Keynote Speech

INSTITUTIONAL CHANGE AND PUBLIC POLICY IN A POST-COMMUNIST SETTING

Daniel Daianu

Minister of Finance, Bucharest, Romania

It is a truism to say that post-communist transformation is liberal in spirit and action (in the European sense) as history unfolds, in the countries concerned, from the command (totalitarian) system to economic and political democracy - to what Karl Popper called the *Open Society*. The Zeitgeist of the eighties only accentuated the liberal spirit, but did not determine it! A simple intellectual exercise can be used in order to verify this assertion. Let us imagine that the domino effect of the collapse of communism in Europe had occurred in the 1960s, which means in the years of paradigmatic supremacy of Keynesism in economic policy. Would that have meant an alteration of the liberal essence of transformation? The obvious answer is NO. What is the *path of transformation* and how would post-communist societies look like after a longer period of time are, however, questions which are still begging answers.

One of the major lessons of the last years regarding transformation is the necessity of being open minded and of considering various hypotheses and viewpoints, of not becoming the prisoners of clichés and taboos, of understanding that there can be no perfect blueprints as there cannot be a perfect world. In this respect, I cannot help recalling the dictum that we all are, one way or another, the prisoners of some famous theories. In addition, this intellectual "serfdom" is part of how science evolves, of its incremental development as well (aside from revolutionary changes) as of its "internal burning". Nonetheless, each scientific demarche needs to strive for authenticity and openness vis-à-vis the world of existing ideas. Additionally, the need for lucidity and pragmatism should compel us to keep our eyes open and confront a reality which can be overwhelming in its complexity and the dimension of changes.

Let us remember how, some years ago, those who were prone to emphasise the *structural nature* of the problems facing post-communist countries made up a minority in the chorus of upbeat voices; they warned about the lack of realism of the theses and conceptions which smelled of the possibility of compressing time at will, of practising a sort of "hocus pocus economics". Currently, the majority of those who are frequent travellers on the circuit of conferences dealing with transformation reveal a different, significantly more poised stance.

An increasing number of professionals emphasise the role of institutions in economic development,[1] the burden of history, and the intensity of what François Perroux named “emprise de la structure” (the power of structure), with the latter including the legacy of resource misallocation and the *strain* it entails in the system. Here one can talk about the structural (social) embeddedness of economic phenomena (Marc Granovetter, 1985), which is an approach having as illustrious precursors Max Weber and Emile Durkheim. Such a broad analytical perspective lends to transformation a much richer meaning and content which goes beyond what is implied by the generic notions of price liberalisation, macro-stabilisation, and privatisation.

Among professionals it is increasingly accepted that an adequate understanding of the deep processes of transformation involves the scrutiny of aspects which can easily overstretch the analytical capabilities of economists; such aspects are the dynamics of institutions (seen as *social norms*[2] as well), corporate governance, the build-up of human capital as an educational effort, etc. In order to overcome this analytical overstretch economists’ investigations need to be intertwined with those performed by other social scientists - sociologists, social psychologists and political scientists.[3] Those who ignore the fact that transformation involves modernisation and catching-up, on a road littered with structural traps, show naiveté and conceptual myopia.

What complicates further the scrutiny of transformation is the need to place the process into a world-wide context, which means the world at the end of this century. Unfortunately, there are many that seem to overlook what is happening on the European continent as well as major processes in the world. In a way, this is not surprising since people have a natural temptation to be self-centred. However, this type of conceptual narrowness can lie at the origin of flawed analyses. When highlighting the need for global embeddedness I have in mind an apparent loss of vitality by Western European countries, the crisis of the welfare state, the “economic rise” of East Asia in recent decades (which cannot be obscured by the recent major financial crisis) and shifting comparative advantages under the impact of the “new information age” and of economic globalisation, etc. I think also of the pressure the globalisation of financial markets imposes on national economic policies and the related increasing marginal cost of imprudent and inconsistent measures over time. Embeddedness into a wide context[4] helps detect both the expected and the new sources of difficulties encountered by post-communist countries, and what may lie ahead for them.

Getting Rid of Clichés, Illusions and Stereotypes

Transformation, as an analytical process is not devoid of clichés, illusions, and intellectual stereotypes. Let us start with semantics and the way we portray performances comparatively. Thus, the members of what is called the Visegrad Group and a few other countries (such as Slovenia) evince remarkably better transformation results; this is the main reason why these countries are called fast-reformers. Obviously, the rest of the pack is made up of so-called slow-reformers. This definition however needs qualifications. On one hand, it does obscure important differences among the countries which are grouped together. On the other hand, it downplays the importance of structural factors and of *history* in explaining performance. In this respect, it seems to me that there has been an excessive temptation to lump countries together, in various groups, by assuming a pretty much deterministic (mechanical) relationship between preordained results and policies implied by a conventional wisdom in the making. In the vein of the old Latin saying "*post hoc, ergo propter hoc*", close performances were ascribed more to presumed similar policies than to commonalties in initial circumstances, the power of structural factors and policy peculiarities.

One can submit the hypothesis that certain traits of politics and social life, of the local (national) industrial and political culture, and other structural factors have strong explanatory power for understanding policy-making. It may be the case that culture (the burden of the past), geography and structural factors explain to a large extent why certain policies (like macro-economic stabilisation) were more likely to be undertaken and were more successful in certain countries than in others.

Likewise, the start of economic recovery in the transforming economies can be linked significantly with structural factors (such as the bottoming out of economies and the accumulation of a critical mass of *organisational* and *institutional capital* - Olivier Blanchard, 1996, P. Murrell), as with macro-economic stabilisation. Macro-economic stabilisation is unquestionably good for growth but it seems to me that the implied causality is sometimes overemphasised and structural factors are underestimated.

If a line of reasoning which emphasises the role of structural factors, of the burden of the past and their impact on policy is well considered then one may need to broaden the focus of analysis: instead of being absorbed by preferred clichés and ideal frameworks one should pay more attention to closer-to-reality second-best scenarios. This logic would have to apply to both first round as well as n-round (feedback) policy measures. Frequently and with surprising nonchalance, those who pass judgement or provide advice equate non-adherence to a "first-best" policy-package to lack of political will. Political determination is clearly an essential ingredient of policy formulation and implementation, but far from sufficient in order to gain credibility and achieve success.

Janos Kornai was very much to the point when he remarked that "Those who attach intrinsic value to democratic institutions must consider in their proposals the existing power relations and the rules of parliamentary democracy. We are not going to achieve much if we rely on advice of this kind: it is our job to advise you about what is good for your country and your job to take advice. If you do not take it, that is your problem. We cannot help it if your politicians are stupid or malicious" (p.5). This is a strong reason to consider the political economy of reform in the post-communist countries. Relatedly, one has to ask whether the advocated "first-best" policies are actually realistic, irrespective of circumstances. For example, can one really believe that not paying wages and salaries to many people who are still employed is a sustainable policy which can durably defeat high inflation? Alternatively, what is the meaning of a small-consolidated budget deficit if arrears as well as the quasi-fiscal deficit are growing? In addition, is the non-inflationary financing of the budget deficit sustainable when its service is skyrocketing because of very high positive real interest rates? It appears that, sometimes, some pundits disconnect what is desirable - from a results oriented perspective - from what is achievable, in terms of policy, under the circumstances. Let us remember how vigorously Jeffrey Sachs pointed out the need of external aid in order to get out of a vicious circle; for such aid would condition the credibility of reform policies and the preservation of a modicum of social stability under certain circumstances.

