CHAPTER 1

OVERVIEW AND POLICY ISSUES

1.1 Overview of the ECE economies in late 1998

Throughout the course of 1998 governments, policy makers and analysts have been struggling to keep up with and adjust to the consequences of the financial crisis which started in South-East Asia in July 1997 and has since been extended and amplified by prolonged recession in Japan and financial collapse in Russia. What was at first diagnosed as a serious regional upset with few, or at least easily manageable, implications for the rest of the world, has developed into a global and economic crisis which is now affecting the prospects for real economic growth in all parts of the global economy. Although the impact of the crisis varies considerably between individual economies, there are no islands of immunity to the effects of global financial turmoil. Although relative calm has returned to the financial markets since early October, and hopes that a further deterioration in the world economy can be avoided have been strengthened by interest rate cuts, especially in the United States, and by the explicit recognition by the Group of Seven countries in late October of the risks of deflation and global recession, the uncertainties and downside risks surrounding the outlook for 1999 remain considerable.

The optimistic forecasts of a year or so ago have been steadily and significantly lowered during 1998 as it became clear that the crisis would be deeper and longer than originally assumed. The IMF's forecasts for world economic growth in 1998 were lowered from 4¼ per cent in October 1997 to 2 per cent in October 1998 and its forecast for 1999 was cut from 3.7 per cent in May 1998 to 2.5 per cent in October; the OECD's forecast for aggregate GDP growth in its member countries in 1998 and 1999 was lowered from 2.9 and 2.6 per cent in December 1997 to 2.4 and 2.5 per cent, respectively, in June 1998 – and in November these were reduced again, to 2.2 and 1.7 per cent; and the Commission of the European Communities has lowered its forecast for the European Union in 1999 from an average 3.1 per cent in October 1997 to 2.4 per cent in October 1998. In the last month or so official national forecasts have been revised downwards, not least in the transition economies of eastern Europe where the adjustments largely reflect re-evaluation of the prospects in western Europe.

The rapidly changing economic outlook underlines how difficult it is to make reliable forecasts in turbulent times. The standard forecasting models, which have a major influence on the stance of economic policy, have always had difficulties in identifying turning points in the real economy, but these problems have been intensified by important structural changes which have occurred in the world economy and which for the most part are poorly reflected, if at all, in the structures of the models themselves. One of the most important of these changes in the world economy has been the wholesale liberalization of capital movements. At first only the advantages of such a process tended to be emphasized: their capacity to channel global savings to where returns were highest (for a given level of risk) and thus to promote growth and development where it was most urgently needed. What has only been gradually realized in many policy-making circles, often with some reluctance, is that unrestricted capital flows, particularly of short-term capital, also have the capacity to provoke financial crises which, because they can be quickly propagated in an interdependent world economy, can be highly disruptive of real economic activity across the globe. At first, there was a tendency to blame the crises in South-East Asia solely on internal weaknesses in these economies, such as poor regulatory regimes, weak systems of corporate governance, and a general lack of transparency in their financial and banking sectors. Similar charges have been made in the case of Russia. The question is not whether such deficiencies exist – they probably do – or whether it is beneficial to remove them – certainly it is – but whether they played a significant role in causing the crisis. This is by no means clear: most of the institutional and economic problems of these economies are well-known and of long-standing; it is inconceivable that foreign investors, with highly-paid advisers and advanced information gathering resources at their disposal, were not aware of them when placing their funds. Moreover, warnings about the accumulation of foreign short-term liabilities to dangerous levels in South-East Asia were being made a year before the crisis by the Bank for International Settlements.

Since the collapse in the United States of the LTCM hedge fund in September there has been markedly less discussion of crony-capitalism, the lack of transparency, and so on, in emerging markets as causes of the crisis. Instead, more concern is being expressed about the

inherent volatility of the global capital markets and their susceptibility to herd behaviour, panics, and "fear-induced psychological" responses (in the words of the Chairman of the United States Federal Reserve). This concern is reflected in the emerging debate over proposals for a new "architecture" for regulating the global economy and responding to crises and, more narrowly, by increasing acceptance of the idea that, in certain circumstances, resort to controls on short-term capital movements – or, where they are still in place, a more cautious and gradual rate of liberalization – may be justified to preserve domestic economic stability.

These developments also point to departures from the standard framework of economic thinking, the "paradigm", that has shaped economic policy making in the G-7 countries and many others for most of the past two decades. Included in that framework was the view that financial factors have little or no effect on the underlying performance of the real economy; instead, the "fundamentals" are assumed to be determined essentially by the structure of the economy and so structural reform is the only way to improve the underlying growth of the real economy and, for example, to achieve lower rates of unemployment. The alternative view – which is not new but rather returning to favour – is that the behaviour of financial markets can have very significant effects on the real economy and its long-run performance. The volatility of financial markets and its rapid transmission (contagion) through interdependent economies increases risk and raises the cost of capital, thus depressing fixed investment and growth. Moreover, the scope for individual governments to use macroeconomic policy to support objectives such as higher growth and lower unemployment is severely curtailed by the threat of capital outflows which tend to respond to a narrow range of short-term financial and monetary indicators. Consequently, macroeconomic stances tend to be dominated by interest rate policy which in turn has led to higher and more volatile short-term interest rates, which again are damaging for fixed investment and for growth. Transition economies that might wish to run a current account deficit over an extended period as part of a general strategy of "catching-up" with western levels of GDP per head, may in fact have to settle for medium-term growth rates below what are feasible if they are to avoid being destabilized by volatile capital movements.[1] These debates about macroeconomic policy and reform of the international monetary system are particularly important because they introduce another element of uncertainty into the present economic outlook, namely, over the intellectual framework which shapes the policy responses to economic imbalances. The tensions thrown up by this questioning of the prevailing paradigm are nowhere greater than in western Europe where the governments of the largest economies in the European Union have declared their intention to give greater priority to growth and the reduction of unemployment while the newly created and independent European Central Bank (ECB) has only a single objective, namely, to keep inflation at below 2 per cent.[2] The actual risk of a serious conflict between EU governments and the ECB is likely to depend on whether the present cyclical upturn can quickly regain the momentum it has lost during 1998.

The economic performance of the ECE member countries – that is, the whole of Europe, Russia and the other members of the CIS, as well as North America – is likely to vary considerably in any circumstances but this is particularly the case in 1998 despite the global nature of the financial and economic crisis. The impact of falling demand for exports and of instability in financial markets will depend on a range of factors including each country's position in the business cycle, whether the growth rate is picking up or falling, the size of its trade with the countries directly affected by crisis, its openness to global capital markets; and the exposure of its banking and financial sectors to losses abroad.

It is still very difficult to judge the likely, combined impact of the Asian and Russian crises on the economies of the rest of the ECE region, in part of course because the Russian default occurred in the second half of 1998 for which there are still very few published data available. The negative trade effects have been increasingly felt in the United States and western Europe during the year, especially in the former, and these have in general been somewhat greater than expected. Nevertheless, on both sides of the Atlantic growth has remained fairly strong in 1998 although its deceleration during the year points to a significant slowdown in 1999, from 3.4 to 2 per cent in the United States and from 2.8 to 2.2 per cent in both western Europe as a whole (21 countries) and in the European Union. In the United States the negative effects of falling net exports and reduced stockbuilding in 1998 were largely offset by the continued buoyancy of private consumption and fixed investment. The latter are both expected to weaken in 1999. There is still a risk of a sudden cut in consumer spending in the United States which has been boosted by a drop in the household savings rate to virtually zero and by large-scale borrowing supported by the increase in stock market wealth. An eventual sharp fall in equity prices, combined with a weaker labour market, could lead to a much more pronounced weakening of domestic demand than currently forecast.

