

EMERGING EUROPE FOCUS

21st Sep. 2011



Lessons from the Fall of the Wall

- **The vast bulk of growth in Emerging Europe since the fall of communism can be explained by the better allocation of resources that has resulted from the transition from central planning to a market economy.** However, the most important lesson from the past twenty years for both policymakers and investors is that those countries that combined economic reforms with institutional reforms have prospered the most.
- At first sight, the performance of Emerging Europe in the post-Communist era has been pretty disappointing – indeed, real GDP growth has averaged just 1% a year since 1989. But this masks the fact that a huge recession during the first decade of transition was followed by a decade of relative prosperity from the late 1990s, during which growth averaged 5% a year – similar to the pace of growth seen in other emerging economies (albeit still slower than in China and India).
- Moreover, output in every country in the region is now significantly higher than it was at the end of communism when measured in current price US dollars. This reflects rapid real exchange rate appreciation in the region, which has led to a substantial increase in purchasing power in world markets. As a result, per capita GDP (measured at market exchange rates) has trebled over the past 20 years, rising from \$3,000 in 1989 to \$10,000 today.
- Increased prosperity has been due primarily to the better allocation of resources brought about by the transition from central planning to a market economy. **Thus, while the initial reorganisation of labour and capital created huge upheaval and was responsible for the deep recession in the early years of transition, it also paved the way for the impressive growth that followed later.**
- The most important reforms that were undertaken during the first decade of transition included the development of a private sector; the introduction of a proper price mechanism; the opening up to trade and capital flows; and the development of credit markets.
- But the development of institutions to support private enterprise and markets was also critically important. **Indeed, in those countries where institutional reform has been deepest, such as Poland, Hungary and the Czech Republic, market reforms have become more entrenched and growth has been faster.** By contrast, in those countries where institutional reform has been more gradual, such as Russia and Ukraine, economic growth has been correspondingly slower. It follows that for these economies, institutional reforms to improve the business environment, protect property rights and stimulate investment are now critical if rapid catch-up to Western levels of income is to be achieved.

Neil Shearing

Tel: +44 (0)20 7808 4985

North America

2 Bloor Street West, Suite 1740
Toronto, ON
M4W 3E2
Canada
Tel: +1 416 413 0428

Europe

150 Buckingham Palace Road
London
SW1W 9TR
United Kingdom
Tel: +44 (0)20 7823 5000

Asia

16 Collyer Quay
Singapore 049318

Tel: +65 6595 5190

Managing Director
Chief Emerging Markets Economist

Roger Bootle (roger.bootle@capitaleconomics.com)
Neil Shearing (neil.shearing@capitaleconomics.com)

Lessons from the Fall of the Wall

From Cairo to Cuba, the prospects for economic and political reform in some of the world's poorest regions seem to be brightening. But what steps do policymakers need to take in order to set an economy on the path to lasting prosperity? In this *Focus* we take a look at the lessons from Central and Eastern Europe's transition from Communism.

Transition: The Facts

At the outset, we need to set the scene with a few facts about Central and Eastern Europe's (CEE) development over the past couple of decades¹. A thorough analysis is, of course, made difficult by the paucity of good quality data from the communist era. This makes it tricky to assess accurately the region's starting point.

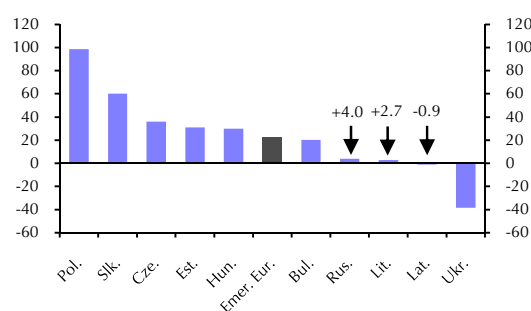
Nonetheless, even with this important caveat in mind, the performance of Central and Eastern Europe over the past twenty years or so appears, at first sight, to have been pretty disappointing. Indeed, in real terms regional GDP is now just 20% greater than it was in 1989, when the first communist regimes were toppled. **Put differently, real GDP growth has averaged just 1% a year since the 'Fall of the Wall'.**

The reality, however, is a little more complex for at least three reasons. **First, there has been a vast divergence in performance among countries.** Poland stands head and shoulders above the rest of the region in this respect. In real terms, its GDP nearly doubled between 1989 and 2010. (See Chart 1.) This equates to an average growth rate of 3.3% a year – well above that seen in other countries. The rest of Central Europe (the Czech Republic, Slovakia and to a lesser extent Hungary) has fared reasonably well too – output here has increased by around one-third since 1989 (equating to an average growth rate of 1.6% a year). Likewise, real GDP in Estonia is now just

over 30% larger than it was in 1989, despite the fact that the economy shrank by almost 20% in real terms between late 2007 and mid-2009 after the bursting of last decade's property bubble.

