growth identified in Table 1 is driven by high oil prices, while it is slowed down by corruption. The other side of the coin is that the other growth drivers have not played a statistically detectable role during the recent period. Thus the evidence apparent in Figure 2 shows that the countries that grew fastest over 1998-2003 were the poorest ones. It turns out that most of the poorest countries are primary commodity exporters. As Figure 3 shows, these are also countries where corruption is high (correlation = 0.669), and corruption tends to be associated with the share of oil exports (correlation = 0.381). This confirms the widely held view – see Sachs and Warner (1995) and Ellman in this volume

[3] The Corruption Perception Index (CPI) is from *Annual Report* (2004) of Transparency International (http://www.transparency.org). The index runs from 0 (most corrupt) to 10 (less corrupt). The measure used in the regression is –log(CPI). Earlier data would have been preferable to rule out reverse causality, but earlier reports do not cover all 26 countries in the sample. Fortunately (or unfortunately), the index changes little from year to year and can therefore be considered as exogenous.

[4] Unfortunately, comparable data including transfers are not available.

[5] Note that, for the whole sample, inflation used in the regression is measured over the more recent period 1998-2003, when it has declined massively from the rates, often huge, observed in the immediate post-central planning period.

– that access to vast natural resources is a frequent source of deep corruption, which in turn stunts growth.

Table 2. Growth of GDP per Capita

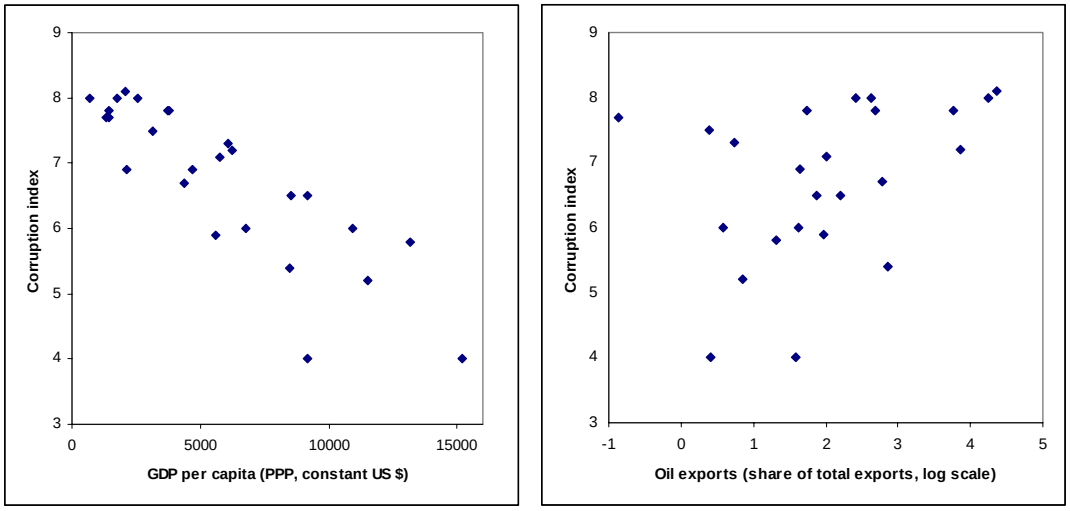
(Dependent variable: average annual growth; cross-section)

	1992-2003		1998-2003	
GDP per capita at start (log)	-4.81	-4.89	-1.53	-1.97
	-5.23	-4.90	-1.42	-1.46
Government spending (% GDP)	-0.13	-0.13		
	-1.80	-1.72		
Oil exports (% merchandise exports)	0.16	0.16	0.13	0.14
	6.85	6.35	5.14	4.61
Manufactures exports (% merchandise exports)	0.15	0.16		
	6.32	5.08		
Services, value added (% of GDP)	0.13	0.15		
	2.71	2.46		
Corruption index (log)	-4.95	-5.38	-4.35	-4.38
	-3.57	-3.04	-1.53	-1.29
Average inflation	-0.02	-0.03	0.00	0.00
	-2.18	-1.93	1.66	1.69
EU member dummy		-0.38		0.01
		-0.36		0.01
FSU dummy		0.41		-1.11
		0.33		-0.59
Adj. R2	0.80	0.77	0.56	0.52
SER	1.24	1.32	2.32	2.42
N. Obs	24	24	26	26

Source: *World Development Indicators*, The World Bank, 2005 and *Annual Report* (2004) Transparency International.

Notes: t-statistics are shown beneath the coefficients. Constant not reported. 'Average inflation' in columns 1 and 2 refers to average annual inflation 1998-2003; in columns 3 and 4, it refers to the difference between average annual inflation over 1992-1997 and average annual inflation over 1998-2003. See the Appendix for the country list; for the period 1992-2003, Bosnia-Herzegovina and Uzbekistan are not included because of missing variables.

