The Political Economy of Reform Failure

Edited by
Mats Lundahl and Michael L. Wyzan

Routledge studies in development economics
Economists have moved in recent years beyond analysing the manner in which the macroeconomies of different countries function and prescribing appropriate policies for dealing with domestic and external imbalances. Increasingly, they have sought to understand the complex interaction between political and economic phenomena.

*The Political Economy of Reform Failure* considers issues of economic reform in a broad range of settings: developed, transition and developing countries. Using country-specific cases this book focuses on those territories which have encountered problems reforming, allowing the reader to gain an accurate understanding of the factors that inhibit the success of economic reform, the different context in which economic reform is attempted and the different challenges that individual countries face. *The Political Economy of Reform Failure* uses case studies which are often difficult to find such as Uzbekistan, Burma or Haiti.

An international team of contributors including Bo Södersten, Deepak Lal and Ronald Findlay have been brought together to analyse these issues.

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Stockholm and Asmara, March 2004
Mats Lundahl and Michael L. Wyzan
1 Introduction

Mats Lundahl and Michael L. Wyzan

Happy families are all alike; every unhappy family is unhappy in its own way.

(Leo Tolstoy, Anna Karenina)

Economists have moved in recent years beyond analysing the manner in which the macroeconomies of different countries function and prescribing appropriate policies for dealing with domestic and external imbalances. Increasingly, they have sought to understand the complex interaction between political and economic phenomena. Both economic and political forces, almost by definition, shape economic policy-making. Anne Krueger (1993, p. 138) has noted that ‘politicians’ decisions as to economic policy are an outcome of the existing balance of political forces, which are themselves a function in part of the state of the economy’. She and other economists have identified cycles of economic policy in such areas as external trade and payments regimes and agricultural pricing policies. They have also examined the ways in which the political process has interacted with policy cycles. This refers to the manner in which political factors affect the severity of the economic crisis that precedes major shifts in economic policy and the political ramifications of such shifts.

Policy response is frequently delayed (Alesina and Drazen, 1991; Howitt and Wintrobe, 1995; Drazen, 1996; Perotti, 1996). Recent work in political economy – which focuses on countries where governments must take into account the will of the governed – traces policy delays not to shortsightedness, ignorance or irrationality, or to the fact that the best course of action is unknown. Rather, such work begins with the question: why might conflicts of interest and the mechanisms by which such conflicts are resolved lead to a delay in the adoption of beneficial reforms (Drazen, 1996, pp. 25–6)?

The contributions included in the present volume take into account both purely economic and political aspects of the reform problem. The book is intended as an exercise in ‘distant comparison’. The idea here is to contrast the perception of crisis and need for reform in three different
settings in order to contribute to the understanding of the political, historical and other factors that constrain governments’ ability to identify and respond to conditions that call for alterations in their economic policies.

The emphasis here is on policy-reform failure. What can we learn about the difficulties of reform by studying countries that for one reason or another have got themselves into crisis situations that have called for reforms of economic policy? These countries have failed to devise a set of policy responses, have come up with a package with the wrong prescriptions, have delayed reform unduly or have reformed briefly and thereafter reverted to the type of policy that made reform necessary in the first place. We have divided our cases into three different groups: developed economies, transition economies and developing economies, in each case including as an introduction a more general chapter serving as an introduction to the problems that each group faced.

Beginning with the developed economies, in Chapter 2 Martin Paldam provides an overview of the economic performance of the ‘old’ member states of the Organisation for Economic Co-operation and Development (OECD), that is, Western Europe, the United States, Canada, Australia and New Zealand. He goes on to examine these countries’ policy responses to the only major crisis they have had to face: the 1973 oil-price shock. Bo Södersten in Chapter 3 tells the story of Sweden’s adjustment problems during approximately the same period. In Chapter 4, Sarantis Lolos evaluates the influence of European integration on shaping policy outcomes in Greece. The Greek experience is interesting not only because we can compare it to that of other relatively less developed member states of the European Union (EU), but also because it contains useful lessons for the Central and East European (CEE) countries on the path to accession. The first part of the book ends with an analysis, in Chapter 5, by Erinç Yeldan and Sabit Khakimzhanov, of the main processes characterising Turkey’s macroeconomic adjustment efforts since the inception in 1980 of reforms aimed at integrating the country into the global economy.

The second part of this volume deals with economies from the former communist bloc that are struggling more or less actively to dismantle the mechanisms and policies that characterised the planned economy and to substitute for them a market economy organised along largely capitalist lines. In his general Chapter 6, Jozef van Brabant sketches out the transition agenda, the politics of transition, and criteria for judging the relative success and failure of different transition episodes, before going on to elucidate the various policy choices and the worst shortcomings of actual transition policies. Chapter 7, by Marta Muço and Örjan Sjöberg, reviews the problems that Albania faces, where a political culture inherited from traditional society has inhibited the implementation and sustainability of structural reform. The country was a slow starter, and the reforms have mainly been superficial, so the economy remains fragile.
Georgy Ganev and Michael Wyzan, in Chapter 8, analyse Bulgaria’s 1996–7 crisis, as well as the post-crisis period. The introduction of a currency board arrangement (CBA) and the problems connected with it have dominated the latter period, especially on the political side, including the danger that political unwillingness to stick to fiscal discipline will undermine the arrangement. Barry Ickes, in Chapter 9, argues that transition in Russia has led the economy to evolve into a cross between plan and market, a ‘virtual’ economy. The adaptive behaviour by economic actors during this process has made structural reform more difficult than at the outset, since the distribution of income depends on a non-transparent process of redistribution in a ‘loot chain’. Chapter 10, by Richard Pomfret, the final one in Part II, deals with Uzbekistan, which has avoided the standard IMF shock therapy, but also managed to avert economic collapse. The president has played a key role: partly citing East Asian models of leadership as his guide, he has pursued gradual reform in a setting that Pomfret characterises as good governance, but not managed to avoid slipping into an import substitution strategy.

Part III focuses on the Third World economies. The opening Chapter 11, by Deepak Lal, begins with a categorisation of countries in terms of their factor endowments and polities. Lal argues that initial resource endowments matter more than polities when it comes to explaining economic policies. He also deals with the explanation for the political forms that prevail in different countries. The first case story, offered in Chapter 12 by Ronald Findlay, is that of Burma: a political and economic horror story ever since the military took over in 1962. This Via Dolorosa runs via the inward-looking ‘Burmese Way to Socialism’, through a liberalisation that mainly served to boost imports, to highly irregular practices, such as smuggling, under the protective umbrella of an army whose demands are permanently in the forefront. Another sad story is Haiti, which Mats Lundahl and Rubén Silié deal with in Chapter 13. In Haiti, three major reform efforts since 1986 have foundered due to political factors. Politics remains paralysed, the president has had to leave the country and the economy continues to deteriorate.

Another Latin American country with a poor reform track record is Nicaragua, which Jaime Behar analyses in Chapter 14. The Sandinista period in the 1980s turned out to be an economic disaster: only after the advent of a new government in 1990 did reform efforts begin. These efforts, however, in the absence of foreign-debt reduction, have done little to stimulate economic growth. Such reduction has taken place only recently, but has not been sufficient. Without considerable increases in investment in human capital, stagnation is likely to continue. Finally, there is the case of Zambia, which Arne Bigsten and Steve Kayizzi-Mugerwa analyse in Chapter 15, where reforms have been half-hearted and often reversed due to resistance from politically important interest groups.
What is a ‘crisis’?

Our first task is identifying what we mean by an economic ‘crisis’. It is not self-evident that ‘crisis’ means the same thing in developed, transitional and developing economies. On the contrary, what is perceived as the symptoms of an impending crisis, for example in the OECD countries, may not even be noticed, or treated as a minor nuisance, in a typical Latin American country. There can be no single definition of crisis.

Chapters 2 and 3 of the present work bear out the relativity of the notion of crisis. The first of these deals with the OECD countries and their responses to the only major disturbance that these economies have faced during the postwar period: the oil shock of 1973. It is fairly clear that this event deserves the ‘crisis’ label. The shock that the world oil cartel’s price hikes imposed on these countries was no marginal disturbance. Adjustment to that shock proved slow and costly in terms of foregone output. In comparative perspective, however, growth rates, inflation rates and real exchange rates in the OECD countries stand out as extremely stable – as the most stable region in the world in the 1970s and 1980s – especially in terms of inflation, but also when it comes to the other two variables.

The overall stability of the OECD economies does not mean that crises have been absent. Finland and Sweden, for example, experienced a financial crisis at the beginning of the 1990s, very similar to the Asian countries more recently. The only major crisis, however, resulted from the OPEC oil price hikes in 1973 and the adjustment thereto.

The case of Greece also illustrates the relativity of the crisis concept. The country, which had long suffered from structural weaknesses, had entered the European Economic Community (EEC) in 1981. However, the policies that the socialist PASOK party carried out during the ensuing decade diverged from those generally pursued within the EEC. The result was that a major stabilisation effort became necessary. The effort was of short duration, however. A crisis was building but never came to full fruition.

The Turkish crisis has been deeper. We can characterise the policy regime of the 1970s as a variant of the import substitution policy that the majority of the developing countries from the 1950s until that time had pursued. Turkey had by then reached the ‘difficult’ part of the import substitution process, when it had to take the step from a specialisation in consumer and intermediate goods to one in capital goods. The negative effects of this type of policy are well known. In the Turkish case, the difficulties manifested themselves through the balance of payments (there was also an overvalued exchange rate) and through difficulties in financing investment in the manufacturing sector. A foreign-exchange crisis broke out, leading to the promulgation of a structural-adjustment programme.

The experience of the developed economies described in the present
work indicates that, when symptoms of crisis appear, governments make attempts to correct the situation before major catastrophes take place, although not necessarily fast enough, as demonstrated by the oil crisis. The awareness may even be ‘false’ in that they may perceive a profound, drawn-out crisis as inconsequential and transitory.

Crisis in the transition economies has been of a completely different nature. Its cause has been nothing less than the complete collapse of the centrally planned economies, beginning in the Soviet Union at the end of the 1980s and the early 1990s, spreading at the same time to the rest of eastern Europe and Mongolia, as well. This crisis was not just economic, but also political. The entire system fell to pieces. The inevitable result was that the transition economies that arose from the ashes of communism lacked the institutions necessary for coping with the crisis. There was little knowledge about the set-up that was necessary for the functioning of a market economy. The transition countries’ problem was twofold: an economic crisis that was far deeper and more fundamental than any experienced in the West, and a lack of institutions to deal with it.

Albania was the last bastion to fall among the communist states of eastern Europe. Not until early 1991 did the political system finally give in. The country was then in a difficult situation in another sense: its rulers had governed with an iron hand, and reforms had been conspicuous mainly by their absence. There was hardly any opposition or dissidents worth mentioning. In short, Albania represented an extreme case of systemic collapse. Both democratisation and economic reform had to start from square one.

Bulgaria was in a much better shape when the crisis came. Still, it had its problems. The economy suffered from macroeconomic imbalances that were a direct heritage from communism. The country also had to make up for the losses that resulted from the dissolution of the communist trading bloc and from the sanctions imposed on some of its other trading partners, notably Iraq and Libya. Finally, fiscal and quasi-fiscal deficits had arisen out of soft budget constraints and a lack of willingness to implement structural reforms in this area.

Russia, of course, was the ‘original’ communist economy: the country where the entire process began. Inefficiencies had accumulated gradually at least since the 1960s. The system had stiffened little by little, and it turned out to be impossible to implement reforms inside the old structures. The consumer goods available were few in number and low in quality. The economic growth rate fell, absolutely and in relation to that of the west. When Mikhail Gorbachev finally began to relax the political and economic constraints, the dam burst. There was no going back, no choice but total reform.

Uzbekistan was the third most populous republic in the Soviet Union, and the second poorest. Its role was that of a periphery in a socialist empire, limited to the production of primary goods, such as cotton, gold
and uranium. The republic’s leadership, however, had struggled with Moscow over resources in the 1980s and in this gained a certain political popularity, in spite of considerable political corruption. This leadership had resisted economic reform during the Gorbachev era. As it turned out, when the Soviet Union collapsed, Uzbekistan was in a relatively favourable economic position, facing high export prices in the world market; national income did not decline much in comparison with most former Soviet republics.

Crises in developing countries during the period under consideration have in general exhibited a mixture of macroeconomic instability and structural problems. These included: (i) large budget deficits; (ii) public-expenditure patterns lacking clear priorities; (iii) narrow tax bases; (iv) ‘shallow’ financial strategies with interest rates that were frequently negative in real terms; (v) overvalued currencies; (vi) inward-looking trade policies; (vii) severe regulations on foreign private investment; (viii) a proliferation of parastatal enterprises; (ix) distortions reducing the degree of competition in the economy; and (x) weak and uncertain property rights. These deficiencies resulted in a need both for macroeconomic stabilisation and for structural adjustment, that is, for both measures aimed at correcting short-term imbalances and ones designed to increase microeconomic efficiency in the longer run.

The story of Burma is one of mutually reinforcing political repression and economic stagnation and decline. The military regime that had ruled the country since the early 1960s first attempted to implement a ‘Burmese Way to Socialism’, Gosplan style – with predictable consequences. In the end the underground economy took over, smuggling, notably of narcotics, loomed large and inflation was rampant. By 1988, the economy was in severe crisis. The ruling group scrapped the socialist way and held national elections, but declared them null and void when it turned out that opposition leader Aung San Suu Kyi had received 80 per cent of the vote.

Another case of hopeless economic mismanagement is Haiti. Since the fall of the Duvalier dynasty in 1986, its leaders have launched three economic-reform attempts. When Jean-Claude Duvalier (popularly known as ‘Baby Doc’) fell that year, the economy was in severe disarray: a large budget deficit, balance of payments disequilibrium and high inflation, much of this a result of widespread corruption. Political mismanagement has wrecked attempt after attempt to correct the situation. The crisis continues to this day: a drastic fall in income per capita during the international boycott of Haiti over 1991–5, a subsequent freeze of aid by multilateral and bilateral donors, and finally the total political stalemate and the rebellion that forced President Jean-Bertrand Aristide to leave the country in 2004 now accompany it.

Nicaragua in the early 1990s was in a state of severe insolvency. The country was rapidly building up what would eventually became the largest
foreign debt in the world in relation to gross domestic product (GDP) – the outcome of a long history of failed stabilisation efforts. GDP per capita fell by 35 per cent between 1976 and 1979 and a further reduction of no less than 50 per cent took place during the first half of the 1980s. The authorities had grotesquely overvalued the currency and the balance of payments was under severe strain.

In Zambia, GDP per capita took a downward turn after the mid-1970s. Export earnings from copper were falling. A large foreign debt had accumulated. Economic regulation of the economy had increased. State-owned companies were making large losses covered by the government budget. Real wages were declining.

**Why do crises arise?**

In Western economies, the need for reform tends to arise out of crises related to economic recession, on the one hand, and a stagnation (frequently of economic policy) that systemic weakness had induced, on the other. The government budget begins to display heavy deficits, the rate of inflation shoots up, balance of payments problems rear their ugly heads and the currency depreciates. The rate of growth slows down and investment falls.

The reasons behind this sequence of events vary. In the OECD countries one chain of events leading to the launching of policy reform is the rapid growth of the size of the public sector. Paldam stresses this point for the OECD region as a whole, as does Södersten for Sweden. During the 1970s, Sweden also saw a shift away from employment in private production to that in the public sector as a result of lower productivity in the latter and high subsidies to, for example, health and childcare.

Until 1976, Sweden’s social-democratic government maintained a high level of public spending. The bourgeois party-coalition government resulting from the parliamentary elections that year, however, did not attempt any major expenditure cuts, and could not increase taxes from an already extremely high level. This led to borrowing and the build-up of a large public debt, as well as a balance of payments deficit. At the same time, the economic growth rate fell. In 1982, the Social Democrats returned to government, but the growth rate refused to increase, despite the fact that the late 1980s were a boom period internationally. There also appears to have been a relationship between mass unemployment and the welfare state. Large transfers to ill, unemployed, early retirees and people on parental leave created negative attitudes towards work, with the result that output suffered. However, after unemployment had shot up, large numbers of people belonging to these categories returned to the labour force, leading to further increases in unemployment. This was partly the result of efforts to reform the various transfer systems and make them less attractive to individuals.
Greece offers some similarities. The rule of the leftist PASOK party marked the 1980s. The party came to power in 1981 promising to follow a programme of income redistribution, social cohesion, higher earnings and creation of a modern welfare state. To this end, PASOK governments pursued an expansionary macroeconomic policy, leading to macroeconomic imbalances; large budget deficits, inflation and a boom-and-bust cycle accompanied these imbalances.

Turkey fell into a similar pattern. During the 1970s, the crisis arose from policies centred on import substitution and public investment in heavy manufacturing. At the beginning of the 1980s, the time had come to implement a structural adjustment programme with the support of the World Bank and International Monetary Fund (IMF). After 1980, the degree of state intervention increased anew, ending for the time being the neo-liberal policies pursued in the preceding years. The result has been large fluctuations in both national income and investment. Fiscal deficits have been persistent, as has inflation, with increased unemployment and rising income inequality complementing the picture. The Turkish crises have been policy crises.

The transition economies’ problems differ. Of course, they may and do experience the same type of problems as the developed economies. However, far more fundamentally, they have had to come to grips with a systemic problem: the devastating heritage of the centrally planned economy. The crises of the four transition countries with which we deal in the present volume all had the same cause: the gradual distortion and petrifaction of the economy during the socialist era. All of them have had to cope with the evils of central planning: (i) a lack of information and coordination; (ii) the absence of positive incentives for production; (iii) contradictory commands from a variety of authorities; (iv) queues, scarcity and low quality of consumer goods; (v) the absence of the influence of demand on prices and quantities; (vi) queues, scarcity and misallocation of inputs; (vii) technological stagnation; (viii) over-regulation of foreign trade; (ix) non-availability of imports; (x) proliferation of the underground economy; and (xi) corruption at all levels. In the end, the system broke down under its own weight, and a domino effect ensued. The totalitarian regimes collapsed and the need for economic reform came to the fore. Whilst in most cases correctly designed policy reforms should put the ‘western’ crisis-hit economy back onto a normal track in a few years, the required systemic reforms in transition economies may take a decade or longer.

In developing countries, the crises and the need for reform typically arose out of governments basing their development and industrialisation policies on import substitution behind high tariff walls (and supporting them with quantitative import restrictions and similar measures). Accompanying these policies was far-reaching regulation of domestic markets, on both the commodity and factor sides, and an overly expansive
macroeconomic policy that helped create large budget deficits, along with rapid inflation and balance of payments difficulties.

These policies have a threefold origin. The starting point came during the Great Depression of the 1930s. When the slump hit, today’s developing countries were producers of primary commodities dependent on the international market for their standard of living. The Depression saw severe declines in the prices of these commodities. As a result, observers increasingly saw the international division of labour as unfair or at least not conducive to growth and development. The idea of industrialisation based on the domestic market began to take root. This idea received further impetus during World War II, when there was a ready market for primary products, many of which were strategic goods in the war effort. However, imports of manufactures were difficult to obtain. Again, one could cast doubt on the wisdom of pursuing a development strategy based on primary exports. When decolonisation began in Asia and Africa after the war, nationalist sentiment ran high in the new states, and with it the desire to break with the established international division of labour.

During the 1950s and 1960s the idea that industrialisation for the home market was a superior development strategy received further support from the alleged success of the Soviet Union and its satellites, on the one hand, and from the prevalent development doctrine, on the other. What we ‘knew’ about Soviet industrial statistics at that time indicated that socialist industrialisation, which relied not on market-related incentives but on administrative decision-making and commands, had been rapid. On the academic side, the resuscitated infant industry doctrine supported this view. This doctrine suggested that countries may have a comparative advantage in manufacturing that cannot come into play unless temporary protection allows the reduction of costs, the realisation of a learning process and so on.

As our four case studies of developing economies demonstrate, outright mismanagement by governments that either did not understand the consequences of their actions or did not care about them frequently compounded the evils of excessive intervention. Burma and Haiti are clear instances of the second variety. The military regime in Burma combined the worst features of socialist interventionism with those of a Leviathan state intent on creating a guaranteed income for those with a stake in the system. Haiti is an even worse case of rent creation for the benefit of the rulers. The country has a nefarious political heritage, its rulers having been pure kleptocrats ever since the emergence of Haiti as a sovereign nation. This situation did not change with the fall of Baby Doc in 1986: those in power continued to milk the resources of the country, reducing investment and distorting its allocation. The situation reached its climax when, during the exile of the legally elected president in 1991–4, GDP per capita fell by an estimated 30 per cent, because of plunder, on the one
hand, and politically motivated sanctions from the international community, on the other.

In comparison, Nicaragua and Zambia stand out as cases of bad management, pure and simple. In Nicaragua, war – first the fight of the Sandinistas against the regime of Anastasio Somoza and thereafter the Contras war – compounded the problem. Both these events had large impacts on the economy, but were not the only causes of these economic problems. The Sandinistas had introduced expansive macroeconomic policies that led to enormous budget deficits (28 per cent of GDP in 1988), hyperinflation (no less than 33,600 per cent the same year), grotesque overvaluation of the currency and negative domestic savings. The regime held back exports and more or less systematically diverted investment from the private sector to the public one.

In Zambia, as well, governments committed a number of serious mistakes in the 1970s and 1980s. They erroneously saw the rise in the world copper price towards the end of the 1960s as a permanent phenomenon and undertook to increase public consumption. In the same way, they saw the price and output shocks of the 1970s and 1980s as likely of short duration. Instead of cutting back public consumption, they chose to curtail investment and increase the country’s foreign debt. Soon crisis was a fact.

What precipitates policy reform?

One could forgive the innocent spectator for thinking that crisis inevitably leads to reform. ‘Indeed, if there is one single theme that runs through the length of the political economy literature it is the idea that crisis is the instigator of reform’, writes Dani Rodrik (1996, p. 26). However, this is by no means self-evident, since there is frequently a delay in the response, and factors that differ substantially from those central to the crisis in the end trigger action. An understanding of political economy is central to an appreciation of the causes of policy inaction and delays.

In Greece, the trigger for final policy reform largely was external. The fact that the country was progressing towards EEC integration forced conservatives and socialists to draw closer. Whereas, during the 1980s, the opposition did what it could to discredit government policies, during the 1990s, when the parties alternated in power, they chose to support each other to a much larger extent. The result was that policy displayed a much greater degree of continuity. In the end Greece came a long way towards meeting the Maastricht criteria, although as it turns out not far enough to be amongst the countries to join the European Monetary Union (EMU) in the first round.

Sweden has by and large failed to respond to crisis signals. The country had an extremely good growth record for a full century, 1870–1970, but this changed with the onset of the oil crisis. The country turned out to be unprepared to meet this challenge. Politicians did not appreciate that the
good times might come to an end until calamity was a fact. Denmark is a parallel case. Paldam argues that better policy could have reduced the adjustment period to about five years and the losses in output and employment to about a third of what they actually were. However, Danish politicians had short time horizons and failed to appreciate that they were in a new situation calling for changed behaviour.

In Turkey, the reforms of 1980 indeed emerged from a crisis. The capital-goods phase of import substitution had come to a dead end. The currency was overvalued and the economy was running out of foreign exchange. This situation called for immediate measures, and the government took such measures.

In the transition countries, there were two immediate spurs to reform. One was, of course, the collapse of the system, and the other the change in political regime. The first proved that it was impossible to go back to the old regime and the second provided the political will to undertake the change. Even so, in some instances, there were delays in launching reform. Whilst things moved swiftly in Russia, in Albania procrastination dominated. It took more than a year after the onset of the crisis in 1990 until the Albanian Party of Labour yielded in its resistance to reform. It was not until under duress the old guard formed a coalition government with the opposition that the work could begin.

In Bulgaria, an economic crisis helped precipitate political change. Unemployment had been on the rise up to the 1991 elections, and against this background, it is no surprise that reform-minded forces won and launched the first reform effort. In Uzbekistan, the fact that the country was a new nation breaking away from the former Soviet Union greatly aided the reform process. This break did not see the fall of a regime. On the contrary, the incumbent leader, an autocrat, continued in power. The task of nation-building confronted him and the Uzbek elite, and the population in turn gave them carte blanche in a number of policy areas. In this context, economic reform ran second: the government implemented it to a certain degree, but made it subservient to the imperatives of constructing a new nation.

In the developing economies, the situation was more complicated. In Burma in 1988, the economy had deteriorated to the point where reform had become inevitable. It was so obvious that the socialist way constituted nothing but a dead end that the pendulum had to swing in the direction of liberalisation. The same was true in Haiti in 1986. The fatal policies of the two Duvaliers (Jean-Claude and his predecessor, his father François, or Papa Doc) engendered macroeconomic disruption so devastating that their successors had to do something drastic; the change of political regime facilitated the drafting of a reform package.

In Nicaragua, the situation had got completely out of hand, and the Sandinistas had already attempted economic reform. However, for political reasons, they did not obtain the necessary support from the
international financial institutions. A sensible stabilisation package could be put together only after the Sandinistas had left office, the US-backed Violeta Chamorro government had taken over in 1990 and the Contras war had come to an end. Only then would the World Bank and IMF step in and provide the necessary finance.

The launching of reform met with considerable delay also in Zambia. The structural-reform programmes implemented during the 1980s did little to change the situation, since they met strong resistance from important domestic interest groups, notably copper miners. This, inevitably and repeatedly, led to a failure to carry out important parts of the reform programmes. It was not until after the fall of the Kaunda government in 1991 that the Movement for Multiparty Democracy launched a comprehensive stabilisation and market liberalisation package.

What determines the responses to crises?

Dani Rodrik (1996, p. 10) has made the observation that there is no obvious correlation between economic policies that work and the popularity of their policies, but many ‘instances of collective irrationality’. Bad policies often mobilise strong popular support, whilst good polices meet with strong resistance. It should then come as no surprise that popular but faulty policies may remain in place for long periods.

Once the politicians perceive the need for reform, what do they do? This is another difficult question to answer in general terms. Anne Krueger (1992, p. 3) has stressed that ‘in practice, any change in economic policies is described as a “policy reform program”’, but this is hardly what we are after here. Policy reform is more than this. It must represent a radical break with the policies that contributed to creating a crisis situation – actual or potential. In the best case, policy-makers perceive the need for change before the crisis has come to maturation.

The most notable feature of the responses of the OECD countries to the oil-price shock was their slowness. According to Paldam, that was to a large extent the result of the structural change that had taken place after World War II. This refers in particular to the rapid growth of the public sector, from about 17 per cent of GDP on average in 1948 to some 45 per cent of GDP on the eve of the oil crisis. The intermediate years saw the creation of the welfare state, and once the crisis hit, stepping on the brake turned out to be difficult, since by then the welfare state was firmly entrenched amongst voters. The pattern that developed typically included the emergence of a budget deficit due to increased public spending to reduce unemployment, which governments followed with cuts in the public sector, which they in turn followed with a renewed public sector expansion, and so on. As a result, the adjustment took 15–20 years, depending on which indicator one uses. Governments doled out the medicine, states Paldam, only slowly and in small doses.
To substantiate this point, Paldam tells the story of Denmark in some detail, arguing that better policy could have reduced the adjustment period to about five years, cutting the losses in terms of output and employment by some two-thirds. However, both the politicians and the citizens had short time horizons and had to learn a new mode of behaviour. In the end, the correct recipe was the standard IMF package of budget discipline, tight monetary policy and devaluation.

Nor is it clear that policy-makers’ perceptions determine whether or not an economy is in ‘crisis’. Governments are motivated to intervene in economies by many factors, many of which have nothing to do with the crisis itself. Conversely, an economy may be in a state of ‘crisis’ in the perceptions of the majority of the population and the government may still fail to react. Sweden illustrates this point well: at first, society viewed the oil crisis as only a short-run phenomenon and the government waited for a boom that refused to come. In the meantime, productivity dropped and inflation shot up as a result of government spending.

When policy reform first became necessary in Greece in the mid-1980s after an overly expansive economic programme during the first half of the decade, conventional economic wisdom dictated the programme’s contents: measures to improve the competitiveness of the economy; control inflation and the balance of payments via a strong incomes policy; devaluation of the currency; and reduced public borrowing. This was merely the beginning, however. The programme was successful from the standpoint of stabilisation, but political pressure arising from social discontent caused the authorities to abandon it after a mere two years. Destabilisation crept back into the picture. In the meantime, the degree of integration within the EEC was increasing, and once the conservative New Democracy party had taken over political power, it initiated another round of policy reform. Again, it followed a conventional economic recipe: reduction of imbalances, increased competitiveness, a reduced role for the state and tax reform. The new programme met with opposition from the trade unions, and the socialists returned to power.

Before that, however, the conservatives had managed to devise a new stabilisation and reform programme, which the new administration modified only marginally. The philosophy prevailing amongst the members of the EEC at the time, notably when it came to measures conducive to the fulfilment of the Maastricht criteria for entry into the EMU, dictated the programme’s contents. Funds under the Community Support Framework (CSF) – interventionist measures designed to provide financial assistance to lagging regions within the EEC – complemented these measures. In other words, as Lolos makes clear, the process of European integration has had a decisive influence on the Greek ruling party’s ideological position.

The Turkish response to the crisis that emerged in the 1970s was a standard structural-adjustment programme with the support of the IMF and
the World Bank, with trade liberalisation, export promotion, price reform and reduction of government involvement in the economy. The effort came to an end in 1988, however, when the trade unions, with populist support, managed to negotiate significant wage increases. At the same time the involvement of the state in the economy grew anew. The 1990s saw rising fiscal deficits and increasing difficulties in raising government revenue. When the authorities liberalised the capital account of the balance of payments, the central bank lost control over the money supply, and by 1993 the short-run outflow of funds had become so severe that GDP contracted.

Historical experience strongly conditioned the initial response of Albania to the crisis that the breakdown of the old regime had engendered. Matters had got to the point where the population, after years of oppression and isolation, held favourable views of capitalism and ‘Europe’. There was a new-won openness and optimism, and a willingness to go about transforming one of the worst communist economies along capitalist lines. This was, however, not the only, and arguably, not the most important, factor conditioning the response. That role fell to the institutional vacuum that arose in the wake of the disintegration of the centrally planned economy. According to Muço and Sjöberg, the rise of the notorious pyramid schemes was a direct outcome of the absence of economic regulation.

In the case of Bulgaria, the determinant of the response to the crisis is a straightforward one: the notion of the crisis itself. The country had inherited large macroeconomic imbalances from the old regime, and had lost a great deal from the breakdown of its old foreign-trade structure. Large fiscal and quasi-fiscal deficits had built up and the central bank had monetised them. In order to ease the burden of interest payments on the government, it maintained low rates of interest, with losses of currency as the result. In the end, successive currency crises ensued. To put an end to these crises, the country adopted the CBA. Interestingly, the introduction of the CBA ran against the interests of the elite, who were busy siphoning off state funds, for example, via soft bank loans refinanced via the central bank. It was also against the interests of the poor, who, as a result of forming a coalition with the elite, had been able to retain their jobs at state-owned enterprises. It was only the very severity of the crisis that made the poor rethink their position.

In Russia, some of the very mechanisms that were present in the old system conditioned the contents of reform, and these mechanisms, according to Ickes, biased the response towards the status quo. After communism had fallen, the privatisation of state enterprises became inevitable. However, under the old, rigid system, much depended on personal ties and safety nets amongst different parts of the economy. When reform saw the privatisation of companies, it also witnessed the ‘privatisation’ of these relations: the old system continued to function, with loss-
making enterprises producing negative value-added receiving transfers from other parts of the system. (Ickes calls this the ‘virtual economy’.) This practice was necessary because there were few winners in the privatisation game, and these winners had to compensate the losers to a certain extent. This, in turn, worked against the development of a market economy.

In the case of Uzbekistan, Pomfret lists four determinants of the response to crisis: initial domestic conditions, natural resource endowment, the international context and the role of the president. The poverty of the economy and the local-boss culture made for a cautious reform strategy. Reform was difficult in large enterprises, agriculture and finance, all sectors with strong vested interests. Small-scale privatisation and the creation of new enterprises, on the other hand, were completely within the prevailing bazaar culture. Uzbekistan’s ample natural resources appears to have made decision-makers prone to wishful thinking, so they failed to anticipate lower world prices for gold and cotton. Uzbekistan has also demonstrated ambitions with respect to regional leadership, which may have been one factor behind its strained relations with the IMF and World Bank before 1995. Finally, the president was instrumental in pushing reform.

In Burma, the 1988 political crisis forced the military regime to change its policy line. It had to scrap the socialist way, ‘opening’ the country to market forces and foreign investment. A liberalisation of the economy made exports rise steeply, to levels that were not sustainable in the longer run. The domestic demand for rice suffered, prices soared and exports fell after 1995. Imports rose even faster and the trade deficit mounted rapidly. Foreign investment never materialised to any extent.

In Haiti, leaders attempted reforms on three separate occasions: after the fall of Baby Doc in 1986, at the beginning of the presidency of Jean-Bertrand Aristide in 1991 and after the return of the latter from exile in 1994. On all three occasions macroeconomic imbalances had reached such proportions that intervention along IMF–World Bank lines had become inevitable. However, political factors quickly neutralised, wholly or partly, their interventions, which in any case represented only short-run responses. Haiti’s unfortunate political heritage, including kleptocracy and a completely confrontational style of politics, called for a completely different response to crisis. History has always been an obstacle to change in Haiti, and the historical tradition dictated the crisis response as well. Measures were necessary to break up old corrupt structures, reduce rent creation and seeking and stabilise the economy.

In Nicaragua, necessity dictated the nature of the response. The Sandinista government’s stabilisation programme was essentially the same as the one coming from the Chamorro administration that won support from the international donor community. The Sandinistas, on the other hand, had attempted stabilisation without recourse to sufficient
international funds, an effort that failed to have the desired impact. Thus, in both Haiti and Nicaragua, political factors were important determinants of the reactions to crisis: domestic factors in the former case and international ones in the latter.

**Why does policy reform fail?**

Recent work on political economy – which focuses on countries where governments must take into account the will of the governed – traces policy delays not to short-sightedness, ignorance or irrationality, or to the fact that the best course of action is unknown. Rather, such work often begins with the question of why conflicts of interest and the mechanisms by which such conflicts are resolved lead to delays in the adoption of beneficial reforms (Drazen, 1996, pp. 25–6). One such mechanism is a ‘war of attrition’ amongst interest groups that wait each other out, hoping that another group will bear the costs of reform. Another mechanism is uncertainty on the part of a substantial number of groups as to whether they will benefit from a given reform package.

According to Södersten, an important reason for Sweden’s failure to adjust was that macroeconomic and microeconomic policies were at odds with each other. Thus, the devaluation policy that characterised the period failed because the government was unable to contain inflation and to make the cuts in the size of the public sector needed to push resources into export activities. Public-sector employment continued to rise. In this way, the government’s failure to change its policy course laid the foundation for the creation of mass unemployment in the 1990s on a scale not seen since the Great Depression.

In Greece, there was a marked difference between the quality of policymaking in the 1980s and that in the 1990s. In the late 1980s, in the face of popular demands, the government abandoned the policies that it had pursued during the first half of the 1980s. The state was not sufficiently autonomous to put up resistance. The government failed to instill public confidence in its policy measures, people were not prepared to pay the cost of stabilisation, the opposition used the occasion to obtain political gains and the socialist party itself was split over the issue. Matters had improved by the 1990s. Lolos argues that this improvement resulted from both domestic and international factors, especially the latter, which took precedence as relations with the now European Union (EU) deepened and globalisation issues became more important. The Convergence Programme and the substantial flow of EU structural assistance under the Community Support Framework reduced the social costs of stabilisation and reform and provided the funds for economic restructuring. Indirectly, the European integration process altered the ruling socialists’ ideological stance and improved the state’s capacity to impose policy measures.
Yeldan and Khakimzhanov concentrate their discussion of failure in Turkey on the vicious circle that occurred in the financial sector. They construct a dynamic general equilibrium model with government and banking sectors. They employ their model to demonstrate that, given sustained high inflation and a large initial debt stock (with an excessive debt-service burden), inflation is likely to be inertial. This is true as long as current interest-rate expectations do not reflect the lower inflation rates contained in the government programme. This, in turn, creates a stable vicious circle that may lead to a financial breakdown.

The case of Albania is a mixed one in terms of policy-making success. Macroeconomic results during the years prior to the collapse of the infamous pyramid schemes were favourable. However, if one holds that transition is not just about growth but also about redistribution, the achievements appear less impressive since politicians manipulated economic policies to benefit certain interest groups, above all themselves. Still, they favoured the recommended structural policies, such as privatisation, but only to the extent that it benefited their own private interests and eroded the position of their political adversaries. Muço and Sjöberg argue that the institutional, normless vacuum that the breakdown of communism had created proved instrumental in the tragic rise and fall of the pyramid schemes.

However, institutions exogenous to the Albanian economy also have economic consequences. Thus, the re-election of reformist politicians, parliamentary support for reform and the social acceptability and credibility of the reform process all have had roles to play. Albania’s macroeconomic success over 1992–6 owed much to political continuity and orderliness: differences in opinion over structural issues largely remained buried within the ruling Democratic party. However, the 1996 election campaign resulted in populist measures and ineffective policy-making. After the collapse of the pyramid schemes, a period of chaos ensued, which ended with elections in 1997 and the creation of a one-party socialist majority. A major political murder in 1998 cut short this seeming return to normality. In the end, the absence of a democratic political culture put obstacles in the way of the social acceptability, political support and credibility of reforms. Albania remains a traditional society with a political culture that repeatedly gets in the way of sustained structural reform.

Bulgaria’s CBA has been successful, but its sustainability is not self-evident. Ganev and Wyzan argue that the only remaining channel for realisation of profit at the expense of the government is the accumulation of payments arrears to state-owned utility companies. Given the political clout of these monopolies, they may be able to persuade governments to convert the resulting indebtedness into budget deficits. Rising unemployment during the CBA’s first years hit the poor hard, making them susceptible to populist appeals from groups representing the rich. One cannot exclude the possibility of the formation of a new anti-reform coalition.
Ganev and Wyzan conclude that it is this type of political phenomenon, rather than any alleged inherent macroeconomic weaknesses in the CBA, that constitutes the greatest threat to the survival of such arrangements.

In Russia, Ickes argues, the loot chain inherent in the virtual economy reinforces the status quo. People’s incomes and safety depend on a non-transparent and personalised redistribution process. They are not optimistic that a progressive redistribution of the gains from improved economic performance resulting from a sustained reform process will accompany the realisation of incomes during that process. This status quo bias not only makes it difficult to adopt reforms, but also encourages behaviour that makes their implementation harder.

Pomfret points out that Uzbekistan has avoided the shock therapy that the IMF advocates, but that it has also sidestepped the economic collapse that non-reforming economies have experienced. The country witnessed a smaller decline of real GDP over 1989–99 than many other transition economies. However, the contents of the ‘Uzbek model’ to which the government continually alludes remain unclear, and the government appears to make many key decisions reactively. Political factors have been important in the determination of economic outcomes. The president’s voice is decisive, but he does not make his decisions in a political vacuum. Pomfret argues that the president shows a genuine commitment to social welfare and has discouraged blatant rent-seeking, but has not been able to avoid an import substitution strategy inimical to growth.

The failure of Burma is a political one. After the crisis of 1995, the needs of the army came to the fore: today the army is four times its size in 1962. The authorities print money and requisition goods from the peasantry in order to keep the officers happy. There is an overvaluation of the currency by fifty times or more. Unrecorded border trade is several times larger than official exports.

Haiti, as well, is a complete political failure. The country has one of the worst political histories in the world, with the theme of the predatory state connecting events since its emancipation from France in 1804. During the turbulent nineteenth century, politics quickly degenerated into a series of fights between kleptocratic cliques that had no interest in government other than as an instrument for private income maximisation. This pattern has persisted to the present, leaving a heritage of confrontation in politics and precluding the development of the social capital needed for economic and social development.

In Nicaragua, the main problem for a number of years was a huge external debt; the largest in the world in relation to GDP, accumulated as a result of the ill-considered economic policies of the 1980s. Attempts at economic and institutional reform failed because of this fact: exports did not increase and the deficit on the current account of the balance of payments persisted. The authorities had to pledge whatever foreign currency flowed in to servicing the debt. Simultaneously, the international donor commun-
ity kept pumping money into the country, which in turn allowed the government to maintain the deficit and to let the currency remain overvalued. The economy neither stabilised nor grew. Gradually, however, the donor community heeded the call for debt reduction, bringing down the debt service and enabling the economy to grow by 5 per cent per annum. The crucial causal link between debt reduction and economic growth was forged, and further debt reductions will take place in the future. In order to meet its scheduled future debt obligations, Nicaragua will, however, need a strong export performance. According to Behar, an endogenisation of growth via exports may not be possible without increased investment in human capital. Such investments, however, require a source of finance, notably further direct-debt reduction and concessionary loans.

Why have the reform efforts met with so little success in Zambia? The post-1991 reforms concentrated on liberalisation of foreign trade and external payments, as well as on movement towards a market-determined exchange rate. The authorities tightened fiscal and monetary policies, eliminated subsidies in commodity and factor markets, freed interest rates and began the privatisation of state enterprises. Despite these efforts, however, growth rates have been uneven and wage employment in 1998 remained below the level of 1980. Again, political factors have made reform difficult. The authorities have made exceptions to the cash-budget principle from time to time when political considerations have called for them. The sequencing of the reform package has not been ideal, and the government has failed to build an active and engaged civil society that supports the reform effort. On the contrary, such groups as small businesspersons losing tariff protection and public-sector employees fearing losing their jobs have opposed the changes.

The broader perspective

What determines success or failure in the end? The two chapters in the present volume dealing with these more general issues, the ones by van Brabant and Lal, provide some clues. Van Brabant points to the essential elements of the political economy of transformation of the former socialist economies. He is careful to stress that there is no one set of measures that fits all settings. Still, it is possible to map a few essential steps that may serve as an agenda. On the political level, the most important issues involve building consensus and transparent institutions. Effective conflict resolution is possible only when agreed-upon rules and procedures exist; without them, comprehensive economic and social restructuring is impossible. Moreover, without developing political infrastructure, including stable political parties and interest groups, it will be impossible to achieve pluralistic democracy.

The preferable order of economic transformation begins with macro-economic stabilisation; price, trade and exchange-rate liberalisation;
establishment of property rights; corporatisation; reform of the banking system; and labour-market reform. In the second round, governments design measures to ensure effective competition. In the final round, they create an adequate regulatory and anti-trust environment, large-scale privatisation takes place and the sophistication of capital markets increases. Overall, the most important task is the creation of efficient markets. The transition will be over when the economy has reached a self-sustaining growth path that permits catching up with western European levels of income.

Lal, dealing with developing economies, argues that the resources at nations’ disposal and the kinds of governments that they have to a large extent determine the economic fates of nations. Initial resource endowments matter more than polities in explaining economic policies. The task is easy for labour-abundant countries. These start with labour-intensive production and then, as capital accumulation proceeds, move up the ladder of comparative advantage. Economic policy-making there is essentially about realising comparative advantage.

At the opposite extreme, we find land- or natural-resource-rich economies. Their comparative advantages are in more capital-intensive lines of production, since land abundance makes for a higher price of labour. Unless capital accumulation proceeds sufficiently rapidly, these economies may experience falling wages. These in turn may result in pressure for protection and import substitution, or ambitious development programmes that only foreign borrowing can finance. They also face the problem of natural-resource rents, which different groups are likely eagerly to seek. In an intermediate group of countries, policy-makers easily make mistakes, since the countries’ comparative advantage is not obvious. Some acute crisis often triggers economic reform, although it need not be so, and governments frequently interrupt such reform when indicators point up. However, they return to their original policy – the one that caused the crisis – as groups that benefited from rents under the old system apply pressure.

Lal next deals with explaining the political forms prevailing in different countries. He makes a distinction between the easily malleable material beliefs (about different ways of making a living) and the deep-rooted cosmological beliefs (‘how to live’). The latter originated in the distant past under the influence of, for example, the physical landscape in which the cultures in question began. Thus, China sprang from the compact Yellow River valley, where nomads from the north threatened it. As a response to the threat it developed a tightly controlled and stable bureaucratic authoritarian polity. India, in contrast, originated in the plains south of the protective Himalayas and has failed to achieve the same degree of stability.

In the Americas, with their abundant land, one of the main problems was the impossibility of extracting rents from free peasants who had access
to a land frontier. In North America, this resulted in an independent yeomanry, with family farms steadily pushing westward, creating an egalitarian society. In Latin America, this type of society failed to develop. The possibility of quick riches from mineral exploitation lured people away from farming, and the Spanish crown distributed land in large chunks. Production conditions were different as well. Whilst, in the north, wheat production (an activity without economies of scale) came to dominate, some tropical crops, notably sugar, displayed increasing returns to scale, with labour tied to the plantations as slaves. Finally, the Spain that emerged out of the *reconquista* was a strongly centralised, patrimonial nation, a feature that would carry over to its New World empire.

Divergence in religion also played an important role in establishing differences between the states of North and South America. The Protestants going to the north saw themselves under no obligation to evangelise the ‘pagans’. All they had to do was to elect a minister from amongst their own group. This made for a number of basically unrelated societies and a state acting as an ‘umpire’ that reconciled their conflicting interests. In the south, a fundamentally different situation existed. The Roman Catholic church felt duty bound to convert the peasants, with this duty looming large in both justifying the conquest and constructing a hierarchical society.

Finally, when it comes to Africa south of the Sahara, the overriding characteristic of the states is their artificiality, with Europeans with an absolute disregard for ethnic realities having drawn the boundaries between ‘nations’. These states after independence attempted to imitate the nation states that emerged in Europe after the Renaissance. This attempt was doomed to fail, not only because of ethnic rivalries, but also because of the existence of rents ripe for politicising.

**General conclusions**

We can draw four general conclusions from the essays in the present volume. The first is that what constitutes a crisis is relative. We can give no single definition, because what motivates policy-makers to act differs widely amongst countries, and especially amongst groups of countries. We find the most coherent notion in our case studies vis-à-vis the transition economies. However, there the problems had a common root: the collapse of the Soviet Union and the domino-like fashion in which the shock waves emanating therefrom spread to the countries within the socialist sphere.

The second general conclusion emerges almost as a corollary to the first one: crises have very different causes. Frequently, however, they are policy-induced, that is, they are the more or less direct result of flawed policies that sooner or later require corrective action. In the worst case, these policy-induced crises are the inevitable outcomes of the actions of
dictatorial and/or predatory governments that do not have to account for their actions.

The third generalisation is that there is no direct link between crisis and reform. Crisis may precipitate reform, but it does not necessarily do so, and the nature of the crisis may dictate the contents of the reform package, but not necessarily either. Governments procrastinate because the required action runs counter to their political interests. Thus, the timing of their responses is often suboptimal, prolonging the period required for adjustment. Moreover, backlashes easily result, either because policy-makers (and society in general) think that the crisis is over, or because preferences for the pre-reform type of policies are very strong amongst decision-makers.

Fourth, and finally, in the worst case, reform fails, for shorter or longer periods, as all of our cases illustrate. Here again, political factors tend to take precedence over economics. The political set-up – the type of political regime and the configuration of interest groups – strongly conditions the relative success or failure of reform. If an important interest group has a vested interest in preserving the status quo, the corruption of reform or its outright derailing, the reform effort will likely be unsuccessful.

References
Part I

Developed countries
Stable growth with slow and expensive adjustments

An essay on the old OECD countries using Denmark as an example

Martin Paldam

This essay looks at crises in the OECD area, which is the area in the world that has experienced the smallest crises during the second half of the twentieth century. It presents two seemingly contradictory points:

(i) In a comparative perspective the OECD countries have had an unusually stable growth. This point is demonstrated in two ways: section 2.1 looks at the evidence on comparative volatility and gives some examples of the robustness of the underlying growth to shocks. Section 2.2 looks at the large structural changes in the OECD countries. It is remarkable that economic growth has been robust to such large structural changes. The second half of section 2.2 considers new developments of the economic system that might help keep it stable in the future.

(ii) The slowness and great costs of adjustment to the only big crisis, the Oil Crisis of 1973, are discussed in section 2.3. Several studies have been made of the slow adjustment of the developed countries in the Oil Crisis. Most are studies of individual countries, and I will use the example of my own country as the main illustration. I will first show that Denmark is a typical case, and then look at the political economy of the adjustment.

The contradiction between the two points (i) and (ii) is discussed in the conclusion in section 2.4. The reader should be warned that this is a heroic essay. The perspective is half a century, and many brave assessments are given.

2.1 Relatively low variability and robustness to shocks

The standard crisis terminology is given in Table 2.1. Like all countries the old OECD countries have needed stabilization policies from time to time. Only New Zealand has made a policy package large enough to be termed a Structural Adjustment, but then New Zealand for long followed a policy taking the country away from the mainstream. Even the policy changes of Margaret Thatcher and Ronald Reagan are not normally deemed so large as to merit the term Structural Adjustment.
What is normally called a reform in an OECD country is a new public-spending programme, or a revision of an old one to follow a new set of principles. Such reforms are not meant to influence the growth path of the economy, except perhaps very indirectly. What is considered is exclusively economic reform.

First, the evidence that compares economic variability in the regions of the world is considered. Then a set of examples discussing aspects of the stability is presented.

### 2.1.1 A look at the data: the most stable region in the world

The most comprehensive study of the volatility of different parts of the world is probably IDB (1995). Table 2.2 gives a typical sample of the results, which show large differences. The calculations reported in Table 2.2 use weighted averages. Volatility decreases when countries are larger. However, nearly all of the decrease is at the low end when microstates are

<table>
<thead>
<tr>
<th>Short name</th>
<th>Adjustment</th>
<th>Reform(^a)</th>
<th>Transition(^a)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Long name</td>
<td>Stabilization package</td>
<td>Structural adjustment (SA)</td>
<td>Big structural change</td>
</tr>
<tr>
<td>Character</td>
<td>Policy instruments changed</td>
<td>Qualitative and institutional change</td>
<td>Change of economic system</td>
</tr>
<tr>
<td>External help</td>
<td>IMF balance of payments cure</td>
<td>IMF-IBRD-liberalizing package</td>
<td>No single approach</td>
</tr>
<tr>
<td>Time horizon</td>
<td>1–3 years</td>
<td>5–10 years</td>
<td>2–3 decades</td>
</tr>
</tbody>
</table>

Note
\(^a\) During the last twenty-five years, only changes from a more to a less regulated economy occurred.

### Table 2.2 Relative volatility of OECD countries 1970–92

<table>
<thead>
<tr>
<th></th>
<th>Sd of real growth rate</th>
<th>Sd of rate of inflation</th>
<th>Change of real exchange rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Absolute OECD area</td>
<td>2.2</td>
<td>3.9</td>
<td>4.8</td>
</tr>
<tr>
<td>Relative OECD area</td>
<td>1.0</td>
<td>1.0</td>
<td>1.0</td>
</tr>
<tr>
<td>Africa (Sub-Sahara)</td>
<td>2.4</td>
<td>22.7</td>
<td>4.8</td>
</tr>
<tr>
<td>Latin America</td>
<td>2.1</td>
<td>118.9</td>
<td>2.8</td>
</tr>
<tr>
<td>South Asia</td>
<td>1.5</td>
<td>2.0</td>
<td>(1.5)</td>
</tr>
</tbody>
</table>


Notes
Sd is standard deviation. Numbers are weighted by population of country. The pattern stays rather constant after 1992. The number in parentheses is a guess based on scattered evidence from other sources.
compared to small states. From about 1 million inhabitants volatility barely decreases, as larger countries are considered. The pattern in the results is therefore robust to the weights.

The most dramatic results in Table 2.2 concern the volatility of inflation. Inflation rates are roughly proportional to the standard deviations of the rates, so the differences in the volatility of inflation reflect similar differences in average inflation as well. The rates of domestic price rises have correlations of about 0.6 in the OECD area (see Paldam, 1994), while the big Latin American and African inflations are all homemade and uncorrelated. Consequently, the more countries isolate themselves from the world market, the more inflationary they become.

The main explanations of the differences in volatility are listed in Table 2.3. None of the explanations are mutually exclusive. The two deep explanations deal with the development process itself. Only rich countries grow at the technological frontier, where productivity gaps are small between the sectors, and income distributions are reasonably equal. LDCs (Less Developed Countries) – notably middle-income countries – have large productivity gaps between sectors, and therefore both a more uneven growth and a skewer income distribution. Hence, it is difficult for political regimes to achieve legitimacy and stability.

IDB’s analysis attempts to sort out the importance of the three concrete explanations B1 to B3 from Table 2.3. It was concluded that B3 dominates. The most volatile countries have normally isolated themselves from the world market, dispensing with the discipline of openness. This has given much extra force to domestic shocks.

This story has a tragic irony. In the heyday of the Import Substitution Strategy, many LDCs isolated themselves from the world market precisely to get protection from its alleged volatility. The result has been the opposite, even in countries like the three southernmost Latin American countries, which were close to European wealth as late as 1950.

| Table 2.3 Main aspects of the relative stability of the West |
|-----------------|-----------------|-----------------|
| **Level**       | **LDCs: Poor and middle-income countries** | **West: Rich countries** |
| Deep            | A1 Dualism, uneven growth, large inequality | No dualism, steady growth, moderate inequality |
|                 | A2 Unstable political system               | Consolidated political systems with stable parties |
| Concrete        | B1 Large primary sectors dependent on nature | Small dependency upon nature |
|                 | B2 Export of few goods to few markets      | Export of many goods to many countries |
|                 | B3 Protection allows internal forces a free play | Discipline of big external openness |
2.1.2 Shocks and disequilibrium

Another approach to volatility is to consider the relationship between shocks and disequilibrium. The ability of the economies to absorb shocks depends upon the equilibrium/disequilibrium situation in the country when it is hit by the shock. Countries in equilibrium can absorb moderate shocks, while countries far from equilibrium can be severely upset even by small shocks.

The external balance of a country is a fine meter of disequilibrium, and in addition it enforces early adjustment. With sufficient protection large disequilibria can develop, making adjustments to shocks much more difficult. My argument is thus that a main reason why the old OECD countries have been so shock resistant is that they were (still are) so open that they have been forced to keep their economies in reasonable equilibrium.

During 1950–73, nearly all OECD countries had budgets that were balanced within ±2 per cent of GDP, balances of payments were largely within ±1 per cent of GDP, and neither external nor internal debts accumulated. However, towards the end of the 1960s most OECD countries developed some “joint” disequilibrium.

The two main signs of disequilibrium were internal: unemployment was for more than a decade well below the natural rate, and consequently inflation rates rose slowly. The rise for long went unnoticed as inflation started around 2 per cent in the 1950s, rose to 4.5 per cent in the 1960s and reached 7–8 per cent in the early 1970s. The logarithm to the inflation rate in the average OECD country is virtually linear with a small positive slope from the early 1950s to 1973. The price level accelerated much as predicted by Phelps (1967) and Friedman (1968), so it is no wonder that the expectations-augmented Phillips curve became the accepted theory in the early 1970s. However, polled data show that few people form inflationary expectations, so the theory builds on tricky arguments where people behave as if they formed inflationary expectations. The end of section 2.2 deals further with this argument.

2.1.3 Learning discipline – some cases

The story above thus confirms the discipline argument: external openness forces countries to behave responsibly. If the economy is closed, no politically convincing argument exists to stop unions and firms from inflating the economy. Governments may want to reduce inflation, but they also want to achieve domestic peace in the short run by allowing “nice” settlements to strikes and other labour unrest. They have political friends to reward, and so on. Under such circumstances it becomes impossible for the central bank to be the one and only nominal anchor.

This argument has a twist: I believe that the evidence demonstrates that
policy-making in all countries (normally) has a time horizon of less than a year. It is hence crucial to have a mechanism that quickly gives a hard problem if countries behave “irresponsibly”. The external balance is probably the best such mechanism.

Most of the OECD countries have learned discipline the hard way, already in the 1950s. Consider the stories of Finland and France in the late 1950s. Both countries had episodes of excessive wage-price rises. France experienced large-scale labour unrest in 1957–8, causing excess inflation of at least 25 per cent over the world level. This caused two large devaluations, and a political change from the fourth to the fifth Republic. After the events had settled, it became clear that nobody had benefited from the process. Finland went through even more dramatic inflationary events in the 1950 and 1960s, before the country reached something like an (implicit) internal stability pact. Having learned this lesson, both countries became economically successful.

One of the most divergent cases in the OECD area is Iceland, which deliberately introduced a system that used the exchange rate to handle conflicts over the distribution between a highly volatile resource-based export sector and the rest of the economy. It caused the Icelandic economy to be one of the most volatile in the OECD area, and the Icelandic Crown devaluated by eight times between 1948 and the late 1970s, when the system was gradually abolished. It is impressive to see how much better the economy has behaved after that.

Another piece of evidence of stability is the small effect of strikes (see Paldam, 1983). The OECD countries have differently organized labour markets generating vastly different frequencies of strikes. A standard statistic available for many countries is the relative number of days lost to strikes. In the strike-prone labour markets in Latin Europe and the Anglo-Saxon countries, this number is about twenty times higher than in the Germanic–Nordic countries. In neither case is it easy to find a macro relationship between the number of days lost and annual production. Even the “events” of May 1968 in France, where most of the country was paralysed for a month, left little (if any) impact on the annual real GDP.

2.1.4 Occasional financial and exchange-rate crises

Financial crises have hit several OECD countries. When the Debt Crisis broke out in 1982, the US banking system was legally bound to write down its assets in the indebted (mainly Latin American) countries by more than its equity capital. So in principle the US banking system was bankrupt. This was not, of course, allowed to happen, and the Debt Crisis did not cause a crisis in the OECD area. In fact, it is hardly even visible in the growth rate of the average OECD country, while it caused a full decade of almost zero growth in Latin America.
However, Finland and Sweden had a financial crisis in the early 1990s much like the Asian Crisis ten years later.\textsuperscript{11} The crisis broke out due to the large drop in the export from Finland to the Soviet Union. The crisis spread to Sweden due to large flows of hot money, and a collapse of the financial sector in Sweden caused by an overhang of bad debt (20–30 per cent of GDP). This double crisis called for large-scale policy action where debt had to be consolidated and written off before the banking system could regain credibility. Like in Asia the result was a sharp, but rather brief crisis. The costs measured in accumulated annual GDP percentage points lost were in the order of 10–15 percentage points or slightly less than the corresponding figures from Asia.

Most OECD countries have had exchange-rate crises without bank crises. They are normally dramatic and newsworthy, but afterwards they turn out to have had little effect on the underlying real economy. The UK has experienced several \textit{pound crises} since 1948. The worst was probably the one in late 1967, which is sometimes (e.g. in the \textit{Encyclopedia Britannica}) alleged to have caused the later downfall of the first Wilson government. However, the real growth rates for the UK in 1967 and 1968 are very close to the trend.

\section*{2.2 Structural change and the development of the economic system}

This section first demonstrates that the robustness of economic growth has prevailed in spite of large structural changes. Then it discusses how the economic model of the West is developing. It is shown that it is developing in a direction that is likely to increase its robustness.

\subsection*{2.2.1 The 25 years of large-scale structural change: 1948–73}

Growth in the OECD area has even been stable in spite of the large structural changes that took place during the last half century. In 1945–50 the agricultural sectors were as large as 10–20 per cent in most OECD countries, while the public sectors were below 15 per cent. Now the agricultural sectors are well below 2 per cent, while the public sectors are between 20 and 25 per cent. If transfer payments are included, public sectors are even twice as large.

The amazing fact is that this massive change took place in the short time span of 25 years, from the start of the stable currency system in 1948 until the crisis of 1973 broke out. It took a couple of years to get the development going, and during the 1960s the expansion in the public sector was even faster. The public sectors in the average OECD country grew by about 1 per cent of GDP per year for the entire 25-year period. The simplest way to present the stylized fact is to speak of \textit{two levels} for the public sector (as shown in Figure 2.1):\textsuperscript{12}
a) An old level of about 10 per cent during the Liberal Century from 1818–1914.

b) A new level of 45 per cent from the mid-1970s onwards.

c) A rapid transition between the two levels especially between 1950 and 1973.

Many writers have tried to estimate the growth pattern for the public sector, concentrating on the period after 1950. They have used models with three sets of mechanisms:

Demand models. The standard approach uses the median voter model to sweep politics under the carpet. Bureaucrats are assumed to be ideal civil servants, helping politicians to maximize the welfare of the median voter. The bottom line in Table 2.4 shows that this explanation has a severe problem. It is difficult to think of a reasonable demand function for the median voter that produces income elasticities that vary as shown in Table 2.4.

Models of social and technological change, which had an old stable pattern before the First World War and after a transition reached a new stable pattern after 1975. Two main changes are likely to be relevant:

(i) On the demand side, the demographic transition and the mechanization of household production changed the family pattern from extended
Table 2.4 The stylized facts of public-sector growth in the OECD area (%)  

<table>
<thead>
<tr>
<th></th>
<th>1820</th>
<th>Period between</th>
<th>1910</th>
<th>Period between</th>
<th>1948</th>
<th>Period between</th>
<th>1973</th>
<th>Period between</th>
<th>2000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Public-sector share at</td>
<td>10</td>
<td>–</td>
<td>10</td>
<td>–</td>
<td>17</td>
<td>–</td>
<td>45</td>
<td>–</td>
<td>45</td>
</tr>
<tr>
<td>Growth rate of GDP</td>
<td>–</td>
<td>3</td>
<td>–</td>
<td>3</td>
<td>–</td>
<td>4</td>
<td>–</td>
<td>2</td>
<td>–</td>
</tr>
<tr>
<td>Growth of private sector</td>
<td>–</td>
<td>3</td>
<td>–</td>
<td>2.75</td>
<td>–</td>
<td>3</td>
<td>–</td>
<td>2</td>
<td>–</td>
</tr>
<tr>
<td>Growth of public sector</td>
<td>–</td>
<td>3</td>
<td>–</td>
<td>3.25</td>
<td>–</td>
<td>6</td>
<td>–</td>
<td>2</td>
<td>–</td>
</tr>
<tr>
<td>Implied income elasticity</td>
<td>–</td>
<td>1</td>
<td>–</td>
<td>1.2</td>
<td>–</td>
<td>2</td>
<td>–</td>
<td>1</td>
<td>–</td>
</tr>
</tbody>
</table>

Note
The public sector is measured inclusive of transfers, including compulsory insurance schemes.
to core families. The extended family had considerable household production, including care for the young and old. The new core families have little household production and contribute much labour to the market, and thus need institutions to care for the young and old. The change from the old pattern to the new happened a little earlier than the change of the public-sector level. It was clearly a change that radically increased the demand for the public sector.

(ii) On the supply side, the ease and efficiency of taxation has increased radically. The underlying reason was the huge jump in the technology of book-keeping, which made transactions and payments much more transparent. The new techniques caused most payments to leave an electronic trail for the taxman to follow. This has allowed a much more efficient and broad-based taxation. A VAT and a pay-as-you-go income tax (in countries with wage shares of 75 per cent) allow an almost distortion-free collection of at least 40 per cent of GDP. Also, the transition of corruption from high to low has made taxation easier (see Paldam, 2002). Finally, it is important that labour-supply functions are virtually vertical. Most people like to work. Hence, a large-scale expansion of the public sector became possible.13

Public-choice models, which assume that politicians and bureaucrats are human beings who pursue their own interests within the constraints of the system. These models often build upon mechanisms where key variables are difficult to measure. A key model builds upon the information asymmetry between bureaucrats and taxpayers. It allows bureaucrats to increase budgets and slack. These theories do not explain why the relative size of the public sector increased, but they explain the inner dynamics in the rise once it started. That is, these theories help us to understand the smoothness and the tremendous inertia of the rise.

The smoothness of the rise makes it problematic to explain the rise by econometric models. Public-sector growth series fail to provide the kinks and twists that allow us to distinguish between alternative explanations, and all models produce impressive R²-scores.

An important consequence of the expansion should be noted: the great expansion solved the problem of absorbing the many new entrants to the labour market leaving agriculture and household production. So the large structural changes balanced neatly and even caused very low unemployment rates – far below the natural rate. Secondly, Europe was catching up with the USA.14 This is mainly the story of the 1950s and early 1960s as told by Denison (1967).

2.2.2 The public-sector push and the economic system of the big compromise

This all worked together to produce the Golden Period of the West, where private and (especially) public consumption rose with an unprecedented
speed and created a whole set of rich welfare states. The system change in
the West therefore is that the countries moved from the laissez faire model
of the Liberal Century to the welfare state model. Schumpeter (1942) pre-
dicted this development, and he further predicted that it would lead to
the end of capitalism. However, as the welfare state developed, something
else developed that he did not predict: the populations of the West came
to increasingly distrust public ownership.15

It has caused the economic system to be increasingly based upon a big
compromise as also listed in Table 2.5.16 On the one hand the left obtained
the welfare state; on the other hand the right obtained secure property
rights and free trade. The development of the welfare state is thus a com-
promise between the moderate left and right, where the right got the effi-
ciency of capitalism, while the left got social security, public goods and
considerable redistribution. The left in Southern Europe and Japan was so
extreme that this compromise took longer to develop, and the USA hardly
had a left. So the big compromise was first developed in north-western
Europe, but it has gradually spread throughout the West.

The trade shares of the average Western country are even larger today
than they were at the end of the Liberal Century, that is in the first decade
of the twentieth century. However, the non-trading public sector has
increased by about 20 per cent of the GDP, so the integration of the
private sector in world trade has increased by about 50 per cent.17

While the welfare state was being built, this was surely an unbeatable
combination. Another question is whether it is viable in the long run. The
argument has been made (most forcefully by Aser Lindbeck, 1995) that
the welfare state destroys “work ethics” in the longer run, and thus under-
mines itself. So far the evidence fails to confirm that this is happening,
and the welfare state is certainly popular among voters.

It is interesting to compare the development of the USA and the other
OECD countries. The USA could not – of course – catch up with itself,
and did not expand the public sector as fast as everybody else. As a result,
US unemployment remained reasonably stable around 5–6 per cent. In
most other OECD countries unemployment rates fell during the 1950s to
about 2 per cent, where they stayed till 1973. Then they went up to more
than 10 per cent and stayed that high for a long time. It is only now that
unemployment rates of the West European countries are dropping to 5–7

<table>
<thead>
<tr>
<th>Table 2.5 Four economic systems</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Property rights and foreign trade</strong></td>
</tr>
<tr>
<td>Production of public goods and redistribution</td>
</tr>
<tr>
<td></td>
</tr>
</tbody>
</table>
per cent. Perhaps a rate of 5–7 per cent can then be taken to be the natural rate for a mature developed economy.

Towards the end of the Golden Period many idealistic and romantic beliefs came to flourish in the West (see Inglehart, 1977, 1997). The most extreme forms were seen in the youth’s revolution, which preached post-materialist dreams and grand visions. It is common to ascribe the end of the Golden Period to expectations that got out of control, but then it should be recognized that the expectation process is really grand. It must include much more than a rise of inflationary expectations (\(p^n\)) discussed at the end of section 2.1.2. It became a widespread belief that the West had learned to “walk on water”: full employment, social security and ever increasing wealth were secured once and for all. Time had come to go for immaterial goals – whatever they are.

2.2.3 Braking patterns after 1973

The two-level theory of the public sector is shown in Figure 2.1. It should ideally have a logistic form rising from the old level of 10–12 per cent in the Liberal Century till the new level. The upswing to the left of the figure has a nice smooth form as expected, but the new level is not reached by a similar process.

The curves for countries like Denmark and Sweden from 1948 to 1973 look as if the upper convergence was to a new level well above 100 per cent. So the process had to be stopped at some new level, allowing a viable and stable relation between the public and the private sector. Part of the crisis after 1973 was that a smooth braking was impossible in most countries. The braking often occurred as drawn in a zigzag way. First, the budget went into a large deficit, while public spending shot up due to rising unemployment. Then a crisis occurred with public-sector cuts. Next the public sector resumed its expansion once again, and was cut. In the meantime new spending programmes came along, such as spending to improve the environment. In some countries large building programmes for heavily subsidized windmills were started to reduce the greenhouse effect, and so on. Welfare expenditures are dynamic, as we all know, and it is difficult to prevent them from growing faster than the GDP.

