The Economics of Transition

Prof. Dr. Reinhilde Veugelers

Economic Advisor BEPA-EC & K.U.Leuven & CEPR

The Transition from socialism to capitalism in former centrally-planned economies is one of the most important economic events of the 20th Century

Before Transition…

- **Markets do no exist** (no price system & no competition)
- **Central administration planned production and exchange** (defines where, what to whom and from whom)
- **Distorted Production structure** (heavy industries, big firms)
- **No profit maximization attitude**
- **Sellers' market:** no attention to the demand side
- **Central control over wages**

The problem of transition ex ante

Murphy's Law of Economic Policy:

Economists have the least infuence on policy when they know the most and the most influence when they know the least

- **Traditional approach of economic development theory assumes markets existed, no transition literature, no road map on what to do first, how and at what speed**

Stylized facts of transition in Europe

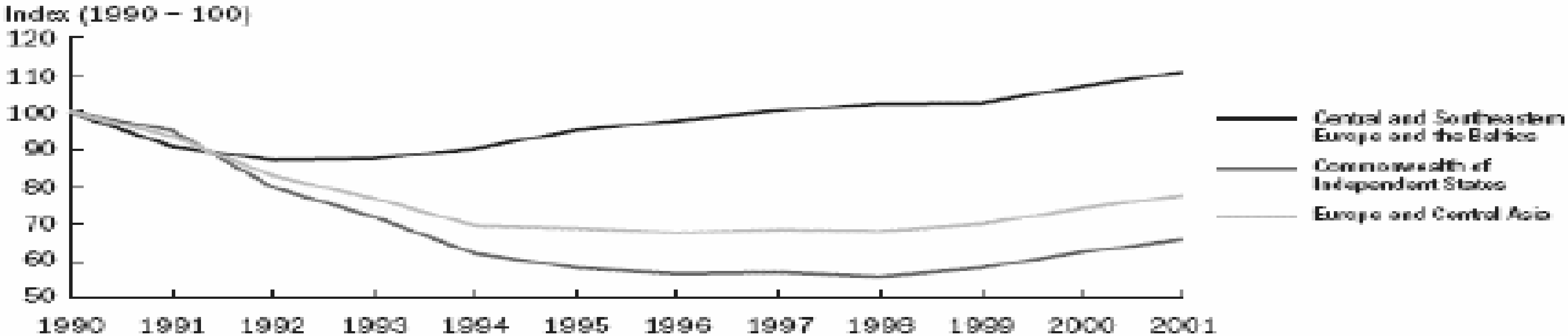
- **What we did in the early 90s:**
  - Washington Consensus: Liberalize, Stabilize, Privatize
- **What we got: The « magnificent 8 »**
  - Massive output fall
  - High & persistent inflation
  - Capital shrinkage
  - Labour movement(out of the labour force)
  - Trade & FDI reorientation
  - Change in economic structure
  - Institutions collapse
  - Transition (social) costs

1. Output fall

- The fall in output was larger and more sustained than initially anticipated
- Deeper and longer fall in output in Central and South Eastern countries and the CIS than in the Baltics
- No smooth recovery: after the initial recovery, Czech, Bul, Rom had at least 2 years of output decline in the mid 90s
- Russian crisis of 1998 caused recessions in Croatia, Estonia, Lith

FIGURE 1.1.

Changes in Real Output, 1990–2001

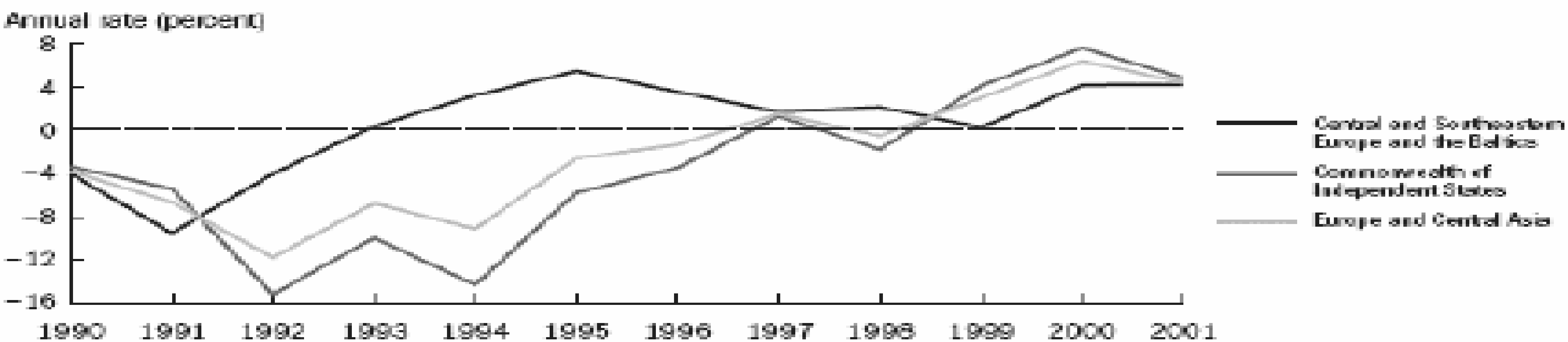


Note: Europe and Central Asia is the average of the CSB and the CIS. All aggregates are population-weighted. Values for 2001 are projected.

Source: World Bank country office data.

FIGURE 1.2.

Output Growth Rates, 1990–2001



Note: Europe and Central Asia is the average of the CSB and the CIS. All aggregates are population-weighted. Values for 2001 are projected.

Source: World Bank country office data.