On this line of reasoning, one can try to understand the sources of *policy credibility* in the transforming economies. Again, aside from vision and the very quality of policy itself, I would highlight the initial conditions (including the legacy of resource misallocation), the history of partial reforms (which made certain environments more "market-friendly"), and the role of foreign capital in triggering a virtuous circle. Particularly the last factor seems to have played a very significant role in the front-runner economies; this role is better understood bearing in mind the extreme complexity and complicated nature (the very high cost) of deep restructuring of economy. In Poland, where political commitment to reforms has been impeccable, the policy thrust was accompanied by a substantial write-off of the external liabilities of the country and by a stabilisation fund; these two elements considerably helped macro-economic stabilisation.[5]

Without massive capital inflows, economies that bear the brunt of the legacy of tremendous resource misallocation run the risk of boiling in their own steam, of stagnating. It is likely that even high savings ratios would not change for the better the consequences of the legacy of resource misallocation and the lack of other favourable conditions. One can argue that some of the fast growing economies of Asia relied less on foreign capital and that, in their case, the essential factor was the very high savings ratios (35-40%). Undoubtedly, such ratios are good for economic growth and economic policy should strive to stimulate them. Nonetheless, I dare to say that geographic and historical circumstances[6] make foreign capital play a special role in the post-communist countries. In addition, a clear indication of these circumstances is the intensity of structural strain in those countries.

Policy credibility, itself, depends on how much structural adjustment the system can undergo in a period covered by the respective policy; and the capacity to adjust depends, basically, on *structure*, on the dimension of required resource reallocation, and on the quality of institutions as premises for policy-making. A "credibility paradox" seems to be at play here: those which need to be more credible are not (cannot be) because of the magnitude of required resource reallocation and of overall institutional change, and their related costs - what I called *strain* in the system; whereas those which can afford not to undertake similarly painful changes (e.g. Hungary) enjoy more credibility due to the, relatively, smaller scale of needed structural adjustment. Obviously, a political element has to be factored in as well which includes the *reputation* of policy-makers.

It is understood that credibility and the boldness of policy can be much enhanced by political climate and various *sui generis* anchors. The prospects for joining the EU and NATO have provided powerful policy-anchors to most of the countries which signed Association agreements with Brussels. This also explains why, where there has been a political backlash at the polls, no major policy reversals occurred in most of the reforming countries. Nonetheless, the question which automatically comes to mind is what would happen if policy and social fatigue combine with receding prospects (for some, or most of the signed countries) to join the two institutions in the near future. This kind of anchor is non-existent for most of the former Soviet republics and its lack gives more degrees of freedom for policy to go astray.

As to the political climate, it can be judged on two grounds. One is related to timing; it is better to initiate reforms when people are still highly enthusiastic and would put up with assumed temporary discomfort. The longer policy lingers the worse it is for policy consistency and coherence. The other ground regards the overall context including the Zeitgeist; the latter enhanced a certain policy thrust and vision in most of the transforming countries which was accentuated by the effects of globalisation and the advent of new information technologies. For instance, internal convertibility of the currency was used as a weapon for systemic transformation which was not the case in the West in the aftermath of the Second World War.

When mentioning post-war western governments it is worthwhile to notice a growing similarity between their then obsession for dealing with high unemployment and their current policy worries regarding the size of structural unemployment. What I wish to imply is that post-communist countries' governments may not be in a better position in this regard and structural unemployment could very likely become very burdensome for their policies - a *hysteresis* phenomenon may develop quite disturbingly in this respect unless proper labour market policies are developed. Likewise, it is striking how the need for western countries to reform their welfare systems compares with the post-communist countries' need to restructure their public budgets. This is part of a dual challenge for Europe as a whole: Western Europe's quest to revitalise its economies combined with post-communist countries quest to build viable economies.

In the framework sketched above one should consider also the dynamic of wealth distribution in the transforming economies. As the experience of Latin America and East Asia amply shows, widely diverging wealth discrepancies are not conducive to social stability and long-term growth.[7] The idea here is that even a rapidly growing social pie may not be sufficient for maintaining (improving) the social fabric of society. The implied policy requirement is highly challenging since it needs to fit into the general pattern of market-based reforms which involve income differentiation; it also needs to help the transforming economies become more flexible (adaptable) instead of being mired into social rigidities which would be fatal in a world increasingly subjected to the pressures of globalisation. In any case, this is a domain which may critically test the governance capabilities of the elites in the transforming economies in the years to come; these elites would have to solve what Arthur Okun coined as the "Big Trade-Off" more than two decades ago.

Because of their major structural distortions (including resource misallocation) and the *fragility* of their institutions, the transforming economies have an almost in-built mechanism for subjecting themselves to intense *strain*. Not even the front-runners have made big strides as far as deep restructuring is concerned and much of the potential *strain* has been mitigated by the effects of heavy capital inflows.[8] It can be submitted that feeble deep restructuring maintains a high degree of actual and potential *strain* in the system. This issue needs to be emphasised since the resumption of growth on a large area may have caused more optimism than is actually warranted. One should not overlook that what is happening now is more economic recovery from an extremely depressed level of production - even if correction is made for formerly useless production - and that this was helped by the achievement of relatively easy to obtain efficiency gains that, unless investment ratios are high, unless there is constant upgrading of the quality of output (tradeables), and unless institutions function well, will stall. Moreover, some of the post-communist countries may face dangerous stagnation against the background of intensifying social tensions.

The implosion of the Mexican economy at the end of 1994, the financial crisis in East Asia which started in the second half of 1997, in an indirect way, and the chaos in Albania in 1996, in a direct way, suggest how fragile and vulnerable post-communist economies are. These examples also show how deceptive macro-economic figures can be when they are not supported by the strength of the real economy and solid institutions.[9] One should not forget that Mexico was hailed in the early 1990s as a role model all over the world; and a few years ago Albania was considered a success story for its macro-economic stabilisation and other reforms.

The *fragility* and *vulnerability* of the transforming economies should be judged against the background of globalising financial markets. Again, the East Asian crisis, the Mexican crisis, and also the hard times the Argentinean policy-makers had in managing the "tequila effect" (the currency board did not make the economy soundproof and IMF money had to be asked for) come to one's mind. There are several aspects to think about here. One regards the link between the development of financial markets and the progress made in the real economy.

It can be submitted that the degree of volatility of domestic financial markets would be exceedingly high unless there is sufficient restructuring of the economy. Conversely, it can be argued that capital markets do enhance restructuring which may suggest that one faces a chicken and egg problem in this respect.

There is here a policy conundrum which outlines a multi-question one needs to answer: how would financial markets better serve the transforming economies and, implicitly, how should they be developed? Do financial markets influence the nature of capital inflows (when real interest rates are high and induce speculative inflows) and if that is the case what are the policy implications? Another aspect is linked with the acute need for much prudence and wisdom in macro-economic policy. The experience of Romania indicates clearly what happens when economic recovery is not backed by changes in the real economy and is driven mainly by domestic absorption. A last aspect to be highlighted is the urgent need to strengthen the supervision of the banking industry since many banks are congenitally fragile, quite prone to poor lending, and heavily fraught by conflicts of interest. It goes without saying that better supervision should be exerted on financial institutions as well.[10]

The role of institutions has been stressed herein several times. It seems to me that economists are insufficiently equipped to analyse institutional change in the transforming economies which is in fact very wide-ranging and deep. This fact is quite unfortunate since, as many of us would agree, the quality of institutions is what counts, ultimately, for the long-term growth differentials of national societies. Recent studies reconfirmed the role of capital build-up, of human capital, for economic growth but this result did not surprise the profession; what needs to be elucidated is what makes a society accumulate more and invest more productively than others, what is the role played by wealth distribution in the process, and why a society can achieve dynamic efficiency gains over time whereas others may be plagued by substantial diminishing returns or secular decline.