During the braking period most OECD countries went into heavy budget deficits – while the balance of payments improved, so the accumulation of debts was largely domestic. The domestic debt of the typical OECD country grew from 10 per cent to 60 per cent of GDP during the first decade after 1973. Section 2.3 will further examine the consequences of the big turn.

2.2.4 Increasing capitalism: is equilibrium in sight?

In the last decade of the century the big compromise developed in two directions, as sketched in Figure 2.2. The public sector grew (much) more
slowly than before. At the same time the share of publicly owned means of production has shrunk in two ways: (a) SOEs (State Owned Enterprises) are privatized; (b) increasingly, the production of public goods is outsourced – even when they are still supplied to people by public bodies at prices below market prices.\textsuperscript{18}

If these developments continue, private ownership of the means of production will continue to increase relatively, at the same time as the welfare sectors develop more slowly. Thus the welfare state becomes more and more capitalist. Hopefully an equilibrium can develop where capitalism controls the tendency for excessive growth of the welfare sector, and the welfare state controls the excesses of capitalism.

\subsection{2.3 The slowness and high costs of adjustment after the Oil Crisis of 1973}

The time series for the real growth rate in the old OECD countries have been endlessly analysed by all the tools of econometrics, and dozens of articles have been published. My understanding of this literature is that as regards the time after 1945: (a) The data for nearly all of the countries are

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{figure2.2.png}
\caption{The big compromise and some new developments.}
\end{figure}
close to white noise around long-run steady-state growth paths; (b) How quickly the real GDP returns to the path is debated, but only weak cyclical patterns have been found, and the series are virtually void of autocorrelation; (c) The only big change in the data for nearly all countries – except the USA – is the downwards shift of about 1.5 percentage points in the growth rate after 1973.

This section argues five points: (i) there was some disequilibrium in the average OECD country in the spring of 1973; (ii) the external oil shock in 1973 was moderately large; (iii) the adjustments to the two problems took 15–20 years; (iv) the cure that finally worked was traditional, much like the standard IMF cure; (v) the main reason it took so long for the medicine to work was that it was given in small doses.

The adjustments story unfolded in different ways in each country, and I know of no survey covering the slowness of adjustments in all countries. I will tell the story of Denmark, after having demonstrated that it is fairly typical.

### 2.3.1 A typical case: Denmark

Figure 2.3 compares Denmark with the average West European country. It demonstrates that the Danish growth rate (for the real GDP) has been almost the same as that of the average West European country. In the early 1960s, Denmark grew a little faster than most countries in Western Europe, and between 1969 until lately the growth has been slightly slower.
The same applies to unemployment. It was relatively low till 1973 and then relatively high for a decade. Now it is – once again – relatively low. Denmark has been one of the richest OECD countries, but gradually the other countries have caught up. The reader may think that Denmark is atypical in the sense of being more regulated than the average West European country. Christoffersen and Paldam (2004) shows that it is not the case. In fact, Denmark is one of the two or three countries that are closest to the average. If one looks at the pattern of regulations, Denmark has slightly more welfare-state programmes than the average, but on the other hand a relatively small SOE sector. Also, property rights and free trade are relatively well protected.

Hence, the Danish story is a typical one, though perhaps a little stronger than the average: (a) the boom in the 1960s was a little larger than average; and (b) the crisis of 1973–85 was a little larger than average.

Another typical trait is that during the last years before the Oil Crisis, Denmark enacted several new laws, which we can now see were remarkably utopian as they were strongly influenced by the post-materialist “anti-efficiency” ideology. The two main examples were the unemployment compensation law and the new social-security law:

(i) Unemployment benefits were raised to 90 per cent of prior wages for most wage earners. The idea was that the average wage earners should not suffer an income loss if he or she became unemployed.19

(ii) A new social reform was enacted, where social payments were to be given according to assessed needs. The guiding idea was that social problems are an anomaly to be treated by a group of experts. People with a social problem should visit their “social treater”, who after a discussion of the problem, and a consultation with her colleagues, should prescribe an individual cure solving the problem. A wide selection of social payments, including a great deal of ad hoc grants, were available. This whole social-treatment ideology demanded a social bureaucracy that was large compared with the number of clients.

2.3.2 The disequilibrium in the spring of 1973

The Danish economy was overheated in the spring of 1973, and many signs pointed to a macroeconomic disequilibrium, even while the size of the disequilibrium was moderate. The numbers listed in Table 2.6 illustrate these points.

During the Golden Period the public sector had a budget surplus most years, and the public debt consequently disappeared; however, the balance of payments had a small deficit. This had been a persistent problem for almost a century. Around 1960 a balance was reached, but then it was allowed to slide back into deficit, and the last five years before the crisis the balance of payments deteriorated. Nevertheless, the foreign debt had not reached serious proportions.
A small digression on an apparent inconsistency may be needed here: how could Denmark have an almost permanent (though small) balance of payments deficit for a century and have accumulated little external debt? The explanation is that Denmark had managed to borrow at a lower rate of interest than the GDP growth rate. The *Golden Age* result from the theory of economic growth is that consumption (welfare) is optimized in steady state, when the growth rate, $g$, and the rate of interest, $r$, become equal: $g = r$. However, for most of the period from 1870 to 1982, Denmark was in the situation where $g > r$. It is easy to show that this allows a permanent balance of payments deficit $d = (X - M) / Y < g - r$, where the debt burden accumulates slowly to $d / (g - r)$. As $d$ was about 1 per cent, and the deficit margin $(g - y)$ was about 3 per cent, no serious external debt burden emerged.

During the Golden Period of overheating, economists frequently warned that the balance of payments was a serious problem that would cause big trouble when an international crisis came. However, for a long time things went incredibly well, and the Danes learned that economists “cried wolf” far too often. In retrospect all the warnings proved true.

The other problem was rising inflation, but everybody else in Europe suffered from the same malady, so the main problem was that the share of the public sector was still rising fast. If the numbers in Table 2.6 are compared with the size of the disequilibrium in countries outside our group when they were hit by external shocks, this appears a puny disequilibrium.

### 2.3.3 Crisis: the external Oil Shock and the internal political shock

Like all oil importers, Denmark was hit by the Oil Shock in the fall of 1973 after the Yom Kippur war. In addition the country was hit by a domestic political shock within two months.

The Oil Shock was a terms-of-trade jump by about 5 per cent – it soon
started to decrease, and after four to five years it was almost gone. The balance of payments went from a deficit level of 2–3 per cent to 5–6 per cent for two years, and then it fell back to about 3 per cent. The external debt burden rose to about 35 per cent, but the world inflation wiped out old debt almost as fast as new debt accumulated. The first decade after the Oil Shock was a period of negative real interest rates. The debt burden did not start to increase rapidly until 1981, when the real rate of interest finally became large and positive. It was clearly a serious external shock, especially as it came on top of a small external disequilibrium. However, compared with the terms-of-trade variations of the average LDC, it is not impressive.

The political shock came at the election in 1973. It took place two months after the Oil Shock, but it was in the polls well before Yom Kippur, and had purely domestic roots: the main reason was that both moderate government alternatives had offended their voters. The Liberal–Conservative Alliance ruled 1968–71 – precisely the period where taxes increased most. The Social Democratic Party took the country into the EU in 1972 against the wishes of most of its voters. Furthermore, the early 1970s was the period where the utopian left peaked, and at the other end of the political spectrum a large anti-tax party emerged. It was created after the sudden TV stardom in the spring of 1972 of the libertarian lawyer Glistrup, who emerged as a “mad genius”. All of this caused the hitherto extremely stable Danish five-party political system to break up, and the country suddenly had 12 parties of which three or four “anti-system parties” shared 25 per cent of the vote. It is doubtful if anybody could have handled the economic crisis with such a parliament, but the Social Democratic Prime Minister at that time did not even try. His policy was to let time pass while hoping something might turn up.

With little government intervention, things rapidly deteriorated. The wage earners managed to get compensation for the external price rises, and the wage share rose by no less than 5 percentage points from a level which was already high in 1972. The net profit share became negative 1974–7. The next few years therefore saw a collapse in investments and domestic savings. After a couple of years unemployment started its climb to reach 12 per cent in the late 1970s. Also public-sector budgets went into deficits of 3–5 per cent of GDP, and a domestic debt burden appeared. Due to the high domestic interest rates (see below), it accumulated rapidly.

2.3.4 Drops of bitter medicine

One of the most commonly expressed policy statements from all responsible politicians in Denmark and most other Western economies was that “unemployment should not be used as a policy tool”. The upward slide of unemployment was something that happened, and the politicians kept
stressing that they were powerless to stop it. It was even stressed by many that the high oil prices had something to do with “the big underlying environmental crisis”. However, by 1980 unemployment had increased from less than 2 per cent to 12 per cent.

With the crisis the social policies came under considerable stress, and after a couple of years a gradual revision process started. In 1980 the average unemployment relief had fallen to 60 per cent of prior wages, so the relative fall was no less than 25 per cent. Also, the assessment principle in the social laws was quietly dropped for three reasons: (a) it became too expensive; (b) after unemployment increased six times, the number of social clients became too big for the social bureaucracy to treat individually; (c) many stories appeared in newspapers of clever social clients who managed to obtain handsome solutions to their problems, while less charming clients received a different treatment. So the assessment principles broke down, and the old principles of equal treatment and legal entitlements were gradually allowed to come back.

The rise in unemployment from 2 per cent to 12 per cent should have caused the share of transfer payments to increase by at least 5 per cent of GDP if all rules and rates had remained unchanged relatively. However, the share of transfer payments stayed roughly the same. So the many small cuts did add up to a considerable aggregate cut.

The period 1976–82 (still under Social Democratic rule) saw a number of small exchange-rate adjustments adding up to a devaluation of about 10 per cent. They were done almost “secretly” in connection with exchange-rate adjustments of other currencies. While the voters took little notice, the capital market reacted strongly, and the Danish level of interests grew dramatically compared to international interest rates. The excess rate reached 6–7 per cent. Even when the devaluations are included, the excess rate is still 5 per cent. This caused the internal debt burden to rise and contributed to continued low investments.

In 1982 the Social Democrats lost power to a Conservative–Liberal coalition that ruled for the next decade. The new government froze the exchange rate and made a demonstrative commitment to a fixed rate. This quickly caused the interest rate to drop to the international level. Also, the new government outlawed price escalation clauses in wage agreements, increased taxes and cut public spending, causing the first budget surplus for a decade.

After a decade of gradual reform, the economy slowly returned to its long-run growth path, as will be discussed in the next section. The key point to note is that the cure that worked was a combination of public-sector cuts, devaluations and a prolonged period of high unemployment.
2.3.5 How long did it take for the cure to work?

The start of the “crisis” is easy to locate, but telling when it ended is difficult, as the economy did not return to the ex ante situation.

The Danish balance of payments reached equilibrium in 1990, partly because of the adjustment and partly because of the North Sea oil that allowed the country to be self-sufficient in energy. After 1990 a balance of payments surplus emerged, and external debts started to fall. The debt burden peaked at 45 per cent of GDP and reached the pre-crisis level of 25 per cent in the mid-1990s. Consequently, the adjustment took 16 or 21 years if one looks at either the balance of payments or debts. Inflation reached 3 per cent in 1990, but it was below 4 per cent already in the mid-1980s – here the adjustment was complete already 12–16 years after the crisis started.

The public-sector budget balance was very negative from 1974 to 1982, but then it rapidly improved and became positive in 1984. Since then it has been positive and negative on and off. Here the adjustment period was only ten years. However, the internal debts that developed during the decade of the deficit have only dropped marginally, so in this light the adjustment has not been made even at the turn of the century.

The big problem to assess is when unemployment returned to equilibrium, as one has to assess the natural rate. Much literature deals with these matters as the natural rate of unemployment is a slippery concept depending on many structural and legal factors. When unemployment benefits are 80 per cent of wages, the natural rate is higher than when the benefits are 60 per cent. Also, *hysteresis effects* of middle-term inertia enter into the adjustment processes. So these matters are difficult to fully understand.

In the Golden Period unemployment was too low, in the sense that inflation was slowly rising. With 12 per cent unemployment, inflation was falling. Actually, inflation was falling faster at 12 per cent unemployment than it rose at 2 per cent unemployment, so one can argue that the natural rate is closer to 2 per cent than to 12 per cent. Further, the experience of the USA, which never had as extreme rates as 2 per cent or 12 per cent, suggests that an unemployment rate around 5–6 per cent is the natural one. However, unemployment did not reach 6 per cent until 1998. That is, no less than 25 years after the crisis started.

To sum up, probably a reasonable middle-of-the-road assessment is that the adjustment of the economy to the disequilibrium and the shock in 1973 took at least 15 years.

2.3.6 The costs of the crisis and the costs of the slowness of adjustment

The total costs of the crisis are easy to assess, though no calculation can attempt precision. Essentially, one has to measure in cps – that is, cumula-
tive annual percentage points of growth or employment lost. The Danish growth rate \((g_t)\) from 1900 to 1973 was slightly above 3 per cent in average, so the growth loss is:

\[
\text{Growth loss: } \sum_{t=1973}^{1990} (3.0 - g_t) = \text{ca 45 cps (1)}
\]

The employment loss can be similarly calculated given that the natural rate is 6 per cent:

\[
\text{Employment loss: } \sum_{t=1973}^{1990} (6.0 - u_t) = \text{ca 90 cps (2)}
\]

The two calculations (1) and (2) do match reasonably well in the sense that the employment lost could have produced the product lost. It could probably have produced even more. That would, of course, have demanded some extra investments, and then the whole picture would have been a little different.

Let us imagine that a determined and competent adjustment had been made starting in November 1973. How quickly could the crisis have been solved? This is, once more, a difficult question, but it could probably have been accomplished in five years. Surely it would have been a bit tougher during the first couple of years, but less so towards the end of the period. A five-year adjustment period would have cut the two losses by something like two-thirds.

The conclusion of the heroic “calculations” is that 15 cps of the growth loss and 30 cps of the employment loss were due to the crisis and the disequilibrium. The remaining 30 cps of growth and 60 cps of unemployment were due to the slowness of adjustment.

The same calculations can be made for all the economies of the old OECD countries. They will show much smaller figures for the USA, and they will be virtually impossible to make for Japan, where the Oil Crisis seems to have caused a permanent downwards shift from high growth to “normal” growth. For most of the other countries the calculations will be similar, though perhaps with somewhat smaller numbers reached in (1) and (2).

We have consequently told a story of a sizeable, but by no means overwhelming, external shock, hitting the group of the most wealthy and “well-rulled” countries in the world, in a situation where they were suffering from a small disequilibrium. The result was a moderate crisis made two to three times bigger by slow adjustments. The slowness was caused by a remarkable lack of will to act decisively.
2.3.7 Why was the West so slow to adjust?

Standard assumptions in economics of rational and far-sighted agents make it difficult to understand why adjustments took so long. One way to begin to understand is to consider two closely related thought experiments.

Imagine, first, somebody in 1972 had suggested that Denmark would spend the next one and a half decades fighting the balance of payments deficit and inflationary pressures with a policy of 10–12 per cent unemployment, a 25 per cent cut in the rate of unemployment compensation, and the scrapping of the new “social-policy law”. Surely such a great prophet would have been deemed insane!

Imagine, then, that Denmark in the late autumn of 1973 had asked the IMF to prescribe a cure for the crisis. The prescription would have been close to what Denmark actually did, but IMF would have recommended that it was done decisively and quickly, not in small drops over more than a decade. If such recommendations had been followed, it would have solved the crisis much faster, but it would have created a big outcry and much political turmoil.

The message from the two experiments is that people and politicians had to be prepared – that is, everybody had to unlearn that they could walk on water. A clear sign that such “sobering processes” were involved is to consider the very different political reactions during the last big crisis and now. The crisis of the 1930s saw big shifts away from the previous political systems to anti-system parties in many countries, even in previously highly civilized ones.

The period since 1973 has seen little such political change. The anti-system left has decreased, while the anti-system right is now for the system (though against immigrants and the EU). The support for the democratic centres has thus increased. People have been rather content with the way governments have handled the crises. The pressure from the 12 per cent unemployed has been moderate.

Another explanation of the slowness is the waiting-for-the-locomotive syndrome. During the crisis, many economic summit meetings were held. They always proclaimed grand plans and visions, but nothing binding. The idea was often that the countries with the “best” balance of payments should expand, acting as locomotives. A locomotive country would clearly suffer a large balance of payments deterioration if everybody else did not follow quickly after. As everybody else would gain from being dragged by the locomotive, waiting for somebody else to be the locomotive was better. When, for example, France tried to be the locomotive (when Mitterrand was elected) it quickly learned that it could not pull everybody along. For nobody to be the locomotive is thus the Nash equilibrium. All the summit meetings never really made everybody try for the cooperative solution of a joint expansion. The waiting-for-the-locomotive syndrome means that all governments could shift the blame to their foreign colleagues.
The slow adjustment was further caused by the fact that both politicians and people had to become ready to take the medicine. The way the big Danish Social reform of 1972 was abolished serves as a fine illustration. It was never formally abolished, but many seemingly small changes were made. They were often purely administrative, though tacitly approved by parliament. In the end the changes constitute a return to the old system – it took ten years for it to vanish. Many similar cases can be told.

The process people have to go through to accept changes is a learning process like the formation of adaptive expectations, and it is clearly a slow one.

2.4 The contradiction

The core of the above analysis is a contradiction: (i) the great stability and crisis-absorbing capacity of the old OECD countries since 1950; and (ii) the slow and painful adjustment to the one and only large crisis starting in 1973. The Oil Crisis is almost as large as the Great Depression of the 1930s in several of the countries, when measured in annual percentage points of employment and growth lost. The Great Depression was approximately twice as deep (unemployment went to 20 per cent instead of 10 per cent), but the adjustment to the Oil Crisis lasted twice as long. In addition it was found that the adjustment to the Oil Crisis was almost void of innovative traits and decisive actions by farsighted agents.

Apart from the huge output of pious words and declarations from governments and international summit meetings, little was actually done. What finally worked was essentially the perfectly traditional IMF-type medicine. However, the medicine was taken slowly. It was argued above that the crisis could have been over much faster if quick and decisive action had been taken in the autumn of 1973 and early 1974. Maybe it could have been “cured” in three to five years instead of 15–20 years.

It is a story of rich and successful countries that developed unrealistic expectations – in a broad sense – after many years where everything went too well. This caused a painfully slow return to realism. It is not like the story of rational adjustment of expectations we economists normally tell. Maybe the story can be seen as one where governments can act within certain limits given by past experience. When events occur that demand action outside these limits, action becomes impossible, and it takes a long time before the political system can adjust to allow such politically impossible actions to be taken.

The author believes that the key to the contradiction is to recognize two facts: (a) most people are quite ignorant about the economy; and (b) politics is a business with a very short-time horizon. Both (a) and (b) occur for very good reasons. Ignorance is rational given the marginal influence of the average man, and politics are so volatile that long-time horizons make no sense.
Acknowledgements

I am grateful to Carl Hamilton, Peder J. Pedersen and the referee for comments.

Notes

1 Seen from afar New Zealand is a bit of an exception in the OECD area (more like Uruguay) of a country that followed a policy of “stop the world I want to get off”. It gradually opted out of the world market and created more SOEs (i.e. State Owned Enterprises). The Structural Adjustment of the Labour government, 1984–90 (of Prime Minister David Lange and Minister of Finance Roger Douglas), was an successful attempt to reverse this policy.

2 That is why high inflation is so harmful.

3 Consider the correlation $\sigma(p_i, p_j)$ between the rates of inflation in two countries (i and j) for any decade since 1950. If the countries are old OECD countries $\sigma \approx 0.6$. If the countries are African or Latin American, the correlation is much more unpredictable, but on average somewhere between 0.1 and 0.2.

4 IDB uses the numbers – including the more detailed calculations – to show a strong connection between stability (low variance) and growth. It is argued that stability causes growth through the investment channel. IDB goes on to argue that the Latin American countries should pursue policies reducing instability.

5 The various schools of ISI-strategies were termed Cepalism or Structuralism (in Latin America) and African and Arab Socialism. Also, the ideology of the Indian Congress Party belonged to this line of thoughts.

6 The external balance is measured as (a) the autonomous posts on the balance of payments, (b) the exchange reserves, or (c) the movements of the exchange rate. Which measure is most relevant depends on the institutional set-up and circumstances.

7 I have spent some time polling the knowledge of inflation and their inflationary expectations in Denmark (see Paldam and Nannestad (2000)), and consequently have some basis for claiming that most people do not form such expectations.

8 The empirical findings are both on the demand and supply side. The demand side is treated in the literature on Vote and Popularity functions; see, e.g., Nannestad and Paldam (1994) and Lewis-Beck and Paldam (2000). The supply side is treated in the political business-cycle literature; see Paldam (1997) and Alesina, Roubini and Cohn (1997). There is a close parallel to the argument of Hirschman (1961) concerning airlines.

9 The three other Nordic crowns (that have exchanged at 1:1:1 ± 10 per cent from 1948 to 2000) have been among the most stable in the OECD area. The Icelandic Crown started from a rate of about 1.2:1 to the other crowns in 1948, and it has now devalued to the rate of 10:1.

10 This is evidence that the economies of the West are normally demand constrained, not supply constrained.

11 The Oriental crisis hit Indonesia, South Korea, Thailand, Malaysia and their neighbours. It was a deep and sharp crisis, but it lasted 5–6 quarters only.

12 See Lybeck and Henrekson (1988) and Gemmell (1993) for surveys of theories and data.

13 These taxes could not be collected in the old society, and today in the LDCs, where typical trade taxes are concentrated on the foreign trade. Even at revenues of 15 per cent of GDP they give large costs of distortion.
14 Catch-up effects can be very powerful when the technological gap is bridgeable, as was the case.

15 The World Value Surveys present data demonstrating a high and growing support for private ownership of production and trading companies, see Christoffersen and Paldam (2005).

16 The vast increase in the freedom of trade has been within Western Europe, turning the world into trading blocks. However, seen from the typical West European country it has appeared as a dramatic increase in the freedom of trade.

17 During the twentieth century the public-sector share (of production) has typically increased from 6 per cent to 26 per cent, while the export (or import) share has increased from 25 per cent to 30 per cent. The public sector hardly trades internationally. This has increased the trade share of the private sector from \( \frac{25}{1-0.06} \) per cent \( \approx 27 \) per cent to \( \frac{30}{1-0.26} \) per cent \( \approx 4 \) per cent. That is, the international integration of the private sector has increased by 50 per cent.

18 This trend is discussed and documented in the set of country studies presented in Sinn and Whalley (forthcoming).

19 The rates took into account that people saved on transport and other work-related expenditures when they became unemployed. The law made some reductions in the 90 per cent compensation rate for high-income earners. It meant that the average degree of compensation was only about 82 per cent just before the crisis.

20 After many changes the anti-tax party is now replaced by a traditional populist party, that is for the welfare state, blaming all problems on immigrants and the EU.

21 If wages and imputed interests on capital are deducted from net national income, the rest is negative.

22 While people did not take much notice, the capital market did. Expectations are formed differently by people with only a marginal interest in the matter and professional dealers.

23 The tightening also brought about a brief boom, contrary to the Keynesian creed of the Danish economic profession. At that time there was known to be one confessing monetarist in the profession. If anybody mentioned the term “rational expectations” it was compulsory to smile derisively. After 1985 this changed rapidly. Today the profession is close to the international mainstream.

24 In Denmark the big political shock of 1973 (discussed) was due to increasing “expectations” during the Golden Period, and the crisis gradually caused the political centre to recover its support among the voters.

25 Polls show that an unemployment rate of 10–12 per cent means that 90 per cent of the population know somebody who is unemployed (see Table 4 in Paldam and Nannestad, 2000).

26 The reason the Oil Crisis is normally treated as smaller than the Big Crisis is that the USA was hit much less than Western Europe by the Oil Crisis.

27 This assumes that the Great Depression ended in 1939/40, when another more serious crisis of a different nature came to dominate.

References


3 Reform failure and poor economic performance
The case of Sweden

Bo Södersten

Sweden is a very interesting case when it comes to a study of success and failure regarding economic development and economic-policy failures. When studying the Swedish performance it is important to get the perspective right.

Without any doubt the Swedish economic-policy performance during the last quarter of a century, let us say from 1971 to 1997, has been a poor one. That performance, however, has to be understood in its correct historical context.

On the one hand Sweden outperformed all countries (except possibly Japan) during the 100 years from 1870 to 1970, with its exceptionally high and even growth. During this time the average growth rate of GDP was 2.4 per cent per year. The distinctive feature of Swedish economic growth during this century was its evenness. One country (Japan) had perhaps a higher growth rate in overall terms but no other country had a comparable evenness in its growth. Sweden managed to stay out of the two world wars, and even the depression years of the 1930s brought only a small downturn in the growth curve.

From the late 1940s to the early 1970s the Swedish growth record was in no way exceptional. The growth of real GDP was high (around 4–5 per cent) but so was growth in the rest of Western Europe and the US, not to mention Japan and the Asian tigers.

When the oil crisis came in 1973 and the Bretton Woods system disintegrated, depression and inflation (“stagflation”) followed in its wake. No country was less prepared than Sweden to meet the new times. Sweden’s economic-policy performance was extremely poor during the 1970s and the 1980s. To a large extent this can be explained by the fact that Sweden fell victim to its earlier long period of success. Both policy makers and the public at large could simply not fathom that the good days were over and that Sweden would meet a new set of problems that could not be handled in a traditional manner.
Challenges of the 1970s

The early 1970s were characterized by turbulence in the world economy. During the first oil-price hike oil prices increased by some 500 per cent. This gave naturally an inflationary impulse to the world economy. Most industrial countries fell into a dilemma of whether to combat inflation and accept higher rates of unemployment or to take a more lenient view on inflation in order to preserve a high rate of employment.

Sweden had experienced a de facto depreciation of the krona against the German mark in 1973–4, providing a boost to exports for a short time. Now Sweden wanted to pursue – single-handedly and apart from the rest of Western Europe – a policy of “bridge-building”. The theory behind this policy was simple.

The crisis of 1973–4 was viewed as a short-term crisis caused by a lack of demand. The Swedish government – and most academic economists – thought that the international economy would soon come back to equilibrium and that aggregate demand would start increasing again. Therefore the government encouraged private industry – through subsidies and tax concessions – to build up inventories so as to be prepared to take advantage of the boom that was expected to be around the corner.

In this way a domestic boom was created. This is best illustrated by the fact that domestic wages increased by over 40 per cent in 1975–6. This in turn caused an increase in inflation so that the Swedish inflation rate during the later half of the 1970s was roughly 5–6 percentage points above the German rate of inflation.

This situation was not tenable in the long run. On the contrary, it led to three negative consequences. In the first place, it led to a decline in productivity growth in the overall economy. This is demonstrated by Tables 3.1 and 3.2 that show the development of labour productivity in the private sector on one hand and in the government sector on the other hand. Productivity measures for the government sector are often not very reliable and they are also not very easy to obtain. The figures shown in Table 3.2 demonstrate, nevertheless, a strong negative trend for productivity in the government sector. One explanation to the fall in productivity

<table>
<thead>
<tr>
<th>Year</th>
<th>Per cent</th>
</tr>
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<tbody>
<tr>
<td>1960–5</td>
<td>5.0</td>
</tr>
<tr>
<td>1965–70</td>
<td>4.5</td>
</tr>
<tr>
<td>1970–5</td>
<td>3.2</td>
</tr>
<tr>
<td>1975–80</td>
<td>1.4</td>
</tr>
<tr>
<td>1980–5</td>
<td>2.8</td>
</tr>
<tr>
<td>1985–90</td>
<td>1.5</td>
</tr>
</tbody>
</table>

is the very large increase in employment in the government sector that took place in the 1970s. The government sector was simply used as a safety valve to reduce open unemployment, and part of the explanation for this is ideological. This also was the time when the Swedish family became “nationalized”; for instance, communal childcare expanded at a very rapid pace (see Freeman et al., 1997; Rosen, 1997).

1976: a change of government

Since 1932 Sweden had – without interruptions – been governed by social-democratic governments. In 1976 the non-socialist (“bourgeois”) parties won the election and formed a new government; they also inherited the economic crisis. The former Palme government, had not been very successful in handling the crisis. Their first and foremost weapon to beat the crisis was by increasing taxes, with the result that the tax share of GDP increased from 42 to 52 per cent of GDP from 1970 to 1976.

The new government was to a large extent the prisoner of the still dominant social-democratic ideology. The main thing that they tried to avoid was an increase in unemployment. It soon became clear, however, that the attempt at “bridge-building” that the social-democratic government had made was a failure. To be sure, the former prime minister Olof Palme tried to argue, in late 1976, that the non-socialist government came to a “well-laid out dinner table”, but the true content behind that remark soon became all too obvious.

In the wake of the oil crisis international competition increased, especially in traditional industries like mining, steel and shipbuilding, all of which were traditionally very important among Swedish industries. Some of these industries, especially shipbuilding, relied heavily on state subsidies. The difficulties were aggravated politically by the fact that the industries, which were declining (like shipbuilding), were often concentrated in certain regions. Shipbuilding is here a case in point. It was thus almost impossible even for non-socialist members of parliament coming from shipbuilding regions to vote for a decrease in subsidies that would lead to a closure of shipyards in their own constituency. Therefore, the necessary

### Table 3.2 Labour productivity growth in the government sector, 1970–80

<table>
<thead>
<tr>
<th>Per cent</th>
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<tbody>
<tr>
<td>Law enforcement</td>
</tr>
<tr>
<td>Education</td>
</tr>
<tr>
<td>Health</td>
</tr>
<tr>
<td>Social insurance</td>
</tr>
<tr>
<td>Total sector</td>
</tr>
</tbody>
</table>

change of industrial structure often became a rather long, drawn-out affair.

Table 3.3 gives a picture of the development from 1970–82. As we can see, the drop in employment in the competitive, private sector amounted to roughly 150,000 persons (almost all male). In practice all the increase in employment took place in the government sector and especially in the local communes. As Table 3.3 shows, employment in the government sector increased by over 1 million persons, or over about 20 per cent of the total labour force. The reasons for the increased employment in the government sector had deep ideological roots. Three of the ideological forces were egalitarianism, feminism and poor understanding and dislike for market solutions.

Health care and childcare were two cases in point. It is important to realize that both these sectors were heavily subsidized. When it came to childcare the typical situation was that the cost per child was high (around 100,000 SEK per year) and that 90 per cent of that sum was paid through government subsidies while roughly 10 per cent of the cost was covered by a user fee paid by the parents. This arrangement had two important implications. In the first place, the large subsidies created a large increase in employment in these government sectors. Secondly, the large subsidies distorted consumption and led to an increase in overall demand (for services like health care and childcare) that would not have come forward if user prices had more closely reflected the true costs of provision of services in these sectors.

These types of subsidization policies led to several important consequences. Consumption of government services ballooned, while consumption of private goods and services diminished. Thus in 1998, 38 per cent of overall consumption was consumption of private firms’ output, while another 38 per cent was consumption of government services. It is important to realize that such figures would not have been achieved without strong subsidies which boosted consumption of government services and that subsidies were not general in nature, but tied to consumption of just these specific services.

A strong element of distortion of the consumption pattern was in this way introduced into the Swedish economy. Some economists (among

<table>
<thead>
<tr>
<th>Year</th>
<th>Government sector</th>
</tr>
</thead>
<tbody>
<tr>
<td>1965</td>
<td>524,000</td>
</tr>
<tr>
<td>1970</td>
<td>954,000</td>
</tr>
<tr>
<td>1980</td>
<td>1,457,000</td>
</tr>
<tr>
<td>1990</td>
<td>1,667,000</td>
</tr>
</tbody>
</table>

Source: Statistics Sweden.
them S. Rosen) have tried to estimate the dead-weight loss of these arrangements in connection with childcare and came up with estimates that amount to 2–3 per cent of GDP, or around 40,000 SEK per child (Rosen, 1997). The increase in the numbers of employed and the high rates of labour force participation among both men and especially women can therefore to a large extent be explained by these specific arrangements of “the work-fare state” (Freeman et al., 1997).

The extremely large expansion of the government sector had great effects on government finances. The non-socialist government that was in power from 1976 to 1982 had – on ideological grounds – vouched not to increase taxes. The only solution left, then, was to finance government expenditures through borrowing. Table 3.4 shows the increase in government debt during the “bourgeois” years. There were several reasons for this unprecedented increase in the national debt. One had to do with ideological reasons. The Fälldin government that took power in the autumn of 1976 did not want to be associated with an increase in unemployment. Full employment was the dominant goal of all Swedish governments at this time irrespective of political colour.

In face of the international crisis of the late 1970s, with declining traditional industries and loss of employment in the competitive sectors, the only policy option left was to expand the government sector. This was also what happened and – as we have seen from Table 3.3 – employment in the government sector increased by over 500,000 persons or roughly 12–15 per cent of the total labour force. This policy also meant that Sweden could continue to be known as a country of full employment with only small numbers of unemployed and high rates of labour-force participation.

The subsidies to consumption – especially government consumption – were also reflected in a general tendency to overspending and to continuous deficits in the balance of payments. Table 3.5 illustrates this. As we can see, the Swedish international debt increased by roughly 84 billion Swedish kronor between 1976 and 1982.

The social democrats won the election in September 1982 and again became the government party.

Table 3.4 Total government debt (in millions of Swedish kronor)

<table>
<thead>
<tr>
<th>Year</th>
<th>Government debt</th>
</tr>
</thead>
<tbody>
<tr>
<td>1976</td>
<td>80,411</td>
</tr>
<tr>
<td>1977</td>
<td>97,982</td>
</tr>
<tr>
<td>1978</td>
<td>131,175</td>
</tr>
<tr>
<td>1979</td>
<td>175,145</td>
</tr>
<tr>
<td>1980</td>
<td>229,589</td>
</tr>
<tr>
<td>1981</td>
<td>295,590</td>
</tr>
<tr>
<td>1982</td>
<td>377,089</td>
</tr>
</tbody>
</table>

Source: Statistics Sweden.
During the latter half of the 1970s and the early 1980s, it became increasingly clear, to at least some economic observers, that the Swedish economy had started to function less well and that it had difficulties in coping with the new situation that followed in the wake of the international crisis. The balance of payments went into deficit at the same time as the growth rate fell. Employment had been sustained through an expansion of the government sector (where productivity fell) and through large government borrowing both in the foreign and the domestic capital markets.

Table 3.1 illustrates this development in an interesting way, showing that during the “record” years of the 1960s the increase in labour productivity was 4–5 per cent per year, which laid the foundation for increasing real wages, increasing taxes and expanding of the welfare state. Even the first half of the 1970s showed a relatively good performance. The real shift in economic performance occurred in the latter half of the 1970s, as labour productivity decreased to a yearly rate of 1.4 per cent.

We then also have to remember that productivity in the government sector fell at the same time, partly as a result of the large increase in employment in this sector, and was negative, as is seen in Table 3.2. The combination of the low productivity increase in the private sector and falling productivity in the government sector, in fact, led to Sweden (for the first time since the 1870s) having a zero-growth rate during the latter half of the 1970s.

Table 3.1 also illustrates another interesting feature of the Swedish economy in the late 1980s. The low growth of productivity in the late 1970s can be explained by the international crisis that occurred during these years and that led to a fall in employment in the competitive sectors. But what about the latter half of the 1980s? These were boom times, with the end of the long economic upswing that started in the United States in 1983 and then spread to Europe and the OECD countries. Why was Swedish economic performance in the internationally competitive sectors under these conditions still so poor?
There is no clear answer to this question, but one possible explanation is that the long expansion of the public sector and the compression of wages started to take its toll. Industry had difficulties in recruiting workers as wage levels there had fallen and the social-security system had undermined incentives, which among other things led to a very high degree of absenteeism due to sickness.

That attitudes do change due to changing economic incentives should not be astonishing, but rather should be understood as part of a rational behaviour of the employees.

The devaluation era

As can be seen from Table 3.5, Sweden had a continuous deficit in its balance of payments from 1976 to 1982. There were two reasons for this situation: on the one hand, the decline in competitiveness of the traditional industries and the poor performance of labour productivity, and, on the other, overspending that was a consequence of the struggle to keep employment up at all costs.

The objective of this part of the essay is not to try to give a complete view of the policy mistakes of especially the 1980s (which then culminated in the crisis of the early 1990s) but rather to highlight the lack of consequence that accompanied the devaluation approach. The left hand simply did not know what the right hand did. Or, to put it somewhat more precisely: the governments tried to pursue one line of policy at the macro level, which was completely undone by the policies pursued at the micro level.

The ambition of the various governments regarding the krona was to fix its exchange rate to a currency basket consisting of a mix of the currencies of Sweden’s major trading partners (where the dollar had a double weight compared to its trade importance). It soon turned out, however, that this was difficult and a depreciation trend soon became attached to the krona. That this would be the case was not difficult to understand as inflation in Sweden tended to be higher than in most of its trading partners, with the most important trading partner, Germany, being a case in point.

The first minor depreciations in 1976–7 of around 9 per cent could be seen as an adjustment to the “basket arrangement” prevailing at the time. These were followed by two large devaluations in 1981 of 10 per cent during the Fälldin government and one of 16 per cent in October 1982, right after the new Palme government came into office after the victory in the election in September.

In the first years of the 1980s it became more and more apparent that Sweden had problems both with its competitiveness and its growth performance (Lindbeck, 1997a). This was shown by the fact that around 150,000 jobs were lost during the international crisis that hit the economy.
during the latter half of the 1970s. The larger devaluations of 1981–2 were
done in order to initiate a structural change in the economy. These devalu-
ations are often referred to as offensive and aimed at strengthening the
Swedish competitiveness in the international markets.

According to the standard theory of devaluation, for such a policy to be
successful two criteria should be fulfilled: the overall absorption in the
economy will have to be restrained so as to give room for an expansion of
exports, and some flexibility will have to be present to allow a switching of
resources from the domestic sectors of the economy to the internationally
competitive sectors so that the latter can expand at the expense of the
domestic sectors.

Immediately after the two large devaluations, relatively stringent
demand policies were pursued in 1983 and 1984. This also led to an
improvement in the balance of payments that improved by some 25
billion kronor during an 18-month period and the growth of the Swedish
economy picked up during 1983 and the first half of 1984.

Soon, however, the gains from the devaluation policies were dissipated.
The government did not manage to control inflation. We would naturally
expect the large devaluations of the early 1980s to give inflationary
impulses to the economy. That was also the case as can be seen from
Table 3.6. An important explanation for the high inflation rates had to do
with the wage-setting mechanisms. Wages were not set primarily with
regard to the conditions of the internationally competitive sectors. Instead
the domestic low-wage sectors (with large shares of women in the labour
force) tended to be leading in the wage setting, due to the prevailing
egalitarian modes of thought.

There was also significant policy disagreement within the social-
democratic government (see Feldt, 1991). Already when the new Palme
government took over in 1982 it was decided that the government sector
should not be diminished. Soon a debate within the government and the
social-democratic party broke out concerning which economic policy line
to follow (“the war of roses”). After the execution of a fairly stringent line
concerning expansion of consumption demand in 1983 and early 1984, a
more expansionary policy line won the day. This had – as I will now
demonstrate – important implications for the micro side of the Swedish
economy.

<table>
<thead>
<tr>
<th>Year</th>
<th>EU</th>
<th>Germany</th>
<th>Sweden</th>
</tr>
</thead>
<tbody>
<tr>
<td>1977–86</td>
<td>9.0</td>
<td>3.5</td>
<td>8.9</td>
</tr>
<tr>
<td>1987–95</td>
<td>4.2</td>
<td>2.8</td>
<td>5.5</td>
</tr>
<tr>
<td>1996–9</td>
<td>1.8</td>
<td>1.2</td>
<td>0.7</td>
</tr>
</tbody>
</table>

Micro versus macro

The general policy line, especially from 1984 onwards, was to expand the government sector. The interconnections between the competitive sector (represented by manufacturing) and the public sector and the exchange rate is illustrated in Figure 3.1.

I will now deepen the analysis somewhat by studying the interrelationships between the exchange rate and employment in two important sectors within the public domain: childcare and health care. Developments in these sectors are illustrated in Figures 3.2 and 3.3. As can be seen, the exchange rate depreciated around 50 per cent from the late 1970s to the middle of the 1990s. Meanwhile, employment in both sectors increased sharply.

My conclusion is, therefore, that devaluation policies were a failure in the sense that they never managed to strengthen the competitive sectors of the economy. This is again illustrated in Figure 3.1. Employment in the internationally competitive engineering industry fell despite the large depreciation of the krona. The failure of devaluation policies when it came to improving market shares has also been demonstrated by Jakobsson and Jagrén (1993).

The devaluation policies were aimed at improving the competitive situation for Swedish industry, improving the balance of payments and increasing the growth rate. They failed because the macro policies were never coordinated with micro policies. Here the expansion of the government sector took precedence, which is shown in Table 3.7.
Figure 3.2 Exchange rate and employment in childcare, 1970–97 (index 1970 = 100) (source: Pettersson and Södersten (1999)).

Figure 3.3 Exchange rate and employment in the health-care sector, 1970–97 (index 1970 = 100) (source: Pettersson and Södersten (1999)).
The crisis of the early 1990s

The micro policies that we have described with very high public spendings were primarily motivated by employment concerns. From this point of view they were also successful as Sweden had very high rates of employment until the early 1990s.

In 1991 Sweden met a very severe economic crisis with a large increase in unemployment and a fall of numbers in the labour force, as is illustrated in Figure 3.4. Tables 3.8 and 3.9 also reveal that labour force participation and employment fell very drastically for both men and women.

It is also true that Sweden, until around 1990, had the characteristics of a “work-fare state”, where various types of social benefits were tied to work and where rates of labour-force participation were very high, especially for women. This is shown in Tables 3.8 and 3.9 (cf. Freeman et al., 1997). The

Table 3.7 Total government outlays as a percentage of nominal GDP

<table>
<thead>
<tr>
<th>Years</th>
<th>Per cent of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>1982</td>
<td>64.8</td>
</tr>
<tr>
<td>1985</td>
<td>63.3</td>
</tr>
<tr>
<td>1990</td>
<td>59.1</td>
</tr>
<tr>
<td>1994</td>
<td>68.3</td>
</tr>
<tr>
<td>1997</td>
<td>62.3</td>
</tr>
<tr>
<td>1999</td>
<td>60.2</td>
</tr>
</tbody>
</table>


Figure 3.4 The number of people employed and in the labour force, 16–64 years old, 1976–98 (source: Statistics Sweden).
large expenditures on childcare contributed to this development. It is, however, also remarkable that despite the large expenditures on childcare and other welfare arrangements, the rates of labour-force participation and of employment fell drastically during the 1990s, as is again shown in Tables 3.8 and 3.9.

This is in contrast to the development in, for instance, Denmark and the Netherlands. In the former country labour-force participation increased from 69.9 per cent to 71.2 per cent and in the latter from 39.7 to 55 per cent (Lidbeck, 1999).

It is, however, hard to deny that the tables illustrate the effects of the reform failures and all the policy mistakes that the various governments made during the twenty-year period beginning in the early 1970s. The developments of the 1970s and the 1980s that I have described laid the ground for the crisis of the 1990s, and the creation of mass unemployment that followed in its wake. This crisis was certainly deep and may have proved to be a catharsis for the Swedish economy.

The welfare state and economic growth

The interconnections between welfare-state arrangements and economic growth are complex. It is easy to think of welfare arrangements that are beneficial to economic growth, for instance. They may correct market failures in the capital and insurance markets, and thereby lead to increased investment in human capital (subsidies to schooling) or improved health. It is, however, also possible that they may give rise to various types of disincentive effects (see Lindbeck, 1997b).

During the 1970s and 1980s Sweden moved in the direction of being a work-fare state. Many – or most – of the welfare arrangements of the

---

**Table 3.8 Rates of labour-force participation 1976, 1990 and 1998**

<table>
<thead>
<tr>
<th>Year</th>
<th>Men</th>
<th>Women</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1976</td>
<td>0.89</td>
<td>0.69</td>
<td>0.79</td>
</tr>
<tr>
<td>1990</td>
<td>0.87</td>
<td>0.82</td>
<td>0.84</td>
</tr>
<tr>
<td>1998</td>
<td>0.79</td>
<td>0.74</td>
<td>0.76</td>
</tr>
</tbody>
</table>

Source: Statistics Sweden.

**Table 3.9 Rate of employment 1976, 1990 and 1998**

<table>
<thead>
<tr>
<th>Year</th>
<th>Men</th>
<th>Women</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1976</td>
<td>0.87</td>
<td>0.68</td>
<td>0.78</td>
</tr>
<tr>
<td>1990</td>
<td>0.85</td>
<td>0.81</td>
<td>0.83</td>
</tr>
<tr>
<td>1998</td>
<td>0.74</td>
<td>0.69</td>
<td>0.72</td>
</tr>
</tbody>
</table>

Source: Statistics Sweden.
welfare state, like sick insurance, early retirement benefits, unemployment insurance and paid parental leave, were tied to employment (Freeman et al., 1997).

At the same time wages became more and more equal across various groups of employees, due to the solidaristic wage policies and to the prevalence of feminist ideology which demanded special increases in the wages of women.

The devaluation policies touched on earlier also led to high inflation during the second half of the 1970s and 1980s in Sweden. The high rate of wage inflation and the low rate of increases in real wages are illustrated in Table 3.10. The table implies that the Swedish economy did not develop well during the 1970s and the 1980s. I have given the misdirected devaluation policies as one of the reason for the economic policy failure. Another reason is that the welfare policies now also started to create clear disincentives for many workers.

For the 1980s there is little doubt that welfare policies started to induce negative attitudes towards work. Self-risks in the insurance system were taken away, often due to pressure from the labour unions. Various types of allowances, especially in connection with child-rearing, became increasingly generous and with time spending on family policy increased. That entailed, on the one hand, an increase in government outlays and, on the other hand, a reduction in hours worked which jointly began to undermine the government budget.

Another important case in point is absence from work due to sickness (see Figure 3.5). Here it is clear that the response from the workers when taking sick leave to a large extent depends both on the generosity of compensation and on labour-market conditions. The absence from work due to sickness amounted to around 3.5 per cent of the workforce in the middle of the 1960s. We have to remember that these were days of very low unemployment. Why should absence from work have been lower in those days than it was in the recession years of 1979–82? Why does the figure representing absence from work show a large peak during the full-employment years in the late 1980s? In relative terms Figure 3.5, in a way, underestimates the absolute increase in absence from work due to sickness during the latter half of the 1980s. The diagram is expressed in percentages and thus in relative terms. The labour force, however, during the latter half of

**Table 3.10 Nominal and real-wage trend for industrial workers between 1970 and 1990**

<table>
<thead>
<tr>
<th>Year</th>
<th>Nominal wages after taxes</th>
<th>Real wages after taxes (acc. to 1970 prices)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1970</td>
<td>16,870</td>
<td>16,870</td>
</tr>
<tr>
<td>1980</td>
<td>46,300</td>
<td>19,170</td>
</tr>
<tr>
<td>1990</td>
<td>100,770</td>
<td>20,100</td>
</tr>
</tbody>
</table>

Source: SAF.
the 1980s increased by roughly 300,000. Therefore, absence from work due to sickness increased more in absolute than in relative terms.

It is easily seen that when mass unemployment started to rise it was worsened by the fact that roughly 100,000 workers or 2.5–3 per cent of the labour force suddenly started to go to work, thereby also increasing the degree of unemployment. Figure 3.5 gives a further picture, including the dramatic development in sick leave that has occurred during the latter half of the 1990s. The diagram shows that there is a clear correlation between absence due to paid sick leave and the business cycles. In times of boom and increasing employment (1955–75) and (1985–91) the absence due to paid sickness increases and in times of falling unemployment absence due to sickness falls. The latter phenomenon is especially striking during the years from 1991 to 1995 when the Swedish economy had its greatest crisis since the 1930s. In recent years, from 1995 to 2001, absenteeism has again risen sharply.

The reasons for this development are not completely clear. Some would argue that modern life, characterized by stress and demanding work conditions, produces sickness. Within the medical profession there seems to be no agreement about where to grant persons the right to stay at home for assorted and vague medical reasons or not. Some medical doctors argue that being away from work due to leave of sickness does not cure people claiming to be sick, while other doctors are more lenient.

It is, however, not possible to deny that the conditions for granting sick leave and especially the compensation levels play a great and very clear

Figure 3.5 Absence from work due to sickness in per cent of employed, 1963–97 (source: SAF).
role. The more generous the levels of compensation, the greater the absenteeism due to sickness. Both in 1987, when compensation rates became more generous, and especially in 1991, when they became less generous, the effects caused by these changes were very clear (Henrekson and Persson, 2001). The Swedish recession that started in 1991 caused unemployment to rise and public-sector finances to deteriorate. That caused the government to cut down on sickness compensation for the first time in thirty years. The effect was sharp and immediate: workers started to go to work in much larger numbers than before which is clearly demonstrated by Figures 3.6 and 3.7.

**Figure 3.6** Days of paid sick leave according to the RFV database (number of days annually per person, 1955–99) (source: Henrekson and Persson (2001)).

**Figure 3.7** Days of paid sick leave according to the RFV and SAF databases combined, 1955–9 (source: Henrekson and Persson (2001)).
It should also be observed that absence from work due to illness is about 30 per cent higher among women than among men and it also tends to be higher among people with low skills and involved in manual work than among white-collar workers. The interrelationships between work environment and illness is quite a debated and hot issue. That there is a negative correlation between unemployment and leave due to sickness seems, however, to be undeniable. When unemployment increases, absence due to illness decreases, and when unemployment falls, absence from work due to illness increases. This has again been witnessed during the boom years from 1997 to 2000.

It is therefore important to realize that the workforce is not a constant but changes with changing conditions in the labour market. In recession times workers leave the labour force due to shrinking job opportunities. As a consequence, during recessions the number of people who leave the labour force and instead go into long-term sick leave, early retirements and the like does increase (cf. Jonasson and Pettersson, 2004).

It is therefore quite obvious that the existence of the welfare state itself changes the incentives of the individuals and of families. It does so in rather complex ways. Returning to Figures 3.6 and 3.7, it can be said that the sharp increase in unemployment had a beneficial effect on work behaviour. During the height of the boom in the late 1980s, roughly 250,000 people on average did not go to work but were home sick every day. This figure then fell sharply and was halved during the years of high unemployment from 1992 to 1995. What are the reasons for this sharp decline in absence from work during the unemployment years in the beginning of the 1990s? This change of behaviour can hardly be explained in medical terms.

Traditionally, Swedish society was characterized by a strong work ethic. It seems that the growth of the welfare state with its generous benefits for not working (for instance, sickness and unemployment benefits) has changed these attitudes. In more recent years the Swedish state has become more of a “soft” state. We have just referred to a change of behaviour regarding sickness and work, where unemployment created a change of behaviour that may be characterized as not beneficial to society as a whole.

Some of the welfare reforms, however, seem to have created changes in the behaviour of the citizens that may be deemed as undesirable. During the latter half of the 1980s it may be argued that the rules for sick-leave pay were so generous as to make workers indifferent if they went to work or not. This behaviour changed with bad times and changes in remuneration for being absent from work.

Still it could be argued that some of the welfare reforms have turned out to function as subsidies to non-work and to forms of behaviour that are not necessarily good for society as a whole, like generous support to people who are long-term unemployed or single parents, and for parental leave from work, and so on (cf. Lindbeck, 1995).
There also exist poverty traps for low-income groups and disincentives to work for some of these groups. This is shown, for instance, by the fact that over 40 per cent of the unemployed had a degree of compensation that was 90 per cent of their income or higher. The average rate of compensation was 85 per cent.

There has been an intense debate in Sweden whether a so called “last parenthesis” – a last date after which the unemployment insurance should no longer be available for the unemployed – should be introduced or not. So far the social-democratic government has not dared to introduce such legislation, primarily due to pressure from the trade unions. It is also well known, both from Swedish investigations and from the international scientific literature, that high rates of compensation in unemployment insurance (which in Sweden is over 90 per cent financed by taxes) leads to an increase in search periods and thereby increases in the persistence of unemployment and decreases in the labour-force participation rates that were shown in Table 3.8 (cf. Harkman, 1997; Carling et al., 1999; Holmlund, 2000).

The combined effects of high income taxes, generous welfare and day-care benefits often leads to very high marginal effects when moving from unemployment to employment. Often these marginal effects can be as high as 90 per cent (ESO, 1997). This lowers incentives to work and leads both to a high degree of unemployment and to a “discouraged worker effect”. That implies that many of the people who were leaving the labour force during the depression of the early 1990s never did come back. That helps explain why the labour force in the beginning of the year 2000 is about 7–8 per cent smaller than it used to be ten years ago.

That the Swedish welfare state has some problems therefore seems indisputable. As Figure 3.8 demonstrates, Swedish economic growth was also poor from 1970 to 1995. Summing up, it is possible to state that three basic policy faults lay behind the poor economic performance. One was misguided macroeconomic policies reflected in the misdirected devaluation policies which primarily created high rates of inflation, with no gains in international market shares. Another was an expansion of the government sector, basically due to employment reasons. This distorted incentives and led to falling and low productivities within the sector, while at the same time increasing the tax pressure. The third was a too large and rapid expansion of the welfare system, which as a negative by-product led to distortions regarding incentives to work. This finally resulted in the large recession in the early 1990s, which for the first time in modern times created mass unemployment.

Perhaps Sweden is now ready to make a U-turn and go back to more sound policies. For the time being, times seem good and promising. Whether that situation will remain or change is impossible to say today.
Are we witnessing a U-turn?

My main analysis and conclusions regarding Swedish economy policies from the early 1970s to the late 1990s have been quite negative. During recent years – say from 1998 – some important changes have been taking place in the Swedish economy. As my main theme has been that of reform failure, I will only very briefly turn to some bright sides that have occurred during the very latest years.

One is that inflation has disappeared from the Swedish scene and the rate of inflation in recent years has been around 1–2 per cent yearly. Two reasons can be given for that important change. One is that Sweden now has an independent central bank that has the control of inflation as the overriding goal for its monetary policy. Furthermore the very deep crisis that occurred in the early 1990s with mass employment in its wake also helped to drive inflation out of the system.

At first the crisis was interpreted, generally speaking, as an economic disaster and it was discussed how much of it was due to mismanaged macro policies and how much of it was due to structural problems that had built up over a long time (cf. Korpi, 1992 and 1996; Agell, 1996; Henrekson, 1996; Lindbeck, 1997a; Holmlund, 2000). As can be seen from this essay, I basically support the structural point of view. But an important blessing in disguise, which took a few years to see and understand, was that the crisis

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**Figure 3.8** GDP per capita in Sweden and the OECD countries, 1970–98 (source: Lindbeck (1999)).
of the 1990s helped to drive the inflation out of the system. During the deep crisis it was not possible to increase prices or to ask for higher wages.

Another important change that has occurred is that stricter fiscal policies have been introduced. This has been effected by parliament introducing a ceiling for government expenditures and also for social-insurance expenditures. This has then been translated into specific ceilings for the various government-department expenditures. In this way, parliament has tried to tie itself to the mast, as it were. There are, however, no constitutional guarantees for the new reforms so parliament can change or undo them with a simple majority vote. It is still too early to say if these policies will have any effect over the longer term or if they will be eroded (cf. Eklund, 2000).

A third important element concerns inflation and wage negotiations. During the inflation and devaluation era that has been described, we tended to get “devaluation cycles”. After a devaluation we went into an expansionary phase and industry expanded. That, in turn led to a demand for increased wages (partly due to rising prices caused by the inflation). That in turn, eroded the competitiveness of the international sector and a new cycle of devaluations and inflation was soon introduced (Jakobsson, 2000). With the new era of monetary policy it is the duty of the central bank to keep prices reasonably constant. If the central bank observes tendencies towards wage inflation it would be its duty to act so that the wage development can be controlled.

All these new factors just mentioned may therefore mean that the Swedish economy is making a U-turn and going back to the more efficient growth policies that existed before the reform failures started to become abundant with the arrival of the 1970s and the international crisis that followed in the wake of the oil crisis and the break-down of the Bretton Woods system.

It is still too early to make any firm predictions. The Swedish economy has been very influenced by and sensitive to international crises during “the dismal quarter of the last century”. Whether the future will be brighter no one knows. But the scope for a “U-turn” with more efficient economic policies is at least a possibility in coming years.

Acknowledgements

I would like to thank the Bank of Sweden Tercentenary Foundation for research support. I also thank Ulf Jakobsson and Lars Pettersson for helpful comments and Annika Gustafson, Désirée Nilsson and Kristian Nyberg for good assistant work. I also thank an anonymous referee for his/her helpful comments.
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4 The role of European integration in the reform process

The Greek experience

Sarantis E.G. Lolos

Introduction

Greece became a member of the European Economic Community (EEC) in 1981. Since then the country has embarked on an effort at modernizing the productive structures, reducing macroeconomic imbalances and enhancing her competitive position, in view of an increasingly internationalized economy. However, although far more prosperous and stable than other south European countries, Greece has not been a successful case of economic performance, with the exception of the recent past. In the 1980s and early 1990s, Greece underwent wild swings in economic policy resulting in poor economic performance. From the mid-1990s, the sustained stabilization and reform effort has enabled Greece to meet the Maastricht criteria (March 2000).¹

The purpose of this essay is to evaluate the role of European integration in influencing the economic and political factors that have shaped economic policy choices and determined policy outcomes and economic performance in Greece. The experience of policies pursued since the country’s EEC entry is presented and discussed, distinguishing between the 1980s and the 1990s and focusing on international influences and in particular on the European integration process.

There are good reasons for dealing with the Greek case. It is a medium-sized, fairly developed country that is experiencing economic integration and the relevant literature on similar country experiences is rather poor. Furthermore, the Greek case could be compared to the behaviour of other countries undergoing similar experiences, such as Portugal and Ireland, and more general conclusions could be drawn on the role of EU factors in determining economic performance. Finally, and perhaps most importantly, we can draw useful lessons for other countries that will be soon undergoing similar experiences, such as the Central and Eastern European countries.

The debate over the determinants of the type of policies adopted by governments to deal with macroeconomic imbalances, structural and industrial adjustment and declining competitiveness focuses on a variety of interrelated, overlapping and not mutually exclusive issues.²
Economic performance and policy outcomes are, to a great extent, attributed to particular policy choices. Policy choices are explained by national specific characteristics, such as historical legacies (traditions, attitudes, values) and national institutional characteristics, deriving from the political and economic environment inherited by the government. The institutional characteristics comprise the role of interest groups and political institutions on policy formation and the degree of polarization or consent characterizing the political system; as well as the capacity of the state to impose policy options, such as state tradition and bureaucratic autonomy. In addition, the prevailing views regarding the state of the economy, the expectations on future developments and the actual state of the economy (e.g. the existence of “economic crisis”) are among the factors determining policy options. Furthermore, the government exercises direct control on factors such as the timing of policy actions (e.g. reform initiative), the composition of the policy-making team, the coherence, the comprehensiveness and the credibility of economic policies. Finally, the influence of international factors and trends, including the availability of foreign assistance, seem to play a crucial role in determining policy choices.

However, the role of international factors in shaping policy options and affecting policy outcomes is somewhat undermined and is not recognized explicitly in the relevant literature. We believe that in certain circumstances, as in the process of European integration, the role of international factors is far more decisive than, or at least as important as, the national characteristics in determining policy options. The European integration does not have an historical precedent as a non-violent economic (and potentially political) integration process and the actual realization of the process is a relatively new phenomenon so it has not been scrutinized adequately.

The increasing role of the EU factors stem from the fact that domestic policies are becoming impotent and national sovereignty is gradually decreasing. The influence of EU factors on domestic policy making is both direct and indirect. The former relate to specific prerequisites determining a country’s policy options in the prospect of European integration (e.g. Maastricht criteria, EU Directives). The latter refers to influences of international characteristics (values, attitudes) on national ones, the inter-relation of which is greatly facilitated by the integration process. In the longer-term horizon the national characteristics are expected to adjust to the ones prevailing internationally.

The following will analyse the post-EEC entry-policy developments in Greece, distinguishing between two time periods, the 1980s and the 1990s, and then draw conclusions on the role of the EU factors that determined economic performance. The distinction relates to the very different characteristics in terms of policy choices and outcomes between these time periods, as shown below. Before embarking on the discussion, I will
briefly present some major structural features and pre-1981 developments that greatly determined future policy options.\textsuperscript{4}

After the end of World War II and the subsequent Civil War (1949), with the defeat of the left-wing alliance, Greece had almost exclusively been ruled by conservative parties until 1981. The repercussions of the Civil War were the political discrimination of the “losers” which effectively led to the formation of a “two-tier” society in the post-war period. The economic activity was brought to a bare minimum and the production and social fibres were left in disarray. Subsequently, the economic situation was gradually normalized and from the mid-1950s until the first energy crisis, the Greek economy registered unprecedented high annual growth rates (6–7 per cent). Macroeconomic policies succeeded in achieving internal and external stability (Halikias, 1978), while international trade policies, of the “import-substitution” variety, were quite interventionist, reflecting failures to achieve economic adjustment in certain key sectors.\textsuperscript{5}

However, classical features of developing economies persisted and some of these still coexist along with the developed aspects, such as the fragmented productive base and the persistence of labour-intensive activities, the extended share of self-employment, informality and underemployment, the large agricultural sector, tax evasion, the state-controlled banking system, the extended public sector, public employment and emigration as outlets for unemployment (not any more), inefficient public administration, and a backward welfare state.

After the restoration of democracy in 1974 with the fall of the seven-year military junta and the return to power of the conservative party (New Democracy) under Constantine Karamanlis, the political system started gaining credibility and the political discriminations quickly faded out. However, it would be PASOK (Panhellenic Socialist Movement), the newly formed socialist party, which contributed greatly to the national reconciliation. In 1974, a decade after Greece’s EEC Association Agreement (1962) and after a heated debate, the country’s EEC orientation was finally decided. The decision was taken by the conservatives and was supported by the “euro-communist” party but it was opposed by the “pro-soviet” communist party and the socialists. PASOK, founded in 1974 by Andreas Papandreou, a prominent economics professor in the USA, had a strong “populist” brand and anti-EEC (also anti-American) rhetoric, with a “Third World” preoccupation, and appeared as the alternative to post-war conservative ruling.\textsuperscript{6} The steep rise in the popularity of PASOK in the second half of the 1970s created a strong anti-EEC sentiment which was to affect, if not determine, policy choices for a long time.

Over the second half of the 1970s the annual rate of growth receded (3–4 per cent) but it still remained higher compared to those of the Western European countries, a fact that kept up high expectations for a continuation of the fast pace of post-war growth in future. As a result, the post-war development model was not questioned. Macroeconomic policies
of the ruling conservative party continued to be expansionary, as in the past, and the role of the state increased substantially with the nationalization of certain large enterprises, mainly in the transport sector. By the end of the 1970s the structural weaknesses of the Greek economy started manifesting themselves openly, while inflation approached 25 per cent.

The 1980s: the unresolved issues of economic policies

In 1981 there was a major swing in government with a stop of the post-war conservative ruling and the socialists (PASOK) came to office and remained in office over the 1980s. They were supported by a broad alliance of, mainly middle class, social groups (salary and wage earners, farmers, self-employed and small businesspersons) who greatly felt they had not experienced political participation for a long time. The socialists were mandated to follow a radical programme of income redistribution fulfilling demands for a more egalitarian society, social cohesion, higher earnings and a modern welfare state. PASOK has always been suspicious of the European perspective and opposed Greece’s Accession Agreement with the EEC (1981), regarding it as damaging to the nation’s interests. In the early 1980s they focused on achieving a special status for Greece within EEC but by the end of the 1980s the party’s anti-EEC stance was moderated and, for reasons explained below, the European integration was gradually adopted as the country’s priority.7

This anti-EEC sentiment was more pronounced in rural and relatively less developed regions and this should be attributed to deeply rooted ideological preoccupation against the Western bloc (remnants of the Civil War). Paradoxically enough these regions were those that benefited the most from the subsidization of agricultural prices via the EEC Common Agricultural Policy. Note that over the 1980s and most of the 1990s, about one half of agricultural income derived directly from EEC funds.8

Over the 1980s, contrary to what happened in most EC countries, the socialists pursued an overall expansionary macroeconomic policy, in line with the prospects of the broad social alliance that brought them to power. However, the expansionary policies were clearly unsustainable, since they effectively led to the creation of economic imbalances, an explosion of deficits and inflation, and the socialists were obliged to follow a boom-and-bust cycle.9 Thus, the expansionary (1981–5) policy was abruptly interrupted by a severe two-year stabilization programme, framed with the full support of the EC.

The main objectives of the programme concerned the improvement of competitiveness of the economy, the control of the balance of payments and inflation as well as the cutting down of the public-sector borrowing requirement.10 The person in charge for the implementation of the stabilization programme was Costas Simites, a Law Professor, one of the founders of PASOK in 1974. Simites, unlike the party leader Andreas
Papandreou, was a firm supporter of the European orientation of the country. This policy was successful in that it managed to control the current account balance and improve competitiveness through an austere incomes policy and a 15 per cent devaluation of the drachma. The implementation of the programme caused substantial social discontent and the policy of consolidation and adjustment of the economy was abandoned by the end of the two-year period, thus reverting policies for a second time.\textsuperscript{11} As a result its success was only temporary, since it failed to create conditions of sustainable growth.\textsuperscript{12} However, its application showed that stabilization of the Greek economy was possible (Papademos, 1990).

The abandonment of the stabilization measures should be attributed to government’s inability to gain social acceptance for its policies and also to the political and economic environment inherited from the past.

Firstly, there was lack of a credible government policy and public confidence in the success of the programme, mainly deriving from a diversion between pre-election promises and post-election policies of the ruling socialist party. Secondly, the economic difficulties facing the country were not perceived by the great number of the politicians, the public and the press as serious, due to lack of information, dialogue and communication among the social actors. It seemed that the Greek society (especially middle classes and self-employed), being used to living standards above their actual productive potential, was not yet ready to pay the cost of the necessary economic reforms. Thirdly, the reaction to the stabilization measures came from all political parties, including the conservatives, the unions and the press, and there was a widespread sentiment calling for a reversal of restrictive policies. The fierce reaction from the opposition conservative party is attributed to a “war of attrition” engaged against the government to obtain electoral gains. Furthermore, there was substantial friction within the ruling socialist party and reactions from the “left-wing opposition”, unable to understand how a socialist party could implement austere measures for the improvement of the economy.

In the period after the end of the stabilization programme until the general elections of 1989 were created conditions of political “instability” with an expected turnover in government, given that the conservatives constituted a real alternative, proposing a different redistributional policy.\textsuperscript{13} Furthermore, the government’s policy was expansionary and the economy continued to move along a destabilizing trajectory diverging from the performance of the other EC member states. These developments made more and more difficult the gradual incorporation of Greece into the Single European Market and jeopardized the country’s integration to the Economic and Monetary Union. Note that at that time, contrary to what happened in Greece, most European countries, and especially those lagging behind, were engaged in austerity programmes in view of the completion of the Single European Market.

Over the 1980s, the interventionist character of industrial policy
intensified, aiming at attracting investment and protecting domestic production, exports and employment through vertical-sectoral measures and grant allocation. These policies were not successful. Besides, the establishment of an intervention mechanism for industrial restructuring was not only delayed, judging from Western European practices, but it also failed to carry out the necessary adjustments, owing to extended social pressures on government (Caloghirou, 1993). As a consequence, industrial restructuring did not come off, with severe negative implications in the years to come.

As regards the financial system, as a mechanism in supporting economic growth, its reform has been very slow. A major structural feature of the Greek banking system was its institutional specialization required by law rather than dictated by market forces. The regulation and control of the banking system was carried out through a complex system of credit rules in an environment of administrative fixed interest rates. The structural deregulation of the Greek banking system was initiated in early 1980s but it was not until the late 1980s that there was a process of gradual liberalization and rationalization of the market, motivated by international developments and the need for participation in the Single European Market for financial services. Nowadays, the Greek financial system includes the smallest number of credit institutions in the EU and has been characterized by a decisive presence of the state, rare in other Western economies. The share of foreign banks is rather limited while the relative weight of banking in the financial system is still very high, although the depth of the capital and money markets gradually increased considerably in recent years.