Economic growth in selected CEEC

Country	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Bulgaria	2.1%	-11%	-6.9%	3.5%	2.4%	4.0%	4.1%	4.3%	4.4%	5.6%
Estonia	4.3%	3.9%	10.6%	4.7%	-1.1%	7.7%	5.0%	5.6%	7.2%	5.1%
Hungary	1.5%	1.3%	4.6%	4.9%	4.5%	6.0%	3.7%	3.3%	3.5%	3.0%
Latvia	-8.0%	3.3%	8.6%	3.9%	0.1%	6.8%	7.7%	5.3%	6.4%	7.5%
Lithuania	3.3%	4.7%	7.3%	5.1%	-4.2%	3.8%	5.9%	5.9%	6.8%	9.7%
Poland	7.0%	6.1%	6.9%	4.8%	4.1%	5.0%	1.0%	1.3%	1.4%	3.8%
Romania	7.1%	3.9%	-6.1%	-5.4%	-3.2%	1.5%	5.3%	4.5%	4.8%	8.0%
Slovakia	6.5%	5.8%	5.6%	3.9%	1.3%	2.2%	3.3%	4.2%	4.6%	4.5%
Slovenia	4.2%	3.5%	4.5%	3.8%	5.2%	4.6%	2.9%	3.0%	3.3%	2.5%
Czech R.	5.9%	4.8%	-1.0%	-2.2%	-2.0%	2.0%	3.3%	2.6%	1.5%	3.7%

Source: Licos

The length of transition recession

Countries	*Consecutive years of output decline*	*Cumulative output decline (%)*	*Real GDP, 2000 (1990 = 100)*
CIS	***6.5***	***50.5***	***62.7***
Armenia	4	63	67
Azerbaijan	6	60	55
Belarus	6	35	88
Georgia	5	78	29
Kazakhstan	6	41	90
Kyrgyz Rep.	6	50	66
Moldova	7	63	35
Russia	7	40	64
Tajikistan	7	50	48
Turkmenistan	8	48	76
Ukraine	10	59	43
Uzbekistan	6	18	95

Countries	*Consecutive years of output decline*	*Cumulative output decline (%)*	*Real GDP, 2000 (1990 = 100)*
CEECs	***3.8***	***22.6***	***106.5***
Albania	3	33	110
Bulgaria	4	16	81
Croatia	4	36	87
Czech Rep.	3	12	99
Estonia	5	35	85
Hungary	4	15	109
Latvia	6	51	61
Lithuania	5	44	67
Poland	2	6	112
Romania	3	21	144
Slovak Rep.	4	23	82
Slovenia	3	14	105
Output decline during the Great Depression, 1930-34			
France	3	11	n.a.
Germany	3	16	n.a
UK	2	6	n.a.
USA	4	27	n.a

Source: Licos

2. High & persistent inflation

- **CFB:**
  - High initial inflation in POL, SLO, but fast stabilization
  - Later price stabilization in Baltics
  - Gradual approach in Hungary
  - Failed stabilisation in ROM, BUL
- **CIS: Initial hyperinflation and persistent inflation in all CIS countries**

Consumer price inflation in %

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Bul	23.8	419	91.3	72.8	96	62.1	121.6	1 058.4	18.7	2.6	10.3	7.4	5.8	2.3	6.1
Cze	9.9	56.7	11.1	20.8	10	9.1	8.8	8.5	10.7	2.1	3.9	4.7	1.8	0.2	2.8
Est	18	202	1 076.0	89.8	47.7	29	23.1	11.2	8.2	3.3	3.9	5.8	3.5	1.1	3.1
Hun	28.9	35	23	22.5	18.8	28.2	23.6	18.3	14.3	10	9.9	9.2	5.4	4.9	6.8
Lat	10.9	172.2	951.2	109.2	35.9	25	17.6	8.4	4.7	2.4	2.8	2.4	1.9	3	6.3
Lit	9.1	216.4	1 020.8	410.2	72.2	39.6	24.6	8.9	5.1	0.8	1	1.5	0.4	-1.2	1.1
Pol	585.8	70.3	43	35.3	32.2	27.8	19.9	14.9	11.8	7.3	10.2	5.5	1.9	0.7	3.5
Rom	5.1	170.2	210.4	256.1	136.7	32.3	38.8	154.8	59.1	45.8	45.7	34.5	22.5	15.4	11.9
Slova	10.4	61.2	10	23.2	13.4	10	5.8	6.1	6.7	10.6	12	7	3.3	8.5	7.5
Slove	551.6	115	207.3	32.9	21	13.5	9.9	8.4	7.9	6.1	9	8.6	7.6	5.7	3.7

Consumer price inflation in %

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Arm	6.9	174.1	728.7	3 731.8	4 962.3	176	18.8	13.8	8.7	0.6	-0.8	3.2	1	4.7
Aze	6.1	106.6	912.3	1 129.1	1 663.5	411.8	19.9	3.7	-0.8	-8.5	1.8	1.5	2.8	2.1
Bela	4.7	94.1	970.8	1 190.2	2 221.0	709.3	52.7	63.8	73	293.7	168.9	61.4	42.8	28.5
Geo	4.2	78.7	1 176.9	4 084.9	22 470.0	162.7	39.4	7.1	3.6	19.2	4.2	4.6	5.7	4.9
Kaz	5.6	114.5	1 514.8	1 658.4	1 877.4	176.2	39.3	17.7	7.1	8.3	13.4	8.5	6	6.6
Kyr	5.5	113.9	854.6	1 086.2	180.7	43.5	32	23.4	10.5	35.9	18.7	6.9	2.1	3.1
Mol	5.7	101.1	1 108.7	1 183.7	486.8	30	24	11.8	8	39	31.3	9.8	5.3	11.7
Rus	5.2	160	2 510.0	840	220	131	21.8	11	84.4	36.5	20.8	21.6	16	13.6
Taj	5.9	101.6	963.1	2 136.1	239.4	443.1	270.2	71.7	43	26.3	32.9	38.6	12.2	16.3
Ukr	5.4	94	1 527.0	4 734.9	891.2	377	80.3	15.9	10.6	22.7	28.2	12	0.8	5.2

3. Physical capital

- Aggregate investment followed dynamics similar to the evolution of real output
- FDI started to flow in these countries, largely contributing to the Fixed Capital Formation