Figure 3. Corruption, GDP per Capita and Oil Exports



Source: *World Development Indicators*, The World Bank, 2005 and *Annual Report* (2004) Transparency International.
Note: The corruption index is computed as 10 – CPI, where CPI is Transparency International's own index that ranges from 0 (most corrupt) to 1 (least corrupt).

A few more useful conclusions can be drawn from Table 2. Growth can be enhanced by the economic structure. In addition to primary commodity exports, two variables are found to have played a role during transition. The first one is the share of manufactures in total exports – in effect at the expense of agricultural exports since oil exports are already taken into consideration.[6] The other significant factor is the size of the service sector. In both cases, a 10 percentage point increase in these shares raises growth by about 1.5 percentage point. On both counts, the European transition countries have had a reasonably satisfactory position, less so many FSU countries, see Figure 4. This underlines the importance of structural change. The sad fact is that the countries with the lowest shares are those where there has been the least change, often in the wrong direction.[7]

Of equal interest are the variables that are not found to have had any effect on growth. Sala-i-Martin (1997) provides a list of 22 variables that are known to play a significant role in growth regressions. Many of these are not available for the transition countries, but a few do. Usually, productive investment is a crucial variable; it is not significant in the present case. A natural interpretation of this most surprising result is that much investment is not directed to growth-enhancing uses. Further investigation is needed to determine whether this result is driven by countries where there remains a large state-

[6] What is missing, for lack of available data, is the share of non-oil primary commodities in total exports.

[7] The correlation between the share in 1998 and the change of this share between 1998 and 2003 is positive (0.23) in the case of manufacturing exports and nil in the case of the service share in GDP.

owned sector or where the government can channel investment to preferred industries and firms.

Openness to trade is another variable that is known to enhance growth and that remains non-significant in the case of the transition countries. Trade supports growth by raising competition and encouraging the acquisition of new technologies. The latter effect often comes along with foreign direct investment (FDI). It turns out that FDI is not found to be significant here either (and is not in Sala-i-Martin's list).[8] Why is not trade the engine of growth in the transition countries? It must be that, explicitly or not, sufficient protection (trade, subsidies) is in place to prevent both mechanisms to operate.

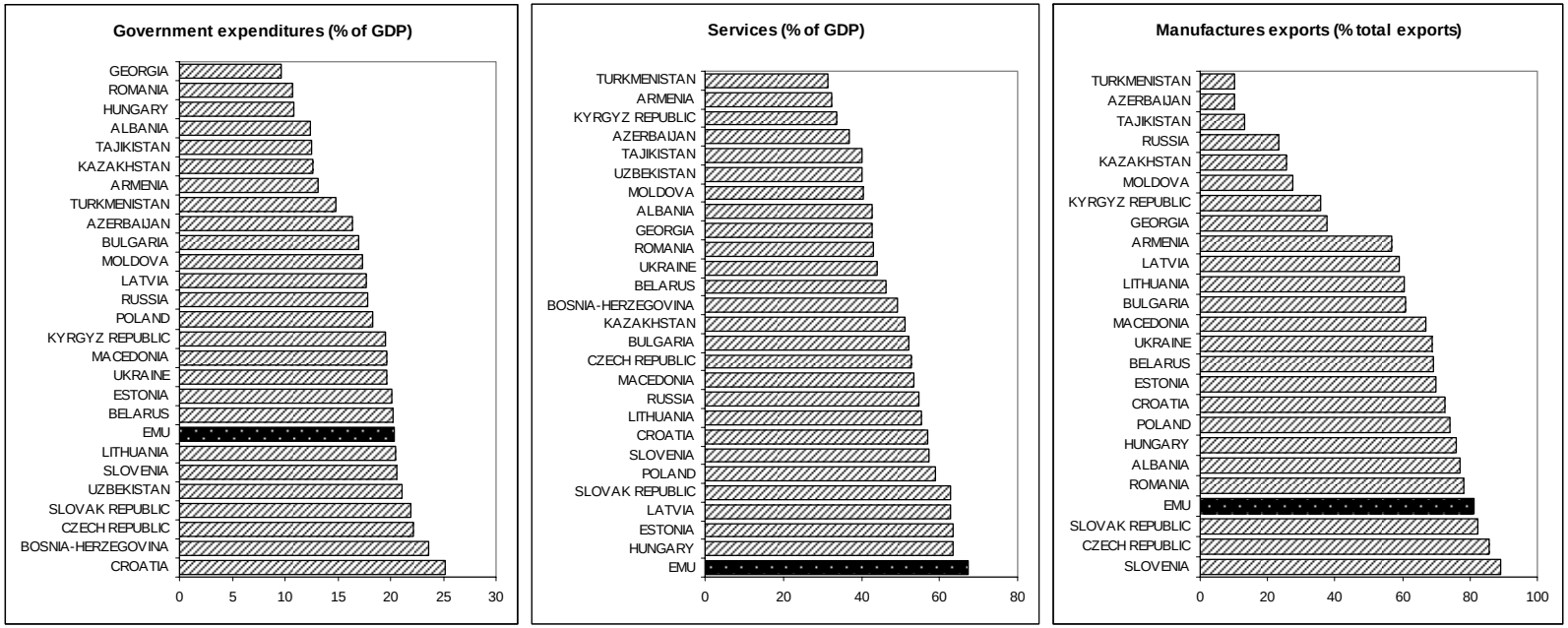
Several other variables that usually matter concern the availability of human capital. Indicators such as the proportion of people with primary, secondary or tertiary education are not found to have any significant effect in explaining transition growth. In general, the level is high by international standard and should play an important role in the catchup phase. The result is very surprising. One possible explanation is that distorted labor markets prevent the efficient use of skills. Relatively little is known on this issue (FIND REFERENCES). Much the same may applies to another series of variables that reveal health and social protection. The traditionally important life expectancy at birth variable is not found to be significant.