With respect to labour policies, the socialists restricted labour dismissals and strengthened labour unions through successive legislation, thus increasing socialist influence within the General Confederation of Labour. Also, union leaders of public firms were granted substantial powers in the management of enterprises and they exercised considerable influence on policy choices. Note that the labour movement in Greece had “traditionally” been under the close control of the ruling party. The effects of such policies and attitudes are perceptible in the reform efforts by the present government.

The quality of economic-policy choices is after all reflected in policy outcomes: the Greek economic performance in the 1980s was rather discouraging compared with the EC scores, as a result of policy failures. In particular, over the 1980s the average annual growth of GDP in Greece was less than 1.5 per cent compared with about 2.5 per cent of the EC–12 average, while real gross capital formation almost stagnated as against 2.5 per cent average annual rises in the EC. The average annual inflation rate (of GDP) was 18 per cent for most of the decade and even faster in the first years of the 1990s, compared with about 6.5 per cent in the EC. Also, over the 1980s, the government deficit was around 15 per cent of
GDP (compared with 4.4 in the EC), while the current account averaged a deficit of around 5 per cent of GDP. The public debt from 30 per cent of GDP in early 1980s exceeded 110 per cent in early 1990s. On the other hand, the rate of unemployment in Greece which stood at 4 per cent in 1981 had risen to about 7 per cent by the end of the 1980s, which was lower compared with the EC average by about 1 per cent. As a consequence, real GDP per head increased at an annual rate of only 1.1 per cent over the 1980s, against 2.6 per cent in the period 1973–9.

Thus, in a period that European integration was gaining momentum, policy decisions in Greece were diverging from European trends and the implementation of the Single European Market was not given the necessary attention. Although the EEC Association Agreement dates back to 1962 and the Accession Agreement to 1981, it was not until towards the end of the 1980s that the European perspective was fully recognized and accepted. As a result, there has been a gradual loss of the country’s international competitiveness and the process of convergence with the EU has been extremely slow, preventing the country from closing the gap in terms of real GDP vis-à-vis the European average. Over the 1980s the influence of national specific characteristics has been dominant in shaping policy choices and the effect of international trends was secondary, though creeping and pressuring. However, these pressures manifested themselves openly in the 1990s and paved the way for policy reforms.19

The 1990s: the EU convergence effort

In March 1990, after a sequence of three general elections resulting in rather controversial coalition governments, the conservative New Democracy party, under the veteran centrist Constantine Mitsotakis, obtained a slim parliamentary majority. Once in office, the conservatives embarked on a three-year (1991–3) programme of fiscal consolidation.20 The main objectives of the programme were the reduction of economic imbalances and the restructuring of the economy, since the failure of industrial policies practised up to then made apparent the declining competitiveness of the economy. The central philosophy of the programme was the liberal proposition for the cutting down of the role of the state through an extensive programme of privatization and the reduction and rationalization of tax revenues. A crucial role for the readjustment of the economy was assigned to the expected high amount of the EC financial assistance through the Community Support Framework. I will return to this later.

The stabilization programme was not successful in achieving the set targets, with the exception of a short-term consolidation of the social-security system. Also, although the privatization of public enterprises became the primary objective of the conservative government, far fewer enterprises than intended were sold to the private sector.21 The government policies were met with unexpectedly strong disapproval by the
unions, leading to extensive strikes over privatization, tax reforms, reform of the social-security system and market liberalization. There was the least possible consensus for the government policies resulting in extended social discontent and upheaval. The ideological blend of policies led to the politicization of demands and the opposition socialist party, in an effort to overthrow the government, gave full support to all strikes. The society’s difficulty in accepting reforms is also reflected in the extended critique of the government from conservative members of parliament. Besides, the conservatives were also unlucky since the implementation of the programme coincided with the recession of the European economy, and thus of the Greek economy.

However, the stabilization programme registered an important success in making Greek society sensitive to the surging economic imbalances which would jeopardize the country’s integration with the European Union. In 1993, the government lost its parliamentary majority, being unable to resolve conflicting entrepreneurial interests and contrasting views on foreign affairs within the ruling party.

Before the termination of the 1991–3 programme, a new programme, the Convergence Programme, was launched for the period 1992–6, which was to be implemented by the socialists, since they made a striking comeback in the 1993 general elections. The stabilization effort continued and intensified under socialist ruling. Once in office, the socialists revised the Convergence Programme of the conservative government, but surprisingly enough its philosophy was retained.

The new element was a turn in the stance of the socialists on a number of important issues: the European integration process was fully recognized and the EMU prospect was conceived as an opportunity for gradual and labour-protective, economic reform, also maintaining social cohesion. In addition, the role of the public sector and the objectives of industrial and structural policies to improve competitiveness were re-assessed, but structural reforms were not stated explicitly, in view of the absence of a clear mandate for that. Towards the end of the 1990s structural reforms, liberalization and deregulation increased pace and only became a distinct policy goal after EU pressures. Nevertheless, the long period of instability due to delays in stabilization and structural adjustment made the reform process more costly.

This turn was finalized in 1996 under the new pragmatist leadership of Costas Simites, the present Prime Minister, who belonged to the standing party opposition and had always been a staunch supporter of the European orientation. Thus, the “reformers”, who were prepared to take a long-term view on what is at stake regardless of the short-term political cost, increased their influence in the party. Recall that until the early 1990s the socialist party was a left-wing party with a populist blend, not even a member of Socialist International. And PASOK’s “technopols” (in Williamson’s, 1994b jargon) were left behind the developments, being late.
to understand that the market-oriented reforms were a global phenomenon.

It should be noted at this point that economic policies in the 1990s consisted of three main elements. Firstly, the Convergence Programme, serving as a macroeconomic guideline for the fulfillment of the Maastricht criteria. Secondly, the Community Support Framework, aiming at the structural adjustment of the economy. Both are related to all aspects of policy decisions and are directly or indirectly agreed upon by the EU. Thirdly, policy choices are also dependent on the enforcement of various EC Directives.

The Convergence Programme defines explicitly the annual macroeconomic targets for the fulfillment of the Maastricht criteria and the achievement of sustainable economic growth. It is agreed upon by the EU and quantifies the stabilization effort and the macroeconomic restructuring process. The implementation of the programme sets the timing and pace of economic reforms and directly determines macroeconomic performance. Although policy options are left open, the philosophy of the Convergence Programme assumes restrictive policies, thus leaving little room for policy-makers to decide.

The Convergence Programme (1994–8) that was eventually implemented had particularly ambitious targets, aiming at the fulfillment of the Maastricht criteria by the end of 1998. The macroeconomic policies pursued have been particularly successful due to a credible policy implementation and the determination shown by Simites’ government to observe closely the annual targets of the Convergence Programme. Of great importance has been the gradual restoration of the private sector’s confidence and the investment-led growth of the economy. Fiscal policy has been successful at reducing extensive tax evasion but there was less success in rationalizing and cutting down the public expenditure side of the budget, as this is related to deeply rooted “state-supported” entrepreneurial interests, for the government is the sole customer of a great number of enterprises.

However, besides the efforts made and owing to severe past delays, Greece did not manage to fulfil all Maastricht criteria and join the EMU by January 1st 1999 along with the first group of countries. The stabilization and convergence effort continued and intensified with the full support of the European Commission. In March 1998 Greece, owing to international market pressures, devalued her currency and joined the European Exchange Rate Mechanism, declaring at the same time the acceleration of economic reforms (privatization, liberalization). By the end of 1999 the Convergence Programme was updated to cover the period 1999–2002 and was appended with a kind of an extended reform schedule agreed upon by the Greek government and the European Commission. The acceptance of the programme from the European Commission in fact granted the entry of Greece to the euro zone. Greece
managed to meet all Maastricht criteria in March 2000. The relatively short time during which the country achieved these criteria reflects its exceptionally positive economic record from the mid-1990s.

As regards the Community Support Frameworks (CSF), the second element of economic policy, they are interventionist measures adopted by the EC to provide financial assistance to regions whose development and structural adjustment lagged behind. The eligible CSF regions were mainly Greece, Portugal, Ireland and parts of Spain. The first CSF covered the period 1989–93, since the widening of regional disparities could threaten the successful realization of the Single European Market (for Greece it amounted to about 2 per cent of GDP annually). It was followed by the second CSF (1994–9) to help regions and countries to achieve the Maastricht criteria and participate in the EMU (for Greece it exceeded 3 per cent of GDP), while the third CSF (2000–6) is even higher, aiming at facilitating the catch-up process in the first years of the EMU.

The CSF is essentially a structural-reform programme consisting of specific actions which are set in a comprehensive framework for the improvement of physical and human capital. It is expected to improve the productivity of the economy as a whole by strengthening the endogenous growth mechanisms. The CSF aims at enhancing the productive capacity of the economy; making the operation of the markets more efficient; and also alleviating the social costs of adjustment. The positive impact of the CSF on the economy is expected to stem from a temporary demand-multiplier effect (boost in demand due to the inflow of EC funds) and also from a permanent supply effect (improvement of productive capacity due to the enforcement of the supply side factors). Empirical assessments of the CSFs suggest that they have an important bearing on economic development. However, these beneficial influences are curtailed if funds are inefficiently used and/or if they have not adopted suitable accompanying policy measures aiming at facilitating structural reform (e.g. improving flexibility, competition).

Regarding the Greek case, empirical studies show that the CSF 1989–93 has not been implemented efficiently since only the demand-side effects were motivated. It failed to mobilize mechanisms that would create positive externalities in the production process through the application of accompanying policies for the improvement of market functioning. However, the implementation of the CSF 1994–9 was more efficient and allowed for the structural adjustment process to gather momentum. Over the second half of the 1990s, the beneficial impact of the CSF on the economy is strengthened by the implementation of microeconomic policies aiming at the improvement of market functioning, as a result of direct or indirect EU pressures.

Recalling that the CSF is an unprecedented huge-scale structural programme, the experience gained in materializing extended projects has
gradually improved, leading to an improvement of the implementation procedures (e.g. production of public works). The necessity to carry out the programme in time brought about the inefficiency of the public sector. This called for a substantial reform in the public sector. As a result, the private sector is gradually taking over the management of various projects that in the past were considered to belong to the public sphere. In addition, the CSF is gradually conceived by the decision makers and the public as a reform programme with a long-term perspective and not as a short-term EC financial assistance. Finally, the CSF moderated the short-term social costs of stabilization and facilitated the public acceptance of the stabilization measures and the European orientation of the country.

Structural-industrial policy became an integral part of the CSF. Thus, in the early 1990s, owing to direct EC pressures, the industrial policy objectives were radically transformed and the emphasis shifted from interventionist policies and vertical-sectoral measures to open-market policies and horizontal actions. These policies together with privatization and a strict exchange-rate policy are leading to substantial restructuring of the industrial fibre, thus improving its competitiveness. Market-liberalization policies were intensified towards the end of the 1990s under the urge of the EU Directives in the areas of telecommunications, energy and especially in the financial sector. However, contrary to what has happened in other south European countries (e.g. Portugal), the Greek economy in fact did not use up all reform potential before joining the EMU. Consequently, more reforms will be carried out in the future allowing for further growth opportunities.

With respect to the financial and especially the banking system, developments have been largely determined by international factors and also by direct EU actions, which led to substantial market liberalization and deregulation. Over the 1990s the process of deregulation of the banking system was carried out at an accelerating pace, since the complicated system of direct controls and interventions, although frequently modified, essentially remained in place until the late 1980s. In 1992 further liberalization and deregulation of the Greek banking system resulted from the implementation into Greek law of the EC Second Banking Directive, establishing the abolition of the remaining direct controls and interventions and leading to a common financial market. Various measures were also taken recently towards the modernization of the capital market and corporate governance.

Since the mid-1990s, the Greek financial and banking landscape changed rapidly with the entrance of new private financial institutions but there is no significant increase in foreign presence. Major changes are expected in the years to come, as a result of the government’s will to reduce the state’s presence and initiate structural changes in the credit market. In addition, competition is deepening and a wave of mergers and acquisitions has already started as a result of the dynamics of the domestic
and the EU financial markets. A recent distinct development in the financial sector is the steep rise in the number of firms whose shares are quoted in the stock exchange and also an increase in capitalization. As a result, the traditional high share of banking in financing entrepreneurial activity is reduced and disintermediation has been in evidence.

Finally, in the labour market, there has been a turn towards active unemployment measures but policies to make the market more flexible were not introduced. The government’s incomes policy was met by strong pressure from all political parties and organized interests demanding the end of the so-called “socially cruel policy”. Ironically over this period real wages increased. It is also interesting to note that the opposition conservative party was aligned with the most extreme demands of the Communist Party, hoping to gain electoral benefits. Furthermore, the government faced fierce reactions from the teachers’ unions and also from extended pupils’ uprisings in its effort to reform the national educational system.

Over the 1990s, the role of international factors and tendencies seems to have played a distinct role in shaping policy options. Apart from the growing internationalization and globalization of the economies which are narrowing down the policy choices of national governments, it has been the EU perspective and the process of European integration that played the most crucial role in policy choices. As already shown, European integration has decisively affected policy choices both directly and indirectly, though the distinct way the country perceived international tendencies and especially European integration eventually determined the speed of adjustment.

In the early 1990s, the long-delayed stabilization effort was initiated by the conservatives, with some degree of success. However, it was the sustained effort of the socialist government before the mid-1990s that intensified stabilization, when the stated policy objective became the country’s full participation in the EMU. Eventually, the economic-policy reforms received a fair amount of public support despite their restrictive character, also attributed to the bad experience of poor economic performance in the 1980s. Towards the end of 1980s there was a growing consensus from social and economic actors increasingly viewing European integration as a way of ensuring economic competitiveness and the role of Greece as an equal EU partner. This development was facilitated by the economic, social and political stability provided by the country’s relationship with the EU, compared with the instability and poverty in the neighbouring Balkan states coupled with the fall of the socialist perspective. It was also facilitated by the contribution of the European financial assistance minimizing the cost of stabilization and adjustment.

Furthermore, the socialist government received increasing acceptance due to lack of populism, so intense in the 1980s, and its consistency between words and deeds. The socialists have managed to obtain
confidence from the Confederation of Industrialists as well as trust from the Labour unions. Important in this direction has been the new social-democratic outlook of PASOK, in contrast to its “Third World” image of the 1980s, in line with international and European trends at a time of increasing social-democratic options in the EU. A consequence of these developments was the electoral victory of the socialists in the April 2000 general elections, for the third consecutive time since 1993, with the defeat of the populist policies of all opposition parties.

Concluding remarks

The rationale behind economic policy-making in Greece over the 1980s and 1990s has been presented and discussed. The institutional factors determining policy choices and political and economic constraints have also been thoroughly analysed. Emphasis has been put on the role of the EU in affecting economic and political factors determining policy options and economic performance. The comparison of policy developments between two time periods, the 1980s and the 1990s, with different characteristics allows us to understand better policy choices and outcomes. The results of the analysis can be used in developing some general themes that might be applicable to other countries. The conclusions drawn and the explanations of the policies pursued are given below.

Judging from policy outcomes and policy choices, the 1980s has been a period of underperformance due to policy failure at the macro and micro economic level. Policy decisions were diverging from European trends and the implementation of the Single European Market was not given the necessary attention. Over the 1990s, Greece showed increasingly impressive economic results due to successful stabilization and reform policies in line with international and EU trends, which towards the end of the 1990s surpassed the scores of almost all other EU countries.

Policy choices seem to have been largely shaped by two main factors. They are determined by national specific characteristics, such as the prevailing historical legacies and national institutional characteristics. They are also determined by international factors and tendencies, in the Greek case by the European integration process. In the 1980s the former were mainly responsible for policy choices, while over the 1990s the latter gradually became far more important. The influence of international factors on policy options and economic performance has been either direct or indirect.

The direct effect of international factors on policy choices and economic performance derived from three main influences: (i) the application of the Convergence Programme, agreed upon by the EU and quantifying the stabilization effort and the macroeconomic restructuring process; (ii) the implementation of the Community Support Frameworks (CSFs), which moderated the short-term social costs of stabilization and
reform and provided for the necessary funds for economic restructuring; and (iii) the enforcement of various EU Directives introducing competition in various sectors, such as the financial system.

International factors and in particular European integration have had an indirect, though crucial positive influence on national specific characteristics. In particular:

a) The European integration process has decisively affected the ideological position of the ruling party. Over the 1980s, the economic policy choices of the socialists reflected the widespread anti-EEC sentiment in Greece, mostly created in the 1970s or earlier, where the European perspective was perceived as threatening the country’s sovereignty. However, over the 1990s, international developments and the past bad experience of poor economic performance gradually led to public acceptance of stabilization and reform. Thus, stabilization and reform policies, although initiated by the conservatives, were implemented by the socialists, who in the meantime were obliged to change their stance with commitment to European integration and economic reform.

b) The process of European integration has only to a certain extent affected the stance of political institutions and the degree of polarization characterizing the political system. Over the 1980s, the socialist policies enjoyed a consensus since the conservatives in opposition had followed an expansionary and interventionist policy themselves while in office during the 1970s. In the 1980s, the stabilization policy was undermined by strong opposition from labour unions as well as by all opposition parties including the conservatives, who got engaged in a “war of attrition” against the government to obtain electoral gains. The same happened during the conservative government in the early 1990s, when the socialists gave full support to all strikes, although they applied the same kind of restrictive policies when they came to power. Also, when the socialists moved to more pragmatist positions towards reform and European integration, the conservatives changed their standpoint towards populist positions, with their leader making a “left-wing” critique to the ruling socialist party.

This lack of consensus between political and social actors made difficult the application of policies that were in conflict with organized interest groups with large electoral weight. Furthermore, the absence of social dialogue between social and political actors in Greece on crucial policy issues made unions suspicious of policies that infringed on their rights and were mobilized against all restrictive policies. However, in the 1990s, the reactions to reform policies were much more weak due to the gradual acceptance of EU perspective. The gradual realization of past policy failure with adverse effects across social groups moderated the resistance of interest groups and political parties to stabilization and reform. In other words, the delays in taking the necessary policy actions paved the way for a wide acceptance of stabilization measures and eventually for the initiation and implementation of structural adjustment.
c) Finally, besides distinct policy choices, the *capacity of the state* to impose policy options was greatly improved by the European integration process, also upgrading the quality of policy-making. The traditional *bureaucratic incompetence* and inefficiency of the Greek public administration in setting up and implementing coherent and credible policies bears responsibility for unsuccessful policies in the 1980s and for the failure of structural adjustment. However, the accelerated momentum of the European integration process over the 1990s pressured for a reform of the public administration and eventually for a re-assessment of the role of the state. It also minimized the adverse effect from the absence of *bureaucratic state autonomy*, where policy implementation relies mainly on politicians who take the political cost into serious consideration before deciding, rather than on bureaucrats. The same applies to the traditional problem of Greek governments facing difficulties in the composition of a coherent and united *policy-making team* because of party polarization.

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**Notes**

1. The Maastricht criteria refer to the achievement of certain reference values for specific key economic variables (inflation, public deficits, public debt and long-term interest rates) which grant the entry to the 3rd Stage of the Economic Monetary Union (EMU).
3. See, Caloghirou et al. (2001) for a discussion on these points.
4. For an extended discussion of the developments in Greece, see Lolos (1998); also Caloghirou and Ioannides (1999).
5. These policies favoured the development of traditional products, which can be characterized as unskilled labour intensive, natural resources and capital intensive (Mitsos 1989, Neven 1990, Lolos and Papayiannakis 1993).
6. By “Third World” preoccupation I mean ideas and policies relevant to the experience of Third World countries. According to PASOK’s analysis, there had always been a dichotomy in Greece among two broad (though not so well-defined) social blocks: the traditional ruling class (the “Establishment” in PASOK’s jargon), which effectively had been in power over the whole post-war period, and the “People” (again in PASOK’s jargon).
8. See, for instance, National Bank of Greece (1998). However, towards the end of the 1990s EU income support is gradually losing importance due to the enforcement of Agenda 2000 decisions.
10. The main mechanism for the achievement of the targets was the slow-down of
labour costs, that would result in a boost in entrepreneurial activity and investment and the improvement in competitiveness. For a presentation of the stabilization programme, see Bank of Greece (1986) and Garganas et al. (1989).

11 For a discussion on the social reactions to the programme, see Tsoukalis (1991).

12 Although a drastic cut in public investment and substantial improvements in tax-collection procedures was achieved, budget deficits persisted due to the lack of fiscal consolidation of the expenditure side. Unemployment increased marginally and inflation slowed down considerably.

13 The polarization of political life was intensified due to a politico-economic scandal threatening to overthrow the government and the sudden illness of Papandreou, which disorganized the government.


15 See OECD (1987) for a detailed presentation of the European experience.

16 For a detailed discussion on the regulatory framework and actual policies pursued see, inter alia, Halikias (1978), Courakis (1981) and Hondroyiannis et al. (1999).

17 The capacity of the unions to veto particular policies has been substantial, but this was less a direct outcome of labour’s market strength and more the outcome of the political power of the unions due to their close relationship with the socialist party in power. For an extensive discussion on these points, see Zambarloukou (1997).

18 A detailed account on Greek economic developments can be found in Bank of Greece, Annual Reports of the Governor (various issues). Also, in OECD, Economic Surveys, Greece (various issues).

19 Pressure to adjust to international economic trends have also been detected in Portugal (Lolos, 1998) and Spain (Caloghirou et al., 2001).

20 For a presentation of the programme, see Ministry of Finance (1990) and Bank of Greece (1991).

21 This was mainly due to the absence of consensus between the interested parties (government and managers of public firms) and to pressures from organized interests (unions and “state-supported” industrial interests). See Caloghirou (1993).

22 Note that apart from the European integration identified as a renewed opportunity for improved economic performance, policy options included close cooperation with the neighbouring Balkan states. Recently relations with Turkey are also intensifying after the Helsinki EU Summit (December 1999).

23 The main objective of the programme was the drastic reduction of inflation from around 14 per cent in 1993 to around 3 per cent in 1999, the achievement of which was to be based on an austere monetary and foreign-exchange policy and a rapid fiscal adjustment and consolidation, together with a gradual reduction in labour costs. A presentation of the Convergence Programme can be found in Bank of Greece (1999).

24 The hard-currency policy which has consistently been followed for several years has been contributing to the disinflation of the economy allowing for a reduction in interest rates. Thus, a substantial drop in inflation was achieved (to single-digit figures in 1996, for the first time since the energy shock of 1973), together with a reduction in the short- and long-run interest rates and in fiscal deficits (from 10.5 per cent of GDP in 1994 to 2.5 per cent in 1998).

25 Note that over the 1990s the Convergence Programme was updated many times. For a review, see Stournaras (2000).

26 The CSFs are financed by EC transfers from the European Structural Funds, as
well as by national sources of the beneficiary country at about equal proportions (in the case of Greece), while a contribution is also provided by the private sector.

27 See, *inter alia*, Beutel (1990, 1995), Bradley *et al.* (1995) and for the case of Greek, Lolos *et al.* (1995) and Christodoulakis and Kalyvitis (1998). However, Spraos (1991) supports the view that the substantial flow of current capital transfers would affect adversely the competitiveness of the economy since it raises the exchange rate (the so-called "Dutch Disease"). Similar effects are expected from the Community Support Framework in the financing of Greek imports.

28 Note, for example, that the authorities, in view of the difficulty in absorbing the EC funds in large-scale construction projects, reallocated a quarter of these funds to the construction of a great number of small-scale projects of regional range, very useful in local development but unable to trigger endogenous growth mechanisms. Also, the majority of funds for the improvement of human capital (e.g. training) were fully absorbed though without adequate inspection. For a discussion on these points, see Evalion (1995) and Lolos *et al.* (1995).

29 In 1993, the EC was unwilling to co-finance an industrial restructuring programme proposed by Greece (HELPEID) because it diverged from the new philosophy of EC industrial policies for the 1990s. This new philosophy combined structural adjustment with industrial competitiveness and was in line with the objective of the Single European Market, which called for the abandonment of policies traditionally implemented (sectoral policies, subsidies, etc.). See European Economy (1990).

30 See Christopoulos and Tsionas (2002).

31 Also, in 1992, the Own Funds and the Solvency Ratio of credit institutions Directive were enacted into Greek legislation and foreign-exchange controls concerning current transaction were lifted, while capital movements were completely liberalized in 1994. For a presentation of the deregulation measures of the Greek banking system, see Gortsos (1995), Hondroyiannis *et al.* (1999) and Christopoulos *et al.* (2002).

32 Note that the decision to privatize the Ionian Bank, the fourth largest commercial bank, in 1998 was met by a substantial uprising from the unions.

33 See, for instance, Bank of Greece (1999).

References


European Economy (1990), Social Europe: The Impact of the Internal Market by Industrial Sector: The Challenge of the Member States, European Commission.


5 The political economy of reform failure and macroeconomic mismanagement
Turkey, 1980–2002

A. Erinc Yeldan and Sabit Khakimzhanov

5.1 Introduction
Turkey’s post-1980 history of macroeconomic and political developments under the neo-liberal model is observed to suffer persistent difficulties and wide fluctuations in national income and rates of capital investment, with conflicting policy adjustments. This observation pertains despite the overall thematic continuity with the ambitious programme of economic liberalization and market-led adjustments put into full force during the early 1980s led by the military government and its civilian successors. Currently the most distinguishing aspects of the Turkish political-economy context remain the persistence of price inflation under conditions of a crisis-prone economic structure; persistent and rapidly expanding fiscal deficits; marginalization of the labour force along with the dramatic deterioration of the economic conditions of the poor; and the severe erosion of moral values with increased public corruption.

It is the purpose of this essay to identify and study the main stylized facts and processes characterizing the dynamic macroeconomic adjustments of Turkey since the inception of its reforms towards global integration – namely, post-1980s. In what follows, we will regard the state not as an exogenous entity consisting of reform-minded techno-bureaucrats, but rather as an active agent in addressing the often conflicting demands of various social classes and interest groups. We regard the macroeconomic results of this political-economy game as a direct outcome of the endogenously driven cycles of growth, stagnation, delayed stabilization reforms, and crisis. Following the main thematic motivation of this research project, we trace the policy-reform failures not to the inapt short-sightedness and irrational behavior of a set of exogenously given ignorant bureaucrats; but, rather, to the resolution of the social conflict in the creation and distribution of economic surplus wherein the state has found itself as a regulatory agent. In this context, of particular importance is our investigation of culminating inherent tensions of macroeconomic disequilibria embodied in the process of integration to the world markets under conditions of a poorly supervised banking system and underdeveloped, fragile domestic asset markets.
The essay is organized under five sections. In the next, we provide a broad overview of the recent macroeconomic history of Turkey. We find it analytically convenient to decompose this path into three major sub-periods partitioned by the strategic steps of commodity trade liberalization in 1980, and then the financial liberalization of 1989 which led to the full de-regulation of the capital account. This latter reform effectively completed the full integration of the domestic market to the global financial markets. We address the modes of accumulation and surplus creation under all three sub-periods separately, and investigate the inherent disequilibria under each episode. A detailed analysis is carried out on the rise of the public-sector deficits, especially following 1990, and the macroeconomic consequences of the expanding fiscal gap on the commodity and the financial markets. The general equilibrium characteristics of the national economy under the constraints of an open macroeconomic environment are discussed in section 5.3. Here, we further introduce the elements surrounding the demise of the IMF-led disinflation programme of 2000 and the February 2002 crisis. Section 5.4, in turn, offers a game-theoretic approach in identifying the main actors and their strategic role in generating dis-equilibria and in sustaining inflationary expectations. Finally, the essay concludes with summary comments in section 5.5.

5.2 Phases of macroeconomic adjustment in Turkey

The 1972–2001 evolution of the Turkish economy is portrayed in Table 5.1. Overall, it is possible to distinguish three distinct cycles of growth-crisis-and-adjustment under the post-1972 Turkish historical path. The first covers broadly the period 1972–9, with its main attribute being the deepening of the import substitutionist industrialization strategy. This period, often regarded as the second phase of import substitution, is characterized by the implementation of a vigorous public investment programme in heavy manufacturing and capital goods. The foreign-trade regime was heavily protected via quantitative restrictions along with a fixed exchange-rate regime which, on average, was overvalued given purchasing parity terms. The state was both an investing and a producing agent with state economic enterprises (SEEs) serving as the major tools for fostering the industrialization targets.

In retrospect, the underlying political-economy basis of the ISI strategy was one of grand, yet delicate, alliance between the bureaucratic elites, industrial capitalists, industrial workers, and the peasantry (Boratav, 1983; Boratav et al., 1984). Private industrial profits were fed from two sources. First, the protectionist trade regime enabled industrialists to capture oligopolistic profits and rents originating from a readily available, protected domestic market. Second, the existence of a public-enterprise system with the strategic role of producing cheap intermediates enabled the private industrial enterprises (and the rural economy) to minimize on material
input costs. Industrialists, in turn, “accepted” the conditions of a general rise in the manufacturing wages, and an agricultural-support programme which induced the domestic terms of trade to favour agriculture.

The import substitutionist development strategy reached its limits at the beginning of 1976 when financing of the balance of payments and industrial investments became increasingly difficult. The foreign-exchange crisis of 1977–80 brought together the cessation of the civilian democracy and imposition of a new constitution and labour codes regulating the industrial relations under a military regime.

A structural-adjustment programme was introduced in January, 1980 under the auspices of the international centres such as the World Bank and the IMF. The period 1981–7 was marked with commodity trade liberalization and export promotion along with a price reform aimed at reducing the state’s role in the economic affairs. With the adoption of an open pro-export stance and the introduction of a crawling-peg regime of exchange rate administration based on daily adjustments of the Lira, the real rate of exchange depreciated by almost 70 per cent until 1988. Subsidies on manufacturing exports were also significant, averaging around 25 per cent of the value of manufactured export revenues, reaching a peak of 35 per cent in 1983. The most important component of the subsidy was the production tax rebates, which accounted for about half of the subsidies granted in 1982 and 1983, and amounted to as much as 75 per cent of the total subsidy rate in 1984 (Milanovic, 1986; Yeldan, 1995). In addition to being a source of high losses to the central government budget, the subsidization scheme was held responsible for “export-oriented rent-seeking” by way of over-invoicing of exports and through the emergence of the so-called “fictitious exports”.

Export promotion was further supported at the institutional level via creation of specialized export firms under the status of Foreign Trade Companies (FTCs). FTCs were built upon the East Asian model of export promotion, and were thought to function as the long arm of the domestic industrial capital in reaching the foreign markets at a centralized scale. Those FTCs that were able to meet specific export volume targets were granted additional subsidization by the government. Thus, it was through the FTCs that the large-scale, export-oriented capital could enmass the rents of the new trade regime.

FTCs, by law, were not allowed to engage in production and investment activities. However, they evolved as “the marketing outlets of domestic corporations, [and] organic links exist[ed] between FTCs and the major domestic industrial, trading or construction conglomerates” (Öniş, 1992: 77–8). According to calculations in Öniş, the share of FTC-based exports in total exports increased steadily to a peak of 49.6 per cent in 1986. Consequently, the degree of concentration of FTC exports remained high, with the top four contributing about a third, and the top eight registering about half of the export revenues in 1988. Clearly, this observed pattern of
Table 5.1 Phases of macroeconomic adjustment in Turkey, 1972–2001

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<td>7.9</td>
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<td>1.2</td>
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**Fixed investment:**

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<td>−9.6</td>
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<td>14.1</td>
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<td>16.2</td>
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<td>25.8</td>
<td>−14.3</td>
<td>−31.7</td>
<td>25.6</td>
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<td>4.8</td>
<td>7.7</td>
<td>9.7</td>
<td>14.3</td>
<td>−0.5</td>
<td>4.7</td>
<td>−6.3</td>
<td>−17.5</td>
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<td>2.9</td>
<td>−1.6</td>
<td>18.6</td>
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<tr>
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<td>4.8</td>
<td>−5.6</td>
<td>−17.6</td>
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**As % share of GNP:**

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<td>21.9</td>
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<td>20.7</td>
<td>20.2</td>
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<tr>
<td>Investment</td>
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<td>22.3</td>
<td>18.3</td>
<td>20.9</td>
<td>26.1</td>
<td>23.7</td>
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<td>24.3</td>
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<tr>
<td>PSBR</td>
<td>5.7a</td>
<td>6.9</td>
<td>3.7</td>
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<td>4.8</td>
<td>9.1</td>
<td>7.9</td>
<td>7.2</td>
<td>9.2</td>
<td>15.1</td>
<td>12.5</td>
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### II Distribution and prices

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<th>68.8</th>
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<th>106.3</th>
<th>85.0</th>
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<td>50.4</td>
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<table>
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<th>(TL/$)</th>
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<table>
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<th>Manufacturing real wages[c]</th>
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<table>
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<th>Share of wages in manufacturing value added (%)</th>
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<tr>
<td>27.7</td>
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### III Internationalization

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<th>Manufacturing exports</th>
<th>39.4</th>
<th>14.3</th>
<th>19.7</th>
<th>12.5</th>
<th>14.0</th>
<th>5.1</th>
<th>18.0</th>
<th>14.2</th>
<th>3.2</th>
<th>-5.5</th>
<th>4.9</th>
<th>12.4</th>
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<td>As % share of GNP:</td>
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<tr>
<td>Imports[e]</td>
<td>11.7</td>
<td>11.2</td>
<td>14.0</td>
<td>15.9</td>
<td>15.8</td>
<td>14.6</td>
<td>17.8</td>
<td>23.2</td>
<td>22.5</td>
<td>21.7</td>
<td>27.2</td>
<td>28.2</td>
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<td>8.5</td>
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<td>-0.7</td>
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<tr>
<td>Stock of foreign debt</td>
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<td>35.1</td>
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<td>50.9</td>
<td>55.7</td>
<td>59.1</td>
<td>74.3</td>
</tr>
</tbody>
</table>

Sources: SPO Main Economic Indicators; Undersecretariat of Foreign Trade and Treasury Main Economic Indicators; SIS Manufacturing Industry Surveys.

Notes
a 1975–6 only.
b Annual average of Compounded Interest Rate on Government Debt Instruments deflated by the wholesale price index.
c Wage earnings of workers engaged in production. Private manufacturing labour data cover enterprises employing ten or more workers.
d Refer to unit wage costs in ($) obtained from production workers in private manufacturing.
e Including luggage trade after 1996.
export orientation generated strong pressures of non-competitive pricing and accumulation behaviour in the industrial commodity markets, and also gave way to intense “rent-seeking” behaviour among the industrial conglomerates, their financial extensions, and the government.

Given all this promotion and support, export revenues increased at an annual rate of 15 per cent during the decade, and gross domestic product rose at an annual rate of 4.2 per cent in 1981–2, and 6.5 per cent in 1983–7. The period, however, was also characterized by severe erosion of wage incomes via hostile measures against organized labour. The suppression of wages was instrumental both in lowering production costs and in squeezing domestic absorption capacity. Through this manner, an exportable surplus could have been generated which found its way to the newly growing Middle Eastern markets with heavy use of export subsidies. Consequently, the share of wage-labour in private manufacturing value added receded from 30 per cent to 20 per cent, and in public manufacturing from 27 per cent to 15 per cent between 1980 and 1988. In contrast, the average mark-up rate (profit margins) in private manufacturing increased from 31 per cent to 38 per cent (Yeldan, 2000).

It has to be noted that one of the major components of this wage-suppression mechanism was the continued price inflation, enabling both the real wage squeeze to be captured as surplus profits for capital, and also inflation tax revenues for the state. Implemented under a regime of continued currency depreciation supplemented by direct export incentives, inflation policy did not seem to lead to any loss of competitiveness of Turkish exportables.

This “classic” mode of surplus creation reached its economic and political limits by 1988. Coupled with a new wave of populist pressures under the approaching civilian elections, organized labour succeeded in attaining significant increases in wages. Furthermore, the rural economy witnessed a significant improvement in its terms of trade vis-à-vis the industry. Finally, beginning in 1989, there had been a major shift in the public-expenditure accounts towards populist patterns with an overall increase in both the share and level of public salaries. With possibilities of further surplus extraction via wage suppression limited, the state’s involvement in economic matters has to be intensified in order to sustain the level of capital incomes, and this called for an actual increase in the economic and administrative interventions of the state despite the officially stated stance.

One of the leading revelations of the state’s continued role in surplus re-distribution in the 1990s was in the realm of its taxation policy. In retrospect, the post-1988 populism could evidently be financed by expanding the tax base and moving towards a more “fair” tax burden on the working classes. Yet, the strategic preference of the state was the maintenance of its present stance towards evasion of taxable capital incomes and enabling a mechanism of surplus transfer by way of a lax attitude towards the so-
called unrecorded private transactions. Consequently, the state apparatus turned into a bastion of privilege as it assumed a regulatory role in the creation and absorption of the economic surplus, and the fiscal balances have taken the major brunt of adjustment. Thus, the main macroeconomic policy response to the increased wage costs and the shift of the rural terms of trade was the rapid widening of the fiscal gap, and the sustenance of the profitability of private capital. As a major indicator of the (functional) distribution of income, for instance, the share of interest income in total gross domestic product rose to 8.4 per cent in 1991, and to 15.2 per cent by 1998 from its minuscule share of 0.7 per cent in 1980 (Yeldan, 2000). Simultaneous to this development was the rapid rise of the borrowing requirement of the public sector, as the ratio of the PSBR to the gross domestic product rose to 10.3 per cent in 1991, and to 12.1 per cent in 1993.

Given all this, it is clear that the widening fiscal deficit and the macroeconomic disequilibria it generated should be understood in the context of the historical role of the state in sustaining capital incomes against the faltering performance of the export-led growth patterns along with the rapid increases in costs of wage-labour. As extensively discussed in Yeldan (1995) and Köse and Yeldan (1998), the fiscal deficit of the Turkish state in the early 1990s does not necessarily imply a problem of “bureaucratic mis-management” in the abstract, but is a reflection of the administrative and socio-economic policies on the part of the public sector, which were deemed necessary to sustain the generation of economic surplus for the private capital. The state has used its taxation-cum-subsidy policies and the prices (losses) of its production enterprises as the strategic instruments of this historical manoeuvre, and financed its fiscal deficits via forced savings by way of price inflation and increased domestic indebtedness through securitization at very high real rates of interest.

5.2.1 The rising fiscal gap: the role of the state in regulating income distribution

The post-1990 macroeconomic balances recorded an unprecedented rise in the fiscal gap. The period witnessed a series of reluctant and failed attempts of tax reform. The succession of short-lived coalition governments are all observed to rely on indirect taxation as budgetary revenues. In the meantime, net factor earnings dwindled abruptly over 1989/1991, and current transfers (consisting mostly of expenditures on servicing domestic debt and transfers to social-security institutions) rose steadily over the decade.

Table 5.2 documents the main fiscal indicators of the public sector, presenting the relevant data in real 1987 prices using the wholesale price indexes. The erosion on factor income in the early 1990s reaches almost 5 per cent of the GNP, while the rise of the current transfer expenditures
### Table 5.2 Public-sector balances (real 1987 prices, billions TL)

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<td><strong>Tax revenues</strong></td>
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<tr>
<td>Direct</td>
<td>10,313.8</td>
<td>11,818.9</td>
<td>13,855.2</td>
<td>15,145.1</td>
<td>15,970.0</td>
<td>15,830.0</td>
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<td>22,235.4</td>
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<td>Indirect</td>
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<td>5,120.1</td>
<td>5,879.7</td>
<td>6,013.8</td>
<td>6,359.6</td>
<td>6,820.7</td>
<td>6,619.1</td>
<td>7,380.5</td>
<td>9,668.1</td>
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<td>Factor revenues</td>
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<td>6,698.8</td>
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<td>7,951.8</td>
<td>8,785.5</td>
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<td>8,776.4</td>
<td>9,768.1</td>
<td>10,869.9</td>
<td>12,718.7</td>
<td>12,567.3</td>
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<td>9,966.8</td>
<td>9,498.1</td>
<td>8,083.3</td>
<td>8,779.7</td>
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<td>9,919.9</td>
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<td>3,801.4</td>
<td>3,084.7</td>
<td>613.1</td>
<td>718.0</td>
<td>2,660.6</td>
<td>925.0</td>
<td>69.0</td>
<td>1,634.7</td>
<td>854.4</td>
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<td>Domestic debt</td>
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<td>9.0</td>
<td>6.7</td>
<td>10.6</td>
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<td>Net new domestic borrowing/</td>
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<td>1.4</td>
<td>1.1</td>
<td>1.1</td>
<td>0.9</td>
<td>1.2</td>
<td>1.7</td>
<td>1.3</td>
<td>1.2</td>
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<td>40.7</td>
<td>41.7</td>
<td>58.6</td>
<td>48.9</td>
<td>53.1</td>
<td>52.4</td>
<td>57.8</td>
<td>52.4</td>
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**Ratios to GNP (%)**

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<td>-0.6</td>
<td>-0.9</td>
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<td>3.4</td>
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<tr>
<td>Net new domestic borrowing/</td>
<td>41.7</td>
<td>48.5</td>
<td>40.7</td>
<td>41.7</td>
<td>58.6</td>
<td>48.9</td>
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<td>57.8</td>
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**Sources:** SPO *Main Economic Indicators*; Undersecretariat of Treasury, *Treasury Statistics, 1980–1999*.

**Notes**

a Deflated by the Wholesale Price Index.
exceed 125 per cent in real terms over 1992 to 1996. These developments led to a sharp decline of the disposable income of the public sector. The collapse reaches 45 per cent when contrasted across 1992 and 1996. The saving performance of the public sector, likewise, broke down and turned negative after 1991. The state acted as a net dis-saver for the whole decade – with the single exception of 1997. Thus, the borrowing requirement of the public sector (PSBR) rose sharply, and as a ratio to GNP, stood around 10 per cent over 1990–6. This ratio hit 15 per cent in late 2001.

A significant constraint on the state’s capability in financing its gap was its limited options in borrowings from abroad. Given the fragile asset position of the public sector, government net foreign borrowing was minimal, and in most instances was negative. With the advent of fully-fledged financial liberalization after 1989, however, the governments had the opportunity of bypassing much of the liquidity constraints on its operations. Consequently, the financing of the PSBR relied exclusively on issues of government debt instruments (GDIs) to the internal market – especially to the banking sector.

The stock of securitized domestic debt grew rapidly over the 1990s. The stock of GDIs was only 6 per cent of the GNP in 1989, the year when the capital-account liberalization was completed. By the end of 2000 this ratio reached to 29 per cent. Interest costs on domestic debt grew to 10.6 per cent of the GNP in the same year, increasing almost ten-fold in real terms over the decade (Table 5.2). As a further comparison, interest costs on servicing the debt reached 1,010 per cent of public investments, and 481 per cent of the transfers accruing to social-security institutions in 1998. In this regard, the central budget in Turkey is observed to lose its instrumental role of social infrastructure development and long-term growth, but rather became a tool of finance capital.

5.2.2 The main elements of the 2000 disinflation programme and the 2001 crisis

Following a series of ill-founded and poorly focused set of stabilization attempts through the decade, the government finally initiated a comprehensive disinflation programme in December 1999 under the guidance of the International Monetary Fund (IMF). It aimed at decreasing the inflation rate to a single digit by the end of 2002. Aided with the supervision and technical support of the IMF, the new programme relied on exchange-rate based disinflation and monetary control by setting upper limits to net domestic asset position of the Central Bank (CB). Accordingly the CB committed itself to a policy of no sterilization, whereby changes in the monetary base would directly reflect changes in the net foreign assets of its balance sheet. The programme further entailed a series of austerity measures on fiscal expenditures and set specific targets for the balance on the non-interest, primary budget.
Yet, just eleven months after launching the disinflation programme, Turkey experienced a severe financial crisis in November 2000. More than US$6 billion of short-term capital fled the country, creating a severe liquidity shortage in the domestic commodity and asset markets. The government requested to access the Supplementary Reserve Facility from the IMF. The request was granted with US$7.5 billion of additional support in 22 December, and the technical limits of the monetary programme have been revised. Only then continued implementation of the programme could have been secured as the markets seemed to have calmed down. However, shortly after this rearrangement with the IMF, the public disclosure of a political dispute between the Prime Minister and the President of the Republic on 19 February 2001 badly hit the uneasy markets. The CB was forced to sell a large portion of its foreign reserves in an attempt to support the Lira as the short-term interest rates rocketed to above 5,000 per cent. In what followed, the government could not endure the pressures of the markets any further, and declared the surrender of the pegged exchange-rate system on 22 February, thereby letting the exchange rates free float.5

Following the demise of the exchange-rate-based disinflation programme, the newly appointed minister, Kemal Dervis (former Vice President of the World Bank), submitted a new letter of intent to the IMF. Finally, on 15 May, Dervis announced the invigoration of a new stabilization effort under the guidance of the “Transition to the Strong Economic Programme”. As mentioned in its introduction, the new programme would be the continuation of the previous disinflation programme, and would be backed by a series of “structural reforms” aimed at strengthening the banking system and transforming the “old ways of economic policy making”.

The macroeconomic performance of the economy under the disinflation programme is shown in Table 5.3. Disinflation, being the most important objective of the programme, is observed to be materialized especially in the second half of its implementation. Despite the fact that the annual rate of change in the price level has exceeded the programme’s end-of-year targets by a significant margin, it nevertheless displayed a break in its 30-year trend towards a lower plateau. The monthly rate of change of both the consumer (CPI) and wholesale (WPI) price indexes decelerated especially after May, and hit its lowest rate in June 2000. The core inflation rate, as measured by the change in private manufacturing industry prices, has fluctuated around the aggregate WPI and CPI, and yet has clearly shown a deceleration throughout the whole programme period.

Given the 1999 deflation, the invigoration of the gross domestic product is clearly visible. Rate of growth of GDP accelerated from +5.6 per cent in the first quarter, to a score of +8.3 per cent in the last quarter of 2000. The annual rate of growth averaged 7.2 per cent in 2000, with commerce and trade services registering 11.6 per cent, and industry and
Table 5.3 Macroeconomic developments in Turkey under the 2000 disinflation programme and beyond

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<td>-0.7</td>
<td>12.6</td>
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<tr>
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<td>117.844</td>
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<td>88.932</td>
<td>87.932</td>
<td>89.154</td>
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Source: State Institute of Statistics (www.die.gov.tr).
construction both growing by 5.6 per cent. The boom in consumption demand was evident, especially with its peak in the third quarter. Investment demand, both public and private, likewise registered a strong upturn over their contraction in 1999. The February crisis is visible over the columns depicting the first two quarters of 2001. As data accumulate one gets a clearer picture of the prolonged deepening of the crisis and the associated impoverishment.

Balance of payments statistics reveal the main source of the growth spurt of 2000 quite succinctly. Over the whole year commodity imports have increased at a rate of 35.9 per cent, while export growth remained at only 7.9 per cent. The deficit on the current account, which was a mere $1.4 billion in 1999, widened abruptly to $9.7 billion by the end of 2000. The current-account deficit was initially targeted at $2.8 billion, and was revised upward to $5 billion. Thus, the realized current-account deficit has exceeded its revised target by 100 per cent over the programme implementation. The deficit on the current account was primarily covered by the capital-account surplus totalling $9.4 billion. Both short- and long-term capital were instrumental in bringing foreign capital into the domestic asset markets, while the aggregate foreign debt outstanding jumped by 12.3 per cent, from $103.3 billion to $116.1 billion within 2000.

The increased inflows of foreign capital have been instrumental not only in financing the current-account deficit, but also in the expansion of domestic liquidity. Given the no-sterilization rule and the constraints on the net domestic asset position of the Central Bank, inflows of foreign capital called for an expansion of the monetary base in line with the increase in net foreign assets. Coupled with the elimination of the currency risk, these developments led to a steep decline in the real rates of interest, especially in the early phases of the programme.

It has to be underlined at this juncture that the Turkish authorities were clearly successful in maintaining the programme targets both in exchange-rate administration and monetary control, as well as attaining the fiscal targets. Throughout the year, exchange-rate devaluation followed the programmed schedule and the Central Bank successfully controlled expansion of the monetary base by constraining its net domestic-asset position within the programme limits. Similarly, the fiscal operations were in line with both the revenue and expenditure targets, and the non-interest primary balance on the consolidated budget succeeded in attaining the end-of-year target by as early as September. Given the weak financial markets, the underlying cause of the meltdown was ultimately the external fragility generated by the unregulated in- and outflows of financial capital which were excessively mobile, excessively volatile, and subject to herd psychology.

In the context of the Turkish disinflation episode, Figure 5.1 portrays one of the important elements of the culminating process of external fragility: the path of the ratio of short-term foreign debt to the Central
Bank’s international reserves. This ratio is regarded as one of the crucial leading indicators of external fragility and has recently been called the “most robust predictor of a currency crisis” in Rodrik and Velasco (1999). Figure 5.1 further contrasts the evolution of this ratio against the background of selected East Asian economies just before the eruption of their respective financial crises in mid-1997. Data at hand disclose that, before the crisis in June 1997, the ratio of short-term foreign debt to the Central Bank international reserves was in the order of 170 per cent in Indonesia, 150 per cent in Thailand, 90 per cent in Philippines and 60 per cent in Malaysia. Thus, it could be argued that the value of 60 per cent for this ratio is regarded as a critical threshold from the point of view of international speculation. It is alarming to note that in Turkey this particular ratio has never fallen below the 100 per cent mark since the opening of the capital account in 1989. Thus, the Turkish financial system had been operating constantly under the “danger zone” for the past 12 years as far as this indicator is concerned.

What is crucial in Figure 5.1 is that the disinflation programme had actually increased the fragility as signalled in this indicator. Let alone turning this path to a favourable trend, the 2000 programme which aimed at disinflation (and stabilization!) caused an increase of external fragility with a rise of this indicator to 112 per cent in June, and to 145 per cent by December of 2000. This level was the highest score since 1993, just before the 1994 financial crisis. Yet, the authors of the “Letter of Intent” had envisaged that possible increases in CB reserves would be able to match the increase in outstanding short-term foreign debt, and that Turkey would be able to remain sound externally. However, during the course of the year the banking sector had succeeded in increasing the net inflows of

*Figure 5.1 Short-term foreign debt/CB reserves (%).*
foreign credit by $4.7 billion to reach a total of $11.1 billion. During this process, total short-term debt stock of the banking sector had increased to $16.9 billion from its level of $13.2 billion. The lure of the uncontrolled flows of speculative gains clearly unleashed all its might throughout 2000, when the currency risk was eliminated and the whole liquidity generation mechanism was based on the short-term, hot money inflows.7

To summarize, the programme itself has achieved modest gains in disinflation, and as such it should be seen as a programme for maintaining price stability at the expense of destabilization of the Turkish economy along with the worsening of its financial and external balances. The Central Bank was deprived of all its traditional tools of austerity and crisis management and was left defenceless against both the “speculative attacks” and the “sudden stops”. Under these conditions it has to be no surprise that the viability of the programme would finally suffer at one point when the “uneasy speculators” shift focus, and decide to reverse their flows, leaving the incipient country illiquid and dried out.

In the meantime, the distributional conflict underlying the neo-liberal structural adjustments was thereby resolved with the state’s strategy to achieve accelerated growth on the basis of short-term inflows of capital. The unsustainable character of this type of growth, however, led to the disguise of the major structural bottlenecks of the Turkish economy, rather than offering viable long term solutions (Özatay, 1999; Türel, 1999; Cizre-Sakallıoğlu and Yeldan, 2000; Önis and Aysan, 2000). We now turn to the destabilizing nature of this episode in the section below.

5.3 Macroeconomic adjustment under post-financial liberalization: overall assessment

The 1989 policy manoeuvre of capital-account liberalization meant a drastic change in the nature of macroeconomic adjustments in Turkey. It paved the way for an injection of liquidity to the domestic economy in terms of short-term foreign capital (flows of “hot money”). Such inflows enabled, on the one hand, financing of the accelerated public-sector expenditures, and also provided relief of the increased pressures of aggregate demand on the domestic markets by way of cheapening costs of imports.

In this setting, the Central Bank lost its overall control over the exchange-rate depreciation and the domestic rate of interest as independent instruments of monetary policy. From the point of view of the domestic financial markets, liberalization of the capital account necessitated a higher rate of return on domestic assets as compared to foreign currency (as given by the rate of nominal depreciation). The rationale of this link can be traced directly to the threat of currency substitution (dollarization and/or D-Markization of the domestic liquidity markets). Given this threat, the monetary authority has to assume a passive role against
excessively high real rates of interest on domestic assets, coupled with an overvalued exchange rate. Liberalization of the capital account to the short-term capital transactions requires a commitment to high real rates of domestic interest exceeding the rate of currency depreciation. As this commitment stimulates a higher level of speculative capital inflows, domestic currency appreciates, inviting an even higher level of hot money inflows to the domestic economy.

The elements of this process are displayed in Table 5.4. The net return on “hot money” is reported in column 1. This return is calculated as the rate of difference between the highest (nominal) interest offered in the domestic economy and the rate of (nominal) depreciation of the TL. It yields the net return to a unit of foreign portfolio investment which switches into TL, captures the interest income offered in the domestic economy and switches back to the foreign currency at the end-of-period exchange rate. The difference between interest earned and the loss due to currency depreciation is the net earnings appropriated by the investor.

In columns 2 and 3, the gross in- and out-flows of foreign credits acquired by the banking sector are displayed. As one of the major components of “hot money”, one can see that such flows show quite high sensitivity to the domestic rate of return calculated in the first column. Except for the 1991 values, the net flows are observed to be of the “expected” sign, and they are observed to have fluctuated widely, especially between 1993 and 1996.

We witness that the gross inflows of foreign credit obtained by the banking sector had been in the order of around US$10 billion per month between 1991 and 1993. The gross annual volume of such inflows reached US$209 billion in 2000 – exceeding the overall Turkish GNP in that year! Clearly, the domestic financial system is under severe pressure from the international speculative centres and is no longer in a position to generate an independent monetary and foreign-exchange policy. Furthermore, the flows of hot money constituted the major rationale of the short-termism and volatility of the real business cycles, led to increased fragility of the financial and the external position of the domestic economy, and resulted in worsening the distribution of income (Balkan and Yeldan, 1998; Yentürk, 1999).

The last column of Table 5.4 utilizes the composition of the time deposits between foreign and domestic denominated currencies as a measure of the extent of currency substitution. As an indicator of denunciation of the Lira and the ongoing dollarization of the currency markets, the share of foreign-exchange deposits in total rose at a secular rate over the 1990s and passed the 50 per cent benchmark by 1996.

Thus, the episode of hot money inflows should be interpreted, in the Turkish context, as the long arm of fiscal policy, overcoming the credit restraints and the monetary constraints of the monetary authority. The availability of such funds enabled the fiscal authority to postpone any
### Table 5.4 Inflows of short term foreign capital and selected financial indicators (millions US$)

<table>
<thead>
<tr>
<th>Year</th>
<th>Rate of return on 'hot money'</th>
<th>Foreign credits of the banking sector</th>
<th>Balance of payments, net errors and omissions</th>
<th>Net short-term capital flows</th>
<th>Current-account balance</th>
<th>Currency substitution</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>(1) Inflows (2) Outflows</td>
<td>(3) Balance</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1988</td>
<td>0.073</td>
<td>–</td>
<td>515</td>
<td>-2,281</td>
<td>1,596</td>
<td>27.0</td>
</tr>
<tr>
<td>1989</td>
<td>0.236</td>
<td>–</td>
<td>971</td>
<td>-584</td>
<td>961</td>
<td>23.0</td>
</tr>
<tr>
<td>1990</td>
<td>0.293</td>
<td>–</td>
<td>-468</td>
<td>3,000</td>
<td>-2,625</td>
<td>22.5</td>
</tr>
<tr>
<td>1991</td>
<td>-0.038</td>
<td>43,186</td>
<td>948</td>
<td>-3,020</td>
<td>250</td>
<td>29.5</td>
</tr>
<tr>
<td>1992</td>
<td>0.154</td>
<td>64,767</td>
<td>-1,190</td>
<td>1,396</td>
<td>-974</td>
<td>39.8</td>
</tr>
<tr>
<td>1993</td>
<td>0.045</td>
<td>122,053</td>
<td>-2,222</td>
<td>3,054</td>
<td>-6,433</td>
<td>47.5</td>
</tr>
<tr>
<td>1994</td>
<td>-0.315</td>
<td>75,439</td>
<td>1,769</td>
<td>-5,127</td>
<td>2,631</td>
<td>54.0</td>
</tr>
<tr>
<td>1995</td>
<td>0.197</td>
<td>76,427</td>
<td>2,354</td>
<td>3,713</td>
<td>-2,339</td>
<td>48.0</td>
</tr>
<tr>
<td>1996</td>
<td>0.329</td>
<td>8,824</td>
<td>-1,781</td>
<td>5,945</td>
<td>-2,437</td>
<td>50.0</td>
</tr>
<tr>
<td>1997</td>
<td>0.278</td>
<td>19,110</td>
<td>-2,755</td>
<td>1,761</td>
<td>-2,638</td>
<td>50.0</td>
</tr>
<tr>
<td>1998</td>
<td>0.254</td>
<td>19,288</td>
<td>-1,985</td>
<td>2,601</td>
<td>1,984</td>
<td>54.1</td>
</tr>
<tr>
<td>1999</td>
<td>0.298</td>
<td>122,673</td>
<td>1,899</td>
<td>759</td>
<td>-1,360</td>
<td>52.0</td>
</tr>
<tr>
<td>2000</td>
<td>0.073</td>
<td>209,432</td>
<td>-2,677</td>
<td>4,035</td>
<td>-9,280</td>
<td>50.0</td>
</tr>
</tbody>
</table>

Sources: Boratav et al. (1996); Central Bank of Turkey, Balance of Payments Statistics.

Notes:

- a \( \frac{(1 + R)}{(1 + E)} - 1 \); R: rate of return in domestic financial markets (Boratav et al., 1995); E: TL depreciation rate.
- b Inclusive of luggage trade after 1996.
- c Foreign deposits/total deposits (%).
adjustment in its revenue-enhancing capabilities such as implementation of added taxes on capital earnings and reducing evasions on taxable corporate earnings. Yeldan (1995) and Cizre-Sakallıoğlu and Yeldan (2000) discuss this stance in terms of a discretionary surplus redistribution strategy on the part of the state via its fiscal policy. Thereby, through the availability of short-term borrowable funds, the fiscal operations of the state became a viable apparatus to generate an economic surplus for the corporate incomes by way of a lax attitude towards tax evasion and the consequent deficits. In so doing, as the Treasury offered market-yields on its instruments, it became the dominant agent in the financial economy, enabling the banking system to make significant returns based on the arbitrage of open-positions.

Indeed, throughout the course of these events Turkey’s banking sector and financial institutions became disengaged from production to become the dominant faction of the capital manipulating the overall economy. The driving force behind this development was two-fold, one domestic, the other global. On the domestic level, it was the collapse of the public disposable income which led to the fever of public-sector borrowing. The consequent high interest rates of government bonds and treasury bills set the course for the dominance of finance over the real economy. As a result, the economy is observed to be trapped in a vicious circle: commitment to high interest rates and cheap foreign currency (overvalued TL) against the threat of capital flight leads to further increase in the real interest rates. When adverse impacts on the current-account balance become excessively destabilizing, real depreciation seems imminent, which, however, needs to be matched by further upward adjustment in the rate of interest if currency substitution or capital flight is to be restrained. This process, as in the case of Mexico in 1994, and the recent crises of East Asia, leads to overvaluation of the domestic currency, cheapening of imports, and thus an acceleration of domestic consumption demand at the expense of exports, and the real productive industries in general.

The global dimension of the rising prominence of finance was no less important. As internationalization of the Turkish state intensifies, it also becomes directly accountable to the global asset markets. Complete deregulation of the financial transaction enable the international finance capital to act as the sole arbiter aiming at immediate financial gain, rather than the long-term economic development and sustainable growth. The crisis of 1994, in hindsight, shows the vulnerability of the Turkish economy to the speculative gains of hot money and ‘casino capitalism’ (Strange, 1986).

Erratic movements in the current account, a rising trade deficit (from 3.5 per cent of GNP in 1985–8 to 6 per cent in 1990–3), and a drastic deterioration of fiscal balances disclose the unsustainable character of the post-1989 populism financed by foreign capital inflows. In Boratav et al.’s (1995: 34) words:
the post-1990 Turkish experience shows the serious problems confronting a developing economy which decides to move into full external and internal deregulation in the financial system under conditions of high inflation. The specter of capital flight becomes the dominant motive in policy-making and creates commitment to high interest rates and expectations for cheap foreign exchange. The links of these two policy variables with the real sphere of the economy, i.e. investment on physical capital and the current account balance of payments, are deeply severed. Instability in the rates of foreign exchange and interest rates creates feedbacks which lead the economy into further instability.

This prolonged instability reached its climax during the fourth quarter of 2000, when the currency appreciation and the consequent current-account deficits rose to unprecedented levels. With the sudden drainage of short-term funds in the beginning of February 2001, production capacity contracted, followed by a continued fall in industrial output throughout that year. Together with this contraction, the post-2001 crisis management gave rise to significant shifts in income distribution, and to an intensification of the ongoing processes of transfer of the economic surplus from wage-labour in particular, and the industrial/real sectors in general, towards the financial sectors. Likewise, dollar-denominated wage costs decreased substantially and enabled export earnings to rise. In this manner, Turkey has, once again, switched back to a mode of surplus extraction whereby export performance of industrial sectors depended on savings on wage costs.

Clearly, the “reform fatigue and exhaustion” of the 1988 crisis, and the unsustainability of the post-1989 growth path which culminated into the 1994 and the 2001 crises have had quite different macro dynamics in operation. Under both episodes, however, one witnesses the presence of the state as an active agent regulating both the paths of accumulation and the patterns of income distribution. It is interesting to note that in spite of the official stance towards privatization and a mandated policy of “reducing the role of the state” in the economic scenery, there is continued use of the state’s frontiers as a regulatory agent, overseeing the distributional conflict over the national product. In this process, its fiscal operations share the major brunt of adjustment in resolution of this conflict in favour of private capital and the banking sector. This is very clearly manifested within the context of the delayed/postponed disinflationary programme. The next section analyses these adjustment dynamics towards disinflation in the context of a game-theoretic model.
5.4 A game-theoretic approach to credible disinflation programme

It has to be clear from our arguments thus far that the current policy environment in the Turkish economy is very much characterized by an impasse between the state and the private actors – the main one being the banking sector. Given the impasse of the state to correct its fiscal balances, it was the commercial banking system which had intermediated between the foreign sector and the Treasury so as to fill the fiscal gap. Given the availability of short-term foreign capital, the banks have played a crucial role in borrowing from abroad at relatively cheap rates of foreign exchange and thereby accumulating short-term foreign debt. The political/economic environment of this mechanism, however, resulted in a standstill with high rates of inflation and domestic debt, which we model as inertial equilibrium in a game-theoretic context. In fact, as we documented in Table 5.1, the environment in which Turkey embarks on disinflation has certain characteristics that make reductions in the inflation rate very costly after it had reached a threshold of 60–80 per cent. Formally, we will replicate that feature of the economy in a dynamic general equilibrium model with a sequentially rational government and a banking sector.

There is now a wide consensus in the literature that the optimal inflation rate is at or below zero. The result is robust with respect to the choice of the models which recommend inflation reduction to avoid the deadweight losses associated with inflation. However, comparisons between the steady states with constant inflation rates and the results vary widely as to the optimal disinflation policy, or the optimal speed of disinflation. It is natural to expect that to the extent past inflation rates do not affect the current fundamentals, they should affect the optimal monetary or fiscal policy.

We demonstrate that even when the direct effect of inflation on the fundamentals is short-lived, say, due to the short-term structure of the government’s debt, its indirect effects may last much longer slowing down the optimal disinflation. The stylized facts of our apparatus are as follows: private sector – mainly bankers – voluntarily holds a large part of government debt. As a result of expansionary fiscal policies, the government consistently ran budget deficits in the last 30 years. Since the initiation of the policy of securitizing the deficit, the government debt began to grow and reached a very high level by 2002. Maintenance of the debt is taking a significant portion of the government’s tax revenues. Even though the budget is in primary surplus, debt-servicing requirements bring the government finances into an operational deficit.

Under the above conditions, debt reduction is difficult to achieve politically unless a tax reform is successfully enacted to increase efficiency of tax collection, or a disinflation programme that would increase the efficiency of the overall economy could be implemented. We will not touch
upon the causes of repeated delays in tax reform, taking it as a given fact. Instead, we will show that in such an environment, presence of high debt, even mostly short term, results in sustaining an inertia in the existing rate of inflation, making it difficult to be overcome through traditional monetary/deflationary policies. We consider different scenarios of the disinflation programme as perceived by the government and the bankers, a proxy for the government’s creditors.

The bankers buy government bonds expecting a high inflation rate $\pi^H$. With competitive bankers, the interest rate on these bonds will also be high

$$i^H = (1 + \pi^H - \beta)/\beta$$

where $\beta$ is a time discount rate of the bankers. Suppose the government decides to reduce inflation to $\pi^I < \pi^H$ after the bonds are sold. This means that the government’s obligation to the bankers increases in nominal terms by

$$B(i^H - i^I) = B(\pi^H - \pi^I)/\beta$$

where $B$ is the government’s debt in real terms at the date of bond maturity. This is the cost the government has to pay to the bankers to conduct the unexpected disinflation programme. Trivially, the cost of unexpected disinflation may be avoided if it credibly pre-announces the programme. In that case the competition among the bankers for the bonds will drive the interest rates down to $i^I = (1 + \pi^I - \beta)/\beta$.

Therefore, the key to a successful reduction of the interest rate on bonds is in the credibility of the disinflation programme itself. We distinguish two types of credibility, conditional and unconditional. An unconditionally credible programme is such that the government prefers to disinflate despite its failure to reduce the nominal interest rate. A conditionally credible disinflation programme imposes a weaker requirement: the government is expected to disinflate only if the interest rates are reduced. Thus, the success of a conditionally credible disinflation programme depends on market expectations being optimistic. Should the bankers expect the programme to fail, it will fail making bankers’ expectations self-fulfilling. Note that in either case the expectations are correct.

Now we will describe the conditions that determine whether the disinflation programme is conditionally or unconditionally credible. Denote the benefit of disinflation in terms of greater private and government income as valued by the government as $W^u(\pi, \pi - \pi')$. We assume that it depends on the initial inflation rate $\pi$ and the rate of disinflation $\pi - \pi'$. On the other hand, the cost of disinflation in terms of greater debt service is $W(B, \pi')$ which depends on the market expected inflation rate $\pi'$ and the stock of government debt $B$. From the discussion above, it is apparent
that $W$ is increasing in $B$ and $\pi'$, while $W^*$ is increasing in $\pi - \pi'$. Note that $W^*$ is known before the programme is started, while $W^*$ will depend on the interest rate on bonds.

The *ex ante* and interim comparison of the benefits and costs of the disinflation programme shapes government’s sequentially rational policy. It may apparently involve the following: for relatively high levels of inflation and low debt, the benefits of the disinflation are greater than the costs regardless of the market interest rate. For higher levels of debt, the benefits are greater than the costs only if the interest rate reflects the expectation of lower inflation. Supposing that the market is always pessimistic, the inflation rate will never fall if the government is slightly more impatient than the bankers.

Figure 5.2 demonstrates the equilibrium inflation policy for two different levels of initial debt. This result is obtained under the assumption that the government is more impatient than the bankers. The $45^\circ$ line corresponds to the stationary inflation policy, with $\pi_t = \pi_{t+1}$. The distance from the stationary $45^\circ$ line to the policy function with initial debt $B_1$ and $B_2$ reflects the rate of disinflation. The government with high initial debt $B_2$ does not have an incentive to reduce the inflation as fast the government with lower initial debt $B_1$, even though it improves the prospects of future disinflation.