Aggregate Investment as Percentage of GDP
Regional Averages: 1990-1998

	1990	1991	1992	1993	1994	1995	1996	1997	1998
BALTICS	24.78	16.52	18.40	20.43	21.66	21.38	22.62	23.67	24.51
BALKAN	18.49	13.23	14.94	14.88	15.68	16.99	19.17	18.30	18.63
VISEGRAD	24.01	22.48	22.99	22.74	23.20	23.92	26.72	27.77	28.36
ASIA	28.74	20.44	18.38	15.50	17.21	17.34	20.37	18.66	19.05
BUR	24.64	21.85	25.51	26.18	26.19	23.07	21.22	21.20	20.95
CEEB	22.43	17.41	18.78	19.35	20.18	20.76	22.84	23.25	23.83
CIS	25.92	21.58	21.68	22.37	22.05	21.84	22.30	19.87	19.41

Foreign Direct Investment in Transition Economies

	Cumulative FDI inflows, 1988-99 (Billion dollars)	Cumulative FDI inflows as % of GDP, 1988-99	Cumulative FDI inflows per capita, 1988-99 (dollars)	Average FDI inflow as % of gross domestic investment, 1997-99
BALTIC	2.10	30.27	923.67	27.00
BALKANS	2.07	16.85	277.50	21.40
VISEGRAD	14.41	22.30	1122.80	13.40
ASIA	1.73	32.35	183.00	39.28
BUR	8.17	9.37	91.00	7.33
CEEB	6.19	23.14	774.66	20.60
CIS	4.95	20.85	137.00	23.31

Source: World Development Indicators

4. Human Capital

- Unemployment boomed (job destruction)

… but high school enrollment rates remain

Registered Unemployment Rates
Regional Averages: 1990-1999

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
BALTIC	0.55	0.80	2.97	6.57	9.37	15.13	15.27	12.87	12.40	13.60
BALKAN	7.80	9.23	15.52	16.58	14.92	14.97	13.28	13.90	14.70	15.58
VISEGRAD	2.55	8.28	8.98	11.06	10.72	9.70	9.34	8.42	9.78	11.20
ASIA	n.a.	0.44	4.18	4.45	4.57	5.76	6.57	7.29	8.80	9.48
BUR	n.a.	0.05	2.00	2.57	3.40	4.07	5.03	5.43	6.43	6.03
CEEB	3.63	6.10	9.15	11.40	11.67	13.27	12.63	11.73	12.29	13.46
CIS	n.a.	0.25	3.09	3.51	3.99	4.91	5.80	6.36	7.62	7.76

Source: EBRD (2000)

5. Trade re-orientation and FDI

- **Generalised increase of real exports during transition**
- **Re-orientation from CMEA (Council of Mutual Economic Assistance: *eastern counterpart of the EU Common Market*) to industrialised economies: more pronounced for CSB**
- **Role of FDI in restructuring**

Countries	*Real export growth* *1993–98*	*Share of exports to industrial countries* *1992–93*	*1998–99*
CSB	*8.8*	*35.8*	*67.5*
Albania	22.0	62.9	94.1
Bulgaria	4.3	55.1	59.0
Czech Republic	10.4	29.9	69.3
Estonia	10.8	25.9	71.3
Hungary	11.1	67.4	81.5
Macedonia, FYR	7.3	22.2	65.5
Poland	12.9	71.6	75.5
Romania	8.7	44.3	71.0
Slovak Republic	6.9	15.9	59.2
Slovenia	5.7	33.7	70.7
CIS	*3.2*	*28.0*	*29.0*
Armenia	–8.6	9.4	34.9
Azerbaijan[a]	14.0	4.2	20.0
Belarus	–3.2	15.3	11.0
Georgia[a]	10.3	2.3	25.9
Kazakhstan	3.4	43.8	29.6
Kyrgyz Republic	–2.4	24.7	44.0
Moldova	4.8	6.2	31.3
Russian Federation	4.7	59.3	49.4
Ukraine	5.8	18.1	23.3

Source: Licos

FDI inflows (millions of USD)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Albania	–	–	20	68	53	70	90	48	45	41	143	207	135	178
Bosnia-Herzegovina	–	–	–	–	–	–	–	–	67	177	146	119	268	382
Bulgaria	4	56	41	40	105	90	109	505	537	819	1002	813	905	1419
Croatia	–	–	16	120	117	114	511	533	932	1467	1089	1559	1124	1998
CzechRepublic	132	513	1004	654	869	2562	1428	1300	3718	6324	4986	5641	8483	2583
Estonia	–	–	82	162	215	202	151	267	581	305	387	542	284	891
Hungary	311	1459	1471	2339	1146	4741	3291	4166	3344	3311	2777	3949	3021	2340
Latvia	–	–	29	45	214	180	382	521	357	347	413	132	254	300
Lithuania	–	–	8	30	31	73	152	355	926	486	379	446	732	179
Poland	89	291	678	1715	1875	3659	4498	4908	6365	7270	9343	5714	4131	4124
Romania	–	40	77	94	341	419	263	1215	2031	1041	1037	1157	1146	1840
Serbia-Montenegro	–	–	–	–	–	–	–	740	113	112	50	165	475	1360
Slovakia	18	82	100	195	269	308	353	220	684	390	1925	1579	4012	571
Slovenia	4	65	111	113	117	151	174	334	216	107	136	370	1645	339

Source: Licos

	Cumulative FDI per capita (in US$)	*Flow of FDI per capita (US$)*		*Flow of FDI per capita (In % van GDP)*	
	'89-99'	1998	1999	1998	1999
Poland	518	128	172	3,2	4,3
Czech R	1447	256	476	4,7	9,2
Hungary	**1764**	144	140	3,1	2,9
Slovak R	391	70	130	1,8	3,6
Bulgaria	284	65	98	4,4	6,5
Romania	252	92	42	5,0	2,8
Estonia	1115	397	154	11,0	4,3
Albania	137	13	15	1,5	1,4
Slovenia	701	125	72	1,3	0,7

Source: Licos

6. Economic structure

- Industrial sector shrank; the share of services grew
- In the CEECs this was the only reallocation of output; in the CIS both agriculture and industry shrank;

- The most important transformation was the moving of resources from the state to the private sector

Composition of Output, 1990–91 and 1997–98

Regions and periods	*Percentage of GDP*		
	Agriculture	*Industry*	*Services*
CSB			
1990–91	13.7	45.1	41.2
1997–98	13.9	33.0	53.1
CIS			
1990–91	27.5	39.7	32.8
1997–98	18.7	31.2	50.1

Source: World Bank country office data.

