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THE BENEFITS OF IGNORING *IMF*[1]

Tranzicije u Istočnoj Europi i bivšem Sovjetskom Savezu započela je s jasnom slikom stvarne situacije bez potpuno razrađene sheme novog ekonomskog sustava, i bez prikladnih ekonomskih i društvenih aranžmana na pravom mjestu. Slovenija se često uzima kao uspješan primjer tranzicije. Slovenija je zapravo posjedovala daleko najbolje početne uvjete, jer mnoge bitnosti tržišne ekonomije stvorene su prije godine 1989. i mogla si je priuštiti primjenu tranzicije oprezno bez pragmatizma i averzije prema riziku prilikom odbijanja pokroviteljstva MMF-a i stranih savjetnika.

What went wrong if anything?

What can we say after ten years of transition? Was it a success or was it a failure? Was a high speed of transition bound to the so called Washington agreement a major error as suggested by Joseph Stiglitz (Stiglitz,1999)? The answers to the questions depend on the goal. If the goal was the destruction of the old political regime, transition can be considered a success, if, however the goal was the creation of economic prosperity, the answers is, at best, ambiguous. Expectations of prosperity have not materialized. Instead, transition has proven to be a painful process with many setbacks, and social and political tensions emerging from the redistribution of income, wealth, and power. Production declined, unemployment increased, distribution of income worsened, and most people suffered substantial reductions in their standards of living. Michael Ellman (Ellman, 2000) distinguishes the following major social costs of transition: increase of impoverishment, decline of employment, growth of unemployment, increased inequality, deterioration of

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public services and polarisation of their provision, spread of disease, decline of fertility, increase in mortality, depopulation, criminality, growth of corruption, and armed conflicts. The disappointing economic outcomes and, even more so, enormous social costs could in some countries even push political process back towards variety of non-market and non-democratic arrangements.

It is beyond the scope of this paper to try to distinguish between avoidable and unavoidable economic problems and social costs related to transition. It is also obvious that social costs of previous transition to socialism in Russia (1917-1922) and in the rest of Eastern Europe (1945-1949) were incomparably higher. However, this can hardly be an excuse for the architects of transition. Their promises which are well represented by the slogan "If the people.. can endure the hardship that the policies of stabilization, liberalization and institution building inflict, they will emerge at the other end of the valley of tears, into the sunlight of Western freedom and prosperity" (Mandelbaum, 1993) do not differ much from similar promises of old communist regimes.

Transition countries are in a vast literature of "transformatology" often grouped into transition models. However, the commonly used division to "the shock therapy" and "the gradual" model does not provide proper grounds for reasonable grouping. First, the patterns of transition were various mixtures of systemic changes and economic policies, some of which could be considered elements of a gradual approach while others could be considered elements of a shock therapy. Second, what was a shock for one country, for example price and trade liberalisation, was an element of a gradual approach or even an element of the initial conditions in another country. Third, one could argue that transition in most countries consisted of a rather chaotic mixture of systemic changes and economic policies.

The division suggested by Stanislaw Gomulka (Gomulka, 2001) to three models: (1) shock therapy model followed by former Eastern Germany, (2) gradual model followed by CIS countries, and (3) rapid adjustment model followed by CEE countries does not provide better grounds for grouping. Furthermore, allocating a country to a transition model by the outcome of transition and claiming, for example, that acceptance of the rapid adjustment model generated relative success of CEE countries while acceptance of the gradual model caused failure in CIS countries is superficial. What really mattered were initial conditions; most CIS countries simply did not posses institutions or even memories of institutions required to introduce the elements of the rapid adjustment model.

Transition to a market economy, a counterpart to sweeping political and ideological changes began without clear picture of the actual economic and social situation, without a fully worked-out scheme of a new economic system, and without suitable economic and social arrangements in place. They were replaced with explicit or implicit assumptions that the elimination of deformed non-market institutions, restoration of private ownership, and a laissez-faire free market mechanism would transform socialist countries instantly into welfare states. New, mostly inexperienced governments were assisted by international financial institutions and Western scholars who in most cases learned about the countries from tourist brochures and journeys from the airports to Holiday Inn hotels. In addition, many domestic radicals and foreign advisers were ideologically biased and politically motivated - their major goal being destruction of socialism and existing institutions rather than creation of a viable economic system and increased economic prosperity for everybody. In short, previous "prevention of capitalist exploitation" paradigm was replaced by what George Soros called "market fundamentalism".