Consequently, we can follow the underlying conditions of the current impasse of the Turkish government towards disinflation from the mechanics of Figure 5.2: the government’s disinflation programme is shaped by its expected benefits and costs of the programme, *ex ante*. Given sustained rates of high inflation and an initially high stock of debt with an excessive servicing burden, the inflation is likely to be inertial against reductions as long as the current expectation of interest rates do not reflect the expectations of programmed lower inflation. This bind, however, leads to a stable,
yet vicious circle, which could be broken either with increased confidence and reduced impatience of the government, which itself is a very unlikely outcome given the politics surrounding the programme, or with resort to hyper-inflation, a state which could involve a complete breakdown of the fragile, domestic financial network and disruption of the civilian democracy along with many unforeseen yet unarguably onerous adjustments.

5.5 Concluding comments

In this essay, we have studied the post-1980 episode of trade integration and financial liberalization of the Turkish economy from a political-economy context. We have argued that the state has assumed a regulatory role in the generation and distribution of the economic surplus and its fiscal balances shared the burden of necessary adjustments. We have regarded the macroeconomic balances of the 1990s as a direct outcome of the endogenously driven cycles of growth, stagnation, delayed stabilization, and crisis.

Throughout the adjustment era, there emerged a significant need to reorganize the state apparatus so as to achieve a conformity between the economic rationale of the market forces and the political realities of the policy-making process. Indeed, the post-1980 Turkish macroeconomic development experience scored a leading example of how the stated objectives of the structural adjustment programme towards lesser involvement of the government with the economic affairs may run counter to both the economic/political realities of the market and the interest of the surplus-extracting groups which command power, especially those of the industrial and financial capital.

In this context, the opening of the capital account and full financial liberalization reforms of 1989 served both as the supplier of liquidity into the domestic economy to sustain the fiscal costs of this manoeuvre, and provided relief of domestic markets through cheapening import costs. The availability of short-term capital flows, however, became a significant source of instability in the domestic financial markets and led the banking sector to be disengaged from intermediation for productive investments to become the leading faction of capital manipulating the whole economy. With the advent of high real interest rates following the collapse of the public disposable income, the banks could have amassed massive returns based on the arbitrage of open positions vis-à-vis foreign financial markets, and the domestic economy drifted towards the vicious circle of high interest rates, current-account deficits, and expectations of devaluation to be matched by ever higher rates of interest.

All of these conditions, generated in the meantime, a high rate of inflation together with an inertia of its own, which is difficult to overcome through traditional monetary/deflationary policies. A break of this inertia seems to involve either the confidence build-up of an intertemporally
patient government, or the build-up of hyper-inflationary pressures with their devastating consequences. The hopes are that the system will be able to succeed in generating solutions towards the former.

Acknowledgements

We are grateful to Michael Wyzan, Mats Lundahl, Evrim Yada, the participants in the conference “The Diverse Experience with Reform Failure and Poor Economic Performance: A Political Economy Approach”, and to colleagues at Bilkent for their very helpful comments and critical suggestions.

Notes

1 See Yeldan (1995 and 2000) for a discussion on the characteristics of the post-1989 Turkish macro adjustments in terms of creation and absorption of the economic surplus. Yeldan (1998) provides, in turn, a quantitative analysis on the strategic role played by the state apparatus. Cizre-Sakallıoglu and Yeldan (2000), Boratav et al. (1996), Ekinci (1998), and Boratav et al. (2001) report similar analyses based on the effects of international speculative financial capital flows on the Turkish economy.


3 According to estimates in Yeldan (1995: 50), costs of export subsidies reached 22 per cent of the central government revenues between 1984 and 1988, and in general exceeded the level of corporate taxes paid throughout the decade.

4 This phrase which has repeatedly appeared in the popular press during the 1980s refers to those foreign funds that were transferred to Turkey being registered as earnings from export sales while no shipment of any goods have taken place. The transfer, however, gave entitlements to the “exporter” to claim export subsidies. It is conjectured that the mechanism was used in legalizing the illegal (black-market) foreign-exchange funds accumulated during the crisis of 1977–79.

5 The underlying elements of the disinflation programme and the succeeding crises are discussed in detail in Celasun, 2000; Ersel, 2000; Boratav, 2001; Gencay and Selçuk (2001); Uygur, 1996; Yeldan, 2001, 2001a, 2001b and 2001c; Yentürk, 2001; Boratav and Yeldan (2002); Yeldan (2002); and Ertugrul and Yeldan, 2003. A series of “Round Table Discussions” are also provided in the Turkish literature by Mülkiyeliler Birliği Dergisi, January 2000; İktisat Isletme ve Finans, March 2000; Birikim, April 2001; İleri, June 2001; and İktisat Dergisi, May 2001.

6 The non-interest – primary – budget surplus was targeted at 3.1 per cent of the GDP within the programme. The end-of-year realization reached 6.1 per cent. Clearly, the fiscal austerity objectives were reached under the programme.
According to Boratav’s (2001) calculations, before the November 2000 crisis non-residents have brought a total of $15.2 billion of “hot money” into the Turkish asset markets, while the residents enabled an outflow of $5.3 billion. Thus, during the course of the programme, much of this accumulated short-term debt had financed residents’ capital flight.

References


Part II

Transition countries
6 On the political economy of transformation

Reasons for success, causes of failure

Jozef M. van Brabant

In dissecting the political economy of policy-reform failures in a group of countries, one cannot skip the issue of why some succeeded with roughly the same “broad” reform features. In earlier work on the political economy of transformation (as summarized in Brabant 1998) I focused primarily on the broad economic-policy and institutional aspects of transformation. I did so on the assumption that policy makers had already forged genuine agreement on the basics of the transformation agenda, including on pluralistic politics and market-based resource allocation. Because of the ambiguity about success and failure of policy reforms (Brabant 1998, pp. 133–7), it is too myopic to confine the discussion to the technocratic aspects of the economics and politics of transformation. Incoherence of transformation approaches reflects in part the uneven political and social support for purely technocratic designs. These need to be fully included in understanding the details of formulating, implementing, enforcing, monitoring, assessing, and fine-tuning (FIEMAF) concrete actions.

Providing in one essay a cogent overview of the economics and politics of policy reform in transition economies (TEs), let alone drawing meaningful conclusions about success and failure, is a daunting task. I therefore aim at sketching a broad picture of how I approach the essential elements of the political economy of transformation (see Brabant 1993a). Given the role played by non-TE national and international actors in supporting the transformation in many TEs, they too belong in the picture. But I cannot delve into that dimension here (see Brabant 1998, pp. 464ff.; Davis 1998; Wedel 1998).

After sketching the transformation agenda in broad-brush strokes, I discuss the politics of transformation. This is followed by an inquiry into how best to adjudicate success or failure with transformation. Next I point out the kind of policy choices to be resolved in setting the FIEMAF framework, beginning with the conditions prevailing at the transition’s inception, notably in view of incomplete or absent markets under conditions of incipient political pluralism. Before concluding I hint at the gravest shortcomings in transformation policies in TEs that have
apparently succeeded as well as in TEs that have apparently failed to “govern” the transformation.

6.1 Towards a coherent transformation agenda

Transformation has often been identified with building pluralistic democracy and liberal markets for allocating resources on the remnants of state socialism. Nothing can be further from the truth. Not even at the transition’s inception did this stereotype apply. There are at least as many democracy-market combinations as there are TEs. Even in TEs that embraced the twin agenda, however vaguely, erosion and reversal have occurred over time. Several TEs, like many Commonwealth of Independent States (CIS) and southeastern European TEs, committed themselves only to market-based resource allocation and remain reluctant to yield centralized control over the political mind and the material interests of their citizens. Generalization is therefore a treacherous exercise. At least, it should not be attempted without some reference marker, if only as a taxonomic compass.

Transformation can be dissected into several building blocks. As far as its economics is concerned, at least four need to be distinguished: (1) macroeconomic stabilization; (2) liberalization of domestic and foreign markets; (3) privatization of state-owned assets in all of its dimensions; and (4) institutional requirements of reaching market-based decisions in a transparent, predictable, reliable, and comparatively inexpensive manner. Since I consider here explicitly the political angles of economic transformation, two components of the politics of economic transformation arise: (5) generating and sustaining a sociopolitical consensus; and (6) establishing the political institutions for functioning political pluralism. Each block consists of a sequence of components with various attributes, which can be specified in five categories: (1) comprehensiveness; (2) sequencing; (3) choice in timing; (4) intensity; and (5) sectoralism.

Either–or choices rarely provide the realistic remit for progressing with transformation. Instead, an appropriate agenda should be specified by recognizing the initial conditions; path-dependent legacies of the past and of present decisions; opportunities for forging ahead, given prevailing domestic and foreign resources; the resilience of the sociopolitical consensus in spite of the adjustment burdens; and the political compact within which the transition unfolds. It is important to treat matrix cells realistically. By necessity some have only one option and others are all but empty apart from timing. Thus, stabilization in the sense of coming to grips with the excessive money emissions of the past must be pursued quickly, with great intensity, without much sequencing, with perhaps minor sectoralism, and comprehensiveness in the monetary variables. But even in this domain there is choice, such as between enacting a monetary reform, inflating away the monetary overhang, or saturating domestic
markets with goods and assets. Of course, if the leadership prior to “1989” observed macroeconomic rectitude through sensible policies, there is no need for such stabilization, leaving the cell blank. By contrast, stabilization in the sense of ensuring that current monetary and fiscal policies generate macroeconomic balance might be pursued through regular policy choices based on realistic parameters for each option in each cell. For most there is always some policy choice. While a devaluation may be necessary, for example, the range by which the currency needs to be devalued is not a given nor can it be seen independently of other measures.

There are also policies that could be introduced quickly but might be ushered in more gradually. Price and foreign-exchange liberalization provides ready examples, as the experience of all TEs has underlined. This may well not be the preferred technocratic approach. But policy credibility needs a coherent program with a sequence of measures that policy makers and the population at large can support, if only tacitly. There is no magic, let alone simple, formula according to which government can best secure that goal (see section 6.4).

Finally, there are transformations that cannot be accomplished quickly. Examples are privatization, restructuring state-owned enterprises (SOEs), or laying the institutional foundations, broadly defined, for market-based decision making without intolerably straining the sociopolitical fabric. Even in these domains some tasks such as small-scale privatization can be carried out much faster than others such as divestment of large SOEs. A radical transformation in attitudes, expectations, and behaviour in economic agents can only be accomplished over time.

The above suggests that, in practice, the distinction among the policy tasks that can be carried out quickly, must be accomplished rapidly, and cannot be attained at record speed is, at best, fluid. The choice has its inherent logic. But other considerations matter. I include here events that are largely beyond the control of domestic policy makers. Although one may now find broad agreement on the above exposition, there is still considerable controversy about the speed and intensity with which an orderly-sequenced transformation strategy can realistically be implemented. The same applies to the precise meaning of the construction of political pluralism and a market economy, especially in TEs with a weakly anchored democracy (see section 6.4).

My preferred order of proceeding with economic transformation encompasses measures that should be done quickly and rather comprehensively. I include here, but not necessarily in this order, macroeconomic stabilization, price liberalization, anchoring property rights, entry and exit, corporatization and enterprise restructuring, the creation of a viable commercial-banking infrastructure, setting up a minimal social safety net, labour-market reform, and trade and foreign-exchange liberalization. A second tier of measures encompasses desirable speedy actions. I include here ensuring effective competition, putting in place the legal
infrastructure of markets, divestment of state assets, current-account convertibility, and encouraging foreign investment. These actions all have a time dimension that cannot be compressed to the short run. A final tier comprises longer-term actions. These include the creation of an adequate regulatory and antitrust environment (Tirole 1999); starting “large” privatization through the outright sale of SOEs; creating some components of capital markets beyond commercial banking; ensuring reliable statistics; streamlining the flow of dependable economic, political, and social information more generally; setting up an independent pension system; and instituting new accounting rules. Note that actual transformation must be tailored to the tasks at hand, to the concrete starting conditions and governance capabilities, and to the experiences gained during implementation.

This brief taxonomy should also dispel the polemics around juxtaposing “shock therapy” and “gradualism” as ideal, mutually exclusive transformation strategies (as summarized in Brabant 1998, pp. 102ff.), where the latter is not confounded with policy choices made by default in countries that have not really embraced incisive transformation. It is a paradox of sorts that neither strategy is in reality a feasible transformation path. Certain necessary and desirable changes can be introduced quickly; other modifications must be done fast, perhaps in the form of a shock as one intrinsic element of a more encompassing package of measures; and there is a range of mutation tasks that simply cannot be accomplished rapidly. In other words, a certain degree of gradualism is inevitable even if policy makers are bent on deploying simultaneously and rapidly all relevant categories associated with the transition. Any comprehensive transformation strategy must pay close attention to appropriate sequencing of the various components and subcomponents of the policy package. These in turn inevitably affect other attributes of the policy package, including the ability to correct in a timely fashion for unanticipated setbacks or seize newly arisen opportunities. Because of the time dimension of gradualism, policy concerns must aim at establishing and maintaining a sociopolitical consensus, for which functioning political institutions, rather than the authoritarianism and outright dogmatism of “extraordinary politics” or the stealth of a “policy conspiracy” (Wallis 1999), are required. This all the more since markets in TEs do not exist or they function haphazardly at best during the initial phases of transformation, when the societal pains are most acute.

6.2 The rationale for specifying a road map

Since transformation must be managed under concrete circumstances of time and place, politics in reality may well not leave enough leeway to chart an “optimal” agenda and pursue carefully each element as part of a coherent whole; optimal means completing the economic transformation
as rapidly as possible, so that sustainable economic growth can begin to pay off, while minimizing the transformation’s socioeconomic cost and duration. Yet it may be helpful to have such a consistent agenda as a beacon. In as polarized societies as the TEs on the eve of the regime switch (Brabant 1998, pp. 74ff.), it is imperative that something bold be undertaken rather quickly if only to jolt economic agents out of their lethargy and preclude a return to the old regime. Even so, much of the apprehension about transformation and some errors committed could have been compressed if those under fire had better understood what was at stake and formulated their concrete strategy accordingly. I advance the basic contours of an “ideal” transformation agenda for a generic TE primarily as a framework for a holistic discourse on the various policy choices posed starkly with their respective virtues and drawbacks. That forms an important ingredient of steering the political debate and informing the public at large about what is really at stake. It should also provide the backdrop for the formulation and implementation of concrete policies in an objective and transparent manner. But one should harbour no illusion that those most influential in setting the framework for debate and in outlining policy choices will avoid promoting their own agenda (Brabant 1998, pp. 464ff.). At least the subsequent modulations and refinements in many TEs could have been conceived, and evaluated, within the contours of a coherent agenda such as that presented here.

Whereas the twin components of political economy are intricately interlaced, up to some degree they should be kept separate. One must ask in particular whether economic (political) battles should be waged with noneconomic (nonpolitical) instruments (for Russia, see Boycko et al. 1995, 1996). Wielding the economic axe to settle intrinsically ideological and political battles is not usually the most fruitful option. Alas, economists are not good at configuring the tradeoff, except in the spirit of Bergson’s “illusion of retrospective determinism” (Garton Ash 1996, p. 18).

Depriving politicians and bureaucrats of the economic resources they formerly commanded may be highly desirable. I have my doubts that utilizing formalized privatization to achieve that aim, as in Russia, offers a compelling rationale. The argument made by “shockers” that economic instruments, notably property rights to state assets, be utilized en masse to forge an irreversible coalition for transformation and improved resource allocation is a weak one. The “market” in these countries was at least as weak as the “state”. As a result, “political capitalism” often transformed itself into the shriller disparities of primitive or robber-baron capitalism. Never in peacetime have so few acquired so much from so many in such a short time span. Perhaps a dose of carefully chosen authoritarian shock was useful. But experience has shown that this does not suffice. So, in the first instance, economic and political battles should be fought with economic and political instruments, respectively. Furthermore, positive
change usually comes about slowly and requires a sustained commitment to a goal whose achievement is far from guaranteed; in the process nonergodic path-dependence cannot be avoided.

But what if the political and bureaucratic battles cannot be fought by political means because the reform agenda precludes meaningful changes in the way in which society’s controversies get ironed out? Political paralysis is obviously very serious. While I lean toward rejecting shock therapy as a cudgel to rid the TEs of the most obdurate political and administrative legacies of state socialism, I recognize that the latter need to be overcome sooner to break irreversibly the back of the old regime. At least the bureaucracy, lethargic managers of SOEs, the political intelligentsia, the inflationary expectations of consumers, the syndrome of chronic shortage, and so on need to be restructured or abolished. Could these more political purposes not primarily have been accomplished through the political process? Eliminating this “political capitalism” is easier said than done (Mokrzycki 1991; Staniszkis 1991), if only because the new governments in TEs tend to be weak.

That said, the first task of governing the economic agenda of the transition is to stabilize the economic situation, thus removing one vital dimension of uncertainty in these already labile economies. By that I do not simply mean macroeconomic stabilization, or the removal of imbalances in internal and external sectors through Draconian policies. When the transition erupts in an environment with runaway inflation, a loss of confidence in macroeconomic policies, a government lacking popular support, a loss of control over basic monetary aggregates, and/or inability to stabilize the fiscal regime (such as in Poland and Yugoslavia in 1990), this may well be the first order of business. Rapid stabilization must be accomplished through monetary and fiscal instruments, as well as through a more than trivial measure of price and trade liberalization. But these are not all-or-nothing options (Bruno 1992) and decisions cannot stand apart from other needed mutations. Since most occur under pervasive uncertainty, monitoring, assessing, and fine-tuning the policies wielded according to evolving circumstances is necessary to avoid policy reversal.

It would be wrong, however, to recommend this démarche to all TEs. Indeed, in most the initial conditions for a meaningful transformation were not as bleak as some observers have depicted them. True, the underlying socioeconomic reality in virtually all TEs had earlier been on a corrosive path, entailing a severe malaise in some countries. But the really dramatic slide occurred with the implementation of transformation policies. The reason is simple: a genuine stabilization program within the context of comprehensive structural change cannot avoid temporarily depressing sustainable levels of economic activity, notwithstanding arguments to the contrary (Nuti and Portes 1993, p. 11). As experience has shown, at least two to three years pass before growth resumes; it takes much longer to carve out a sustainable modernization trajectory, however.
Policy credibility matters in minimizing this loss. This does not, however, mean that policy makers should adhere at all cost to policies that are not working or encumbering other transformation components. Central on the agenda should be sound macroeconomic management, including in fiscal and monetary policies as well as with respect to external liberalization, and a vision of the broad direction into which institutional and structural change should preferably evolve, while defusing any suspicion that the current transformation process may be retracted. It is hard to envisage how this could be accomplished without an activist government, obviously one markedly differing from the remnants of state socialism.

In designing transformation policies as coveted by TEs, it is crucial to be clear about the fact that a market is essentially a set of institutions set up by man rather than an immutable part of the natural environment. For that very reason, there are various configurations with specific institutions for encouraging competition. But the latter should not be confounded with the former. Competition provides a constraint on self-interested behaviour of individual agents, channelling it into a confined range of mutually compatible outcomes, involving at times suitable modifications in the market as a “man-made institution” (Kregel 1990, p. 45). Market liberalization does not necessarily generate competition, nor does it guarantee the quick and orderly emergence of constructive competition.

As an organizational and coordinating mechanism markets involve positive transaction costs. Even to create and sustain functioning markets, society must bear costs. These include in the first instance the creation of a legal framework for the identification, protection, and enforcement of contracts for all kinds of market-based transactions. Reliance on explicitly detailed contracts with spelled-out pecuniary costs and benefits leads to increased dependence on laws, lawyers, litigation, and codified procedures—all costly—for ostensibly market-based contracts that in other societies are handled with greater trust in partnerships, custom, and networks (Pistor 1999). It also involves the creation of an entire industry that insures against risk, if at a price.

When available, properly functioning markets for production factors (capital, labour, land, and other natural resources) as well as for all kinds of goods and related services must aim at efficient resource allocation, that is, the maximization of the sum of the discounted values of consumer and producer surpluses (Hay 1993, p. 2). This outcome is trivial, given the stated circularity. One or more markets may not be available or function only poorly because either no equilibrium exists or economic agents do not behave competitively, leading to market failure. The real world is riddled with imperfect and asymmetric information. In addition, the specifics of marketing and production technologies are hardly such that atomistic competition among economic agents solely bent on maximizing their profit or utility prevails or can emerge in an orderly manner.
Moreover, gathering and processing this information is costly. Furthermore, there are scale and learning economies and externalities that, when not regulated, distort market outcomes. Also monopolies and oligopolies exist, mostly but not all “network industries”. Others are subject to corrective action. Both need to be regulated through other than pure market channels (Willig 1993), none of which is cost-free. Nor does it provide an ironclad guarantee that minimal separation of powers can be enforced at an affordable cost, given other priorities (Laffont 1999).

In other words, in charting the transformation agenda one must investigate how quickly functioning markets can be erected and what could conceivably be done in the interim to mitigate market failure endemic to the *sui generis* nature of transition, those typical of economies working toward catch-up modernization, and those prevalent even in mature market economies. Note that the aim of transformation policies must be more encompassing than perfectly functioning markets. Also, improving the environment for resource allocation depends on performing tasks that the market will normally not, or only inadequately, take care of. In view of the considerable constraints on perfect competition, asymmetries of information, restrictions on the ability to contract, limits to designing comprehensive incentive rules, and other real-life features (Stiglitz 1994, 1997a, 1997b), many markets simply do not function properly. If only for that reason, setting aside market fundamentalist ideology (Petrella 1999), one may seek relief through non-market intervention when the latter is not itself subject to failure whose cost exceeds the dimension of the market distortion.

**6.3 Transformation – an evolving agenda subject to uncertainty**

Transformation policies are by their very nature path dependent and subject to a range of generic uncertainties. As regards path dependence, transformation must necessarily encompass far more than bolstering efficient resource use. Some layers of society will lose from the policies enacted to change incentives. Others will gain. Governing the means whereby the diverging and mutating interests of losers and winners, including by redistributing ownership rights, can be reconciled must be a crucial ingredient of transformation (Brabant 1992, pp. 102ff.). This affects all-around incentives. Transition also profoundly disturbs the makeup of society and how its conflicts arise and can be resolved.

Perhaps most important, though least heeded, in the now decade-long debate on transformation is agreeing on the path whereby incentives are changed as an integral component of governing the transformation. It is all good and well, for example, to praise the merits of transparency, openness, participation, and so on. But realizing those qualities in the process of governing a society that is being so profoundly shaken up must dispro-
portionately affect various groups as gains are made or setbacks incurred. Managers confront pervasive principal–agent problems, only some of which stem from the profound uncertainty in these societies, particularly during the early phases of the transition. These can be discussed under eight rubrics, which I have detailed elsewhere (Brabant 1998, pp. 128ff.): (1) cost uncertainty as relative and absolute prices change dramatically is thoroughly inimical to productive investment, intertemporal resource allocation, and improving emerging markets; (2) demand uncertainty results from the rapidly changing levels and distribution of incomes as well as choices becoming available to households; (3) monetary uncertainty, including the viability and stability of the national currency, affects virtually all nominal magnitudes or titles, undermining confidence in money holding or fragmenting the security of nominal instruments; (4) substantial legal uncertainty inhibits swift adjudication of most contract disputes and can be remedied only gradually (Pistor 1999, pp. 7–9); (5) rampant political uncertainty around all governing branches, present and potential successors, complicate settling sociopolitical disputes (Comisso 1997); (6) policy uncertainty may be exacerbated by such traits of society as homogeneity, ethnic or religious strife, or submissiveness to authority; (7) structural uncertainty due to the highly monopolized nature of economic activities in TEs can be abated only through pro-competitive, efficiency-oriented economic restructuring, which is bound to be protracted, painful, costly, and very messy; and (8) personal uncertainty rises as a result of job insecurity, unemployment, loss in real incomes and liquid wealth, erosion of expectational incomes and social services, and the disintegration of state authority, leading to corruption, extortion, assault, theft, and other criminal activities well beyond anything previously experienced. Even if only confined to the latter, uncertainty of transformation has inflicted upon TE citizens every conceivable insult to their intelligence and theft of their “social” patrimony.

In other words, for some time into the transformation decisions must be made in an environment with very few certainties. The latter’s depth and breadth depend on the inherited weaknesses, the boldness of the transformation program put in place, and the “luck” and “pluck” of transition managers, including in obtaining relief from abroad. Pervasive (black) noise, meaning fluctuations that exhibit no pattern at all, complicate the preparation of informed decisions because contingencies cannot really be assessed. This has important repercussions for the order in which markets can emerge and their transitional, and perhaps other, failures rectified.

6.4 On the politics of transformation

Politics is pivotal in securing economic (and other components of) transformation affecting all FIEMAF stages. For it to be the handmaiden of
comprehensive economic and social restructuring, the TE’s political framework needs to undergo dramatic change. Eliciting a political mandate can best do this. Securing a sustainable sociopolitical consensus on transformation, at any rate “a substantial body of public support” (Williamson and Haggard 1994, p. 575), is paramount. Many controversies have evolved among commentators. Most have come out on the side of “as rapidly as possible”, subscribing to the notion that speedy transformation ought to be introduced while there is “a political window of opportunity”, allowing a “policy conspiracy” (Wallis 1999) to be perpetrated by “technopols” (Williamson 1994) to advance the cause of transformation. If such can do the job, one can work without a sociopolitical consensus or simply ignore it.

This is unsatisfactory. One reason is that it would mean essentially proceeding with transformation in the most rejectionable authoritarian manner, albeit this time for the ostensible “common good” as perceived by well-intentioned economists. As indicated earlier, speed and stealth (Rodrik 1996, p. 36) under some conditions are of the essence in initiating transformation policies, and there may simply be no time to forge a sociopolitical consensus. Initiative and independence of the executive are under some conditions crucial in making a major dent in the inherited conditions. Such a salutary objective is, however, a far cry from advocating a political course that is manifestly not aimed at pluralism with all of its “conveniences” for those imbued with perfect knowledge on what needs to be done and how. A second reason why “extraordinary politics” should be dealt with gingerly is that it cannot be sustained as the costs and inequities, hence controversies, of transformation policies take hold. Consolidation of transformation to enact necessary structural change must build legislative and interest-group support (Haggard 1994, p. 468). This is best done from the very inception of transformation, even if only in the form of building ex post validation for the policy conspiracy. Issues of decision making on behalf and in the interest of society, even on the most technical and painful matters, need therefore to be spelled out. Not in all TEs have policy makers held on to precepts about seeking popular support through pluralistic decision making. A leadership consisting chiefly of a narrow oligarchy similar to the erstwhile Politburo and Central Committee, with vast resources amassed through the less than legal acquisition of instant fortunes, that has not in deeds foresworn state socialism, acts without accountability to society, and shackles media is manifestly not among the aspirations of “1989”.

Whatever the configuration subscribed to, political transformation must at the very least aim at vesting political power in institutions rather than personalities, even though political change may have become possible precisely because of some charismatic leader’s prominent stance against the regime in place. It is important that this vestige of power be prospectively institutionalized so that the political culture does not deify
him/her. Politics must be about more than acting within the finer print of the constitution and safeguarding democracy in some highly formalized manner while at the same time undermining its very existence. Pluralistic politics in general and a functioning democracy in particular depend vitally on the continuity of government, on building parties, on fighting corruption, on enforcing the law, and on generally establishing the institutional framework that democracy demands. Also, the electorate’s mindset will need to continue to gravitate toward genuine political pluralism in tolerating diversity, in learning to work in diversity, and in exploiting diversity to strengthen the polity, all integral parts of the sociopolitical consensus.

Pluralistic political democracy by its nature requires a great deal of transparency and autonomy for all societal agents. This can be targeted only when the infrastructure for such decision making is in place. It is also predicated on society finding ways and means of overcoming at times obdurate principal–agent problems as the electorate at large cannot be consulted constantly on which way to tip tradeoffs. Instead, the electorate needs to delegate authority to elected officials sitting in some central forum, most likely a parliament. For that very reason those upon whom power has been bestowed must be accountable. However, political pluralism depends not only on holding infrequent elections and safeguarding the framework that permits an orderly transfer of political responsibilities from those in power to the opposition (Andorka 1996). That may be adequate for “procedural democracy” but does not contribute much to “substantive democracy” (Comisso 1997), which is predicated on continuity of government, on building stable political parties and coalitions, and on checks and balances that enable elected officials to discharge their mandate in a reasonable fashion.

When the infrastructure for such continuity is leaky, the political transformation needs to aim at building stable parties, civil society, and interest groups while fighting corruption, enforcing the law, underpinning appropriate jurisprudence, and generally strengthening the institutions that support the very basics of pluralistic decision making. An integral component of the infrastructure for governance according to the electorate’s expressed will is to enable elected officials to delegate part of their responsibilities to subordinate organs through some kind of compact that regulates the delegation and in turn holds those agents responsible for their actions. None of these agents can be truly independent for that would undermine the powers vested in policy makers by the electorate.

In TEs that are not working toward political pluralism, those managing transformation must justify their actions by different means, possibly in an entirely authoritarian manner that ignores society’s preferences. Repressive regimes, history has shown over and over again, can sustain themselves for very long periods of time. But should such an outcome even be entertained for TEs? For one thing, even the authoritarian post-socialist
ruler will need some measure of consent from the population at large, possibly secured otherwise than through a formal vote. Not only will the leadership need at least tacit support for technocratic transformation, it will need it also to reach such goals as sustainability of development, some measure of distributional equity, and sharing in the costs and the benefits of transformation. And so, delegated authority and accountability need in most circumstances to be respected just the same.

Nurturing the political dimensions of economic transformation is multifarious. It encompasses not only the formal political process with the agencies to which policy makers delegate part of their responsibility and therefore exact accountability. It also extends to ensuring involvement and participation of civil society, where that exists, and otherwise fostering the development of civil society and transforming elements of civil society inherited from state socialism that are not completely redundant or counterproductive under transformation. The evidence is quite clear on the links between good governance and the political situation; among capacity building, human-resource development, and private-sector development; between legal reforms and the creation of an environment of economic security; and between the participation of civil society and the sustainability of the reform effort. In other words, there is a need for greater clarity on how decisions are formulated without incurring the wrath of society or its major oppositional interest groups.

Most commentators agree almost instinctively on three features of the conflict-resolution framework, if only because they belong to the canon of the Washington Consensus (Williamson 1993). Accordingly the state must establish a set of mutually agreed, fair ground rules for private activity and enforce them equitably and consistently; provide internal and external security for its citizens; and focus its limited resources on fostering the development of human capital and basic infrastructure (Ouattara 1999, p. 4). Furthermore, delivery on these tasks, while in principle tailored to the limited financial and administrative resources available, must be political variables par excellence in TEs. Moreover, the state itself must, through its own example of ethical rectitude, set the moral tone for broader socioeconomic activity.

For lack of space, I cannot here delve into the specifics (Brabant 1998, pp. 346ff.). But a few suggestions may be derived from the above. First, the rule of law applied in practice is the only way to regulate contracts of exchange in all matters affording societal interaction, but this is by no means easily converted into practice (Pistor 1999). Second, the politics of transformation requires that a minimal sociopolitical consensus be reached and sustained, or regained if lost, over the total amount of the transformation’s burden and its distribution within society and over time. This goes by definition beyond the night watchman’s role of the state at the core of neoliberalism. A consensus requires some explicit or tacit agreement among various private, semi-public, and public actors that is
not incestuous. Rather, it should provide for an arm’s length relationship that accommodates quality, accountability, efficiency, governance, integrity, transparency, trust, and good faith in societal relations in some proper combination depending on concrete circumstances. Finally, politics should focus on providing an environment in which private initiative and other instances of non-state associative undertakings, not just private enterprise, can flourish. It should also be able to formulate broad economic and social goals and specify the policies necessary to achieve them.

Transformation that elicits and sustains a minimal sociopolitical consensus depends on adequate resources to finance mandated objectives. The individual voter may well choose not to endorse such a relationship, especially during the first years of transformation, when legacies of state socialism tend to widen the gap between claims on state expenditures and the citizens’ willingness to fund mandated tasks. Reality has often forced slashing expenditures from desperation rather than from deliberate consideration or electoral or legislative support. This only complicates reaching and sustaining, or recovering, the essential sociopolitical consensus.

Inasmuch as the compass of the state, provided governance capabilities are available or can be acquired relatively quickly, must be broader than the night watchman’s, the state must be one core institution of the nascent market. Those arguing for explicitly destroying the venal elements of the state soonest, so that the better-motivated policy makers can embark on the construction of democracy and a market economy (for an extreme view, see Åslund et al. 1996), have equated this with destroying the state. In this they have been out of touch with reality because their assertion that governance capabilities in TEs are absent and it is pointless to acquire such capabilities is unrealistic. Furthermore, it is an oxymoron to assume that good governance capabilities can emerge spontaneously from the transformation processes instigated through “preemptive strikes”. While the venal elements of state socialism need to be swiftly eradicated, a very different strong state is desperately required to nurse along the market- and democracy-building processes and indeed to prevent the “new class” from twisting prevailing opportunities for malfeasance to their own narrowly defined interests (Poznanski 1999, p. 336).

6.5 Success and failure with transformation policies

Commentators on TEs do not share a view on what constitutes success or failure of particular policies or on when the transformation will have been completed. On the first issue, the diverse commentary stems in part from differing precepts on what the policies chosen were designed to accomplish and the options that were realistically available when policy makers embarked on these measures, from an elastic view of what is positive and negative evidence, from the penchant of observers to skirt multidimensional problems, and from a selective reading of statistics. In any case,
almost by definition a transition may not be judged a success before it is complete (Flemming 1999, p. 11). Yet that too is almost impossible to define. Conversely, failure should almost by definition be equated with a complete reversal of transition. Yet that too is almost impossible to define, given that a return to the *status quo ante* is not feasible. This leaves a broad range for asserting different views. One that should not be controversial, however, is that policies be evaluated in terms not only of the drift of the overall stance but also of the concrete elements of each policy package. An economic upturn, however measured, while welcome, is not necessarily indicative of successful transformation. Though growth is now positive in most TEs, the pace continues to be quite uneven, tepid in most cases, and volatile as compared to what should have been feasible when doing away with the purported inefficiencies of state socialism and the imperative of catch-up modernization.

Any monistic metric for adjudicating success and failure is, in my view, the wrong way to proceed. This applies to both comparisons over time and across countries. Let’s take a concrete example. Holger C. Wolf (1999, p. 5) recently characterized the private-sector share of gross domestic product (GDP) as “perhaps the single best indicator of progress in transition”. Though the private sector’s share is very high, economic recovery in Russia has been elusive in part because what is private is not quite the private Wolf would like to identify (see Mesnard 1999) and stands as perhaps the greatest obstacle to effective transformation. It would not work for Poland either, allowing for categorical shifts, although it has booked substantial success in terms of growth. One can safely dismiss such monistic approaches, no matter how sophisticated the apparatus wielded to “test” whether this or that country has been successful. At the very least, the criterion of success, and implicitly of failure, must be measured against some reasonable standard, such as what the observer expects the country to accomplish, the path to be travelled, or the starting conditions for transformation. Even when one contents oneself with a single-dimensional metric, the outcomes will be very different depending on which of the three views, with their possible extensions, one is willing to subscribe to.

Adjudicating success and failure must, then, be based on multiple considerations, which can usefully be distributed among three categories. One comprises the elements that form the entire economic, political, and social backdrop against which transition as a shared policy task emerges, ranging from the state socialism’s multiple bequests to the expectations of the population at large. It is impossible to condense all this into some meaningful indicator to capture favourable and unfavourable starting conditions. Various organizations have nonetheless based “liberalization”, “freedom”, “transparency”, “corruption” or “democratization” indices using nonparametric measures of the presumed component indices. Even the most sophisticated leaves a lot to be desired if only because such an
index is likely to be endogenous to at least one measure of performance that one is trying to identify (as usefully surveyed in Krueger and Ciolko 1998) and transformation must be adjudicated at least in its economic, political, and social dimensions.

Second, policies matter as do the determination and vision, including the coherence of views on economic transformation, of the transition’s leadership. Whereas policy makers may well not have the time or inclination to reflect thoroughly on the “best” course to be pursued, the quality and success of the policies adhered to need to be adjudicated in terms of their FIEMAF features. And transition is necessarily a comprehensive exercise in social engineering (see section 6.1). None of the “indices” of transformation that I am acquainted with comes even close to agglomerating the diverse elements of any encompassing transformation agenda.

Finally, no matter how favourable starting conditions and how visionary and bold new policy makers may be, the external environment may not cooperate. Touching upon the external factors that impinge on transformation would take me too far away from matters concerning transformation as such. Suffice it to note that I do not find it easy to gauge even approximately the precise impact of positive and negative external forces, if only because the counterfactual is by definition absent. In fact, a negative external event may well impart a positive impetus to reform.

In view of the above, it should not come as a surprise that I find it hard to specify unambiguous criteria for success and failure of the transformation policies put in place or to identify unambiguously countries that succeeded or failed. Such a Manichean approach is much too simplistic in any case as per the agenda for transformation emphasized here. Thus a country can do very well in terms of macroeconomic stabilization, liberalization, and privatization and benefit from favourable starting conditions, but then falter grossly on other items of the agenda, such as building the institutions of the market as defined or maintaining a minimal sociopolitical consensus. How could one synthesize this into a useful metric of success and failure?

Clearly, it is not very useful to even think about success or failure in terms of only one policy dimension, such as macroeconomic stabilization or private-sector development. That ignores all but one criterion of adjudication and rarely helps to clarify the daunting aspects of transformation. For that reason I hesitate to characterize any of the “successful” TEs as per the above metric as being on a path of sustainable catch-up growth (Flemming 1999). Inasmuch as one of the goals of transformation is to improve the population’s lot, macroeconomic stabilization should be a means toward meeting other preconditions for building a flourishing market economy; otherwise it leads to nothing more than an illusory inflation or budget target. Speed and commitment *per se* cannot be good or bad—at best a Pyrrhic victory for Bolshevik-type reformers. It all depends on the particular element of the transformation agenda that is being addressed.
and the concrete circumstances of the country in question. In other words, it might be useful to work out a continuum, at least multidimensional scale of relative success and failure, utilizing something like the proposed transformation agenda. That should, of course, be individualized so that one could ideally compare what needed to be done with what has actually been accomplished in the dimensions of the transformation agenda that matter. I return to these issues in section 6.9.

Whereas I do not have a patent indicator for when the transformation will be over, any answer must be based on what a market economy and pluralist politics are supposed to accomplish. A normal market economy is one that functions well, is not beset by rampant bank failures, where enterprises are largely privately owned and work for their own profit, where governance of economic organizations is effective, where taxes are not onerous, the social safety net is tailored to what is sound social policy and fiscally affordable, where government and external imbalances are not too large and soundly financed, and so on. Absent most of this, effective transformation has yet some way to go. An answer should also heed the need of all TEs to embark on a self-sustainable growth path permitting catch-up with levels of income, wealth, and productivity prevailing in western Europe; a distribution of income and wealth, and influence over societal affairs, that sustains the sociopolitical consensus; and a level of maturity in politics that allows stable, transparent, and reliable governance through the institutions built. Despite resumption of growth in many TEs, there can be no room for complacency in economic transformation. Few if any are on a self-sustainable growth trajectory, as recent events in the wake of the Russian crisis have amply underlined.

6.6 On the starting conditions of economic transformation

History matters, and all the more when participants have been able to learn useful lessons, not just in economics. The starting conditions of transition are multifaceted in and vary among the TEs. I can here touch only upon some of the economic, political, and social factors. Note that even these are rarely unambiguously positive or negative for pursuing genuine transformation and may or may not warrant going “fast and deep”. But they surely affect the outcome of the transition, given path dependence (Hausner et al. 1995; Krueger and Ciolko 1998).

Perhaps the overriding political feature was the state of crisis present when the transition erupted or brought about by transformation. This has varying sociopolitical and economic overtones. First of all, communism as an inspiring ideology based on a fundamental chiliastic–salvationist creed, enforced through state terror and authoritarian control, had all but completely dissipated by the late 1980s. State socialism endowed its citizens with broad-based welfare policies that households had gradually come to accept as an entitlement; channelled thought processes, largely in a pater-
nalistic mode; lack of entrepreneurship, a good deal of dysfunctional experience in the second economy, and poor mobility of workers and management; considerable security in respect of health, education, medical care, pensions, jobs, and civil protection; and economic structures poorly geared to the consumer and intermediation.

Second, the extent to which communist fervour had fibrillated into lacklustre ideological commitment fostered incrementalist social engineering that contributed to forging a special sociopolitical environment for transition: demands for change by existing lobbies (the trade unions in Poland), the underground opposition among the intelligentsia (as in Czechoslovakia and Hungary), or ad hoc oppositional groups (as in Czechoslovakia) left no choice but rapidly to replace the political forces in place. The degree to which these groups participated in the transfer of power and were able to govern depended importantly on persuading the population at large of the desirability of moving toward political pluralism to arbitrate political rivalry and the degree to which the various interest and opposition groups in place had benefited from political liberalization prior to state socialism’s collapse. This differed greatly among the TEs, perhaps nowhere more than in central Europe as compared with the CIS.

Third, anti-communism combined with independence claims by various political groups determined the outcome of the transition’s inceptions in several Baltic, Caucasian, and Central Asian states as well as in inciting the Yugoslav conflagration. Pro-independence sentiments determined the extent and urgency of the need to build a new nation, hence the degree to which the political leadership could focus primarily on economic transformation. The quality of state administration and the degree to which the legal system had been transformed during earlier attempts at decentralization were important factors in pursuing transformation.

Finally, state-socialist commitments to a strong military, and perhaps even an adventurous foreign policy, varied enormously among the TEs, and hence had differential impacts, for example in budgeting, defence production, and society’s perceptions of an erstwhile regime pillar.

No transition can realistically be envisaged in the absence of minimal sociopolitical support for the various hardships and uncertainties engendered (Melich 1997). Many factors influence the thickness and robustness of the cushion for experimental transformation policies. But I limit myself to eight. First, countries enjoying a great degree of ethnic homogeneity do not have to deal with rival claims by various ethnically based interest groups, which may have implications for preferred economic links or modes of operation to be emulated in the new country. Second, a militant trade union operating as a dissident group may help to negotiate an orderly transfer of political power. But it is unstable as its ostensible united front rests on opposition to the regime in place rather than on a common understanding of the changes to be launched. Third, TEs with
some tradition of managerialism underpinned by enterprise independence find it difficult to dislodge managers. It is not always clear how best to design incentives to buy out this class or induce it to behave constructively in the nascent market environment. Fourth, the population at large harbours expectations that the state-socialist social-welfare policy should be retained at little direct monetary cost, which narrows the room for manoeuvre for policy makers bent on fiscal consolidation. Fifth, imbalances under state socialism leave economic agents with deeply embedded behavioural traits that cannot be rectified overnight. Sixth, though educational attainments under state socialism were considerable some TEs were better prepared for seizing the newly emerging economic and other opportunities. Seventh, fiscal reform must aim at minimizing microeconomic distortions, if only because these societies value limited income differentiation, nearly free education and health services, fostering the arts for the wider public, and related social services. The associated trade-offs between fairness and economic efficiency need to be factored into the policy setting, which itself will be constrained by downward pressures on fiscal revenues at a time of rising pressures on expenditures. Finally, societies with a young population and a recent elevated birth rate may experience special demographic pressures with potentially dysfunctional social consequences, given the limited employment opportunities.

The economic starting conditions can be grouped into five classes. First are inherited economic structures, including the level of economic development; the distribution of resources among various activities; the degree to and the forms in which state socialism tolerated private enterprise; the extent to which the economy had been exposed to international competition; and the degree to which domestic resource allocation had heeded production costs. Second, prior reform experience has positive as well as negative implications for transformation. Especially in the smaller TEs, positive aspects are a better grasp of the instrumental and institutional requirements of the market economy, hence in forging ahead with sound FIEMAF actions. Negative influences are the poor economic coordination on the transition’s eve, the emergence of the second economy, scepticism with respect to the economic role of the state, and deep-seated distrust about the ability of the powers-in-place to discharge those functions. Third, the economic crises and policy dilemmas on the transition’s eve varied among the countries (Brabant 1998, pp. 74ff.). Arguably the greatest economic crisis was the inability of the political leaders to live up to their ambitions, at least to deliver the steady, if modest, gains in per capita income earlier promised. By the late 1980s, the room for policy flexibility had become very confined, with loss of control over money aggregates in some TEs. Fourth, prior experience with the second economy is not always a bonus in a nascent market economy, as much of it (even disregarding the criminally illegal) was based on shady access to state resources, thus fostering widespread corruption, deep-seated furtiveness,
and general dishonesty not limited to pilfering and theft—an enduring legacy for the behaviour of economic agents. Fifth, although the foreign sector remained arguably the weakest links of state socialism, the TEs had varying experiences with external economic linkages, especially with market economies, in spite of external imbalances and foreign debt.

By way of summing up, it is not at all easy to classify which country had clearly superior starting conditions. Some inherited fewer macroeconomic imbalances from the period of communism (Czechoslovakia); fewer structural distortions (Hungary, Poland, and Slovenia); and a partially decentralized, somewhat liberalized economy with some vestiges of market institutions and policy instruments (Hungary, Poland, and the former Yugoslavia). There may have been remnants of the experiences with democratic traditions (as in Czechoslovakia) and the market economy (the Baltic States and several eastern European countries). But the latter should not be overemphasized, given the time passed and the different realities.

6.7 Economic and political intermediation, markets, and transformation

The above suggests that a desirable transformation agenda must necessarily be a compromise between what ideally should and what can be done. Regardless of the starting conditions, ensuring effective intermediation in contemporaneous and intertemporal resource allocation has been one of the more daunting transformation tasks. Yet it is paramount since the heart of the market economy coveted by TEs is the exchange of, really property rights to, goods or services for money at a realistic transaction cost. The latter needs to be reduced to ensure progress by relying on an ever finer division of labour according to “assignment rules”. The three critical issues at stake are securing property rights in law, transferring property rights at an affordable cost, and improving the utilization of the transferred property rights. These pose issues of law, of market intermediation, and of the microeconomics of property rights. Resolving them is paramount for the TE to regain an adequate growth path that can be sustained for some years.

A market is about contracts. These are usually implicit. Even when explicit it is all but impossible to specify all parameters of the object of exchange. But this is more easily done for some categories of exchange than for others. Most product markets differ markedly from factor markets. Furthermore, not only individuals exchange goods and services. Societal preferences must be regulated through and supported by appropriate “market institutions” and macroeconomic policies. Resource allocation in such an environment can be aimed at maximizing output only if all enumerated markets operate properly. Furthermore, markets function more or less smoothly only when there is an adequate, simple and clear,
institutional and legal framework for economic activity, ownership, enterprise formation, intermediation, and so on. Finally, actions of microeconomic agents need to be coordinated. If the market fails to do so, another mechanism, including the state’s, needs to be explored.

To grasp the essential differences in various markets, it is important to reflect upon the “institutions” required to smooth resource allocation according to some maximand. Efficient resource allocation for capital assets, for example, can take place only when the tradeoff between present and future consumption is properly intermediated. For that a flexible capital market, including for land and real estate, is indispensable, but this can be envisioned only when much of the transition’s uncertainty abates. A financial infrastructure encompassing a competitive network of intermediating institutions placed in a well-defined and economically sensible legal framework is required. In the first instance, this should consist of a competitive network of commercial, and later investment and merchant, banks. There should also be room for pension funds and for the management of their assets, and insurance companies covering a wide variety of risks. In time it also requires stock and bond markets that enhance the intertemporal allocation of resources and regulate the acquisition and disposal of wealth in all its forms. Given the starting conditions and the recent “history” of TEs, establishing a fully integrated financial infrastructure takes time and the pace in most TEs should not be forced. Rather, policy should focus on the components that are absolutely indispensable to smooth resource allocation. Given that the TEs must re-create markets almost from the ground up, the real challenge for transition managers is not that some markets function poorly. Rather, because the entire infrastructure for market-based decision making is in statu nascendi over a protracted period of time, decision making can in the interim be efficient only in a restricted sense. And it remains highly uncertain how quickly functioning markets can be innovated. Moreover, some become operational sooner than others. And some will continue to transgress on the conditions for best-practice allocation. Yet, managers must forge ahead expeditiously with transformation. Provided governance capabilities are available and market failures can be remedied to some degree, supplementary coordination mechanisms with transitory institutions, policies, and instruments should be embraced (Brabant 1993b, pp. 125–7).

That is to say, the realistic choice of policy package invoked in section 6.1 depends critically on the nature and strength of a country’s economic, political, and legal institutions; on its social cohesiveness and traditions; and on the conditions at the transition’s inception. These factors obviously differ among countries, thus determining the speed at which economic forces and institutions can realistically be transformed. But that depends also on the acceptable cost of adjustment, including in correcting errors, and unanticipated developments that may call for fine-tuning
the transformation strategy or perhaps even temporarily reversing the order of its priorities.

The most important task for managers of the transformation is to assist in the creation of markets through market-conforming, -augmenting, and -correcting measures. All these recognize the effectiveness of product and factor markets where they work by removing regulations and controls and improving flexibility, such as by strengthening the discipline of exit and entry at early stages of competition. Anti-trust policies, the privatization of state assets, and more consistent fiscal policies are examples of measures that seek to diminish the politically motivated allocation of resources and the associated opportunities for rent seeking. Until all the institutions of the market fall into place, transactions will be subject to various shortcomings. Market failures provide the most convincing rationale for attempts by government or the “non-market” to remedy them, but only if the expected cost of failure does not exceed that of the market failure it seeks to rectify. This risk is considerable because the capacity of central administrators to innovate and modulate substitutes for emerging market forces is shallow and uneven. Ways and means must be explored to acquire such capabilities quickly through training or from abroad. Until then, intervention should be minimized.

Measures that reduce transaction costs have an important place on the core agenda of transformation because they enhance the search potential of firms striving for more cost-effective ways of producing higher-quality products. The government has therefore an additional role in reducing or meeting these costs, including by acquiring information about relative prices and technological achievements in alternative markets, and in shoring up investment decisions. Corresponding policy measures include the provision of public goods such as education, transportation, and communication; training to stimulate general competence in science and technology; fostering R&D; and furnishing non-price information about available and prospective technologies, product standards, and market conditions abroad that firms find it difficult to collect themselves. The experience of east and southeast Asian economies should be instructive here (Brabant 1993b, pp. 207ff.).

It is important to ensure that markets are integrated to benefit from competition among all economic agents. An activist state may be required to carry out many of these tasks, particularly during the transformation’s earlier phases. This holds certainly for expeditiously erecting the key institutions of the market, ensuring that the “institutional” legacies of state socialism are eradicated soonest, and establishing some protective measures during the transformation to avoid the legacies of state socialism encroaching on the emerging market economy or nipping it in the bud. Market-correcting policies may be effective for particular industries and under certain conditions. Just as sequencing is central to liberalization, so is targeting, particularly given the TE’s need for rapid catch-up
modernization. That is contingent on a coordinated approach to creating an environment conducive to rendering new activities viable. Technology, investment, and training cannot proceed independently of each other. Rather, they must be supported by a mutually consistent goal around the core of economic modernization, which reaches well beyond the horizon of individual firms.

6.8 Towards a constitutional framework for political coordination

Societal conflicts must be resolved through agreed-upon rules and mechanisms. These generally fall into two parts. The broad concepts that underlie the purposes, means, and instruments to generate harmony in society are usually enshrined in a constitution. The other is the political coordination mechanism that germinates from efforts directed at ironing out the rougher edges of cooperation, competition, and coordination in society through the political process, using the constitution as inspiration and ultimate arbiter.

A constitutional framework for a pluralistic democracy as a rule differs substantially from one suitable to an autocracy or dictatorship, and so TEs did not inherit a constitution suitable to steering societal matters with transparency, participation, and accountability. Some constitutional conference will need to draft a new basic framework that separates legislative and judicial powers from the executive’s prerogatives. It must also provide the basic contours of how those entrusted with tasks in each area will be elected or appointed; the fundamental guidelines for the operation of each branch; and spell out the rights and duties of citizens and non-state for-profit and other organizations, in contrast to the prerogatives of the state and its organs. Needless to say, all this is easier said than done, especially in TEs where conflicts about basic dimensions of the transition remain unresolved. Even if a new constitutional compact can be arranged, there is no guarantee that the ensuing political discourse will be steered more constructively within the basic societal compact. Presumably modernization and catch-up growth are common aspirations, whereas the distribution of resources and of the benefits of modernization may provide major bones of contention until a workable scheme can be elaborated.

As sketched earlier, there is no agreement in TEs about the goals, ways, and means of the kind of political pluralism the transformation should aim at. Views range from a continuation, for all practical purposes, of the communist kind of centralized control (such as is Tajikistan) to western European democracy (as in Hungary). Whereas modern society need not be patterned after western European parliamentary regimes, it cannot be very remote from that arena. As catch-up gains are booked, policy makers will come increasingly under pressure to confront squarely the question of how best to accommodate the divergent interests of citizens, some of
which can be channelled only through greater transparency and participation. Also in this respect the east and southeast Asian countries offer useful precedents.

A stable pluralistic polity requires that societal issues be resolved according to precepts that the electorate at large can share. That requires stable political parties in which the majority of the electorate can “vest” trust. Parties must also assimilate the art of compromise (Sztompa 1996b), preferably in a parliamentary setting. To date there are few comforting signs of a modern party structure emerging in all too many TEs. Most elections held to date were dominated by protest voters. Most parties lack clear and consistent programs. Many are ad hoc groupings formed purely as electoral vehicles bent primarily on benefiting from the populist appeal of a charismatic figure.

A polity can hope to resolve its core conflicts, and thus become “modern”, only when there exists a powerful “modern” middle class. Society should have not only a dense layer of small shopkeepers and merchants whose role is strengthened as modernization proceeds, but also strong agents of civil society encompassing managers, the intelligentsia, professional people, some skilled workers, the self-employed, and others that are democratically oriented and imbued with a modern mentality (Avineri 1995; Hobsbawm 1996; Sztompa 1996a). A modern society must also enable all those willing to be integrated into its framework and respect its parameters until they can be modified consensually. Society must be an integrated community. None of its members should feel excluded from the welfare and opportunities granted to the majority or be marginalized at society’s selvedge, though the state’s coercive powers should be wielded sparingly but with determination in accordance with the constitution. A society that deliberately imparts to the individual the feeling of being at the mercy of authority cannot be deemed “modern”, regardless of its ability to generate material prosperity. The same holds for a society that destroys, intentionally or not, traditional values and norms as well as the communities that might have offered some protection against authority. At the same time, a modern society must embrace a social policy that protects the losers and cannot tolerate more than a certain degree of dissatisfaction, anomie, and alienation. It requires that residents not only can but actually do take part in shaping their environment; that they should not feel at the mercy of authority but carve out their own destiny; and that they accept as binding certain moral rules of behaviour in business, political, and social intercourse. Without modern attitudes and mentality on the part of the individual, including “trust” in society (Sztompa 1996a, 1996b), it seems hopeless to ensure the proper functioning of a market economy within a democratic setting.
6.9 On success and failure of transformation policies

If the ultimate goal of transformation is catch-up modernization, when can this stage be attained? One can quip, as did Ralf Dahrendorf (1990, pp. 99–100) at the time of the “1989 events”, that constitutional transformation could be achieved in six months; that it would take six years to improve the economic conditions to make themselves felt; but that it would take sixty years for the civic culture and society to evolve and bring about stabilization and the proper functioning of democracy and of a market economy. With the hindsight of over a decade of transition, it is clear that the constitutional transformation has taken more than six months. Many TEs do not yet possess a “modern” constitution. In all too many countries six years as the horizon for reaching tangible economic improvements for the majority of the population was far too optimistic. I do not, of course, know whether it will take over two generations for modernization to crystallize. The past decade has shown that much time and determined efforts are required to move onto the modernization trajectory and stay on it.

That said, the terminal points hinted at are not particularly useful in adjudicating what has so far been achieved and the positive and negative experiences registered in the process. Recall (see section 6.5) that I am sceptical about measuring in anything but a hortatory manner progress made with transformation. Yet one needs some kind of yardstick to “measure” it. Many claims have been made for the “success” of transformation policies. Most refer to the results of stabilization, liberalization, and privatization, and in some cases of institution building and the social safety net. It is a paradox of sorts that the prime motivation of the 1989 seismic shocks—regaining sustainable growth and modernization, while maintaining the sociopolitical consensus and assiduously constructing the market institutions—has been all but removed from the adjudication table.

One cannot help but be bewildered by the varying assessments of success that observers have been issuing. Consider stabilization: a marked reduction in inflation but still well at double-digit level, the elimination of the shortage economy (on the supply side) but with many goods disappearing from markets, a movement toward more general access to foreign exchange, the reduction in budget and current-account imbalances, a rise in exports, and other features in some combination have been viewed as marking successful transition. All too often, these are treated in a highly partial perspective with an oblique terminology. Neither is helpful in a dispassionate discourse. Even so, output growth in and of itself cannot be a good success indicator, if only in view of the huge production and income losses sustained since 1989, and in some even well before that. The pace has to be strong, bolstered by capital formation in activities that signal decisive structural change and shore up prospects for sustained expansion in the years ahead, for that provides the only way to boost levels of living over a protracted period of time.
In spite of recent gains, the outlook for any quick transition to sustainable growth is not particularly encouraging. One only needs to look at budget and external imbalances or the continued high pace of inflation. Domestic imbalances stem largely from lack of an adequate tax base and effective collection policies to service rising entitlement and debt-service obligations. Also current-account imbalances in several countries are large and the prospects of closing the external gap on a predictable basis via sustainable long-term capital inflows are not particularly reassuring. In addition, export gains continue to be booked overwhelmingly by firms in flux—really under threat of survival and divestment—for products with which these economies cannot realistically hope to merge themselves into the virtuous network of rapidly expanding intra-industry trade. Furthermore, measured as well as real levels of unemployment are substantial in most countries, entailing prodigious economic, political, psychological, and social costs that crimp the room for policy manoeuvre. Gains in income, wealth, and welfare for broad layers of the population have been meagre at best. For all the dynamism of the new private sector, in most TEs there continues to be substantial room for mobilizing domestic savings for productive investment. The insufficiencies derive in part from limping financial intermediation, but also from pervasive uncertainty. Many other less bright features of the transition could be cited, even without delving into its non-economic, especially political and social, aspects. Until uncertainty about crucial markers of the wide-ranging societal reform programs will have been removed, credible economic stabilization enforced, and decisive measures activated to restructure the more footloose TEs, a sharp improvement in their economic fortunes is unlikely to materialize soon.

How can one analytically and empirically come to grips with the measurement conundrum? Ideally one would wish to have one coherent aggregate appraisal for any one or group of TEs. The problem is familiar: how can one appropriately aggregate qualitative or quantitative measures that lack a common denominator? Among the many success indicators, a resumption of strong growth at moderate levels of inflation based largely on solid investment financed primarily from domestic savings in “modernizing activities”, in combination with movement toward a functioning democracy and social accord through a strong civil society, while far from perfect, is one criterion for economic success on which I place a premium; other items can then be discussed on their own merits.

Can one think of meaningful composite measures? A satisfactory measure remains beyond our reach. So to say something meaningful about success and failure one must fall back on something in between, closer to the monistic than the desired multifaceted metric. In earlier work, I proposed a “misery index” for TEs as a first makeshift discriminator. It simply subtracts GDP growth from the sum of the rates of unemployment and inflation (Brabant 1998, p. 135). Others have proposed
similar combinations. For example, Charles Wyplosz (1999, p. 8) recently suggested combining average GDP growth over 1996–1998, real wages in dollars in 1998, and share of the private sector in GDP. Needless to say that the outcomes are not really consistent, yielding in some cases rather strange results. Thus, Slovakia is ranked as having “clearly turned the corner” (Wyplosz 1999, p. 8), but events since the measurement period cast doubts on the conclusion’s robustness.

A widely utilized scale, if only because it is conveniently available, periodically updated, and has some official imprimatur, for adjudicating TE performances is that compiled by the European Bank for Reconstruction and Development (EBRD 1996, pp. 10ff.). It provides aggregate indicators, in addition to the share of the private sector in GDP, of qualitative assessments of enterprises, utilizing metrics of small and large privatization as well as restructuring; markets and trade, utilizing price liberalization, trade and foreign-exchange systems, and competition policy; financial institutions, utilizing banking reform and interest-rate liberalization as well as securities markets and non-bank financial institutions; and legal reform, utilizing as indicator the extensiveness and effectiveness of legal rules on investment. These non-parametric metrics are scaled between 1 and 4, but the Bank has found it useful to add an asterisk or more recently +/− indicators (EBRD 1998, p. 26), presumably in recognition of the narrowness of the original scale adopted. Given the shallowness of the span and the enormous variety of change among the TEs at any moment and even more over time, I have serious reservations about what precisely these indicators convey at any point in time or over time. Can they be more than a crude impressionistic, perhaps partisan, assessment?

6.10 Conclusions

I have stressed the complexity of coming to grips in a dispassionate manner with the transformation tasks at hand and the adjudication of interim results. Some are basically conceptual in nature, given that few elements of democracy and market-based allocation were present on the transition’s eve. Others derive from measuring precisely what was then in place, what the ultimate goal is, and how much progress has been attained to date. In many respects, little progress has been made over the past decade with critical elements of, for example, capital, labour, and product-service markets. “Little” is, of course, a relative concept, bearing in mind the core threats and inequities of state socialism that these countries have successfully removed. When compared with the tasks set for these societies to function as “normal” democracies with a solid market foundation, however, the progress made to date has been disappointing, in some cases quite meagre. In a number of TEs substantial retrogression has occurred after the first momentous changes promised a more reward-
The more subtle and qualitative transition tasks ahead therefore remain utterly daunting.

Note

1 This essay is a highly condensed redraft of the paper submitted to the conference. The full paper is available on request.

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A chequered history
Political culture and conflict in Albanian economic reform

Marta Muço and Örjan Sjöberg

The Albanian people have been ripe for a revolution – any revolution – for decades.

Sir Reginald Hibbert, May 1997

Introduction

Mention Albania, and it conjures up a picture of disaster and poverty. From the refugee crisis of the early 1990s to the collapse of the pyramid schemes in early 1997 to the war in Kosovo two years later, not to mention its Stalinist past, Albania has been the hapless victim of a long list of calamities. Yet this was not always so. Just prior to the fall of the pyramid schemes, it may be recalled, Albania seemed to be on the right track. Growth rates surpassing most other transition economies, surprisingly high levels of inward foreign direct investment (FDI), successful inflation abatement and a measure of consensus on the need for strict and radical economic policies earned it the accolade ‘Balkan tiger’ (Misha and Vinton 1996). Alas, the 8.0 per cent growth projected for 1997 was not to be. Instead, Albania was thrown into a state of near civil war.

The existence of such pronounced swings begs a number of questions. The high rates of growth of GDP recorded for a period in the mid-1990s can readily be explained, indeed explained away, with reference to the low starting point and a steady inflow of remittances. The ability to attract FDI can likewise be laid at the door of huge factor cost differentials. After all, most investors came from neighbouring Italy and Greece and they were clearly lured by the existence of plentiful labour available at rock-bottom wages. It may be harder to justify why Albania’s successful quest to contain inflation did not issue from serendipity rather than concerted and purposeful action on the part of politicians and technocrats. Yet, already a couple of months before financial disaster struck, The Economist (12 October 1996) could report, correctly as it turned out, that the Albanian economy was just a ‘house of cards’. As the prediction of the respected London weekly proved accurate, we may perhaps be excused for believing that we have solved the puzzle: the impact of economic reform was only skin deep.
This is also the position of some academic work which has since been published both in Albania and abroad (as in, for example, Vaughan-Whitehead 1999; Pëllumbi 2002). If left at that, however, we are also left with a number of unresolved issues. For one thing, it does not explain why economic restructuring was only skin deep. Furthermore, why did reforms grind to a halt as economic success seemed to be within reach? Indeed, why did a consensus of sorts – on privatisation, for instance, or on the need to fight inflation (Pashko 1993) – yield to political confrontation? Or was it that consensus on the need for radical reform was never established? If so, why were such policies pursued by early post-communist governments, irrespective of ideological preferences and relative patterns of strength?

Not entirely convinced that the ups and downs of Albania’s post-communist experience with economic restructuring merely reflects the predictable behaviour of self-serving politicians, or even a basic lack of understanding of the realities of modern capitalism on the part of large segments of the population, this essay sets out to explore the role of long-established institutions in economic reform. As these are factors that are seldom brought out into the open, not even in institutionalist accounts, a first objective is simply to try to cut through the thicket of conflicting patterns of behaviour and interpretation. It does so with recourse to two potentially illuminating heuristic frameworks, the one focusing on economic reforms per se, the other on the environment within which those policies were formulated and implemented.¹

The past is a foreign country

In his influential paper on economic policy reform, Rodrik (1996, p. 11) argues that most writings on the subject fail to make some critical distinctions, in particular as regards the different nature and implications of policies pursued with macro-economic stabilisation in mind and those that aim at structural change. ‘It has become commonplace’, he notes, ‘to conflate these two groups of policies, but for analytical purposes they are best kept apart.’ Not only is it easier to make economists agree on what it takes to achieve the former as opposed to the latter, but ‘they also have different political-economy underpinnings’.

It is plain to see why this critique is relevant to the literature on economic reform in the formerly centrally planned economies of Europe. Policies aimed at macro-economic stability have long had a strong following, not least in the wake of the very high rates of inflation unleashed at the beginning of post-communist transition. Without it, little could have been achieved. There is ample evidence to show that in particular in economies that failed to come to grips with these basic imbalances little headway has been made also with respect to structural change. Conversely, all major success stories share a good track record as far as the
ability to contain or mitigate these imbalances is concerned (Åslund et al. 1996; de Melo and Gelb 1996; EBRD 1999; IBRD 2002). The more contentious issue, however, has been the efficacy of prudent macro-economic policies to engender desired structural change. Not only are there cases of conscientiously carried out macro-economic reforms yielding little positive effect (as in Moldova, on which see Orlova and Ronnås 1999). In fact, critics maintain, radical policies do little to advance the cause of micro-level or structural reforms simply because they cannot. To demolish old structures and patterns of behaviour is not to replace them with new ones. Indeed, at its worst radical policies may even impede the progress of reform as such. This is so as markets require institutions to do their job properly – and they require proper institutions that are up to the task of supporting a modern market economy (e.g. Murrell 1993).

Albania, at least initially, appeared to belong amongst the successful reformers. True, it was a bit down the league tables as far as absolute numbers were concerned, but it was doing palpably better than virtually all of its Balkan peers. Table 7.1 details the progress made. A quick glance at the table may suggest that the disastrous years 1997–8 have now been left behind. Such a conclusion is in all likelihood at least in part premature. The impact, including the consequences of financial loss experienced by a large number of Albanian savers, may not have been as long lasting as first thought (Jarvis 2000). However, it is likely to have produced a very pronounced loss of confidence in the reforms, perhaps also in the market economy as such. If so, this would represent a considerable loss as prior to 1997 Albanians were generally more favourably disposed towards market reforms than most other Central and Eastern Europeans. Besides, in this case of ‘institutional failure writ large’ (Sjöberg 1997), reforms are still imperative and in need of strong political and popular support.

Orthodoxy in action . . .