Private Sector Growth, 1990s

Countries	*Percentage of GDP*		
	1990	*1994*	*1999*
CSB	*11*	*50*	*68*
Czech Republic	12	65	80
Estonia	10	55	75
Hungary	18	55	80
Romania	17	40	60
CIS	*10*	*20*	*50*
Armenia	12	40	60
Belarus	5	15	20
Russian Federation	5	50	70

Source: EBRD (2000).

7. Institutional changes

From BAD (=1) to GOOD (=10) Governance

- **Law tradition:** degree to which citizens are willing to accept the established institutions for making and implementing rules and resolving disputes
- **Property rights:** government influence on judicial system, commercial codes and foreign arbitration on contract dispute, corruption and delay in judicial decisions, protection of private properties
- **Rule of Law:** property, human and ethnic minority rights, reforms of criminal code, independence of courts…

Rule of law
Regional Averages: 1990-1999

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
BALKANS	3.611	4.389	4.250	4.111	5.333	5.889	6.167	6.389	6.500	6.500
VISEGRAD	6.800	7.933	8.133	8.133	8.633	8.800	9.233	9.633	9.833	9.833
BALTIC	4.667	5.667	7.789	8.333	8.333	8.333	9.111	9.433	9.500	9.500
BUR	4.000	5.000	5.289	5.056	5.056	5.056	5.056	5.056	5.056	5.056
ASIA	2.250	2.375	2.271	2.937	3.896	3.896	4.417	4.913	5.625	5.625
CEEB	5.026	5.996	6.724	6.859	7.433	7.674	8.170	8.485	8.611	8.611
CIS	3.125	3.688	3.780	3.997	4.476	4.476	4.736	4.984	5.340	5.340

Source: Licos

8. Social Costs

- Increase in poverty during transition, persistence of the phenomenon even for the most successful countries
- Increase in inequality

Changes in Inequality during the Transition, Various Years

	Gini coefficient of income per capita		
Countries	*1987–90*	*1993–94*	*1996–98*
CSB	*0.23*	*0.29*	*0.33*
Bulgaria	0.23	0.38	0.41
Croatia	0.36	—	0.35
Czech Republic	0.19	0.23	0.25
Estonia	0.24	0.35	0.37
Hungary	0.21	0.23	0.25
Latvia	0.24	0.31	0.32
Lithuania	0.23	0.37	0.34
Poland	0.28	0.28	0.33
Romania	0.23	0.29	0.30
Slovenia	0.22	0.25	0.30
CIS[a]	*0.28*	*0.36*	*0.46*
Armenia	0.27	—	0.61
Belarus	0.23	0.28	0.26
Georgia	0.29	—	0.43
Kazakhstan	0.30	0.33	0.35
Kyrgyz Republic	0.31	0.55	0.47
Moldova	0.27	—	0.42
Russian Federation	0.26	0.48	0.47
Tajikistan	0.28	—	0.47
Turkmenistan	0.28	0.36	0.45
Ukraine	0.24	—	0.47

— Not available.

a. Median of countries with data.

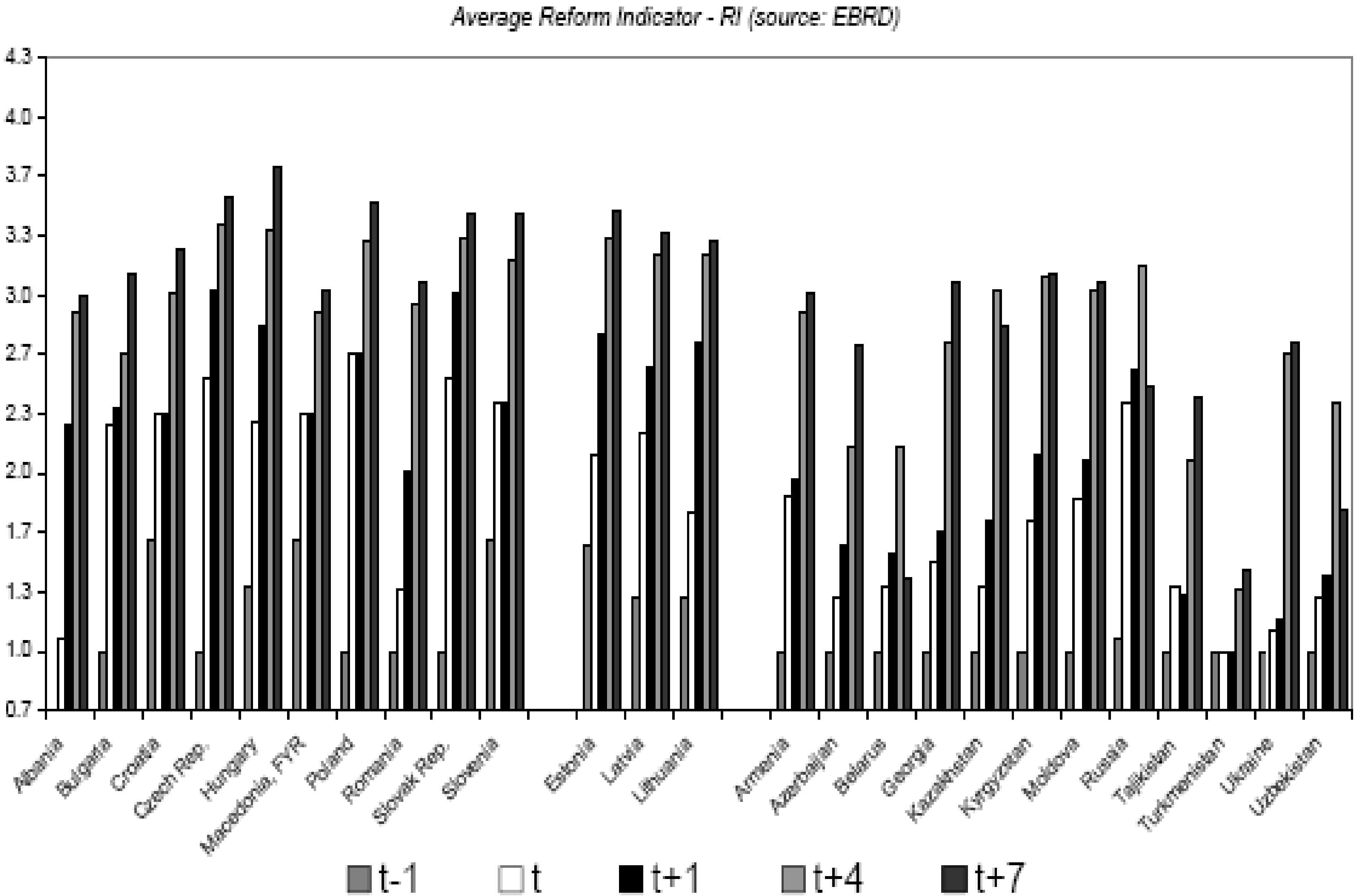
Source: World Bank (2000b).