One should think that the post-communist countries are in a period when the basic constructs of the future systems are being put in place and this can be seen as an historical opportunity for designing viable societal aggregates. For example, the future dynamics of the consolidated public budget will very much depend on how its structure is being built now, on reforming the pension systems, etc. At the same time, due to the pace of events and the complexity of the whole process big mistakes can be made. These mistakes may put the evolving systems on a less convenient path; they can create bad “path dependency”. This is like saying that the institutional “QWERTY keyboard layout” of the transforming economies is now being established and one needs to be very careful about which path the lock-in occurs.

Two Major Under-Played Issues

What puzzled me during all these years of transformation has been the relative neglect of two issues which, in my view, are of the utmost importance in coming to grips analytically and operationally with the reality of post-communist transformation. One issue regards the relative backwardness of the former command systems; the other issue refers to the magnitude of required resource reallocation in relation to the new relative prices dictated by liberalisation and the opening up of the economy.

The legacy of backwardness

Knowledgeable professionals can often be heard making judgements on the transformation process, while seeming to neglect the legacy of backwardness of most of these societies - a state of affairs which goes back far into history. A note of caution is nevertheless required. The post-communist societies of Europe are societal entities that show common (structural) traits, but also major discrepancies; the latter can be linked with the different pre-communist legacies (the former Czechoslovakia, as a leading industrial country during the inter-war period is the most conspicuous example) and the different brands of national central planning, in terms of relaxation of direct controls and economic policy choices. The different histories explain widely different incomes per capita (see Annex 1), why market institutions vary qualitatively among the national environments and why macro and micro-disequilibria differed among them on the eve of 1989.

Backwardness should be seen as bearing considerably on the potential for overcoming the performance deficit of societies with poor institutional arrangements; it points, on one hand, at the lack of specific knowledge of individuals and of society as a whole and at the constraints for genuine institutional change and, on the other hand, it suggests that there is much scope for a system to get outside what can be conceived as an ideal tunnel of evolution. The stress put on the burden of the past is meant to warn against its dragging effects and an unfavourable *path dependency* from which it may not be easy to break away. Backwardness makes it harder to overcome the fragility of the emerging market institutions and enhances the potential for the dynamics of change to get out of control. Institutional fragility was much underestimated by policy-makers and their advisers.

Similarly inadequate is the neglect of the extreme complexity of the process under way. Gross oversimplifications and reductionism of the type “black vs. white” (with no shades in-between), and the lack of understanding of how interests are socially articulated - particularly in a transition period - cannot but obscure real processes and lead to hasty and inadequate decisions. As G. Schöpflin aptly noted, “The elite failed to understand that society was a far more complex organism than they had thought, that simple, well-meaning declarations were not effective in politics, that ideas and programmes would have to be sold to the public, and that institutions were necessary for the routinised exercise of power" (1994, pp.130).

There are some people who have a very rudimentary view of what a modern market-based system means and who do not realise that a "pure" market economy as such does not exist in reality and that the concept is meaningless without proper qualifications. Besides, "imperfect and costly information, imperfect capital markets, imperfect competition: these are the realities of market economies - aspects that must be taken into account by those countries embarking on the choice of an economic system".[11] The implication is clear in the sense of the stringent need to consider how market economies actually function.

Many people are opaque to the reality that it is high time to deal seriously with the *fine print* of reform and that this involves much more than simple ideological statements and exhortations; that this involves unavoidable pragmatism and making hard policy choices based on solid theoretical and empirical knowledge when one cannot escape facing painful trade-offs and dilemmas. For instance, one issue that badly needs serious debate is the structure of *corporate governance*; it is ever more clear that one needs to go beyond the general statement regarding the necessity of privatisation.

The sintagma of *institutional fragility* has already been implied. Apart from the insufficient analytical attention paid to the institutional build-up in the transforming societies in Europe, one has to consider the seeds of instability produced by this fragility. The poor performance capacity of immature institutions needs to be mentioned in this context. For example, the debate on universal vs. narrow banks (on whether and how banks should be involved in resource allocation) is quite relevant for the concern immature market institutions create in terms of enhancing instability and uncertainty in the system.[12]

From a broader perspective one can pose the issue of the *governance capabilities* of the political and economic elites of these countries - to what extent these elites are capable of inducing and managing change (transformation) when so much fuzziness, volatility and uncertainty is prevailing. One can also assume that institutional fragility will bear significantly on the nature of capitalism in the region.

The magnitude of resource reallocation : the emergence of Strain

In Eastern Europe, the structure of the economy and the legacy of resource misallocation have put the system under exceptional *strain* once the combination of internal shocks (engineered by reforms or simply triggered by the uncontrolled processes of system dissolution) and external shocks occurred. When one sees Western governments - and their social constituencies - vacillating and deeply reluctant to undertake relatively minor adjustments, the *strain* under which the former command economies operate becomes understandable. Annex 2 is an attempt to illustrate *strain* analytically and empirically.

What are major implications of this *strain*? One is that these economies can easily become exceedingly unstable and that their capacity to absorb shocks is quite low; these economies have a high degree of vulnerability. Another implication is that policy-makers face extremely painful trade-offs and that, in most cases, unless policy is clever and sufficient external support is available, the room for manoeuvre is in practice quite limited. Finally, macro-economic stabilisation in certain countries hides deeply seated tensions which, sooner or later, come into the open unless deep restructuring takes place.

Current unemployment rates in the transforming economies are not exceedingly high in comparison with the European levels of the mid-nineties and this could assuage the perception of *strain*. However, several factors provide cause for concern. One is that the yardstick used is itself questionable taking into account the unemployment problem in Western Europe. A second factor is the weakness of safety nets; this problem acquires particular significance in the poorer post-communist countries where the consequences of a “new type” of poverty could be extremely serious.[13] And another factor is the fact that the restructuring of large companies - which mostly need to shed labour in order to become profitable - is very slow, or, in practice, not taking place; this means that potential unemployment increases are still very significant.

One should also mention an increasingly intense *distribution struggle* and an erosion of the consensus for societal change when many individuals appear as losers - once market forces start to reward people in accordance with merit, effort, good ideas, and inspiration, but also as a result of some workers’ misfortune to have jobs in bad (unprofitable) enterprises. These two processes are not a good omen for securing consistency of and support for economic policy-making. This also explains why some governments see inflation as a redistribution device when *strain* is extreme.

There is another dimension to this distribution struggle which needs to be highlighted both for its exceptional character in human history and for its effects on system transformation. It is the process of privatisation, which means a massive (total) redistribution of state assets. As we know, economic textbooks take as a *given* the initial distribution of assets among individual private owners; this distribution is almost God given and it underpins the whole reasoning on how best to allocate resources and achieve Pareto optimality (highest welfare). In the case of post-communist countries, “God” has decided to come down from heaven - for what we are witnessing currently is an extraordinary process without precedent in the history of mankind. In the next few years, much of the fate of tens, if not hundreds of millions of living individuals (and of their descendants) is going to be shaped by the mechanics and dynamics of privatisation. What took many hundreds of years in the advanced capitalist countries is supposed to occur through various procedures (more or less legal) in the post-communist countries in a snapshot on the scale of history. It is not, therefore, surprising that everything surrounding this process is so highly charged emotionally - why so many hopes, dreams, reckless and ruthless actions, misbehaviour, and delusions are linked to it. All individuals want to be on the winning side, but markets cannot make them all happy.