Albania was a latecomer to the scene of political change; it was in a sense the final domino. Only in late 1990 did the Albanian Party of Labour cave in to the demands of the emerging political opposition. It would therefore seem to have had the benefit of learning from the mistakes of others. On the other hand, Albania was far more of a laggard than the mere delay of a year in accepting the inevitable suggests. It had no, or very little, prior experience with reforms. There was no such thing as an Albanian equivalent of Hungary’s New Economic Mechanism or even perestroika (e.g. Sjöberg 1991). Similarly, only sporadic and isolated attempts at increased openness and political reform were made. There was no organised opposition, and dissidents were few and far between. Although there were exceptions, in many instances what may have passed for an opposition against the old regime was merely a struggle for personal power, not a struggle for democracy. Whatever democratic traditions and supporting institutions
Table 7.1 Selected macro-economic indicators, 1992–2002

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<tbody>
<tr>
<td>GDP, real growth(^a)</td>
<td>-7.2</td>
<td>9.6</td>
<td>8.3</td>
<td>13.3</td>
<td>9.1</td>
<td>-10.5</td>
<td>12.1</td>
<td>7.7</td>
<td>7.7</td>
<td>6.8</td>
<td>4.7</td>
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<tr>
<td>Private-sector share of GDP (%)</td>
<td>10.0</td>
<td>40.0</td>
<td>50.0</td>
<td>60.0</td>
<td>75.0</td>
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<td>75.0</td>
<td>75.0</td>
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<tr>
<td>Inflation</td>
<td>226.0</td>
<td>85.0</td>
<td>23.0</td>
<td>8.0</td>
<td>13.0</td>
<td>33.0</td>
<td>21.0</td>
<td>0.0</td>
<td>0.0</td>
<td>3.0</td>
<td>5.0</td>
</tr>
<tr>
<td>Trade balance (% of GDP)</td>
<td>-64.0</td>
<td>-39.9</td>
<td>-23.2</td>
<td>-19.6</td>
<td>-25.7</td>
<td>-22.7</td>
<td>-20.4</td>
<td>-18.0</td>
<td>-21.4</td>
<td>-24.1</td>
<td>-23.9</td>
</tr>
<tr>
<td>Current-account balance (% of GDP)</td>
<td>-61.1</td>
<td>-29.7</td>
<td>-14.0</td>
<td>-7.3</td>
<td>-9.1</td>
<td>-12.1</td>
<td>-6.1</td>
<td>-7.2</td>
<td>-7.1</td>
<td>-6.2</td>
<td>-9.1</td>
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<tr>
<td>External debt (% of GDP)</td>
<td>-</td>
<td>-</td>
<td>51.0</td>
<td>32.0</td>
<td>28.0</td>
<td>39.0</td>
<td>36.0</td>
<td>31.0</td>
<td>31.0</td>
<td>28.0</td>
<td>24.0</td>
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<tr>
<td>State-budget balance (% of GDP)</td>
<td>-20.3</td>
<td>-14.4</td>
<td>-12.4</td>
<td>-10.3</td>
<td>-12.8</td>
<td>-12.9</td>
<td>-10.4</td>
<td>-11.8</td>
<td>-8.9</td>
<td>-8.2</td>
<td>-6.9</td>
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Note
\(^a\) GDP data for 1997–2002 are based on the revised national accounts, released in 2003.
that may have existed in the past were effectively suppressed by the totalitarian regime (Prifti 1978; Biberaj 1990). The dual transition of democratisation and introducing a market economy had little prior experience and few established institutions to lean against.

To this should be added the pace of the opening-up once it began. Starting from scratch may have its benefits, but the lack of experience on the part of leaving and in-coming politicians – and it is worthwhile to remember that representatives of both categories shared a common position of power during a good part of the first, critical year of reform (the so-called National Government of Stability, a coalition of Socialists, i.e. ex-communists, and liberals drawn from the ranks of the Democratic Party) – often left them in the dark on how to move forward also in those instances where ideological or personal differences did not tie the hands of the government. This was of some consequence as speed was at a premium, not least to stem the tide of frustrated citizens voting with their feet as the economy fell apart around them (Åslund and Sjöberg 1992). This is not to suggest that innocence and altruism were the predominant character traits of the first generation of post-communist politicians and top civil servants – it certainly was not – only that effective policy making was often left to external experts, chance or simply inertia.

There were also, it should be noted, a number of factors that at least initially worked in Albania’s favour. Some of these were of indigenous origin. The opening quote, from Sir Reginald Hibbert (1997), captures some of that. Years of isolation and oppression, and perhaps a much too favourable view of what capitalism can do for you, and not least how it does it, contributed to that. The notion, once held out to the population by the communists, that everyone was to eat with a ‘golden spoon’, now simply became associated with the market. Support for the market and market reforms grew accordingly. Others issued from abroad. The fact that the Albanian refugee crisis threatened to hit neighbouring Italy and Greece certainly had the benefit of making the international community notice the predicament the country found itself in. International economic support was critical, as was the surprisingly tolerant attitude towards a succession of waves of Albanian immigrants shown by Greece and Italy in particular. This served to generate remittances and to diffuse social and political tension at home. It also made Albanians think highly of the prospects for improvement. Importantly, unlike in some other Balkan countries, there was little sense that Europe had forgotten it or tried to push it to the margins.

Whatever the true roots and nature of Albanian exceptionalism, if this is indeed what it amounts to, before long Albania earned itself a reputation for doing most things correctly. There certainly were excesses of various sorts, not least of a political nature, and the standard of living remained appallingly low for the great majority of the population. But as Albania got inflation under control and growth rates recovered well
beyond expectations the word got out that this small Balkan country was actually on to something. This was in marked contrast to the neighbouring former Yugoslav republics and Balkan economies somewhat further afield, all of which had difficulties getting their act together.

In fact, and in spite of a less than propitious start of the post-communist period, Albania did indeed implement policies designed to rectify problems created by the old system, those that became an issue because the old system fell apart and those associated with the adjustment to an emerging economic order. This included measures to achieve macro-economic stabilisation, domestic- and foreign-trade liberalisation, privatisation and not least legal reform. The latter was widely seen as the most contentious and difficult part, not least because implementation was of a long-term nature. Although not particularly smooth, the process to adapt the legal system to the twin goals of marketisation and democratisation is generally thought to be on track; by and large it has taken a rather liberal form and is typically to be regarded as appropriate, at least in theory. Macro-economic issues, by contrast, have largely been directed towards the solution of pressing, short-term problems, such as high inflation (on which see, e.g., Rother 2002), sizeable deficits in the state budget and high levels of unemployment. Although the latter remains high, and no doubt higher than the officially reported figures, in other respects the measures implemented appear both appropriate and reasonably successful. The very large trade deficit is compensated for by remittances and overseas development assistance, resulting in a far less alarming current-account deficit; whether or not it will be sustainable in the long run is an altogether different issue. The budget deficit is clearly a cause of concern, but as long as this has not translated into the return of high levels of inflation most governments seem happy to continue in the same manner as their predecessors; it should be acknowledged, however, that the revenue side of the budget has been addressed with some success over the past few years.

Privatisation is an altogether different story. The privatisation of agricultural land, based not on restitution but on the sharing out of land amongst current members of collective farms, has had its fair share of problems – conflicts over distribution, sometimes accompanied by violence, were common enough – but has been reasonably quick and in most parts of the country enjoyed a measure of legitimacy (Lemel 2000). The privatisation of other assets has been far more complicated, in particular as regards the major formerly state-owned enterprises. The so-called small privatisation proceeded rather quickly, but also there were both irregularities and unforeseen or unwanted consequences. The divestiture of larger entities, however, often stalled and according to critics the entire process has proven both more time-consuming, more costly and less beneficial, including less equitable, than originally envisaged (Vaughan-Whitehead 1999, chap. 8).
Yet, the overall impression was that Albania was in fact on the right track, at least as far as macro-economic policies are concerned. Or so most observers thought until the events of the spring of 1997. From that point on, verdicts have been far more pessimistic, not to say downright critical; the ‘shining star’ (Vaughan-Whitehead 1999) has fallen from grace. The discussion has turned on the notion of reforms being seriously incomplete or indeed flawed. As the *Financial Times* (19 February 1997) put it, the Albanian economic success of the early half of the 1990s had been ‘shown to have a thin veneer’. The crisis laid bare the weak structural foundation upon which the Albanian economic miracle was based. Above all, the lack of regulation has been mentioned as the main reason for the emergence, ascent and subsequent collapse of the investment funds or pyramid schemes in which a substantial part of the Albanian population deposited their earnings. The subsequent disintegration of the economy not only demonstrated just how frail it was, but also confirmed the suspicion that as a result of flawed policies other sectors also suffered from severe structural faults. As one (pre-collapse) observer wryly put it, Albania ‘appealed to free-market fundamentalists in the IMF and the World Bank, as one of the last governments in eastern Europe where their ideas are actively espoused’ (Pettifer 1996, p. 181).

...or merely self-serving politicians?

One might perhaps be excused for thinking that such critical observers repeat the mistake of conflating different types of policy identified by Rodrik (1996), only with the added proviso that they err on the other side, that is, taking a lack of micro-level reforms as a pretext for dismissing all other economic-policy reforms as inadequate, mistaken or both. This is not necessarily the case, however. Vaughan-Whitehead (1999, p. xviii) at least implicitly makes the same distinction as does Rodrik (1996), while Bezemer (2001) suggests that fragile financial markets resulting from regulatory failure may have rendered Albania an extreme case of financial instability, but it was neither unique in the region nor at fault across the full spectrum of necessary reform.

Others would no doubt subscribe to a somewhat cynical view of the policy process. As some parts of the literature (e.g., Gligorov and Sundström 1996) insist, transition is not primarily about growth but about redistribution – of power, wealth and opportunities. If true, choice would be exercised accordingly, with the stronger and more influential agents, be they individuals or interest groups, coming out on top. The very beginning of post-communist reform was such a point in time. Although choice could not be exercised entirely at will, the chances are that outcomes in considerable part would reflect the struggle over the assets and positions to be redistributed. The successful contenders would set the agenda, and that agenda would by and large be biased in their favour.
There are quite a few instances in recent Albanian history that could be mustered to confirm this view. The prime example is the implementation of stringent macro-economic policies, which, as the parliamentary elections of 1996 drew closer, comes across as far less stringent than in the past. Indeed, by 1996, the inflation rate as measured by the official consumer price index began to increase again, and notably so (see Table 7.1). The reason is not far to seek. By increasing expenditure, not least on salaries for civil servants, and by postponing the introduction of VAT, the Democratic Party tried to ensure victory in the elections. The result was not only that it may have contributed to the return to power of the incumbent government but also that the budgetary deficit increased by leaps and bounds.

More ominously, if for obvious reasons not quite as manifest, there appears to have been a close rapport between President Berisha, many if not most of the members of the cabinet and several of the pyramid schemes, the collapse of which in late 1996–early 1997 would bring such misery to the country. Ministers regularly turned up at receptions and parties organised by these ‘investment funds’ or ‘charitable organisations’, as they described themselves. Undisclosed sums of money were spent on the support of the candidates of the Democratic Party. In return, and despite the alarm sounded by the governor of the Bank of Albania, and subsequently by the World Bank and the IMF, the government turned a blind eye on their activities. In the event, once action was taken it proved, in the words of an IMF report, ‘to be too little, too late’ (Jarvis 2000, p. 16).

Other instances can easily be quoted. By and large, politicians were not above corrupt practices (Muço 1999). If anything, or so we are tempted to conclude, at times they considered themselves above the law. Yet, precisely because this was the case, the willingness and ability to abide by the rules of fiscal rectitude and other expressions of sound macro-economic policies need to be explained. It is not self-evident that a political caste bent on enriching itself, or at least doing whatever it would take to stay in power, should also pursue such prudent policies.

Liberalisation introduced with a view to furthering structural reform, to employ Rodrik’s (1996) distinction, may, however, have something to do with it. After all, early on nomenklaturaisation, asset stripping and other antics were frequently identified as one of the major vehicles for self-enrichment (e.g., Levitas and Strzałkowski 1990). It was widely seen then, not least in Central Europe, as one of the main vices of transition; in some countries it still is. To achieve such ends, it may be noted, it is not necessarily imperative to tamper with the policies as such; implementation may also provide for the opportunities sought by self-serving politicians and bureaucrats. Put differently, not only policy failure but also reform by the book may advance the selfish interests of individuals in the public sector, at least insofar as it provides a legitimate means to an illegitimate end.
Any such conjectures, however, need to be proven, not merely asserted as has typically been the case. The fact that the above picture is consistent with the predictions of a sizeable part of the literature on the political economy of reform makes this an interesting proposition, but no more than a proposition, no matter how plausible. What is more, it conveniently overlooks the role of institutions – including, critically, the ones that politicians have *not* been able to influence to their benefit – and other expressions of the environment within which any policy has to evolve. At the very least, it overlooks the effects of interaction with the electorate (at least to the extent that it entails anything other than vote buying) and society at large. And although the suggestion that context and contingency are an important component part of the picture, an assertion unlikely to go down well with the economist’s urge to find universal truths, it may prove inevitable for purposes of empirical substantiation. This is where we now turn, beginning with a suggestion of what the conceptual tools needed to achieve this end could look like.

**Additional tools for economic archaeology**

On closer inspection, it becomes clear that both the phenomenon that spawned the most recent crisis, the pyramid schemes, and the reaction to their collapse, owe a thing or two to more deep-seated factors than the anger over the newly won and unwanted realisation that there are no shortcuts to the creation of wealth. As noted early on by Gligorov (1997, p. 27), ‘the fact that such a dramatic failure was neither anticipated nor expected calls for a more structural explanation’.

This is where our second heuristic framework is expected to chip in. It focuses on the environment within which political decisions take place. Burdened by ‘huge structural imbalances’ issuing from ‘unprecedented restructuring’, Albania found itself suffering, Gligorov (1997, pp. 28–29) asserts, from an ‘institutional vacuum’, which in turn resulted in a ‘state of normlessness’. While the profound structural changes and the resulting imbalances irrevocably made Albania head for a transitional crisis, the lack of appropriate institutions or norms made the country head for anarchy.

Many, if not most, observers of Albania will find little in this picture to argue with. What is lacking from Gligorov’s admittedly brief account, however, is an appreciation of the origin and nature of the institutional vacuum itself. For, while a vacuum in the sense of inadequate institutions there may have been, it is not to be inferred that there was a vacuum understood as a void where no regulations, norms and policies were to be found at all. It is true of course that the oft-reported lack of political action on part of the then President, Dr Sali Beisha, and the leadership of the Democratic Party could be interpreted as leaving voids where none should ideally have been, but for the most part this only meant that old
institutions as may have existed remained in place. And although often singularly unsuited to the needs of an emerging market economy, many institutions of the recent past are still at work. They may simply ‘persist beyond their usefulness’ (Bruckner 1995, p. 202), and this presumably because it may prove costly to dismantle them.

In fact, just as institutions associated with a given system or situation may provide strong incentives for maintaining the status quo, pre-existing institutions may prove to be an important constraint should the urge to reform make itself felt. If nothing else, the point of departure will to some extent influence the range of possible outcomes. As is well known, this is a central tenet of the neo-institutional economics (as espoused for instance by North 1990), where it is typically referred to as path dependence. As we shall argue below, at times this can indeed be observed to be the case in Albania.

Institutional economics, which admonishes its followers to study issues such as property rights and perhaps above all the perpetual interaction between institutions and organisations under conditions of competition, and additionally equips the analyst with fruitful concepts such as transaction costs and governance structures, thus appears to be a suitable point of departure. Other reasons as to why this would be so could of course also be mustered. Notably, the new institutionalism yields the useful insight that institutions provide means to reduce risk and uncertainty, but that this does not necessarily imply that institutions are efficient.

As anyone attempting to apply this framework of analysis to Albania (and we suspect to other countries in the region) will soon find out, however, neo-institutionalism is not enough. Not only does it leave many questions unanswered; as importantly, it leaves many salient issues out of view. For one thing, in at least the early Northian versions of this school of thought institutional change and development are seen as endogenous in nature: institutions as a means to rectify market failures. As noted above, this is not to imply that emerging institutions are rational or efficient, but they do arise as a consequence of prevailing circumstances and needs. However, to the extent that institutions are seen as basically economic phenomena, this does not take into account the possibility that institutions that are non-economic in nature may have economic consequences. What is more, even a cursory look at the Albanian experience indicates there are quite a number of developments that cannot adequately be explained simply by reference to transaction costs, self-interested behaviour and changing relative prices.

To a considerable degree, this would seem to stem from the insufficient attention devoted to political issues. As a sympathetic critic of economics drawn from the ranks of political science has noted, while ‘[p]olitical facts’ thus lurk just beneath the surface of the new institutionalism’, it fails to embed its analysis ‘within the study of politics’ (Bates 1995, p. 42). To the extent that it does, one may add, the problem is simply dealt with by
adopter a public-choice approach, thereby effectively reducing political imperatives to the self-interested behaviour of political actors. Otherwise, it offers a functionalist programme of research where outcomes are assessed solely in terms of some imputed utility.

In particular, Bates goes on to suggest, the issue of power is given short shrift, as are also the effects of party politics and the political system or setting as such. These are factors that not only are likely to have an impact on the structure and efficiency of economic institutions, but may also provide for ‘explanations for the direction and magnitude of the departures from the status quo that economic institutions make possible’ (Bates 1995, p. 44). In short, non-economic factors and institutions of both a systemic and contingent nature should be taken into account; as a heuristic device, the new institutionalism fails to do precisely that. Similarly, legitimacy as an adjunct, but not necessarily a handmaiden, to power needs to be taken into account (Clemens and Cook 1999).

The suggestion that politics cannot be reduced to the issues focused upon by public-choice theorists, no matter how helpful this approach may otherwise be, concurs with the observation made by Major (1994, pp. 319–23) that this type of theory is rather blunt. It is also consonant with the argument developed by Rodrik (1996). Although institutional economics reminds us that there are costs attached to the removal of old institutions and the introduction of new ones (thereby creating a trade-off between change and the status quo), neither it nor political-economy approaches will tell us anything about the extent to which (pre-)existing institutions actually are of any use or simply are a burden not only economically but also politically; as noted above, institutions are rather assumed to be useful. To rectify this problem, Major (1994, p. 323) introduces the concept of ‘institutional efficiency’, the effects of which will help us differentiate between formal or informal institutions that continue to be beneficial and those that have simply exhausted their usefulness (if they ever were to advantage). Thereby, institutions need not be reduced to being either economic or political in nature. Rather, both types can be accommodated, indeed coexist, and the focus is shifted to their interaction, not merely downgrading the one or the other to a constraint on an otherwise irrevocable process of unimpeded progress towards the twin goals of the current period of transition: the introduction of democracy and a market economy.

Does this imply that Gligorov’s analysis of the Albanian scene will have to be given up? Not necessarily. There are at least two options that may be worthwhile pursuing, both of which take the impact of the structure of power on the economy seriously. The first one is the ‘old’ or original version of institutional economics associated with the likes of Veblen and Commons, the former of whom in an often-quoted remark defined institutions as the ‘settled habits of thought common to the generality of man’ (Veblen 1919, p. 239). From this angle, markets are seen as social
institutions with both ‘legitimizing and informational functions’ (Hodgson 1988, p. 187), not primarily price-setting devices. Unlike the view taken by, for example, North (1990, p. 84), shifts in relative prices are not the driving force of institutional change. On the contrary, the reverse is said to be true. As a consequence, the rather drastic version of standard structural adjustment programmes that have been implemented in many transition economies, Albania included, would come across as at best futile and misinformed, at worst downright destructive – at least insofar as they aim at anything beyond macro-economic stabilisation.

This, of course, goes against the grain of a number of recent mainstream analyses that suggest that there is a strong correlation between successful macro-economic stabilisation programmes and subsequent economic growth and, possibly, restructuring. And although one may want to qualify this by noting, with Friedman and Johnson (1996), that the point of departure – whether macro-economic stabilisation is of some urgency or not – does play a role in determining how to best proceed with institutional reform, the fact remains that a good number of the economies in transition needed to bring down inflation, balance their budgets in order to do so, reduce exchange-rate risks and generally provide for better incentives to economic activities, not all of which could be done by redesigning formal institutions alone. Albania is no exception in this regard.

The other alternative to relying in full on the new institutionalism can be found in the domain of political science. Yet, and usefully, unlike in the case of heterodox economic theory it does not preclude that insights or empirical findings from orthodox, essentially neo-classical, work can be usefully drawn upon. Thus, heeding the advice by Bates, it would seem possible to link transaction-costs economics to a political-culture approach. In this manner, we need not privilege on a priori grounds either the economic or political domain. Nor is there a need to reduce it to traditional political-economy prescriptions, whether as typically conceived within economics (i.e. for the most part public choice or variants thereof) or in the other social sciences (where it is often rather more radical with a distinct tinge of conspiracy theory to it).

Although the finer detail is perhaps best left to the specialists, it should be noted that political culture shares with institutionalist accounts a concern with not only formal but also informal institutions (as in the locus classicus, Almond and Verba 1963). Here, though, it takes the form of norms, values and attitudes. Political scientists have been divided over whether to include behaviour in this list of attributes, but as Brown (1977, p. 9) has pointed out, this would amount to circular reasoning. After all, the justification for making political culture an operational concept, as its critics also acknowledge (e.g. Welch 1993, p. 47), is its utility in explaining observed political behaviour. Be that as it may, an immediate consequence of adopting the more
restricted definition is a focus on change and continuity, which incidentally is consonant with the notion of path dependence. So is its insistence on being sensitive to context. Unlike institutional economics, however, but not necessarily at the cost of it, a political-culture approach also allows for the use of pairs of concepts such as stability and legitimacy, the consonance or dissonance between the political system and the political culture, and the differences between official and dominant political cultures, should politicians find themselves pursuing projects that are not necessarily seen as legitimate among the electorate (on these issues see, e.g., Brown 1977).

Importantly, following Rosenbaum (1975, pp. 37–55), we may also distinguish ‘integrated’ and ‘fragmented’ political cultures, in which the former is characterised by orderly procedures, consent and widespread political trust, the latter by a prevalence of distrust and the propensity to put parochial political interests before the welfare of the country. In the fractious, person-centred and highly politicised setting that is Albania’s, a leading observer of the political scene has argued, ‘[p]olitical parties, currently underdeveloped and fragmented, need strengthening, if they are to participate meaningfully in the political process. Parties so far remain largely vehicles of individual leaders’ (Biberaj 1998, p. 356). Indeed, everything, it seems, is construed in terms of ‘we’ and ‘they’. Opponents are ridiculed and lambasted at every turn, and all political proposals, also those pertaining to economic issues, run the risk of being fought over, not because of their inherent merits or shortcomings, but because they are associated with a particular political grouping. The fact that opponents may belong to the same party only marginally adjusts this picture, as attested to by the splits in the Democratic Party when in power and the more recent stand-off between Socialist Party veteran Fatos Nano and upstart Ilir Meta. Under such circumstances, economic rationality and even individual self-interest may easily be overshadowed by what is good for the party, party faction or other grouping to which one owes one’s allegiance.

What political culture adds to the Albanian stew

Much has of course been written on the interaction of politics and economic reform in the transition economies of Europe. Among economists, work as diverse as Kornai (1990), Dewatripoint and Roland (1992a, 1992b, 1995), Bruno (1993), Coricelli and Millesi-Ferreti (1993), Rodrik (1993), Roland (1993, 1994), Wyplosz (1993) and Gomulka (1994) argued early on that the interaction between political and institutional factors on the one hand, and macro-economic policy choices on the other, was of some consequence. The direction, speed and sequencing of reform were all important, as were the political feasibility and credibility of reform. More specifically, a politically sustainable reform package can be defined as one for which there is sufficient political support to carry out the reforms in
full (Asilis and Milesi-Ferreti 1994). This political support can take various forms and could be influenced by factors such as:

1. the number of parliamentary re-elections and changes in government over a certain period;
2. parliamentary support for reforms, especially in creating the necessary legal framework and proper institutions to sustain the emerging markets; and
3. the degree of social acceptability and credibility of the economic reform.

In the case of Albania, the first free and democratic elections since the 1920s were held on 31 March 1991. This ballot returned the Socialists to power. A general strike in May forced the government, lead by Fatos Nano, to resign. In its place a multi-party coalition, generally known as the Government of National Stability, was formed. That government collapsed in December, as the Democratic Party, the main coalition partner, withdrew its representatives. This caused a parliamentary crisis and brought about new elections. It also caused a rift within the Democratic Party, which was subsequently to result in the purge of some influential members. Meanwhile, a government of technocrats lead the country until 22 March 1992, when new elections were held. At this occasion the Democratic Party got a solid majority of votes and a majority of its own in the People’s Assembly.

From December 1990 to March 1992, then, formal power changed hands on four occasions. This is indicative of the political instability, which had a dramatic impact on the economy. As uncertainty and tensions prevailed, production was practically blocked. The legal system was inadequately equipped to support the new political structures and the emerging market relations. Indeed, the very notion of legal institutions, let alone the rule of law, meant little. What else could one expect from a country where the notorious idea of ‘socialist legality’ had long been dominant and the Ministry of Justice had been abolished by 1966? In the event, the reform programme initiated in 1991 by the Government of Stability never got very far; by early autumn discord between the coalition partners froze all initiative. This period, although it represented the first determined effort at serious economic-policy reform, was accompanied by confusion and half-measures in part reflecting the lack of a clear and transparent economic strategy. Moreover, the state of crisis inherited from the past aggravated the situation. In fact, election campaigns in 1991–2 took place against a background of rising inflation, increasing expectations and plummeting production. In this situation the propensity and ability of state enterprises to adjust to the economic and political changes fell sharply.

After the second parliamentary elections, political changes were less
dramatic and political life evolved with lower intensity. The government that resulted from the 1992 victory of the Democratic Party was installed on 13 April 1992 and reorganised about a year later. By the end of 1994 it was thoroughly overhauled again. A referendum on a new Constitution, held in late 1994, proved a blow for Democratic Party and the President. As such it was a sign of a lower level of political support, and was widely interpreted as a lack of trust in the President himself and the policies he favoured, including in the realm of economic reform (Vickers and Pettifer 1997, pp. 258–65).

These developments notwithstanding, we would venture the guess that the sizeable progress made over the period 1992–6 as evidenced by the return to growth at least owes something to continuity and the more orderly political situation. The fact that there was a considerable consensus on the need to contain inflation proved critical, as did the basic agreement on how to achieve it. Beyond this, however, both within the government and between government and opposition there was little concord on a series of other critical issues. These included poverty alleviation, unemployment and particularly privatisation and restitution. That economic growth was the best way to mitigate problems of poverty was not at issue, but whether stop-gap measures were needed and, if so, how they were to be designed, decidedly was. Similarly, the related issue of unemployment remained high on the agenda. In these two cases, however, the main rift was between the parliamentary majority and the opposition and therefore largely contained as the Democratic Party enjoyed an absolute (but not qualified) majority in the People’s Assembly. Even so, they were indicative of possible future controversies. Worse still, privatisation and restitution of real estate and agricultural land divided also the ruling party, effectively tying the hands of the government despite its considerable room for manoeuvre.

It was at this point that critics began to voice concern that the economic success might not be sustainable, indeed that it had been achieved thanks to serendipity, perhaps even manipulation, rather than proper policy (Gramoz Pashko, in Vickers and Pettifer 1997, p. 242). The chances are that we shall never know whether this was a correct assessment or not. The elections in May 1996 saw to that. As noted above, the government changed its up to this point rather conservative stance on macro-economic policy. In the interest of staying in power, expansionist policies were implemented and the ballot itself came to be associated with widespread fraud and irregularities. Although nominally a victory for the Democratic Party, most detached observers would argue that it did not reflect the true sentiments of the electorate. Even so, the resulting ‘one-party parliament’ proved surprisingly ineffective in economic-policy matters. This was most clearly seen in the failure to introduce bills that would have addressed the need for institutional reform. The banking sector remained seriously under-regulated, and financial operations were
largely the prerogative of a thriving informal sector. This in turn opened up for the fraudulent pyramid schemes to operate at a scale that at times defies description (e.g. Gostentschnigg 1998, Bezemer 2001, Korovilas 1999, Jarvis 2000). Widely regarded as a natural part of the existing informal financial markets it took quite a while before their true nature and style of operation were revealed. Meanwhile, the privatisation of large enterprises continued to be stalled at the cost of closure, subsidies or both, while land reform was basically completed (if not always sipas ligjit, i.e. according to the law).

Things came to a head as the pyramid funds collapsed. With their demise, disgruntled depositors took to the streets. In the ensuing chaos, old scores were settled, armoires looted and criminals took charge. Hundreds of thousand of weapons were stolen and distributed far and wide, including by the accomplices of the President. After several months of severe disorder, and only at the behest of active international interventions, new elections took place at the end of July 1997. Again a one-party parliament was formed. The Socialist Party won two-thirds of the seats and its allies (Social Democrats, Union for Human Rights, Agrarians and Democratic Alliance) won another sixteen for a total of 117. The Democratic Party was reduced to the main opposition party, but for a long time refused to take up their seats in the People’s Assembly. Yet again, the interest of a major party took precedence over the concern of the orderly operation of the main democratic institution of the country.

But this was not the end. Political stability proved hard to achieve. In addition to the boycott by the opposition (lifted only in mid-1999), the murder in September 1998 of a leading opposition politician and MP, Azem Hajdari, proved an effective break on the return to normalcy, as did the violent behaviour of opposition crowds and local warlords alike. In the event, the government elected in 1997 did not last long; by late September 1998 a new one, also dominated by the Socialists, was installed. Party politics remain bitterly divided and post-crisis Socialist administrations, despite some mostly half-hearted efforts in this direction, have failed to stamp out the widespread practice of regional governors and politicians appointing friends and relatives to public office; also sometime Prime Minister Ilir Meta reputedly advanced the cause of his own ‘clan of Skrapar’ (his home district). In short, government control needs to be asserted much more effectively. The fact that the Socialist Party on and off has been ridden by the infighting between factions, as was the Democratic Party before it, has done little to further the cause of reform. As a result, setbacks and confusion threatens to continue to accompany the Albanian transition.

Together with the new government that took office in February 2002, since March 1991, Albania up to that point had had eleven governments with several substantial changes in between periods, five general elections, three local elections and one partial local election. In addition, there have
been two referenda on a new constitution, the first (in 1994) being a blow to the then President, the other (in 1998) attracting a low turnout at the ballots. Ministries have been reorganised several times over, with individual ministries hamstrung by a lack of continuity. For instance, over the same period there were eight Ministers of Finance and five different Governors at the helm of the Bank of Albania. Although frequent changes do not necessarily threaten routines or even continuity, the lack of orderly transitions has had a markedly negative impact on the formulation of economic-policy reform and economic decision making.

This lack of political stability must not be allowed to obscure the fact that at least over the period 1991 to 1996 – and again after the 1999 Kosovo crisis – parliamentary support for the core of reforms has remained relatively high. Some cases of extreme polarisation across majority and minority groupings in parliament can be observed during these periods, but for most economic issues of a technical character consensus carried the day. The legal framework created, rudimentary as it is, typically has seen wide support and no doubt effectively contributed to the progress made. At least prior to the collapse of the pyramid funds, this was also reflected in the election platforms and party programmes of the dominant parties that, minor differences aside, were remarkably similar. Any remaining differences and controversies between them reflected, in a rather limited fashion, the interests of the social groups in Albanian society that these parties choose to represent. On the other hand, it is not to be ruled out that the consensus on the main points of economic reform, especially as regards the action to be taken during the initial or emergency phase of stabilisation, may have its origin in a genuine lack of experience and theoretical knowledge on issues of relevance to modern market economies. It is telling that, unlike in many other transition economies in Central and Eastern Europe, theoretical discussions and arguments of principle on how to reform were late to appear in Albanian media. Discussions on these matters, to the extent that they took place at all, remained the prerogative of closed circles drawn from high-level civil servants, government representatives or political functionaries.

Instead, on the eve of reform, and presumably reflecting forty-five years of totalitarian rule, economic thought took on a largely propagandistic character, verging on populism pure and simple. In the public sphere, then, unlike in the early parliaments, technicalities and matters of principle, to the extent that they were discussed at all, also became politicised. This presumably had some consequences down the road, both with respect to the expectations it created and the divergence of ideological positions it promoted. For instance, there was long widespread agreement that privatisation of public property was a necessity. With time, however, the manner in which it was to be implemented took on an increasingly ideological character in part based on the alleged interests of various social strata, in part in response to the perceived lack of transparency of
the process and the dishonesty that accompanied the divestment of public property.

The third national assembly, elected in 1996, was almost of ‘one colour alone’, which should not have created any problems in proceeding with the economic reforms. Yet, parliament failed to act both on the long-term issues of reform and on the urgent issues of the day. This created a vacuum and resulted in a loss of credibility and legitimacy, which in turn arguably contributed towards the difficulties in containing popular unrest as disaster struck. This void did not go unfilled, however. The years 1996–7 represent a difficult period during which political coercion became an established means of ‘solving’ problems. As such it became a serious obstacle to economic reform in its own right. Similarly, parliamentary boycotts have emerged as a favoured tactic since 1996, a practice that has also been made use of in municipal and regional political assemblies.

In contrast to the other countries in transition, where voters have cast their ballots across a wide spectrum of parties with relatively small (albeit at times politically significant) swings in parliamentary majorities, Albanian elections have typically returned absolute majorities by one party or other. Voters have shifted from the left to right and back again. Whether a sign of a lack of democratic maturity, or indicating a legacy of totalitarianism, the outcome has regularly been treated by the losing party as a tell-tale sign of pronounced irregularities – also in cases when this has not been so. As a corollary, parliamentary support for economic reform has been much easier to achieve than has support for political and institutional reform; bills and motions presented to the national assembly have almost invariably been treated as conspiracies in disguise. As a result, the non-institutional underpinnings of democracy leave much to be desired. The failure for a long time to reach an agreement on a new constitution is a case in point. Such a lack of a democratic political culture has also served to reinforce, and possibly owes something to, the climate of intolerance and stubborn resistance also to sensible propositions that do not originate in the ranks of one’s own political party or the relevant faction thereof. Compromise is not the hallmark of Albanian political life.

This has certain consequences for the degree of social acceptability, political support and credibility of economic and other reform. The opposition has consistently favoured the role of the unyielding critic – and expects members and sympathisers to do likewise. This may also play a part in accounting for the dramatic shifts in political support for various measures and proposals. Not being based on arguments and considerations of principle, ideological or otherwise, opinion becomes hostage to the prevailing views amongst those whom you owe allegiance to. And if patrons shift their position, so do clients. In opposition, populism typically reigns supreme; when in power, at least as far as major components of economic reform are concerned, conservative prescriptions have been
favoured no matter the colour or ideological position of the party. In that sense a convergence of sorts concerning economic reform has been achieved. Less charitably, it may reflect the confusion and immaturity of the electorate and elected alike.

**Concluding remarks**

The past may be a foreign country, yet clues to the nature of that distant past are at times to be found in the visible landscape. But just as is true of the elements of the physical landscape, man-made or natural, some of the features no longer serve their original function and perhaps now serve no purpose at all. This is equally true of the political landscape. The above description of post-communist political life and style of course begs the question from where these practices and sentiments may hail. Although perhaps best left to the historian, political scientist or anthropologist, some of the correlates of Albanian political culture can presumably be found in the manner in which Albania has entered the modern world. Indeed, although it has been suggested that communist rule served to initiate the process of modernisation (e.g. Blumi 1999), by 1990 Albania in many respects remained a traditional society. It is not self-evident that the process has been speeded up since; indeed, old ways may have made a comeback (although not always as an exact replica of the original model; see Saltmarshe 2001; Schwandner-Sievers 2001). Indeed many parts of the country, now that the chance was there, reverted to the familiar ways of Albania’s pre-communist past. The return of blood feuds in the north of the country have been much publicised, but serious as this might be, other processes at work might prove more important and challenging to the continued progress towards a modern society. A telling example is the manner in which rural land privatisation was received in some parts of the country (de Waal 1996). In implementing land distribution, local land commissions often carried out their work *sipas kanunit* (according to the canon, i.e., according to the prescriptions of the fifteenth-century Code of Lek Dukagjini). Old practices were reinstituted, complete with village councils of elders and representatives of each clan to man it. This was done not because of an institutional void but out of preference. Post-socialist legislation, after all, stipulates otherwise.

Such tension between modern industrial values and traditional rural ones are perhaps only to be expected in a society where at the time of reform almost two-thirds of the population lived, and earned their living, in the countryside. On the other hand, as agriculture is no longer as dominant as it was up to the recent past, perhaps sentiments are changing (Lawson and Saltmarshe 2002; Hedlund and Sjöberg 2003). However, even if this were the case, we must take care not to jump to the conclusion that a change is about to take place. For, even if it did, the tension between elite and dominant political culture need not disappear. Besides,
the elite has long been subject to the pressure of modernisation, as most
of them have been drawn from the urban elite formed during commun-
ism and subsequently, without therefore betraying any superior degree of
democratic maturity than that which can be observed by the electorate in
general. There have been few fora where such skills and attitudes could
have been formed, in the past and at present. Civil society is something
that has been slow to develop in Albania. Being essentially of Rosen-
baum’s fragmented type of political culture, this is only to be expected. It
is of course no less a tragedy for Albania that this might be the case.

Although the above remarks are indicative of the as yet explorative
nature of our endeavour, the foregoing is intended to hint in what ways,
and how, a political culture perspective may usefully be adopted to supple-
ment and strengthen our analyses of institutional change and develop-
ment. As such, it also opens up possibilities of treating the two processes
of marketisation and democratisation in the economies in transition as
the interrelated phenomena everyday experiences tells us they are.

Notes

1 Some of the ideas presented here have been explored in previous work, e.g.
Sjöberg (1997) and Muço (2000). While our focus here is economic policies,
and the analysis therefore is pitched at a rather high level of generality, the
processes and standpoints referred to can be traced, for instance, in the printed
media, which not only is given to conspiracy theories (Schmidt 2002), but typ-
ically reflect party allegiances. For an in-depth and sophisticated discussion on
issues such as privatisation vs. restitution, the new constitution or politics in the
wake of the fall of the ‘pyramids’, as the Ponzi schemes are colloquially known
in Albania, as articulated in the media, see Fuga (2001).

2 Political culture has seen some, if as yet limited, use within economics. Hillman
and Ursprung (2000), for instance, provide an interesting application to the
context of transition economies, but for the most part such efforts seldom move
beyond issues of rent-seeking and corruption. Katayama (2000) is something of
an exception in this regard.

3 In the new parliament, 122 seats out of 140 were taken by the Democratic Party,
nine by the Socialist Party – these remained unoccupied because of a boycott –
and the remaining nine by smaller groupings.

4 In April 1997 an international military force, 7,000 men strong, was established
in Albania. The main objective of ‘Operation Alba’, as it was called, was to
ensure the safety of about 500 foreign observers before, during and after the
elections held that summer.

5 Sometimes seen as an outcome of generational conflict (e.g. Schmidt 2000), the
most recent occasion was in early 2002 when Prime Minister Ilir Meta resigned
over a challenge to his authority from Party Chairman and former PM Fatos
Nano – only to return as foreign minister and yet again depart as a consequence
of a split between the two.

6Nota bene, this is not a pure first-past-the-post system; the effects of one-man con-
stituencies, which do exist, are balanced by a proportionate allocation of a sub-
stantial number of additional seats in parliament.
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8 Bulgaria

Macroeconomic and political-economic implications of stabilisation under a currency board arrangement

Georgy Y. Ganev and Michael L. Wyzan

Introduction

On 1 July 1997, after plunging into one of the post-communist world’s worst crises, Bulgaria introduced a currency board arrangement (CBA) as a means of achieving macroeconomic stabilisation and sustainable economic growth. This event has implications that go far beyond the standard ones regarding the macroeconomy and external sector. One of the major side-effects of introducing a CBA is a qualitative change in political relationships, and in the rules of the economic game. This is especially true for Bulgaria, where the crisis reflected not only macroeconomic imbalances, but also fundamental structural problems, resulting from complex political-economic interactions amongst diverse social actors.

In this essay, we utilise both macroeconomic and political-economic tools to analyse the salient aspects of the crisis and of the immediate, CBA-dominated, post-crisis era in Bulgaria. Whilst it is possible to focus solely on short-run macroeconomic performance under Bulgaria’s CBA, as does most of the literature on CBA, a more important question is the sustainability of such an arrangement in terms of both macroeconomic indicators and political factors. Any discussion of the broad applicability of CBA at a variety of developmental levels, something which is taken for granted by the CBA’s more enthusiastic proponents (see, for example, Hanke and Walters, 1992; Hanke and Schuler, 1994), must pay attention to the need to generate sustained political support for the arrangement. Such an analysis is necessary in light of the theoretical arguments according to which CBA make macroeconomic adjustments more socially painful than under floating exchange-rate regimes (see, for example, Dobrinsky, 2000).

Bulgaria is the clearest case in Central and Eastern Europe of an economic and political failure to reform caused by the dysfunctional nature of domestic institutions that arose during the post-communist era. Most macroeconomic data (especially inflation, interest rates, investment and, recently, exports and growth of gross domestic product or GDP) suggest
that the Bulgarian CBA has been a success. The rapidity and seemingly decisive nature of the country’s macroeconomic turnaround, however, may obscure relevant political and social processes that affect the regime’s sustainability. No evaluation of the appropriateness of a CBA as a tool for lasting economic improvement would be complete without careful consideration of its political-economic aspects.

We organise this essay as follows. The next section examines the macro-economic aspects of the crisis and the post-crisis era under the CBA. This section is subdivided into three parts: the first deals with the crisis era; the second subsection attempts to provide a balanced assessment of the positive and negative consequences of the introduction of the CBA for the macroeconomy and the external sector; the third subsection evaluates the relevance for Bulgaria of a number of problems that have been associated in the literature with the operation of CBA. The third section deals with the political-economic aspects of the crisis and its roots, presenting a first attempt to come up with a political economy of a transition economy under a CBA. The final section discusses the sustainability of current Bulgarian institutions.

**Macroeconomic policy and performance before and after the introduction of CBA**

**Macroeconomic performance during pre-CBA era**

A number of authors (see Dobrinsky, 1996; Dobrinsky, 1997; Wyzan, 1998; Balyozov, 1999; IMF, 1999; OECD, 1997, 1999) describe and analyse the economic crises in Bulgaria before the introduction of the CBA. Our purpose here is not to provide a detailed description of these crises, but to outline briefly the main macroeconomic developments. A stylised picture of the situation and its dynamics before the introduction of the CBA would have several main elements.

First, there were large macroeconomic imbalances inherited from the previous era, when the Bulgarian economy experienced distortions that were generally more severe than in other socialist-bloc countries (Dobrinsky, 1997). This meant that a rapid transition towards ‘authentic’ (a term coined by Avramov and Guenov, 1994) market behaviour was problematic, if not impossible. As a consequence, there were repeated waves of smaller or larger crises related to the effects of these imbalances on the economy.

Second, Bulgaria was amongst the significant losers from the dissolution of the Council for Mutual Economic Assistance, from which it had benefited under the international socialist planning system. It also lost important markets in Russia, Iran, Iraq and Libya. International sanctions against Iraq and Libya effectively froze the servicing of more than $2,000 million of their debt to Bulgaria. Sanctions against the former Yugoslavia damaged trade flows and fostered criminal activity.
Third, the lack of hard budget constraints and the will to implement structural reforms aimed at introducing market competition led to the accumulation throughout this era of fiscal and quasi-fiscal deficits. This problem manifested itself in losses at large state-owned and even private enterprises, the build-up of bad debt towards many (mostly state-owned) banks and the bailing out of these banks through acts of parliament. This process, punctuated by the occasional ‘fiscalisation’ of quasi-fiscal deficits, underlines the whole macroeconomic dynamic of the era between 1989 and 1997. Parliament adopted such legislation in 1991, 1992 (both of which were for relatively small bail-outs) and 1993 (the now infamous ZUNK bonds; see Wyzan, 1998, p. 8), and in 1996 it passed deposit-guarantee legislation in the face of a severe banking crisis.

In addition to their occasional ‘fiscalisation’, the Bulgarian National Bank (BNB) more or less continually monetised quasi-fiscal deficits through the provision of generous, often unsecured loans. Dobrinsky (2000, p. 3) sees this process as an example of ‘fiscal dominance’, which ‘denotes a mix in which primary deficits do not respond to the level of government debt in a systematic way and hence monetary policy has to correct for that in order to prevent a public debt crisis’. The BNB’s policy was principally to accommodate these deficits, its only constraint being the size of the foreign reserves. The government had a short-term interest in seeing deficits monetised, a practice that took two basic forms. These were central-bank purchases of treasury debt, and the setting of low-base interest rates so as to decrease the burden of government domestic-debt service. Movements in the foreign reserves, however, depend on the domestic and foreign public’s perceptions of the desirability of holding Bulgarian currency, which in turn reflect the fiscal position of the government and current and expected interest rates. Thus, the foreign reserves would start falling whenever it became obvious that the combination of the fiscal position, including the quasi-fiscal component, and interest-rate spread between the lev and foreign currencies could not sustain the current exchange rate. Ultimately, these runs on the reserves resulted in currency crises.

Accordingly, any stylised description of the first eight years of the Bulgarian transition must mention the series of ‘fiscalisation’ and monetisation crises and the periods of relative macroeconomic calm between them. A look at the dynamics of inflation, real and dollar wages and the real exchange rate clearly shows an alternation of crises and relatively uneventful periods (see Figures 8.1, 8.2 and 8.3). Table 8.1 contains a brief description of the main periods during this era.

**Macroeconomic performance during CBA era**

The importance of the CBA for Bulgarian macroeconomic dynamics after the crisis of 1995–1997 necessitates a brief description of the nature of
such an arrangement. In principle, a CBA is an arrangement under which the growth of the monetary base is automatically tied to changes in the foreign reserves. The monetary base must be backed at all times at least 100 per cent by foreign reserves. The institution serving as a CBA is prohibited by law from holding domestic assets. It cannot make loans to the government or to commercial banks, so domestically generated changes...
Table 8.1 Periodization of pre-CBA era in Bulgaria

<table>
<thead>
<tr>
<th>Period</th>
<th>Description</th>
<th>Main events</th>
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<tr>
<td>February–November 1991</td>
<td>Good start on stabilisation and liberalisation</td>
<td>First IMF stand-by (February); reform programme involved price liberalisation, floating, unified exchange rate, foreign-trade liberalisation, incomes policy, fiscal reform; tight monetary policy; general elections (October) result in reformist coalition between Union of Democratic Forces (UDF) and ethnic Turkish party</td>
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<td>November 1991–October 1992</td>
<td>Abortive attempt to initiate structural change</td>
<td>First UDF government: inflation steady at 4–5% per month, unemployment continues to rise from 9% to 15%, real appreciation of lev, foreign reserves rise from $300 million to $900 million (not servicing foreign debt yet); second IMF standby (April); important structural-reform legislation: foreign-exchange law, privatisation law, law on agricultural land ownership and use</td>
</tr>
<tr>
<td>December 1992–December 1993</td>
<td>Treading water until first currency crisis</td>
<td>Uneventful regime of Berov (with tacit support of socialists) begins; trough of transformational recession seems to be reached: unemployment peaks at 16.5% (January 1994); biggest trade and current-account deficits in 1993; inflation on downward trend; significant real appreciation of lev; monthly dollar wage peaks at $128 (September); BNB lowers base interest rate (June, August), and international reserves fall from $1 billion (October 1992) to $600 million (January 1994); large fiscal imbalance; IMF never releases fifth tranche of April 1992 standby (no IMF credits, April–December 1993)</td>
</tr>
<tr>
<td>January–May 1994</td>
<td>First currency crisis</td>
<td>Large depreciation of lev (US$33 in December 1993 – US$56 May 1994); surge in inflation (especially in April); crisis had few if any real sector effects (unemployment continues decline. GDP grows slightly in 1994), as IMF approves standby (April, after VAT introduced) and foreign reserves recover</td>
</tr>
<tr>
<td>Period</td>
<td>Description</td>
<td>Main events</td>
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<td>June 1994–</td>
<td>Calm between storms</td>
<td>Debt reduction and rescheduling agreement with London Club, as IMF, pleased with monetary and fiscal policy, approves special support for agreement (September); deceptive improvement in macroeconomic performance: CPI inflation and unemployment falling, GDP growth picking up slightly, dollar wages rising, almost balanced trade and current accounts, lev nominally stable, foreign reserves rise, despite large foreign-debt service (1994 and 1995) and no new IMF funding (September 1994–July 1996); Berov regime resigns (October), socialists take power (January); but absence of structural reform and problems accumulating</td>
</tr>
<tr>
<td>June 1995</td>
<td></td>
<td>First sign of trouble: foreign-reserve meltdown ($1.5 billion in June 1995 to $480 million in July 1996) and consequent weakening of leva (US$71 in January 1996 to US$488 in January 1997); socialist regime tries to deal with structural problems (liquidation or credit cut-off for troubled large enterprises, bankruptcy for insolvent banks) and IMF approves standby (July 1996), but poor policy (e.g. illiberal price and trade regimes) continues and IMF does not release later tranches of stand-by, with foreign reserves falling to $381 million (January 1997); performance collapse, as of February 1997: 243% monthly CPI inflation, lev hits 2,937 to US dollar (12 February), monthly dollar wage under $25, run on banks resulting in many bankruptcies; socialist government resigns (December 1996), UDF caretaker government (February 1997), elected majority UDF government (May 1997)</td>
</tr>
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in the monetary base are not possible. Moreover, the nominal exchange rate of the domestic currency against a reserve currency – in the case of Bulgaria, initially the Deutsche mark and later the euro – is indefinitely fixed by law, and economic agents are allowed to freely convert unlimited amounts of domestic currency into reserve currency at that rate.

A major macroeconomic implication of a CBA is that, in principle, the domestic inflation rate converges towards the inflation rate in the reserve country. Due to the nominal exchange-rate peg, adjustments to shocks affect the economy through the balance of payments in a manner similar to the operation of the gold standard. For example, domestic inflation higher than in the reserve country results in a real exchange-rate appreciation, which may lead to a deterioration in the current-account balance, and a slowdown in economic growth, accompanied by downwards pressure on prices. Such inflation is particularly likely in less developed and transition countries, where there is relatively fast growth of productivity in the production of tradables (the Balassa–Samuelson effect). Neither theory nor practice suggests that there should be a rapid convergence of the domestic inflation rate towards the inflation rate in the reserve country.

The Bulgarian CBA differs somewhat from the orthodox version (see Dobrev, 1999). The central bank continues to exist and is divided into three departments: Issue Department, Banking Department and Bank Supervision Department. The Issue Department plays the role of a CBA, although in addition to the monetary base, its liabilities also include a deposit holding the fiscal reserve of the government and a deposit of the Banking Department. The central bank also has the ability to affect commercial-bank operations by setting minimum reserve requirements and

![Figure 8.3 Real exchange rate, Bulgarian lev vs US dollar (downward movement indicates depreciation of lev).](image-url)
supervising commercial banks. The existence of the government deposit and the possibility of setting reserve requirements allow for what Nenovsky and Hristov (1998) call ‘quasi-monetary policy’.

Bulgarian macroeconomic indicators after the introduction of the CBA show signs of significant stabilisation. Despite the relatively short time since the introduction of the CBA, we can tentatively divide the era into three periods, based largely on trends in quarterly year-on-year GDP growth (see Figure 8.4). The first period is the initial recovery from the trough of the 1995–7 crisis, with impressive growth of 18.3 per cent in the first quarter of 1998, which largely reflected a very low base.

During the second period, which started in the third quarter of 1998 and ended in the last quarter of 1999, quarterly year-on-year GDP was essentially stagnant. The only exception was the relatively strong year-on-year growth in the third quarter of 1999, which can again be explained by the low base set by the weak third quarter of 1998. The period was shaped by two major external shocks – the Russian meltdown of August 1998 and the Kosovo crisis in the second quarter of 1999 – and was also characterised by low prices for many Bulgarian export goods (e.g. metals and chemicals). Moreover, it was a time of an apparent slowdown in reforms, manifested in a declining pace of privatisation, delays in the liquidation of insolvent state-owned enterprises (SOEs) and falling public confidence in the will of the government to maintain the reform momentum.

During the third period, from 2000 to 2003, the data suggest a new era of macroeconomic dynamics under the CBA. Exports experienced robust growth, industrial sales and production reversed their decline and posted real growth (initially modest and later robust) and investment steadily served the role of a growth engine. Real GDP growth was above 4 per cent in each of these four years. The liquidation programme for insolvent state-
owned enterprises, which was supported by the International Monetary Fund (IMF), was fully completed, with about two-thirds of them privatised and the remainder closed by the end of June 1999. This structural policy was one of the main causes of the growth in unemployment in the second half of 1999. After reaching record high levels for the transition period between the spring of 2000 and the spring of 2001, unemployment began a slow but steady decline slowly in 2001 and 2002, with the pace of decline picking up significantly in 2003 (see Figure 8.5). During these years, the Issue Department’s foreign reserves grew by more than 2,000 million euro (over 65 per cent), indicating that the economy has been generating an overall balance-of-payments surplus.

During the CBA era, annual real GDP has posted four consecutive years of modest growth, namely 4 per cent in 1998, 2.3 per cent in 1999, 5.4 per cent in 2000, 4.1 per cent in 2001, 4.8 per cent in 2002 and an expected 4.4 per cent in 2003. More promisingly, real gross fixed-capital formation grew during these years by 16.9, 20.8, 15.4, 23.3, 9.3 and an expected 18 per cent, respectively. Consumer-price inflation (see Figure 8.1) has been brought down sharply from pre-CBA levels, falling from a geometric mean of 7.92 per cent monthly over April 1991–June 1997 to 0.60 per cent over July 1997–December 2003. This era exhibits different consumer price index (CPI) dynamics during each of these three periods. The first period (initial recovery) was accompanied by a geometric mean monthly rate of inflation of 1.77 per cent until April 1998, possibly reflecting inflationary inertia and continuing macroeconomic adjustment in the aftermath of the crisis. The second period (stagnation) coincides with a geometric mean monthly rate of inflation of 0.22 per cent, including a deflationary period in the summer of 1998 and the first half of 1999. During the third period, however, the

![Figure 8.5 Bulgarian unemployment rate.](image-url)
pick-up in GDP, production and exports was accompanied by a slight acceleration of mean monthly inflation to 0.51 per cent.

An interesting issue related to price performance under a CBA – especially in a developing or transition country – is the real appreciation of the currency. Figure 8.6 shows the real exchange rate (based on the CPI) of the Bulgarian lev against the US dollar and the Deutsche mark over the CBA era. The latter is more relevant, because it broadly represents the real exchange rate of the lev against the currencies of the euro-zone countries, which are by far Bulgaria’s most important trading partners. Because of the fixed nominal exchange rate, this index simply tracks the difference in consumer-price inflation rates. Not surprisingly, the higher inflation in Bulgaria over this era resulted in a real appreciation of the lev so measured. The real exchange rate of the lev follows generally the same dynamic over the CBA era as the inflation rate (see Figures 8.1 and 8.6). The lev’s appreciation is much weaker and more variable when the real exchange rate is calculated against the US dollar (again on a CPI basis). Although trade is dominated by the euro zone, energy imports (especially from Russia) are denominated in dollars, so the real exchange rate against the dollar continues to be of interest.

Wages, shown in Figure 8.2, have exhibited a dynamic broadly consistent with the already outlined periods of the CBA era, especially when measured in US dollars. During the first period, real wages recovered from the extremely low levels inherited from the crisis period of 1996–1997, posting a growth rate of 6.5 per cent. The momentum of nominal wage growth continued into the second period, despite price deflation in the first half of 1999 and GDP stagnation. Real wage growth was 13.4 per cent, perhaps contributing to widening external imbalances.

![Figure 8.6 Real exchange rate, Bulgarian lev, since introduction of CBA (downward movement indicates depreciation of lev).](image-url)
in the first half of 1999. During the third period, real wages continued along a similar trend, rising by about 14.7 per cent over 2000–2001. Trends in dollar wages are similar, although the strengthening of the US dollar against the euro from early 1999 to mid-2002 lessened this tendency to some extent. During these two years, dollar wages hovered around and slightly below their post-communist peak of $128, reached in September 1993 and December 1998, and then increased to $144 in December 2001.  

The performance of the external sector has been clearly related to real exchange rate and real wage movements. Figure 8.7 traces three measures of external sector performance since the introduction of the CBA. Whilst the trade balance as a share of GDP has clearly deteriorated throughout this era, these deficits have not reached alarming levels compared with other transition countries with CBA: relevant examples are Estonia in 1997 (−32.5 per cent) and Lithuania in 1998 (−19.4 per cent). The current-account balance and the overall balance of payments registered sharp declines during the first period of the CBA era in Bulgaria. Since then the overall balance of payments has been positive, often above 4 per cent of GDP, whilst the current-account balance has gradually deteriorated, reaching −8 per cent of GDP by the end of 2003. The behaviour of the current account under a CBA is an important issue, one to which we shall shortly return.

During the CBA era, a fixed nominal exchange rate and increased confidence in the country’s financial stability have contributed to a dramatic drop in interest rates. The effective annual base interest rate (as measured by the rate of return on 90-day treasury bills) fell from a peak of
837.89 per cent in September–October 1996 to 5.42 per cent in July 1997, and has remained at between 3 and 6.5 per cent since, whilst the monthly short-term credit rate fell from 24.19 per cent to around 1 per cent over the same period. The low base interest rate has decreased the burden of servicing domestic government debt and, coupled with some progress in tax reform and an improvement in tax collection, generated a small budget surplus in 1998 and contributed to very low deficits in the following years.

Financial stability and low interest rates during the CBA era have led to consistently slow growth of real monetary aggregates. Thus, monetary aggregates have not recovered relative to GDP from the sharp drop during the crisis period of 1995–7. This is mainly because low interest rates tend to discourage the large-scale capital inflows received by many other transition countries (see, for example, Gács et al. 1999); as a result, the monetary base has not grown significantly during this era. Whilst M1 has not changed over time as a proportion of GDP, broad money so measured has decreased from a seasonally adjusted 53 per cent at the end of 1995 to 24 per cent during the third quarter of 1997, recovering steadily to 46 per cent in the third quarter of 2003.

Another possibly worrisome indicator under a CBA, in addition to the trade deficit, is the rate of unemployment. As shown in Figure 8.5, the tendency for the unemployment rate to move independently of other major economic indicators, including GDP or the real wage, has continued under the CBA. After a period without consistent movement in any particular direction, at the end of the second period, the unemployment rate rose rapidly, reaching 19 per cent in April 2000. During the third period, it defied the economy’s overall growth trajectory, remaining at around 18 per cent until 2003, when it fell sharply to around 13 per cent. The explanation for this phenomenon lies perhaps in the acceleration of structural reforms and the rationalisation of production at privatised companies that took place in 1999–2002.

**Potential problems under CBA**

The multitude of statistical indicators presented above suggests that the CBA has worked tolerably well since its introduction in Bulgaria. There are only a few tendencies that may be interpreted as pointing towards worrisome medium-term prospects for the arrangement’s sustainability. These tendencies include large trade deficits, rising unemployment during the most recent period and rising real wages.

To what extent do these trends support those who have expressed scepticism about the applicability and sustainability of a CBA? In an exhaustive discussion of the advantages and disadvantages of CBA, Williamson (1995) lists seven potential problem areas. We now consider the relevance for Bulgaria of each of these in turn.
The first problem is the loss of seigniorage. For a small open economy such as Bulgaria’s, the net loss from backing the monetary base with potentially low return foreign reserves instead of high return domestic ones is negligible. This is because, on average, such an economy needs to hold relatively large foreign reserves regardless of its exchange-rate regime (see Williamson, 1995, p. 32). The second problem concerns start-up logistics (Williamson, 1995, pp. 20–1; Enoch and Gulde, 1997). The smooth start and quick results in the Bulgarian case indicate that this problem has been successfully resolved (Gulde, 1999).

Third, countries operating under CBA may experience a transition period, during which inherited imbalances and inertia affect their performance (Williamson, 1995, pp. 21–3; Roubini, 1998; Dobrinsky, 2000, pp. 14–19). The most salient danger during this period is relatively high price and wage inflation, which leads to increases in unit labour costs and a real appreciation of the currency, ultimately eroding the competitiveness of the country’s exports. According to Williamson’s (1995, p. 21) ‘optimistic view’, this phenomenon is to be expected immediately after the introduction of a CBA, but ‘the government’s determination to maintain a fixed exchange rate will cause wage setters and price setters to moderate their behaviour so as to avoid pricing themselves out of the market’. Writing in early 2004, a case can be made that the Bulgarian economy is conforming to the optimistic scenario. Moreover, a rough measure of the unit labour costs of industrial sales indicates that the trend towards an increase in unit labour costs was reversed in the second half of 1999, with a unit labour-cost index stable over 2000–3.

The fourth problem area is the paucity of tools for facilitating adjustment to external shocks. The presence of this problem can be viewed as one of the root causes of the failure of the CBA in Argentina at the end of 2001. During the period in question, Bulgaria has faced four potentially significant crises, namely those occurring in East Asia (October 1997), Russia (August 1998), Kosovo (March–June 1999) and Macedonia (2001). One explanation for the stagnating GDP, price deflation and falling exports during the second period of the CBA era is that the economy was adjusting to these shocks. The existence of the CBA, of course, prevented a nominal depreciation as an alternative form of adjustment. The key questions are whether there is a significant difference in the social costs engendered by these two alternative types of adjustment, and, in turn, whether this difference will have an impact on the CBA’s sustainability. It is too soon to answer these questions definitively. In any case, the fact that the lev is pegged to the euro, the currency of its dominant trading partner, will mean that severe asymmetric shocks will probably be relatively rare.

The fifth problem, which can also be observed in the case of Argentina, is a lack of ‘degrees of freedom’ for running fiscal and monetary policy (Dobrinsky, 2000, p. 3). This is related to the issues of the pro-cyclical
nature of the CBA and the lack of synchronisation with the business cycles in the reserve country. Output movements during the second and third periods of the CBA era in Bulgaria suggest that there has not been a visible synchronisation problem. In any case, it is difficult to compare Bulgaria’s performance under a non-active, pro-cyclical arrangement such as the CBA with what it might have been under other, hypothetical policy regimes.

The sixth problem is that financial crises may become more severe after a country adopts a CBA. Santiprabhob (1997) and Roubini (1998) stress that, rather than stabilising the financial system, a CBA puts the full weight of any financial crisis on that system’s shoulders, thus increasing its fragility. This fragility remains a significant potential danger, even though a CBA considerably alleviates asymmetric information problems and in practice often allows for a limited lender-of-last-resort function. Williamson (1995, pp. 25–8) suggests that bank consolidation, capital-market development and an increase in the share of foreign-owned and controlled banks in a CBA country are particularly desirable in this respect. Bank privatisation in Bulgaria has progressed considerably, and the private share in banking was approximately 98 per cent by the end of 2001. An additional stabilising factor is the existence of a lender-of-last-resort facility at the BNB, which allows lending under predefined conditions to sound banks experiencing temporary illiquidity. This facility now has at its disposal around 15 per cent of the total foreign reserves. In addition, by the end of 2003, the foreign reserve backing of broad money was 61.7 per cent, so the danger of an uncontrollable bank run appears to be low.

From the perspective of this chapter, the most interesting and important problem is Williamson’s (1995, pp. 28–9) seventh one. He calls it the ‘political problem’, stressing that no CBA can be successful in the absence of the political will to maintain fiscal discipline. He admits that the record of countries employing CBA is fairly good in this regard, but his work was published before the events in Argentina in 2001. Roubini (1998) pushes this point further by claiming that, theoretically, CBA may even create political incentives for fiscal indiscipline, because such budget deficits do not immediately punish politicians through ‘humiliating’ currency depreciations.

These views concentrate only on the explicit fiscal problems under a CBA. Dobrinsky (2000) notes that the relevant measure of the government fiscal position includes important quasi-fiscal components, especially losses at SOEs. For Bulgaria, he claims, the fiscal crisis ‘was not so much due to major flaws in conventional fiscal policy but rather to more general flaws in government policy with negative quasi-fiscal implications’ (p. 19). According to Dobrinsky (2000, p. 41, Table 4), the state sector’s profit performance has deteriorated steadily during the CBA era, at least through mid-1999, especially in manufacturing and mining. Overall state-sector after-tax profitability dropped from a peak of 3.4 per cent in 1997.
to −5.3 per cent in the first half of 1999. Unlike in the pre-CBA era, these losses are ‘covered’ by running large tax arrears and increasing inter-firm indebtedness.

One factor that may work against fiscal discipline is the perception that the standard of living has fallen during the entire post-communist transition. It is difficult to reconcile this perception with the data on real wages described above, or with Dobrinsky’s (2000) concerns about declining international competitiveness. However, it must be acknowledged that this sort of reasoning is widespread and may lead to political pressures to increase fiscal (and quasi-fiscal) deficits.

Overall, the analysis of this section suggests that the most serious danger facing the CBA is a breakdown in the political willingness to stick to fiscal and quasi-fiscal discipline. The political process is the only channel through which possible concerns over competitiveness or the standard of living can influence the CBA’s sustainability. Accordingly, in the next section, we devote our attention to the political economy of the pre-CBA and CBA eras in Bulgaria.5

Political-economic analysis of pre-CBA and CBA eras

In this section, we begin by providing a political-economic analysis of the channels through which financial indiscipline and perverse incentives worked to generate fiscal and monetary crises during the pre-CBA era. We go on to identify the ways in which the existence of the CBA has cut off some of these channels, but left others open, allowing for renewed accumulation of quasi-fiscal deficits. We argue that such deficits represent the most serious threat to the sustainability of Bulgaria’s CBA.

Political economy of pre-CBA era

Recent literature on the political economy of macroeconomic policy explores the reasons why stabilisation is delayed, why rational policymakers accept large deficits and why the same policymakers sometimes manage to adopt performance-enhancing policies after long periods of failure in this respect (see, for example, Drazen, 1996, and Rodrik, 1996, for reviews of the literature). The major insight of these analyses is that there are more fundamental reasons for the failure to push through welfare-improving reforms than short-sightedness, ignorance, irrationality or uncertainty. These reasons include the presence of conflicts of interest between elites with different ‘projects’ (Ganev, 1999), the resolution of which as a collective choice may easily result in inefficient outcomes. The initial question motivating this theoretical work is as follows: why might conflicts of interest and the mechanisms by which such conflicts are resolved lead to a delay in the adoption of beneficial reforms (Drazen, 1996, pp. 25–6)?
Rodrik (1995) and Fidrmuc (1999) build some of the few political-economic models aimed at explaining the dynamics of political support for economic reform in post-communist economies. Their models are driven by the dynamics of the labour market, namely the flows of workers between the state sector, unemployment and the private sector. They show that over time support for reforms may dwindle because of a decreasing probability of finding a higher paying private-sector job, leading to a higher relative attractiveness of state subsidies. Fidrmuc (1999, p. 48) demonstrates empirically for the four Visegrád countries that ‘unemployment generally reduces support for parties associated with economic reforms, and increases support for post-communist and other left wing parties’.

Post-communist parliamentary elections were held in Bulgaria in October 1991, December 1994, April 1997 and June 2001. A look at unemployment dynamics (Figure 8.5) shows that the pro-reform party won after long periods of rising unemployment (1991 and 1997), that the post-communist party won after a considerable time of falling unemployment (1994) and that a brand new movement established by the former king of Bulgaria (Simeon II – the prime minister as this is written in early 2005) largely as an alternative to both major political parties won in 2001 after a period of sustained high unemployment. Accordingly, the dynamics of the political process in Bulgaria clearly do not conform to the Rodrik/Fidrmuc hypothesis, except for the elections in 2001. The greatest surge in political support for radical economic reform – as manifested by the electoral results of April 1997 – occurred in the midst of a severe economic crisis characterised by hyperinflation, bank failures and rising unemployment. The economic arguments entering voters’ utility functions obviously include more than their prospects of finding well-paid private-sector jobs. In any case, workers are not the only relevant decision-making group in the post-communist context.

A political-economy model by Perotti (1996) designed to explain coalition formation in a developing country seems more relevant for analysing the Bulgarian situation than the aforementioned work. His model allows for the formation and shifting of coalitions by three sets of social actors, whose attitudes towards redistribution and the timing of foreign-debt payments diverge. In his two-period set-up, tax revenue collected by the government is used either to service the foreign debt or to make lump-sum transfers to all voters. Society consists of three groups: capitalists who in the long run are able to immunise themselves against the costs arising from macroeconomic stabilisation by emigrating; the poor, with incomes so small that they pay no taxes, but who gain disproportionately whenever the government elects to engage in fiscal redistribution rather than servicing the debt; and a middle class.