What explains cross-country variation in performance?

- **Initial conditions *(but effect fades out over time)***
  - Macroeconomic distortions & unfamiliarity with market environment
  - Income & resource endowment
- **Stabilization: bringing down inflation is conducive to growth *(necessary but not sufficient)***
- **Structural reform: privitization, price/trade &forex liberalisation *(SR negative, LR positive)***

Structural Reform (EBRD reform index)

- **Price liberalisation:** rapid progress, but stalled
- **Trade/foreign exchange liberalisation:** rapid progress
- **Privatisation: small firms:** fast&successful, **large firms:** more cumbersome
- **Restructuring:** necessary, but difficult when insider opposition
- **Competition policy:** neglected
- **Banking sector reform:** progress much slower than expected


Average Reform Indicator - RI (source: EBRD)
4.3
4.0
3.7
3.3
3.0
2.7
2.3
2.0
1.7
1.3
1.0
0.7
Albania
Bulgaria
Croatia
Czech Rep.
Hungary
Macedonia, FYR
Poland
Romania
Slovak Rep.
Slovenia
Estonia
Latvia
Lithuania
Armenia
Azerbaijan
Belarus
Georgia
Kazakhstan
Kyrgyzstan
Moldova
Russia
Tajikistan
Turkmenistan
Ukraine
Uzbekistan
t-1
t
t+1
t+4
t+7

t=1992

Transition evaluated ex post: Essential elements in transition

- Macro-economic stabilisation
- Price and trade liberalisation
- Elimination of Soft Budget Constraints (SBC)
- Enabling environment for private sector development : Privatisation
- Reform of the economic system & restructuring
- Reform of the legal system & rule of law
- Reform of public sector institutions

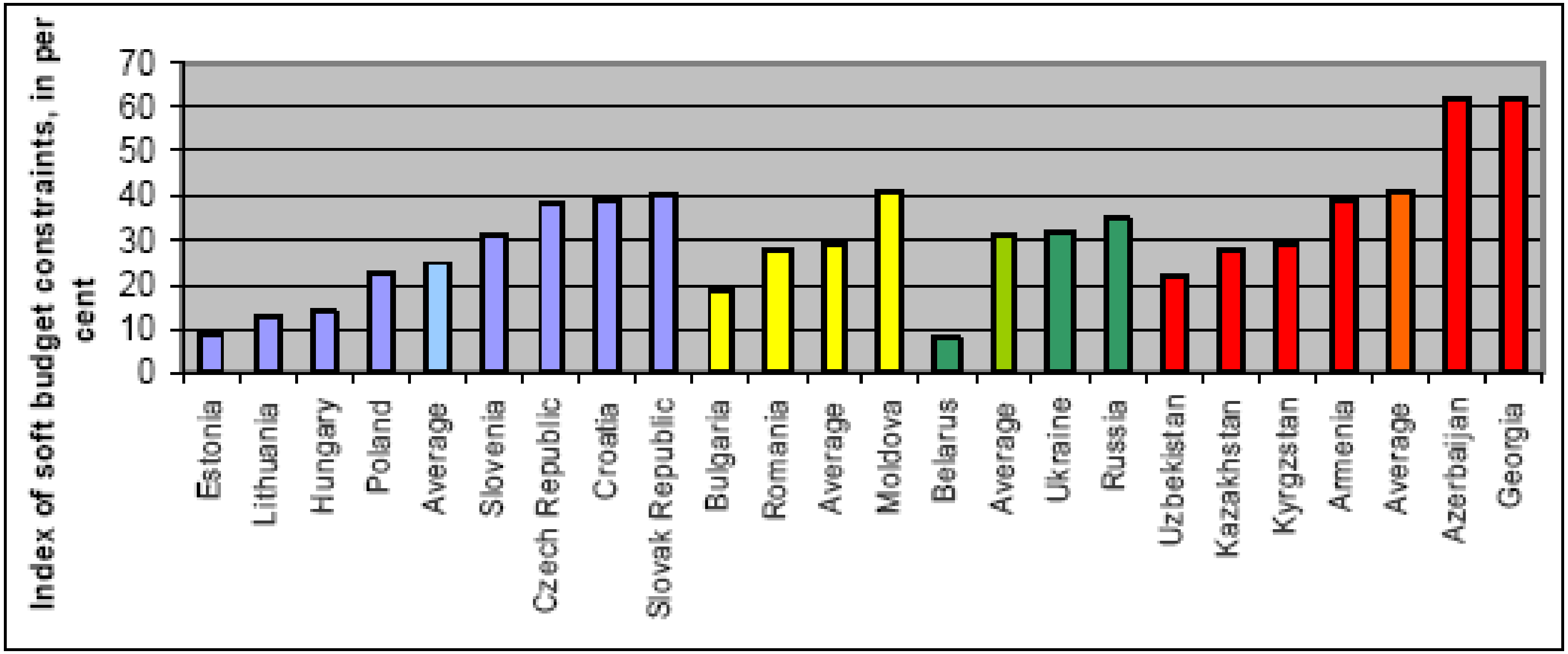
Soft Budget Constraints

Government cannot commit not to bail out money losing firms

Why is this important?