[1] On these issues see J. Eatwell and L. Taylor, "International capital markets and the future of economic policy. A proposal for the creation of a world financial authority", paper prepared for the project on International Capital Markets and the Future of Economic Policy, funded by the Ford Foundation and available at www.newschool.edu/cepa; and UN/ECE, "Catching up in a global economy: sustaining growth in the transition economies", *Economic Survey of Europe*, *1998 No. 1*, pp. 9-10. See also J. Stiglitz, "More instruments and broader goals: moving towards the post-Washington consensus", *The 1998 WIDER Annual Lecture* (Helsinki), 1998, as well as J. Stiglitz, "Towards a new paradigm for development: strategies, policies, and processes", *1998 Prebisch Lecture*, UNCTAD (Geneva), October 1998.

[2] See below, chap. 2.2(ii).

In western Europe, the growth of industrial production was slowing down in the first half of 1998 and capacity utilization rates started to fall, also affected by the slowdown in export growth. Surveys of industrial and consumer confidence show them both to have been weakening during the year with a particularly sharp deterioration of industrial confidence in the autumn. Stock levels have also risen in recent months and there is a generally more pessimistic assessment of order books and export prospects. It should be emphasized that there are still large differences among the west European countries in terms of growth rates and their relative position in the cycle. Nevertheless, the two key economies as far as growth in 1999 is concerned are France and Germany, and in both of these there is a clear weakening of the forces for cyclical recovery. Even with the present outlook, of west European growth of 2.2 per cent in 1999, there is unlikely to be any significant improvement in the average unemployment rate of around 10 per cent in the EU or just over 11 per cent in the EMU area. A more severe slowdown will risk reversing the small gains of the last few years and increasing the tensions, noted above, among those responsible for macroeconomic policy.

At present there is no problem of inflation in the western market economies. Despite the long period of sustained growth in the United States, the year-on-year rate of increase in consumer prices is still running below 2 per cent and was 1.6 per cent in the third quarter. Inflation is similarly below 2 per cent in western Europe, and in the EMU countries was under 1.5 per cent in the third quarter, with France and Germany both under 1 per cent. It is difficult to see why there should be any significant change in this low-inflationary environment. The inflationary expectations of wage earners and producers have clearly changed since their experience of the high inflation rates of the 1970s and 1980s, and there have been major changes in the world economy which tend to reinforce those lower expectations. The removal of barriers to international trade and capital movements, the privatization of state enterprises, the breakup of national monopolies by technological change in industries such as telecommunications, as well as new sources of supply in Asia, Latin America and eastern Europe, have all contributed to a marked intensification of international competition. The investment led expansions in the United States and Asia have contributed to global overcapacity in many industries – as evidenced by the growing demands for protection by western producers of steel, computer chips, automobiles, textiles, etc. – leading to falling profitability and the increasing risk of falling prices. In addition, primary commodity prices, including energy, are still falling or remain very weak and most forecasters see little prospect of a rapid recovery in the next two to three years. Faced with the prospect of a premature cyclical slowdown, it is hardly surprising that European Union governments see unemployment as the major economic and social problem in Europe and are planning to coordinate their economic and employment policies in order to stimulate growth in the Union.[3]

Economic performance in the transition economies has continued to be highly variegated and the shocks from Asia and Russia have also had a wide-ranging but variable impact on individual economies. Most of the east European and Baltic economies appeared by mid-year to have weathered the effects of the Asian crisis quite well with relatively little contagion from the world financial markets. In the first half of 1998 economic growth was relatively strong with an average 3.5 per cent in eastern Europe (rather better than 1997) and 7.1 per cent in the Baltic states (slightly less than in 1997). For 1998 as a whole, average rates of some 3 and 6 per cent respectively would seem to be in sight, provided there are no serious setbacks in the second half. However, as in western Europe, there seems to have been a slowing down of east European growth after the first quarter. In the second quarter this already appears to have been due, at least in part, to the situation in Russia. Although the importance of Russia in total east European exports is now relatively small (mostly some 3 to 8 per cent) and total CIS is somewhat larger (some 5 to 14 per cent), it is frequently concentrated in a few industries (such as food and light industrial products) or in certain border areas where the impact of the crisis on economic activity and employment is already significant. The impact on the Baltic economies will be much greater since their exports to Russia and the CIS amount to some 15 to 21 per cent and 23 to 43 per cent, respectively, of total exports. A number of governments (the Baltic states, Hungary and Poland for example) are proposing to try to preserve their trade with Russia and the CIS by resorting to alternative means of settlement, such as barter, state-to-state sales, etc. The situation will almost certainly have worsened in the third quarter and estimates for the year as a whole suggest that exports to Russia could fall by an order of magnitude of some 20 to 25 per cent.

Although the influence of the Russian factor on eastern Europe is perhaps rather more important than would appear from just a consideration of export shares, the major concern of the east European and Baltic countries is with the prospects for growth in western Europe, and particularly the European Union. Hungary now sells over 70 per cent of its exports to the EU; for the Czech Republic, Poland, Romania and Slovenia the shares of the Union are close to two thirds, and for most of the other countries it is around 50 per cent. Thus any setbacks to the growth of import demand in the EU could have serious effects on the outlook for eastern Europe. Indeed, there already appears to have been some slackening in the growth of east European exports to the western market economies in the second quarter of 1998 which accelerated

[3] It was agreed at the Council Meeting at Pörtschach (25 October 1998) that the 15 Finance Ministers would draw up such a plan to be discussed at the EU Summit in Vienna in December. Among the various proposals aired in the press and informal briefings are: the exclusion of public investment expenditure from the Maastricht budget deficit rule; European infrastructure projects, particularly for transport; and calls for lower interest rates.

in the third quarter. In this context it is very important to ensure that proposals to ship large amounts of food aid from the EU and the United States to Russia this winter (see box 1.1.1 on humanitarian aid to Russia) are not implemented in such a way as to weaken further east European and Baltic exports to Russia. From the point of view of maintaining economic stability in the region, it might be more efficient for the EU to finance shipments from east European and Baltic producers.[4]

[4] On the issue of possible food shortages in Russia in the coming winter, see the next section.

BOX 1.1.1

Humanitarian aid for Russia

Although western and international financial institutions' assistance for reform in Russia is "on hold", there has been remarkably swift action in assuring that programmes of food aid, including $600 million for the purchase of food, from the United States,[1] and a package[2] of some $500 million from the EU, will be available to help the Russian people overcome any winter food shortages.

There have been conflicting reports from Russia on the issue of possible food shortages in the coming winter, and no one wishes to be complacent about disaster warnings, even if they are hotly disputed within the country itself.[3] The problem, however, would appear to be overwhelmingly one of distribution, especially to remote and depressed regions, or to low income groups of the population, not one of overall supply as it is often presented. It is clear, however, that the offers of aid from the United States and the EU are also motivated by the desire to assist their own domestic farmers and food producers. Both have large surplus stocks of food, and both had been expanding their exports to the growing Russian market.

The United States and EU shipments would represent a substantial proportion of Russia's annual imports of food which in the last few years have been in the range of $10 billion.[4] Thus the risk of crowding out shipments from other transition countries is evident. These countries have been trying to increase their barter transactions to Russia to compensate for losses in the present crisis, sectoral shocks and layoffs. If the overall welfare impact of the credits offered were the prime consideration it would be better if the aid could be used to purchase Polish sausage or Lithuanian dairy products.