Privatisation was considered the cornerstone of transition; it has been assumed that it would improve efficiency in the use of resources, enable fairness in the distribution of wealth and welfare, and serve in the abolition of the mono-party system. The efficiency assumption of private property is, rightly so, taken for granted. Indeed, private property is a necessary condition for economic efficiency but it is not sufficient. If one cannot find stakeholders responsible for the proper use and maintenance of capital assets the efficiency would decrease rather than increase. Furthermore, responsible owners cannot be created by a decree. The validity of the second assumption, i.e. that privatisation is to bring fairness into distribution of wealth and welfare is, at least, dubious. Fairness is an extremely ambiguous concept as illustrated, for example, by enormous variations in income redistribution and social protection such as pensions and health care, even among most developed market economies. It is also true that the dominance of private property rights is a proper basis for a stable political democracy. However, the new political and economic elites created in transition, and foreign investors have given a new meaning to what is proper privatisation. In short, it should increase their political legitimacy, wealth, and profits which therefore became the criteria to evaluate the performances of ownership "restructuring". Actual privatisation techniques therefore reflected specific distribution of political power and the ideas of randomly chosen western "privatisers". Their privatisation schemes however exhibit one common characteristics; they were grandiose administrative operations outclassing the dreams of central planers.

The creation of proper legal framework and market institutions which enable "invisible hand" to replace administrative controls was also neglected. However, even if legal framework and market institutions similar to those that exist in developed market economies could be established quickly, their existence would not imply that the problems are overcome. It is namely unlikely that formally the same institution in a new market economy would operate as it does in a developed market economy. The performance of market institutions depends on norms and patterns of social behaviour. The development of market institutions can be, as it was the case in the West, a gradual process of interactions between economic development, politics, and institutions of civil society.

Macroeconomic stabilization was considered another pillar of transition. However, the assessments of initial macroeconomic conditions in CEE and CIS countries were false from the very beginning or quickly became false. The so called “monetary overhang” and shortages which presumably existed in socialist economies disappeared practically overnight by high inflation or hyperinflation, while basic policy prescriptions were based on the assumption that Aggregate Demand exceeds Aggregate Supply. The corresponding stabilization policies therefore suggested the reduction of the gap by restrictive monetary and credit policy, rapid liberalization of foreign trade and prices, while anchoring exchange rate, wages, and government spending. Too much stress was given to stop inflation although causal links between growth and inflation, monetary policy and inflation, or budget deficit and inflation in the initial stage of transition are questionable. Wrong economic policies therefore augmented transformational depression, and pushed more goods to the bunch of Balzerowicz`s “pure socialist production goods” thus destroying domestic manufacturing and transforming many countries, notably Russia, to become providers of raw materials, and most other CIS countries without raw materials to become the third world countries.

Inflation, interest rates, exchange rate regimes, existence of financial institutions, financial deepening, liberalization of capital flows, and share of private sector in GDP have been commonly used performance criteria which is, at least, questionable. Instead, macroeconomic performance of CEEs should be judged much more by sustainability of growth linked to the current which is also the only lasting remedy for social problems. It is therefore of interest to see whether conditions for a sustainable growth have been created. Here, **sustainable growth** is defined as growth which an economy attains for a longer period without lasting current account deficit; the latter namely implies reliance on foreign savings in different forms: assistance, loans or sale of the assets to foreigners.