By contrast, the other ex-Soviet Union States and the economies of South Eastern Europe (Bulgaria and, in particular, Romania) have lagged behind. In real terms, Russian output has barely changed since 1989. In Ukraine, it has *fallen* by nearly 40%. Given the comparatively large size of the Russian economy in particular, this has had the effect of dragging down the average growth rate for the region as a whole.

CHART 1: CHANGE IN REAL GDP (% 1989-2010)



Sources – World Bank, Capital Economics

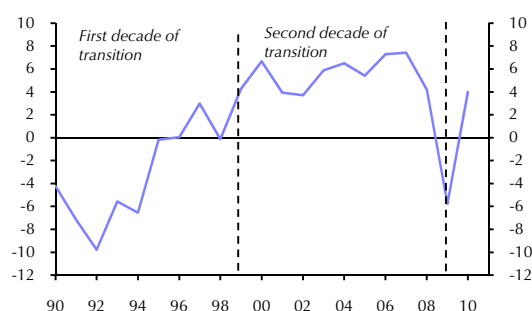
The second important point to note is that the region's relatively low average growth rate over the past twenty years masks the fact that it has been on something of a roller coaster ride. The first decade of transition, during which the old command and control economy was dismantled and the structures of a new market economy were put in place, saw real GDP in Central and Eastern Europe drop by 30%. During this period the Russian economy contracted for eight consecutive years between 1989 and 1996 – the longest peacetime recession of any major economy in history². Even allowing for the fact that the official data are unlikely to fully take account of activity in

¹ For the purposes of this Focus we define CEE as the following countries: Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Russia, Slovakia, Slovenia and Ukraine.

² T. Judt, 'Postwar: A History of Europe since 1945' (2005), pg. 686.

the black economy, the first decade of transition was a wrenching experience.

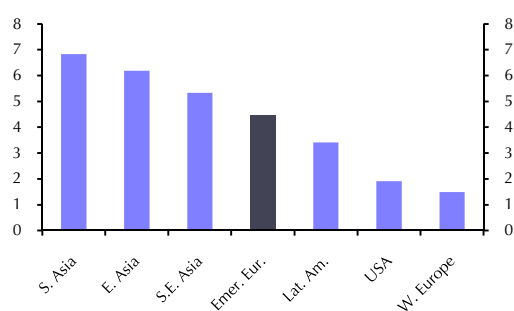
CHART 2: EMERGING EUROPE REAL GDP GROWTH (% Y/Y)



Sources – World Bank, Capital Economics

However, as we shall see later, the reforms undertaken during this period paved the way for a rebound in growth from the late-1990s. (See Chart 2.) Between 2000 and 2008, regional growth averaged 5.5% a year – somewhat slower than growth in China and India, but comparable to the pace of expansion seen in South East Asia and Latin America. (See Chart 3.)

CHART 3: REGIONAL GDP GROWTH (% Y/Y 2000-10)



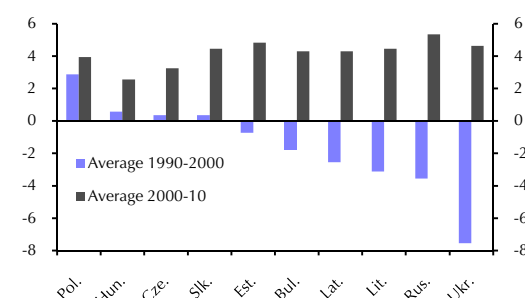
Sources – IMF, World Bank, Capital Economics

The turnaround in performance during the second decade of transition was most marked in Ukraine, Russia and Lithuania (where the initial drop in output was greatest). But the key point is that every country has seen an improvement in economic performance since the turn of the last decade. (See Chart 4.)

The third and final point to note is that while GDP growth over the past twenty years as a whole has been disappointing when measured in real terms,

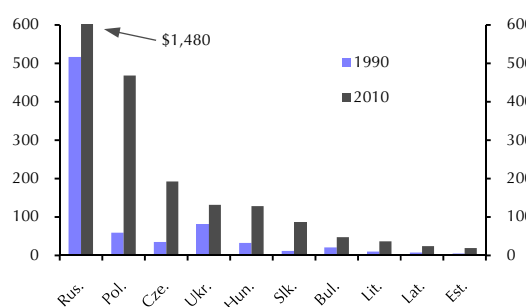
output in every country in the region is now significantly higher when measured in current price US dollars (at market exchange rates) than it was in 1989. (See Chart 5.)