In addition to the potentially negative effect of crowding out other transition economies' food exports to Russia, it is already clear that the terms of the proposed deals risk a repetition of the 1992-1993 aid episode. In what seemed to be an efficient arrangement then, the food was delivered to Russian enterprises for further processing and distribution. The profits were supposed to be used for "social purposes". This is precisely what has been agreed again. In the earlier episode, however, there were many charges of corruption, some still under investigation, the net effect of which was to create considerable ill will. Some of the Russian groups and individuals involved in the 1992-1993 programme are again involved in the new transactions. The United States government is proposing to send only two people to check on the deliveries and, in contrast to normal United States practice, it appears that there will be no bidding by the Russian agencies for the right to process and deliver the food.[5] This stands in marked contrast to an earlier warning by the new Russian Deputy Prime Minister for Social Policy, Matviyenko. She has noted that problems of food distribution do exist for 26 identified Russian districts, which need both food and medicines. Recalling that there had been many abuses with respect to humanitarian aid in the past, she asked for "firm and rigid control" in future, including checks by donors.[6] This plea appears to have gone unheeded.

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[1] The United States is reportedly offering a (tied) credit of $600 million for food, a donation of 1.5 million tonnes of wheat and another outright gift of 100,000 tonnes of food. The credit is repayable over 20 years at an interest rate of 2 per cent, and has a five-year grace period.

[2] This would be for a commodity loan, similar to that being agreed with the United States for $600 million. The food available for this would be about 1 million tonnes of EU wheat, 500,000 tonnes of rye, and 50,000 tonnes of rice, all of which are in stocks. There would also be 100,000 tonnes of pork and between 100,000 and 150,000 tonnes of beef. *Moscow Times*, 11 November 1998.

[3] There has been considerable exaggeration of the extent to which Russia today depends on food imports, with initial (excessive) estimates of over 50 per cent, no doubt based on partial data, and predominantly from large cities/oblast capitals. (The figures now quoted by Russian policy makers tend to be in the range of about one third.) Goskomstat has previously presented quarterly data, reporting the weight of selected imported food items in retail trade. The basis, geographical distribution and method of sampling is unclear, but the results are perhaps indicative. Thus, in the fourth quarter of 1997, 22.3 per cent of meat, 56.9 per cent of poultry, 24.5 per cent of sausage, 56.4 per cent of vegetable oil and 40.8 per cent of pasta products on sale in retail outlets were said to be imported (*Sotsial'no-ekonomicheskoe polozhenie Rossii, 1997* (Moscow), 1998, p. 133). It does not need to be stressed that Russian families also produce some of their own food, and this has been on a distinctly rising trend in recent years. (The Minister of Agriculture has suggested that 100 million Russians (that is two thirds) now grow their own vegetables and potatoes.) Some better indications may be found in trade and production data. UN/ECE secretariat estimates of the total value in 1997 of net imports of food and agriculture produce, minus alcohol and tobacco, based on State Customs Committee of the Russian Federation figures, are $9.4 billion. For the first half of 1998 the corresponding figure is $5 billion. Meat, including poultry, is the single most important item in both periods. In tonnes, over half the poultry consumed as early as 1996 was imported. In the first half of 1998, 34 per cent of meat imports were from the United States, 31 per cent from the European Union and 11 per cent from eastern Europe and the Baltics. As table 3.2.8 makes clear, this trade is far more significant overall for the latter countries. Thus, in 1997, 53 per cent of Latvian, 46 per cent of Estonian and 37 per cent of Lithuanian exports to Russia consisted of food, beverages and agricultural products. The total value of these products was less than the $600 million in soft and tied trade credit being offered by the United States, in addition to which the latter will pay for the transportation costs.

[4] This is without an adjustment for the understatement of Russian imports noted by a number of observers. Even with an upward revision for the value of imports of 20 to 30 per cent, as suggested by the Bureau of Economic Analysis (Moscow), or the 40 to 50 per cent consistent with a recent study by Finnish customs (Bank of Finland, Institute for Economies in Transition, *Russian Economy. The Month in Review*, No. 8, 1998, p. 1), the United States and EU aid would still amount to a substantial proportion of annual Russian imports.

[5] There is no particular reason to believe that the current round of proposals for aid will do any more to win "hearts and minds" than the previous exercise. Apart from popular scepticism about corruption, recent survey data indicate that it is precisely those in possible need of assistance who are not in favour of it. The major national opinion polling organization, VTsIOM, in a stratified sample of 1,608 Russians questioned on 23-26 October, found that 45 per cent were in favour of such aid, and 39 per cent were opposed. Those opposed, however, were disproportionately pensioners, those with lower than average incomes, over 40 years old, living in small towns, or unemployed. Those in favour were likely to be found among industrial managers, white collar workers, the young, people with higher than average incomes, living in Moscow or other large cities. *Johnson's Russia List*, No. 2458, 4 November 1998.

[6] *Reuters*, 27 October 1998 quoting *ITAR-TASS World Service*, 27 October 1998.

In general, trade and current account balances have tended to deteriorate in 1998, although the deficits of the Czech Republic and Poland fell more than expected. In relation to GDP, current account deficits are very large in Slovakia, Croatia, The former Yugoslav Republic of Macedonia and Lithuania (10 to just over 12 per cent), over 7 per cent in Estonia and Latvia and for most of the other east European economies they are in the range of 3½-4 per cent. Apart from some of the south-east European economies, most of the transition economies have been able so far to finance these deficits without much difficulty.[5] The impact of the Asian crisis on the flow of capital into eastern Europe seems so far to have been relatively minor: the inflow of some $16.3 billion in the first half of 1998 was actually larger than a year earlier (and larger than in the second half of 1997), and within this total foreign direct investment accounted on average for just under 30 per cent. Foreign capital inflows also held up in the Baltic states, with a slightly higher proportion of FDI. However, most of the direct and indirect impact of the Russian crisis will only begin to affect the current accounts in the second half of 1998 – when the data become available they may very well show a deterioration. Moreover, whether current account deficits will continue to be financed easily in 1999 is open to question. Since the Russian debt crisis in August the costs of international finance rose sharply for all the transition economies and although they have since fallen back from their levels in the immediate aftermath of the crisis, they still remain higher than in 1997. Some transition economies have had their credit ratings downgraded, which will add to the costs of borrowing, while others with severe structural problems and continuing uncertainty over the direction of their reforms will continue to have difficulty in accessing the foreign capital markets at all. Although there will be some exceptions, many transition economies are likely to face increasing difficulties in financing current account deficits at their present levels, which implies a tighter balance of payments constraint on their economic growth. Their vulnerability to renewed turmoil in the world financial markets is also underlined by the fact that the share of short-term capital in the financing of deficits rose sharply in the first half of 1998, from 35 per cent in 1997 to 58 per cent.

Many governments are hoping that inflows of FDI will be maintained and continue to provide an important source of current account financing. Although the inflow was more or less maintained in the first half of 1998, it was mostly concentrated in Poland and a small number of other transition economies: in Russia the inflow was virtually halved. FDI is influenced by factors in its countries of origin – overall profitability, the prospects for growth, etc. – as well as those in the host countries. A major determinant of FDI in the transition economies in the last eight years has been the pace and scale of privatization programmes. These have already fallen behind schedule in many countries of south-east Europe and the CIS where the general environment for investment has generally deteriorated; but where they are going ahead asset valuations have been cut substantially, even for certain prime investments in countries with relatively strong economies. Large investments, such as car plants, and those already in the pipeline are unlikely to be curtailed, but smaller investments and those still on the drawing board are likely to be delayed until the economic outlook becomes less uncertain. On balance, an increase in FDI into the transition economies looks unlikely and instead there may very well be a falling off in the rate of inflow seen in the last two years.