The nature of capitalism in the post-communist countries will be decisively influenced by the actual results of privatisation as a process. If privatisation results in the development of a strong middle class as the social backbone of the new economic system, stability and vigour will be secured and democratic institutions will develop. Otherwise, the new system in the making will be inherently unstable - like the bad Latin American model - with politics likely to take an authoritarian route.

There is a feature of communism that needs to be emphasised in order to understand better the social tension engendered by post-communist transformation and the intensity of the distribution struggle. Communism - as an economic system - functioned as a kind of poor and steadily declining (suffering from *economic euthanasia*) but, nonetheless, "welfare state". The post-communist countries maintain among the most generous social welfare budgets in the world when calculated as a share of GDP; social spending budgets are between 15-30% of GDP as compared to 5-10% in the case of East Asian countries at similar income levels for similar social programmes.[14] As in Western countries where there exist powerful vested interests which oppose economic adjustment, in post-communist countries those who cannot compete on the markets have turned into a strong coalition of interests which can slow down or even arrest reforms. This mass of individuals is most likely to fall prey to populist slogans and is obviously inclined to support left-oriented parties. Robert Gilpin's observation that adjustment is very difficult in welfare states, applies *mutatis mutandis* in the case of post-communist countries.

Institutional Change and Economic Performance: Some Linkages

The post-communist countries experienced a quick collapse of much of the old institutional framework and of the previous administratively upheld links among enterprises - what Calvo and Coricelli called "trade implosion" (1992) and this author named "network deconstruction" (1994). That was a spontaneous process which distinguishes post-communist transformation of reforms "controlled from above", as is the case in China, for example. The emergence of the private economy (including the second economy) at the grass roots level and the creation of *sui generis* forms of financial intermediaries occurred spontaneously in all the post-communist countries. However, there is another side of the process which refers to institutional change by design; the latter can have a heavy dosage of imitation or can present novel features. It can be said, therefore, that institutional change is the result of the interaction between spontaneous change and large scale re-engineering. Here one can see the tension between the work of organicist and constructivist forces.

Institutional change by design: are there any guiding principles?

There are several ingredients in the melting pot which produce policy in a transforming economy and it is worthwhile to present them with reference to the issue of institutional change; in this way policy options and constraints can be better explored.

Firstly, the interaction between the realm of ideas and policy needs to be mentioned; what I have in mind is the clash of paradigms. The neo-classical paradigm would consider the quick reallocation of resources and the maximisation procedures of agents. Simultaneously, a frictionless environment is taken as the standard and adjustment processes are viewed as being quickly triggered by price liberalisation. Rigidities are largely discounted which would in turn suggest that public intervention in managing adjustment is thought to be unnecessary. As to the question of picking winners, of creating comparative advantages, the *parti pris* is clearly against something which goes against the complete (undisturbed) operation of market forces. This equilibrium-focused paradigm pays less attention to the "innovation moment", to the entrepreneurial drive of agents which create new circumstances in the economy via disequlibria, as does the Neo-Austrian School. Since releasing "entrepreneurial energy" is essential for the transformation of the former command systems, this fact too hints at the need to go beyond the boundaries of the equilibrium based paradigm. The neo-classical approach also underestimates the time-consuming nature of building up institutions and their impact on economic performance.

Two other competing paradigms exist which provide a rationale for public intervention in the economy. One is the Neo-Keynesian approach which takes for granted the imperfection and rigidity of markets, of information and transaction costs, which all compound in portraying an economy in which adjustments cannot be frictionless and in which there can appear large externalities (positive and negative). Whereas some Neo-Keynesians are quite ambivalent as to whether public intervention can be effective (Gregory Mankiw), others - like Joseph Stiglitz - are in favour of selective intervention. There are, also, economists (Alice Amsden etc.) who point the finger at the East Asian experience and emphasise that public intervention went farther and constructed comparative advantages against the background of the operation of market forces.

A third paradigm, neo-structuralism (Lance Taylor, Sweder van Wijnbergen, etc.) looks at the tremendous structural distortions of the less advanced economies and stresses the "power of structure" and its consequences - the inability of price adjustments to trigger quick resource reallocation and the time-consuming nature of institutional change.

Applying the paradigms highlighted above demands understanding the reality of post-communism; huge resource misallocation, the precariousness of institutions, and the collapse of Eastern markets indicate the existence of much friction in the system and explain why production imploded and, also, why revenue collection fell so much in most of the countries (see Annex 2). Structural factors have significant explanatory power with respect to the evolution of output in the post-communist countries after 1989 and the resumption of growth in several economies appears to be due, to a large extent, to the build-up of *organisational* and *institutional capital*.

What all these paradigms need to incorporate nowadays are the effects of technological progress and of globalisation; namely, the need for flexible markets, for higher adaptability, has to be reconciled with the demands of building up human capital and of creating public goods as positive externalities. This is why the debate on capitalism in the making in post-communist countries is justified and highly relevant for policy-making.

Obviously, the paradigm embraced by policy-makers cannot leave policy unaffected, be it stabilisation, trade, or industrial policy. Let me give a simple example to show why industrial policy of a special kind is badly needed under the circumstances. If a big gap between exit and entry - caused by market forces - is accepted and, further, if this imbalance is seen as adversely affecting the size of the budget deficit, the development of the private sector and social stability, then the need for an industrial policy viewed as a damage-control device becomes quite clear. This means that when exit cannot proceed but gradually, the downsizing and the restructuring of enterprises involves government policy as well; in this situation, public intervention aims at managing change (possibly as crisis management) by processing market information. The magnitude of required resource reallocation asks for a restructuring process which combines market forces with the entrepreneurial activity of the state. To claim otherwise and to deny any role for the state is to live in a fantasy world, especially when liquidating very large plants means political decisions. In fact, this policy reality was imposed on policy-makers in several post-communist countries.

When viewed in relationship with institutional change and structural rigidities, the dispute “shock therapy”’ vs. “gradualism” loses much of its relevance for change cannot take place via a “big bang”. At the same time, gradualism is out of touch with reality when it ignores the institutional dissolution of the former command system, the collapse of external markets, and, consequently, the inability to control change from above.

Another ingredient of the “melting pot” underlying policy-making regards the competition between different brands of capitalism: the Continental vs. the Anglo-Saxon view. It is true that globalisation brings the variants of capitalism nearer and this is pertinently exemplified by the debate on corporate governance and labour markets. However, differences among the variants are still substantial and rooted in institutional specificity which predetermine economic and social performance. This competition affects policy formulation in the transforming economies in domains like the role of capital markets (vs. banks) in allocating resources, the size of the public sector, the role and the nature of state intervention in the economy, the content of the welfare state, etc.

The competition mentioned above takes place via several channels. One channel is scholarly debate which always has some impact on policy. A second channel is the advice of the international financial organisations. Thirdly, national states, as suppliers of financial assistance, come into the picture themselves. Clearly, Europeans (Brussels included) favour certain solutions whereas Americans propound their own model; I use generic terms since in both the USA and Western Europe one can find a wide range of opinions. Ultimately, real life itself makes a verdict, with feedbacks becoming an input of policy or even shaping the latter. A telling example in this respect is what happened with the mass privatisation programme in the Czech Republic and the role played by banks in the whole process. One would have expected a big surge in the role of capital markets and a corresponding diminution in the role of banks as resource allocators. It appears that history, a certain cultural background, the involvement of European banks, and the design of the institutional big bang (represented by the privatisation scheme) did not give way to the Anglo-Saxon model; this explains why many foreign business people complain about the lack of transparency (insider-trading) and the very close relationships between banks, local investment funds, and enterprises.