Finally, the quality of economic and political governance is generally found to matter a lot in growth regressions. Kaufman et al. (2005) provide a list of six measures that cover all the transition countries. None of them enters significantly in the present case, including their own corruption measure. This is most surprising given the presumption that mismanagement lies at the root of the disappointing performance of several transition countries. It may be that the measures are not adequate for this group of countries.[9] Alternatively it may be that the other variables better reflect economic and political mismanagement through some of its symptoms.

[8] None of these two variables enter significantly when interacted with dummies corresponding to EU members of FSU countries. One possible reason why neither investment nor trade enters significantly in the regression is that there is too little variation across countries; this is not the case, actually.

[9] The correlation between Transparency International's CPI and the World Bank's corruption index is 0.753, and yet the latter does not enter significantly.

Figure 4. Factors Affecting Growth



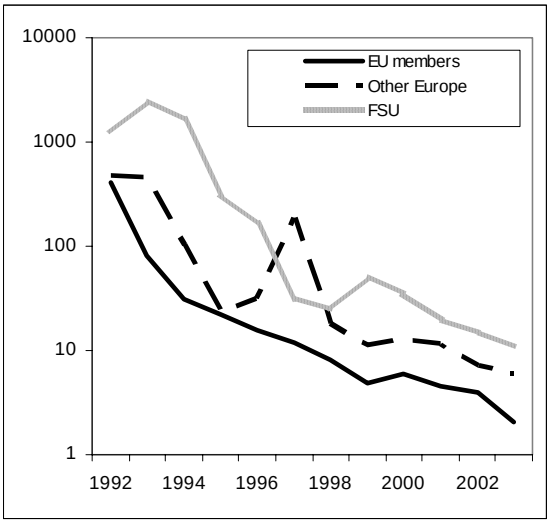
Source: *World Development Indicators*, The World Bank, 2005.

4. Inflation

With very few notable exceptions (the Czech and Slovak Republics, Hungary and Poland), the sharp early fall of output was accompanied by triple or even quadruple-digit inflation. Indeed, the immediate priority then was less to restart the economy than to extinguish the inflation fire, a necessary step to end deep disorganization. Figure 5 shows that disinflation has proceeded slowly and the performance of the three groupings mirrors that on growth displayed in Figure 1.

Figure 5. Inflation

(GDP deflator, % p.a.)



Source: *World Development Indicators*, The World Bank, 2005.
Note: Logarithmic scale.

The similarity on both performance measures can reflect either causality or the quality of economic management. The first view is that growth could only return once inflation had been brought down to tolerable levels. This view is partly supported by the results from Table 2. The second view is that bad policies caused both lasting high inflation and low growth. These two views are not mutually exclusive, quite the opposite is likely. The regressions shown in Table 3 are designed to shed some light on the issue. They ask whether the same factors that explain cross-country differences in growth also explain cross-country differences in inflation. The answer is ambiguous.

With one exception – government spending – the right-hand variables from Table 2 are not significant in the inflation regression.[10] Yet, all the other variables point to the role of economic and political management. These variables are not significant in the growth

[10] If they were, inflation could not be considered as exogenous in the growth regressions. Reestimating these regressions using the institution variables from Kaufman et al. (2005) as instruments for the inflation term does not affect the results in any meaningful way.

regressions, but others are, either directly through the corruption index or indirectly through economic structure indices.