Table 1

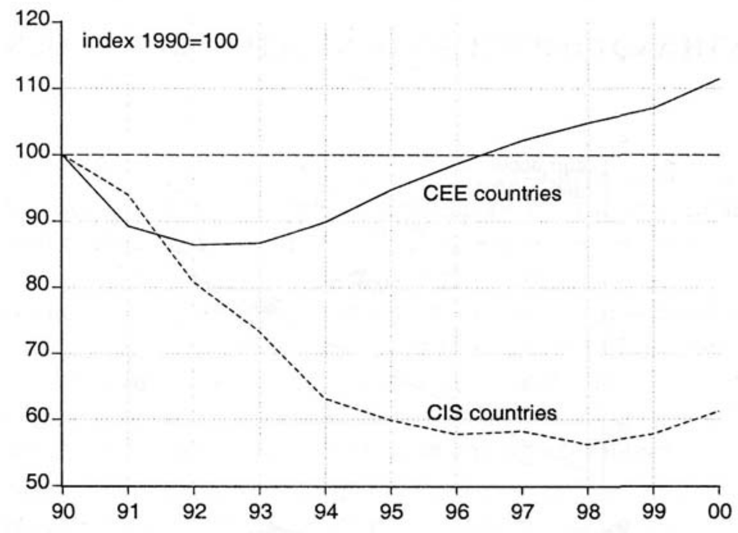
GDP GROWTH AND CURRENT ACCOUNT IN *CEE* AND *CIS* COUNTRIES

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
				GDP	**growth**					
CEE	-10.7	-3.2	0.3	3.7	5.4	4.1	3.6	2.6	2.1	4.1
CIS	-6.0	-14.1	-9.3	-13.8	-5.2	-3.5	0.9	-3.5	2.8	5.9
				Current	**account**	**share**				
CEE	-2.0	-8.6	-2.5	-1.7	-3.3	-5.9	-6.4	-6.4	-6.1	-5.8
CIS	-	-6.6	-7.0	-4.6	-4.9	-7.4	-8.2	-10.1	-6.3	-4.6

The growth figures presented in Table 1 (by rates) and Figure 1 (by indexes) indicate that CEE countries passed transformational depression in 1993, entered a period of rapid recovery which has been followed by the period of decreasing growth. The turn in the CIS countries lagged for five years; they reached the bottom in 1998. As the results in 1999 and 2000 were affected by the increase of oil prices, the discussion on sustainability of growth in CIS countries seems premature. Let us therefore concentrate on CEE countries alone i.e. only on ten applicants for the EU membership.

Figure 1

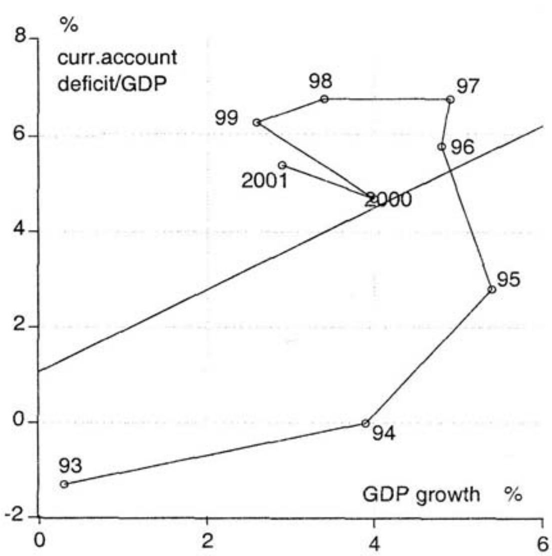
GDP IN *CEE* AND *CIS* COUNTRIES



Combination of GDP growth and current account balance in GDP for ten countries has been changing from year to year. In 1993, which marks the end of Kornai's "transformational depression", four countries combined decline in GDP with current account deficit, two had a combination of decline and surplus, in two countries growth was accompanied with deficit, while two countries exhibited growth with surplus. In 1994, four countries combined growth with surplus. Since 1995, combination of growth and current account deficit have prevailed indicating that applicant countries have relied more and more on foreign savings to finance growth. In 1997, only Slovenia retained growth without deficit while in 1999, Slovenia was the only country in which growth of GDP exceeded the share of current account deficit in GDP. Is a rather modest growth in CEE countries sustainable if sustainability is defined as ability to grow without foreign savings, regardless of the form in which they enter the country?

Figure 2

GROWTH AND CURRENT ACCOUNT DEFICIT IN *CEE* COUNTRIES



The dynamics of growth and current account since 1993 in CEE countries is presented in Graph 2 by a scatter diagram with average GDP growth on the horizontal and average current account deficit in GDP on the vertical axis. Only in 1994 and 1995, average growth rates exceeded average current account deficits; rather modest average growth between 2 and 4 percent has been since accompanied by an average current account deficit of approximately 6 percent. In short, sustainable growth as defined above turned to decline already in 1996. The performances of individual CEE countries also confirm that high growth has been accompanied by enormous current account deficits, particularly in the three Baltic countries, and that reliance on foreign savings has been growing. This might be a warning that economic vitality of CEEs, i.e. their potency to grow without reliance on foreign savings is weak and fading. This also casts doubts on the assumption of convergence of the applicants towards EU countries; the existing gap between EU and CEEs might escalate rather than diminish, making a delayed accession even more difficult than a "premature" one (Mencinger, 1999).