The need for public policies

The magic words of transformation are liberalisation, privatisation, stabilisation, and opening. Nonetheless, it would be hard for someone to dispute on solid grounds the need for public policy in the transforming economies. As J. Stiglitz and Nicholas Stern, the chief economists of the World Bank and the EBRD respectively, stressed “A well functioning economy requires a mix of government and markets. The balance, structure and functioning of that mix is at the heart of a development strategy” (1997, p.1). The real issue at stake is, therefore, the nature and the scope of public intervention. For instance, after the events of recent years in most of the transforming economies, can one deny the need of strict regulations regarding the banking industry and capital markets?

Clarifications regarding public policy are more than welcome in the case of post-communist economies, bearing in mind where they come from and where they intend to go to. Such clarifications are also needed because some people may find arguments in favour of public policy as being strange - in the historical circumstances of the transformation of the former totalitarian systems.[15] Moreover, such arguments may tempt some to capitalise on them in a direction opposed to market-based transformation. Nonetheless, such a risk should not deter a serious debate on how to formulate an intelligent public policy, wisely calibrated in order to serve transformation and modernisation.

Let us be more explicit by making reference to economic globalisation. Some - such as Kenichi Ohmae - would argue that economic globalisation destroys the effectiveness of national economic policy, implicitly, of public intervention; moreover, the relevance of the nation state, as a relevant economic entity, is strongly questioned. However, what economists call the “one price law” does function as a tendency and imperfectly; and the claimed mobility of factors of production is much incomplete and asymmetric in the contemporary world. Let us think only of the “mobility” of labour and of technological progress - the latter seen as an outcome of “clusters” of technologies (Michael Porter). Can one realistically assert that the genesis of technological clustering is to be explained by the work of hazard only?

In the world, there are powerful factors at work which push globalisation. Moreover, values and norms specific to industrial civilisation are to be highlighted, aside from the integration of financial markets. Such factors have a strong impact on the formulation and the effectiveness of national policies. Nonetheless, globalisation should not be equated with uniformisation and, particularly, equalisation of conditions; globalisation can coexist with and even deepen economic gaps.[16] Additionally, if attention is directed to the soft portion of a societal aggregate - that which ensures social cohesion and which makes individuals become members of a community (*Gemeinschaft*) - things get more complicated for analysis. National societies, as aggregates which are economically structured and politically articulated, have *cultural identities* with strong emotional content; human beings are not androids, and the need of identification is felt at the level of both family and community. Identification (the need of icons) and its linkages with public policy do affect the long-term performances of national communities (nation states).

Related to the ideas mentioned above it is worthwhile recalling Ernest Gellner’s thesis that nation states can be a driving force behind modernisation. The fact is that the world is made up of national aggregates which reveal different economic dynamics. If the world were atomised and borders (not only geographic) were irrelevant, no major economic discrepancies would be detectable among regions. This is why it makes sense to think in terms of the quality of national institutional settings and of national economic policies. If this line of reasoning is accepted, public policy gains its rationale as macro-economic policy, industrial policy in a broad sense (including foreign investment, education and development of infrastructure), trade policy, social policy, and last but not least, the working out (or the preservation) of a societal model hypostasised by values, principles and a “social glue”. An explicit or an implicit “social contract” between the citizenry and government is also to be included. Public policy refers to *norms* and *procedures* as well; without them policy could easily degenerate into malign authoritarianism.

In history one hardly finds examples of successful economic catching-up which did not involve exceptional vision and effective public policy. Therefore, the question is not whether public authorities should intervene in the economy; it is how and how much they should.

The capitalist world is multicoloured with respect to the quality of public policies. Thus, past decades in Latin America show how not to practice public intervention. Exacerbated populism in economic policy, large budget deficits (which were financed by inflation), overbloated public sectors, extreme import substitution and heavy subsidisation of unperforming industries, social and political clienteles, huge income inequalities, etc., are features of the ill-famed Latin American model. A glaring example of what bad public policies do is Argentina of 30 years ago, which changed from a very prosperous country before the Second World War into an economic mess during the years of Peronist policies. Likewise Venezuela, which in spite of its enormous riches has suffered from very poor public management in recent decades. In addition, there are examples in Southeast Asia where public policy proved successful. The results of the Asian Tigers in the 1970s and 1980s were due, essentially, to sound macro-economic fundamentals, high savings ratios, and clever (selective) public intervention in the economy. Their experience teaches the importance of export orientation, of educational build-up, and of infrastructure development. But at the same time, the recent and very severe financial crisis in East Asia highlights the economic merits of transparency, self-restraint, and strong institutions including healthy financial entities.

A conclusion is easy to infer: although there is a demand for it, the construction of a wise and effective public policy is a hard task for policy-makers bearing in mind the risk of committing major errors. Moreover, it can be argued that in the case of post-communist countries one is faced with an almost innate lack of capacity (including the mindset) to formulate and implement public policies - which is due to the legacy of communism.[17] But this state of affairs cannot obliterate the need for public policy, for rallying efforts for the sake of modernisation.[18] The big question is therefore: how to work out and implement clever public policies which on the one hand should unleash the forces of creativity and the energy of individuals, and on the other hand should solve problems which require state intervention - without bringing the demons of totalitarian thinking and practice back to life.

Three Major Challenges

I would submit that post-communist countries face three historical challenges:

- institutional construction (transformation);
- economic catching-up;
- ensuring social stability.

In what follows, several initial remarks are made on these challenges.

Firstly, the special historical and political context has to be underlined, namely, the transformation of the former command systems into market based democratic polities. The *political dimension* of the “Great Transformation” started in 1989[19] and implied the conquest - by citizens - of political freedoms and the build-up of political democracy. Therefore, the thesis can be advanced that in Central and Eastern Europe, authoritarian[20] forms of government, of managing transformation, would be rejected by citizens and would cause themselves instability.[21] This thesis should be judged from the perspective of other modernisation efforts - like in Asia where authoritarianism has been conspicuous for decades now.

Secondly, a distinction should be made between modernisation and economic growth, though, in a broad sense, the first notion comprehends the latter as an expression of the dynamic performance of institutions. Simultaneously, dealing with structural *strain* and macro-economic stabilisation are put under the umbrella of sustainable fast growth since they condition the latter.

Finally, the conventional analytical matrix represented by notions such as price liberalisation, stabilisation, and privatisation cannot capture each of the three major challenges.

Institutional change has not been neglected in debate but the burden of the past and the “path-dependency” issue need to be given more attention. In this respect, two important aspects deserve to be underlined. One refers to the impact of institutions on overall economic performance; poor institutions explain, *inter alia*, low yields in agriculture, the fragility of the banking sector, or the malfunctioning of democracy. Institutions can also explain why the entrenched patterns of corporate governance make the use of resources inefficient. The second aspect regards the existence of two types of fragility: one linked with the infant nature of institutions; and another type related to the extraordinary magnitude of the changes under way (*structural strain*).

It can be inferred that both pre-communist and communist histories influence a post-communist country’s transformation. Thereby, a modernisation strategy - where it does exist - needs to consider the difficulties of institutional build up and the available options; on one hand, “*natura non facit saltus*”, on the other hand, the “making of history” (as against the mere presence in history) and the overcoming of structural traps asks for big “historical jumps”, which imply vision and wise choices in the realm of institutional construction and modernisation strategy.