CHART 4: GDP GROWTH (% Y/Y, 1990-2000 & 2000-10)



Sources – IMF, World Bank, Capital Economics

CHART 5: NOMINAL GDP (US\$BN, 1990 & 2010)

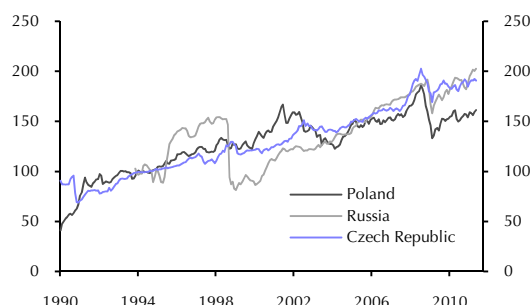


Sources – IMF, World Bank, Capital Economics

The fact that growth measured in nominal US dollars has far outstripped growth measured in constant prices reflects the fact that every economy has experienced substantial real exchange rate appreciation since the fall of communism. (See Chart 6, over the page). This in turn has been due primarily to the so-called ‘Balassa-Samuelson’ effect³.

³ The Balassa-Samuelson effect suggests that emerging markets tend to experience real exchange rate appreciation for two reasons. First, productivity gains tend to come in the tradable sector, which justifies a stronger nominal exchange rate. Second, productivity gains in the tradable sector then lead to higher wage demands from workers in these industries. This in turn must be paid to all workers in the economy (in order to prevent labour moving from the non-tradable sector to the tradable sector). The result is higher inflation since workers in the non-tradable sector receive pay rises without a commensurate increase in productivity. The overall result is that the real exchange rate appreciates.

CHART 6: REAL EXCHANGE RATES (1994 = 100)



Sources – Thomson Datastream, Capital Economics

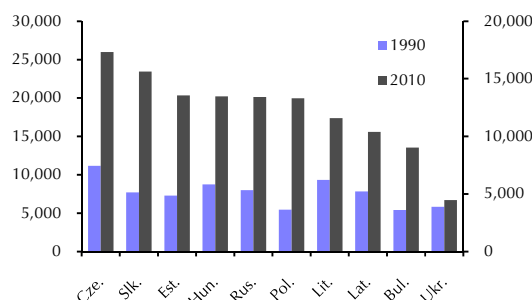
As a result, when measured in current price US dollars (at market exchange rates), the region’s economy has more than trebled in size since the fall of communism, increasing from \$780bn in 1990 to \$2,600bn by 2010. At the same time, GDP per capita (again measured at market exchange rates) has risen from just \$3,000 to \$10,000 – representing a considerable increase in purchasing power on world markets.

Of course, at least part of the rise in nominal GDP (and GDP per head) reflects the comparatively high rate of inflation seen in the region (which has eroded, rather than boosted, purchasing power in *local* markets). Accordingly, GDP per capita measured at PPP (as opposed to market) exchange rates is probably a better measure of changes in the region’s welfare.

Yet even on this basis the economies of Central & Eastern Europe have still experienced a near trebling of income since the fall of communism. Overall, GDP per capita at PPP exchange rates has risen from \$7,500 in 1989 to just under \$21,000 in 2010. At a country level, the biggest gains have again been in the Central European economies of Poland, Slovakia, Hungary and the Czech Republic, as well as the Baltic States. (See Chart 7.) Ukraine remains the laggard.

CHART 7: GDP PER CAPITA

(US\$, CURRENT PRICES, PPP EX. RATES, 1990 & 2010)

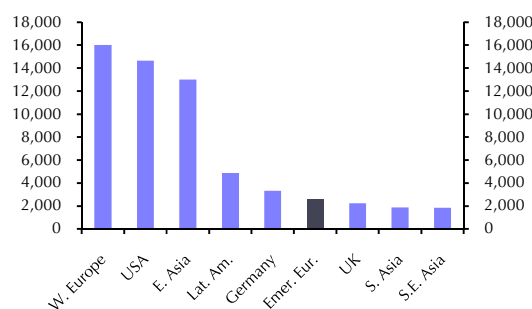


Sources – IMF, World Bank, Capital Economics

Of course, not every section of society has benefitted equally from the rise in incomes. Income inequality has increased over the past twenty years (particularly in the former Soviet Union) and some parts of the population have been hit particularly hard. This is especially true of the elderly, many of whom lost jobs in the old system that were never replaced in the new system.

But while this has created significant social problems that it would be wrong to play down, the broader point remains that regional output and incomes have increased markedly since the end of communism. As things stand, the region’s economy is now larger than the UK’s and almost as big as Germany’s. (See Chart 8.) And with per capita GDP still just 20% of the euro-zone average, despite the rise seen over the past two decades, there remains significant scope for further catch-up growth over the coming years.

CHART 8: REGIONAL GDP (US\$BN, CURRENT PRICES, 2010)



Sources – IMF, World Bank, Capital Economics

What did policymakers do to unleash growth?

So what explains the region's performance over the past couple of decades? And, more importantly, why have the likes of Poland and the Czech Republic performed better than Russia and Ukraine?

Although it is dangerous to generalise, prior to the collapse of communism the region had a first-world educated labour force and a third-world capital stock. These factors of production were then organised – with huge inefficiency – through central planning.