Under certain conditions – namely, in a poor country characterised by a high degree of inequality – the rich and the poor form a coalition. That
coalition opts not to allocate any funds for debt service in the first period, so that all such expenditure must be made in the second one. The poor are the beneficiaries of this redistribution and pay no taxes, leading them to support putting off servicing the debt. The rich gain as well, because the redistribution during the first period raises domestic demand and profitability. In any case, during the second period, their wealth allows them to emigrate, so they will not be in the country and have to pay the taxes needed to fund the higher debt payments.

This model is quite appealing as an analysis of the political-economic situation in certain post-communist countries. Instead of ‘capitalists’, pre-CBA Bulgaria had elites who earned economic rents by exploiting positions obtained during communist days or through criminal activity, and who were able to emigrate or engage in capital flight. Although one might expect that the poor would resent domestic capitalists’ self-enrichment, this group may well have believed that it gained whenever those capitalists prospered. We can substitute the poor fiscal discipline that caused the crises punctuating the pre-CBA era for unsustainable expansionary fiscal policy in the first period. We can replace postponed debt service with the quasi-fiscal subsidisation of enterprises and banks. These substitutions allow us to make use of Perotti’s model to explain the formation of anti-reform coalitions between ‘red grannies’ and ‘red mobiphones’.

Despite the evident affinity between Perotti’s (1996) analysis and pre-CBA reality in Bulgaria, we need to make some additional adjustments to the analysis to make it fit that reality. For example, there is a reversal of intra-coalition relations: instead of the rich acquiescing to a redistribution of resources towards the downtrodden, the poor assented to an arrangement benefiting the elite. Perotti’s (1996) rich support a redistributive policy because they indirectly gain from it, whilst Bulgaria’s poor supported a perverse redistribution from which they anticipated that they would gain.

In a multifaceted case study from a state-building perspective of Bulgaria’s pre-CBA transition, Ganev (1999) analyses the observed devolution of the state in post-communist countries. He argues that it cannot be explained without recognising that the ‘dominant elite project’ in this period is ‘extraction from the state’ as a major form of predatory action (p. 24). Figure 8.8 (inspired by Avramov and Guenov, 1994, p. 23) illustrates the ways in which strategically embedded elites in Bulgaria used the state to enrich themselves at the expense of the middle class during the pre-CBA era. The main channels involve the siphoning of funds directly from the government (through corrupt sweet deals) and the BNB (through the refinancing of banks with a high propensity to make soft loans), and indirectly from both sources through preying on SOEs.

To be successful, this elite project required poor fiscal discipline. A large segment of the ‘poor’ in Bulgaria, namely many workers, acquiesced in this project, because their jobs at SOEs were guaranteed, at least in the
short run. This certainty was more important to them than the possibility of a crisis in the future. It is also possible, of course, that many of the poor understood the workings of the market economy so little that they did not see that a crisis was coming. At the same time, the elites stood to gain from their predation, even though they may have rationally expected a certain proportion of their newly acquired wealth to be eroded by the coming crisis. The severity of the ensuing breakdown, however, created a fault line within this previously stable coalition. The poor revised their mental model of the way that the economy works, redoing their cost–benefit analysis of the probable outcomes of different policy regimes. This rethinking is consistent with the literature pointing to the importance of crises in bringing about shifts in policy regimes (for a review, see Rodrik, 1996, pp. 26–9).

We close this subsection by posing two final questions. What is the chance that the coalition between the elites and the poor will be revived, so that we see the beginnings of a cyclical process reminiscent of Latin America? Moreover, how does the existence of the CBA affect the answer to this query? To the extent that their participating in the coalition was based on a lack of understanding of how market economies function, the crisis may have facilitated a learning process. In such an instance, they may not join in any future coalitions with the rich. However, certain macroeconomic developments under the CBA may provide fertile ground for the poor to redo their cost–benefit calculus and decide that it is

Figure 8.8 Relations among main groups of actors in economy, pre-CBA era.
worthwhile to obtain short-term gains. They may do so even if in the process they dramatically increase the likelihood of an economic catastrophe down the road. We take on these two questions in the next subsection.

**Political economy of CBA era**

We concluded the previous section by noting that the most serious danger facing the CBA is a breakdown in the political willingness to stick to fiscal discipline. Whilst other problems with the CBA’s operation in Bulgaria are possible, our analysis indicates that the political one is the most salient at present. World experience suggests that the relationship between the nature of macroeconomic performance and the political support for the parties whose periods in power coincide with such performance (and their opponents) is not straightforward.

The possible coalition that may oppose the continued existence of the CBA in Bulgaria is a reunion of the rich and the poor from the pre-CBA era, as stylised by Perotti (1996). The major reason why the rich may be interested in joining such a coalition is their desire to continue to extract resources from the state. The introduction of the CBA has severely limited their ability to engage in such extraction. In terms of Figure 8.8, the existence of the CBA has either eliminated or severely limited all the aberrant flows, indicated by the thick arrows.

Figure 8.9 illustrates the effects of the CBA on the extraction project,
depicting the only remaining channel for continuous realisation of profit at the expense of the government. The basis for the existence of this channel is the underdevelopment of the payment and judicial systems. The private firms associated with the extracting elites accumulate payment arrears to other private or state-owned firms, which may be either their suppliers or their customers. The firms victimised by such siphoning in turn run up arrears to their suppliers, and the process goes on until all the arrears are concentrated in a handful of large, state-owned monopolies, such as Būlgargaz (the state gas monopoly), the National Electrical Corporation and Bulgarian State Railways. It then becomes possible to convert the accumulated inter-firm indebtedness into arrears to the budget (including value-added tax, customs and excise duties and social security contributions; see Dobrinsky, 2000, p. 41, Table 5), and to use the political clout of the large monopolies to eventually fiscalise these arrears.

The growing indebtedness of large state-owned monopolies to the budget was recognised by Prime Minister Ivan Kostov as early as the summer of 1998, just a year after the CBA’s introduction (see Kostov, 1998). The problem continued to compound throughout the first two periods of the CBA era. There have been widely varying reports on the exact amount of inter-firm indebtedness and budget arrears. Whilst many such estimates are speculative and do not follow any recognisable methodology, one number may be used to gauge the dimensions of the problem. By mid-1999, Būlgargaz had accumulated budget arrears to the tune of 300 million euro, or approximately 2.5 per cent of GDP. This case is especially telling for the workings of this extraction mechanism. The company used its political ties to convince parliament to fiscalise a large proportion of these arrears, and to reduce and reschedule the remainder by normative act (Būlgargaz zakon, 1999). This and similar developments forced the government, under pressure from the IMF, to adopt a set of measures for decreasing the opportunities to accumulate budget arrears. The progress achieved in implementing these measures is described in the government’s reports on the realisation of its programme between 1997 and 2000 (Otchet, 2000, pp. 73–4; Otchet, 2001, part 5).

Regardless of the volume of resources that this channel is capable of siphoning, it is much smaller than the flows typical of the pre-CBA era. The major reason for the decrease is the presence of the CBA, which credibly tightens financial discipline and forces the government to face up to possible fiscal and quasi-fiscal problems quickly and in a transparent manner. Confidence (Williamson, 1995) and transparency (Enoch and Gulde, 1997) are amongst the major advantages of CBA over other fixed exchange-rate regimes. These two factors make extraction activities costlier, so the elites wishing to benefit from extraction have an incentive to engage in activities aimed at having the CBA abolished.

For entirely different reasons, the poor may also have an interest, at least in the short run, in seeing the CBA abandoned. This is because the
existence of the CBA has forced the government finally to engage in large-scale restructuring of enterprises, which, as noted in the previous section, which led to increases in the unemployment rate through early 2003. However, a lack of support for the CBA on the part of the poor seems to be time-inconsistent. Ultimately, the best hope for this group to raise its standard of living is for the economy to achieve sustained economic growth, which is far less likely if Bulgaria goes back to operating as it did in the pre-CBA era. In any case, articles have appeared in the local media arguing that the standard of living has declined alarmingly in recent years and that the CBA has failed to bring economic growth to Bulgaria, or that the registered economic growth is worthless since people do not feel it; this was especially the case during the early years of the CBA era. As noted by Wyzan (1998, p. 34), before the CBA the elites were skilful in using the media to convince readers of tendentious, self-serving arguments.

The most important consideration is whether the elites and the poor will be willing and able once again to form a coalition against hard budget constraints. The third period of the CBA era marks a convenient time for forging such a coalition. It is precisely during this ongoing period that a systematic effort on the part of the state to close the quasi-fiscal channels for continued extraction naturally coincides with rising unemployment due to accelerated structural change. Whilst we cannot predict such a development with any degree of certainty, our analysis suggests that such an eventuality would pose the most serious threat to the sustainability of Bulgaria’s CBA.

Recall that when we applied Perotti’s (1996) model to the pre-CBA era in Bulgaria, we reversed the usual relationship between the elites and the poor. Rather than the rich agreeing to a redistribution of resources benefiting the latter, the poor acquiesced in a set-up designed to allow the rich to extract resources from the state. Interestingly, in the CBA era, the situation may be more in line with Perotti’s (1996) conceptualisation. Namely, with the elites having lost most of their channels for such extraction, those purporting to represent the poor would have to be the driving force behind the formation of a renewed coalition. It remains to seen whether these elements, who in the past have not had sufficient clout to influence economic policy on their own in Bulgaria, will manage to engage in such collective action.

The first months of 2000 saw such an attempt. The reformist Bulgarian government came under serious pressure first to ameliorate the economic situation, and later to resign. First, yielding to the demands of the poor, it undertook the obligation to keep the costs of heating and electricity down for at least one year, that is, until the next parliamentary elections. This contradicted the obligations previously undertaken by the IMF to continuously raise the prices of these two services according to a predefined schedule. In a sense, the government felt a threat from the poor, to which it attempted to respond. Second, between March and May 2000, the
government came under a sharp political and parliamentary attack, culminating in an unsuccessful no-confidence vote in parliament on 18 May 2000. The mottos of those mounting the attack were that the government was corrupt and that corruption was the reason why the economy was failing.

Whilst these developments reflect a genuine fall in the government’s popularity, the debate accompanying the corruption allegations showed that a coalition between the rich and the poor cannot yet shape the public agenda. In reality, the message heard throughout the debate, and the reason why the corruption allegations gained momentum amongst the public, came from the middle class. This message, encapsulating the main reason why the government was losing popularity, was that the government, whilst moving in the right direction, was not implementing reforms well and that it should intensify those reforms. However, the players opposing reforms (and opposing the CBA as well) were not able to define, shape or lead the debate, even though it is highly probable that they had started the debate in the first place.

These developments were further confirmed in the first half of 2001, when the former king of Bulgaria Simeon II Saxe-Coburg-Gotha entered Bulgarian politics and formed a new political movement. This new formation rapidly gained popularity as an alternative political force, with a style quite different from those of the two major parties that had governed Bulgaria during its transition to date. Majorities in all three major groups of the Perotti (1996) model had reason to be dissatisfied with the status quo. The rich were not seeing opportunities to profit either through extraction (due to the hardening of budget constraints) or through legitimate business (due to incompleteness of reforms and the formation of clientelist groups around the incumbent government). The poor faced high unemployment and lacked expectations for improvement of their employment status or living standards in the foreseeable future. The middle class was dissatisfied with the slow pace of reforms and with the governance style of the ruling coalition.

All three groups saw the new National Movement Simeon II (NMSS) as the bearer of their interests, and they obtained clearly discernible political representation in its formation and decision making. As a result it won a landslide victory in all social groups regardless of their status according to age, education, region, place of residence, occupation or income. In July 2001, Simeon II became Prime Minister of Bulgaria.

The NMSS, viewed through the prism of Perotti’s (1996) model, is a reflection of Bulgarian society writ large. The NMSS reflects the conflicting interests of the different social groups, a fact that one can observe in its governance and decision making. Since the interests of the middle class and of the rich–poor coalition are impossible to reconcile, the NMSS has been unable to keep all its explicit and implicit promises. Calls to increase government spending, open up large budget deficits and circumvent price
liberalisation (see various addresses of Simeon II to the public, e.g. Simeon II, 2001a; Simeon II, 2001b) were effectively checked by reform-minded members of NMSS and cabinet members acting in concert with representatives of international institutions. The inability of the NMSS to keep its political promises has led to a sharp drop in its popularity.

The dissatisfaction of the different social groups in Bulgaria has continued after the blip of optimism surrounding the NMSS’s emergence and victory. That emergence occurred roughly simultaneously with the events in Argentina that led to the fall of its CBA arrangement and the abandonment of the exchange-rate peg and monetary-base rule in the midst of a severe economic and social crisis. The question about the sustainability of the Bulgarian CBA arose again in a series of publications in the Bulgarian press, especially in the financial daily Pari. The public debate lasted for approximately two months, and again the two opposing groups (‘middle class’ and ‘rich–poor coalition’) could be clearly discerned. Once again, the issue was resolved in favour of the preservation of the political will to continue with the CBA, but it would be naïve to imagine that we have witnessed the reaching of a final consensus on the matter.

Both groups ultimately focused on the fact that Bulgaria would be joining the EU and the European Monetary Union (EMU), the latter possibly within a decade of the present. They broadly agreed that hastily dropping the CBA would prevent the country from enjoying the benefits of joining the EMU. The presence of a clear and visible exit strategy from the CBA in Bulgaria explicitly played a role in the policy debate, contributing to its sustainability. Such an exit strategy is also present in Lithuania and Estonia, and has played a role in the public debate in the former. Conversely, Argentina did not have such an exit strategy, arguably depriving the Argentinian CBA of an important pillar of sustainability. This observation supports the notion that the formulation of an exit strategy in the initial design of a CBA is pivotal for the arrangement’s sustainability.

**Conclusion: how sustainable is Bulgaria’s CBA?**

In this chapter, we have outlined some of the more important developments characterising Bulgaria’s transition to a market economy. Unique to the Bulgarian case, it introduced a CBA in order to make a fundamental break with malfunctioning institutions, which had driven its economy into an abyss. We have divided the Bulgarian post-communist transition period into two eras, the dividing line between which occurs when the CBA is introduced. The first era was dominated by extraction from the state by strategically situated elites. These elites formed a coalition with the poor, with the former benefiting from an opportunity to extract resources from the public domain with impunity. The latter preferred having guaranteed jobs in the short run, rather than accepting the risks of authentic market
reform, even if such reform would have benefited them in the long run. This process led to a continuous decrease in the economy’s productive capacity and a series of crises punctuating periods of relative calm.

The CBA’s introduction in July 1997 severely limited the elite’s opportunities for extraction from the state. The tangible results from this move include financial stabilisation and what seems to be the beginning of a period of economic growth. Data on quarterly GDP, inflation and interest rates indicate that the economy stabilised fairly quickly under the CBA, indeed faster than in other transition countries employing such arrangements. At the same time, other macroeconomic indicators point to possible problem areas for the future. These include the trade deficit and unemployment, as well as the real exchange rate and real wages as indicators of competitiveness. Unlike certain other authors (e.g. Dobrinsky, 2000), however, we do not find recent internal and external trends particularly alarming. We consider only moderately large and mildly rising current-account deficits and a relatively high unemployment rate as problematic. However, unemployment fell sharply in 2003, and the current-account deficit has neither caused an overall balance of payments deficit nor hurt the growth of exports; it is presumably the latter two indicators that matter for the health of the CBA.

Our analysis of the operation of Bulgaria’s CBA reveals the importance of the political process for the sustainability of such policy regimes. Whilst it seems unlikely that movements in macroeconomic variables will cause the arrangement’s demise, it is certainly possible that an anti-CBA coalition may reappear between the rich and the poor. The rich have clung to the few (albeit smaller) remaining channels for extraction and would like to expand them, but progress in economic restructuring may cause those channels eventually to disappear. Meanwhile, the poor were hit by economic reforms in the early years after the introduction of the CBA, mainly through rapid rises in unemployment due to lay-offs at liquidated or privatised SOEs. Both groups would like to receive transfers from other social groups (especially the middle class), but the CBA effectively prevents such transfers, at least on a significant scale.

We conclude that it is highly unlikely that macroeconomic imbalances alone will lead to the failure of Bulgaria’s CBA. Nothing in the behaviour of macroeconomic variables provides any grounds for suspecting that the economy may experience uncontrollable turbulence in the near future. However, the CBA’s very success in stabilising the economy, building up confidence and the foreign reserves and stimulating structural reform may yet make it vulnerable through the political process.

The over 5,000 million euro in foreign reserves as of the end of December 2003 represent an attractive target for elites inherited from the communist regime that specialise in extraction from the state. The poor would not benefit directly, of course, from the formation of a regime conducive to another round of extraction, but may value the higher job security
associated with a softening of budget constraints. The only salient threat to the CBA’s long-run sustainability would come from a re-formation of the rich–poor coalition from the pre-CBA era.

There are a number of possible directions that future research on this topic may take. One such direction would be to integrate the results of surveys on popular attitudes towards the economic situation during the pre-CBA and CBA eras. Another direction would be to extend the analysis to include case studies of other transition countries employing a CBA, especially Lithuania, where such an arrangement was also introduced after a period of unsatisfactory macroeconomic performance. Finally, the political-economic relationships that we have analysed in this chapter provide fertile ground for formal modelling and empirical work.

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Notes

1 Between 1994 and 1997, the ratio of corporate losses of loss-makers to GDP ranges between 8 and 16 per cent (see Dobrinsky, 2000, p. 41); for more details, see Avramov and Sgard (1996).
2 Later dynamics in dollar wages are dominated by the large depreciation of the US dollar.
3 After 1999, real GDP exhibited accelerated growth, exports were growing and real wages were increasing relatively slowly.
4 The index is based on real output indices, employment and nominal salaries in the mining, manufacturing and electricity–gas–water sectors. (Source: National Statistical Institute and authors’ calculations.)
5 Although we are concerned in this essay largely with economic performance in Bulgaria, it is useful to note that recent cross-country empirical work by Ghosh et al. (1998) finds that CBA appear to have important advantages. For example, they discover that inflation under CBA is approximately 4 per cent lower than under other pegged exchange-rate schemes, and, more interestingly, that this difference is far more due to a ‘discipline effect’, reflecting increased confidence manifested in increases in money demand, than to slower money growth. They also find that countries operating CBA exhibit more rapid GDP growth and smaller fiscal deficits than those with other pegged exchange-rate regimes.
6 In his empirical work, which is based on regions within the Visegrád countries, Fidrmuc (1999, Chapter 3) includes such other economic variables as the percentage of small private entrepreneurs in the population, the share of industry and agriculture in employment, average wages and a number of demographic factors. However, his theoretical model is driven by the dynamics of unemployment.
7 Another channel for extraction is inherently temporary in nature. It uses the
traditional methods of siphoning from SOEs, and then relies on the state’s assuming all the debts of these enterprises upon privatisation. Thus, these debts are fiscalised as well. This channel is not depicted in Figure 8.9 because of its one-time aspect. The fact that extraction of this type can only occur until an SOE is privatised clearly demonstrates that structural reform is a powerful tool for limiting the opportunities for extraction.

8 In Bulgaria the figure of the ‘foreign debt’, which is an inanimate object in Perotti’s model, is in reality an active participant in political and social life. Even though Bulgaria has a substantial actual foreign debt, it is much more accurate to think of the ‘foreign debt’ variable as the external conditionality on structural and macroeconomic policies that the international financial institutions and the EU have imposed on the country.

9 Data from different polling agencies indicate that the NMSS, the government and the Prime Minister lost the trust and approval of about two-thirds of their supporters between August 2001 and December 2003.

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9 The political-economy trap and economic reform in Russia

Barry W. Ickes

Introduction

Transition in Russia has led the economy to evolve into a cross between plan and market: a mutation known as the “virtual economy.” The result of this evolution is an adaptation of behavior that makes structural reform more difficult to implement than in the earlier stages of the process. The purpose of this essay is to explain why this is the case.

The most puzzling aspect of the transition in Russia has been the lack of impact from the adoption of efficiency-enhancing reforms. Mass privatization has transformed the ownership structure of Russian industry. Despite these reforms, however, the economy has not generated improved economic performance. There are two ways to think about this. First, this could be due to poor implementation of the reforms. Well-designed reforms may not achieve their intended effects because the proof is in the details. Second, reforms fail to have the intended consequences because of behavioral responses that were not anticipated.

In this essay I argue that the particular form of evolution that has taken place in Russia has generated a particularly severe political-economy trap. The evolution of Russia’s virtual economy has been studied elsewhere (Gaddy and Ickes 2001). Here I examine the implications of this system. In particular, I ask why it is so difficult to implement efficiency-enhancing reforms in this environment. The argument focuses on the role of uncertainty over the distribution of value in the Russian economy, and on the implications of this uncertainty for predicting the individual-specific effects of reforms.

Status-quo bias

The delay in adopting efficiency-enhancing reforms has been studied widely in the economics literature. It is straightforward to understand why reforms that impost costs on some parts of the population fail to be implemented. It is more difficult to understand why reforms that are potentially Pareto improving are delayed. There are many potential explanations that have
been discussed in the literature. Some emphasize public-good aspects of policy changes that lead to inaction. Others point to differences between policymakers and the public over the desirability of policies. This essay focuses on another important strand in this literature that stems from uncertainty over the personal benefits that will accrue from policy changes.

One important analysis of nonadoption of policies focuses on the status-quo bias (Fernandez and Rodrik 1991). This literature is interesting because it answers the question of why people who may, in fact, benefit from the policy changes nonetheless oppose them ex ante. This arises from incomplete information about what will happen to the individual once reform has taken place. This essay explains how the institutional legacy of planning, combined with the development of the virtual economy, greatly complicates this fundamental uncertainty about the implications of reform. My argument is that these factors seriously enhance the force of the status-quo bias.

There are two critical elements to the argument, and both are relevant to our discussion. First, there is heterogeneity across parts of the economy as to the benefits of reform, and heterogeneity within sectors as to who, specifically, would benefit from it. In the simplest example of trade liberalization, there are two sectors: in the exporting sector all workers benefit from liberalization. In the import-competing sector some lose, while others move to the expanding exporting sector (at some cost). Suppose that after the reform enough workers will switch sectors so that a majority of the population benefits. Ex ante workers in the import-competing sector do not know if they will be among the winners. Hence, it is possible that all the workers in this sector oppose the reform—and constitute a majority of the vote. This is due to uncertainty over who will make the move. The second key element of this argument is the impossibility of ex post compensation. This is obviously crucial to any explanation of why reforms that benefit a majority are not implemented.

The status-quo bias arises because reforms that are adopted but ex post hurt a majority of the population can be reversed, but policies that are not adopted can never be reversed. Hence, individual-specific uncertainty biases policy towards the status quo (Fernandez and Rodrik 1991).

Notice that in the standard model of status-quo bias agents know their current incomes but are uncertain of their incomes in the reformed state. What is interesting about the Russian case is the extra degree of noise. Not only is there uncertainty about what incomes would be in the wake of reform, agents have only a noisy signal of their current productivity. Moreover, because of an inadequate public sector households engage in a personalization of safety nets. This makes them less dependent on public sources, but more dependent on the distribution of value via the virtual economy. The “loot chain” that results implies that current incomes do not necessarily reveal much about true productivities. This adds to the status-quo bias because reform will bring about non-marginal changes.
Virtual economy

There are two key features of the virtual economy: value destruction and pretense. It is the combination of these two features that is the essence of this peculiar system.

Soviet roots of the virtual economy

The roots of Russia’s virtual economy lie in the largely unreformed industrial sector that the new nation inherited from its Soviet predecessor. At the heart of the phenomenon are the large number of enterprises that still produce goods but destroy value. An enterprise destroys value when the value of inputs purchased from other enterprises exceeds the value of the output that is produced. To assess whether value is created or destroyed, market prices are crucial. The same configuration of activities can produce value at one set of prices and destroy it at others.

In the Soviet economy, energy and raw-material inputs were under-priced. Their prices were based on the operating costs of extraction and were separated from the world market, thus ignoring opportunity cost. This bias in raw-material prices fed into the system of industrial prices. Heavy consumers of energy were, in effect, subsidized. So too were heavy users of capital, thanks to the absence of interest charges. In short, costs of production were calculated on the basis of an incomplete enumeration of costs.

The fact that the pricing system disguised the relative efficiency of various activities meant that only with economic liberalization would the true viability of these activities become apparent. Many sectors that appeared to be creating value turned out to be destroying value once prices moved to reflect all relevant costs. This effect was magnified by the shift to world prices. Many industrial enterprises could not cover costs once prices moved to market-clearing levels. Raising prices only led to unsold output. Price liberalization revealed the extent to which value added in the Soviet economy was really created in the energy and raw-materials sector, but it had a destructive effect on the manufacturing sector.

That was the time at which industrial managers made critical choices regarding the way they would behave. Would they restructure or would they adapt to the new reality in other, nonmarket, ways? For many of the enterprises restructuring was not a possible option. The Soviet economy was too extreme an example of value redistribution as compared to, say, Eastern European countries such as Poland, Hungary, and others. Price liberalization appeared to leave many enterprises no option but bankruptcy and closure.

Thus the managers of nonviable enterprises began looking for ways to preserve the system of value redistribution. Here, one key difference
between the Soviet economy and the current Russian economy should be discussed. Under Soviet conditions of directive planning the transfer of value from energy and raw materials to industry was merely an accounting exercise. In the Russian economy, on the other hand, the transfer of resources from energy and raw materials to industry had to be induced. The transfer of value was no longer simply an accounting convenience. It now reflected a redistribution of income. To maintain this, the owners of assets that were contributing value had to be induced to do so. This was accomplished by utilizing so-called relational capital accumulated by enterprise directors through years during the Soviet period.

In Soviet times, personal relations, connections, and influence (*blat*) had important value to the functioning of the system. The primary benefit to the director lay in an increased ability to fulfill the production plan developed by the central authorities. However, in the highly distorted regime of central planning, supply failures were a constant feature of economic life. Relations with local party officials and with other enterprise directors were often crucial to obtaining scarce inputs. In the late perestroika era, and even more during the economic reform period, the autonomy of the director increased as the force of the plan weakened. One consequence of this was that directors obtained the ability to appropriate the returns of their enterprises to support the relationships they had developed. To keep value-destroying enterprises operating, the directors utilized relationships to obtain inputs and find customers. If the enterprise had produced marketable products, these relationships would have been of far less importance.

The fact that many enterprises continue to operate despite the fact that they destroy value is at the core of the virtual economy. It is precisely the need to keep these enterprises in operation that necessitates value transfers between the productive sectors of the economy and the lossmaking sectors. These value transfers are the sustenance for the lossmakers, and this sustenance is critical to keep these enterprises, and the individuals who depend on them, afloat. But this value transfer also diverts resources from the productive sectors of the economy, and acts as a tax on restructuring.

The pretense at the heart of the virtual economy is the denial of the fact of value destruction. It is the myth that lossmaking enterprises are not fundamentally non-viable, but rather the victim of transitory bad luck (or policy). This pretense is important because it reinforces the need to continue the value transfers. The main argument of this essay is that pretense is the primary barrier to restructuring in Russia. It exacerbates that uncertainty that agents have about the individual-specific effects of economic reform.
Privatization lottery

To fix ideas it is useful to consider the privatization lottery (Gaddy and Ickes 1998a). This is a rather stylized way to think about the process of privatization in Russia. The purpose of the analogy is not to describe the details of the privatization process, but rather to point out the implications of privatizing assets the value of which will only become clear ex post.

When the drive to privatize state-owned property was launched in post-Soviet Russia, few Russians had a clear idea of their own true value in a market economy. The reason was that, as explained in Ericson (1999), the Soviet pricing system concealed the true value of production and thus of all the various assets in the economy. Privatization demarcated the nation’s formerly state-owned assets into specific bundles and assigned ownership to them. This was a very different process than privatization of state-owned property in a market economy. In a market economy, even state companies had a market valuation. But in Russia, privatization—redistribution of ownership of assets—was taking place at the same time as liberalization—revaluation of those assets. As a result, privatization in Russia was tantamount to giving everyone a lottery ticket. People did not know whether they had won, and what, until later. This lottery, as it turned out, was to have very few winners and many losers. In retrospect, this should not have been so surprising because we know that wealth creation in the Soviet economy was concentrated in relatively few sectors, of which oil, natural gas, and nonferrous metals were the most prominent. These were handed over to a small number of individuals. The rest of the citizens received pieces of various other industries, most of which would turn out to have little value.

To better understand the nature of the privatization lottery, let me present an extreme version. We will assume that all of the value in the economy is produced by Gazprom; all other industries contribute no value. This implies that the lottery has only one winning ticket: Gazprom. Every other ticket is a loser. Suppose further that after the privatization lottery has been held, the government strictly and completely enforces this outcome. That is, the winner’s ticket is redeemed, the prize is awarded, and the winner’s rights are guaranteed absolutely. Moreover, the government makes no attempt at further redistribution—in other words, the lottery prize is “tax free.” The shareholders of Gazprom have all the valuable assets, and everyone else holds assets with no market value. This is a pure “winner-take-all” model of asset distribution. Let us refer to it as the lottery distribution, or \( L \)-distribution.

Of course, there are many possible alternatives to the \( L \)-distribution. The extreme opposite case to the \( L \)-distribution would be one in which the government were to break up Gazprom in such a way that its assets are equally distributed to every Russian citizen. Let us refer to this perfectly equal distribution as the \( E \)-distribution. As designed, Russia’s privatization
scheme was in principle the $L$-distribution. But Russian society was unwilling to accept the $L$-distribution; especially once it became clear what had happened.8

My purpose here is not to offer an alternative scheme for privatizing Russia’s assets.9 Rather, my concern is with the implications of the way privatization was, in fact, implemented. The key point to recognize is that in this process the political and social reality of Russia expressed itself. Russia is a democracy. And if we assume that there existed (and exists) some minimally acceptable level of inequity among the Russian population, it follows that there were limits on how close to the $L$-distribution the outcome of privatization would be allowed to come. In real-world terms, there were limits on how much value owners of Gazprom could obtain. As a result, there had to be a mechanism to redistribute some of the value produced by Gazprom among the other lottery-ticket holders.

That mechanism was the virtual economy. By helping redistribute Gazprom’s value, it was a way of making Russia’s privatization lottery more equitable, a means of paying off on more tickets. It is the outcome of a bargaining game between agents in the economy over the value of the lottery tickets. The reason that this game is played is because it is politically impossible to enforce the $L$-distribution in a democracy in which equity norms differ substantially from those of that extreme “winner-take-all” outcome. Consequently, Gazprom must pay off other parts of society to retain some share of the value that is produced. This bargain determines where the economy ends up between the $L$-distribution and the $E$-distribution.

In Russia, privatization of state-owned enterprises as a policy was an essential element of market reform. Indeed, it was the cornerstone of the imperative to introduce a free-market economy. What was impermissible was not the policy, but (some of) the consequences of that policy. As the desired policy began to be implemented, it became apparent that it was going to have effects that simply could not be tolerated. In principle, one reaction might have been to reject the policy in toto. That was not done, because to reject a policy such as privatization, or divestiture, would have been tantamount to rejecting the imperative of introducing free markets. So the appearance of the policy was retained while its actual substance was modified. This was the route to the virtual economy.

For the sake of completeness, one ought to also consider another possible reaction to the case of impermissibility. Since it is the consequences of the policy, and not the policy itself, that is impermissible, might there be a way to implement the policy but correct the impermissible policy impact in ways not inconsistent with the policy? Take, for instance, the case of Russia’s privatization lottery. Could not the Russian government have allowed the winner-take-all $L$-distribution but then corrected the impermissible result—inequity—by means of heavy taxation of Gazprom and subsequent redistribution of wealth? Such a policy would be acceptable in a market economy. So why did that not happen? There are many
partial explanations, but perhaps the best explanation is that nearly all segments of Russian society refused to acknowledge the nature of the lottery. They did not want to admit that Gazprom was the only winning ticket. They wanted to believe that the rest of the economy was (or at least soon and relatively easily could be made to be) valuable as well.

The virtual economy, whose mechanisms allow Gazprom to subsidize loss-making manufacturing enterprises in a nontransparent way, upholds the pretense that many manufacturing enterprises are much better off than they actually are.

Thus, in principle, in strictly accounting terms, we have two approaches:

1. \( L \)-distribution with a transparent tax on Gazprom (\( L_G \)), and
2. \( L \)-distribution with the virtual economy (\( L_V \))

Note that each of these approaches can achieve the same final result, namely subsidization of enterprises in the manufacturing sector, \( M \). Where they differ fundamentally is in the degree of transparency about what is really going on. In the first case, it would be apparent to all not only that Gazprom is supporting the rest of the economy, but to what extent it does so. It would make transparent the cost of subsidization and hence reduce the resistance to reform. It would also make evident the extent to which all of the wealth redistributed from Gazprom is going only to \( M \) and that, as a consequence, other parts of society get none. Lack of transparency makes it easier to maintain the status quo, as it keeps hidden the fundamental resource transfer that supports the system.

The key question for understanding the reform in Russia is why the second approach has been the solution.

The non-transparent solution

Why do we not get the transparent solution to the privatization lottery? Given that the virtual economy pays off more lottery tickets than in the \( L \)-distribution, why not simply effect the same distribution without the virtual economy? The reason, of course, is that the virtual economy makes winning tickets out of politically powerful agents. Without the virtual economy distribution relational capital would lose value.

Just as enterprises differed in the amount and quality of physical and human capital they inherited from the Soviet era, so too they differed in their inherited relational capital. Some enterprises (or their directors) had very good relations with local and/or federal officials. Relations with other enterprises also varied. What kind of relations, with whom, how solid they were, and so on, can be thought of as the enterprise’s “stock” of relational capital. It is this stock that determines the types of transactions that can be supported (barter instead of cash payment, pre-payment or not, etc.). To put it another way, relational capital, \( r \), is goodwill that can
be translated into the ability to survive when the distance to the market, $d$, is high.$^{11}$

While we can, in general, think of $r$ as support for informal activity, in the Russian case it takes on a particular aspect that we emphasize: high $r$ enterprises can escape the strictures of the budget constraint. Enterprises with high $r$ can delay payments or barter at inflated prices when other enterprises, with poor $r$, cannot. Relations thus serve as a substitute for financial responsibility. There are many economies where relational capital is developed but enterprises still are financially responsible. In Russia, the use of $r$ to evade responsibility is an important element.

What was not recognized in Russian privatization was that at the same time that physical capital was privatized, so too was relational capital. Relational capital was a vital asset in the Soviet system. Its privatization was one of the most important results of economic reform in Russia. In the Soviet Union enterprise directors relied heavily on the accumulation and use of personal connections or “pull,” known colloquially as $blat$. $^{12}$ Blat was critical to performance, especially fulfillment of the economic plan, in the highly distorted regime of central planning, where supply failures were a constant feature of economic life. Relations with local party officials were often crucial to obtaining scarce inputs. As Grossman has emphasized, informal economic activities were an essential feature of the Soviet economy. Plan fulfillment required enterprise directors and their $tolkachi$ (expediters) to utilize informal skills. Their ability to accomplish this, and their position in the economic hierarchy, was critical to their incomes. But directors and tolkachi earned income from these positions; they did not own the source of these incomes.

The importance of $blat$ in the Soviet economy was critical to the formation of what Gregory Grossman called the “loot chain.” $^{13}$ In any economy where side payments are widespread the incomes of individuals are a composite of flows from different sources. The proliferation of payments throughout the economy makes it very difficult to understand the value contribution of an agent’s activity.

The demise of the planning system, which began already in the late perestroika period, began the process of privatizing relational capital. Gorbachev’s reforms had the effect of increasing the autonomy of enterprise directors. With the start of economic reform and privatization, the role of the enterprise director increased; other mediating actors (planners, party officials) no longer played a role in economic allocation. Directors used this opportunity to privatize their relational capital. That is, they obtained the capability to appropriate the returns to the relationships they had developed and cultivated under the previous system.

But in order for directors to appropriate these returns, the enterprises had to continue to operate.$^{14}$ Much of the relational capital was enterprise specific. The primary form of these connections was in relationships with directors of other enterprises, often in related lines of activity. The
director could not cash this out. Instead, in order to appropriate these rents, it was crucial to keep the enterprise operating. The privatization of relational capital is thus an important part of the explanation of why directors fought to keep open enterprises that had few prospects in the market economy.

But it is important to note that it is not just directors that want to keep these enterprises operating. If the enterprise does not operate the relational capital does not bear value. The survival interest of workers is also at play here. Given their dependence on the enterprise for their personal survival they accept the director’s exploitation of relational capital to keep the enterprise open. This is the implicit bargain: directors are allowed to steal for themselves as long as they steal for the enterprise.

Relational capital was also important in the old regime, but there it was used to prop up the state interest. Under planning enterprise directors often relied on the services of local government and party officials to help them fulfill plans. Clearly some of this activity led to diversion for personal profit; but the primary motivation for this activity was the need to fulfill plans. Hence, we can argue that relational capital was primarily directed towards state interest under planning.

In the current environment, however, relational capital works against the state interest, if that is taken to be market reform. Relational capital is typically used in ways that frustrate market reform. The reason is that the primary use of relational capital is to soften budget constraints. Enterprises that lack effective demand for their goods at cash prices that would cover costs use relational capital to survive. Use of offsets and other non-monetary transactions is an alternative means of survival.

**Relationship to rent-seeking**

How does this argument relate to the notion of rent seeking? It is often argued that the contest for rents in Russia is the critical barrier to economic reform. Because the political system has rents to distribute, entrepreneurs focus on influence activities rather than on restructuring. A modification of this view is given in Shleifer and Treisman (1999), where it is argued that in order to co-opt stakeholders that would resist reform it was necessary to create rents that could be used to buy these agents off. This argument suggests that rents are endemic, and indeed, endogenous in the transition environment, but it is crucial to prevent the pursuit of these rents from inhibiting real restructuring. In either case, however, rent-seeking is viewed as a strictly unproductive activity.

It is interesting to compare rent-seeking with investment in relational capital. Clearly the concepts are related. Both involve the diversion of effort and resources away from directly productive activities. Notice, however, that rent-seeking does not provide a productive function, whereas relational capital can. Investments in relational capital pay off
when agents can engage in activities that cannot be enforced by contract. The trust created by relational capital enhances the opportunities available to agents; this is especially important in the transition environment where contract enforcement is so very weak. Thus, relational capital can play a directly productive role—as with trust—in reducing transactions and contractual costs.  

Relational capital is not always used for productive purposes, however. Enterprise directors can exploit relational capital to promote enterprise survival. While this is individually rational it may be socially inefficient. Here the contrast with rent-seeking is most informative. Rent-seeking is destructive because agents undertake activities which waste resources to obtain already produced value. Exploitation of relational capital also results in wasted resources to the extent that lossmaking enterprises remain in operation, and it is used to redistribute value that is produced elsewhere. The particular difference is that the waste of resources in the case of relational capital includes the production that takes place through its use.

The problem with relational capital is that its value may depend on the postponement of reform. Relational capital has value because it is a non-market means of allocation and distribution. Relational capital is useful in enabling enterprises to avoid the consequences of budget constraints. True market reform may eliminate this possibility. Hence, market reform may result in the dissipation of the value of relational capital. The possibility of early dissipation encourages intensive use of this form of capital.

The key element was privatization of relational capital; this set the stage for virtual economy. Proper reform would have eliminated them. But this would have required side payments to buy off all other interests who live off the relational capital of the director.  

**Personalized safety nets**

An important development in Russia has been the *personalization* of the social safety net. As value runs out in the degenerative virtual economy, the active part of the economy shrinks. As the public sector fails to perform its role as safety net and protector, the population has to rely more and more on its personalized, household safety nets. Households survive wage arrears and loss of benefits by insulating themselves as much as possible from the cash economy. Personalization takes many forms. Among these are the traditional rural plot. More interesting in the current situation, however, would be police “charging for services” in lieu of wages, or a library that receives no budget allocation and instead rents out space to retailers. The essential feature in this activity is coping by converting assets they work with to an alternative, income producing use. These agents have no other buffer. In effect, they self-insure.

The self-insurance generated by personalized safety nets enables households to cope, albeit quite imperfectly, with a shrinking public sector.
Fragmentation of taxing authority

The virtual economy thus creates a vicious circle. Less cash is paid into the budget due to the proliferation of non-monetary transactions. This, in turn, leads to more desperation on the part of individual agencies to get cash on their own. They resort to a form of “tax farming,” or privatization of tax collection for their own survival.

A very special case arises if a government agency itself has the power to extract cash directly from a taxpayer. Who can do that? Law enforcement, the customs, etc. The customs police are a good example. They collect fees which they are supposed to remit to the center. Meanwhile they are being underfunded. What do they do? They collect exta and remit the standard customs fee.21

This is often mistaken for corruption, that is, personal gain. This is somewhat different. These are different from bribes, because they are apparently being reported at the local-agency level—as both revenues and expenditures. They are expenditures to keep the local branch of government, whether notionally local or federal, functioning. There was even a point at which it was officially sanctioned. (It may still be sanctioned, albeit informally.) There is really no limit to this, though. The idea is that if I am a government employee, endowed with some revenue-generating ability, whether taxing “authority” or some tools (a truck, for instance), and I am not being paid by the government budget, then I am entitled to use whatever means I have at my disposal to ensure my living standard at a minimum level. Since this level is so low, no one can really object. It is not legal. But it is defensible in the eyes of nearly everyone. It is the mentality of the collective farm that has been “privatized.” It is very much in the spirit of privatization in Russia. It has become standard practice. A town like Zarechny could beef up its local police force by allowing them to operate kiosks to earn extra cash.22 Its public librarians in spring 1999 went on strike, not for more money from the budget (they knew there was none), but for the right to earn their own money using city property.

This fragmentation of value collection for the public sector, every agency for itself, is already one negative effect of the virtual economy’s pretense, the “virtual” budget. There is not enough value to go around, and the government itself is not doing the job of referee, so agents of government act on their own. There is some temporary implicit deal on who gets what, through all these various bottom-up mechanisms. Then, one day, the federal government implements the cash-collection campaign, the crackdown. This might be preferable to the anarchistic system that prevailed before, if the federal government (1) effectively prohibited them from collecting on their own, which in turn is likely to happen only if the federal government (2) uses the cash it collects to substitute for the extra cash sources the agencies had.

If, on the other hand, the federal government collects the cash for
entirely different purposes, e.g. debt repayment, the situation will be worse than ever. The agencies will continue to collect payments in their disjointed way, at the same time the federal government collects more cash.

**Implications of fragmentation and personalization**

The key issue associated with fragmented tax authority is similar to that of the personalization of the safety net: people’s standard of living depends on a set of implicit, or informal, transfers not related to the formal cash flows in the economy. Agents’ survival depends on these flows and it becomes very complex to distinguish one’s market value from these side payments. Hence, there is great confusion about the effects on an agent of market reform.

The weakness of the central, national government is exacerbated by the virtual economy’s natural tendency towards more localism. Self-protection is the essence of the virtual economy. But in the Russian virtual economy of the late 1990s this has gone rather far. There is too much self-protection. Or rather, it has fallen down to too low a level. In the ideal virtual economy, the government—the state—keeps the self-protective circuits at a relatively efficient level. It does so by acting as coordinator — choosing among competing uses for limited value. It also has to stop bad leakage (stealing “from the plant”). If it doesn’t do these things, the virtual economy itself is threatened. Then things degenerate down to the level not of the virtual economy but of household economy.

**Government behavior**

Up to now we have treated government behavior as exogenous. We have assumed that enterprises choose how to apply effort and how much to invest in distance reduction versus relationship capital taking the government’s behavior as given. Even in this case the problem for enterprises was rather rich. But government policy, especially with regard to the willingness to engage in tax offsets in lieu of cash payments, is a choice variable. In particular, it will depend on the characteristics and initial conditions that policymakers face. This is especially true when we think about regional governments.

Just as enterprises differ in their endowments of distance and relationship capital so do regions. Some regions are endowed with natural resources that can be easily exported (e.g., Tyumen Oblast with its huge reserves of oil and natural gas). Other regions are dominated by industrial dinosaurs that are characterized by high $d_i$. It is thus useful to think of the average distance of the region, $\Delta_r$, which we can define as the unweighted average of the $d_i$ of the constituent enterprises. A region endowed with many lossmaking enterprises (e.g., Ivanovo) would have a high $\Delta_r$, and
vice versa. The key difference between regions with low and high $\Delta$ is the marketability of output. A region with low $\Delta$ will have more cash in circulation, while regions with high $\Delta$ feel the burden of the cash constraint to be much tighter.

Relational capital also varies by region. Because relationship capital is necessarily personal and idiosyncratic, we are primarily identifying with the capital of the regional administration, essentially the governor. The relationship capital of a regional governor is the result of personal history and investments in maintaining relationships. It may also be related to the connections between the regional leadership and the federal government. These relationships were especially important in the Yeltsin regime. Let us denote the relationship capital of region $j$ as $\Theta_j$. A region with high levels of $\Theta_j$ is able to obtain a better deal for tax offsets than a region with a low level of relationships.

We can thus think of regions as having an initial stock of $\Delta_j$ and $\Theta_j$. Just as with the enterprise, the attitudes and policies chosen by regional officials will depend on these endowments. For example, we would expect regions with high $\Delta$ and lower $\Theta$ to be more likely to choose pro-market policies. Just as the choice of reform policies can affect the subsequent evolution of the region, the initial conditions of the region impact on the attitudes of the leadership to reform. The same leaders might choose different policies were they to find themselves in power in other regions. Certainly the same arguments would be less effective in different regions.

An important result of this analysis is that in regions where the average market distance is greater, effort choices will be biased towards non-cash taxes. In such regions the relative price of non-cash goods will be high relative to the case where distance is lower. Enterprises will tend to invest in relations rather than reducing distance. This suggests that regions that start out with high $\Delta$ and high $\Theta$ may get stuck in non-cash traps. Initial conditions result in policies that raise the relative return on non-cash activities. This biases investment decisions toward increasing relational capital rather than reducing distance. This means that the governors of such regions will have even more incentive to bias policies in favor of non-cash activities. Of course, the opposite will hold true in regions that start with relatively low $\Delta$ and low $\Theta$. In such regions policies are biased towards cash, and this favors further investment in reducing distance.

Over time the evolution of the virtual economy thus results in a bifurcation of regions. Some regions with relatively good endowments of physical capital will be more willing to induce cash payments, while other regions will emphasize non-cash transactions. In these latter regions, relational capital will be the key currency. This equilibrium may be stable. A region where non-cash activity prevails increases the cost to any enterprise that chooses to reduce distance. Without investments in relational capital any cash income will be immediately taxed away.
Addiction

In the equilibrium we observe that in some regions reliance on tax offsets and other virtual strategies grows over time. Officials in such regions become addicted to these sources. This is the consequence of policies that dissuade enterprises from investing in distance reduction.

As one side invests in relational capital the recipient becomes dependent on it. Enterprises and officials become mutually dependent on offsets and bribes. It is not too far fetched to compare this with the relationship between a pusher and his junkie. The more the junkie uses drugs the more addicted he becomes. The same phenomenon is at work in the virtual economy. The more an enterprise adopts such strategies the more dependent it becomes on them. Producing goods that cannot be sold for cash but can be used to obtain tax offsets market it harder to exit this trap in the future. Just as using drugs saps the health and vitality of the drug addict, the enterprise that produces for tax offsets rather than the monetary economy concedes the battle to remain competitive.

It is important to emphasize why this addiction weakens the enterprise over time. The key reason for this is that an enterprise that does not invest in reducing \( d \) finds its competitive conditions worsening over time. This is a condition of operating in a globally competitive environment. Stagnation does not mean that \( d \) remains constant. Rather, it increases as other enterprises enhance their productivity. Hence, just as with the drug addict, the enterprises become more addicted to the behavioral strategies adopted to ensure survival. They may be myopically rational, but they worsen the enterprise’s opportunities over time.

Hence, the addiction to the behavioral strategies associated with the virtual economy increases the difficulty an enterprise or region will face if it tries to escape this equilibrium. The enterprise that chooses to invest in \( r \) rather than reducing \( d \) becomes more dependent on the region continuing to accept offsets and barter. The region that encourages tax offsets encourages enterprises to invest in \( r \) rather than reducing \( d \). Hence, these enterprises are more dependent on future tax offsets. Just as with drug addiction, the virtual economy is a condition that is painful to overcome.

Argument

The key issue for a potential voter is to ascertain how real market reform impacts on his/her standing in the loot chain. With personalized safety nets, relational capital, and fragmented tax, authority agents face a signal extraction problem. The question they face is how they will personally fare from a reform that will improve aggregate performance.

The status-quo bias is rooted in two themes we have already examined. The first is the “loot chain,” the notion that people’s incomes depend on a complex and nontransparent process of redistribution of value in the virtual economy that not even participants themselves comprehend. Given
their uncertainty over how they would fare in a transparent system, they prefer to stick to the current state. Even if they believe that the aggregate economy would improve from the move to the market, individual-specific uncertainty may cause a person to oppose any change. And because the virtual economy guarantees that such uncertainty will be widespread, the status-quo bias may be quite powerful.

The second cause of the status-quo bias is the process of “personalization” of social safety nets in Russia. As value runs out in the degenerative virtual economy, the active part of the economy shrinks. As the public sector fails to perform its role as safety net and protector, the population has to rely more and more on its personalized, household safety nets. They have no other buffer. In effect, they self-insure.26

The self-insurance generated by personalized safety nets enables households to cope, albeit quite imperfectly, with a shrinking public sector. Personalization further exacerbates the bias against reform because any serious effort to dismantle the virtual economy would threaten precisely these informal networks that agents have created to self-insure, thus further adding to their uncertainty. Hence, the risks to individuals of policies that would generate a more transparent regime are quite severe.

Consider the bargain that households in Russia would face in choosing to eliminate the virtual economy.27 Real market reform requires trading non-cash and virtual incomes for an unknown share of a larger pie. To support reform the agent must trust that if these virtual and non-cash incomes are converted to cash that they will get their fair share. The virtual economy localizes incomes while market reform generalizes them. For reform to be acceptable agents must expect that they will be compensated for the loss of virtual incomes. Not just that performance will improve, but that these gains will be distributed. Now the more transparent regime would increase aggregate resources. In principle, then, publicly provided safety nets could replace personalized ones. Because the former are more efficient than the latter, households would be better off if such systems could be established. But this possibility is not sufficient to induce households to support reform. Households would also have to believe that public systems would actually be created, and would function effectively, to replace the personalized ones. In other words, they would have to expect that the extra resources would not be diverted to other ends. In the context of the Russian transition such an expectation would be very hard to generate.28

The status-quo bias is thus reinforced by cynicism concerning government policies that has developed during the transition, not to mention the Soviet period. This cynicism implies that households will question policies that improve aggregate performance and promise government support for those who lose in the bargain. Personalized safety nets may be highly inefficient, but they have the advantage that the particular individuals are in charge—there is no reliance on Moscow to deliver promised outcomes. The history of Russian governments that have failed to pay
pensions and wages on time makes it very difficult for households to believe that they will be adequately insured if they choose to give up their personalized safety nets. The status-quo bias thus suggests that it will be extremely difficult to exit the virtual economy via democratic means.

There is one more important implication that is worthy of comment here. Not only does the status-quo bias make it difficult to adopt efficiency-enhancing reforms. It also encourages behavior that makes reforms harder to implement. Note that the processes of personalization and fragmentation are endogenous responses to transition. The behavioral responses of agents work to frustrate the intended outcomes of reforms. Policies do not have their intended effects because they were designed for an economy that operated according to the rules of the market, not the virtual economy.

Appendix: government behavior

Here we develop the argument of the section “Government behavior” on pages 208–210.

Just as enterprises differ in terms of their endowments of distance and relationship capital so do regions. Let \( \Delta_j \) index the average distance of region \( j \). We define the average distance of the region as a weighted index of the distances of the constituent enterprises in the region:

\[
\Delta_j = \sum_{i=1}^{n} \delta_{ij} d_i
\]

where \( \delta_{ij} \) is the share of enterprise \( i \)'s output in region \( j \). A region endowed with many lossmaking enterprises (e.g., Ivanovo) would have a high \( \Delta_j \), and vice versa. The key difference between regions with low and high \( \Delta \) is the marketability of output. A region with low \( \Delta \) will have more cash in circulation, while regions with high \( \Delta \) will feel the burden of the cash constraint to be much tighter.

Relational capital also varies by region. Because relational capital is necessarily personal and idiosyncratic, we are primarily identifying with the capital of the regional administration, essentially the governor. The relational capital of a regional governor is the result of personal history and investments in maintaining relationships. Let us denote the relational capital of region \( j \) as \( \Theta_j \). A region with high levels of \( \Theta \) is able to obtain a better deal for tax offsets than a region with a low level of relationships.

Tax collection with variable effort

A productive way to think about the governor’s problem is to consider the choice over how to allocate effort to maximize government consumption. The key variable input is the governor’s effort, which is given at \( \bar{\epsilon} \). This must be divided between collecting taxes in cash and using tax offsets to obtain products in-kind. We assume that it is more efficient to collect
taxes in cash and procure consumption goods through cash disbursement. Procuring consumption via tax offsets is expensive for two reasons. First, the goods received may not be exactly what was preferred. Second, tax offsets create conditions of bilateral monopoly and may lead to high virtual prices for the goods offered. 34

The amount of effort needed to produce cash and non-cash goods is not the only difference between the two types of taxes. Evasion is another. Cash tax collection must be shared with the central government, while tax offsets are not. This creates a wedge between the returns to the two types of activities. The combination of these two differences between cash and non-cash goods—the differing costs of production and the difference in returns due to the tax wedge—means that the resources used by the enterprise in production have two prices: a market price and an informal shadow price.

We can thus think of regions as having initial stock of $\Delta_j$ and $\Theta_j$. The policies chosen by regional governors will depend on these stocks. To see this we consider the governor’s decision problem as maximizing regional government consumption.

Let government consumption for region $j$ be given by:

$$C^g_j = (1 - \alpha) \tau \Sigma_y pf(e, d) + \psi \Sigma_y p\hat{g}(e_n, r)$$

(2)

where $\Sigma_y pf(e, d)$ is the total value of production of cash goods in region $j$, $\Sigma_y p\hat{g}(e_n, r)$ is the total value of non-cash production in region $j$, $\tau$ is the cash tax rate, $\alpha$ is the share of taxes that are sent to Moscow, and $\psi$ is the share of non-cash production that is “sold” to the government in the form of tax offsets. Notice that government consumption depends on the choices of the enterprises in the region. The governor chooses tax rates but treats the prices of cash and non-cash goods as given.

The formulation in (2) still treats government behavior as exogenous. To endogenize it we allow the regional governor to choose how much effort is put into tax collection and negotiating offsets. Thus we no longer treat $\tau$ as a constant, but rather as a function of the effort level devoted to tax collection, and on regional characteristics:

$$\tau_j = \tau(e, \Delta_j, \Theta_j)$$

(3)

and similarly for non-cash:

$$\psi_j = \psi(e_n, \Delta_j, \Theta_j)$$

(4)

where clearly $\hat{e} = e + e_n$. It is important to note that $\tau$ and $\psi$ are now effective tax rates. That is, they give the amount of receipts the government receives from its effort choices, given its initial conditions.

Notice that effective tax rates will depend on effort choices and on conditions in the region. Thus,
\[ \tau_1 \left( \frac{\partial \tau}{\partial e_r} \right) > 0, \tau_2 < 0, \text{ and } \tau_3 \approx 0, \]

while for non-cash tax collection we have \( \psi_1 > 0, \psi_2 > 0, \) and \( \psi_3 > 0. \) The fact that \( \tau_2 < 0 \) and \( \psi_2 > 0 \) are critical. This implies that greater distance to the market reduces the ability to collect cash taxes and increases the capacity to collect non-cash taxes. The latter assumption follows because a region with high distance to the market has many enterprises that cannot sell production for cash and seek offsets as a survival mechanism.

Moreover, notice that an increase in relational capital increases the return to effort devoted to non-cash tax collection; i.e.,

\[ \frac{\partial^2 \psi}{\partial e_r \partial \Theta_j} > 0. \]

The essential point is that as the level of relational capital in a region increases the return to effort in non-cash tax collection rises.

The problem for the governor is now:

\[
\max_{e_r, e_{nc}, \tau, \psi} \mathcal{C}^e_x = (1 - \alpha) \tau(e_r, \Delta_p, \Theta_j) \sum_{g} p f_i(e_r, d) + \psi(e_{nc}, \Delta_p, \Theta_j) \sum_{g} p g_j(e_{nc}, \tau) \tag{5}
\]

subject to:

\[ e_r + e_{nc} = \bar{e} \tag{6} \]

\[ (1 - \alpha) \tau(e_r, \Delta_p, \Theta_j) \sum_{g} p f_i(e_r, d) \geq m \tag{7} \]

where (7) represents the cash constraint for the governor. Regional governments will have some minimum needs for cash, wages being a prime example. If the cash constraint were absent, some regions (those with high \( \Delta \) and high \( \Theta \)) might devote all effort to tax offsets. The cash constraint limits this.36

**Equilibrium**

In the static framework, distance and relational capital stocks are given. Hence, both enterprises and governors take their respective stocks as initial conditions. We have also taken the relative price of cash to non-cash goods \( p/\hat{p} \) as a parameter in the enterprise’s decision. This is appropriate for pre-tax prices, but after-tax relative prices depend on the tax rates that are chosen. The enterprise chooses effort levels based on

\[ \frac{p(1 - \tau)}{\hat{p}}. \]
This relative price will depend on the degree to which the region invests in tax offsets. If $\psi_j$ is low then the price of non-cash goods would be low relative to cash. Indeed, the price of non-cash goods depends on $\psi$ and on the tax rate. Hence, once tax rates have been chosen this determines the relative price ratio:

$$\rho \equiv \frac{h(1 - \tau)}{\hat{p}}.$$ 

An equilibrium in this framework is thus a set of tax rates ($\tau^*, \psi^*$) and effort levels ($e^*_{nc}, e^*_{b}, e^*_{r}, e^*_{m}$) such that directors maximize expression (5) subject to (6) and (7).

An important result is the following. Suppose that a region has high $\Delta$ and high $\Theta$. Then the optimal effort choices will be biased towards non-cash taxes. This means that the relative price of non-cash goods will be high relative to the opposite case. Enterprises will tend to invest in relations rather than reducing distance. This suggests that the equilibrium with high $e_{nc}$ and $e_b$ may be stable with regard to small changes in parameters. Regions may get stuck in non-cash traps.

Over time the evolution of the virtual economy thus results in a bifurcation of regions. Some regions with relatively good endowments of physical capital will be more willing to induce cash payments, while other regions will emphasize non-cash transactions. In these latter regions, relational capital will be the key currency. This equilibrium may be stable. A region where non-cash activity prevails increases the cost to any enterprise that chooses to reduce distance. Without investments in relational capital any cash income will be immediately taxed away.

**Acknowledgments**

This essay is based on my on-going collaboration with Clifford Gaddy. I am grateful to him for many valuable discussions on this topic.

**Notes**

1 One might be tempted to argue that the problem is that policymakers have failed to actually implement reforms—settling for the proper form but sacrificing the substance. One popular explanation for this would be corruption. This is a convenient explanation, but it is not very satisfying. It does not explain why some countries suffer from corruption more than others. Is Russia’s difficulty with economic reform simply an accident of a peculiar political culture? This is not a silly question given the special history of this country, and especially the Soviet period. But to answer it we need to probe deeper to understand the problems of Russian transition.

2 Thus, Williamson and Haggard 1994: 531 note that if there is a consensus about the desirability of the so-called “Washington consensus,” this raises the
question: “if the consensus is in fact widely endorsed, why is it not more widely implemented?”

3 See also Drazen 2000: Chapter 10 for a general discussion.

4 Notice that the argument also suggests that an unpopular policy that is nonetheless implemented may turn out to be sustainable. This follows because _ex post_ a majority benefits.

5 In the standard model of the status-quo bias (Fernandez and Rodrik 1991), there are two sectors. In one sector reform is beneficial to all. In the other sector, reform is costly, but some agents from that sector can move, at a cost, to the expanding sector. The problem is that agents do not know if they will be so lucky. The argument here is that the loot chain increases uncertainty over one’s chances of succeeding in the expanding sector. And personalization increases the losses to reform.

6 See, for example, Gaddy and Ickes (1998a) and Ericson and Ickes (1999).

7 Some may argue that because privatization took place via shady methods—e.g. loans for shares—that the lottery analogy is inappropriate. But this is not correct. It means that the lottery is rigged, but the essential point of this analogy is not the _process_ of privatization but the _resulting distribution_.

8 The revelation had less to do with realizing that the Gazprom ticket was a winner—that was no secret—than the recognition that so many others were losers.

9 Any method of privatization must cope with the equity-efficiency tradeoff.

10 You could always argue that the state was too weak to implement the transparent solution. But the question is why is this the case? The point of our argument is the importance of relational capital in explaining why the non-transparent solution resulted.

11 Relations, in other words, can aid in production. This is one important distinction between investment in relational capital and rent-seeking. An investment in relational capital can be productive for the economy. Whether or not it is depends on what the investment is used for.

12 Ledeneva (1998) provides the most comprehensive study of _blat_ in both the Soviet period and in post-Soviet Russia. See also Fitzpatrick (1999) which summarizes the importance of _blat_ in the Stalinist era (pp. 62-5) and cites other important works on the topic.

13 This effect was enhanced by the predominance of the so-called shadow economy in the Soviet Union. The cascade of payments that spread through the system, the “loot chain” as Gregory Grossman has called it in an analogy with the food chain, meant that the income of a typical person was a convolution of formal and informal activity. This was another factor that made it very hard to estimate how one would fare in a liberalized economy. People did not know how liberalization would affect the loot chain.

14 Survival is thus a key motive for enterprises in the early stages of transition. It is the only way for directors to preserve the assets they have accumulated in the enterprise. See Ickes and Ryterman (1994) for a discussion of the survival-oriented enterprise.

15 There is also the issue of the limited prize in the prior regime. The greater degree of control over assets and reduced scope for hiding them lessened the gains to diversion in the prior regime. Nonetheless, the gains were sufficient so that this activity was fairly widespread, albeit on a lower scale.

16 See, for example, Hewett (1988: Chapter 4).

17 The role of trust in enhancing economic performance was emphasized by Fukuyama (1995).

18 Note the importance of the legacy of social assets that gives stakes to everyone in the enterprise.
19 It would not be entirely correct to think of this as the cash economy. But as more transactions shift from the monetary to the non-monetary economy there is less tax revenue for governments, and hence less capacity to fund safety nets.

20 Notice that one key benefit of personalized safety nets is that—much like relational capital in general—they are well suited to a regime where contract enforcement is weak. Under such circumstances agents must use self-enforcing contracts. Personalized relations satisfy this criterion. They involve transactions between agents who know and trust each other.

21 In an interview in December 1998, Tat’yana Nesterenko, the head of Russia’s Federal Treasury (kaznacheystvo) since January 1998, described how, despite efforts to establish a treasury system as a sort of giant, centralized bookkeeping department that could monitor all payments from the budget, government agencies still successfully manage to illegally appropriate funds for their own uses. Even the Treasury is defenseless, she noted, when suddenly some government agency concludes a contract not provided for in the budget. “The scheme works as follows. The [contracting] agency cannot pay for the services stipulated in the agreement. Under the terms of the Civil Code, the contractor issues a collection notice, goes to court, and as a result the sum in question is charged to the account of the Treasury . . . We [at the Treasury] raise a hue and cry: ‘How dare you?! There’s no provision for this payment in the Budget Law. You’re violating the rights of other budget-financed agencies . . .’. They just point to the Civil Code . . .”. See Ekonomika i zhizn’/Moscow edition 30/98 (Dec.), pp. 1–2.

22 Zarechny is a small town in central Russia that has a nuclear power plant.

23 This section is an extension of Gaddy and Ickes (1998b).

24 See the Appendix for a fuller discussion.

25 Though one might also argue that the role of the region in the national economy might also be important. This is certainly the case in terms of conflict with the central government.

26 Notice that one key benefit of personalized safety nets is that—much like relational capital in general—they are well suited to a regime where contract enforcement is weak. Under such circumstances agents must use self-enforcing contracts. Personalized relations satisfy this criterion. They involve transactions between agents who know and trust each other.

27 What needs to be shown is that reform is more likely when starting with a transparent distribution of value than with the virtual economy. Notice that it is not a fair comparison to consider the \( L \)-distribution with the virtual economy; given the severe inequity of returns in the former, majority rule certainly results in reform. The appropriate comparison is between the virtual economy (the distribution noted \( L/V \)) and the \( L \)-distribution with a transparent tax on Gazprom (\( L/G \)). Because the actual distribution of values are the same in the two cases any difference in outcome is due to the confusion created by the non-transparency of the virtual economy, combined with the fact that relational capital has a positive payoff only in the virtual economy case. The hypothesis is that reform will be more popular—in a majority voting sense—with \( L/G \).

28 This is a variation on the theme in the status-quo bias literature that \textit{ex post} compensation is not feasible.

29 This problem was analyzed in Gaddy and Ickes 2001.

30 Though one might also argue that the role of the region in the national economy might also be important. This is certainly the case in terms of conflict with the central government.

31 Of course by governor we really mean the local administration.

32 The idea is that maintaining one’s position as director is so lucrative compared with other alternatives that directors supply as much effort as possible. Hence we can ignore the question of the \textit{level} of effort and focus on its composition.
For simplicity we assume that regions run a balanced budget so that government consumption is equal to total taxes collected.

Notice that the enterprise always has the option of paying its taxes in cash rather than in kind. Hence, it only will pay taxes using offsets if the government accepts the goods for a greater value than what the enterprise could obtain by selling the goods directly. One could, in fact, interpret paying taxes via offsets as a means of price discrimination—a cash-strapped government being a consumer with more inelastic demand.

For simplicity we assume that all cash taxes are paid to the regional government.

The presence of this constraint also explains why in regions where non-cash activities predominate the effective marginal tax rate on cash remains so high—the fact that so many enterprises resort to barter increases the need to obtain cash in any way possible.

References


Uzbekistan is regularly listed as a case of “reform failure” among the thirty-plus economies in transition from central planning during the 1990s. The government explicitly avoided the shock therapy adopted by Poland in January 1990 and advocated by some international financial institutions, but it also avoided the economic collapse of non-reformers such as Belarus or Turkmenistan. Uzbekistan’s economic performance, measured by change in real GDP between 1989 and 1999, was one of the least bad among transition economics and the best of all former Soviet republics (Table 10.1). Transition to a market economy has been taking place, and some observers (e.g. Agzamov et al., 1995) have promoted Uzbekistan as an example of successful gradual reform.

The government refers to the Uzbek model but, apart from not being rapid reform, the model’s content is unclear and on several key occasions policies appear to have been reactive, rather than part of a consistent strategy – a process characterized by Pomfret and Anderson (1997) as “inconsistent gradualism”. Part of the problem of classifying Uzbekistan on a reform scale is the changing nature of economic policy. Initially, to the end of 1993, the government resisted dramatic economic change, although even this period was not one of non-reform. In 1994 economic reforms were accelerated, although the government remained cautious and when faced with a serious balance of payments crisis in the second half of 1996 it reacted in an illiberal way, resorting to exchange controls. During the remainder of the decade, the government continued to develop a market economy, but was seriously impeded by the lack of market-determined interest and exchange rates. The first three sections of this essay will describe how Uzbekistan’s reform strategy has evolved during the three policy eras in the 1990s.