Rapid economic growth is not easy to achieve for there are no easy blueprints. Although conventional theory suggests that any economy that possesses cheap labour has the potential for catching up, ultimately what matters is the quality of institutions and of human capital. Again one can see the importance of institutions which determine the way resources are combined and used, and the overall performance of society. It should also be mentioned that institutions explain the size of savings ratios (as a premise for fast economic growth) and the attractiveness of a national space for foreign capital.

Ensuring social stability is going to be a major challenge in the years ahead. The lessons of history teach that distribution tensions in production and consumption affects the homeostasis and performance of societies (economies). Globalisation of trade and financial markets puts societies under much *strain* and enhances social fragmentation. The latter can be detected all over the world, including the economically most advanced countries. Therefore, in the transforming societies, wherein market reforms (including possibly ill conceived privatisation schemes) are likely to lead to rapidly increasing economic status differentiation and against the background of citizens' expectations (people expect revolutions to make them better off and soon), even fast economic growth can be accompanied by social tension if wealth discrepancies are perceived as too large. Social instability becomes an unavoidable phenomenon in an environment which produces marginalised people - or what the current French political terminology calls "les exclus" - systematically and on a large scale.

However much one espouses the vision and the precepts of economic liberalism, to close one's eyes in the face of reality is inexcusable and can lead to monumental policy mistakes. From this perspective can be assessed the dire need in the post-communist countries to reform what Kornai named "premature welfare states" since their total dismantlement hardly seems a realistic policy option (much like in Western Europe). In this context should be judged the importance of human capital build up and of public education as a means to ensure equal opportunities for all citizens.

It may be that capitalism finds itself in a stage on the secular cycle which explains the symptoms of fatigue and the loss of economic vitality in a series of Western countries. At the same time, tenacious modernisation efforts in emerging countries, the new information age, and globalisation explain the redistribution of economic power in the world. This stage of capitalism would suggest the need for institutional readjustments. It appears that in the age of large organisations, social aggregates (societies), even when they are market-based and rely on ubiquitous hard budget constraints, do not seem to have "institutional adapters" which could ensure spontaneity of large scale adjustments when needed. This state of being can explain the development of rigidities and inertia in large systems and lends additional meaning to Schumacher's "small is beautiful" sintagma. A *policy of adjustment* - which implies public intervention in order to trigger or smooth adjustment - demonstrates *ipso facto* this reality. Even the appearance of elements of the welfare state took place before Keynes's Magnum Opus, for it was asked for by social and economic dynamics.[22] The fact that it is high time today in many advanced capitalist countries to eliminate rigidities and institutional bottlenecks does not mean going back necessarily to the Victorian capitalism of the last century. That would be practically impossible. Moreover, the debate has to be carried on in terms of variants of capitalism and the direction world capitalism is heading towards.[23]

The dilemma underlined above has a double long-term meaning for a transforming economy: in the sense of imagining the systems in the making as a response to two sets of pressures, domestic and external. This assertion is made for its implications in both conceptual and policy terms. For it is one thing to view transformation, in a post-communist country, as a simple automatic by-product of world evolution after 1989; and it is something else if transformation is viewed as a modernisation process that has a powerful domestic engine. Does it make sense to talk about a project of society to describe what we are building in post-communist countries? I think it does. Talking about markets and democracy in an oversimplified way is insufficient analytically and cannot help identity solutions to the acute problems confronting economic policy in the short and the long run.

The Role of Institutional Capital

High savings ratios and the formation of human capital are essential for promoting rapid and sustainable economic growth. This is what both conventional and more recent growth theory underline. However, as argued herein, the primary determinants of growth and modernisation are to be sought elsewhere, namely, in the realm of institutions; the latter determine the quality of policies and the overall performance of the economy. This thesis is extremely important when applied to the case of transforming economies which face extraordinary challenges, particularly in the field of institutional build-up.

At the end, it may be of interest to present this author's visualisation of the role played by institutions in driving post-communist transformation. An attempt to capture institutions conceptually would pin attention on four forms of institutional capital: *social capital*, *civic capital*, *leadership capital*, and *cohesion capital*. Among these forms of institutional capital, there are visible linkages; their analytical separation is, however, useful.

Social capital refers directly to the norms which govern interactions among individuals, groups, and organisations. Kenneth Arrow (1974), Robert Putnam (1993), and, lately, Francis Fukuyama (1996) stressed the importance of social norms - as a form of social capital - for economic development. The difficulty for economic analysts is linked not necessarily with the fuzzy nature of the concept, but with the way institutions develop - in an incremental way, but without a mechanical determination. The import or the imitation of institutions can nevertheless be practiced without ensuring their required organic assimilation and social embeddedness.

Civic capital comprises several elements. Among them an essential role is played by the system of institutionalised checks and balances which is supposed to control power (those mandated to run public affairs). Another element is represented by civic organisations. Civic capital implies a generalised state of mind, of civic behaviour. As in the case of social capital, civic capital poses a critical question: are not these two forms of institutional capital - when seen as sources and resources of transformation (modernisation) - themselves a product of an advanced degree of societal development? Namely, do we not have here a vicious circle? These questions indicate the tension between organicism and constructivism as approaches to transformation (modernisation). In the post-communist countries, during extraordinary times,[24] decision-makers are almost condemned to be constructivists. Their actions need however to be wise and consistent in order to avoided major historical blunders.

Leadership capital becomes an issue whenever it is acutely needed. The real world of the life of organisations shows that leadership comes to the fore especially during hard times when critical decisions are to be made. Would it not be better that decisions themselves be subject to optimisations which should rid us of uncertainty, “artistry”, and arbitrariness? On the one hand, this is practically impossible; on the other, it may be quite undesirable since optimisation algorithms are likely to impede creativity and breakthrough which in turn lead to the gaining of a competitive edge and to progress in general. Moreover, transformation as a led-process involves more than the impersonal forces (mechanisms) of markets at work. Leadership, which involves vision and determination, cannot and should not be downsized to mere co-ordination.

Do post-communist countries have a significant stock of leadership capital? A pessimist would answer that a country’s economic and political elites are themselves “infant industries” and that spectacular results should not be expected. An optimist would stress the lack of homogeneity of humans, the existence, always, of exceptional individuals who can rise to the challenge of history, provide a sense of direction, and run organisations (social aggregates). In any case, since post-communist transformation is going to be a lasting process the performance of post-communist countries’ political and economic elites must have a high common denominator for a longer period of time - even if some of these countries have the chance to use NATO, the EU, and other international structures as institutional and policy anchors.

Cohesion capital is a form of institutional capital which may sound esoteric to some. I thought it useful to introduce it within the quadrangle by taking into account the importance of social stability for the long-term evolution of society. Here, as well, one encounters the dilemma: is social stability a prerequisite or a product of the process? In the same equivocal way, the answer springs into the open: social cohesion helps development, or going through difficult times, but is itself influenced by the process. It should be mentioned relatedly that the stock and the flow of social cohesion depend on the functioning of institutions. Therefore, a lot depends on the choice of institutional constructs which lend regularities to and give birth to norms in the overall functioning of society. From this perspective, it is justified to ask which kind of capitalism is more liable to ensure a higher degree of social cohesion concurrently with sustainable economic growth. Clearly, this is a question which has significant policy implications.

Endword…

Globalisation and the new information age, the quest to join the European Union and the redistribution of economic power in the world all pose enormous challenges to the transforming economies of Central and Eastern Europe. These economies need to "learn to race" when time cannot be compressed at will; they need to reconcile the exigencies of economic efficiency with those that demand coping with social fragmentation and with what Geoff Mulgan named *connexity* (1997), i.e., the interdependency as the defining characteristic of the world today. Moreover, these economies will have to focus on human capital build up as the main tool for securing long-term economic growth in a period of severe public budget retrenchment. How they find solutions to these and other challenges and whether, primarily, they can improve the quality of their institutions, will the long run, make the difference between success and failure.