Countries with larger governments tend to have less inflation. On the other hand, paradoxically government effectiveness, a measure of competence of the bureaucracy and of the quality of public service delivery from Kaufman et al. (2005), raises inflation. Thus countries with large and ineffective governments witness less inflation than countries with small but effective governments. These results suggest a trade-off between inflation and government spending: when spending is efficient, *ceteris paribus* governments run large budget deficits which are financed by money creation and inflation. This would amount to a surprising degree of rationality.

On the other hand, countries that have allowed their governments to increase spending have undergone more inflation. This result sends a very different message: raising government spending requires more financing, which has been, partly at least, provided by the inflation tax. This is more in line with usual expectations, as is the result that the rule of law index from Kaufman et al. (2005), which measures contract enforcement, police, courts and crime, has a negative effect on inflation.

Can these results be reconciled? It is not just that big and bad governments create inflation. It seems that good governments use the inflation tax to sustain public spending when they need it but also manage to reduce both public spending and inflation. The opposite applies to bad government.

5. Unemployment

Unemployment was set to nil under central planning. Transition ushered in a previously unknown, or unmeasured, phenomenon as the labor markets were radically transformed. Unsurprisingly, unemployment quickly rose. Disappointingly, it only moderately declined after peaking in the early 2000s. Here again, as Figure 6 shows, the situation is widely different from one group to another. The new EU member countries have quickly settled at a rate that is only slightly higher than in the average of the rest of the EU, with some important differences from one country to another. Unemployment is quite low in Hungary and Slovenia, and very high in Poland and Slovakia. On average, the other European countries have fared much worse. Yet, differences are large within this group as well: the unemployment rate is huge in Macedonia (above 30%) but quite low in Romania.

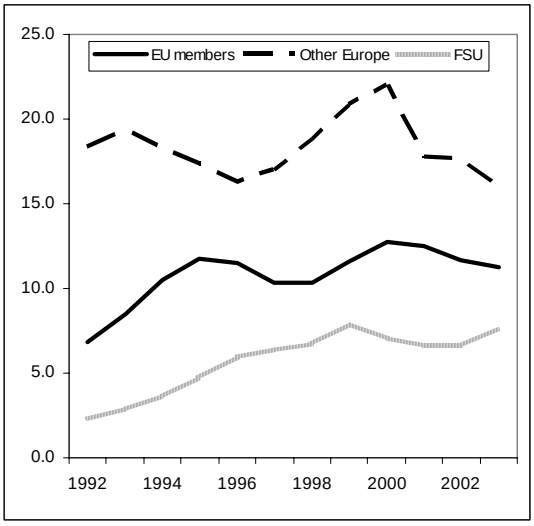
Table 3. Average Annual Inflation 1992-2003

Government spending (% GDP)	-44.92	-41.38
	-3.19	-2.87
Change in Government spending (% GDP)	25.88	25.70
	2.51	2.35
Government Effectiveness	655.76	731.56
	2.67	2.92
Rule of Law	-970.53	-771.36
	-3.67	-2.65
EU member dummy		-213.86
		-0.96
FSU dummy		208.37
		1.15
Adj. R2	0.51	0.52
SER	272.79	269.89
N. Obs	25	25

Source: *World Development Indicators*, The World Bank, 2005 and Kaufman et al. (2005).
Notes: t-statistics are shown beneath the coefficients. Constant not reported. The dependent variable is the average annual rate of inflation. Reduction in government spending is the difference between average government size (as a % of GDP) in 2003 and in 1992 – a positive number means that government size has increased. See the Appendix for the country list; Bosnia-Herzegovina is not included because of missing variables.

The odd man out is the FSU. Despite the early output collapse, followed by slow growth, until the late 1990s unemployment rates have remained low, often less than 1%. Then, as growth picked up in the early 2000s, unemployment rates did not decline; they only remained generally low on average. The average is increasingly misleading, though. While a number of countries have 'normal' unemployment rates by transition economy standards (Armenia, Georgia, Kazakhstan, Kyrgyz Rep., Russia, Ukraine), others still announce rates of 3% or less (Azerbaijan, Belarus, Tajikistan, Uzbekistan).

Figure 6. Unemployment Rates



Source: *World Development Indicators*, The World Bank, 2005 and *Transition Report*, EBRD, 2005.

The unmistakable impression is that labor market liberalization has proceeded at very different pace from one country to another. Most European countries have quickly liberalized their labor markets; naturally then, the worse unemployment performance in the non-EU members reflects the generally worse economic performance (as indicated by growth and inflation). In the FSU countries, in contrast, labor market liberalization has been proceeding very slowly, and remains far from complete in several countries. In fact, it is not just the labor market that has not been fully liberalized, but the goods markets as well, with significant state sectors where firms' policies towards employment have not fully changed from the Soviet times.