Assessment of the nature of gradual economic reform in Uzbekistan and its success are important prerequisites for analysing “reform failure”. Rodrik’s review of the political economy of reform failure is premised on the emergence among economists of substantial “convergence on . . . what constitutes an appropriate economic strategy” (Rodrik, 1996, 9), but advocates of the Uzbek model would disagree fundamentally with
### Table 10.1 Initial conditions: republics of the USSR, 1989/90

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<td>51.9</td>
<td>2,500</td>
<td>0.235</td>
<td>6.0</td>
<td>–18</td>
<td>35</td>
<td>30</td>
</tr>
<tr>
<td>Estonia</td>
<td>1.6</td>
<td>4,170</td>
<td>0.299</td>
<td>1.9</td>
<td>–32</td>
<td>79</td>
<td>12</td>
</tr>
<tr>
<td>Latvia</td>
<td>2.7</td>
<td>3,590</td>
<td>0.274</td>
<td>2.4</td>
<td>–24</td>
<td>60</td>
<td>10</td>
</tr>
<tr>
<td>Lithuania</td>
<td>3.7</td>
<td>3,110</td>
<td>0.278</td>
<td>2.3</td>
<td>–31</td>
<td>65</td>
<td>13</td>
</tr>
</tbody>
</table>

**Sources:** columns 1–2, World Bank (1992, 3–4); columns 3–4, Atkinson and Micklewright (1992, Table U13) – based on Goskomstat household survey data; column 5, Tarr (1994); columns 6 and 7, European Bank for Reconstruction and Development *Transition Report Update*, April 1997 (page 9), and *Transition Report 1999* (Table 1.1).

**Notes**

a GNP per capita in US dollars computed by the World Bank’s synthetic Atlas method.

b Poverty = individuals in households with gross per capita income less than 75 roubles.

c Impact on terms of trade of moving to world prices, calculated at 105-sector level of aggregation using 1990 weights.

d Annual increase in consumer price index (end of year).
such an assertion. Similarly, Drazen’s (1996, 25–6) theory of a war of attrition among interest groups waiting each other out hoping that other groups will bear the costs of reform is less appropriate if there are fundamental disagreements about the means to achieve a market-based economy.

This is not to argue that political factors are absent in Uzbekistan. One reason for the slow progress in agricultural reform is the entrenched power of former state-farm managers, although the slow pace of agrarian change is also related to the reliance on taxes on cotton to fund the social programmes which are part of Uzbekistan’s transition strategy. As Krueger (1993, 138) has argued, “politicians’ decisions as to economic policy are an outcome of the existing balance of political forces, which are themselves in part a function of the state of the economy”. The political system matters for determining how “politicians” interact; Uzbekistan is an authoritarian state in which the president’s voice is decisive, but the president does not make policy within a political vacuum.2

Among the features influencing political decisions about economic reform in Uzbekistan, four will be emphasized in sections 10.4–10.7 of this essay: initial domestic conditions, natural-resource endowment, the international context, and the role of the president.

First, the social and economic structure and attitudes prevalent when the country became independent at the end of 1991 were crucial for early decisions when the government faced a carte blanche in many policy areas. Initially, economic reform was secondary to the need for nation-building and establishment of political legitimacy by the incumbent president and elite, but from the start there was a predisposition to cautious change because of the high poverty rate and fear of the social and political consequences of income losses for the poor. Traditions of social and political connections could be used positively to create a social safety net, but the power of local bosses was a force against significant reform of agriculture, finance or large enterprises. A tradition of home ownership and the bazaar culture were conducive to housing and other small-scale privatization; these reforms and de novo enterprise creation were widely acceptable. The cotton monoculture favoured centralized power. Blaming the negative effects of monoculture on Soviet planners provided legitimacy for economic diversification through the encouragement of grain-growing and import-substituting industrialization.

Second, Uzbekistan can be viewed as an example of economic reform in resource-rich countries. Rent-dissipation has occurred in Uzbekistan, although this was not due to excessive competition for resource rents, which were largely kept under the control of Uzbekistan’s central government. More serious for Uzbekistan has been the magnified expectations effect of assuming that cyclically favourable export conditions in the early–mid-1990s were permanent, and failing to prepare for the cyclical downturn in cotton and gold prices.
Third, Uzbekistan has aspirations to political leadership within Central Asia, although during the 1990s the forum for such aspirations varied, initially focussing on cooperation with Russia within the Commonwealth of Independent States then through an independent attempt at regional leadership and finally to cooperation with the USA. The shifting political allegiance has had an impact on the trade relations of Uzbekistan as an open economy, and also influenced thinking on economic reform. At the same time, Uzbekistan has steadfastly refused to be pushed into following the Washington Consensus model of economic reform, and especially since 1996 has taken glee in ignoring IMF advice and treated this as an assertion of national independence.3

Finally, the character of the president must be taken into account. President Karimov is autocratic, but there is some evidence that he is concerned about the well-being of the population. Also, it is relevant that he is described as an economist, even if his training and experience were from the days of central planning. Karimov recognizes the significance of economic policies, and the need for a shift to some form of a market economy, and on key occasions he has taken the initiative to push reform along, notably in January 1994.

10.1 Initial conditions, to the end of 1993

The Uzbek Soviet Republic had a troubled political history during the second half of the 1980s. When Andropov launched the anti-corruption campaign in 1983, the Uzbek Republic’s leadership was his first target, and although First Secretary Sharof Rashidov’s timely death in 1983 excluded him from the purge, many thousands of officials were punished by Gorbachev.4 The determined attempt to remove Rashidov’s appointees and bring Uzbekistan more firmly under Moscow’s control was, however, abandoned after riots in June 1989, when a local technocrat, Islam Karimov, was appointed the Republic’s leader.

At the time of the last Soviet census in 1989, the Uzbek Republic with twenty million people was the third most populous Soviet republic. It was, however, one of the poorest republics with the second highest poverty rate (Table 10.1). Its role in the Soviet division of labour was as a producer of primary products, especially cotton, which dominated the agricultural sector where 40 per cent of the labour force worked, and minerals such as gold and uranium. Politically the Uzbek Republic, like the other Central Asian republics, was conservative, making no reform experiments during the Gorbachev era. Ethnically, the republic was one of the more homogeneous in Central Asia (Akiner, 1983, 277), with a strong historical and cultural tradition to draw upon.5 Although there were ethnic troubles between Uzbeks and Kyrgyz in Osh in the Kyrgyz Republic in 1990 and Uzbek minorities lived across most of the Uzbek Republic’s other borders, there were no serious irredentist claims. Tashkent was the acknowledged
metropolitan centre of Soviet Central Asia and fourth largest city in the USSR.

For most of 1991 the Uzbek Republic continued to slumber. Its citizens overwhelmingly supported continuation of the Soviet Union in the March referendum. Its leadership kept silent during the August coup. In September the Uzbek Republic, like several other republics, declared independence, although this was seen at the time as a formal statement without impact. During the last three months of 1991, President Karimov seemed little concerned about the possible dissolution of the Soviet Union, perhaps because his attention was focused on securing his own position. When the three Slav republics declared independence in early December, Karimov was a follower rather than a leader in negotiations to replace the USSR by the Commonwealth of Independent States (CIS) at the end of 1991.

Newly independent Uzbekistan seemed little prepared for nationhood in 1992. Still using the Soviet rouble as a common currency, Uzbekistan had little choice but to follow the Russian price reform of January 1992. Although prices were generally freed, Uzbekistan retained controls on more items than neighbouring Kazakhstan or Kyrgyzstan (Pomfret, 1995, 53–7). Uzbekistan’s stance through 1992 and early 1993 was to try to maintain external stability, and Uzbekistan was one of the CIS republics which participated in the various unsuccessful conferences to re-establish common monetary or trade institutions.

Domestically, change was limited. The price controls caused recurring border closures as arbitragers sought to export fixed-price goods from Uzbekistan to higher price destinations within the rouble zone. Uzbekistan shared in the rouble’s hyperinflation in 1992 and 1993, but because of the controlled prices the high 1992/3 inflation rates in Table 10.2 were among the lowest in the CIS. Enterprise privatization moved slowly, but housing privatization was extensive, partly because of a history (unusual in the USSR) of high levels of home ownership.

During the second half of 1993 the rouble zone disintegrated, due partly to Russian policy choices, but mainly to the design fault of having multiple centres of credit creation (Pomfret, 1996, 118–29). Uzbekistan appeared to hang on until the last minute and, apart from war-torn Tajikistan, was least prepared to issue a national currency. When Uzbekistan did leave the rouble zone in November 1993, it issued a temporary currency, the som coupon, in which people had little trust. Issue of the new national currency was delayed until July 1994.

10.2 Emergence of the Uzbek puzzle, 1994–6

Following a January 1994 Presidential Decree on deepening economic reforms, a period of accelerated change began. Uzbekistan’s output performance had not been bad by former Soviet republic standards, with
<table>
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<tr>
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<th></th>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Growth rate of real GDP</strong></td>
<td>-11.1</td>
<td>-2.3</td>
<td>-4.2</td>
<td>-0.9</td>
<td>1.6</td>
<td>5.2 (2.4)</td>
<td>4.4 (3.4)</td>
</tr>
<tr>
<td><strong>Consumer-price inflation</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>End-of-period (in per cent)</td>
<td>11002</td>
<td>1281</td>
<td>117</td>
<td>64</td>
<td>28(50)</td>
<td>26</td>
<td></td>
</tr>
<tr>
<td>Revenue</td>
<td>31.3</td>
<td>36.0</td>
<td>29.2</td>
<td>34.6</td>
<td>34.3</td>
<td>30.1</td>
<td>32.4</td>
</tr>
<tr>
<td><strong>General government finances (in per cent of GDP)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Expenditure</td>
<td>43.8</td>
<td>46.4</td>
<td>35.3</td>
<td>38.7</td>
<td>41.6</td>
<td>32.3</td>
<td>34.2</td>
</tr>
<tr>
<td>Balance</td>
<td>-12.5 (-18.4)</td>
<td>-10.4</td>
<td>-6.1</td>
<td>-4.1</td>
<td>-7.3</td>
<td>-2.2</td>
<td>-1.8b</td>
</tr>
<tr>
<td>Domestic bank financing</td>
<td>n.a.</td>
<td>16.4</td>
<td>4.8</td>
<td>1.4</td>
<td>6.9</td>
<td>1.3</td>
<td>1.6</td>
</tr>
<tr>
<td><strong>Current-account balance</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>In million US dollars</td>
<td>-236</td>
<td>-429</td>
<td>119</td>
<td>-21</td>
<td>-980</td>
<td>-584</td>
<td>-195</td>
</tr>
<tr>
<td>In per cent of GDPc</td>
<td>-11.8</td>
<td>-8.4</td>
<td>0.5</td>
<td>-0.2</td>
<td>-7.2</td>
<td>-4.0</td>
<td>-1.4</td>
</tr>
<tr>
<td><strong>Gross official reserves</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>In million US dollars</td>
<td>79</td>
<td>1,022</td>
<td>1,330</td>
<td>1,867</td>
<td>1,907</td>
<td>1,167</td>
<td>1,168</td>
</tr>
<tr>
<td>In months of imports</td>
<td>0.6</td>
<td>3.8</td>
<td>5.9</td>
<td>6.9</td>
<td>5.4</td>
<td>3.7</td>
<td>5.0</td>
</tr>
<tr>
<td><strong>External debt stock</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>In million US dollars</td>
<td>6.0</td>
<td>1,032</td>
<td>1,244</td>
<td>1,787</td>
<td>2,363</td>
<td>2,761</td>
<td>3,322d</td>
</tr>
<tr>
<td>In per cent of GDPc</td>
<td>3.0</td>
<td>20.3</td>
<td>5.2</td>
<td>17.8</td>
<td>17.4</td>
<td>19.0</td>
<td>23.5</td>
</tr>
<tr>
<td><strong>External debt service</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>In million US dollars</td>
<td>4.7</td>
<td>29.6</td>
<td>138.0</td>
<td>243.3</td>
<td>291.7</td>
<td>515.9</td>
<td>386.9d</td>
</tr>
<tr>
<td>In per cent of exports</td>
<td>0.3</td>
<td>1.0</td>
<td>4.7</td>
<td>7.0</td>
<td>8.3</td>
<td>14.0</td>
<td>13.4</td>
</tr>
</tbody>
</table>


Notes
IMF estimates are given in parentheses when they considerably differ from official statistics.
a Excludes foreign-financed expenditures.
b Includes an increase in the deposits of line ministries equivalent to 1.5 per cent of GDP.
c At the average annual official exchange rate.
d External public debt only.
real GDP declining by only 11 per cent in 1992 and 2 per cent in 1993 (Table 10.2). This reflected a favourable resource endowment with the major export commodities facing buoyant world prices, and Uzbekistan able to reduce its dependence in imported energy and grain. Uzbekistan, however, continued to suffer from high inflation in 1994 (Table 10.2), even as price increases started to moderate elsewhere in the former Soviet Union. Karimov’s decision to pursue macroeconomic stability was in contrast to other gradualists of the time such as Belarus, Turkmenistan and Ukraine.

Uzbekistan’s national currency was introduced in July 1994 and supported by reductions in the growth rate of money supply over the next three years. Price controls were reduced and food rationing abolished, so that open inflation reached a peak in 1994 before declining to below 50 per cent per year in 1997. Foreign trade was liberalized and exchange restrictions relaxed. The fiscal deficit was cut from 10.4 per cent of GDP in 1993, to 6.1 per cent in 1994, and 4.1 per cent in 1995 (Table 10.2). The tax system was reformed and collection improved, while expenditure on supporting state enterprises and on consumer subsidies was reduced.

During the middle 1990s Uzbekistan emerged as a paradox among CIS countries. Although cumulative reform was still far behind the Baltics, Russia or even neighbouring Kyrgyzstan and Kazakhstan, Uzbekistan did not experience the deep decline in GDP suffered by all other CIS countries. The cumulative decline in GDP between 1989 and 1996 was the lowest among all former Soviet republics. Moreover, Uzbekistan appeared to do relatively well by other measures such as providing a social safety net, alleviating poverty and limiting spending cuts in education and healthcare (Pomfret and Anderson, 1997). Taube and Zettelmeyer (1998) examine the relative importance of various potential explanations of the “Uzbek Puzzle” and, although measurement errors and favourable initial conditions played a part, their impact was dismissed as small in magnitude; good policy and public investment were left as the major explanatory factors.

The resource endowment was, however, fundamental to the balance of payments, the public-sector budget and investment. Buoyant export earnings from cotton and gold contributed directly to GDP, and were a major source of government revenue. The government kept tight control over both activities and, by a state-order system which gave farmers a small fraction of the world price, siphoned resources from agriculture amounting to as much as a twelfth of GDP in 1996 (Pomfret, 2000). An important difference to Russia or Kazakhstan was that the resource rents were not privatized and the government used the revenue to maintain public spending on education and healthcare better than in other CIS countries. The government also acted innovatively and effectively in targeting social assistance through the decentralized mahallah scheme (Coudouel and Marnie, 1999).

Public investment contributed to GDP, although the attempt to pick
winners led to several failures and no obvious successes. Chemical and petrochemical projects in the desert were the biggest flops, but heavily subsidized cotton textile mills may also have been socially wasteful, even if they survived on the basis of distorted prices. The import-substituting nature of these projects illustrates the inward-looking development strategy, even though Uzbekistan was an open economy by measures such as the export/GDP ratio.

Direct foreign investment into Uzbekistan was modest in total, but included some high profile projects. Apart from Newmont Mining’s involvement in gold production, practically all the foreign investment was in import substitutes such as Mercedes Benz, BAT in tobacco and Daewoo in cars. The Daewoo plant, in language familiar from Beijing Jeep in China or Proton Saga in Malaysia in the 1980s, was claimed to be a base for exporting to the region but its two cars and a minibus were sold only in domestic markets during the 1990s. The ubiquitous Daewoo cars, however, were a conspicuous sign of higher living standards during the second half of the 1990s.11

Economic success was accompanied by greater confidence in international relations. In the early years of independence President Karimov represented himself as a bulwark against Islamic fundamentalism, and continued to work with Russia in the Tajikistan conflict as well as in trying to maintain economic ties from the Soviet era. After a brief period of economic nationalism tinged with isolationism in late 1993, Karimov started to exert a more positive leadership role in Central Asia during 1994 and then on the world stage. Relations with the USA warmed considerably as Karimov took opportunities to denounce Iran and vote with the USA at the United Nations.12 In July 1996 Presidents Clinton and Karimov met in Washington.

### 10.3 Reintroduction of exchange controls

Up until the summer of 1996 relations between Uzbekistan and the IMF and World Bank had been thawing. Uzbekistan was still seen as a slow reformer, near the bottom of most liberalization league tables such as that in the World Bank’s 1996 *World Development Report*, but there were signs of improvement. In particular, Uzbekistan was committed to liberalizing its foreign-exchange regime and establishing convertibility for current-account transactions. In autumn 1996, however, the government reneged on this commitment by re-introducing draconian exchange controls.

The exchange controls appear to have been a drastic reaction to balance of payments pressures rather than part of a considered strategy. Other elements of Uzbekistan’s gradual transition remained essentially unchanged. The exchange controls were strongly criticized by the IMF, and the Uzbekistan government took pride in asserting its independence by defending the policy.
Economic performance continued to be good by CIS standards as growth became positive in 1996 and accelerated in 1997 and 1998 (Table 10.2). Inflation was brought below 50 per cent, although this figure’s meaning is in some doubt as over 1,400 prices remained controlled in 1999. A mass privatization programme was initiated through Public Investment Funds with World Bank aid, but the outcome was meagre, as was that from a case-by-case approach to privatizing thirty large enterprises (only one had been privatized, through foreign purchase, by late 1999). Creation of new small and medium-sized enterprises was also slow, apart from small-scale restaurants and other service activities.13

The most worrying sign was a growing external imbalance, not fully reflected in official statistics, but by 1999 frequently referred to by officials as a crisis. Some negative external developments contributed, such as cotton and gold prices and the 1998 Russian crisis, but the major problem was the import-substitution strategy exacerbated by the foreign-exchange policy. Production for export was discouraged by policies directing capital to import-competing projects and skewing relative producer prices in favour of such activities. As the gap between the official exchange rate and the black-market rate widened to 100 per cent by autumn 1998 and 300 per cent a year later, voluntary exports through official channels became less and less attractive. The external debt increased in 1998 and 1999; although debt-service ratios were not yet high (Table 10.2), the more recent loans had been contracted at 14–15 per cent and earlier IMF loans were coming due for payments in 2000.

In important respects Uzbekistan’s experience mimicked that of many newly independent countries of the 1950s and 1960s which enjoyed early economic success, but ran into subsequent problems after pursuing import-substitution policies and ignoring the resource-misallocation costs. An overvalued official exchange rate discouraged production of traded goods, while the large black-market premium encouraged rent-seeking activities. Capital was allocated mainly by government directive. The outcome was declining productivity of capital. By 1999, official estimates of Uzbekistan’s incremental capital–output ratio were around six and the IMF estimate 8.3, compared with ICORs for well-functioning economies of 3–4.

The viability of the government’s strategy depended heavily on its continued implicit tax on cotton and gold.14 Supply of these commodities was believed to be relatively price inelastic, which is likely to be true in the short run but less plausible for the longer term. Apart from the continued misuse of public resources by directing credit and foreign exchange to specific enterprises, the government continued to spend relatively wisely by maintaining health and education spending and extending the social support delivered via the mahallas. Nevertheless, wise use of GDP is not a substitute for misuse of productive investment in promoting future economic growth.
10.4 Domestic political economy

Economic-reform strategy in Uzbekistan was initially driven by the domestic conditions at the time of the sudden collapse of the USSR in 1991. As with all former Soviet republics Uzbekistan was most concerned with nation-building in 1992–3 and, unlike the Caucasus Republics or Tajikistan or Moldova, was not distracted by armed conflict. Nor was Uzbekistan troubled by internal ethnic splits or substantial emigration of minorities as in Kazakhstan or the Kyrgyz Republic.

President Karimov enjoyed considerable legitimacy as a leader little beholden to Moscow, even though he consolidated his power by ruthless means. Retaining this legitimacy, however, depended heavily on his ability to look after the people. The high poverty rate could be blamed on Soviet policy, but any increases in poverty would undermine Karimov’s position. Karimov often invokes the spectre of Islamic fundamentalism to justify autocratic policies, but he is as aware as anybody that poverty would be the best breeding-ground for fundamentalism.

A major reason for Uzbekistan’s gradual reform strategy was fear of the consequences of a sharp decline in incomes. Every eastern European and former Soviet transition economy has experienced a U-shaped output path with a deeper U in the former USSR than in central or eastern European countries. Uzbekistan, with its high pre-existing poverty rate, was poorly placed to handle a steep decline in incomes, and by its gradual reform strategy was most successful in avoiding that outcome.

Using the mahallahs to target welfare recipients, drawing on and adapting a traditional institution, was a brilliant innovation to moderate the distributional impact of economic transition in a context of tight government budgets. Again, Uzbekistan has probably been most successful among all former Soviet republics in creating a social safety net at low cost. For an authoritarian regime, the revival of the mahallahs had the added benefit of providing an instrument for social control as the local committees reported to government officials.

The network of social and political connections is an important inherited institution. While this had positive elements such as the mahallah-based social-security system, it also had negative elements such as the power of state-farm and enterprise managers who could defend their interests by calling on patrons higher up the network. This effect has been especially noteworthy in limiting agrarian change, and in stifling large-scale privatization and active competition policy.

Traditions of home ownership and the bazaar culture provided fertile ground for small-scale privatization. Housing was quickly privatized, and the tea houses and shashlik stands revived. Kiosks and petty trading suffered under the heavy bureaucracy, but not because of cultural opposition to such initiatives. The growth of such small-scale activities has been
slower than in more reformist transition economies, but it has been cumulative and especially in Tashkent was flourishing by the late 1990s.

Resource abundance may have affected policy making in several ways. Based on other resource-rich economies’ experience, rent-seeking and magnified expectations effects are likely to have been present; they will be analysed in the next section. The specific nature of the cotton economy contributed to a strong central control of the reform process. In the Soviet era the largest ministry in Uzbekistan was that for water resources, and the significance of administering and maintaining the irrigation system remains. Moreover, centralized marketing of cotton exports provides a ready source of revenue to the central government. Because cotton is an export crop, the economy has remained an open one, at least when measured by export–GDP ratios.

At the same time, policies to reduce dependence on world markets and to diversify the domestic economy derived legitimacy from the belief that Soviet planners impoverished Uzbekistan by imposing the cotton monoculture. As with some of the other elements of Uzbekistan’s reform strategy, the import-substitution policy has not been uniformly pursued and its sustainability, at least in extreme form, was being questioned by the late 1990s.

In sum, most of the features of Uzbekistan’s economic reforms since 1991 can be explained by inherited social structures, attitudes and economy. This is especially true for microeconomic and public-finance matters. It is less true of macroeconomic policies and trade policies, with which there had been no experience within the USSR and on which views were less strong (macro) or more ambiguous (trade).

10.5 Resource abundance and policy reform

A negative relationship between resource abundance and economic growth has been claimed by Sachs and Warner (1995). Although the universality of this result has been challenged, there are sufficient examples of resource-rich countries performing poorly for it to be an enigma. The most frequent explanations have been in terms of policy failure. Tornell and Lane (1999) have ascribed the poor performance to competition for resource rents diverting energies from productive activities until the rents were dissipated.

An alternative but not mutually exclusive argument concerns the asymmetric policy response to export earnings’ volatility. Policy makers commonly accept praise for good economic performance even when exogenously caused, and may even convince themselves that success was more than chance. Both the December 1994 Mexican peso crisis and the July 1997 Thai baht crisis were preceded by economic booms fuelled in part by substantial but unsustainable inflows of foreign capital; when the capital flows reversed, the government had to allow a drop in real income.
but in both Mexico and Thailand was unwilling to do so, and failure to take timely action led to a hard landing in both cases. A similar pattern of magnified expectations has characterized countries experiencing commodity booms; during the boom governments overspend on the assumption of a trend rise in future earnings, and then find it difficult to cut spending when the price increase proves to be cyclical. When export earnings drop, desperate governments often turn to poor policies for salvation. A paradox of the 1982 Debt Crisis was that the heavily indebted countries not only included oil importers who had borrowed to finance consumption, but also oil exporters such as Mexico, Nigeria and Venezuela and other primary-product exporters such as Morocco who had responded to a commodity-export boom to finance redistributive policies or import-substituting industrialization projects that could not create forex earnings to service the external debt when export prices fell.

Uzbekistan’s brief independent history has elements of this pattern of magnified expectations. Although initially not considered resource-rich among transition economies, Uzbekistan was fortunate in the first half of the 1990s that its two main exports were readily transportable and their world prices buoyant. Relatively good economic performance was then ascribed to wise policies and a special Uzbek model of gradual reform. When cotton and gold prices fell in 1996, the authorities hit the panic button, imposing draconian exchange controls.

10.6 The international context

International considerations have influenced economic reform in Uzbekistan in two main ways. First, after independence Uzbekistan joined the United Nations, International Monetary Fund and World Bank, and became eligible for technical and financial assistance. Second, as an independent country with aspirations of regional leadership, Uzbekistan has actively adjusted its international relations.

Relations with the IMF, and to a lesser extent with the World Bank, UN economic agencies, ADB and EBRD, have been fraught. In 1992 the IMF advocated gradualism by encouraging retention of the rouble-zone in order to minimize economic disruption. For all rouble zone members, except possibly Russia, this denied the possibility of pursuing an independent monetary policy and consigned the countries to hyperinflation. Although the IMF shifted its position in late 1992 and actively supported the Kyrgyz Republic’s national currency in May 1993, its prestige and reputation for technical competence had been seriously compromised in Uzbekistan.

The periods of Uzbekistan’s assertive nationalism in late 1993 and attempted Central Asian leadership in 1994 provided a poor background for accepting advice or assistance from international institutions. Uzbekistan received no financing from the IMF or World Bank prior to 1995
and, consequently accepted no conditions. Nevertheless, the foreign advisers were not without impact as Uzbekistan did adopt macroeconomic stabilization as the primary target in 1994 and has pursued that target ever since.

The strained relations with the IMF and World Bank have played a role in validating non-conventional policy responses. When Uzbekistan ran into balance-of-payments problems associated with cotton-revenue fluctuations in the second half of 1996, the government paid little attention to IMF advice and commitments made to the IMF not to impose stricter exchange controls. A year later when Malaysia adopted a similar stance, but with far less draconian controls, Uzbekistan celebrated the snub to the IMF. In the medium term, however, the policy has been a disaster for Uzbekistan, creating major distortions. Removal of the controls will need to overcome the opposition of the few but powerful people who benefit from the distortions.

Uzbekistan’s international relations have provided a background to policy decisions, although it is unclear how far they have influenced actual economic reforms. Continued adherence to the CIS through 1992–3 was consistent with retaining the rouble. Shifting to a Central Asian arena was associated with proposals for a Central Asian free-trade area or customs union, but they made no concrete progress (Pomfret, 1999). Trade relations within the wider regional organization, ECO, were damaged by the shift towards the USA and denunciation of Iran in 1996. All that is left for trade policy is either autarchy or multilateralism. The openness of the economy, in export/GDP terms, reinforces the pressures to become more open in the policy sense, and with autarchy unattractive for an export-oriented economy Uzbekistan has become more conscious of the requirements for accession to the World Trade Organization. Although its WTO application remains at an early stage, this could be an important catalyst triggering the reform of exchange controls and shift to a transparent trade and forex system.

10.7 The role of the president

The absolute rule of President Karimov, re-affirmed by an overwhelming victory in the January 2000 presidential election, is an important element in the determination of the economic-reform process in Uzbekistan. Karimov has looked to East Asian models of presidential leadership, combining a commitment to political stability and harsh response to open dissent. Also, as in China, the autocratic leader has on critical occasions pushed economic reforms forward rather than allowing interests resistant to change the opportunity to turn back the clock. The president’s personal influence lay behind the adoption of more radical reforms in January 1994, the maintenance of macro stringency, and the prevention of backsliding in other reform areas after the adoption of exchange
controls in 1996. Personal qualities and background clearly matter, when presidential decisions are compared across the five Central Asian countries.23

Karimov has appeared to show a more genuine concern for people’s welfare across the country than other autocrats in the CIS or in China. This may, of course, have a Realpolitik intent of pre-empting dissent, but spending on social programmes has been maintained better in Uzbekistan than in neighbouring countries and perhaps better than anywhere else in the CIS. Although Karimov sponsors monumental projects in Tashkent, Urgench and elsewhere, it is to stimulate national pride and cohesion rather than a personality cult, and the scale of expenditure on non-productive construction projects has been far below that of Turkmenistan or Kazakhstan.

Karimov has taken a lead in discouraging blatant rent-seeking. This may, in part, be due to the need for centralized bureaucratic management of rent extraction from the cotton sector, in contrast to the simpler rent-extraction from mineral or energy sectors. Karimov has also mediated between clans and regions. Although there are references to a Samarkand clique around the president, he has not obviously provided excessive favours to his home city.24 In terms of the Tornell–Lane model, the president has contributed to reducing the negative consequences of the voracity effect. This is not to deny the ubiquitous corruption in Uzbekistan, but it is petty theft compared to the grand larceny of Kazakhstan or Russia.

10.8 Conclusions

The hallmark of Uzbekistan’s economic policies since independence has been cautious recognition that economic change is inevitable, and a commitment to gradual reform in order to minimize negative or disruptive consequences of change. In important respects this has been a wise approach, as Uzbekistan has avoided the pitfalls of rapid reform in Russia and Kazakhstan without falling into the trap of non-reform as in Turkmenistan. In particular, Uzbekistan avoided alienation of natural-resource rents, which gave the government an important continuing source of revenue.

Uzbekistan has also benefited from good governance in the economic sphere, at least by a narrow definition of economic management and by the generally low standards of the CIS.25 Although some revenue has been frittered away on wasteful public investment in industrial projects, the government has done fairly well in maintaining health and education expenditure and in providing a social safety net (Pomfret and Anderson, 1997). Public building has improved the cityscape in Tashkent and other towns, without the grandiose aspirations of the Presidential Palace in Turkmenistan or the new capital in Kazakhstan. Transportation and other public services have continued to function. Loosening of restrictions on
small-scale activities and rising disposable income in the late 1990s, at least in urban areas, saw a revival of eating and drinking out, which recalled a past cultural heritage and raised the quality of life for many. Politically the regime is unattractive to liberal observers, but President Karimov appears to enjoy a degree of popularity for maintaining relative stability with social justice. Corruption is endemic, but is widely accepted, with little perception that it has created a *nouveau riche* class comparable to that of other CIS counties.

Nevertheless, all is not well. Although reasonably well administered, the general strategy is flawed. Import substitution is not a viable strategy for promoting long-run growth, and the severe exchange controls imposed since 1996 are a major error with ever more dire consequences. The cautious approach to reform means that there is still time to loosen up the controls and reverse the bias against exports, much as South Korea did in 1964 after a decade of relatively mild import substitution. The longer that change is delayed, however, the more severe the shock of reform will be and the more unpredictable and uncontainable the negative consequences.

**Acknowledgements**

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**Notes**

1 The characterization of Uzbekistan as a non-reformer is often derived from the rankings produced by World Bank staff (reported in, for example, de Melo *et al.*, 1996) which were the basis for the analysis in the 1996 *World Development Report*. Wolf (1999, 5) lists Belarus, Tajikistan and Uzbekistan as examples of formerly centrally planned economies which “have barely commenced the transition”.

2 This essay does not address the relative merits of democracy or autocracy as a political framework for economic reform, but accepts that in a dictatorship it matters who the leader is (Gourevitch, 1993).

3 Williamson (1999) has expressed dismay about inconsistent use in the literature of the 1990s of the term “Washington Consensus”, which was never intended to suggest an ideological pro-market stance, but this is how it has been widely used and how the IMF/World Bank position is viewed in Uzbekistan. The IMF’s technical disrepute in Uzbekistan dates from 1992, when both the IMF and World Bank were poorly equipped to deal with the Soviet successor states and primarily interested in those with Baltic coastlines and Ukraine; for the other successor states, the advice to continue using the rouble effectively consigned them to unnecessary hyperinflation which prevented macro-economic stabilization and hindered economic reform. In Uzbekistan’s Central Asian neighbours, IMF and World Bank advice has tended to be fairly heterodox on such matters as financial reform, although the two institutions are often represented as shock therapists and free marketeers.

4 Carlisle (1995, 79) reports that 58,000 senior officials were replaced.
Before the Russian conquest in the late nineteenth century, the region’s major rulers were the Uzbek emirs of Bukhara, Khiva and Khokand. More important, the Uzbeks claimed the heritage of the great historical cities and rulers such as the Emir Timur (Tamerlaine). The existing sense of nationhood, clearly lacking in all Uzbekistan’s neighbours, was reflected in the attitude towards Rashidov, castigated by Gorbachev for corruption but lauded at home for directing resources from Moscow to the Uzbek Republic; after independence one of Tashkent’s major streets was named after Rashidov.

The Uzbek Republic, along with the neighbouring Kyrgyz, Tajik and Turkmen republics, declared sovereignty in 1989 and all four declared independence after the failure of the August 1991 coup. Sovereignty at the time meant control over a republic’s use of its own natural resources.

Carlisle (1995) argues that Karimov’s personal position was insecure in the year before the coup and that he only consolidated his power in the second half of 1991. Fierman (1997) analyses Karimov’s use of repression in 1991 and the first half of 1992 to create a centralized state under his control.

Many citizens had lost out in the July 1993 price reform when Russia unilaterally replaced the Soviet roubles with new Russian rouble banknotes. The November temporary currency issue was confiscatory and the issue of a permanent currency was also expected to be confiscatory. The som coupons were unimpressive in appearance and traded at huge spreads in the black market as almost any other currency was preferred as a store of value.

Tarr (1994) predicted a small terms of trade loss to Uzbekistan as a result of switching from Soviet to world prices, but this ignored the possibility of import substitution in oil and wheat. Uzbekistan ceased importing energy products in 1995 and had net export energy capability by 1997, while its grain output doubled between 1991 and 1997. Moreover, unlike Kazakhstan or Turkmenistan whose oil and natural gas exports were sold to CIS customers at below world prices but who could not access world markets due to pipeline routes, Uzbekistan’s cotton and gold were fairly easy to transport to global markets.

In Uzbekistan’s more rapidly reforming neighbours, annual inflation had dropped below 50 per cent in the Kyrgyz Republic in 1995 and in Kazakhstan in 1996.

The symbolism was also fairly egalitarian, because the little Tico (which cost not much over $1,000 at black-market exchange rates in 1999) was less opulent and exclusive than the imported Mercedes and BMWs which appeared in Kazakhstan and to a lesser extent Turkmenistan and the Kyrgyz Republic.

The most notable denunciation of Iran was at the May 1996 ECO summit in Ashgabat, which consequently broke up a day earlier than planned. ECO, the Economic Cooperation Organization, which includes Iran, Pakistan, Turkey, Afghanistan, Azerbaijan, Kazakhstan, the Kyrgyz Republic, Tajikistan, Turkmenistan and Uzbekistan, has attempted to bring together all of the non-Arab Islamic countries west of India, but has made little concrete progress (Pomfret, 1999). In the United Nations the USA found itself on occasion with only two supporting votes, Israel and Uzbekistan.

Uzbekistan’s record in new enterprise creation may, however, have been superior to that of most of its neighbours. Estimates of de novo firms’ share of GDP by Havrylyshyn and McGee (1999, 8) are: 35 per cent in the Kyrgyz Republic, 30 per cent in Uzbekistan, 20 per cent in Kazakhstan, and 15 per cent in Tajikistan and Turkmenistan.

The foreign-exchange controls helped to hide the full extent of the difference between world cotton prices and farmgate prices set in domestic currency.

Although the details are murky, there is some evidence that Karimov came to...
power in 1989 as a compromise candidate without a strong personal power base. In his struggle with other Communist leadership contenders over the next three years, Karimov adopted much of the programme of the nationalist groups which emerged in opposition to Gorbachev’s centralized rule. The dissolution of the USSR hugely assisted Karimov in the power struggle by removing constraints formerly imposed by Moscow and allowing him to create an institutional framework favourable to the incumbent president. Presidential power was reinforced by laws of May and September 1993, and Karimov may not have felt secure enough to consider major economic-policy innovations until then.

16 In 1992 the fall of Kabul in the spring followed by the defeat of the incumbent government in Tajikistan’s civil war were vivid reminders of how quickly political instability could overturn ex-Communist regimes. Uzbekistan was involved in both the Afghan and Tajik conflicts as a neighbour and because of large Uzbek minorities.

17 Rodrik (1996, 30) denies that short-term hardship is a necessary consequence of economic reform. In the transition from classic Stalinist centrally planned economies it has, however, been universal. Blanchard (1997) analyses the causes of this universal pattern.

18 Other economic explanations emphasize Dutch Disease effects discouraging investment in non-primary activities which may have superior long-term growth effects through positive externalities or greater learning potential (Redding, 1999).

19 Tornell and Lane (1999, 38–42) explain the dissipation of windfall gains in Mexico, Nigeria and Venezuela from the 1970s oil boom and in Costa Rica, Côte d’Ivoire and Kenya from the 1977–80 coffee boom to increased spending on redistributive policies.

20 Even after IMF and World Bank loans began to be made to Uzbekistan in 1995, the per capita amounts were far less than loans to Kazakhstan or the Kyrgyz Republic (Pomfret, 2004) and the 1996 exchange controls indicated that Uzbekistan did not feel bound by IMF policy conditions.

21 The petty point-scoring runs both ways. A recent IMF study of economic reform in the five Central Asian countries contrasts the faster reformers, Kazakhstan and the Kyrgyz Republic, with the slower reformers suggesting that the former have been more successful and the latter can learn from them (Gürgen et al., 1999, especially 3–4 and 73); Uzbekistan’s relative success in minimizing GDP decline is dismissed as due to favourable initial conditions (by distorting the conclusions of Taube and Zettelmeyer, 1998) and its superior record on poverty alleviation is ignored.

22 In China, Deng Xiaoping used his authority to push through the initial reform package in December 1978. In 1981–2, when conservative leaders were fearful of the growth of unregulated township and village enterprises, Deng’s camp gave the seal of approval to this development. Again in 1986, after a brief reversal of the reform process, the leadership pushed ahead with major liberalization of foreign-investment legislation and in 1992, after a longer hiatus, Deng’s symbolic Tour of the South signalled further reforms. On all of these occasions the decision to move forward was taken in Beijing, despite strong opposition, even though the main beneficiaries were specific reform-oriented regions of China.

23 Unlike most post-Communist leaders Karimov appears to have a genuine appreciation of economic matters. Official biographies record that he received his doctorate from Tashkent Institute of Economy in 1967 and that from 1983 to 1986 he was Minister of Finance in the Uzbek republic.

24 A recurring theme in Soviet-era politics was the clash between Bukhara/
Samarkand cliques favouring greater self-determination for Central Asia and Tashkent/Fergana cliques more closely connected to Moscow. The former were dominant up to 1929, in the Rashidov era 1959–83, and again under Karimov.

25 In the European Bank for Reconstruction and Development’s ranking of twenty East European and former Soviet republics by quality of governance (reported in Transition Report 1999), Uzbekistan ranks fourth, behind Hungary, Slovenia and Estonia – and ahead of Poland or the Czech and Slovak Republics.

26 An interpretation might be that Uzbekistan has been relatively successful in managing the transition from central planning to a market-oriented economy, but has yet to undertake “reform” in the economic development context.

References


Part III

Developing countries
11 Political economy of economic policy making in developing countries
An overview

Deepak Lal

In this essay I shall not confine myself to just the four developing countries – Burma, Haiti, Nicaragua and Zambia – discussed in the subsequent chapters. This is partly as these are not a representative sample, all being failed states, of which only Nicaragua seems to have achieved some economic and political viability in the 1990s. But, they do provide examples as we shall see, to illustrate particular aspects in the general overview of the political economy of economic policy making in the heterogeneous set of countries and polities that make up the developing world, which I have spent the best part of the last fifteen years trying to develop in two books, Lal and Myint (1996) and Lal (1998a).¹

In organizing one’s thoughts as well as the diverse experience of the myriad of developing countries it is essential to have some classificatory scheme. Section 11.1 provides the one I have found most useful. Given the current penchant for the West to launch a crusade in favour of its ‘habits of the heart’, democracy is being touted as essential for development. So in section 11.2, I go beyond the pure classificatory devices of the first section to see if there are deeper reasons why countries fall into these particular political-economy categories and if it is likely that they will give up their traditional political habits because of Western exhortations and ‘conditionality’. Section 11.3 then goes on to examine if the on-going process of global economic integration is likely to alter the political economy of policy making outlined in the first section.

11.1

In Lal and Myint (1996) we found it useful to categorize countries by a five-fold classification of polities and a three-fold classification of economies based on factor proportions. The latter were countries which compared with the world endowment of capital, labour and land were classified as ‘labour abundant’, ‘land abundant’ and ‘intermediate’. This allows an application of the three-factor trade theoretic framework of Krueger (1977) and Leamer (1984, 1987) to yield a rich menu of alternative efficient development paths, and the implied patterns of changes in
the functional distribution of income as with capital accumulation and population growth the factor endowments of the relevant countries change over time.

The five-fold classification of the polity distinguished between the objectives of the government and the constraints on its activities. On the former distinction two basic types were distinguished: the autonomous and the factional state. In the former the state subserves its own ends. These differing objectives allow a further subdivision. The first is the benevolent Platonic guardian state of public economics seeking to maximize some social-welfare function. The second is the predatory state whose self-seeking can take either the form of the absolutist state seeking to maximize net revenue for the sovereign’s use or the bureaucratic state maximizing public employment.

A state is needed to provide the classical public goods of defence and justice. For their provision the state has to have a monopoly of coercive violence (including the power to tax) in its territory. It is therefore best viewed as a natural monopoly providing these public goods. Being as self-regarding as its citizens (except for the Platonic guardian version), the autonomous state’s public goods cum tax equilibrium which yields the net rents it can obtain from its natural monopoly will depend upon the extent to which its natural monopoly is contestable from internal and external rivals. The greater the barriers to entry the greater the net revenue the state can garner for its own purposes. But even if this contestability is very low, there will be a further constraint on the autonomous state’s ability to levy confiscatory taxes. Particularly in developing countries, where a subsistence rural sector and an untaxable ‘informal’ urban sector are common, as the net of tax income decreases, at some stage the ‘prey’ will exit the taxed sector and melt into the bush (as happened, for example, in Tanzania and Ghana in the 1960s and 1970s). While this puts an upper bound on the tax rate even when the state’s natural monopoly is not contestable, in practice depending upon geography, military technology, and the internal legitimacy of its rulers, the maximum tax rate will be much lower, and will depend on this degree of contestability.

Of the three types of autonomous states, the Platonic guardian one provides the optimal level of public goods at least cost. The predatory-state tax cum public-goods equilibrium will be with a net-revenue-maximizing tax rate (determined by the degree of contestability) and the provision of less than the ideal amount of public goods in the absolutist version, and an over-provision in the bureaucrat-maximizing version.

The factional state by contrast has no objectives of its own but subserves those of whoever is successful in its capture. Two major types can be distinguished – the oligarchic state and a majoritarian democracy. The former limits the polity and hence the contestants to the state’s capture, while the latter extends the polity to the adult population. As is well known from the median-voter theorem, the ‘predator’ in a majoritarian democracy will be
the median voter with their well-documented ‘middle-class’ capture of the unavoidable transfer states that result, in both developed and developing countries. Moreover, the tax rate will be the revenue-maximizing one based on the so-called Ramsey tax rule (see Becker, 1983; Brennan and Buchanan, 1990; Lal, 1994: Ch. 13), as in the case of the autonomous predatory state, while the provision of public goods will be close to that of its bureaucrat-maximizing version (with pure public goods being supplemented with ‘merit-good’ provision).

Where do the four countries discussed in subsequent chapters fit into this classification? Clearly, Haiti is a classic predatory state, where one predatory ‘sovereign’ (the two Duvaliers) have been succeeded by another (Aristide) seeking to become one. Zambia under Kaunda would also fit in this category, but since his fall it is hovering between a factional state of the oligarchic, and a continuation of the net-revenue-maximising predatory kind. Burma has clearly been a predatory state of the bureaucrat-maximising type, while Nicaragua after the ending of its civil war seems to be a majoritarian democratic factional state.

In Lal and Myint (1996) we found that the initial resource endowment was more important in explaining divergent policy regimes and outcomes than the polity. Thus the labour-abundant countries (e.g. Korea, Singapore, Taiwan, Malta), irrespective of their polities, had the easiest policymaking task. For them the standard policy prescription of the two-factor Hechsher–Ohlin model of initially developing labour-intensive industries and then moving up the ladder of comparative advantage is easy to follow. First, this policy leads to politically desirable factor-price movements. With wages rising as capital is accumulated, there is unlikely to be political resistance from the bulk of the population in factional states which realize the country’s comparative advantage. While all types of autonomous state will also find that even their predatory ends are better served by undertaking the development of their only resource – the human – on which their revenues and prosperity depend. The major task of government is to provide an adequate infrastructure to reduce the transactions costs of the relatively small-scale organizational units which will predominate in the earlier stages of their development. Second, if the country is small, the limited size of the domestic market makes reliance on foreign trade inevitable. Also, there is unlikely to be vertical-import substitution when the ubiquitous dirigiste impulse leads to some departures from free trade. This means that when a switch to free trade is made there will not be lobbies preventing competitive imports of intermediate inputs. The political costs of rectifying past mistakes are, therefore, likely to be lower than in the land-abundant or intermediate group of countries. Third, their incremental comparative advantage is readily apparent to economic agents in both the private and public sectors. It is thus easier to pick ‘industrial winners’ and the consequences of picking losers or policies which stimulate them are more immediately apparent – as with Singapore’s ill-judged attempt to
jump a few rungs on the ladder of comparative advantage through an artificial raising of wages in the 1980s.

Of the four states discussed in later chapters, only Haiti with its population expansion relative to land would seem to fall into this category. But with a failed state, there seems to be no obvious way in which even the basic public goods – law and order – required for any economic activity can be provided.

The comparative advantage of land and natural-resource-abundant countries is also likely to be clearer than for the intermediate group, but more difficult to realize than for the labour-abundant group of countries. This is for two reasons. First, with a higher supply price of labour than the labour-abundant countries, due to their more favourable land–labour ratios, their incremental comparative advantage is likely to lie on the relatively capital-intensive rungs of the ladder of comparative advantage. Public promotion may be required because of the ensuing lumpiness of investments, and the need to develop scarce skills and absorb complex imported technology. The dangers of ‘bureaucratic failure’ endemic to such promotion may then lead to a failure to realize their economic potential. Second, if the rate of capital accumulation is not high enough, then with growing labour forces, their efficient development path could contain declining real-wage segments. If the polity is subject to factional democratic pressures, this ‘equilibrium’ time path of real wages could lead to political pressures to resist the requisite real-wage adjustments by turning inward. The polity could be at odds with the economy, with political cycles of economic repression (during factional ‘populist’ political phases) followed by liberalization (during autonomous political periods). Third, given the political imperative of avoiding the ‘falling-wage’ segments of their development paths, such countries have attempted ‘big push’ development programmes, often financed by foreign borrowing. This big push has often pushed them into a fiscal and debt crisis and thence a growth crisis. Finally, given the rents available from the natural resources, the inevitable politicization of their disbursement leads to ‘transfer states’ which inevitably bear harder on the revenue-generating sector in terms of trade decline, while raising entitlements when they improve. Thus natural resources may prove a ‘precious bane’ leading to polities which tend to kill the goose that laid the golden eggs.

The story of Zambia told in a subsequent chapter as well as the current travails of South Africa and Russia would fit these patterns in the political economy of natural-resource- and land-abundant countries. The story of Burma would fit to some degree too, but it is also strongly conditioned by the predatory nature of the state.

Finally, the intermediate resource-endowment group faces the most difficult development policy task. Their incremental comparative advantage is more opaque, so ‘mistakes’ are not so easily recognized or rectified, particularly by the public sector, which in the absence of any bankruptcy
constraint resists the exit of inefficient firms. Secondly, this group is also more likely to face situations in which the polity is at odds with the pursuit of their comparative advantage. Two of the largest developing countries – India and China – fall into this category (see Lal, 1995).

There is also overwhelming evidence that, as first hypothesized in Lal (1987), a ‘crisis’ provides an important impetus for initiating economic reform (see Little et al., 1993; Bruno and Easterly, 1996; Lal and Myint, 1996). This has happened in all four of the countries discussed in later chapters, though only Nicaragua seems to have been able to get closest to a sustainable economic recovery after its economic reforms.

In these cases of ‘crisis’-induced reforms, there are important parallels with the liberalization of the mercantilist ‘ancien regimes’ in the late eighteenth and nineteenth centuries (see Hecksher, 1955; Lal and Myint, 1996). One unintended consequence of past mercantilism and contemporary neo-mercantilism is that, while both were motivated by the desire to establish ‘order’ and thence ‘nations’ by expanding the span and scope of government control, after a certain stage increased dirigisme bred disorder. As economic controls become onerous, people attempt to escape them through various forms of avoidance and evasion. This has a devastating effect on the state’s fiscal base. The first sign of an impending crisis is fiscal, with the accompanying unMarxian ‘withering away of the state’. It is to regain control over what seem to have become ungovernable economies that economic liberalization is undertaken, to restore the fiscal base and government control. But there may be a lot of ruin in countries – as the decades-long crisis in Ghana demonstrated. Moreover, if even half-completed reforms allow this crisis of the state to seem manageable, there is no further incentive for predatory states to continue with liberalization. The recent stalled Indian liberalization provides a salutary example.

This suggests that a crisis usually provides a small window of opportunity for liberalizers. A ‘big bang’ may, therefore, be desirable to smash the equilibrium of ‘rent-seeking’ interest groups who have a stake in maintaining the past system of dirigisme. It had been thought that to stiffen the government’s spine in this unenviable task, sweeteners which ease its fiscal problem, in the form of ‘conditional’ soft loans and grants from multilateral and bilateral donors might be useful. But the emerging consensus from the sorry experience of ‘conditional’ lending is that, unless the government has decided to ‘bite the bullet’ which inevitably involves rescinding the politically determined income streams its past dirigisme has created, invariably predatory governments just ‘take the money and run’. The recent sad history of aid to Russia and Kenya, for instance, would support this judgement. So it is now being recommended that aid should only be given to those who ‘ex post’ are known to have reformed (see Collier and Gunning, 1999)!
11.2

An obvious question following from the above discussion is why do countries have the political forms we observe? A second and related question is whether, as the West is currently asserting along with the market, other of its ‘habits of the heart’, in particular its political form – democracy – needs to be adopted to aid development.

My Ohlin lectures (Lal, 1998a) tried to provide a cultural explanation. I distinguish between two aspects of a culture – its material beliefs which are concerned with ways of making a living and its cosmological beliefs which in Plato’s words relate to ‘how one should live’. There is considerable cross-cultural evidence that material beliefs are fairly malleable – when the environment changes they can rapidly alter. By contrast, there is greater hysteresis in cosmological beliefs and it seems they are related to the beliefs of the parent-language group from which the culture emanated.

Cosmological beliefs are also of importance for the polity. No matter how tyrannical and predatory the state, it must command some general acceptance of its legitimacy by the general populace. For the ancient ‘states’ this general acceptance of its right to rule and the political form which is considered legitimate depend upon ancient political habits. To understand these political habits and hence the feasibility of different political forms we need to look at the history and cosmological beliefs of the people. The chapter on Haiti, and Lundahl’s other work, strongly suggests that the continuation of the strange predatory state in Haiti is largely explicable in these terms, so that even when democracy was introduced it has not taken any root.

I also argued in *Unintended Consequences*, that the political habits of different cultures were formed as much by the geography of the territory where the relevant culture was formed than by any ideology. Thus, China in its origins in the relatively compact Yellow River valley, constantly threatened by the nomadic barbarians from the steppes to its north, developed a tightly controlled bureaucratic authoritarianism as its distinctive polity which has continued for millennia to our day. By contrast Hindu civilization developed in the vast Indo-Gangetic plain, protected to a greater extent by the Himalayas from the predation of barbarians to the north. As I argued in *The Hindu Equilibrium* (1988), this geographical feature (together with the need to tie down the then scarce labour to land) accounts for the traditional Indian polity which was notable for its endemic political instability amongst numerous feuding monarchies, and its distinctive social system embodied in the institution of caste. The latter, by making war the trade of professionals, saved the mass of the population from being inducted into the deadly disputes of its changing rulers. While the tradition of paying a certain customary share of the village output as revenue to the current overlord meant that any victor had little incentive to disturb the daily business of its newly acquired subjects. The democratic
practices gradually introduced by the British have fitted these ancient habits like a glove. The ballot box has replaced the battlefield for the hurly-burly of continuing ‘aristocratic’ conflict, whilst the populace accepts with a weary resignation that its rulers will through various forms of ‘rent-seeking’ take a certain share of output to feather their own nests.

By contrast consider the Americas. Both North and Latin America shared similar resource endowments, with an abundance of land and scarcity of labour. Whereas much of development economics is concerned with the development of labour-surplus economies of relevance for Asia, it is the economics of land-abundant, labour-scarce economies which is relevant for the New World. A seminal essay by Domar (1970) provides the necessary theoretical framework. He cogently argues that in a land-abundant economy, free labour, free land and a non-working upper class cannot coexist. Any two can but not all three.

Thus consider the case where land and labour are the only two factors of production. Land is so abundant that there are no diminishing returns to labour, whose marginal and average product are the same \( \text{mpl} = \text{apl} \). If employers seek to hire labour, they will have to pay a wage equal to this common marginal and average product of labour, leaving no surplus rents from land for the employer. Hence the agrarian form that will emerge is family-labour-based farms, as any form of hired labour or tenancy will be unprofitable and landlords – who have to depend on one or the other – cannot exist. A government, by taxing this independent peasantry through direct or indirect taxes, could support a non-working class of retainers; but the latter or an independent nobility of landlords could not support themselves from land rents – as none would be available. Economic expansion based on an independent yeomanry was the form that North American development and its agrarian structure took in the colonial period. Next, suppose the government wants to create an independent class of landowners and grants the chosen few sole rights of ownership to land. If the peasants are free to move, competition amongst landlords will drive the rural wage up to the marginal product of labour which is close or equal to its average product because of the abundance of land. There will be little or no surplus left for the landlords. In order to provide this surplus some means will have to be found to restrict or abolish the peasant’s freedom to move. Various forms of tying labour down to land – serfdom, slavery and the caste-system – emerged in the great agrarian civilizations. They created a landowning class which derived a rent not from land but from the peasants by expropriating a large part of their income above a subsistence level.²

Finally, as the labour force expands from natural increase and/or migration and land becomes scarce relative to labour, diminishing returns to labour appear with the \( \text{mpl} < \text{apl} \). This allows landlords to obtain the rents from land and an assured labour supply to work it through hired labour paid its mpl, or else through various forms of tenancy.
The land-abundant US sub-continent was gradually tamed by the gradual westward spread of the family farm. In Latin America a society of small farmers failed to take shape. Spain could not export many, and in America the lure of mines, the possibilities of large scale, preemptive acquisition of land, and the opportunities for exploiting Indian and African labour militated against such a design. (Morse, 1964, p. 128)

Equally important were the differing ecological conditions for agriculture in North and South America. In the North, unlike the tropical parts of the Americas, grains were the most suitable crops for cultivation. These have constant returns to scale in their production, unlike plantation crops like sugar which have increasing returns to scale. The same is true, to a lesser extent, of tobacco and coffee. Where climatic conditions in the Americas were suitable for cultivating tropical crops, the use of coerced labour had enormous cost advantages over free labour, which led to great social and economic differentiation in society with large inequalities of income and wealth.

By contrast, given its factor endowments (including the climate), in most of the US (except for the South) the family farm became the backbone of the colonial economy and a society with fairly egalitarian mores could develop. That these factor endowments (including the climate) rather than the cultural differences between the Protestant North and Catholic South were responsible for the development of these different types of societies in the Americas is illustrated by the case of the Puritan colony of Providence Island, which developed the Caribbean and Latin American pattern of land ownership and settlement rather than the North American one of its co-religionists.

These cultural differences were vital however, in the different polities that were established in the areas of Iberian and Anglo-Saxon colonization. Morse (1964) argues that Spain after the reconquest (from the Moors) was a patrimonial state in which feudalism never developed fully. It was a centralizing state without the decentralization of rights of the manorial system.

The patrimonial rather than feudal states that Latin America inherited was not to convert the pagans but to elect their own religious leaders. The American Indians ... were ... to be tamed or exterminated. Moreover, the idea of salvation of one's neighbor never enters the Calvinist ethic because only divine grace, not human action, can save
man . . . As the intermediaries between the individual conscience and God are suppressed, the evangelizing mission of Christianity disappears.

(Paz, 1988, p. 27)

By contrast evangelism was the public justification given for the Conquest and for the Spanish and Portuguese domination of Latin America. New Spain even more than its parent state adopted the neo-Thomism developed by Suarez and his disciples as part of the Catholic church’s revitalization during the Counter-Reformation. This provided an ideological justification for the patrimonial state. Society is considered to be a hierarchical system in which every person and group ‘serves the purpose of a general and universal order that transcends them’ (Morse, 1964). This hierarchy is part of a universal and natural order and not the product of any social contract. The sovereign is responsible to God not to society even though his authority originates in the people.

Neo-thomism was a philosophy destined to offer a logical and rational justification of the Christian revelation. In turn the teaching and defense of the Christian revelation formed the basis of the Spanish empire. Religious orthodoxy was the foundation of the political system. (Paz, 1988, p.30)

Its economic correlate was corporatism.

This political and economic system was *par excellence* an ‘enterprise’ association as delineated by Oakeshott (1993). By contrast, the Protestant colonies were relatively indifferent to religious orthodoxy. In the previously cited work, Luther maintained that, in the colonies, if a group of Christians had no priest or bishop amongst them they should elect one of themselves as a priest and this election would not only legitimize their authority but also consecrate it (see Morse, 1964; Paz, 1988). As Paz notes, ‘nothing similar exists in all of Catholic tradition’ (p. 27).

Thus in the Protestant North a pluralist society developed, with the view that

the world is composed not of one *highly differentiated society* for which certain common forms, acts, and ceremonies are a needed binding force, but of a *multitude of unrelated societies*, each of them a congregation of similar persons which in finite time and place are ordered by the declarative terms of a compact rather than by common symbolic observances.

(Morse, 1964, p. 152)

This allowed the notion of the state as a civil association (in Oakeshott’s terms) to develop, with the state as the umpire between many competing
interests. This difference in what I like to call cosmological beliefs (see Lal, 1998a) explains the observation by political scientists that:

politically, North Americans confine their feuds primarily to selecting officials and debating public policies, but in Latin America feuds are more fundamental . . . democrats, authoritarians, and communists . . . all insist they know what is best for themselves and their neighbors.

(Wynia, 1990, p. 3)

This ‘universalism’ of the neo-Thomist tradition was further strengthened by the attempt of the Jesuits in Latin America (and in other parts of the world) to promote a religious syncretism which would lead to a ‘unification of diverse civilizations and cultures . . . under the sign of Rome’ (Paz, 1988, p. 39).5

This fundamentalist universalism also provides, in my view, an explanation for the continent-wide swings in political and economic fashions over the last two hundred years.6 In the post-war era, the pronouncements of the Economic Commission of Latin America (ECLA) have been accorded the status of gospel truth. When it advocated dirigisme, that became the policy for most of Latin America; when it finally endorsed economic liberalism in the early 1990s, that has become the new gospel. More than other parts of the world, therefore, a universalist ideology matters in Latin America. This seems to be very much part of the story of the wild swings in ideology and policy to be found in the case of Nicaragua outlined in this book. Instead, therefore, of searching as political economists do in other Western societies for the changing equilibrium of interest groups, in Latin America one needs to explain how these intellectual swings of ‘fashion’ take place, as they are rather like religious conversions – Menem in Argentina and Cardoso in Brazil being outstanding examples.

This penchant for universalist ideological beliefs has also meant that there is a continuing dissonance between the Latin American social reality of the extreme inequalities which are the result of its ecological and political heritage and its Christian cosmological beliefs emphasizing equality – which it of course shares with the North. There is no such Northern dissonance as both for ecological and political reasons a uniquely egalitarian social and political society developed there.

In this context it is worth noting the important difference between the cosmological beliefs of what became the Christian West and the other ancient agrarian civilizations of Eurasia. Nearly all of these believed in some form of hierarchical social order, which for instance in Hindu India – with its belief in reincarnation – was rationalized as resulting from the system of just deserts for one’s deeds in the past life. By contrast, alone among the Eurasian civilizations, the Semitic ones (though least so the Jewish) emphasized the equality of men’s souls in the eyes of their monotheistic Deities. Dumont has rightly characterized the resulting pro-
found divide between the societies of Homo Aequalis which believe all men are born equal (as the philosophes, and the American constitution proclaim) and those of Homo Hierarchicus which believe no such thing.

This matters for the polity. With the rise of Demos, those societies infected by egalitarianism have a greater propensity for the populism which damages economic performance than the hierarchical societies. If as in Europe the granting of democratic rights can be phased in with the growing economic and social equality that modern growth helps to promote, then the political effects of the dissonance between an unequal social reality and egalitarian cosmological beliefs can be avoided. In the colonial and nineteenth-century patrimonial states of Latin America this dissonance was avoided by restricting the polity – in effect to the property owning classes. But if, as in this century, while still in the early stages of modern growth, the polity is expanded by incorporating the ‘dangerous classes’, through an extension of democratic rights to the whole populace, then this dissonance can, as it has, lead to political cycles of democratic populism followed by authoritarian repression as the distributional consequences of the populist phase are found unacceptable by the ‘haves’. By contrast, hierarchical societies can more easily maintain majoritarian democracies, however corrupt and economically inefficient – as the notable example of India shows – despite continuing social and economic inequalities. Thus, as many Latin American commentators have noted, the historic and continuing inequalities of Latin America make democracy insecure, largely – I would argue – because of the dissonance between ‘society’ and ‘cosmology’ noted above.

Finally, consider sub-Saharan Africa, where the largest number of the world’s failed states are to be found. The major point to be noted about African states is their artificiality. They are the result of the nineteenth-century colonial scramble for Africa. These artificially created states have neither the ancient homogenous tribal identity of a state with loose association with tribal chiefs providing the necessary governance. Nor have they succeeded in behaving like imperial states. These have historically provided a means of welding a multitude of ethnic and religious groups into a functioning state. I have elsewhere (Lal, 1999a) distinguished two major types of imperial state: the genuinely multi-ethnic states such as the Austro-Hungarian and Ottoman empires, which were mainly concerned with maintaining their pax over a certain geographic space with no attempt to change or homogenize the ‘habits of the heart’ of their constituent communities; and the homogenizing empire, as best illustrated by the Chinese who created a fictitious homogenized Han identity out of the ethnically diverse people they incorporated. In our day the best example is the USA, which has created a homogenized American identity through its ‘melting pot’ of diverse races and cultures. Then there are the ‘nation states’ of the Renaissance princes, the UK, France and Spain which used mercantilist devices to incorporate different groups into a ‘nation’. It is
this last model that the African elites seemed to be following after independence, and with charismatic leadership there seemed some hope that they might have succeeded. But, given their resource endowments, the inevitable politicization of rents in states with continuing tribal and other ethnic rivalries has led to civil wars. In fact there seems to be an emerging statistical law about civil wars, which shows that there is an inverted U-shaped relationship between ethno-linguistic fragmentation in a state and the risk of civil war, the most homogenous (with every group with its own state) and the most fragmented (as in a multi-ethnic empire) being at least risk of civil war. In this case the idea that constitutions and democratic forms could provide a corset to contain the bloody conflicts to capture the state and the booty that affords is laughable. Much better to either reconvene a new Congress of Berlin – run by Africans – to re-create tribally homogenous states, which, as the shining example of Botswana shows, could prosper, or else hope that some African state will establish a multi-ethnic empire and its pax over much of the continent!

Nevertheless, a number of cross-sectional statistical studies claim to have found a relationship between democracy and development. But the statistical proxies used for the political variables in these studies do not inspire much confidence, which are further plagued by the econometric problem of identification. The two countries studied in this book, where democratic regimes supposedly replaced predatory authoritarian regimes – Haiti and Zambia – do not provide much confidence in this view. In fact, in our 1996 book, Myint and I found no relationship between the form of government and economic performance during the thirty-year economic histories of the twenty-five developing countries that we studied. Rather than the polity the initial resource endowment, in particular the availability or lack of natural resources, was a major determinant of policies which impinged on the efficiency of investment and thereby the rate of growth (as noted in section 11.1). The difference in performance was further explained by the other major determinant of growth – the volume of investment. Thus whilst the efficiency of investment in India and China during both their dirigiste and more economically liberal periods was about the same, China’s investment rate has been about twice India’s, resulting in its growth rate also being twice as high. This might be taken as providing some support for the view that democracies will have very high rates of time preference as compared with dictatorships. But considering dictators like Mobutu of Zaire or Marcos of the Philippines it would be difficult to sustain this view.

11.3

Finally, let us examine the effects of the current episode of globalization on economic policy making in developing countries. There is a view that globalization will lead to the withering away of the State. This view is as
unjustified as the hope of the Marxists that their Communist paradise would lead to a similar – for them desirable – outcome. Two points need to be emphasized.

First, integrating with the world economy is still a matter of choice for every state. The reason so many are increasingly treading this path is due to the unparalleled popular opulence this offers. Some like Cuba and North Korea have chosen to turn their backs on the global economy with predictable dire outcomes for their populace. Nor is there something new about globalization. In the past it has been associated with the creation of empires which have brought hitherto disjointed economic spaces into a common economic area under their pax which has allowed the gains from trade and specialization emphasized by Adam Smith to generate what I call Smithian intensive growth. But these periods of globalization are not irreversible, as witness the nineteenth-century liberal, international economic order created under British aegis, and which was destroyed on the fields of Flanders.

Second, the processes of globalization, in particular the integration of capital markets, does increase the contestability of both states as well as corporations. For the degree of contestability depends, in both cases, on the barriers to entry and exit for potential new entrants and existing customers. Current fears that a globalized economy will be monopolized by large multinationals are thus unfounded, as globalization by increasing contestability will make even the largest of this species behave in a competitive manner.

Similarly the predatory state (in all its forms) will find that globalization will force it to reduce the net ‘revenues’ it can extract from its populace for its own purpose. Ideally, it will force them to act like the Platonic guardian state which only taxes its citizens enough to provide the essential public goods with a balanced budget.

Finally, in a globalized world, size does not matter, as long as the global public good of defence against external predators is ensured by a global hegemon. In parts of the world, for example much of Europe where this external threat has almost disappeared, we are witnessing the unravelling of the ancient ‘nation-states’, such as the UK. For many developing countries such a happy outcome is unlikely, partly because of the reluctance of the current hegemon – the US – to enforce its PAX if it requires it to expend its own men and material – though with the US reaction to the savage events of 11 September 2001 this seems to be changing. So in much of the Third World where the old impulses for territorial aggrandizement are not extinct, this reason to maintain a national identity coterminous with the territorial nation state will remain, and hence the ‘nation-building’ impulse which fuelled much dirigiste neo-mercantilism will remain in place. But to the extent that globalization forces the depoliticization of political life, it also makes it less important to capture the levers of economic power to make a living for oneself or one’s
constituents. This means that domestic politics will need to cater less to the economic interests of particular groups, and could become less fissiparous. The state can then more easily become a ‘civil’ rather than an ‘enterprise’ association in Oakeshott’s terms. This should reduce the tensions between a national identity fostered by the external threat and that belonging to a particular caste, tribe or other narrow group seeking to garner more of the gains in the political redistributive game for itself. All this of course assumes that there is a functioning state in the first place. For the failed states – of which Haiti provides the most vivid and tragic example in this book – until a viable state is created by the two routes outlined in the last section, globalization in itself offers no panaceas.

Notes

1 Also parts of the essay are based on Lal (1998b) and (1999a).
2 On this interpretation of the origins and persistence of the caste system in India see Lal (1988). For Russia, the fact that serfdom was instituted to provide a surplus for the nobility is attested by two facts:

   the first . . . [is] the replacement of the basic land tax by a household tax in the 17th century and a poll tax under Peter the Great. The second is . . . [a]
   cultural trait . . .: as late as in the first half of the 19th century, the social
   position of a Russian landowner . . . depended less on his landholding . . .
   than on the number of souls (registered male peasants) he owned.