One of the more disturbing aspects of developments in central and eastern Europe is the growing divide between the group of so-called leading reformers – those where institutional and market reforms are well advanced, economic growth is relatively high and sustained, and most of which are in the first wave of applicants for EU membership – and a group, mainly in south-east Europe, where a coherent programme of reforms has proved much more difficult to design and implement, which in turn has made it more difficult to achieve an improved macroeconomic performance. In fact, data on recent developments in this group of countries is often scarce or contradictory, or both. In Bulgaria it is difficult to determine whether or not a recovery is underway from the slump of 1997; in The former Yugoslav Republic of Macedonia the economy remains weak and will be further affected by the tightening of policy in Yugoslavia; the Yugoslav economy is beset by chronic external and fiscal deficits, with reduced prospects of financing, an incoherent mix of macroeconomic policies, and by the reimposition of sanctions in the wake of events in Kosovo, which have also made the government's finances even more precarious than before; in Bosnia and Herzegovina a relatively high growth of output is reported, but as this is essentially a partial recovery from the catastrophic levels to which it had sunk as the result of armed conflict it indicates very little about the prospects for sustained improvement. The statistical picture is at least clearer in Romania and it points to a considerable deterioration in the economy in 1998. Domestic demand remains very depressed, industrial output collapsed in the first half of the year, and GDP is likely to fall by at least 4 per cent in 1998 as a whole. At the same time little progress has been made in reducing the government's budget deficit.

The problems facing the south-eastern economies are complex and to some extent interrelated. The regional economy has been destabilized by the breakup of the former SFR of Yugoslavia and the wars in Croatia and Bosnia and Herzegovina, and uncertainty has been maintained not least by the tension in Kosovo. Regional

[5] Some of the transition economies, however, with very large deficits would eventually find it difficult to sustain them even in the absence of the Asian and Russian shocks.

trading links have been broken and there are now many barriers to their restoration, a factor which adds to the discentives for significant FDI to enter the region. This group of countries already finds it difficult to finance current account deficits and it is likely to become more so for the reasons mentioned above. Many commentators are often tempted to blame the lack of significant progress in these economies on a "lack of political will", but this fails to take into account the very severe structural and institutional problems they are facing. As in Russia, the scale of restructuring required, for example in eliminating non-viable enterprises, is simply so large that the adjustment problems are likely to generate widespread resistance and to paralyse policy making rather than stimulate it. The situation is made all the more difficult by the lack of the appropriate institutional structures required both to support the market economy and to handle the social costs of economic change. All of these economies will require large amounts of investment in order to restructure their economies and lay the basis for sustained growth, and a great part of this will have to come from abroad. But the latter is unlikely to be forthcoming without significant progress in institution building (for market-based activity) and improved security in the region. As is suggested below in the case of Russia, perhaps the only way out of such an impasse is to combine a detailed, coherent and carefully sequenced programme of institutional reform and economic restructuring, stretching over a period of, say, some 5-8 years, with a commitment of large-scale financial and technical assistance from the G-7 countries and, especially, from the European Union. Without substantial support from outside, the national authorities will find it very difficult to create the "breathing space" and the political support required to implement such a programme; but without a carefully designed programme and a broad measure of popular domestic support, foreign assistance is unlikely to be forthcoming. The symbiosis between the two elements implies that a strong political initiative has to come from somewhere; given the fragile economic and social situation in these countries, this will probably have to come from the leading economic powers in western Europe out of an interest in overall regional stability.

The economies of the CIS have been subject, in varying degrees, to two major shocks over the last year or so: the collapse in demand and prices for primary commodity prices following the Asian crisis, and the repercussions of the Russian crisis in August. Among the European members of the CIS, there had been hopes that, despite the relatively fragile state of their economies, there would be some improvement in 1998 – a return to growth in Ukraine and an improvement on the modest recovery in 1997 in the Republic of Moldova. In both cases the combination of internal fragility and the disruption of trade with Russia have disappointed those hopes – in both countries GDP is likely to fall in 1998 as a whole and it is possible that the decline could continue into 1999 as well. In Belarus the official statistics give a deceptive picture of economic recovery, but this is largely the result of an expansion of cheap credit and disregard for increasing internal and external imbalances which, at some point, will require a major correction. All three economies, however, have similar structural and institutional problems to those in Russia and essentially the Russian crisis has simply brought them to the fore rather than being the fundamental cause of the current deterioration.

The central Asian members of the CIS are predominantly primary commodity exporters and, as such, have been seriously affected by the collapse in commodity prices. In all five countries the value of their exports fell in the first half of 1998, and by considerable amounts in Tajikistan and, especially, Turkmenistan. Apart from falling demand for their exports, trade in the first half was also probably being affected by payments difficulties in their trade with Russia. The impact of these external shocks on domestic demand and output is difficult to judge as the limited data available are not always consistent in the picture they present. For the first half of 1998 the official statistics still show rates of growth of between 2 and 5 per cent, but the outcomes for the year as a whole are likely to be significantly lower. Of all the CIS, the three Caucasian economies appear to have suffered least from the Russian crisis. Growth rates in the first half of the year were sustained, particularly in Azerbaijan where the economy is benefiting from extensive investments in the oil and related industries.

Although the future of commodity prices, especially for oil, is an important element of the future outlook for the CIS economies, the most important single factor still concerns the stability and longer-run development of the Russian economy. After a brief interlude in 1997 the long-term decline in Russian output resumed in the second quarter of 1998 and accelerated after the August devaluation of the rouble. The crisis in Russia hangs over the discussion of the transition economies in much of this *Survey* and it is discussed at some length in the next chapter. Although the immediate cause of the crisis in August was the government's chronic fiscal imbalance, the more fundamental causes are to be found deeply rooted in the structure of the economy, in the institutional environment, and in the political process. The argument made in this *Survey* is that in this highly deficient structural and institutional environment, and given the limited set of policy instruments available to the Russian government, a sustainable degree of stabilization was not only impossible but that attempts to achieve it with standard policy prescriptions led to perverse responses on the part of enterprises and banks which made the situation even worse. Since, as noted above, there are also a number of other transition economies which share several of the basic problems existing in Russia it is important to try to draw some policy lessons from the Russian crisis in order to suggest ways of

preventing a similar transformation crisis emerging elsewhere.

The short-term prospects for the transition economies are both very varied and very uncertain. The variation is between economies which are still struggling to implement a coherent programme of reforms and get economic recovery underway – much of south-east Europe, Russia and the European CIS – and those where reforms are well advanced and economic growth is re-established. In the former group their prospects depend heavily on combining a reform programme with increased assistance from abroad; while in the latter they are more dependent on maintaining the growth of their exports to the European Union and being able to finance their current account deficits at levels which do not constrain their growth rates. The current official forecasts for eastern Europe and the Baltic states imply average rates of GDP growth in 1999 of some 4 per cent and 6 per cent, respectively, slightly better in fact than the average rates in 1998. But these forecasts may be too optimistic about west European growth: east European exports (and industrial output) appear to have been slowing down already in the third quarter of 1998 and if this continues their economic growth in 1999 could be significantly weaker than currently expected.