The regressions presented Table 4 are an attempt to explain the observed differences across countries. Only two variables have an explanatory power; both are governance indicators from Kaufman et al. (2005). Government effectiveness appears to raise unemployment, while corruption has the opposite effect. This may look paradoxical. The most likely interpretation is that good governments do not tinker – or tinker less – with the labor market, accepting open unemployment as a fact of life.[11] In the end, standards of living rise faster.

[11] This interpretation is supported by the fact that the market regulation indicator appears to increase unemployment as well, although the effect is imprecisely estimated (t = 1.94) when the variable is used instead of the effectiveness indicator and loses significance when it is used along with the effectiveness indicator.

Table 4. Average Unemployment 1992-2003

Government Effectiveness	13.12	12.42
	2.88	3.10
Corruption	-9.28	-10.24
	-2.18	-3.32
EU member dummy		-10.48
		-2.67
FSU dummy		-13.47
		-4.21
Adj. R2	0.23	0.62
SER	6.82	4.83
N. Obs	23	23

Source: *World Development Indicators*, The World Bank, 2005 and Kaufman et al. (2005).
Notes: t-statistics are shown beneath the coefficients. Constant not reported. The dependent variable is the average rate of unemployment over 1992-2003. See the Appendix for the country list; Bosnia-Herzegovina, Bulgaria and Turkmenistan are not included because of missing variables.

Inequalities

TO BE COMPLETED. As documented by Milanovic (1998), income inequalities have increased, sometimes massively, so did poverty. (DATA TO COMPARE POVERTY?) (DISCUSS CHAPTER 7 IF RELEVANT.) There is no evidence, however, that faster or more complete transition has been accompanied by more poverty or deeper inequalities.

6. Net Saving: Public Finances and External Account

As they emerged from central planning, the transition countries were impoverished and poorly equipped in productive capital and public infrastructures.[12] The whole idea of transition was that standards of living were bound to rise though the accumulation of adequate productive capital and public infrastructures. Firms had to borrow to invest massively. Governments could look forward to larger tax bases; it was rational, and still is, to borrow to speed up the provision of much needed public goods and infrastructure. Households, who had every reason to believe that their living standards would rise, wanted to borrow against future incomes. Facing a necessarily limited pool of domestic savings, corporations, the public sector and households were fully justified to borrow abroad. That meant public and current account deficits, possibly sizeable ones. This is an implication of the theory of optimal intertemporal consumption smoothing.

[12] There was much productive capital but it was both obsolescent and tied to sectors that did not necessarily reflect comparative advantage. Restructuring consisted primarily in closing down inefficient plants and allowing new activities to emerge.

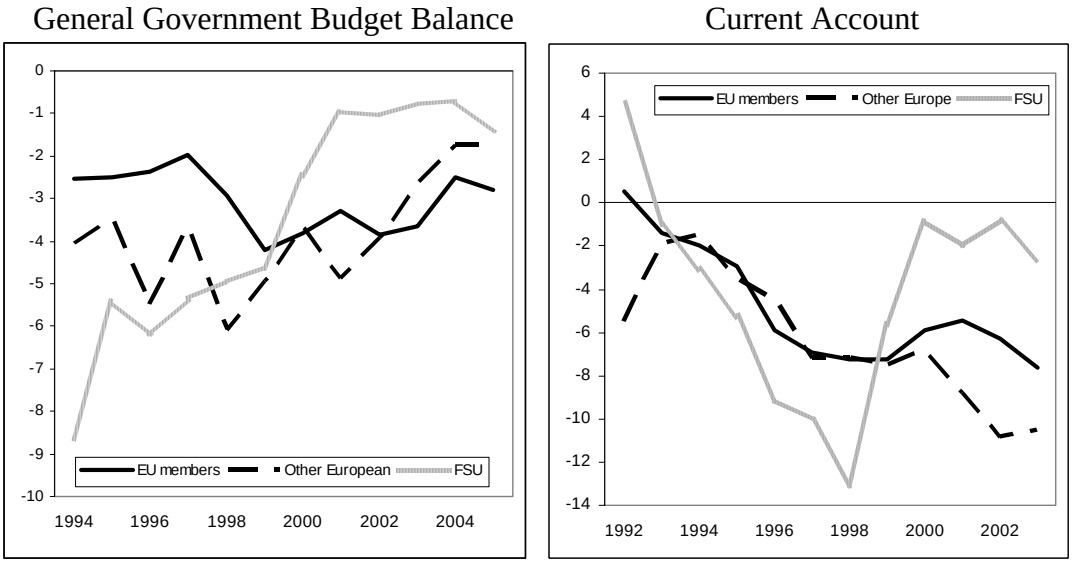
On the other hand, these deficits were only justified by the promise of continuous growth. To fulfill that promise, both corporate and public borrowings had to be channeled into productive capital and well thought-out infrastructures. Poor investment decisions would not deliver the hoped for growth and would make public debts unserviceable. Bad management and poor political institutions could turn potentially promising budget and external deficits into serious sources of hardship.