The "Slovenian transition model"

Slovenia, being part of Yugoslavia, shared its advantages and disadvantages compared to other socialist countries in Eastern Europe, particularly a rather specific economic and political system. Many of the essentials for successful economic transition were, at least partly, met before 1989; enterprises were autonomous, basic market institutions existed, and government used some standard economic policy tools. Slovenia was far the richest part of Eastern Europe with homogeneous, socially stable population; a diversified manufacturing sector; predominantly private agriculture, partly private service sector, well established economic links with western markets; and geographic position were among advantages.

Economic development in Slovenia can also be divided into three distinct periods; "transformational depression" 1991-1993, "recovery 1993-1995", and "steady state" afterwards. Independence brought predictable economic results induced by dramatic reduction of trade with former Yugoslav republics. Production was pushed down to a decline by 9.3 percent in 1991, and 6.0 percent in 1992. Employment went hand in hand with decrease of economic activity; total employment fell by 5.6 percent in 1992, and by 3.5 percent in 1993. The so called restructuring of the economy consisted mainly of "firing and retiring"; number of unemployed nearly quadrupled in three years, total unemployment reached 137 thousands in the last quarter of 1993, with official unemployment rate exceeding 15%, the number of pensioners doubled in the same period to 408 thousands. Both demanded enormous social transfers and increase in the share of public expenditures in GDP. At the same time, a switch from the former Yugoslav to the "genuine" foreign market led to a trade surplus in 1992 which was a joint result of increased exports and reduced imports due to the contraction of domestic demand and vanishing links with the rest of Yugoslavia.

In 1993, the country reached the bottom of the depression. GDP increased slightly, and turned to growth of 4 percent in 1994. While rapid recovery ended in 1995, macroeconomic performances in the first decade of the country existence can be considered satisfactory. Growth stabilized on the 3-4 percent annually, unemployment acquired European characteristics based on asymmetric employment patterns (Mencinger, 2000), prices have been gradually stabilized, budget remained roughly balanced. Surplus in services has until 1999 outweighed deficit in trade, and foreign exchange reserves have until recently matched foreign debt.

Table 2

SLOVENIA AND OTHER *CEE* COUNTRIES

1993-2001 averages

	Slovenia	CEE (8)
GDP growth	4.1	3.6
Inflation rate	13.0	15.9
Current account	-0.5	-4.1
Budget balance	-0.8	-3.0

Double transition, from a socialist to a market economy and from a regional to a national economy, was accompanied by structural changes from manufacturing towards services, and from large towards small enterprises. Restructuring has been gradual, disorganised, and managed by enterprises themselves, and only occasionally combined with ad hoc government interventions in cases of large troubled enterprises.

Social stability has remained an important advantage of Slovenia; it was based on regional dispersion of industry, which together with land holding limit created part time farmers as an important social group[2]. Social costs of transition were paid

[2] In 1998, Human Development Report was for the first time prepared for Slovenia. The Human Development Index which encompasses indices of economic development, health, and education and is used for international comparison, put Slovenia in 26th place among 194 countries which is 11 places above its ranking measured by GDP per capita

by middle age unadaptable industrial workers. The majority of Slovenian population quickly adapted to a new political order and accepted it as legitimate which implies that the support for democracy has become largely unconditional and independent of its economic and social effects (Bernik, Malnar, Toš, 1997).

The controversy of "shock versus gradualism" to changes in economic system arose in Slovenia during preparations for independence and immediately afterwards. The "shock therapists" supported by foreign advisers suggested an overwhelming package encompassing price stabilization, fixed exchange rate, balanced budget, administrative restructuring of the manufacturing and of the banking system, and centralized privatisation. Gradualists, on the other hand, suggested decentralized privatisation, gradual construction of missing market institutions, and flexible economic policy based on floating of the new currency. It was hoped that such policy would result in a smaller loss in product and lower unemployment on the account of some inflation. Pragmatism and gradualism prevailed which relates both to economic policy and to changes in economic system.