There was some private enterprise – for example as much as 30% of the Polish labour force was employed in the private sector (mainly in agriculture, which was never collectivised). Hungary had a small private sector too. But for the most part, the old command and control system dominated, particularly in the Soviet Union. Here there was no private sector and the factors of production were organised primarily to support military prowess rather than promote growth (with the result that some industries were value *subtracting*). By the end of the 1980s some estimates suggest that military spending was equivalent to around 25% of Soviet GDP.

Dismantling the old system required the reorganisation of labour and capital on a huge scale and was responsible for the initial loss of output. Accordingly, in the early days of transition, the focus of policymakers was on stabilisation. Fiscal positions worsened dramatically as tax bases collapsed and, in some cases (notably Russia), state subsidies were withdrawn only gradually. The region's fiscal problems were compounded by the vast sums of foreign debt that some governments accumulated in the process of trying to prevent the old system from collapsing. Taken as a whole, Central and Eastern Europe's external debt rose from \$6.1bn in 1971 to \$66.1bn by 1980 and to around \$140bn (18% of GDP) by 1990. The external debt burden was greatest in the Soviet Union and Poland (which together accounted for almost three-

quarters of the region's foreign debt by the late-1980s) and Bulgaria⁴.

Meanwhile, inflation spiralled. This was due in part to the abolition of price controls and the inevitable drop in currencies as controls were removed. But in many cases (notably in the former Soviet Union) it also stemmed from a fundamental lack of monetary control and, in particular, a temptation to monetise budget deficits. Inflation peaked at 250% in Romania (in 1993), 550% in Poland (1990), 875% in Russia (also 1993) and 1075% in Bulgaria (1997).

On the fiscal side, stability was ultimately achieved in three ways. First, government spending was cut sharply as public industries were privatised and price subsidies were removed (more on both later). Data are patchy but, Polish government spending, for example, fell by 10% of GDP during the 1990s.

Second, governments took steps to shore up their tax bases. For the most part, this did not mean raising tax rates. Indeed, most countries *lowered* tax rates and several (including Russia, Slovakia and the Baltic States) adopted flat tax regimes. Nonetheless, a combination of lower tax rates, a simplified tax code and tougher enforcement resulted in increased compliance and thus helped to raise overall revenues. Higher receipts coupled with lower spending meant that by the mid-1990s most countries were able to run primary budget surpluses.

Finally, a number of governments also restructured their debts. Poland and Bulgaria did so as part of the US-led Brady Plan in the early 1990s, while Russia and Ukraine defaulted on debt in 1998. Taken together, these steps caused public debt in the region to fall from close to 110% of GDP in 1992 to around 55% of GDP by 2002. **Fiscal stability, coupled with greater monetary discipline, set in train a virtuous circle that**

⁴ An important exception to this was Romania, where Nicolai Ceausescu's obsession with repaying the country's debts in full resulted in external debt falling from around 20% of GDP in the mid-1980s to less than 5% of GDP by 1989 – but at the expense of severe shortages of food and other basic goods.

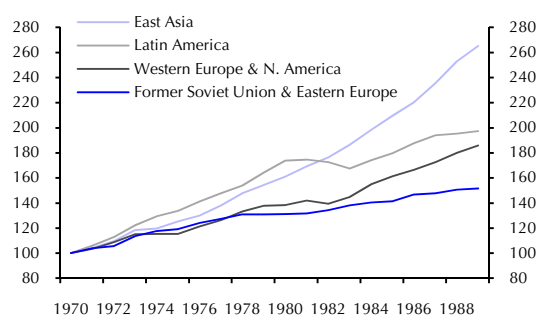
brought currencies and inflation under control and led to a rise in domestic savings and investment.

More than just a stabilisation story

The restoration of macroeconomic stability goes some way to explaining the recovery in the region's output from the late-1990s on. But it is only part of the story – and a relatively small part at that. After all, the key problem prior to the fall of communism was not the absence of macroeconomic stability *per se*. Unlike Latin America, Central and Eastern Europe did not experience a boom/bust cycle in the 1970s and 1980s, nor was hyperinflation a problem (although Poland did experience periodic bouts of inflation during the 1980s as price controls on some goods were relaxed).

Instead, the chief concern was a more general decline in output and living standards relative to other regions of the world from the mid-1970s on (the so-called 'Brezhnev stagnation'). (See Chart 9.) According to the historian Tony Judt, in 1979 a shopper in Washington DC had to work just over 12 hours to afford a basket of basic foods.⁵ By contrast, a worker in Moscow had to work over 42 hours in order to afford the same basket of goods (assuming of course they could be found in shops in the first place).

CHART 9: REAL GDP (1970 =100)



Sources – A. Maddison, Capital Economics

⁵ Basket of goods includes: sausages, milk, eggs, potatoes, vegetables, tea and beer. See T. Judt, 'Postwar: A History of Europe since 1945' (2005), pg. 581.