The fragility of the transition process in much of eastern Europe and the European CIS, and the uncertain outlook for growth in the stronger economies, puts considerable weight – and responsibility – on economic development and policies in the European Union as the region's major economic power. The present outlook for western Europe in 1999 – an average increase in GDP of some 2¼ per cent – is already causing concern about the prospects for unemployment, and most of the uncertainty points to downward rather than upward revisions to this forecast.[6] Adjusting policies to aim for higher rates of growth is therefore desirable not only for western Europe but also for stability in the central and eastern parts of the region as well. It is also vitally important for the authorities in the EU to resist pressures for increased protection, especially under the guise of complaints against dumping, and to avoid any other actions that might, inadvertently, damage the exports of the transition economies.

1.2 Policy lessons from the Russian crisis

Over the past decade it has become commonplace to claim that Russian reform was "at a crossroads" or a turning point.[7] Today, it is clear that Russia finds itself in a cul-de-sac.[8] There is very little point, therefore, in telling the country's policy makers to keep going forward "on course", which is the standard advice from abroad. No matter how blame is apportioned for the situation, the reality is that the course that has been followed so far has led precisely to this unpromising point. A fundamental reappraisal is necessary.

The 17 August announcement of the Russian government and central bank, of an effective default and devaluation, was a declaration that a three-year strategy of juggling an unsustainable fiscal position with a tight monetary policy and a stable exchange rate regime had come to an unproductive end.[9] The instrument which had borne the main burden of this strategy, the continued placement of rouble denominated Treasury bills (GKOs) of short maturity, had exhausted its capacity for papering over the cracks. There was no longer any yield on this debt which could persuade investors to roll over existing commitments. Higher, and apparently more attractive returns, by increasing the dramatically rising cost of servicing the debt, could only reinforce the conviction of potential investors, resident and non-resident, that the situation was not sustainable, even in the very short run.

The Russian state's inability to rectify its major fiscal imbalance is thus indisputably at the heart of its crisis. The contentious and unresolved issue, however, is why the fiscal situation has proved so intractable. The most common answer today is that, quite simply, political will was absent.[10] This, however, remains too superficial a diagnosis to be useful for policy. It needs to be asked *why* Russian political will for fiscal discipline and structural reform has been so much weaker than, for example, in Poland and Hungary. The analysis presented in this, and earlier, *Surveys,* proposes a rather different answer: political will is not determined exogenously but

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[6] See chap. 2.2(ii) for a discussion of these risks.

[7] See, for example, the IMF Managing Director's address, "Russia's transformation efforts at a turning point", at a Conference of the United States-Russian Business Council (Washington, D.C.), 29 May 1995 (internet website).

[8] If anything, appreciation of this may be overstated in the west. G. Somerville, "U.S. says time has run out for Russia reform", *Reuters* (Washington, D.C.), 9 November 1998, cites the United States Deputy Secretary of the Treasury noting that "In August the government's time ran out" and that "The new government of Prime Minister Primakov will have to make its way as it deals with the problems which that failure has wrought".

[9] An IMF stabilization programme was signed on 26 March 1995, central bank of Russia independence began in April, and a target was set for the monetary base; the exchange rate corridor regime was introduced in July 1995. A comprehensive account of the entire period, with an emphasis on the policy dilemmas inherent in the multiple targets, and the conflict with the fiscal stance, will be found in B. Granville, "The problem of monetary stabilisation", in B. Granville and P. Oppenheimer (eds.), *Russia in the 1990s* (Oxford University Press, 1998, forthcoming). Chap. 2.3(i)(a) below presents a detailed analysis of the entire sequence of events.

[10] Thus, J. Odling-Smee, in "What went wrong in Russia?", *Central and East European Review*, November 1998, p. 6, writes, "In particular, there was insufficient agreement and will among the leadership of the country – broadly defined – to impose the fiscal discipline needed to pursue successful reforms".

has been weak, largely because the initial conditions were so daunting.[11]

This issue of the *Survey* argues, in chapter 2, that the Russian fiscal dilemma was made progressively more, not less, acute by the policy mix adopted in 1995. All sides saw the initial narrowing of the fiscal gap through debt financing as a measure to buy time for adjustment, but the conventional wisdom is now that this time was simply wasted.[12] Whilst there is much to be criticized in the conduct of Russian debt policy, this summary dismissal from abroad fails to acknowledge the actual dynamics of the particular stabilization recipe, and its increasing (not decreasing) pathological effects. The perverse incentives generated by macroeconomic policy were, moreover, magnified by the deeply flawed privatization process.

Given the profoundly inappropriate character of so much of the Russian institutional infrastructure for the new market environment, and the added operational incapacity of the state itself,[13] disinflation turned out to be a more easily achievable goal, given the operative policy levers actually available to policy makers. The success in reducing inflation, in one key sense, was unfortunate, in that it distracted much policy attention from other key problems. When other, more difficult goals, in areas such as the reform of the social safety net, the development of local government, or the creation of an anti-monopoly policy, proved unattainable, ever lower inflation targets were effectively seen as some sort of trade-off.

This set in train a series of interlocking, policy-induced pernicious circles. The increasingly excessive emphasis on price stabilization necessitated increasing monetary austerity. The commitment to what became, in effect (from July 1995) an exchange rate anchor, involved a further policy commitment to high interest rates. To help complete this particular vicious circle, the higher interest rates raised the cost of debt service, and thus increased the fiscal burden. This process ruled out a return to growth, and fixed investment has continued to fall throughout the entire period. Whilst there is little doubt that there has been concealment of corporate profits, particularly in light of the continued complex and arbitrary tax structures, corporate profits have actually fallen. Enterprises and regions increasingly resort to barter, further extending the demonetization of the economy. All this, of course, has continued to shrink the tax base. In sum, the chosen policy has made even the fiscal problem worse.

The issue of non-payment of taxes by the important energy sector further reveals the unusual character of the Russian fiscal dilemma. The popular perception in the west that arrogant oil and gas barons were simply unwilling to pay the taxes they owed needs some correction. In the complex Russian tangle of non-payment, the government also came to demand effectively that energy be provided free of charge (that is, with no disconnection for nonpayment) to a substantial proportion of users.

This underscores an important aspect of the Russian situation, the weight and potential significance of rents from its abundant natural resources for resolving some of the dilemmas of development. Policy discussion on this has failed to come to terms with any of the basic issues. Instead, as the unfortunate story told below in chapter 5 of the lack of progress towards a viable framework for production sharing agreements (PSAs) makes all too clear, measures which could have provided some first steps forward have foundered as the delaying tactics of various interest groups, some of them openly nationalist, have blocked progress, and increased the perception abroad that Russia is a hostile and unreliable place for fixed investment.

In sum, the path taken in an attempt to restore fiscal balance in Russia since 1995 has proved to be counterproductive and, in the end, has resulted in a disastrous financial and political crisis. The new Russian government does not appear to be in a position to service either its external or internal debt, and has not even been able to make headway in resolving the issue of wage and pension arrears. Overwhelmed by the scale and complexity of the problems it faces, its time horizon is inevitably very short.

