How Capitalism Was Built
The Transformation of Central and Eastern Europe, Russia, and Central Asia
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The Transformation of Central and Eastern Europe, Russia, and Central Asia

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ISSUES

1. What reform worked best?
2. Lessons from privatization?
3. Impact of democracy on the economy?
4. Role of Western aid?
5. Future: high, sustainable growth
Thesis 1: We Know How to Build a Market Economy

- 18 of 21 postcommunist countries have become market economies
- Radical market reforms worked best
Thesis 2: We Do Not Know How to Build a Democracy

- Only 10 of 21 postcommunist countries are democracies
- Only the implantation of EU institutions has bred democracy
- No intellectual contribution
Official GDP Growth:
1. Collapse Bred Misery
2. Capitalism Brought Growth

Central and South East Europe
Baltics
CIS
Why Was Postcommunist Transition So Hard?

- Communism bred collapse
  - pervasive shortages
  - high inflation (large budget deficit, no reserves, and excessive foreign debt)
  - output fall
  - dysfunctional industrial structure

- Gradual Gorbachev reforms bred extraordinary rent-seeking
Cure: Radical, Comprehensive Reforms

1. Quick Deregulation
2. Defeat Inflation
3. Fast, Extensive Privatization
1. Structural Reform Index: Early Reformers: Early Growth

Central and Eastern Europe

Commonwealth of Independent States (CIS) reformers (Russia, Ukraine, Moldova, Armenia, Azerbaijan, Georgia, Tajikistan, Kazakhstan, Kyrgyz Republic)

CIS non-reformers (Belarus, Uzbekistan, Turkmenistan)
2. No Growth until Inflation under Control: Hyperinflation in the Commonwealth of Independent States
3. Early Privatization: Early Growth

Private Sector as Percent of GDP

<table>
<thead>
<tr>
<th>Year</th>
<th>Central and Eastern Europe</th>
<th>CIS Reformers</th>
<th>CIS Non-Reformers</th>
</tr>
</thead>
<tbody>
<tr>
<td>1991</td>
<td>10</td>
<td>5</td>
<td>15</td>
</tr>
<tr>
<td>1992</td>
<td>15</td>
<td>10</td>
<td>20</td>
</tr>
<tr>
<td>1993</td>
<td>20</td>
<td>15</td>
<td>25</td>
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<tr>
<td>1994</td>
<td>25</td>
<td>20</td>
<td>30</td>
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<td>1995</td>
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<td>1997</td>
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<td>1998</td>
<td>45</td>
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<td>50</td>
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<td>1999</td>
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<td>2000</td>
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<td>50</td>
<td>60</td>
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<tr>
<td>2001</td>
<td>60</td>
<td>55</td>
<td>65</td>
</tr>
<tr>
<td>2002</td>
<td>65</td>
<td>60</td>
<td>70</td>
</tr>
<tr>
<td>2003</td>
<td>70</td>
<td>65</td>
<td>75</td>
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<tr>
<td>2004</td>
<td>75</td>
<td>70</td>
<td>80</td>
</tr>
<tr>
<td>2005</td>
<td>80</td>
<td>75</td>
<td>85</td>
</tr>
<tr>
<td>2006</td>
<td>85</td>
<td>80</td>
<td>90</td>
</tr>
</tbody>
</table>
Has Privatization Been Overdone? NO

Predominance of private sector:
- precondition for market economy
- precondition for democracy
- limits corruption
Democracy and Privatization Go Together, 2005

The graph illustrates the relationship between the private sector as a share of GDP and the Freedom House Political Rights and Civil Liberties Rating for various countries. The countries include:

- Turkmenistan
- Uzbekistan
- Belarus
- Tajikistan
- Kazakhstan
- Azerbaijan
- Russia
- Armenia
- Kyrgyzstan
- Moldova
- Georgia
- Ukraine
- Romania
- Bulgaria
- Estonia
- Hungary
- Slovakia
- Czech Republic

The red line shows the trend line with a correlation coefficient $R^2 = 0.6395$. The countries are plotted according to their political rights and civil liberties ratings, with 1 = free and 7 = not free.
More Privatization = Less Corruption, 2006

Graph showing the relationship between Privatization and Corruption Perceptions Index (CPI) across various countries. The graph indicates a positive correlation between the share of the private sector in GDP and the CPI, with a coefficient of determination $R^2 = 0.5034$. Countries listed include Ukraine, Russia, Georgia, Tajikistan, Uzbekistan, Azerbaijan, Moldova, Kazakhstan, Bulgaria, Hungary, Latvia, Lithuania, Estonia, Poland, Czech Republic, Slovakia, Romania, Armenia, and Turkmenistan.
Democracy: Best Weapon against Rent-Seeking