This decline in relative living standards stemmed, of course, from the distortions inherent in a centrally planned system. In this respect, the key point is that despite the initial slump in output that followed the collapse of communism, the market reforms undertaken in the early days of transition laid the foundations for the subsequent recovery and increase in prosperity seen over the past decade or so.

Crucially, growth in Emerging Europe since 2000 has not been driven by an increase in the region's factors of production *per se*. Instead, almost all of the growth over the past twenty years can be accounted for by technical progress (i.e. better *quality* capital rather than more of it) and a more efficient allocation of the factors of production via market mechanisms.

Indeed, the World Bank estimates that as much as 90% of the increase in Russian output from its low in 1999 to 2006 can be accounted for by a rise in total factor productivity (in other words, using resources more effectively). The rest is attributable to an increase in the capital stock. Virtually none of the growth since the end of communism is attributable to an increase in labour inputs.

Five key market reforms

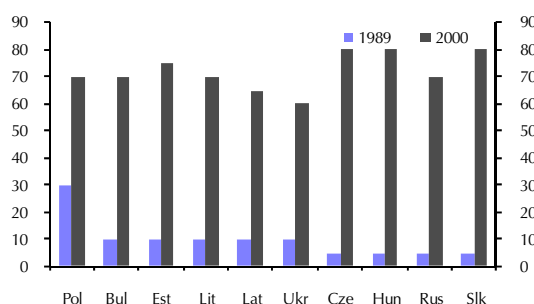
We think that there were five key elements to the market reforms that were undertaken in the region. **First, state-owned companies (which in every country with the exception of Poland meant the entire economy) were privatised.** Smaller businesses in the service sector typically passed into the hands of management. Meanwhile, larger companies, typically either industrial firms or public utilities, were broken up and sold off in waves of privatisations.

In the main, these were conducted via so-called 'voucher systems', whereby investors could purchase coupons entitling them to either a direct stake in the company being sold off, or a stake in an ownership fund. Initially, preference was given to domestic residents and employees in particular, who were typically charged only a nominal fee for

the coupons. But in time the schemes were opened up to foreign investors.

Although the success of these schemes varied from country to country (Russia's 'loans for shares scheme'⁶ stands out as a particularly sorry episode), the ultimate result was that by the end of the 1990s the private sector accounted for between two-thirds and three-quarters of GDP in most countries – up from virtually nothing in 1989. (See Chart 10.)

CHART 10: PRIVATE SECTOR SHARE OF GDP (% OF TOTAL)



Source – EBRD

Privatisation was complemented by a second key market reform – price liberalisation. While the degree of price control under communism varied, the costs of all key products were set by officials within the Ministry of Finance. Not surprisingly, this led to huge distortions in the allocation of both labour and capital.

Following the fall of communism, some countries embarked on price liberalisation more aggressively than others. Indeed, the speed at which prices should be liberalised was arguably the polarising aspect of the policy debate in the post-communist world.

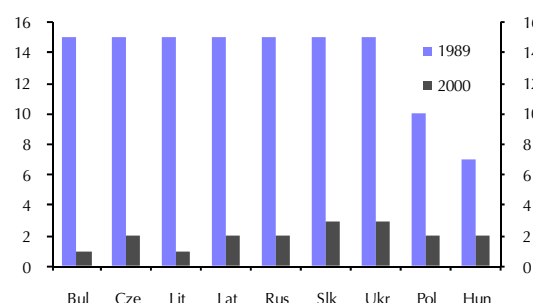
At one end of the spectrum, so-called 'shock therapy' resulted in price controls on 90% of Polish goods and services being abolished

⁶ Under Russia's controversial 'loans for shares' scheme, the government used state-owned companies as collateral for the loans that it needed to plug its large fiscal deficit – and in the process sold of large amounts of public companies to a small number of powerful local 'oligarchs' at well below market prices.

overnight in 1989. At the other end of the scale, price liberalisation in Russia and Ukraine progressed more slowly. In between, most countries maintained controls on essentials such as food, fuels, and public transport, while at the same time liberalising the prices of goods and services that were seen as less essential to everyday life (and thus less controversial).

The relative out-performance of Poland's economy would appear to vindicate the 'shock-therapy' approach to liberalisation, although as we shall see later this is not the sole factor at play. In any case, the key point, is that by 2000 most controls had been removed and prices were largely set by the market in most of the region's economies⁷. (See Chart 11.)

CHART 11: NUMBER OF GOODS WITH ADMINISTERED PRICES WITHIN THE EBRD-15 BASKET*



Source – EBRD; *EBRD-15 basket consists of flour/bread, meat, milk, gasoline/petrol, cotton textiles, shoes, paper, cars, television sets, cement, steel, coal, wood, rents, inter-city bus service.