- **SBC may prevent unprofitable firms from restructuring** (no threat of bankruptcy)
- **SBC may be an obstacle to the sectoral reallocation process** (as money losing firms may prevent private firms from bidding efficiently for workers employed in inefficient SOEs)
- **Macro-economic and banking system stability may be undermined** as SBC make it difficult to keep government expenditures and bank profits under control)

Soft budget constraints in countries grouped by region



Source: LICOS

Privatisation

- **Goals of privatisation**
  - **Efficiency**: Deep restructuring requires capital & technology. Private ownership brings in capital, technology and a desire to make profits
  - **Equity**: give everybody a stake in the new system; restitution
  - **Money**: Increase government revenues (from sale & lower subsidies ex post):
  - **Political** : commitment to reduced government influence
- **Methods of privatisation**
  - **New owners** (managers/workers, former owners, broad population, domestic private, foreign private)
  - **Sale vs free distribution**

Methods of Privatisation

- Auction (open bidding)
- Direct sale (direct negotiations)
- Tender (sealed bids)
- Public offer (IPOs)
- **Mgm.t/employee buy-outs**
- Stock distribution (preferential terms)
- **Voucher privatisation** (*give away or sold*)
- **Joint Ventures**
- **Build-own-operate-and-transfer (BOOT) agreements**
- Leasing
- Management contract

Country	*Direct sales*	*Vouchers*	*Management-employee buyout*
CSB			
Albania	n.a.	Secondary	Primary
Bulgaria	Primary	Secondary	n.a.
Croatia	n.a.	Secondary	Primary
Czech Republic	**Secondary**	**Primary**	n.a.
Estonia	Primary	Secondary	n.a.
Macedonia	Secondary	n.a.	Primary
Hungary	**Primary**	n.a.	Secondary
Latvia	Primary	Secondary	n.a.
Lithuania	Secondary	Primary	n.a.
Poland	**Primary**	n.a.	Secondary
Romania	Secondary	n.a.	Primary
Slovak Republic	Primary	Secondary	n,a.
Slovenia	n.a.	Secondary	Prim,ary
CIS			
Armenia	n.a.	Primary	Secondary
Azerbaijan	Secondary	Primary	n.a.
Belarus	n.a.	Secondary	Prim,ary
Georgia	Secondary	Primary	n.a.
Kyrgyz Republic	n.a.	Primary	Secondary
Moldova	Secondary	Primary	n,a.
Russia	**Secondary**	**Primary**	n.a.
Turkmenistan	Secondary	n.a.	Primary
Ukraine	Secondary	n.a.	Primary
Uzbekistan	Secondary	n.a.	Primary

104

Source: Licos

Effects of Privatisation: *Revenue generation*

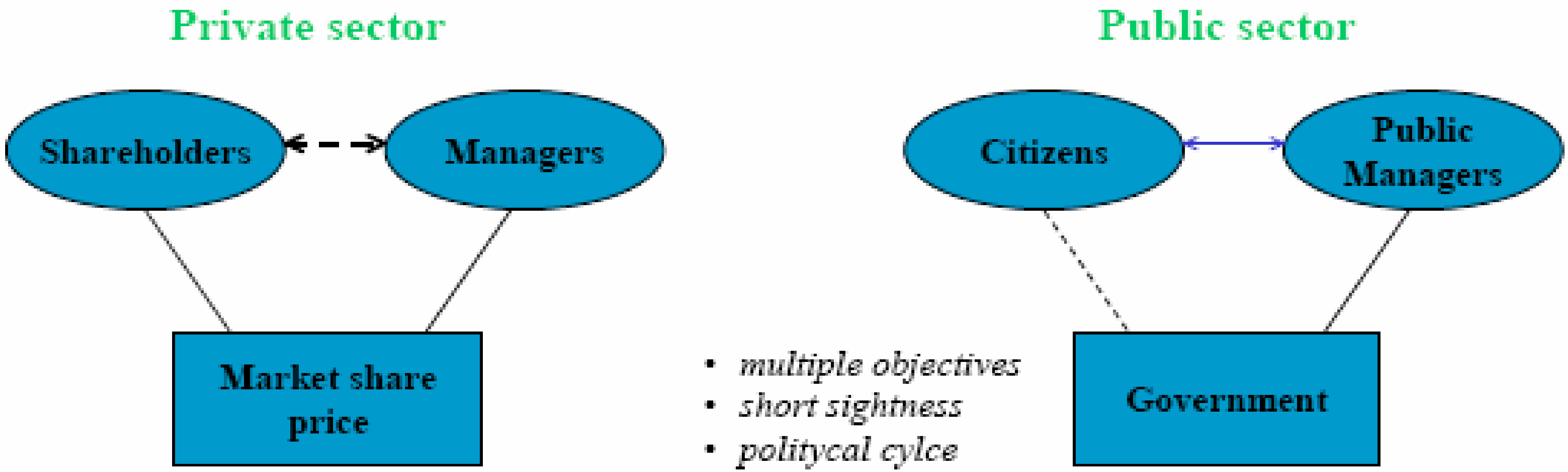
Privatisation revenues (cumulative, % of GDP)

	1995	1996	1997	1998	1999	2000	2001	2002
Czech R.	4.6	6.3	7.1	7.9	9.3	10.3	13.1	18.7
Estonia	0.0	0.0	0.2	0.3	4.2	.5.2	4.2	7.6
Hungary	20.8	23.4	27.5	28.6	29.8	30.2	30.6	30.6
Latvia	0.7	0.8	2.2	3.3	3.5	4.1	4.7	5.4
Lithuania	1.4	1.4	1.6	6.8	8.0	9.8	10.8	11.3
Poland	2.6	3.6	5.1	6.4	7.7	11.4	12.2	12.6
Slovak R.	8.4	10.2	10.8	11.5	11.8	16.3	20.1	35.1
Slovenia	0.4	0.9	1.4	2.2	2.5	2.5	2.7	4.9
Romania	1.2	2.2	4.6	6.4	7.6	8.2	8.9	9.0
Bulgaria	0.7	1.5	4.6	6.2	8.4	9.7	10.3	11.2
Croatia	0.9	1.4	2.0	3.6	8.2	10.2	13.5	15.8
Russia	1.5	1.7	2.7	3.4	3.5	3.8	4.2	4.5
Ukraine	1.4	1.7	1.8	2.3	2.9	4.3	5.5	6.0
Belarus	0.5	0.7	0.9	1.0	1.1	1.1	1.2	2.9
Moldova	0.8	1.3	3.6	4.4	5.4	11.1	11.1	na