Notes

1. Mancur Olson emphasised the role of institutions in economic development in a superb article in the *Journal of Economic Perspectives* (1996.).
2. Douglas North, The Nobel Prize winner, has exceptional contributions in this field.
3. See Stephen Haggard and Robert R. Kaufman (1995), or Adam Przeworski (1991). See also the volume edited by John Williamson on the political economy of reform (1994).
4. See my work on "Vitality and Viability" (1996).
5. Jeffrey Sachs (1996, p.130).
6. The Asian countries did not have to deal with the legacy of resource misallocation which is specific to former command systems. For them, the challenge consisted in saving and investing much. China, and more recently Vietnam, seem to be exceptions because they still have communist regimes. However, one should not forget that at the start of market reforms, both China and Vietnam had predominantly rural economies which mitigated the structural *strain* due to resource misallocation.
7. See also the remarks of the late Michael Bruno, quoted by William Pfaff (1996).
8. Attracted by the big undervaluation of assets; this undervaluation is reflected by the low P/E ratios in the post-communist countries where there are stock exchanges and over-the-counter markets (R. Bonte-Friedheim, 1996, pp.1 and 8).
9. Although one has to admit that the remarkable manner in which Hungarian policy-makers were capable of weathering the fallout of the Mexican crisis is a proof that things may not get implacably worse. However, it is worth repeating that Hungary is the country with the best track record of partial reforms before 1989; these partial reforms are at the roots of relatively better functioning institutions.
10. Although financial liberalisation is a worthy policy goal, it does not have to be pursued to the neglect of the need to build "proper institutional structures of supervision and regulation", in order to avoid financial disasters; this would imply a controlled pace of financial liberalisation (Frederic Mishkin, 1996, p.41).
11. Joseph Stiglitz, 1994, pp.267.
12. Jacek Rostowski, 1993, p.5. Similarly sceptical is Ronald McKinnon (1991).
13. Including the potential for the appearance of aggressive extreme-left groups, liable to engage in domestic and international terrorism. The existence of extreme-right (fascist) groups would compound the danger.
14. Janos Kornai, 1994, p.16

15. Jeffrey Sachs, 1995b, p.2. Though I agree with the main point made by Sachs I think he underestimates the importance of distributional effects entailed by market reforms. Living standards may increase overall and, nonetheless, people may vote against the government if the number of losers in society is high.
16. See also William Greider (1997)
17. Marek Dabrowski, the Deputy Minister of Finance in the first Polish post-communist government, stressed this aspect to me persistently.
18. Apart from the situation when modernisation can be viewed as a "dissolution" in a modernising transnational space - such as the EU in idealistic terms. But is such a vision realistic taking into account that accession implies having achieved already a certain level of development which conditions performance, and that even the EU is facing some deep structural economic difficulties?
19. I say "in general" since partial reforms were undertaken in Hungary and Poland before 1989 whereas Romanian communist leaders practised late Stalinism until that year.
20. *Authoritarianism* is not to be equated necessarily with *paternalism*.
21. I should admit that another logic could be applied as well: reforms can bring about a certain instability and the inability of authorities to administer them would favour the accession to power of authoritarian governments. Russia and other former Soviet republics - but not only them - can easily fall into this pattern. For this reason, analysis needs to be differentiated and consider various circumstances, changes, which can consolidate, or not, democratic processes.
22. Bismarck introduced the first elements of a welfare state in order to prevent the ascendancy of the socialist movement in Germany. 23. In this subject, see also Robert Barrio (1996), Zbignew Brzezinsky, Daniel Cohen, Will Hutton, Paul Kennedy, Paul Krugman, Jeffrey Madrick, Geoff Mulgan, Lester Thurow, J.D. Davidson and W. Rees-Mogg (1997), etc.
24. Leszek Balcerowicz remarked that extraordinary times demand extraordinary policies.

Annex 1
Income Per Capita in Several European Countries (in US dollars)

1993*	
Albania	999
Romania	2,806
Lithuania	3,110
Bulgaria	4,100
Latvia	5,010
Poland	5,000
Hungary	6,050
Slovak Republic	6,290
Estonia	6,320
Czech Republic	7,550
Greece	8,429
Portugal	9,982
Spain	13,110
European Union average	17,288

Sources: Transition Report, EBRD, October 1994, p.7; The European Union Survey, *The Economist*, 22 October 1994, p.4

* for the post-communist countries the income is calculated on a PPP (purchasing power parity) basis, which means that the figures are higher than the official ones.

Annex 2
***Strain* and Structural Change**[1]

As suggested by Daniel Daianu (1997), *strain* can be defined as the distance between two vectors of prices and quantities as follows:

$$: J = \frac{\sum_i q_i \left| p_i - p_i^* \right|}{\sum_i p_i^* q_i^*}$$

1. Research done by Joaquim Oliveira Martins from the Economics Department of the OECD (Paris); Ms. Anne Legendre assisted him.

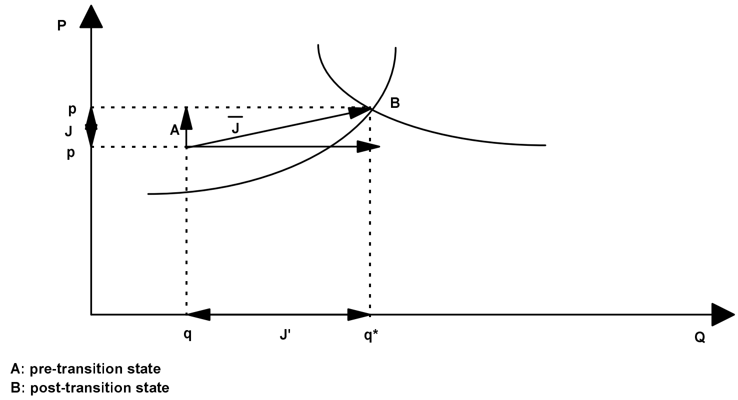
where p_i and q_i refer to current prices and quantities (at the start of transition) for the sector (I) and the (*) denotes their level after the full adjustment takes place. The latter could be associated, for instance, with a shift towards international prices and an economic structure closer to a western country (e.g. lower share of employment in agriculture and industry, and expansion of the service sector). This may give a justification for computing the strain indicator at a relatively aggregated level. At a detailed sectoral level, it would be much less meaningful to use a western country as a benchmark. A higher J means a higher strain, and thus a larger required change in relative prices. Another way of portraying strain is to focus on quantity rather than on price adjustment:

$$J' = \frac{\sum_i p_i^* \left| q_i - q_i^* \right|}{\sum_i p_i^* q_i^*}$$

These two indicators are dual measures of required structural change. Normally, one would expect the economy to adjust both to prices and quantities at the same time. It may happen, however, that either the price or quantity adjustment proceeds more rapidly. In consequence, one should take into account the total level of strain in the economy, i.e. the aggregate distance of both price and quantity adjustments:

$$\bar{J} = \sqrt{J^2 + J'^2}$$

Figure 1: *Strain* in an economy



The level of *strain* in labour market adjustment is compared with other countries in Table 1 below. The equilibrium level was defined, in a somewhat arbitrary way, as the structure of relative wages (on the price side) and employment (on the quantity side) in the UK for the year 1994 (latest data available). Another benchmark country could be used; the essential results do not change dramatically if, for example, France is chosen instead of the UK. The results suggest four main points:

- As expected, the distance between the UK and the transition countries, in particular Romania, is much higher than the distance vis-à-vis a country like France. It is important to confirm this basic and intuitive result before pursuing further the interpretation of the indicator.
- The level of strain in Romania is much higher for the employment structure than for relative wages. Somewhat surprisingly, Romania had by 1995 a much closer relative wage structure to the UK than other countries in transition.
- However, the overall required adjustment (combining the price and quantity sides) is the highest in Romania.
- Finally, without the agricultural sector, the structure of the Romanian economy would appear much closer to the other countries in transition.