The third key market reform was to open up to both trade and capital flows. To be clear, the region has not necessarily seen *more* trade under capitalism than it did under communism. After all, there was substantial trade among COMECON⁸ countries during the Soviet era.

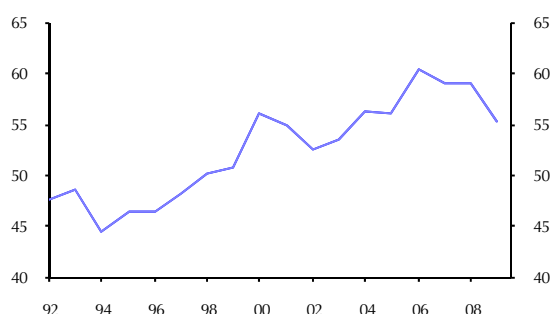
Accurate data for the period before 1989 are not available, but more reliable figures from the early 1990s suggest that there has been a steady rise,

⁷ Note that a number of countries, mostly in the ex-Soviet Union, have retained energy subsidies.

⁸ COMECON or the 'Council for Mutual Economic Assistance' was an organisation comprising the countries of the former Eastern Bloc plus a number of other communist states elsewhere in the world (including Vietnam & Cuba, but not China).

rather than an explosion, in regional trade volumes. Exports as a share of regional GDP (including intra-regional trade) rose from just under 50% in 1992 to a high of 60% of GDP in 2006. (See Chart 12.)

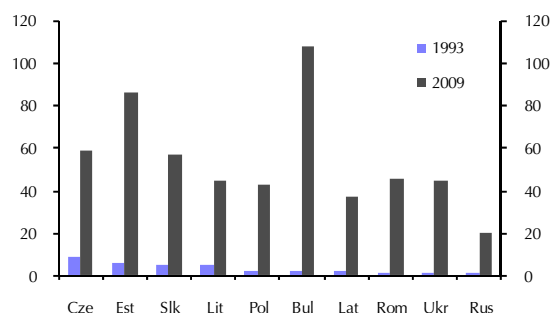
**CHART 12: EMERGING EUROPE EXPORTS
(% OF REGIONAL GDP)**



Sources – World Bank, Capital Economics

Instead, while the transition from communism has not necessarily led to an increase in overall trade volumes, the quality of trade has increased. In other words, the key has been better trade rather than more of it. Whereas trade was centrally directed under the old system, now it is governed by market forces. The result has been that exporters have moved up the value chain of production. Put differently, rather than producing Trabant cars than nobody wanted to drive, the region now produces top-of-the-range Audis that are exported to markets all over the world.

CHART 13: STOCK OF FDI (% OF GDP)



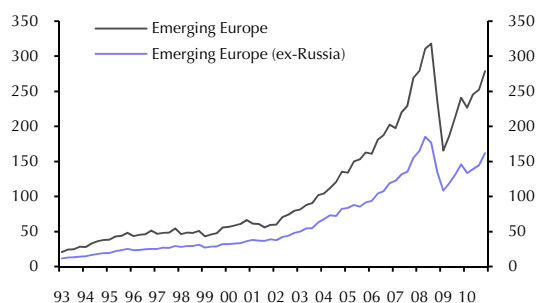
Sources – Thomson Datastream, Capital Economics

A crucial element of this transformation has been opening up to capital flows. This has led to a surge in foreign direct investment (FDI) into the region

(mainly from Western Europe) which, in turn, has built plant, thus improving the region's capital stock, and facilitated the spread of knowledge and know-how. (See Chart 13.)

The overall result of this shift up the value chain has been a massive improvement in the region's terms of trade, that is, the ratio of export to import prices (although in the case of Russia this has more to do with the boom in commodities since 2004). So while exports volumes do not appear to have increased markedly over the past couple of decades, export values have soared. This has been particularly marked from 2000, when FDI into the region really started to accelerate. (See Chart 14.) (Note that we show figures for regional exports that both include and exclude Russia in order to strip out the effects of the surge in commodity prices and the associated impact on Russian exports from 2004 on.)

CHART 14: EMERGING EUROPE EXPORTS (US\$BN)

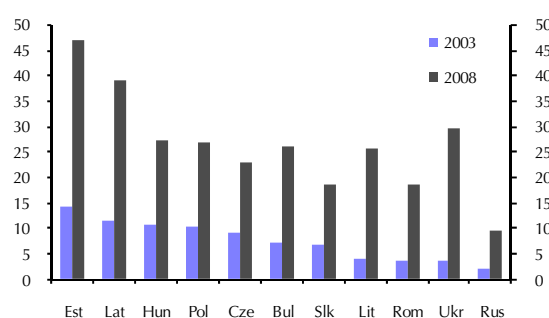


Sources – Thomson Datastream, Capital Economics

The fourth key market reform was the development of financial markets and the spread of credit. The opening up to capital flows also played an important role in this process, since it allowed foreign banks to buy into the region and spread knowledge. (See Chart 15, over the page.) Admittedly, in some cases the development of credit markets was too rapid, and sowed the seeds of the region's crash in 2008. Yet the broader point remains that the development of financial markets and the banking sector created a means by which funds could be channelled between savers and

borrowers and, in doing so, supported both consumption and investment.