The controversy of "shock versus gradualism" was clearly expressed in the concepts of privatization. Two major concepts competed; one proposed a gradual, decentralized, and commercial privatization, the other insisted on a mass, centralized, and distributive privatization. Political rather than economic issues were in the centre of the dispute; the gradualists believed that legacy of selfmanagement could be used in transition, while the shock therapists insisted that the socialist past is to be forgotten. The controversy resulted in a stalemate lasting a year and a half and ending in a compromise. The Law on the Ownership Transformation passed in November 1992 combined decentralization, gradualism, and diversity from the first concept with free distribution of vouchers from the second concept. According to the law, privatization was to be attained in a variety of patterns and their combinations: restitution to former owners; debt-equity swaps; transfer of shares to the Restitution Fund, the Pension Fund, and the Development Fund; distribution of shares to employees; managers and workers buy-outs; sales of shares or of the company; and raising additional equity capital. The patterns and their combinations were to be chosen by enterprises.

Actual start of formal privatisation was sluggish. In 1993, only 135 enterprises (of 1380 which were to be privatized) presented their privatization programs to the Agency and 31 programs were approved. Slightly more than 50 percent of enterprises did that during 1994; and 98 percent presented their programs by May 1995[3]. Demand for assets was assured predominantly by voucher certificates which were

[3] The privatisation in infrastructure and some state owned enterprises in other sectors (steel industry) has not yet started.

distributed to population[4]. Twenty three investment companies with forty investment funds were established mainly by banks and insurance companies. They were competing for the vouchers of those who could or would not use them in their "own" enterprises, or in the auctions. By August 1995, eighty percent of vouchers were used and four biggest investment companies collected 54 percent of certificates. In 1997, privatisation was formally over but most comanies in infrastructure and some companies in other sectors which nobody wanted remained nonprivatised.

Internal division of shares combined with internal buy-out was the most popular method of privatization applied above all by profitable small and medium-sized firms. A combination of public auction and internal division of shares was used by profitable large firms in which majority could not be assured by a combination of internal distribution and buy-outs. Auctions namely enabled predominance of insiders and dispersed external owners over institutional owners. Large loss making firms with no demand for shares by insiders or general public have however remained in the hands of Development Fund or state owned. Foreigners participated in privatization but Slovenia has been far less eager to attain foreign capital than other socialist countries. This can be explained by relative wealth of Slovenia's population, ability of the existing companies to compete on the world market, and privatization rules which did not favour foreigners. On the other hand, foreign investors have also not been queuing; Slovenia's market is too small, and real wages too high. In short, despite fallacies and problems discussed elsewhere, privatization in Slovenia could be considered a kind of "second best solution" and caused less damage than in other CEE countries.

Pragmatism proved successful in preparing institutional settings for a "new" country even before the proclamation of independence[5] and characterized macro-economic stabilization as well. Independence of the central bank (Bank of Slovenia, BS), prompt introduction of floating exchange rate, and benign neglect of inflation

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[4] Three laws added considerably to the scope of privatisation. The Law on the Apartments enabled privatisation of approximately 100.000 apartments; the Denationalisation Act introduced restitution of property nationalized under the communist regime; the Law on Cooperatives assigned 40 percent of shares in chosen food processing enterprises to the farmers cooperatives.

[5] The predominant part of systemic framework for an efficient market economy was created in 1990 and 1991, i.e. before political independence. Simple, transparent, and non-discretionary system of direct taxes was introduced by Income Tax Law and Profit Tax Law. The statutes regulating monetary and financial system such as Law on the Bank of Slovenia, Law on the Banks and Saving Institutions, Law on the Foreign Exchange Transactions, and Law on the Rehabilitation of the Banks and Savings Institutions were passed together with the Declaration of Independence in June 1991. After independence, missing legal rules which guide economic behaviour (company law), assure a predictable bargaining framework (codes regulating business transactions), enforce rules, and resolve disputes (bankruptcy, competition) were added. In short, one might assert that proper legal framework for an efficient market economy exists.