The pattern of budget and current account balances is displayed in Figure 7 for the three country groups. On average, the new EU members have continuously run budget deficits of 3-4% of GDP, although individual experiences differ. The other European countries started up with larger deficits but have recently managed to reduce them on average. The FSU countries started with huge deficits, in many cases a near-loss of control of public finances, which explains the concurrent three-digit inflation rates. Their fast growth performance since the late 1990s has obviously allowed most of them to move towards budget balance. Here again, averages conceal some very different situations, with continuing large deficits in Kyrgyzstan and, to a lesser degree, Tajikistan.

The current account pattern is broadly similar, except that the deficit has been continuously deepening outside of the FSU, reflecting a gradual shift from moderately positive private sector net savings to increasingly larger net borrowing that reached in 2003 4% and 8% of GDP for the EU member country average and the other European countries, respectively. In the FSU countries, on average, the private sector shifted into near balance in the early 2000s.

Figure 7. General Government and Current Account Balances

(% of GDP, averages over country groups)



Source: *Transition Report* (2002 and 2005), EBRD

Note: Because some data are missing over the early sample period, early observations should be considered with care.

The patterns displayed in Figure 7 are in line with the theory of optimal intertemporal consumption smoothing. In that view, the observed public and external deficits are not a source of concern. As noted, however, the theory assumes that public and private borrowings are invested in productive capital and infrastructures. In order to interpret the balances, we need therefore to know what were the borrowings used for. One approach is to look at the detailed evidence. (REFERENCE TO SOME CHAPTERS?)

Another approach is to look for circumstantial evidence. Here we ask what were the motivations that have driven the public and external balances. As before, we turn to cross-section regressions to explore the reasons why outcomes differed across countries.

The results for budget balances are presented in Table 5. They are quite intuitive. Three main factors explain differences among the transition countries. First, the poorer is the country in 1992, the larger is the budget deficit. This is in line with the theoretical argument that prospects of future tax base growth justify borrowing. Under the assumption that transition will eventually lead to catching-up with the leading countries, the poorer initially is a country, the more it stands to gain. This result suggests that the deficits are desirable. Second, deficits are larger in countries where corruption is more serious. Corrupt governments are likely to borrow more and, most likely, for the wrong reasons. The third result shows that budget deficits are larger in countries where the rule of law is better assured. This is another argument in favor of deficits.

Note that there is no indication that the oil share in exports variable produces any effect on the budget balance. This may seem surprising since oil exports require important infrastructures. One possible interpretation is that this effect is offset by government revenues from oil. This would be the case if all the revenues were re-invested in useful infrastructures. But it could also be the case the oil revenues are used to finance wasteful projects or for political patronage, in line with the observation that the abundance of natural resources tend to go along with corruption, see Figure 3 above.[13]

[13] Adding a variable that combines the effectiveness indicator and the share of oil exports in total exports, we find a negative coefficient, but its p-value (significance level) is 15%. This result does not support the view that oil exports are misused by ineffective governments, but it is too marginal to be taken at face value.

Table 5. General Government Budget Balances (% of GDP, 1994-2005)

GDP per capita at start (log)	1.56	1.52
	2.41	2.19
Corruption	-1.20	-1.13
	-2.48	-2.05
Rule of law	-3.28	-3.46
	-3.59	-2.78
Share of manufactures in exports		
EU member dummy		0.47
		0.34
FSU dummy		-0.01
		0.00
Adj. R2	0.40	0.35
SER	1.57	1.65
N. Obs	26	26

Source: *Transition Report* (2002 and 2005), EBRD; *World Development Indicators*, The World Bank, 2005; Kaufman et al. (2005).
Notes: t-statistics are shown beneath the coefficients. Constant not reported. The dependent variable is the average budget balance (% of GDP) over 1994-2005, from EBRD's *Transition Reports*. See the Appendix for the country list; in the second column Bosnia-Herzegovina and Uzbekistan are not included because of missing variables.

The results concerning the current accounts are displayed in Table 6. As with budget balances, the starting GDP per capita level appears with a positive sign. This result implies that poorer countries borrow more heavily abroad, as theory would predict.[14] Second, FDI is mirrored one for one in the current account. This can be seen as an accounting identity, but it also shows that the resources provided by this form of capital inflows are not systematically used to generate capital flight. The political stability variable proposed by Kaufman et al. (2000), which deals with violent threats to, or changes in, government, including terrorism, appears with a clear negative side. This confirms that, in transitions countries as elsewhere, foreign investors are more willing to bring capital resources in politically stable than in troubled countries. All these results support the theory of optimal intertemporal consumption smoothing.