CHART 15: DOMESTIC CREDIT TO HOUSEHOLDS (% OF GDP)



Source – EBRD

Accordingly, ‘financial deepening’ has played a major role in growth. Data from before 2003 are patchy, but a rough estimate suggests that the spread of consumer credit could account for around 20% of the increase in private consumption in the region over the past decade.

The fifth and final market reform was the development of institutions that support private enterprise and markets. This is perhaps the most important aspect of all the measures that were undertaken and took a number of different forms. The most significant of these, however, were:

- the introduction of political competition and the spread of democracy;
- the development of an independent judiciary and property rights (which strengthened investor protection); and
- the erosion of corruption, cronyism and ‘soft finance’ (which tend to undermine the proper working of a market economy).

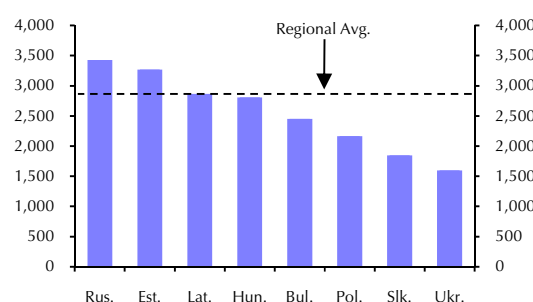
For the most part, these institutional reforms were enshrined either in changes to the legal code or, in most cases, within newly adopted written constitutions.

Why have some countries fared better?

Although these reforms help to explain why the region in general ultimately prospered following the collapse of communism, they do not explain

why some countries have fared much better than others. As noted earlier, Poland and the rest of Central Europe have outperformed, while, with the exception of Estonia, the economies of the former Soviet Union have lagged behind.

CHART 16: GDP PER CAPITA IN 1989 (US\$, MKT. EX. RATES)



Source – World Bank

Poland’s relative outperformance is consistent with its comparatively low starting point. In 1989 GDP per capita was just over \$2,000 at market exchange rates, compared with \$3,400 in Russia and a regional average of around \$2,800. (See Chart 16.) The fact that Poland was poorer in the first instance meant that there was greater scope for it to undergo a period of rapid ‘catch up’ growth.

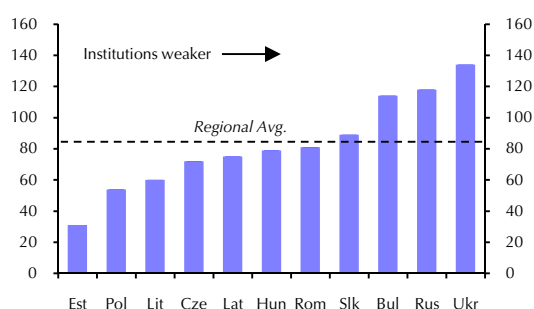
But the reasons for the divergence in performance go beyond each country’s starting point. After all, incomes in Estonia and Russia were broadly similar in 1989, yet the former has easily outperformed the latter over the past couple of decades.

Instead, we think there are three additional factors at play. The first is the speed at which reforms were carried out. In particular, those countries that liberalised prices and built the necessary structures of a market economy quickly – notably Poland and Estonia – seem to have performed better than those where reforms progressed more gradually (e.g. Ukraine). A second, and related factor, is the extent to which the old command and control system was entrenched. In the Soviet Union, where central planning had become more ingrained, the process of dismantling the old system was always likely to be more painful and result in a much larger initial drop in output here than it was

elsewhere in the Eastern Bloc. (Recall that there was some private enterprise in both Poland and Hungary prior to the collapse of communism.) Accordingly, it is no surprise that the public was less enthusiastic about the economic reforms that were needed to complement the far more popular reforms to the region's political structure.

Finally, we suspect that much of the divergence in performance over the past twenty years or so can be explained by the fact that institutional change in Emerging Europe has been two-speed. **In those economies where institutional reform was most substantive and successful, such as Central Europe, economic reforms became more entrenched.** But in those countries where institutional change was slower and/or more uneven, economic reforms have been less effective and still have some way to go. This is particularly true of Russia and Ukraine, and, to a lesser extent, of Bulgaria and Romania. (See Chart 17.)

CHART 17: WORLD ECONOMIC FORUM RANK FOR INSTITUTIONAL STRENGTH (OUT OF 139 COUNTRIES)



Source – WEF 2010-11 Global Competitiveness Index

What explains the strength of institutions?