were the cornerstones of successful stabilization. Such policy mix was at odd with then prevailing doctrine; Slovenia was lucky enough not to be recognized by IMF and The World Bank when the system was created. During initial consolidation (October 1991 - June 1992), BS managed to determine appropriate amount of money for a new country, and to lessen inflationary expectations. Fears of continuing shortages of foreign exchange have not realized[6]; abundance rather than shortage soon prevailed and foreign exchange reserves began to grow. Indeed, BS had to intervene to prevent excessive real appreciation; the largest interventions (purchase and sterilization) took place in the second half of 1994 and in 1997. Decline of inflation which was due to reduced inflationary expectations augmented by increased competition home and abroad and very favourable terms of trade allowed gradual reduction of nominal and real interest rates.

Budget has remained roughly balanced. When the squeeze in economic activity reduced public revenues and increased the needs for social transfers, it was impossible to bridge the gap by budget deficit; its financing by printing money was ruled out, domestic savings were low, borrowing abroad would boost abundance of foreign exchange, further strengthened the Tolar and reduced competitiveness. Consequently, share of public revenues (taxes and contributions) in GDP had to increase and stayed high. Tax structure was gradually changing; the replacement of sales taxes with VAT was after many postponements finally introduced in July 1999. Rather low share of public debt to GDP emerged by obligations related to independence and rehabilitation of the banking system.

The ambiguous role of the former political elite in the transition process often raises a question whether this elite would like to reproduce the old socialist political system. This is nonsense. A vast majority of former members of the League of Communists had already in the 70s changed into a sort of bureaucratic elite which could easily adapt to any changes and to any system of values[7]. At the end of the eighties, a basic consensus on democratization was achieved without formal negotiations. This partly explains why transition was smooth and peaceful, why the members of the former elite became an ally of the emerging civil society against Yugoslav authorities, why they adapted so quickly and successfully to changes in the society, and why they became the winners in the process of transition. This, no doubt, is an issue which threatens the moral foundation of the society. However, an economist could argue that adaptation of the old elite has been cheaper than creation of a new one.

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[6] The design of foreign exchange market in Slovenia described elsewhere (Mencinger, 1993) was influenced by the heritage of persistent shortages of foreign exchange which had prevailed in Yugoslavia. Various restrictions were therefore imposed on the foreign exchange markets. Most of them were abolished in 1992 when the abundance prevailed over shortages.

[7] Liberalism of the Slovenian League of Communists in the 1980's made it possible for Slovenia to become a forerunner in political changes in Yugoslavia; the stand of the Party on the issues of Kosovo, the fact that its delegates left the Yugoslav Party Congress in 1989, and withdrew from it in 1990 characterize its behaviour.

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PREDNOSTI NE UZIMANJA U OBZIR *MMF*

Sažetak

Tranzicija u Istočnoj Europi i bivšem Sovjetskom Savezu započela je s jasnom slikom stvarne situacije bez potpuno razrađene sheme novog ekonomskog sustava, i bez prikladnih ekonomskih i društvenih aranžmana na pravom mjestu. Umjesto toga postojalo je eksplicitno i implicitno vjerovanje da će uklanjanje izopačenih netržišnih institucija, uspostavljanje privatnog vlasništva i laissez-faire mehanizama slobodnog tržišta odmah pretvoriti socijalističke zemlje u države dobrobiti. Iluzije koje su poduprli MMF, druge financijske institucije i brojni zapadni savjetnici, pokazale su se iluzijama.

Slovenija se često uzima kao uspješan primjer tranzicije. Ekonomska događanja u prvoj dekadi postojanja zemlje su uspješna i društveni troškovi tranzicije su prilično niski. Razloge za to treba tražiti u dva glavna pravca: početni uvjeti i uzorci tranzicije. Slovenija je zapravo posjedovala daleko najbolje početne uvjete. Mnoge bitnosti tržišne ekonomije stvorene su prije 1989; poduzeća su bila autonomna, osnovne tržišne institucije su postojale i Vlada je koristila standardna sredstva. Ne manje važna je činjenica da si je Slovenija mogla priuštiti primjenu tranzicije oprezno bez pragmatizma i averzije prema riziku prilikom odbijanja pokroviteljstva MMF-a i stranih savjetnika.