Source: EBRD, 2003

Effects of Privatisation: *Efficiency*

- Privatisation in principle helps in promoting **competition** and **restructuring**, creating as well a demand for stronger **property rights** and institutions of **corporate governance**



- *multiple objectives*
- *short sightness*
- *politycal cylce*
- *soft budget constraints*

- In CSB and CIS countries, privatisation to **concentrated outside owners** (investment funds, foreigners) has benefited restructuring
- Privatisation to **diffuse owners** and to enterprise workers and managers (**insiders**) has not been beneficial, and in some cases even worse than State ownership
  - lack of adequate mechanisms of corporate governance (protection of minority shareholders, rules against insider deals; adequate accounting and auditing standards)
  - lack of experience of insiders

Sale to foreign companies

- **Governments had ambiguous attitudes towards FDI**
  - High hopes at the start to attract FDI
    - Favorable legislation drafted everywhere
  - But nationalistic fear that foreigners would « cherry pick »
- **Success in attracting FDI mixed**
  - Hungary (>35% of enterprise capital foreign); Less so in other countries; not in CIS countries

Effects of FDI on local economy

- **Higher efficiency:**

  better inputs, more technology diffusion (possibility of learning technology & management skills)

- **Higher competition:**

  Lower prices, loss of market share, more restructuring, less X-inefficiency

FDI has been an engine for growth

- **Countries with most FDI have enjoyed strongest recovery**
  – Hungary, Czech Republic, Estonia, Poland
  – FDI enhances enterprise restructuring
  – FDI enhances competition
- **However, absorptive capacity is important**
  – In too backward host economies, FDI may wipe out local competition.

Putting things together

The path of Restructuring in Transition

- **STARTING CONDITIONS**
  - Macroeconomic situation
  - Technology
  - Debts
  - Experience on foreign markets
- **SHOCKS**
  - Changes in prices
  - Loss of government support and direction
- **FIRM-SPECIFIC FACTORS**
  - Managerial skills
  - Managerial autonomy

- **SHORT-TERM RESPONSES**
  - Changes in output level
  - Changes in input use
  - Changes in firm's business strategy

- **CHANGES IN ENVIRONMENT**
  - Economic stabilisation / recovery
  - Markets begin to function
  - Hard budget constraints
- **PRIVATISATION**
  - Corporate governance begins

- **RESTRUCTURING**
  - Changes in marketing strategy
  - Workforce reductions
  - Change in the product mix
  - Quality and quality control
  - Human resource policies
  - Organisational changes
  - Investments