In this unpromising atmosphere, what sort of initiatives, from the Russian authorities themselves and also from the G-7 or the European Union, could point to a way forward? It is easy to be paralysed by the sheer scale of the problems, yet positive first steps can lead to others, provided that there is an overall sense of direction. The greatest source of disorientation, however, has come from the belief that economic policies can be advocated in an

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[11] A substantial and expanding body of literature has emerged focusing, *inter alia*, on the question of the role of initial conditions versus subsequent policies in determining transition economy success. Relying, as it does, largely on cross-section or panel econometric evidence, it is subject to all the strengths and weaknesses of such an approach. This question remains in serious dispute, and a number of papers are now forthcoming. Perhaps the most serious difficulty would appear to lie in the proper specification of initial conditions. As two examples, A. Aslund, P. Boone and S. Johnson, "How to stabilize: lessons from post-communist countries", *Brookings Papers on Economic Activity,* No. 1, 1996, pp. 217-213 stress the role of policy, while M. De Melo, C. Denizer, A. Gelb and S. Tenev, "Circumstance and choice: the role of initial conditions and policies in transition economies," World Bank, International Finance Corporation, October 1997, whilst not denying the role of policies, call attention also to the role of initial conditions and the determinants of policy.

[12] Thus the Director of the IMF's Research Department said at a forum in October that "it turned out in the end, really, to be, you know, giving the key of the liquor cabinet to a drunk, and there was no way to discipline the resort to borrowing and keep it within reasonable boundaries". IMF Economic Forum, "Capital account liberalization: what's the best stance?" (Washington, D.C.), 2 October 1998, p. 28 (internet website).

[13] See J. Sachs, "Russia's struggle with stabilization", *Proceedings of the World Bank Annual Conference on Development Economics* (Washington, D.C.), 1995, pp. 57-80, and A. Cheasty, "The realized net present value of the Soviet Union", in V. Tanzi (ed.), *Transition to Market,* IMF (Washington, D.C.), pp. 125-134, which calculates the dissolution value at -6 trillion (1991) roubles.

institutional vacuum. A critical lesson which emerges yet again from consideration of the Russian crisis is that active assistance in the creation of appropriate institutions should never have been relegated to the rank of "second-generation" transition issues.

(i) Institution building

From the very start of the transition, the *Economic Survey of Europe*[14] has emphasized the role of institutions, stressing that a fundamental difference between the tasks of postwar European reconstruction in 1945 and the transformation of the former centrally planned economies lay in the fact that in the devastated countries of western Europe there was, nonetheless, no need to construct market economies *de novo*, create and demarcate property rights, nor even to undertake to establish the idea of a civil society and the rule of law, although in some cases these had been absent for a decade or so.

The implementation of any set of economic policies must perforce be done through institutions, the state and its public administration. Arguably the most serious consequence of the "policy overshooting" on transformation issues was the exceptionally widespread and deliberate downgrading of the role of the state. Even for something so mundane as the establishment of an effective fiscal administration, with a reasonable degree of grudging respect from the population, there will be little progress without the creation of a professional civil service, a functioning public administration, and the development of broader societal attitudes regarding the legitimacy of the state and of its right to levy taxes. It is evident that the gap which must be bridged in this respect is substantially greater for the countries of the CIS than for most of the states of central and eastern Europe.

Among the most damaging of the mistaken conclusions that were drawn early on in the transition process, both by western advisers and by policy makers in Moscow, was that the Russian state remained too strong.[15] The need to scale back inefficient spending, and to create room for private sector consumption, is a necessary task for which a strong public administration is required; but this is a quite different task from *restructuring* the state so that it is strong enough and capable to perform the functions required to support a market economy. It is often argued that the widespread corruption and criminalization of Russian economic life derives from a state with too much power. This is almost certainly wrong. The development of increasing corruption in the new Russia, and the history of other corrupt structures, whether the original Mafia[16] or India's Income Tax Department,[17] demonstrates that the most damaging of corrupt and criminal structures arise to fill a void, an institutional hiatus in which the state is weak, beginning with the functions of contract enforcement and dispute arbitration, but swiftly taking on much more predatory and disruptive forms.

This is not to deny that excessive state regulation and bureaucracy will create room for bribe-taking and obstruction of all kinds, inimical to the development of an enterprise culture and stifling to small business. The particular inheritance of the Soviet bureaucracy, which made rules as it pleased, magnifies this problem. However, this sort of anti-Weberian bureaucratic structure presents a relatively minor danger, in contrast to the way in which special interest groups have effectively succeeded in privatizing many of the functions of the weak Russian state.[18]

There are many who think that combatting Russian corruption and improving Russian public administration is a hopeless task and it does appear that these are major stumbling blocks to progress. Yet, even in conditions of state weakness and a public sense of a pervasive and hopeless corruption which undermines the legitimacy of fiscal efforts, the development of an entrepreneurial culture, and the democratic process itself, there are still many examples – from 19th century Britain to Sri Lanka in the 1970s, Hong Kong's Independent Commission Against Corruption in the late 1970s, and the working of Singapore's Customs and Excise Department – which demonstrate that a successful struggle against corruption can be conducted even when it seems that the local culture is accommodating to it and the national leadership itself may be corrupt.[19]

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[14] Notably in UN/ECE, *Economic Survey of Europe in 1989-1990,* pp. 5-27. At the time, of course, the assertion (p. 21) that "the transformation of centrally planned economies into decentralized market economies is a much more difficult task than the reconversion of the west-European economies" and the warning that the forthcoming stabilization programmes "will impose heavy burdens on the population in the immediate future" (p. 5), was regarded as heterodox.

[15] Thus, see J. Odling-Smee, op. cit.

[16] F. Varese, "Is Sicily the future of Russia? Private protection and the rise of the Russian Mafia", *Archives Européenes de Sociologie*, No. 2, 1994.

[17] O. Goswami, A. Sanyal and I. Gang, "Taxes, corruption and bribes: a model of Indian public finance", in M. Roemer and C. Jones (eds.), *Markets in Developing Countries: Parallel, Fragmented and Black* (San Francisco, ICS Press, 1991), pp. 201-213.

[18] It should be noted that there are more pessimistic accounts of the relationship between a deficiency of social capital and the nature of certain states which bear consideration: R. Putnam's *Making Democracy Work: Civic Traditions in Modern Italy* (Princeton, Princeton University Press, 1993), and P. Hanson, "What sort of capitalism is developing in Russia?", *Communist Economies and Economic Transformation*, Vol. 10, No. 2, 1998, pp. 27-42 are two examples.

[19] R. Klitgaard, *Controlling Corruption* (Berkeley, University of California Press, 1998). To these cases might be added the recent successes of the mayor of New York, many of whose pragmatic measures seem applicable to Russian conditions. Additional discussion on the importance of public administration is to be found in J. Eatwell, M. Ellman, M. Karlsson, D. Nuti and J. Shapiro, *Transformation and Integration* (London, IPPR, 1995), pp. 15-39. For a more critical view see P. Stavrakis, "State-building in post-Soviet Russia. The Chicago boys and the decline of administrative capacity", *Kennan Institute Occasional Paper* (Washington, D.C.), 1993.

The state performs a myriad of other functions which were forgotten in the rush to the market.[20] The welfare effects of what became known as "state desertion", the abdication of the state from carrying out many of its responsibilities, have been more evident, but the coordinating and enabling role of a well-functioning state is much more visible in its absence. The "anomic reaction" in which it becomes the social norm to seek ways round laws, to connive against authority, to trust no politician, varies in intensity across the region. In Russia its deep roots and present justification have made it a major issue to be tackled, if economic reform is to go forward.

The state, its courts, and its legal systems must also develop appropriate structures but their development can be hampered not just by questions of legitimacy but also by a sheer lack of resources. Such is the situation of much of the Russian judiciary today. Again, the demonstration effect may be very powerful. Some contracts, successfully enforced, send out one set of signals. Others, in which court rulings are ignored and prove helpless to change the situation, create an entirely different perception of whether or not a society is moving towards the rule of law. There has been far more development of Russian legal structures than is often realized, but the negative cases, understandably, have dominated the thinking of economic actors.