This indicator confirms some of the features of the Romanian economy. Notably, the legacy of the previous economic structure appears to be particularly heavy in Romania at least when compared with other transition countries in Central and Eastern Europe. This may explain why there is so much resistance to structural change; and, also, why inflation and inter-enterprise arrears have become a way of diffusing the pressure in the system when unemployment is not allowed to exceed a certain upper limit (for political reasons) and when non-inflationary means for financing the budget are hardly available.

Table 1 - Levels of *Strain* in Labour Market Adjustment

	Romania		Hungary		Poland		Czech Rep.		Slovakia		Slovenia		*France*	Reference point: UK
	1990	1995	1992	1995	1992	1995	1991	1995	1991	1995	1993	1995	*1992*	*1994*
Relative wages (average monthly earnings = 100)[1]														
Agriculture and forestry	**104.2**	**81.6**	68.9	76.8	82.3	90.6	97.2	84.2	99.7	81.7	105.3	95.5	*72.5*	*77.9*
Industry	**98.6**	**107.6**	99.0	104.0	98.7	108.9	104.5	99.2	101.4	104.3	84.9	85.0	*111.1*	*116.5*
Construction	**110.9**	**106.4**	90.2	84.4	106.1	92.5	106.2	108.0	102.4	104.8	83.0	82.5	*98.6*	*109.2*
Trade, hotel and restaurant	**86.1**	**78.2**	97.0	90.0	90.3	88.9	85.8	88.2	89.3	94.0	102.2	99.8	*90.9*	*69.9*
Transport, communications	**108.5**	**121.0**	105.8	106.5	102.1	101.2	102.1	100.7	102.1	108.4	115.0	110.9	*105.4*	*144.6*
Financial banking and insurance, real estate and other services	**109.3**	**126.8**	144.7	137.4	147.7	137.3	99.9	130.7	103.9	131.4	143.8	124.6	*128.0*	*136.8*
Education, health and social assistance	**96.5**	**85.3**	93.5	86.5	86.9	81.7	93.2	91.2	97.6	87.2	111.8	109.6	*75.8*	*53.0*
Public adm. and defence, other branches	**88.9**	**88.6**	118.0	111.3	115.7	108.9	88.5	103.8	103.4	102.5	127.8	132.7	*91.0*	*93.6*
Index of "strain"[2] on prices	23.0	9.8	24.1	19.7	18.3	17.0	21.1	19.1	23.8	17.2	33.9	33.1	*11.7*	
(excluding agriculture)	**21.2**	**12.9**	26.0	21.3	22.9	18.1	21.2	20.0	24.0	18.6	34.5	34.8	*12.0*	
Employment shares (%)														
Agriculture and forestry	**29.0**	**34.4**	11.4	8.1	25.5	22.6	12.1	6.6	15.8	9.2	10.7	10.4	*5.2*	*2.0*
Industry	**36.9**	**28.6**	30.2	27.1	25.2	25.9	41.0	33.2	35.9	30.3	38.7	38.0	*20.6*	*20.2*
Construction	**6.5**	**5.0**	5.4	6.0	6.6	6.1	5.7	9.2	8.2	8.6	5.4	5.1	*7.2*	*6.4*
Trade, hotel and restaurant	**6.7**	**10.4**	14.8	15.9	10.7	13.6	7.8	15.7	8.1	13.1	14.6	15.4	*17.4*	*20.8*
Transport, communications	**7.0**	**5.9**	8.6	8.8	5.5	5.8	9.0	7.7	5.5	7.8	6.5	5.9	*5.8*	*5.8*
Financial banking and insurance, Real estate and other services	**3.9**	**4.2**	5.2	5.9	1.3	2.0	5.4	6.7	5.4	5.8	4.6	6.1	*10.8*	*12.5*
Education, health and social assistance	**6.7**	**8.1**	13.6	15.6	13.1	13.3	13.8	12.1	16.5	14.5	10.2	11.4	*6.9*	*14.5*
Public adm. and defence, other branches	**3.1**	**3.4**	10.6	12.5	12.1	10.7	5.1	8.8	4.6	10.7	9.2	7.6	*26.2*	*17.9*
Index of "*strain*" on quantities	91.4	76.6	47.6	37.2	60.4	56.7	68.1	47.1	68.7	45.9	62.2	56.7	*13.8*	
(excluding agriculture)	**76.4**	**57.5**	41.5	33.7	46.0	42.4	63.1	44.4	63.4	43.2	52.9	48.3	*21.8*	
Indicator of total "*strain*"	94.2	77.2	53.3	42.1	63.1	59.2	71.3	50.8	72.6	49.0	70.9	65.6	*18.1*	
(excluding agriculture)	**79.3**	**59.0**	49.0	39.9	51.4	46.1	66.6	48.7	67.8	47.0	63.2	59.5	*24.9*	

1) Gross monthly earnings, except for Romania, were net.
2) The *strain* indicator is computed as a distance between the structure of relative wages and employment vis-à-vis the UK in 1994.
Source: National Commission for Statistics and OECD.

Annex 3
Comparative Study of Government Revenues (Total Revenue) for Selected Eastern European Countries, 1990-1997 (in %age of GDP)

	1990	1991	1992	1993	1994	1995	1996
ROMANIA	39.7	41.9	37.4	33.9	32.1	31.9	29.6
ALBANIA	46.8	31.5	23.5	25.6	24.5	24.0	...
BULGARIA	52.9	40.4	38.4	37.2	39.9	36.2	33.6
CZECH REPUBLIC	...	...	48.2	50.5	49.4	48.4	...
HUNGARY	52.1	50.9	50.0	50.7	49.6	46.6	45.8
POLAND	45.4	42.4	43.9	47.6	47.2	47.2	45.7
SLOVAK REPUBLIC	...	...	46.1	44.2	46.3	46.8	…
RUSSIA	…	…	…	…	…	…	13
KAZAKHSTAN	…	…	…	…	…	…	18

Sources: Country authorities; and IMF estimates.

The question of the budget deficit invites a multi-level debate. The first level concerns the systematic trend of rapidly falling revenues to the state and the consolidated budget. This trend sets countries apart. In the Czech Republic, Hungary or Poland, these revenues amount to over 40% of GDP - close to the level encountered in the West. In Romania, it took only a few years for the consolidated budget revenues to drop from about 40% of GDP to less than 30% of GDP. Things are far worse in Russia and other CIS countries. This fall reflects the institutional crumbling of the former command systems, but also the frailty of the new institutions. The effects are easy to sense: the public authority finds it increasingly difficult to provide for essential public services (health care, education, public order, etc.) and the state starts to rely ever more strongly on borrowing in order to be able to cover the budget deficit. The second level of debate relates to the crowding-out effect of the state's growing indebtedness on the private sector. Last but not least, when budget deficit financing from non-inflationary sources is not easily at hand, the magnitude of this deficit bears on the inflation rate and this fuels inflationary expectations.

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