Source: Licos

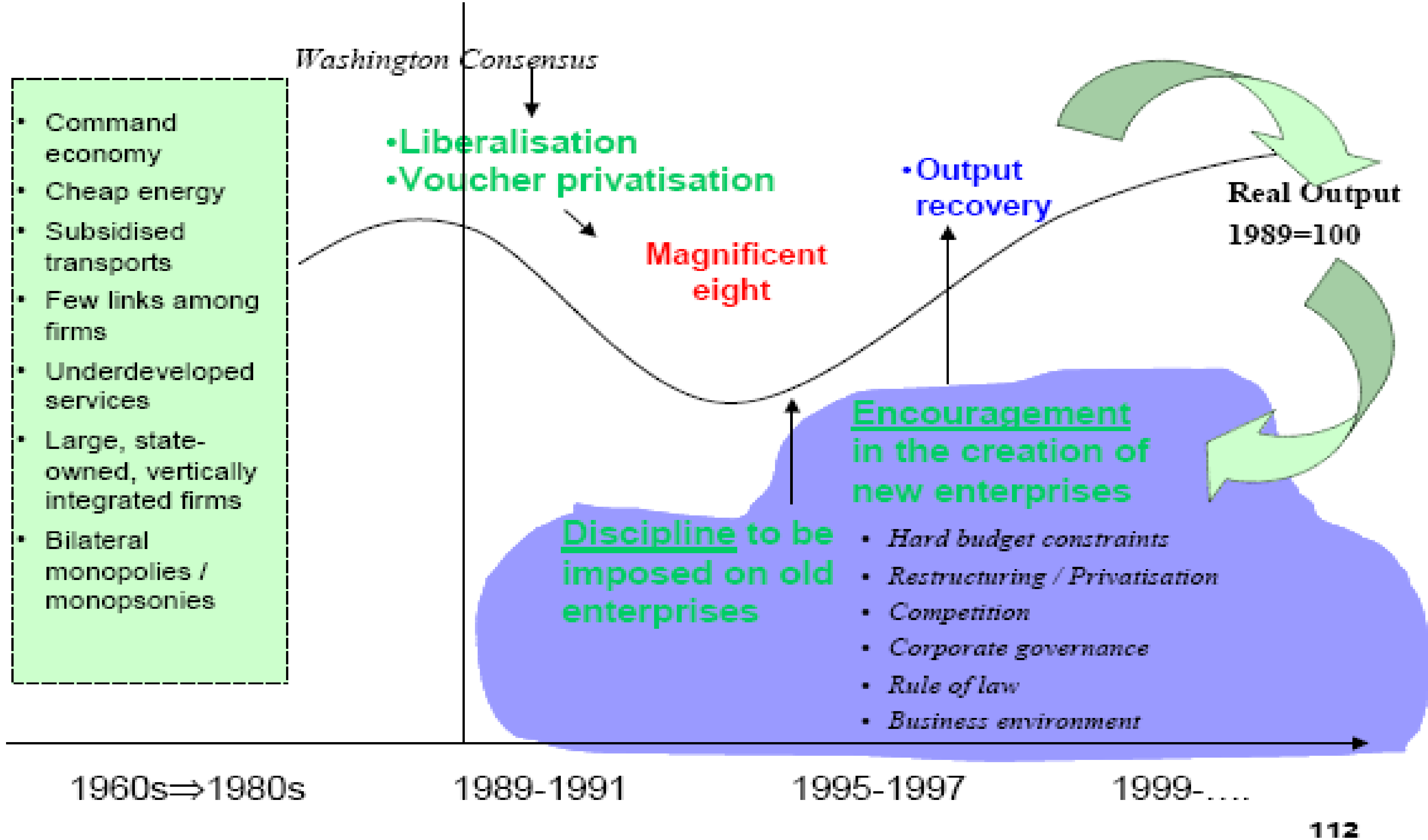
Discipline-Encouragement Cycle

- **Discipline entails**
  - Hardening budget constraints/corporate governance incentives for managers/introducing competition in the market
- **Privatisation policies are an important component in this process**
- **The changes in environment force enterprises to restructure and use resources efficiently**
- **The release for resources from old enterprises are available for more efficient allocation in new enterprises**
- **New/restructured enterprises create growth and employment, and create competition**
- **Policies to encourage business formation and growth have to be present in order for this to happen**
- **This further strenghens discipline, extends process to more difficult « strategic » sectors with more sophisticated forms of encouragment (labour, financial, innovation markets)**

Policies to *encourage* business formation & growth

- Reduce excessive marginal tax rates for the private sector
- Simplify regulatory procedures (licenses…
- Guarantee property rights and the rule of law
- Provide basic infrastructure
- Provide access to finance
- Create a stable and predictable business environment (inflation, exchange rate, GDP growth)

The Tale of Transition

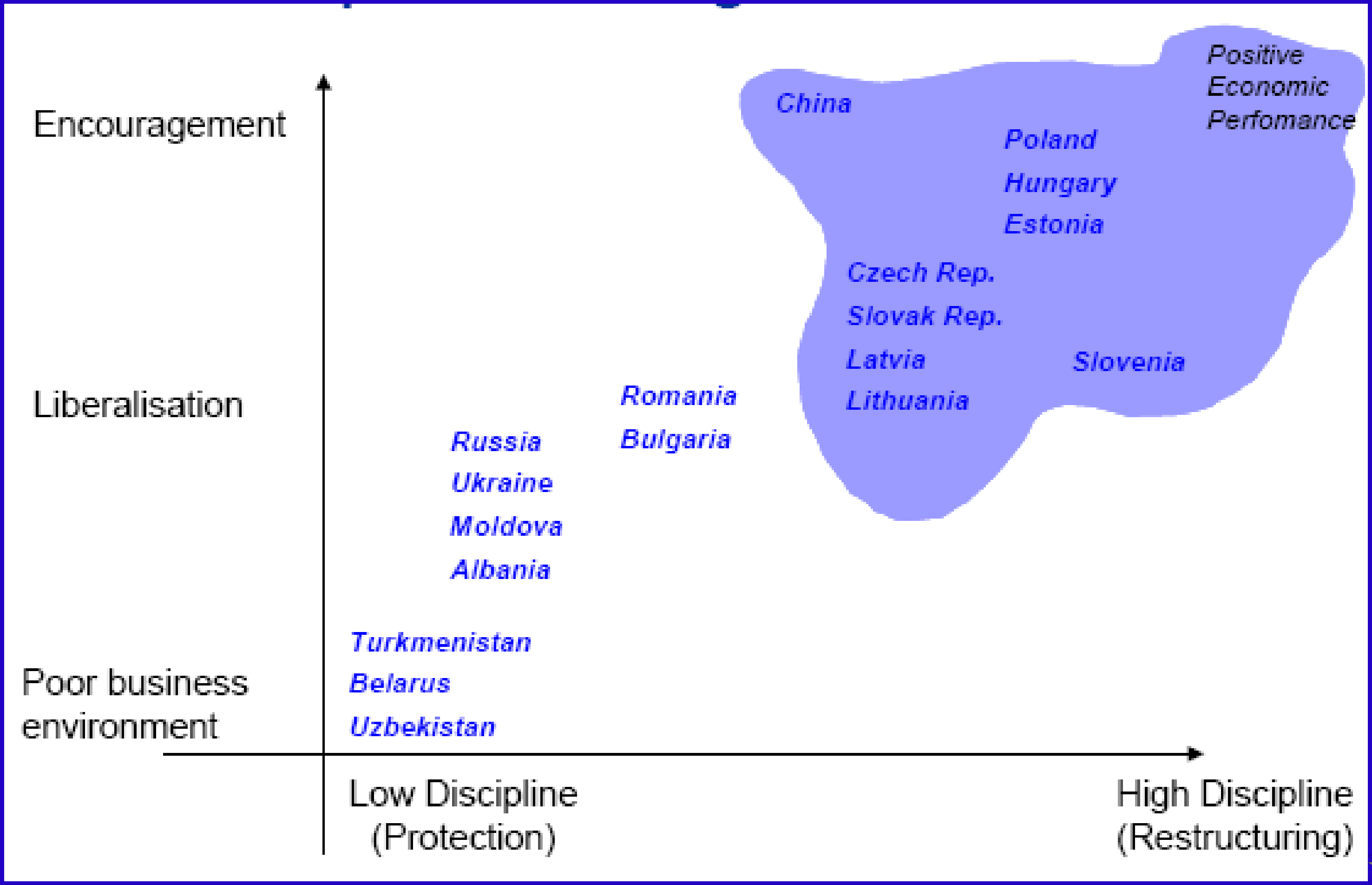


Source: Licos

The Cycle and Performance

- The pattern of growth is initially dominated by the negative contribution of old enterprises
- Over time, the development of discipline and encouragement policies induces restructured and new enterprises to acquire the critical mass needed to overcome the negative effects of old enterprises and hence generate output recovery
- The speed of this virtuous cycle depends on policy choices

Discipline-Encouragement Choices



Source: Licos