Pinning down why institutional reform was easier in some countries than it was in others is difficult since these changes are affected by various social, economic, historical and cultural factors, many of which tend to be somewhat nebulous in nature. Nonetheless, we would make four observations.

First, those countries that were most successful at institutional reform disposed with the old elite quickly, embraced democracy and elected governments whose members had no ties to the

previous regime (or, in many cases, had been prominent members of the opposition). Poland is a good example of this. In the likes of Russia, the old elite was bigger, richer, more powerful and more convinced of its dirigiste heritage – and hence more prepared to fight for its survival (thus the abortive coup of August 1991).

It's worth noting, too, that the economic rents that tend to flow from the production of oil and gas mean that Russia's institutions are inherently more vulnerable to capture from vested interests. This helps to explain why the oligarchs were able to accumulate so much power and influence once the old guard was eventually removed from office, and why a new class of *Siloviki* has since replaced them in the higher echelons of government.⁹

The second factor that affected institutional reform was the degree of social cohesion around the goals of transition. This reflected a number of factors. General anti-Soviet sentiment helped to sustain reform efforts in Central Europe and the Baltics. Conversely, a sense of injustice and loss of empire held back reform in Russia. More generally, starting points matter – in those countries where communist-era distortions were greatest, and thus the transition to a market economy was more wrenching (such as the Soviet Union), it is perhaps understandable that there was more trepidation about the reform process.

The third factor that affected the extent of institutional reform was the longevity of previous regimes. Capitalism – and the old institutions that supported it – had been destroyed in Central Europe in 1945 but its memory was still alive. The same is less true of Russia, which saw its revolution in 1917 and had no history of being a democratic market economy.

But the most important lesson from the experience of Central and Eastern Europe – and the one that is perhaps of most relevance to those

⁹ Or 'strong men', the term used to refer to the group of officials from the military and security services that has risen to power under Vladimir Putin.

countries currently undergoing political and economic change – is that institutional reform was faster and deeper in those countries where the external anchors for change were stronger. In the case of Central and Eastern Europe, these external anchors for change took a number of forms and varied from financial assistance from the likes of the IMF and European Bank for Reconstruction and Development (which was created with the explicit purpose of facilitating transition) to the lure of membership of Western organisations.

The most obvious of these were NATO and, more importantly from the perspective of progressing political and economic reforms, the European Union. Those countries that – for historical, social and geographic reasons – saw themselves as more clearly European strived for EU membership from an early stage and therefore completed the reforms that were a precondition to entry. (EU accession requires meeting criteria on everything from food safety standards to fisheries policies, but it also sets standards on property rights, human rights and political freedoms as well as safeguarding the independence of the judiciary.)

By contrast, those countries (mainly in the former Soviet Union) that for obvious reasons were either less disposed to EU membership or for which membership was a more distant prospect, have generally experienced a slower pace of reform and growth has been correspondingly weaker.

Summary & Conclusions

To sum up then, at first sight the performance of Eastern Europe over the past 20 years has been fairly disappointing – indeed, real GDP growth has averaged just 1% since 1989. But the reality is more complex, for at least three reasons. First, there has been a wide variation in performance at a country level. Poland and, to a lesser extent, the rest of Central Europe have been the star performers. Meanwhile, the ex-Soviet Union and South Eastern Europe have lagged behind.

Second, the region's relatively low average growth rate since the fall of communism masks the fact

that a huge recession during the first decade of transition was followed by a decade of relative prosperity from the late 1990s, in which growth averaged 5% a year – similar to the pace of growth seen in other emerging economies (albeit still slower than in China and India).

And finally, despite the fact that average GDP growth in real terms has been disappointing since the fall of communism, output in every country in the region is now significantly higher when measured in current price US dollars. This reflects significant real exchange rate appreciation throughout the region, which has caused purchasing power to increase substantially. Per capita incomes have trebled over the past 20 years, rising from \$3,000 in 1989 to \$10,000 today.

On this basis, then, the region has undoubtedly prospered since the Fall of the Wall. This has been due primarily to a better allocation of resources brought about by the transition from central planning to a market economy. Important elements of this include the development of a private sector; the introduction of a proper price mechanism; the opening up to trade and capital flows; and the development of credit markets. Crucially, however, those countries that combined economic reforms with institutional reforms have prospered the most.

Accordingly, institutional reforms to improve the business environment, protect property rights and stimulate investment are crucial if the region's laggards since the fall of communism – notably Russia – are to achieve rapid catch-up to Western levels of income. Put differently, economic progress in these countries will ultimately depend on political progress. But while hopes are rising that a more liberal government in Russia will emerge from next year's presidential elections, we remain of the view that powerful vested interests will continue to act as a brake on much-needed reforms. If we are right, the twin-speed pace of development seen across Eastern Europe since the fall of Communism is likely to persist for a while to come.