- Democracy and market reform positively correlated
- Democracy and privatization go together
- Democracy reduces corruption
Democracy and Market Reform Go Together, 2005

Freedom House Political Rights and Civil Liberties (1=free, 7=not free)

World Bank/EBRD Structural Reform Index (0=low, 1=high)
More Democracy = Less Corruption, 2005

Transparency International Corruption Perceptions Index (0=highly corrupt, 10=highly clean)
Has Western Aid Been Excessive?

**NO**

- It barely existed: Western governments received more in debt service on old communist loans than they gave in loans and grants to the postcommunist countries in 1993–96.

- Total grant assistance to the region = a couple of billion dollars a year.

- US peace dividend (the reduction in US military expenditures) amounted to a $1.4 trillion in 1990s (3 percent of US GDP in 1999).

Net private capital flows

Net official flows

USD Billions
<table>
<thead>
<tr>
<th>Year</th>
<th>Percentage of GDP</th>
<th>Current Dollars (billions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1992</td>
<td>1.1</td>
<td>69</td>
</tr>
<tr>
<td>1993</td>
<td>1.5</td>
<td>98</td>
</tr>
<tr>
<td>1994</td>
<td>1.9</td>
<td>132</td>
</tr>
<tr>
<td>1995</td>
<td>2.2</td>
<td>160</td>
</tr>
<tr>
<td>1996</td>
<td>2.5</td>
<td>192</td>
</tr>
<tr>
<td>1997</td>
<td>2.6</td>
<td>211</td>
</tr>
<tr>
<td>1998</td>
<td>2.8</td>
<td>238</td>
</tr>
<tr>
<td>1999</td>
<td>2.8</td>
<td>259</td>
</tr>
<tr>
<td>TOTAL</td>
<td></td>
<td>1,359</td>
</tr>
</tbody>
</table>
Is the European Union the best solution?—Probably

- European Union provided the standard of a normal society to accession countries:
  - transferred all institutions
  - reinforced democracy
  - opened market
Has Sustainable Economic Growth Been Achieved? Probably

- Since 2000, former Soviet region:
  - average growth 8 percent a year because of
    - Sound macroeconomic policies,
    - structural reforms,
    - sharp cuts in public expenditures,
    - low exchange rates, and
    - commodity boom

- Star performers: Baltics, Armenia, Azerbaijan, and Kazakhstan
Openness of the Economy: Great and Growing

Trade as % of GDP

- **Central and Eastern Europe**
- **CIS**

<table>
<thead>
<tr>
<th>Year</th>
<th>Central and Eastern Europe</th>
<th>CIS</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990</td>
<td>~70</td>
<td>75</td>
</tr>
<tr>
<td>1998</td>
<td>~100</td>
<td>85</td>
</tr>
<tr>
<td>2005</td>
<td>~130</td>
<td>100</td>
</tr>
</tbody>
</table>
Gross Fixed Investment: Rising with Growth

Annual % Growth


Central and South-East Europe
Baltics
CIS
Foreign Direct Investment: Rising Net per Capita, 1993–2006

- Central Europe
- Baltics
- South-East Europe
- CIS

USD


estimate
Concerns

- Low Central European Growth:
  - high taxes and large budget deficits
  - large social transfers
  - over-regulation of labor and agricultural markets

- CIS Countries: Uncertain property rights and risk of renationalization

% of GDP


Central Europe  Baltic  CIS
Public Expenditures: Too High But Lowest in CIS

- Central Europe
- Baltics
- CIS

% of GDP

Freest Labor Markets and Lowest Unemployment in the East, 2005

- Central Europe: 12%
- South-East Europe: 8%
- Baltics: 7%
- CIS: 6%

% Change from 1989 to 2004

-20 -10 0 10 20 30 40

Czech Republic Slovak Republic Hungary Estonia Latvia Lithuania Romania Bulgaria Russian Federation Belarus Ukraine Moldova Armenia Azerbaijan Georgia Kazakhstan Kyrgyz Republic Tajikistan Turkmenistan Uzbekistan
Conclusions

1. Capitalism has been successfully built and is likely to last—more growth and structural reform than in Latin America.

2. Democracy building has been deplorable, primarily intellectual shortfall, political scientists failed to provide relevant theory or policy advice.
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