There are some disquieting findings, however. Military spending emerges as a source of external deficits. Military spending is not a channel for productive investment. Then, the share of oil exports enters positively, as expected, but the effect is small (an increase of 10 percentage point in this share merely improves the current account-to-GDP ratio by

[14] This is one case where Lucas (1990) observation that international capital flows in the wrong direction is not verified.

0.9%). Moreover, when the Transparency International corruption index is added to the regression, the oil export term becomes insignificant, which suggests that corruption is associated with oil revenues.[15] As expected, capital flows less readily to corrupt countries.

Table 6. Current Account (% of GDP, 1996-2003)

GDP per capita at start (log)	5.41	5.41	7.83	7.45
	4.62	4.56	5.74	4.97
Foreign direct investment	-1.20	-1.40	-1.11	-1.15
	-5.47	-4.67	-4.71	-3.69
Manufactures exports (%	-0.09			0.04
merchandise exports)	-2.95			0.74
Oil exports (% merchandise exports)		0.09		
		2.19		
Military spending (% public		-1.57	-1.51	-1.76
spending)		-4.03	-4.05	-3.89
Corruption			7.45	
			2.59	
Political stability		-2.47	-2.19	-1.82
		-2.30	-2.08	-1.73
Share of manufactures in exports				
EU member dummy				-4.20
				-1.77
FSU dummy				1.37
				0.59
Adj. R2	0.67	0.70	0.72	0.73
SER	2.84	3.37	3.25	3.17
N. Obs	26	26	26	26

Source: *World Development Indicators*, The World Bank, 2005; Kaufman et al. (2005) and *Annual Report* (2004) Transparency International.
Notes: t-statistics are shown beneath the coefficients. Constant not reported. The dependent variable is the average current account (% of GDP) over 1996-2005. The sample starts in 1996 because many observations for the early years are missing. See the Appendix for the country list.

Overall, the picture is contrasted. Firms, governments and households in well run and non-corrupt countries seem to borrow for good reasons. In these cases, the budget and

[15] The correlation coefficient is 0.395 and the partial correlation coefficient is statistically significant (p = 0.020).

external deficits should not be a source of concern. After all, between 1864 and 1900, Australia's average current account deficit stood at 11% of GDP, with peaks of 20% or more.[16] In other cases, it is likely that public and external borrowings have not been put to a good use.

7. The EU Blessing and Soviet Legacy Curse Hypothesis

A key question is why policies have differed so profoundly. This question matters both to understand the past but also to shape the future. Undoubtedly, history and circumstances, in some cases wars and civil unrest, have played a role. It is tempting to imagine that the further West is a country, the better it has managed the transition process. Geography and history could have created an EU blessing and a Soviet legacy curse. The EU blessing would be the fact that, having been selected early on for accession, the new EU members have been led to implement deep reforms that, maybe, would not have been undertaken without the promise of eventual membership. The Soviet legacy curse would be the difficulty of adopting good governance because of a lack of experience with democracy and the rule of law, along with the poor state of the economy after a very long period of Soviet economics.

Put differently, the hypothesis is that the prospect of EU membership has been an efficient lever to improve policies. This would explain the generally better initial economic conditions and subsequent performance of the EU member countries, the less good outcome among the other European countries, many of which are reaching accession status only now, and the more disappointing situation in the FSU countries, which cannot contemplate EU membership.

In order to test this hypothesis, all regressions presented above include one variant with two dummy variables identifying the EU members and the FSU countries.[17] With one exception,[18] these variables are never significant. Does it also mean that there is no EU membership virtuous circle and no Soviet legacy curse? Not necessarily so.

What it does mean is that prospective EU membership and the Soviet legacy do not need to be invoked in addition to the other explanatory variables that explain the differences in transition macroeconomic performance. But can the explanatory variables themselves be systematically related to geography and history? Table 7 presents tests of the hypothesis. Each of the explanatory variables that appeared in one of the above tables is regressed on a constant and the EU and FSU dummies. When the coefficients of the EU and FSU

[16] Source: The Jones-Obstfeld database (http://www.nber.org/databases/jones-obstfeld/).

[17] This means that the 'other Europe' group effect is included in the constant. The fact that the EU and FSU dummies are not significant implies that an 'other Europe' dummy, introduced instead of the constant, would not be significant either.

[18] The one exception concerns the case of unemployment reported in Table 4. The coefficients imply that, relative to 'other Europe', *ceteris paribus* the EMU members have had a 10.5% lower unemployment rate, and the FSU countries a 13.5% lower unemployment rate.

dummies are significant, they show the differential effect of being an EU member or an FSU country relative to 'other Europe'.