(ii) Political will in democracies

In the western disappointment at the present policy impasse in Russia, there is often a surprising irritation expressed at the failure of the executive branch to handle the rather unruly Duma and often recalcitrant regions.[21] The obstructionism of the Duma is not in doubt and, as the recent rejection of 10 highly promising production sharing agreements shows, this divided and unpredictable body can be a serious barrier to the creation of a more stable and predictable economic climate. But it needs to be acknowledged that the composition of the Duma was determined by a free and fair vote in December 1995; the lack of sensitivity of the political elites for the expressed concerns of the population who have had to bear the social costs of the transition has been inevitably reflected in such elections.

The reality which must be faced, however, is that a consensus for far-reaching market reform has never been created in Russia in the way that it has in a number of other countries.[22] The Baltic states also faced enormous structural distortions in their economies, on a similar scale to those in the European CIS and Romania. Their superior results to date do not simply derive from the advantages of an institutional memory from the interwar period. There was an exceptional consensus for reform, and a desire to reorient to the west, based on national political as well as economic considerations. The three states were politically able and willing to tolerate an immense fall in industrial output and GDP at the start of independence, greater than that of all but the transition economies which suffered a war. Their ability from that point to achieve fiscal balance, and an attractive climate for investment, was certainly conditioned by these factors. "Political will" cannot be demanded of governments or elites alone. In democratic conditions the willingness to sacrifice, even during the period that Balcerowicz has christened "extraordinary politics", is conditioned by far more than the desires, and even the persuasiveness and authority of the political elite. There is, though, much learning which remains to be done, especially in Russia, on how to achieve a democratic consensus and rally popular support for a programme of reform.

The limits to the power of even a very deeply committed central government are presently being tested in Ukraine, where there is an essentially oppositionist parliament (Rada), which has frequently defeated legislation which is an important component of the programme agreed with the IMF.[23] The programme spelled out there, under the IMF's three-year $2.2 billion Extended Fund Facility, which appears to incorporate a wider range of issues than earlier programmes, will also be a testing ground of whether the bulk of the very broad range of institutional reforms enumerated, 88 in all, can be carried through in such a time period.

(iii) Second-best solutions

After the default and devaluation in August, Russian policy makers must work in a second-best world. Policy prescriptions on what *not* to do have been freely given by foreign advisers, almost all of them deriving from a first-best world. It is an appropriate time to consider once more the road to recovery adopted after the Second World War in western Europe, which led to a remarkable two decades of rising prosperity. The ruling orthodoxy of today is mistaken in its swift dismissal of the possibilities for temporary, explicitly time-limited and well thought out controls which might form part of a comprehensive programme to gain some breathing space, some time for governments to implement appropriate

[20] UNDP, *The Shrinking State: Governance and Human Development in Eastern Europe and the Commonwealth of Independent States* (New York), July 1997.

[21] Thus J. Odling-Smee, op. cit., complains that "Even when government decisions were taken and supporting legislation passed, difficult measures were still often not being implemented by regional governments. Municipalities often wanted little more than to keep their local businesses afloat". Against this apparent obtuseness, see R. Kozul-Wright and P. Rayment, "The institutional hiatus in economies in transition and its policy consequences", *Cambridge Journal of Economics*, Vol. 21, 1997, pp. 641-661, particularly 650-653.

[22] On the necessity for this see UN/ECE, "Popular support for the transition process", *Economic Survey of Europe in 1992-1993,* pp. 10-15.

[23] Government of Ukraine, "Memorandum of economic policies for July 1, 1998-June 30, 2001", 11 August 1998 (internet website).

policies.[24] Such a programme would have to give high priority to the key institutional foundations of the market economy such as an effective judicial and law enforcement system, the creation of a healthy commercial banking system, and a coherent policy for changing the structure of incentives so as to encourage entrepreneurship and fixed investment rather than rent-seeking and asset stripping. The precise content of such a programme should be determined by the Russians themselves who are best acquainted with the problems that have to be solved but it must satisfy at least three key requirements: one, the length of the programme must reflect a realistic appreciation of the time required to solve key problems; two, it must set out the problems to be solved and the solutions proposed in a coherent way such that it can provide a convincing case for official support from the G-7 and the international financial institutions; and, three, it must also specify the conditions for lifting temporary controls and restrictions in order to confirm the commitment of the authorities to their temporary character and to increase transparency in making long-term strategic decisions.

A well-articulated and coherent programme is required not only to convince western governments that assistance will be effective but also to help restore popular credibility among the Russian population in the possibility of success. Ad hoc programmes which fail to tackle fundamental institutional problems and which put a premium on speed rather than effectiveness are simply a recipe for another round of failures and false starts. Unmoved by ideological purity, but with a constant pragmatic monitoring, the postwar reconstruction of western Europe proceeded far more smoothly than could have been hoped for in 1947. Russia today needs far more of this well-informed, professional pragmatism in the design of policy.

The situation in Russia may appear to consist of an impossible tangle of vicious circles. The tasks of transformation in Russia are, indeed, enormous and must not be underestimated. Anatoly Chubais, *inter alia,* former Minister of Privatization, asked in September what he thought had been his greatest mistake, replied: “We must recognise that we did not fully understand the scale of the process which we had undertaken. We thought there would be a very difficult three years, five years, eight years. Now, unfortunately, it is clear that reform will take decades. ... It is now clear that Russia does not need billions or tens of billions, but hundreds of billions of dollars”.[25]

This *Survey*, for nearly a decade, has made a similar assessment of the scale of the Russian transformation effort, of the institutional changes required, and, critically, of the necessary scale of investment. A more ambitious, longer-term, transformation programme, drawn up in the country itself, and embarked upon in 1992, would, in the end, have cost an order of magnitude less than the effort now required to solve the problems confronting the country. Failure invariably raises the price of subsequent efforts. The situation is now more perilous, the popular willingness to endure the cost of reform is greatly reduced, and cynicism is rampant. Russia highlights the risks and threats that were always inherent in the transformation process in their sharpest possible form. But, despite all these major difficulties, the development of a coherent strategy, along the lines suggested above, probably offers the best chance of moving forward.

(iv) Broader implications

The Russian crisis has attracted considerable public attention throughout the world not only because of its grave economic implications but also because of the political weight of the Russian Federation. Given the size of the Russian economy and its influence on the economic and political stability of neighbouring countries, the course of the reform process in this country has been both a lasting preoccupation for western policy makers and a focal point for numerous strategic business decisions. For a wide range of international public opinion, the progress achieved in establishing a democratic society and a fully-fledged market economy in Russia is a measure of the success of the entire transformation process in the former communist block. The fact that the August crisis occurred while Russia was implementing a reform programme supported by the international financial institutions casts a shadow over the transition process in general; moreover, it also raises doubts about the fundamental conception of the transformation paradigm, particularly as applied in Russia.

At the same time it is worth noting that in strictly economic terms the Russian crisis is by no means a unique event. In many aspects, the Russian crisis of 1998 is a repetition of the Bulgarian crisis in 1996, which combined a fiscal crisis with a currency crash and a collapse of the banking system.[26] The more recent cases of economic distress in other transition economies (for example Romania and some of the CIS countries, especially Ukraine and the Republic of Moldova) have much in common with these crises and, indeed, contain the potential for further escalation and aggravation. The 1997 exchange rate crisis in the Czech Republic – although not so acute and devastating – was also symptomatic of important, transformation-specific economic weaknesses and was followed by a painful

[24] M. Panić, “Managing reforms in the east European countries: lessons from the post-war experience of western Europe”, UN/ECE, *Discussion Papers*, Vol. 1, No. 3 (United Nations publication, Sales No. GV.E.92-0-1).

