Reform and Transition in Central and Eastern Europe

- East Germany and future members of the EU: Poland, Czech Republic, Slovakia, Hungary, Slovenia, Lithuania, Latvia, and Estonia.
- Former Socialist Countries not likely to enter the EU soon: Bulgaria, Romania, Albania, other republics of the former Yugoslavia (e.g., Croatia and Serbia/Montenegro) and other European republics of the former Soviet Union (e.g., Belarus and Ukraine).

New Entrants to the EU

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<td>Estonia</td>
<td>2.5</td>
<td>$9270</td>
<td>$7,610</td>
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<td>9.6%</td>
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Not Likely to Enter Anytime Soon

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<td>Russia</td>
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<tr>
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<td>Serbia/ Montenegro</td>
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<td>-</td>
<td>4.0%</td>
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Historical Background

• Before 1919, most CEE countries were not independent sovereign states. Treaty of Versailles wrote the borders.
• In 1944-45, Soviet Red Army occupied all of CEE except Yugoslavia and Albania. Churchill's "iron curtain" came down, and Soviets established new policies.
• Joint Allied Occupation in Germany and Austria: East German Soviet Zone became DDR, Berlin Blockade and Airlift, building of Berlin Wall.
• U.S. Policy of Containment, Cold War, Marshall Plan, and NATO.
• Soviet established Warsaw Pact and CMEA (Comecon).

Pre-1989 Hungary

• Matyas Rakosi's "salami tactics," fraudulent elections in 1947, Stalinist First FYP.
• Imre Nagy's New Course, 1953-1955, ended forced collectivization and focused more on consumer goods.
• New Economic Mechanism, 1968-73: indicative planning, limited market, profit motive, foreign trade, no decentralization, labor management, or political reform. Not very successful.
• Reform of Reform, 1979-88: Dismantling of monopolies, bankruptcy, some new firm types.

Pre-1989 Czechoslovakia

• Successful and growing industrial democracy from 1919-1938.
• Free elections in 1946, but communists siezed government in 1948.
• 1963 Reforms were resisted by Nomenklatura.
• Under Gustav Husak, Czechoslovakia became one of the most conservative CEE economies.
• Charter 77 on Human Rights, playright Vaclav Havel would spend years in prison.
Pre-1988 Poland

- Old Empire until 1600s, weak government due to Sejm veto power. Dissolved into Russian, Prussian, and Austrian empires. Reemerged from 1919-1939. New borders after 1945.
- Worker Uprising in 1956 – collectivization abandoned, planning decentralized.
- Worker Uprising in 1970 – Gereks increased wages, imports, borrowing from West.
- 1970s debt crisis led to austerity policies.
- Soviet Military Exercises in 1981 led Jaruzelski to declare martial law and outlaw Solidarity.
- New austerity policies, popular resistance, and economic stagnation. Inflation was 25% in 1987, high for a socialist economy.

Events of 1988-1990

- Gorbachev signaled end of Brezhnev Doctrine, encouraged CEE countries to try reforms – both economic and political – to resurrect their slowing economies.
- June 1989, China’s Tiananmen demonstrations, crackdown.
- East German emigration through Czechoslovakia. Rumors led to a massive crowd that tore down the Berlin Wall, government falls.

Poland

- Balcerowicz Plan under new Solidarity-run government beginning in 1990 – market liberalization and shock therapy most rapid in CEE economies.
- Privatization: public sales, then “mass privatization.” Rapid growth of new firms, rising FDI.
- Collapse of Soviet trade slowly replaced by growth in trade with Germany & EU.
- Macroeconomic stabilization helped: Inflation was 553% in 1990, 3% in 1994, 16% in 1997.
- First CEE economy to recover: growth began in 1992, highest in Europe by late 1990s.
- Political stalemate after 1991, return of renamed communists in 1995 elections led to no retreat on reform.
### Hungary

- **1988 Economic Stabilization and Structural Reform Program**: a radical, but gradual move towards the market. Western laws, economic integration, tax and banking reforms, ending of state firm subsidies, privatization, political reform, et cetera.

- **1990 Elections gave power to Hungarian Democratic Forum under Antall**: gradual economic reforms continued. Deficits (10%), slow privatization, GDP fell by 18%, rising unemployment (12%), foreign debt (250%).

- **1994 Elections to Socialists under Horn**: aggressive privatization (80% by 1998), export promotion, austerity, crawling exchange rate peg, falling inflation, rising FDI (1/3 of total, 1/3 from U.S.), rising trade and faster growth (4.4% in 1998, rising to 6%).

### Czech Republic

- **Husak resigned, free elections, Vaclav Havel new President and Civic Forum in power. Vaclav Klaus new finance minister.**

- **Jan. 1, 1991** – central planning abandoned, most subsidies ended, koruna becomes convertible, liberalization of most prices, foreign trade and tourism.

- **Government surpluses helped cut inflation from 45% to 0% by end of 1991. Inflation relatively low through 1990s.**

- **Privatization through small firm auctions and Kuponova Metoda, FDI and new firm growth, while remaining large SOEs and state banks slid towards bankruptcy.**

- **Political stalemate by mid-1990s.**

### Czech Quotes

- “Transition is not a game of chess.”  
  – Vaclav Klaus

- “Everything is infinitely more difficult than I had anticipated.”  
  – Vaclav Havel
East Germany

• Most advanced of CEE Soviet-bloc economies. Yet when the wall came down in 1989, West Germans discovered a weak economy with inefficient factories, unproductive workers, and terrible environmental damage. Trabants on the Autobahn.
• 1990 – Reunification: monetary, economic, social union, followed by a political union.
  – Extension of West German legal system, labor and other regulations, social insurance, codetermination, et cetera.

Currency Conversion

• 1:1 parity conversion for prices, wages, small savings, pensions; 2:1 conversion for other savings
• 4:1 the official rate, 12:1 the black market rate.
• Political decision with terrible consequences.
• East German goods and labor overpriced given relatively low labor productivity and quality.
• Normally, free trade with Europe would be an advantage for such an economy, since exchange rate would fall and make exports cheaper.

Market Restructuring

• Treuhandanstalt (THA) – privatization agency:
  – East German industry organized into 221 Kombinate, large inefficient monopolies that made privatization difficult.
  – No new investment before privatization, reliance on market restructuring.
  – Difficulty of determining property ownership.
  – Environmental damage made many factories too risky to purchase under German environmental rules.
  – In defiance of expectations, THA eventually completed its mission and shut down.
What happened?

- Fiscal cost of reunification led to deficits, offset by Bundesbank policy. High interest rates led to savings inflows from the rest of Europe, and caused European financial crisis in 1992, and European recession.
- Contrary to expectations, the eastern Länder did not catch up. Unemployment much higher than in west, productivity much lower, growth rate slower so gap is widening. The cost of reunification also helped to slow growth in the west.
- Ossie vs. Wessie social conflict, Neo-nazi problems, blaming Gästarbeiter for unemployment.

Lessons

- Big Bang vs. gradualism.
- Privatization of SOEs vs. new growth.
- Macroeconomic Stabilization is key; it depends on getting government budget under control.
- Creation of an honest government and a safe investment climate (Olson).
- Importance of trade relations, foreign investment.
- Social Safety Net and long transition period.
- Democratic political shifts may not alter economic reality, and policy is not ideological.
- Lots of things can go wrong.