The results spectacularly support the EU blessing and Soviet legacy curse hypothesis. The regressions in the top panel show that the FSU countries started out poor and have retained a disadvantageous economic structure. The regressions also show that the non-EU member European countries stand in-between the FSU and EU member countries, victim of a milder version of the disadvantages faced by the FSU countries but plagued by high military spending. The regressions presented in the lower panel similarly show that the FSU countries are characterized by poor governance, improper institutions and low life expectancy. Here again the non-EU members of Europe generally stand in-between.

Table 7. The EU Blessing and Soviet Legacy Curse Hypothesis

	Economic variables							
	Per capita GDP in 1992	Government size	Oil exports	Manufactures exports	Trade openness	Agriculture	Services	Military spending
FSU	-0.35	-1.83	22.35	-36.75	10.30	5.67	-8.36	-2.09
	-1.38	-0.87	2.16	-4.10	0.80	1.31	-2.72	-2.79
EU	0.65	0.93	-0.03	3.44	26.80	-12.71	10.05	-2.53
	2.35	0.41	0.00	0.36	1.93	-2.72	3.03	-3.13
Adj. R2	0.40	0.01	0.21	0.57	0.07	0.44	0.62	0.26
N. Obs.	26	26	24	24	26	26	26	26

	Institution and governance variables							
	Corruption	Government effectiveness	Rule of law	Political stability	Regulatory burden	Voice	Life expectancy	Secondary education
FSU	0.78	-0.46	-0.50	-0.46	-0.49	-0.53	-4.07	1.51
	2.34	-2.55	-3.50	-1.43	-1.39	-2.42	-3.59	3.79
EU	-1.50	0.79	0.68	0.65	1.11	1.14	-0.25	11.23
	-4.21	4.12	4.43	1.88	2.93	4.85	-0.20	4.01
Adj. R2	0.69	0.73	0.76	0.33	0.48	0.73	0.41	0.29
N. Obs.	26	25	26	26	26	26	26	24

Source: *World Development Indicators*, The World Bank, 2005; Kaufman et al. (2005) and *Annual Report* (2004) Transparency International.
Notes: The dependent variable is indicated in the corresponding column heading. t-statistics are shown beneath the coefficients. Constant not reported. The corruption index is computed as 10 – CPI, where CPI is Transparency International's own index that ranges from 0 (most corrupt) to 1 (least corrupt). See the Appendix for the country list.

8. Conclusions

This broad overview paints a mildly reassuring picture of transition. Growth has returned to an area that underwent a few years ago a deep recession, sometimes accompanied by stunning inflation. In some countries, especially among the FSU countries, the

resumption of growth has taken a lot of time, and it seems dangerously to rely on primary commodity exports, chiefly oil and gas. Primary commodity prices may well remain high for many years – or decades – to come, but the dependence on one source of revenue is not just dangerous, it also shows how little restructuring has happened in these countries.

In many respects, the transition economies are different from other emerging market or developing countries. Some traditional growth factors – education, health systems – do not seem to have played a significant role. Importantly, policies and outcomes have markedly differed, not just because of different initial conditions. As a result, a number of countries cannot be considered any more as transition economies. This is the case of those countries that joined the EU. At the same time, many of the FSU countries are still deeply in transition, in the sense that deep reforms remain to be undertaken.

Looking further ahead, two observations are crucial. First, good governance is essential, even if primary commodity abundance has allowed for an across the board improvement in the laggard countries of the FSU. Second, history and geography seem to have predetermined economic successes and failures. Being close to the EU provides the blessing of the accession prospect. Having been part of the Soviet Union has proven to be a severe handicap, only mitigated by primary resources.

The challenge ahead, therefore, must be to fight the apparent historical and geographical predetermination. Several of the non-EMU member countries are either slated to join the EU or are just starting pre-accession negotiations. The EU blessing effect is likely to greatly help these countries, as it did for the first wave of new members. Bulgaria, Romania and Croatia are probably out of the danger zone.

Albania, Bosnia-Herzegovina, Macedonia and Serbia-Montenegro, on the other hand, may face a door that has been closed for a significant period of time. The FSU countries, at least the few of them that expressed the wish, cannot expect any opening of the door over the foreseeable future. Being deprived of the EU blessing, these countries will have to rely on themselves. The challenge is unmistakable: the evidence from this study, among many others, overwhelmingly shows that they must adopt proper institutions. Why should they succeed now after having failed for fifteen years?

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Appendix. List of countries

New EU Members (8): Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovak Republic, Slovenia.

Other European countries (6): Albania, Bosnia-Herzegovina, Bulgaria, Croatia, Macedonia, Romania

Former Soviet Union (12): Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyz Republic, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine, Uzbekistan.

Note that because of lack of data Serbia-Montenegro is not included in the sample.