[25] *Reuters*, 23 September 1998.

[26] UN/ECE, *Economic Survey of Europe in 1996-1997*, pp. 75-84.

economic downturn.[27] Although similar sources of stress are present in most of the transition economies, their relative importance varies, of course, as does the capacity of existing institutions to handle crises when they appear. The Czech crisis was dealt with fairly rapidly but it is nevertheless a warning of the risks of incipient fragility even among the more advanced transition economies.

In what concerns the primary causes of these transformation crises, a common feature is that their roots are deep-seated in the microeconomics of transition. While the visible outcome of the crises has usually taken the form of major macroeconomic-*cum*-financial disturbances, the latter have been not so much the consequences of erroneous macroeconomic policy per se as the result of failure to make sufficient progress in important microeconomic reforms. The principal microeconomic factors that have led to macroeconomic distress during the transition are often related to the nascent status of the market infrastructure and/or the inherited structural weaknesses of these economies: market distortions and the malfunctioning of markets; perverse incentives and the perverse behaviour of economic agents; weak or poorly functioning regulatory, judicial and other state institutions; weakness and poor regulation of the banking system; and inherent inefficiencies in the corporate sector of the economy. The lesson here is that without microeconomic reforms macroeconomic stabilization is likely to be short-lived and may even produce perverse effects; but without a reasonable degree of macroeconomic stability, the micro-reforms may not be undertaken.

Russia's experience has once again highlighted the daunting policy task of restructuring and rehabilitating the corporate sector in many transition countries. The lack of satisfactory progress in structural reforms in some transition economies, especially in dealing with unviable enterprises, has often been due not so much to a lack of understanding of the problems and an absence of political will to address them, but to the very severe political and resource constraints stemming from the sheer magnitude of the required restructuring effort. The existence of a large, critical mass of unviable firms is a major stumbling block to the successful implementation of the whole transformation policy agenda.

If Russia's painful experience was somewhat different from the crisis episodes that occurred in other transition economies the reason probably lies in the fact that it revealed the crucial importance of the interactions between transformation policy, institutions and the incentives working for economic stability. It showed that, in the absence of an adequate institutional framework, even an otherwise apparently coherent macroeconomic policy mix (insofar as the continued support of the international financial institutions was an indication of such coherence) may generate perverse incentives which, in turn, may not only erode the efficiency of the policy process but may in fact – due to their distortive impact – be counterproductive for economic stability and growth in the longer run. One of the important lessons of the Russian crisis is that deep microeconomic restructuring and fundamental institutional reforms are not only essential for the formation of a new market environment in the transition economies; they are also crucial for macroeconomic stability as well.

Another policy lesson is that focusing solely on the observable progress in macroeconomic stabilization may be deceptive – in the sense of sending wrong signals to the markets – and, as such, may be short-lived if not supported by adequate progress in microeconomic reforms. Actually, in broader terms, this negative outcome has policy implications as regards one of the concepts embodied in the mainstream transformation paradigm, namely, that of the primacy of macroeconomic stabilization over microeconomic and, in particular, institutional reforms. While reform programmes based on this philosophy have been successful in some transition economies, the failures in other countries which have apparently adhered to the same paradigm suggest that the latter may not be universally appropriate. Indeed, as follows from the analysis in chapter 2.3(i)(a), given the nature and depth of the structural weaknesses of the Russian economy, a different policy mix, based on a more gradual disinflation but a more vigorous programme of institutional reform, would have probably been more effective with respect to macroeconomic stabilization in the long run. This experience also suggests the need to reconsider (in some cases and on an individual basis) the balance of transformation policy priorities as well as the sequencing of the reform process so that these are better suited to the specificity of individual countries.

The main features of the Russian crisis are symptomatic of the dangers of major disruptions in the transformation process which are still present – in one way or another and to a different degree – in most of the economies in transition. The risks of encountering economic disturbance and incurring transition-specific damage are further amplified in a situation of high volatility of international capital flows and strong contagion between different economies. The noticeable fallout from the Russian crisis and the effects of global turmoil on other transition economies indicate that even the more advanced reform countries are not completely immune to setbacks. The more advanced reformers, in turn, are and will be facing further challenges in trying to sustain and strengthen the momentum of their recovery; if they are successful in doing so it will make it easier to implement the major programme of policy reform required for their accession to the EU. Considerable caution will thus continue to be needed in setting the

[27] UN/ECE, *Economic Survey of Europe, 1998 No. 1*, pp. 75-82.

future transformation policy agenda in all of the countries with transition economies.

One of the recurring points of this chapter is the key importance of the European Union in influencing not only the short- to medium-run economic outlook in most of the ECE region but also its strategic direction, particularly in that part of the continent where countries are still engaged in the transition to market economies, a process which in many of them is putting considerable strain on their new democratic institutions. The need to achieve rates of economic growth that will lower significantly the prevailing high rates of unemployment in western Europe is obviously important for the members of the Union itself; but it is also crucial for maintaining high rates of growth in those central and east European countries where economic recovery is underway and which are now heavily dependent on the Union as a trading partner. A premature slowdown of the cyclical recovery in western Europe will encourage a resurgence of protectionist pressures and complicate the process of EU enlargement, not least by increasing the resistance of some of the existing members to the adjustments required by the admission of new members.

At the same time most central and east European countries, not only those in the first wave of applications, want to be members of the Union and this objective is shaping their political and economic strategies over the medium to long term, depending on how close to EU membership they are judged to be. The EU itself can exert a major influence on the expectational environment in all the transition economies, not only those in the first wave of applications, by leaving no doubt as to either side's commitment to the ultimate objective of membership, but at the same time encouraging the adaptation of comprehensive and consistent strategies designed to enable the transition economies to meet the requirements of the *acquis* in the shortest feasible time.[28]

There are also other transition economies, especially in the CIS, which have either not expressed any intention to apply for EU membership or have no intention of doing so. But to a large extent the requirements for entry into the EU are the same as those for creating a well-functioning market economy. Whether or not a country wishes to join the EU, if it wants a market economy it must build the necessary institutional infrastructure for market-based activity, and that includes restructuring the state. Reforming public administration and strengthening the state are essential requirements for the EU applicants if they are to be able to carry out the requirements of the *acquis communautaire*; but they are equally essential for any country that wishes to introduce an efficient market economy. For those applying to join the EU, the requirements to be met for membership effectively constitute a programme of reform and, more or less, a timetable for completion; those countries for which membership is a longer term aim or not envisaged at all will have to draw up their own programmes and timetables, although the contents of both programmes will overlap to a large extent.

Much is being done in providing assistance to the transition economies, especially to the EU candidates, but much is also lacking, especially in those other countries where the reform process is lagging behind. The EU is focusing much help on the former, but, as the major economic power in the region, it could be a much more active partner of policy makers in the latter group in supporting their efforts to bring about the economic and social transformation of their countries. The EU has the resources to provide considerable help in actually designing more effective strategies to bring about the degree of institution building and microeconomic reform which will eventually lay the basis for more effective stabilization policies and for a sustained recovery of economic growth. Achieving those objectives will not only ease the transition of those who want to join the European Union but will also make a major contribution to increased security throughout the entire European region.

[28] On the need for a more strategic approach towards EU enlargement see UN/ECE, "Enlarging the European Union to the transition economies", *Economic Bulletin for Europe*, Vol. 48 (1996), pp. 7-18.