   (Domar, 1970, p. 232)

4 See Kupperman (1993).
5 But there was also a more positive aspect of the common Catholic culture of Latin America. As Hugh Thomas has rightly pointed out to me, Latin America succeeded ‘socially’ where the US ‘failed’. This was in part due to the planned cities, the skilful approach to racial matters enabling manumission of slaves, and of course a common Catholic culture which left their personal and social mores closer to the ‘communalist’ ones of the other great ancient civilizations than those based on the new fangled ‘individualism’ of their Protestant brethren. (see Lal, 1998a).
6 Veliz (1994) contrasts this universalism of Latin America with the greater tolerance of diversity in beliefs in North America as between the Baroque hedgehogs of the South and the Gothic foxes of the North in the New World, reflecting Archilochus’ maxim: ‘the fox knows many things, but the hedgehog knows only one thing’, (quoted in Berlin, 1978).
7 See, for instance, Castaneda (1995).
9 See Przeworski and Limongi (1993) for a survey. The best of these studies is by Helliwell (1992), and the most cogent critique of the econometrics involved by Deaton and Miller (1995).
References


Deepak Lal


The experience of Burma for most of the second half of the twentieth century has been one of tragic failure, with political repression and economic stagnation mutually reinforcing each other in a vicious downward spiral. What makes this sorry history particularly deplorable is the stark contrast with the favourable endowment of both natural and human resources that the country possessed at the outset of its national independence in 1948, despite the physical destruction that it suffered as a result of being fought over twice during the Second World War. The objective of this essay is to briefly outline the main determinants of this sequence of events and to consider what the chances are for some improvement in the future. (Further references that the interested reader may wish to consult are Khin et al. (2000) and Thein (2004).) With a population of close to 50 million, and its strategic location between India and China, Burma is not a small or unimportant country, though its military rulers have succeeded in making it an obscure one. I therefore think it necessary to provide more general and historical information than would otherwise be necessary for an exercise of the sort that we are engaged in with this essay.

The country has been a unified political entity since the time of King Anawrahta (1044–77), the founder of the Pagan Dynasty (1044–1287), i.e. since the time of the Norman Conquest in Britain. The ethnic Burmese and several allied ethnic groups are of Sino-Tibetan lineage. They entered the country overland from the north and interacted with Mon-Khmer people in the south. For much of Burmese history kingdoms representing these two groups contended for power, with the north eventually dominating. Under the Toungoo (1480–1752) and Konbaung (1752–1885) Dynasties that succeeded Pagan, Burmese arms and influence were carried into Laos, Thailand and Assam, and rulers such as Bayinnaung (1551–81) were regarded as the most powerful in Southeast Asia by the Portuguese, many of whom served as mercenaries in his army. The last Konbaung Dynasty, founded by Alaungpaya (1752–60), destroyed the Thai capital of Ayuthia in 1767. During the nineteenth century, however, the kingdom fell to the British after the three Anglo-Burmese Wars of 1826, 1852 and 1885.
During all of this time the culture was formed by the Theravada Buddhism adopted from Ceylon and by the ideas of kingship diffused from India. Complex irrigation works in the “Dry Zone” of central Burma provided the familiar “Asiatic Mode of Production” framework of socio-political institutions noted by Marx, Weber and Wittfogel. Direct Chinese influence was rare, except for a punitive expedition under Kubilai Khan that brought the Pagan Dynasty to an end.

The British colonial period 1852–1948

Burma was opened to the impact of world economic forces even before the country fell totally to the British after the Third Anglo-Burmese War in 1885. Indeed the pretext for that war itself was a commercial dispute over timber extraction by a British firm in territory still under Burmese jurisdiction. The Second War of 1852 had placed all of Lower Burma and the Irrawaddy Delta under British rule. The opening of the Suez Canal in 1869 stimulated British trade with India and indirectly therefore with Lower Burma which was governed from India. The contact with the world market led to the remarkable event known as the “colonization of the Delta”, peasants from Upper Burma migrating south to clear the swampland and plant rice for export. Moneylenders from South India, of the Chettiar caste, combined with European-owned rice-mills and Burmese land and labour to fuel the rapid expansion of rice exports that made the country the world’s leading exporter and Rangoon one of the busiest ports in Asia. Timber and minerals were additional export items that made Burma one of the most flourishing colonies in the British Empire. Over 300,000 people, approximately 10 per cent of the population of Upper Burma, migrated to Lower Burma in response to the new economic opportunities. The area under paddy cultivation increased over five-fold between 1856 and the turn of the century, and the volume of rice exports rose from 284,000 tons in 1856 to 658,000 in 1880, over 1 million tons in 1891 and 3.3 million tons in 1931. This 1931 figure was more than double the export volumes of Siam and French Indo-China in 1937.

This spectacular economic achievement went along with what the scholar J. S. Furnivall (1957) called a “plural society”. The ethnic Burmese cleared the land and cultivated the rice, financed over the course of the season by the Chettiar moneylenders. The harvested paddy was processed in rice-mills owned largely by Europeans, while the rice was loaded on the docks by migrant Indian labour, with Chinese and Indian shopkeepers doing much of the wholesale and retail trade between town and country. The higher administration was British, with Indians and Burmese in the lower levels of the bureaucracy.

The collapse of rice prices during the Great Depression of the 1930s had a devastating impact upon this “plural society”. The seasonal agricultural loans were made on the security of the land held by the small owner-
The collapse of the rice price led to over 2 million acres, 25 per cent of the total cultivated area, passing into the hands of the Chettiar through foreclosure. Peasant rebellions and urban riots broke out, reflecting the intense social tensions underlying the success story of the rice-export economy.

The performance of the colonial export economy is worth noting. Some statistics derived from Andrus (1947) show that Burma’s per capita exports, annual average for 1936–9 in US$, was 12.65 compared with 5.10 for Siam, 6.70 for the Netherlands Indies, 4.05 for French Indo-China, 2.00 for India, and 0.40 for China. Only British Malaya, at 75.55, was higher in Southeast Asia, because of its rich deposits of tin, extensive rubber plantations and small population. Annual imports, at 5.60, were less than half exports, reflecting the familiar “drain” of profits and remittances out of a dependent colonial economy to external factor owners and taxing authorities.

Despite its spectacular growth, rice and rice products constituted less than half of total exports in 1939–40, $81 million out of a total of $173 million (figures from Andrus, 1947). Teak and other timber constituted $11 million, minerals $18 million and the relatively new export petroleum as much as $55 million.

Modern education was introduced but confined to a relatively small elite. Rangoon University, established in 1920, was perhaps the most outstanding academic institution in Southeast Asia, with many world-class scholars among the expatriate faculty. Faculties of law and medicine provided the nucleus for training in these professions, and graduates of arts and sciences went largely into civil-service occupations. Industrialization was very limited, and largely confined to processing of natural-resource products, such as rice-milling and saw-milling.

British colonial rule in Burma was marked by a heavy reliance on laissez-faire. The administration, part of British India until 1937, took the view that its duties should be confined largely to traditional “law and order”, eschewing active social intervention. The “plural” nature of the society that this policy created also led the administration to adopt a “neutral” stance towards the different ethnic groups and religious communities. The ethnic Burmese and the Buddhist clergy were thus officially regarded as just one among many claimants for justice and protection. Not unnaturally, the predominantly Buddhist Burmese felt deprived in their own country, and an intense nationalism was not long in developing, exacerbated by the social consequences of the collapse in rice prices during the 1930s. Young Buddhist monks and university students were in the forefront of the movement that increasingly demanded independence, inspired by the examples of Ireland and India. Japan was admired for resisting European domination and the appeal of the “Greater East Asian Co-Prosperity Sphere” was felt by the independence movement. A group of student leaders and political activists, the so-called “Thirty
Comrades”, went secretly to Japan for military training to overthrow British rule with Japanese help. Two of the thirty were the two most influential men in the history of Burma in the twentieth century: General Aung San and General Ne Win.

The Japanese occupied Burma with surprising ease after the crushing British defeat at Singapore. They installed a puppet Burmese regime but it soon became apparent to the Burmese that they had merely exchanged colonial masters. The country was cut off from foreign trade by the war and inflation was rampant as the Japanese simply printed money for their expenditures. Aung San and the independence leaders opened negotiations with the British forces invading from India. Japanese resistance to the allied invasion was fierce and bitter, and heavy damage was inflicted on the country’s physical infrastructure. A significant legacy of the conflict that bedevilled the future of Burma was the large supply of arms that became available in the country and was retained for future use by interested parties.

The British Labour Party regime had decided to confer independence along with India and Pakistan, and Burma duly obtained it in January 1948. In March 1947, however, Aung San and several other leaders of the independence movement were assassinated in a plot hatched by a disgruntled politician. This was a devastating blow to the future of the country. Aung San had no equal for charisma, vision and commitment to democratic values among the other Burmese leaders. Perhaps most important of all he was trusted by the other “national minorities”, who were concerned about what would happen to their interests after the British left. The Karens, largely Christians and living among the Burmese in the fertile lowlands rather than the upland border regions where most of the other minorities such as the Shans, Kachins and Chins were located, were particularly aggrieved and fearful. They rebelled, as did other ethnic groups, as well as the Communists, who felt that the new regime would not be sufficiently “progressive” in its approach to economic policy and international relations. Thus the dawn of independence in January 1948 was not particularly auspicious.

The democratic regime 1948–62

The government of newly independent Burma faced daunting tasks, augmented immeasurably by the loss of its leader. GDP and agricultural production, which were only about 75 per cent of their pre-war levels, sank even further at the height of the multiple insurgencies in 1949–50. The government nevertheless hung on, contained the insurgency and restored the economy to the 1947 level by 1951–2. With relative normalcy restored, the government could turn to the task of economic development and the creation of new institutions for political and social change.

The ruling Anti-Fascist People’s Freedom League (AFPFL) was a loose
amalgam of component political strands, united by nationalist aspirations for a unified state, commitment to democratic values and the creation of a “mixed economy” with a strong role for the state but without hostility to the private sector, particularly indigenous firms and entrepreneurs, to the extent that such could be found. Agricultural land, much of which had been alienated during the depression of the 1930s, was nationalized and redistributed, with a limit of 10 acres per household. A regime of moderately high tariffs, supplemented by quotas, was installed, replacing the essentially free-trade regime of the pre-war era. A central bank was established along with a fixed exchange rate that soon could only be maintained by foreign-exchange controls and an import-licensing regime.

The most important economic institution was the State Agricultural Marketing Board (SAMB). This bought paddy from the farmers at a fixed nominal price that was substantially below world prices. Imported consumer goods, restricted by quotas, were substantially above world prices. Together this represented a severe turning of the “internal terms of trade” against the peasant sector, in favour of urban rice consumers and government revenue from the profits of the SAMB, which was the fiscal mainstay of the government. Needless to say the “double squeeze” on the farmers imposed in this way substantially reduced the incentive for them to supply exportable surpluses, to the detriment of the foreign-exchange earnings of the government, which responded by further tightening import controls and thus further accentuating the problem. The sharp decline in world rice prices after the Korean War boom created further difficulties.

In 1952 the government adopted an Eight-Year Plan, drawn up by a firm of American consultants. Despite the foreign-exchange problems alluded to above the plan was on the whole a modest success. Per capita GDP rose by a third and rice exports doubled, from 1 to 2 million tons in 1959–60. Partially offsetting the price squeeze were the fairly generous state provision of agricultural credit (replacing the pre-war role of the Chettiars) and better irrigation and extension services.

The high world prices during the Korean War boom, together with Japanese reparation payments and foreign aid, meant relatively abundant foreign exchange. This led to some valuable restoration of depleted infrastructure such as the rail system and rolling stock and to some expansion of electric power and irrigation projects. Unfortunately there were also some capital-intensive industrial projects that were not very successful. Private-sector industrial projects in textiles, food processing and other fields were quite promising and successful. Wholesale and retail trade in domestic produce was largely in native hands, but Indians continued to be dominant in the lucrative trade in imported consumer goods. Licences for the import quotas were granted to ethnic Burmese, many of whom had no qualification beyond good political connections. These licences were promptly sold at handsome premiums to the real importers, the Indian merchants. By a common confusion of cause and effect, public opinion
blamed the practice of selling licences for the high prices of the imported goods, which of course merely reflected the restrictiveness of the import quotas relative to the domestic demand at the world price.

Education was a field in which the parliamentary regime made significant accomplishments at all levels. The enrolment in Rangoon University was greatly expanded. Medicine and engineering were particularly popular and successful programmes and subjects such as business administration and management were added. The expatriate faculty of the colonial period were replaced by a much larger body of qualified Burmese, most of whom had advanced degrees from leading Western academic institutions. One area of education that unfortunately lagged behind was vocational and technical training, despite some modest advances.

Perhaps the most notable achievement of the democratic regime, however, was the tolerant, humane and genuinely progressive values that it promoted. The Prime Minister U Nu, who had the unenviable task of succeeding the revered Aung San, impressed even his political enemies with the genuine sincerity and inclusiveness of his personality and approach to life. A devout Buddhist and staunch Burmese nationalist he nevertheless instilled full confidence in citizens of other faiths and ethnic identification of his impartiality. Abroad, he followed the “non-aligned” policy that he shared with Nehru, Sukarno and other Asian leaders to the letter, and Burma enjoyed the goodwill of both blocs in the global competition of the superpowers. Burma thus appeared to be well on the way to being an example of successful economic development and political modernization, active and respected in the United Nations, and vigorously promoting a vibrant civil society with peasants, workers, students, monks and all ethnic groups having a respected role to play in the national life. The various insurgencies were of course carrying on and the rate of economic growth was perhaps a little too slow but there was no reason to believe that Burma could not follow the path that India was treading at the same time and at the same pace.

All of this progress, however, depended upon the political unity of the AFPFL being maintained. Unfortunately the factionalism that has tended to be a continuing feature of Burmese political life led to a split between a “clean” faction, led by U Nu, and a “stable” faction. The disputes were over patronage, policy and perhaps mostly personal rivalries between U Nu and his followers, on the one hand, and the two prominent leaders of the “stable” faction on the other, U Ba Swe and U Kyaw Nyein. The split made the regime so dysfunctional that U Nu called on General Ne Win, the commander of the armed forces, to lead a “caretaker” regime until an election could decide which faction would form the government.

The caretaker regime took some “get-tough” measures that were well received by members of the urban elite but were resented by the masses. Squatters were evicted from the centre of Rangoon, for example, and examinations at the University were tightened up, which was not well
received by students who regarded passing as an entitlement. On the eco-
nomic front a number of new projects were undertaken as joint ventures
between the state, the domestic private sector and foreign investors. The
initiatives were taken mostly by two energetic brigadiers, Maung Maung
and Aung Gyi, with General Ne Win apparently content to remain in the
background. The brigadiers were sympathetic to the “stable” faction of the
AFPFL and it was expected that their support would guarantee the success
of this faction in the elections. Popular resentment at the high-handed
actions of the caretaker regime and the charisma of U Nu, however, led to
the triumph of the “clean” faction at the polls.

The post-caretaker democratic regime of U Nu did not perform well.
Its economic policy was erratic and uncertain and U Nu did not give the
impression of being firmly in control, his tolerance and good nature
making him vulnerable to most groups and individuals that wanted to take
advantage of him. The politicians of the “stable” faction were aggressive in
their opposition and even supporters felt aggrieved at not receiving what
they felt to be their due. The armed forces remained in the wings.
Brigadier Maung Maung was suddenly purged by General Ne Win and
sent into political exile as an ambassador, along with some other senior
officers prominent during the caretaker regime. This move was misread
by the politicians as indicating that Ne Win wanted the army to stay out of
politics. It therefore came as a complete surprise when all of them were
rounded up and arrested one night in March 1962 in a textbook *coup
d’état*. A junta of senior army officers led by General Ne Win, calling itself
the National Revolutionary Council, took over the reins of power on the
pretext that the politicians were endangering the unity of the state by
negotiating with the ethnic minorities of the border regions.

**The Burmese way to socialism, 1962–88**

The armed forces that staged the *coup d’état* of 1962 under the instigation
of General Ne Win emerged out of the nationalist agitation and
independence movement of the colonial period. The Thirty Comrades, as
we saw, were trained in Japan and formed the military arm of the regime
installed by the Japanese. It subsequently joined the allies in the campaign
that defeated the Japanese. The force was then merged with the units
established by the British, officered largely by Karens and Anglo-Burmese.
Many of the Karen officers and soldiers joined insurgent groups and
fought against the forces of the newly independent state. Several of
the original Thirty Comrades went into private life but Ne Win was appointed
chief of the armed forces with some other members of the group also
holding senior commands. He rapidly established his full control and
authority over the military and gained prestige from the successful con-
tainment of the insurgency.

The ideology of the Burmese armed forces owed nothing to the
traditions of the colonial army, as was the case in India and Pakistan for example. The analogy with India would be as if Subhas Chandra Bose and the Indian National Army had constituted the armed forces of India after independence. Ne Win and the other leaders of the new army absorbed not only the intense nationalism of their Japanese teachers but also their distrust of civilian politicians and the view that they were the only true guardians of national sovereignty and integrity. They therefore had no qualms about subverting the constitution that they were supposed to uphold, believing that they were following a higher obligation. However sincere they might be in this belief, it is obvious that it provides an open licence to hold on to power indefinitely regardless of performance since they do not regard themselves as accountable to any other authority.

The new regime did not merely replace the cabinet, leaving the civil administration and public enterprises to be managed as before. It placed serving officers at all levels of every public institution, with a monopoly of all effective decisions. Government was by decree, with no consultation or review by any individual or body outside of the military itself. The only overt resistance came from the students of Rangoon University, who held a rally on the campus with speeches critical of the new dispensation. When they refused to disperse the army opened fire, killing several dozen students and other participants. The student-union building, a revered monument of the independence struggle, was dynamited, and classes suspended.

The economic policy of the regime reflected the intense suspicion and paranoia that it felt about any entity not under its direct control. It was thus not extreme socialist ideology but the desire for control that led them to rapidly nationalize all private industry as well as wholesale and even retail trade. The Quartermaster General was put in charge of the economy which he attempted to run without regard to prices and costs, on a purely physical basis as if he was allocating supplies, ammunition and rations to the troops. This natural inclination towards a purely physical approach to resource allocation was reinforced by the selection of a prominent Marxist as the chief economic adviser, who attempted to apply standard Gosplan techniques to a pre-industrial economy with results that were entirely predictable.

The regime felt it necessary to justify its hold on power by adopting a familiar tactic of Third World dictatorships, a national road to socialism as the official ideology. This was the so-called Burmese Way to Socialism, to be implemented by a Burma Socialist Programme Party (BSPP). Since all other political parties were banned and all politicians in jail, the country became a one-party state. Party membership was effectively obligatory for all civil servants and state employees, and the usual subservient worker and peasant organizations were created by the party apparatus.

In addition to nationalization of industry and trade the state intervened heavily in the agricultural sector with interference in the choice of crop
patterns and imposition of compulsory deliveries. Failure to comply led to expropriation and redistribution of the land. Selling prices for almost all crops including paddy were fixed at low levels and the private credit market collapsed since it was declared illegal to acquire any land, cattle or implements for non-repayment of debt. This made farmers entirely dependent upon the inadequate loans provided by the government itself.

The nationalized industrial plants were on the whole grossly mismanaged and suffered from the scarcity of foreign exchange for imported inputs and spare parts. The scarce imports of consumer goods mostly ended up in the black market. The traders of Indian and Pakistani origin all left since there was no longer any basis for their livelihood. This was of course claimed as a triumph of nationalism.

The best indication of the disastrous effects of the Burmese Way to Socialism on the national economy is provided by the data on foreign trade. From 1962 to 1988 annual exports in value terms fell from about $260 million at the outset of the period to about $220 million at the end, despite a fourfold increase in the unit value of exports. In terms of volume, exports fell by about two-thirds. Imports rose from about $220 million annually at the beginning to about $250 million at the end. Despite the goal of national autonomy and self-sufficiency the external debt went from negligible levels at the outset to over $4 billion at the end, largely because of trade credits to cover the mounting balance of payments deficits.

The economy survived only through the flourishing of an “underground” or “parallel” economy, just as in the case of the Soviet Union. Rice and other agricultural, forest and mineral products were exported illegally across the borders to Thailand, China and Bangladesh, and manufactured consumer goods imported in return. The severe limitation of incentives to go through legal channels resulted in the “second best” alternative of more circuitous and costly overland channels. In addition, the narcotics trade thrived as well, with the “Golden Triangle” region being the major source of the world’s supply of heroin. This also provided the economy with more imports of manufactured consumer goods.

The shortage of foreign exchange and the losses incurred by the state enterprises forced the regime to print money, leading to rampant inflation. To check this, recourse was frequently had to the “demonetization” of higher denomination notes, which of course only speeded up the velocity of circulation and aggravated the inflationary problem even further. By 1988 the situation reached crisis proportions and the patience of the long-suffering people finally snapped.

**The SLORC/SPDC regime, 1988**

The severe economic crisis of 1988 also led to an apparent loss of confidence on the part of the military regime. General Ne Win himself had
long relinquished most of his official political and military positions but continued to be the undisputed master of the army and its civilian supporters. There were some changes and rotation among the prominent military/political leaders, prompting massive demonstrations by all sections of the public in the capital Rangoon and other cities. After some hesitation the regime launched a brutal suppression, mowing down hundreds of unarmed civilians in a manner reminiscent of Budapest in 1956 and eerily foreshadowing Tienanmen a year later.

Contrary to widespread opinion these actions in September 1988 by no means constituted a *coup d’état* by an independent section of the army. The orders were undoubtedly given by General Ne Win himself. The previous junta and its socialist policies having proved such a colossal failure, the army now attempted a drastic change of economic strategy and in the personnel to oversee the “new economic policy”. The BSPP was consigned to the “dustbin of history” and the previous junta replaced by a new one called State Law and Order Restoration Council (SLORC). It proclaimed the country open to market forces and foreign investment, while essentially retaining full control over all the key aspects of the economy.

The new junta attempted to legitimize the army’s hold on power by holding nation-wide elections, confident that its surrogate political party would win. It therefore must have come as a shock to them when the National League for Democracy (NLD), led by Daw Aung San Suu Kyi, captured over 80 per cent of the seats, forcing them to void the election, send most of the elected members of parliament into exile and place the leader herself under house arrest.

Lifting controls on foreign trade, agriculture and forestry led to rapid expansion of exports and imports. Exports rose every year from 1988 to 1995, increasing to $846 million in 1995 from only $147 million in 1988. Rice exports averaged only about 180,000 tons annually from 1987 to 1989 but rose to over 1 million tons in 1994 before falling to 353,000 tons in 1995. Paddy production increased 50 per cent from 1988 to a level of about 20 million tons in 1995, due to increases in both area sown and the yield per acre. Much of these favourable results, however, could not be sustained. For example, varieties with shorter stalks were planted that raised yields initially but were more vulnerable to flooding and pest infestation, reducing output in later years. The million tons exported in 1994 depleted stocks and reduced domestic consumption, driving up prices and reducing the amount exported in the next year by about two-thirds.

The main export under the SLORC regime in the initial years was teak and other hardwoods. Concessions were granted to Thai firms connected to the military that felled trees without any regard for sustainability, causing great potential harm to the environment. Fishing rights were also granted with the same reckless disregard for the future. Exports have been declining sharply since the 1995 peak since rice, timber and fish were all incapable of being sustained at those levels. Beans and pulses have been a
more regular source of foreign exchange but appear to have reached a ceiling at about $120 million a year. Tourism grew to over $150 million a year in 1996 but fell off subsequently.

The opening of the economy to foreign trade was even more pronounced on the side of imports. The level rose very sharply from about $240 million in 1988 to about $1.3 billion in 1995. Trade deficits have mounted sharply and the external debt rose to over $6 billion in 1995. Despite strenuous efforts the regime has not been successful in attracting foreign investment. Much of it has been in hotels and real estate without any genuine developmental effects.

The official revenue base of the regime has been severely eroded, forcing it to rely on printing money or requisitioning labour and goods directly from the citizens, particularly in the rural areas. Expenditure is increasingly concentrated on the army itself. It is now swollen to about 400,000 personnel, from a level of about 100,000 in 1962. The expansion, which has been particularly rapid in recent years, is not in response to any military threat or emergency. The insurgencies have been contained, with the communists having surrendered and most of the ethnic insurgencies in the border areas agreeing to a ceasefire. The expansion is motivated mainly by the need to keep junior officers happy by rapid promotion and so it is necessary to create additional units. The cost of this to the regime is that the benefits it squeezes out of the sagging economy have to be spread more thinly over a larger privileged group, but the gain is that there are more supporters with a stake in the continuity of their rule.

The exchange rate is hopelessly overvalued, the black-market price of a dollar being about fifty times as high as the official rate. Its only rationale is to serve as a basis for rent-seeking, scarce foreign exchange and imports being valued at the official rate for allocation to the privileged. The economy itself is only kept afloat by the extensive unrecorded border trade, particularly with the Yunnan province of China but also with Thailand and, to a lesser extent, Bangladesh. The exchange is mainly primary exports of all kinds, including drugs, in return for manufactured consumer goods. The military itself, rather than attempting to prevent this trade, “taxes” it unofficially in the border regions. In addition, it is estimated that there are now about a million Burmese working unofficially in Thailand, bringing back foreign exchange and scarce consumer goods.

It is estimated that drug exports are worth about a billion dollars annually and other illegal exports can also be put at another billion, both vastly in excess of the mere trickle of legal exports that does not exceed a few hundred million dollars a year. It is the earnings from these unofficial activities that give a false veneer of prosperity to Rangoon and Mandalay. The latter city, the last capital of the Konbaung Dynasty and the site of the Fifth Buddhist Synod, is now largely taken over by immigrant ethnic Chinese and a variety of border drug traffickers and shady businessmen. Real-estate prices were driven up before collapsing as a consequence of
the recent Asian crisis. Several prominent drug lords, including the notorious Khun Sa, have built luxurious villas and acquired other valuable properties in Rangoon and Mandalay. Chinese influence is very apparent in the border areas adjacent to Yunnan province. Several new roads and bridges have been constructed or repaired at China’s expense, linking Yunnan more closely with the Kachin and Shan States. China also provided the army with a large amount of hardware of all kinds. It seems that despite their desire to be free of foreign entanglements, the Burmese junta is being inexorably drawn into the Chinese orbit by economic necessity.

**Comparative performance**

Burma’s dismal economic performance in all respects is best summarized by the foreign-trade data. As we saw, colonial Burma in 1940 had higher per capita exports at world prices than all the countries of Southeast Asia except for Malaya (now Malaysia). Because $1 in 1940 had about the same real value as $12 in 1995, the per capita export of $12.65 in 1940 would be worth about $150 in 1995. With a population of 45 million, Burma in 1995 should have exported $6.75 billion worth of goods if the same per capita performance was maintained. Instead it was just $1.13 billion. Even if we add another $2 billion for illegal trade in drugs and other commodities, this corresponds to barely half of the pre-war achievement on a per capita basis.

Relative to Thailand and the other Southeast Asian economies in 1995 the Burmese trade figures look like rounding errors. Thailand’s export of goods and services was over $60 billion, of which primary exports alone were about $11 billion. Indonesia, the Philippines and Malaysia had $46, $24 and $66 billion respectively. In terms of the structure of exports Burma had only 10 per cent of merchandise exports in manufactures, whereas Thailand, Malaysia and the Philippines all had about 75 per cent and Indonesia 53 per cent. Even communist Vietnam left Burma far behind in the 1980–95 period. In 1980 Burma had $470 million in merchandise exports to Vietnam’s $340 million but in 1995 Vietnam was about $3.8 billion to only $770 million for Burma.

In terms of rice exports Burma was the world leader in 1940 at over 31 million tons annually, compared to only about 2 million for Thailand. Yet that country now exports about 5 million tons annually while Burma’s rice exports have virtually disappeared.

The disparity is comparably bad in social indicators. The situation in education is particularly tragic since it predetermines the future for at least one generation. According to UNICEF figures 39 per cent of children in the relevant age group never attended primary school, 34 per cent dropped out and only 27 per cent completed it. Furthermore, because of the high drop-out rate and repetition it took children twelve years instead of five on average to acquire primary education. Secondary-school enrol-
ment is only 32 per cent of the relevant age group and high school only 5 per cent of the relevant age group. Thailand, which does not do as well as it should, enrolls 20 per cent in high school, and the Philippines enrolls 27 per cent. University education, which used to be the best in Southeast Asia, is now barely surviving. Political tensions have meant that the universities and even high schools have been closed for long periods. Examinations are set even if there are no classes!

The public-health situation is at least as critical as in education if not even worse. Life expectancy is the lowest in Southeast Asia, even if it is reasonably high at about fifty-nine years. Malnutrition among children is apparently very high and rising alarmingly. AIDS is rampant and the regime seems reluctant to take adequate measures to cope with the crisis. The environment is completely neglected and often degraded in the pursuit of short-term gain. Deforestation according to some estimates is occurring at a rate of about 6–8 per cent per annum. This would put Burma in the same bracket as Brazil and Indonesia, among the worst in the world.

**Retrospect and prospect**

It should be apparent from the previous pages that Burma since 1962 has been a tragic case of development failure and missed opportunities. The civilian leaders of the national independence movement are not without blame either, chiefly for the factionalism and disunity that encouraged the military to take power. This final section attempts to reflect on what has happened in Burma since the end of World War Two, in the light of developments in the rest of Southeast Asia over the same period. In terms of “initial conditions”, all the countries of the region, except Thailand, were colonies of European powers that were invaded and occupied by the Japanese. This experience coloured the subsequent history of all of them.

In Malaysia, the resistance to the Japanese was mainly by the Communist Chinese. The Malay sultans and other members of the elite had been preserved in their traditional privileges by the British and were also treated well by the Japanese, who mercilessly suppressed the local Chinese. After the war, the communist rebellion was suppressed by the British, who then handed over the country as a going concern to the old Malay elite. The Chinese were second-class citizens of the new state, but their wealth and business acumen gave them a powerful bargaining chip. The collaboration of the two communities, cemented by skilful leadership on both sides, has been a remarkable success.

In French Indo-China the resistance was again led by the Communists, under Ho Chi Minh. Unlike the British, the French were not prepared to grant independence and a long and bloody war of independence was fought, prolonged even further by the United States intervention. North and South Vietnam are now unified under Communist rule and the pattern of development emerging there is similar to China’s, with the
Communist Party monopolizing political control but with a pragmatic, market-oriented economic policy that is consistently and vigorously pursued. Cambodia has suffered the most tragic fate of all, at the hands of its own Khmer Rouge. Its future still seems highly uncertain.

Indonesia has many similarities to Burma. Sukarno and the other nationalist leaders at first collaborated with the Japanese, then won independence from the Dutch. Sukarno was overthrown in the mid-1960s and the Communists purged by the army under Suharto. Unlike Burma, however, the Indonesian army under Suharto followed a market-oriented economic strategy from the beginning that delivered impressive developmental results for the country despite extensive corruption. The “dual-function” concept of the Indonesian army, whereby military officers are also supposed to perform corresponding civilian roles, is very similar to the attitudes of their Burmese counterparts. Indeed, the whole approach represented by Golkar, the political party associated with the army, was exactly what the Burmese army was hoping to achieve. There was also a lot of fraternal feeling between the two dictators, Ne Win and Suharto. The recent events in Indonesia leading to the fall of Suharto after popular uprisings have not, therefore, come as good news to the junta in Rangoon.

The examples of Thailand and Indonesia demonstrate that military rule for an extended period is not incompatible with successful development and progress towards democracy. What then can account for the continued failure of the Burmese army to achieve even remotely comparable results? The answer, it would seem, lies in the historical differences in the relationship between army and society in the three cases. The fact that Thailand has preserved its monarchy and never lost its independence has meant that the army was always only one segment of society as a whole, sharing power and influence with the bureaucracy, the business community and the Buddhist clergy, with all owing allegiance to the throne as the symbol of the unity of the Thai state and people. Military rule in Thailand always allowed all the other components of society to play their roles. The result has been a very impressive developmental performance and genuine democratic reforms. Even in Indonesia where traditional society was disrupted by Dutch colonial rule, the army shared power with civilian technocrats and was prepared to benefit from the commercial acumen and entrepreneurship of the local Chinese. It is striking that the military has, at least so far, not openly challenged the authority of the civilian government. The military appears to accept the principle that it is not the arbiter of the state. A major unresolved question is the threat of further separatist movements in the wake of East Timor. The army has always been seen as predominantly Javanese and they would have considerable popular support if further secession attempts in Aceh and elsewhere endangered the unity of the state.

As we have seen, traditional Burmese society was uprooted by the
British and replaced by an efficient, abstractly Utilitarian “night watchman” state that followed a strictly laissez-faire policy. It produced a remarkable example of export-led growth up to the depression of the 1930s but could not cope with the resulting land alienation, peasant rebellion and nationalist agitation. The exposure of the nationalist leaders, particularly the “Thirty Comrades”, to indoctrination by the Japanese military with their fascist views, introduced a malignant virus into the national bloodstream. Aung San himself was an enlightened leader with a humane and truly democratic vision. For him the Japanese collaboration was merely a tactical move on the path to an independent Burma. After his death the AFPFL formed a genuinely democratic civilian regime while Ne Win and a few others of the original thirty were put in charge of the army. The profoundly anti-democratic and chauvinistic views they acquired during their training in Japan were reflected in the ideology with which they imbued their new recruits. Loyalty was to the army itself and Ne Win as commander-in-chief, not to the democratic constitution and the parliamentary system. After the split in the AFPFL there was no obstacle to the assumption of power by the army. The bureaucracy was weak and subservient and the business community dependent on political patronage for licences and subsidies. Civil society in Burma was too underdeveloped to offer any resistance. Only the students dared resist repeatedly and they were bloodily suppressed. The crisis of 1988 was a true popular uprising by the common people, who have been broken and demoralized in its bloody aftermath. Thus, unlike Thailand and Indonesia, the army recognizes no authority other than itself. It is indeed ironic that the legacy of the Japanese militarists lives on in Burma long after it has been discredited and wiped out in modern, democratic Japan.

The country is now once again approaching a crisis similar to that of 1988. Foreign exchange is acutely scarce, rice prices are rising sharply and poverty is rampant. The only hope for the people is Daw Aung San Suu Kyi, the valiant daughter of her great father. She remains under house arrest, unable to organize effectively. The SLORC, now renamed State Peace and Development Council (SPDC), steadfastly refuses to negotiate or consider any way out of the impasse. The international community is too distracted by other matters to pay much attention to Burma, unless more blood is shed.

References

13 Haiti

Nothing but crisis

*Mats Lundahl and Rubén Silié*

When I see my people there is a question that always arises. How can they survive with so little?

(Jean-Bertrand Aristide, 2000, p. 2)

A crucial year for Haiti

The year 2000 was a crucial one for Haiti. It was the year when the third democratic presidential elections took place and elections for parliament were held as well – both unfortunately in an exceedingly tense political and economic atmosphere. The origin of this situation was the military coup against President Jean-Bertrand Aristide in 1991 which inflicted severe damage on an economy which was already, without competition, the poorest and most vulnerable one in the western hemisphere. When Aristide returned after the American-led invasion, three years later, real per capita income had fallen by an estimated 30 per cent (Banque de la République d’Haïti, 1995, p. 14), the most dynamic sector of the economy – the export assembly industry – had been all but destroyed, and severe macroeconomic imbalances had developed (Lundahl, 1997a, 1999; Lundahl and Silié, 1998).

During the next few years, attempts were made to put the economy back on track, with international assistance, but far from all the envisaged reforms were carried out. The result was that substantial amounts of foreign aid were frozen, because Haiti failed to live up to the promises made when the development cooperation agreements were signed.

Political developments were even worse. The transition from Aristide to his successor René Préval in 1995 could be effected without disturbances in 1995 although the participation in the presidential elections turned out to be a mere 28 per cent (Schultz, 1996, p. 11). Thereafter, the political course was a downhill one. A breach developed within the *Lavalas* movement, which was the one backing both Aristide and Préval. As a result the national and local elections in April 1997 broke down completely. The *Oganizasyon Politik Lavalas* (OPL) accused its rival, *Fanmi Lavalas*, of having rigged the elections and a political stalemate began (Schultz,
1997–8, pp. 76–7). Parliament, where all seats could thus not be filled, in practice ceased to function.

When Prime Minister Rosny Smarth, resigned in June 1997, it proved impossible to find a successor who could be accepted by the legislature, until December 1998. In January 1999, the parliament could not be opened, due to ‘popular’ manifestations and turmoil in the street. The very same night the president dissolved it. The new cabinet and the programme of the new prime minister could hence not be approved.

Haiti had a government that lacked legitimacy. With elections coming up, the country was being ruled by decree. There was no parliament to vote the budget, much of the political ‘debate’ was carried out in the form of more or less violent confrontations in the street, and attempts to organize peaceful manifestations were regularly met by mob action. The hate and distrust that has permeated the Haitian past continued to beset the country. The situation with respect to human rights left a great deal to be desired, and the judicial system presented numerous and serious defects. All these components of the political paralysis had an impact on the willingness to invest and, in the case of foreign donors, the willingness to provide desperately needed aid.

The political situation continued to deteriorate in 2000. For the parliamentary elections on 21 May, fifteen of the opposition parties joined forces in the Convergence Démocratique coalition, challenging Fanmi Lavalas. The outcome of the elections, where as much as 60 per cent of the eligible voters are believed to have shown up at the polls (Fatton, 2002, p. 115), was that the latter party won seventy-two of the eighty-three seats in the chamber of deputies and eighteen of nineteen of the contested seats in the senate (which has a total of twenty-seven seats). However, OAS observers pointed out that the election officials calculated vote percentages incorrectly, limiting themselves to the top four finishers in each case, depriving the opposition of between 1.1 and 1.2 million votes (Fatton, 2002, p. 116), thus giving the Aristide grouping ten senate seats already in the first round which should have gone to run-offs, since the Lavalas candidate failed to get more than 50 per cent of the votes. Convergence Démocratique claimed that the elections were rigged, and chose to boycott the presidential elections on 26 November, where Aristide won a comfortable victory. The refusal of the government to recount the votes led to another suspension, of more than US$500 million, of foreign aid (FOCAL, 2001). Again, a complete political stalemate developed where the two opposing forces refused to see each other and the opposition nominated its own symbolic president.

This essay provides an analysis of the failure to reform economic policy in Haiti from the fall of Jean-Claude Duvalier in 1986 to the fall of Jean-Bertrand Aristide in 2004. We will sketch the fundamental economic problem of Haiti: the interaction between population growth and soil erosion and we will also provide an account of the predatory political
tradition of the country. This will be followed by a presentation of the three reform efforts between 1986 and 2004 and their failure. The remainder of the chapter deals with the political causes of failure. Before we turn to all these issues, however, we will bring the political narrative up to the year 2004.

More crucial years

The year 2000 was the mere beginning of what would eventually turn into the worst political crisis in Haiti since 1991. Soon after the parliamentary elections, Convergence Démocratique put forward what became known as Option zéro: the resignation of President Préval and his government, annulment of the parliamentary elections, the creation of a new interim government, postponement of the presidential elections and new parliamentary elections overseen by a new and non-biased electoral council (Fatton, 2002, p. 141).

As could be expected, the proposal met with little enthusiasm among Fanmi Lavalas circles. However, both Lavalas and the opposition agreed to a dialogue with the Organization of American States as the mediator in September and October 2000 – a dialogue that produced nothing. In November Aristide was elected president for the second time, and the political process took one more downhill step. An attempt by ‘civil society’ (businessmen, professionals and religious groups) to break the deadlock in January 2001 failed as well, being perceived by Fanmi Lavalas as biased in favour of the opposition. On 7 February Aristide became president for the second time, without the endorsement of the opposition (Fatton, 2002, pp. 146–7).

During the remainder of 2001 the gulf between Lavalas and the opposition widened and the political situation grew increasingly confusing. Further talks between the two political factions, under the auspices of the OAS, were broken off after a series of attacks on police stations by ex-military at the end of July, and the violence culminated on 17 December when thirty heavily armed commandos attacked the National Palace. The president and the opposition blamed each other. However, the attack appears to have been organized by former military and police officers, led by Guy Philippe, a former police chief in Cap-Haïtien, at the time in exile in the Dominican Republic. The attack failed, five commandos were killed and the rest fled. Lavalas branded the attack as an attempted coup d’état, and Aristide supporters, led by notorious Chimères (half-criminal gangs supporting Aristide), burned the headquarters of Convergence Démocratique and some more opposition buildings and put fire to the homes of opposition leaders Gérard Pierre-Charles and Victor Benoît as well. The opposition, in turn, contended that the attack had been staged by Lavalas itself to trigger the subsequent events (Fatton, 2002, pp. 206–7).

The events of 17 December served to make the general political climate
deteriorate even further. After that date the opposition refused to sit at the negotiation table with the government. The OAS attempted to put pressure on the opposition, but without result.

The Aristide government had also begun a more or less systematic persecution of pro-opposition journalists. In April 2000, Haiti’s best-known journalist, Jean Dominique, had been shot to death by seven bullets outside his Radio Haïti-Inter, a radio station that was very critical to Aristide. In February 2002, the judge investigating the murder, Claudy Gassant, who had formally charged Lavalas senator Dany Toussaint with involvement in the case, had to leave Haiti for the United States, fearing for his life, after threats from the Lavalas-controlled police and after Aristide’s refusal to renew his mandate as a judge.

Brignol Lindor, another critical radio journalist, was hacked to death by Aristide supporters with machetes and pick axes in Petit Goâve in December 2001. Throughout the following year independent radio stations received threats, including death threats, and intimidations. In December 2002 an attempt was made to murder Michèle Montas, the widow of Jean Dominique, who soon afterwards decided to close down Radio Haïti-Inter and go into exile. In January 2003 the director of a station in Saint-Marc was shot and wounded. The Association of Haitian Journalists filed complaints about the situation with the Inter-American Commission on Human Rights. In February six journalists from Gonaïves had to seek refuge in the Dominican Republic. Altogether some thirty journalists had had to go into exile over a period of two years, reported Le Monde in October 2003 (Caroit, 2003b). A friend of President Aristide’s became the majority owner of the only independent television station. In December 2003 a radio station in Cap-Haïtien was closed down by the police, after it had been threatened repeatedly by Aristide supporters and an attempt had been made to murder its owner. It became more and more obvious that President Aristide was not a strong believer in free and independent mass media.

Gradually the gulf between the government and the opposition widened. Already before becoming president for the first time, Aristide had introduced a new element into Haitian politics: the masses, which had been marginalized ever since the wars of independence (Lundahl, 1992). During his second term it was time for another innovation, but this time hardly one of his liking. Civil society began to play an ever more important role. One manifestation of this was the Groupe des 184, a civil-society movement headed by businessman André Apaid and the Fondation Nouvelle Haïti. The Groupe was created as an attempt to make a social contract between the citizens and the state and between various political groups in Haiti as a way of breaking the political impasse (Groupe des 184, no date).

Neither the government nor the political opposition, however, turned out to be interested in any social contract. Instead, positions hardened in both camps, and politics increasingly became a street game with
demonstrations and marches, counter-demonstrations and counter-marches, strikes, fighting and killing as the main ingredients. Many of the political events were coloured by blood. The Haitian police force in 2003 did not count more than a maximum of 4,500, way below the envisaged figure of 7,000 (Organisation des États Américains, 2003, para 19). Worse yet, many of its members had not been properly trained but were selected on the basis of political criteria and nepotism rather than merit. The Haitian police was a worthless and a corrupt body not interested in maintaining public order. In June 2003 its director general, Jean Robert Faveur, left office to go into exile after a mere seventeen days, complaining that political interference made it impossible for him to do his job (Faveur, 2003).

The lack of a proper police force left the field open for gangs of various kinds on both sides. At the end of September 2003, the body of Amiot Métayer, the leader of a gang of Chimères, known as Les Cannibales, was found dead on the outskirts of Saint-Marc. Métayer had been accused of burning the driver of an opposition leader in Gonaïves alive and of burning several buildings after the palace incident in December 2001. He had been arrested in May 2002, had been liberated three months later by members of his gang and had thereafter lived happily in Gonaïves without being molested by the authorities (Caroit, 2003a). After his death – it was rumoured that he knew too much and that he was ready to reveal publicly what he knew – the gang deserted Aristide and turned against him.

On 5 December 2003 Aristide sent another band of thugs into the Faculty of Human Sciences at the Université d’État d’Haïti, and attacked the administration and the students, beating up the rector and the vice rector, severely injuring the former, wounding several students and damaging offices and equipment. This incident triggered a series of student demonstrations the following week, with up to 10,000 participants (Caroit, 2003c; Warren, 2003). Haitian politics began to degenerate into something resembling low-intensity warfare. On 12 December the US Department of State advised American citizens not to go to Haiti.

In December a series of desertions from Lavalas also took place: Dany Toussaint, the senator suspected to be implicated in the Dominque murder, also one of the Lavalas heavyweights, one more senator and three of Aristide’s sixteen ministers – Minister of Public Education, Marie Carmelle Paul Austin; Minister of Tourism, Martine Deverson; and Minister of the Environment, Webster Pierre – plus the Haitian ambassador to the Dominican Republic, Guy Alexandre, and the director general in the Ministry of Public Health, Charles Émile Hérard.

The end of December 2003 was marked by a series of street demonstrations and strikes against Aristide, and in Gonaïves shooting broke out between armed youths and police, which resulted in killings of innocent bystanders.

The much-anticipated celebrations of the bicentennial of the
independence of Haiti, on 1 January 2004, turned into a flop. Of foreign heads of state, only Thabo Mbeki from South Africa, a man with notoriously bad judgement, showed up, and he did not risk going to Gonaïves, where the declaration of independence had been read 200 years earlier.

Thereafter, the political temperature rose even further. Manifestations, strikes, sabotage and killings became part of everyday life. Finally, the bubble burst. On 5 February a gang-led rebellion broke out in Gonaïves, and during the following weeks this spread across most of northern Haiti. Some of the most notorious elements from the former army and police surfaced from exile in the Dominican Republic, or from hiding, among them Guy Philippe, who soon became the head of the ‘military’ forces of the rebels. Little by little the international organizations and the foreign embassies evacuated their personnel. The opposition turned down an international proposal that would tie the hands of Aristide but allow him to stay in power until the end of his legal period, in 2006. On 29 February, Aristide left the country, and France, Canada and the United States decided to send troops to Haiti, while at the same time the rebels advanced on the capital. The president of the Supreme Court, Boniface Alexandre, was sworn in as interim president, and a group of three people – one from the old government, one from the opposition and one from the UN – was charged with appointing a council of seven, who put a new provisional prime minister, Gérard Latortue, in place.

Politically, Haiti was back at square one for the umpteenth time, with an economy that remained in bad shape – an economy plagued both by severe structural problems and by the political failure.

The structural economic problem

Economic reform ultimately has to come to grips with the structural component, the fundamental poverty-creating mechanisms, but in the short and medium term it is the problems related to politics that call for attention. Beginning with the structural factors, the simplest possible way to state the key problem of the Haitian economy is that the growth of the population makes per capita income in agriculture decline secularly in a situation where non-agricultural employment alternatives are lacking.

Production and income per capita are very low in Haiti. Thus, recent GDP and GNP per capita estimates range from US$230 to US$260 (GDP) in the wake of the sanctions (Lundahl, 1997a, p. 3) to US$480 (GNI) (World Bank, 2002, p. 1), US$524 (GDP) (IMF, 2001b, p. 52) around 2000. It is quite obvious that these figures mean very little in absolute terms (Catanese, 1997). Still, the basic message is clear. The standard of living is low, not least in the countryside where as much as 80 per cent of the population are believed to be below the poverty line, according to a World Bank study (Wiens and Sobrado, 1997, pp. 3–4).1 A recent Norwegian study which employs a poverty line of US$2 per day2 reveals that no
less than 76 per cent of all Haitians find themselves below this line and 56 per cent live in conditions of extreme poverty (less than US$1 per day). The average income in the latter group was a mere US$0.44. The figures for rural districts are even higher: 88 and 67 per cent, respectively (Egset and Sletten, 2003).

The root of the agrarian problem is found in the exceedingly rugged topography of Haiti. The picture is one of cultivated fields virtually everywhere, including on steep hillsides and mountain tops. This situation—a result of population pressure—has led to an erosion which is the most severe one in the western hemisphere. As the population grows there is a tendency for labour-intensive crops, annual food crops, to take over from land-intensive perennial export crops like coffee. (The demand for firewood and charcoal also increases.) The coffee trees that bind the soil are uprooted and crops that have to be put in the ground precisely during the periods of heavy tropical downpours—with devastating consequences for the soil—are substituted for them. This, over time, reduces the production possibilities in rural areas and depresses per capita income in the countryside, a process that appears to have been in motion for at least half a century, probably more (Lundahl, 1979, Ch. 3, 1997a, p. 4; Cadet, 1996, p. 80).

Theoretically, one could envisage that relative price movements in favour of export crops would reverse the process, but this has not been the case. The output of ‘traditional’ Haitian export crops has decreased over time, and such items as sisal and sugar have disappeared completely from the export list (Bourdet and Lundahl, 1991).

Outside agriculture it is very difficult to find a job. The industrial sector earlier consisted of two distinct segments: an import-substituting one, sheltered by protection, and a successful light-assembly export industry. The former has by and large disappeared, however, and the latter, at its apogee, provided employment for a mere 46,000 people, women in their majority. After the heavy blow dealt to it by the international sanctions during the military regime 1991–4, employment was reduced considerably, to a mere 5,000 in 1995 (Lundahl, 1999, p. 23), and the sector is still struggling to make it back to the 1991 level. In spite of reported growth during both 2002 and 2003, the actual figure (before the disturbances at the end of 2003 and the beginning of 2004) is believed to be in the 20,000–30,000 range (Lundahl, 2004). The tourist sector has been hampered by the lack of a decent physical infrastructure, notably transportation, electricity and hotel facilities (Lundahl, 1999, pp. 30–32). Work in the public administration, in turn, is difficult to find, since recently strong efforts have been made to reduce its size (with about 12 per cent in December 1998) (IMF, 1999a, p. 8).

This leaves few options. Trading is one. Virtually all peasant women have some kind of experience of that, but mainly on a relatively insignificant level (Lundahl, 1983a; Correia, 1997). Trade is an integral part of the
rural economy, most of the time carried out on a part-time basis, but the trading sector is quickly overcrowded in times of hardship as, for example, during the sanctions episode, and it can hardly serve to absorb large numbers of people that are being forced out of agriculture as a result of falling incomes. Instead, emigration – temporary or permanent – has been the badly needed safety valve. The story of the boat people is as much a story of economic pressure as one of politics (Lundahl, 1983b, Chs 7–8, 1998).

**Compounding the problem: predatory rule**

Unfortunately, erosion and lack of extra-agricultural employment have not been the only problems besetting the Haitian economy. One of the most notable threads running through the history of Haiti is that of predatory rule (Lundahl, 1979, Chs 7–8, 1992, Chs 8–15, 1997a, 1997b, 1997c; Trouillot, 1990). This began even before the country had gained its independence, as the former slaves were put back into forced labour by their military commanders, a practice that was to continue also when the French had left the island for good. By tying the workers to the plantations a work-free income could be created for the new governing class.

When the plantation economy finally broke down, as a result of the redistribution of land that was initiated in 1809, predation acquired a new character. The slaves were finally free and there was plenty of unoccupied land to be had. Direct exploitation in agriculture was impossible. Instead, the new rulers resorted to taxation, pocketing the proceeds for private use (Domar, 1970). The period from 1843 to the beginning of the American occupation in 1915 saw the succession and overthrow of a series of kleptocratic presidents who paid virtually no attention to the needs of the population at large. The occupation failed to change this fact. As the occupation began to be dismantled, in 1930, and finally came to an end four years later, the nineteenth-century ruler mentality made a strong comeback, and predatory rule escalated until it produced a successful climax with the two Duvaliers: François (‘Papa Doc’) (1957–71) and Jean Claude (‘Baby Doc’) (1971–86).

The fall of Baby Doc in 1986 brought no qualitative change of government. The military juntas and provisional governments that ran Haiti until the installation of Jean-Bertrand Aristide as president in 1991 were quantitatively less successful than the Duvalier family, but did not differ from it in kind. That the predatory mentality was not gone was also eloquently proved by the events taking place after the coup against Aristide that deposed him after a mere seven months in the presidency. Three years of meaningless rule and income maximization by the governing clique followed and only came to an end when Haiti was invaded by foreign troops for the second time during the twentieth century.

That Haiti has been ruled by kleptocrats has two important
consequences – consequences that are furthermore closely related to each other, or, rather, are mirror images of each other. The first is that politics is dominated by a confrontational style. Haiti is very far from cooperation and consensus solutions both in everyday politics and when it comes to strategic decisions. Parties and individual politicians seek battle with the ‘adversaries’, not consultation, negotiation and concessions. The political game is perceived as a zero-sum one, where the winners take everything and the losers pay the cost. Against the background of the nineteenth-century heritage this does not come as any surprise. Haitian politics before the American occupation was essentially a fight, over the spoils of the presidential office, between incumbent rulers and their cliques on the one hand and would-be rulers and their backers on the other, with no place whatsoever for an institutionalized opposition. This political style has continued to dominate Haitian politics. It made a rapid comeback after the occupation, it took over the turbulent 1957 elections completely and it has not been possible to weed it out of present-day politics either.

The second consequence is that Haiti lacks the kind of social capital or social trust that according to Robert Putnam (1993) and Francis Fukuyama (1995) makes for a good civic community characterized by efficient social networks conducive to constructive solution of common problems and creation of prosperity (Lundahl, 1997a, p. 37; White and Smucker, 1997). It is not that Haitians are unable to constitute organized interest groups capable of collective action for a common cause. On the contrary, Haiti possesses an abundance of cooperative structures of different kinds: rotating savings and credit associations (sang), labour teams (konbit) and cooperatives in the economic sphere and community councils (gwoupman) in the political, rara groupings and secret societies in entertainment and religion. Many of these, however, are temporary only and, what is more, they have often sprung from the need of the population to create structures which may serve to distance common people from leta (the state) and defend them from its sticky and punishing fingers (cf. Barthélemy, 1989). The Haitian ruling cliques, in turn, have done their best to tax and harass ordinary people in their search for prey. As a result, whatever social capital that has been built on the local level has failed to penetrate society on the regional and national levels. There, most notably in politics, the name of the game remains that of destroying your foes.

Two frustrated reform efforts

One of the many problems with predatory political regimes is that since in the economic sphere they are simply intent on income maximization they pay no attention to the consequences of their policies for the economy at large (Lundahl, 1997b, 1997c). In the case of Haiti this mentality has thrown the economy into three acute crises since the mid-1980s, crises that have led to economic-policy-reform efforts, reforms that have been
frustrated, for reasons that are directly related to the dismal political tradition of the country (Lundahl and Silié, 1998).

The first reform attempt took place after the fall of Baby Doc in 1986 (Lundahl, 1992, Ch. 19). The crisis which erupted in the mid-1980s had built slowly ever since Papa Doc came to power in 1957. During almost thirty years the two Duvaliers systematically milked the country, diverting state funds into their own pockets. As the 1980s dawned, this unhampered robbery had thrown the Haitian economy into a severe macroeconomic disequilibrium. In 1980/1 the public sector showed a deficit of 13 per cent of GDP. Part of this was caused by loss-making public enterprises which were used mainly as a device for channelling funds to the presidential family and by expenditure on a repression apparatus. The credit volume increased rapidly as the central bank gave credits to the corrupt public sector, crowding out private investment. Monetary expansion in turn led to a balance of payments problem, since it increased the demand for imports while at the same Haiti’s traditional export products were in decline (Bourdet and Lundahl, 1991). Virtually all the curtailment of government expenditure that took place in the early 1980s took the form of reduced development investment.

This situation was to worsen until the mid-1980s. When a provisional government took over in 1986, acute reforms were called for. Efforts were made to reduce the budget deficit by closing the ill-fated public enterprises, deleting non-existing employees from the payrolls, opening hitherto secret accounts and dismantling, for example, the dreaded tonton macoute militia, the main terror instrument, as well as by reforming the tax system and increasing the revenue collected. The protection of domestic manufacturing was reduced and the tax on coffee exports was removed.

The effort failed, in spite of some initial success. Presidential elections had been scheduled for the end of 1987 but these were interrupted at gunpoint by ex-tonton macoutes, with the army remaining passive. Again, the macroeconomic situation became one of disequilibrium. The budget deficit again soared, the monetary aggregates expanded and balance of payments problems ensued. At the end of the 1980s, Haiti’s economy was back in the situation which had come to maturity during the first half of the decade.

In the end the political situation was resolved by the election of Aristide as president in 1990, and Haiti was due for the second policy-reform effort. Support was obtained from international donors, restrictive fiscal and monetary policies were introduced, the domestic credit volume was curtailed, the government payroll was reduced and efforts were made to increase the efficiency of tax and tariff collection. The pattern of the first reform reproduced itself. After a brief interval of improvements on the macroeconomic indicators, political forces again took over and crushed the reform attempt. Aristide was deposed and forced to leave Haiti, and a
military government headed by Raoul Cédras began to milk the country anew (Lundahl, 1997a).

The establishment of military rule led to international sanctions aimed at reinstalling Aristide, but the sanctions proved ineffective and it was not until the invasion of Haiti in September 1994 by a US-led multinational force that the leading army generals could be forced to step down and go into exile (Perusse, 1995). The costs of the military regime turned out to be high. Real income per capita fell by an estimated 30 per cent, the size of the assembly industry sector was reduced by 85 per cent, and prices of daily necessities skyrocketed, as did oil and gasoline prices. Employment was severely affected and coffee exports fell by one-third. Tax collection deteriorated drastically and the military compensated for the shortfall by credits via the banking system and defaulting on public-debt payments. Capital left the country, the balance of payments surplus was converted into a deficit and the gourde depreciated by two-thirds with respect to the US dollar (Lundahl, 1997a, pp. 25–33).

The military regime not only put Haiti back where the country had begun its reform efforts in the mid-1980s. It also forced the Aristide government to launch a restrictive policy package from a much more unfavourable per capita income level than before, a situation with the majority of the population in a very vulnerable position.

**Round three**

The third round of reforms failed as well. It began with the formulation of an economic emergency recovery programme for the first 18–24 months, aiming on the one hand at rapid macroeconomic stabilization and on the other hand at a number of emergency measures in physical infrastructure, health, education, sanitation, etc. and improvements of the functioning of the public sector. While these measures began to be carried out, a medium-term economic strategy for 1996/7–1998/9 (République d’Haïti, 1998) was worked out, which the Préval government began to implement. In September 1996 an Enhanced Structural Adjustment Facility was obtained from the IMF for a period of three years, to back up the programme (IMF, 1996a, 1996b).

The medium-term programme was a mixture of stabilization and structural adjustment measures, in the spirit of the ‘Washington Consensus’ (Williamson, 1994). (Details can be found in Group Croissance, 1998; IMF, 1998; Lundahl and Silié, 1998; République d’Haïti, 1998.) In the external sector liberalization measures dominated, both on the commodity trade side and with respect to capital movements. Tariffs were to be unified and reduced until a low, single rate of 10 per cent had been obtained and the Central Bank was not to intervene in the currency market other than to ensure that foreign-debt obligations could be met and currency reserves could be maintained at the level deemed to be
appropriate (three months’ imports at the end of the twentieth century). Fiscal reform also played a central role. In the mid-1990s the tax share of GDP was no more than 7 per cent. To increase this when the tariff revenue was planned to shrink called for simplification and restructuring of the tax system as well as for a broadening of the tax base. Also, to ensure that the budget deficit would be contained, current expenditure, notably on wages and salaries, had to be kept back, not least by a trimming of the public administration. The restrictive fiscal policy was to be complemented by a restrictive monetary policy aiming to keep inflation down and the value of the gourde stable. The planned public expenditure was furthermore to be concentrated on the police, to improve the situation with respect to law and order, and to the social sectors (health, education and social safety nets). On the investment side emphasis was on physical infrastructure, which had been sadly neglected for too long, and the social sectors.

Among the structural-adjustment measures we also find reform of the government budgeting and spending process to reduce diversion of funds and corruption, a limited agrarian reform and a strengthening and modernization of the central bank. Finally, there was the most controversial of all measures: privatization of a number of government enterprises, including the notorious telephone and electricity companies, the harbour and airport in the capital, two banks, the cement factory, the edible-oil factory and the flour mill, all of which could boast a long record of mismanagement ever since the Duvalier days.

Turning to the implementation of the programme, this was derailed as a comprehensive donor-backed effort after the resignation of Prime Minister Rosny Smarth in June 1997. In April the following year an IMF staff-monitored programme (SMP) for 1997/8 was put in place as an emergency device in an effort to continue stabilization and structural adjustment. This effort was continued with programmes, for 1998/9 and 2000/1 as well (IMF, 1999a, p. 4, 2002b, p. 3), whereas fiscal slippages in 1999 and 2000 made the IMF disapprove a similar agreement for 1999/2000 (IMF, 2001a, p. 5), and for 2001/2 it was impossible to reach any agreement with the Haitian government (IMF, 2002c, p. 2).

By and large the Préval administrations, by resorting to a cash-budget system, managed to contain the overall public-sector deficit which had had to be increased to around 8 per cent of GDP during the period of urgency measures, 1994/5–1995/6, in order to create much-needed employment. In 1996/7 and 1997/8, figures of 4 per cent of GDP, or a little less, were reached, with the central government deficit falling to 0.6 per cent in 1996/7 and 1.3 per cent in 1997/8 (IMF, 1999b, p. 5), to increase again to 2.5 per cent in 1999/2000 and 2.7 per cent the following fiscal year (IMF, 2002b, p. 4). For the first time since 1996 a regular budget could be presented to parliament for the fiscal year 2001/2 (IMF, 2002c, p. 2).
The rate of inflation could be brought down from over 20 per cent in 1995/6 to slightly over 8 per cent two years later (IMF, 1999b, p. 5) and 7.6 per cent at the end of May 1999 (Portugal and Dhanpaul, 1999, p. 1). During the next two years, however, the figure rose again, to 11.5 and 16.8 per cent, respectively, on average (IMF, 2002a, p. 4). Finally, the deficit on the current account of the balance of payments (excluding official grants) was brought down to 5.9 per cent of GDP in 1997/8 from 16.7 per cent in 1994/5 (IMF, 1999b, p. 5) and to 4.8 per cent in 2000/1 (IMF, 2002a, p. 8). Thus, from the stabilization point of view, the results as of the beginning of the new millennium did not look too bad.

Structural adjustment turned out to be much more difficult. A substantial downsizing of public-sector employment took place at the end of 1998, when 3,360 people (about 12 per cent of the government employees) were laid off and about 3,000 non-working ‘zombies’ were eliminated from the government payroll. The march towards tariff unification was, however, interrupted, due to the non-existence of a legislature. (Tariffs are low, however – on average a mere 5 per cent, among the lowest in the western hemisphere (IMF, 2002b, p. 14).) The envisaged fiscal reforms were delayed, and the police and the judiciary hardly saw any improvement at all. Finally, on the privatization front positions were locked. The most concrete event was the approval by the new prime minister of the sale of 65 per cent of the cement factory (together with management control) (IMF, 1999a, pp. 8–9). The rest was effectively blocked by Aristide and the groups supporting him. During 2000/1 little progress took place. Whereas technical work was completed on the privatization of the port and airport as well as the water, telephone and water companies, no actual sales took place because of the political stalemate (IMF, 2002a, p. 14).

The failure to implement the reform programme is mirrored in the growth figures. A recovery of the economy began in late 1994, as the financial aid flow was renewed. This recovery was not sustained, however. During the fiscal year 1994/5 (ending 30 September) real GDP increased by an estimated 4.4 per cent after having decreased by 8.3 per cent in 1993/4. In 1995/6 the growth rate dropped to 2.7 per cent and in 1996/7 it was reduced to 1.4 per cent, to increase again in 1997/8 to 3.1 per cent (IMF, 1999b, p. 5). The 1994/5 figure represented a normalization from the anomalous political situation that had been created by the sanctions. The setback that followed was related to the uncertainty surrounding the 1995 presidential elections, with the failure to vote the budget in parliament until less than four months of the fiscal year remained, the concomitant aid freeze and the increasing rate of inflation. Fiscal 1997/8, finally, provides an exception in that economic factors played the leading role. It saw a strong export performance and an increased inflow of remittances from Haitians abroad coupled with tight credit conditions which held inflation down. These factors were strong enough to overcome the polit-
ical instability created by the absence of a duly nominated prime minister and government.

The continued worsening of the political situation in 2000 did not fail to have an impact on the economy as well. The rate of investment fell and the growth rate declined from 2.2 per cent in 1998/9 to 1.2 per cent in 1999/2000 (IMF, 2001a, p. 6); i.e. GDP per capita fell. There was no progress in the privatization of the mismanaged public enterprises. Instead the infrastructure saw further decay (IMF, 2001a, p. 10). During 2000/1 real GDP is estimated to have fallen by about 2 per cent (IMF, 2002a, p. 5).

The hope that the reform programme would get back on track in Haiti had, however, not been lost. In his 2001 inauguration speech, President Aristide did what he could to paint a picture of future reform and progress (Fatton, 2002, pp. 201–2):

In this speech, Aristide maintained that his program of ‘investing in human beings’ can be integrated into the larger macroeconomic reforms advocated by the major international financial institutions. He expected that his administration would be able to increase the growth of the GDP to about 4 percent; limit the rate of inflation to less than 10 percent; and reduce unemployment to 45 percent by augmenting investments by at least 50 percent. Finally, he called for the creation of approximately 500,000 stable jobs in the public and private sectors. Aristide also hoped to eliminate the massive shortage of electricity that has plagued the country. Additionally, he promised to raise the level of food self-sufficiency by 30 percent and make drinking water accessible to 70 percent of the rural population and to 80 percent of urban dwellers. Moreover, the president vowed to improve and rehabilitate more than 3,000 kilometers of minor and tertiary roads. Finally he would undertake the refitting of five national airports and the rehabilitation of the international airports of Port-au-Prince and Cap-Haïtien.

However, the prospects did not look too encouraging. Haiti’s foreign donors had not passively accepted the development of a political situation characterized by tension, turmoil and disregard for civil society. Thus in 1998 the amount of World Bank and Inter-American Development Bank aid that had been suspended amounted to US$570 million, or about 17 per cent of Haiti’s GDP (MPCE and PNUD, 1999, p. 3), and without these funds it was impossible to break out of the impasse, because no public investment could be made. Foreign private investors, in turn, stayed out because they feared that the political and social situation might deteriorate even further, and Haitian businessmen were fairly unanimous in their verdict that the failure of the state to guarantee physical security and the eruptive social situation were the two most important obstacles to an
expansion of economic activities (Lundahl, 1999, p. 25). Haitian reality turned out to differ very substantially from the Aristide vision.

It was difficult not to agree with the conclusions of a 1999 IMF report that unless the political Gordian knot could be untied in a fashion that satisfied both the domestic population and the international observers, Haiti risked going into another prolonged period of stagnation and retrogression (IMF, 1999a, p. 9; italics in the original):

The political impasse that has prevailed for more than two years has led to the loss of external assistance, low investment, postponement of important structural reforms, and insufficient growth to reduce the high rate of poverty. [...] carrying out parliamentary elections in a transparent and democratic manner with strong voter turnout should be a major policy priority and is crucial for resumption of external aid flows and the implementation of structural reform.

The Haitian government was extremely dependent on external finance both for its operating budget (about 50 per cent) and, even more, for its development budget (80 per cent) (Dailey, 2003, p. 23). In February 2002, the IMF, however, again decided that it could not extend new credits to Haiti. The Inter-American Development Bank had stopped loan disbursements and the World Bank had cancelled undisbursed loans to Haiti. The same month, the World Bank published an evaluation of its assistance to Haiti during the previous fifteen-year period. The conclusions were devastating (World Bank, 2002, p. 11, italics in the original):

The large amount of aid that poured into Haiti in the mid-1990s accomplished little, and may have even had a negative impact by overwhelming government capacity and creating opportunities for rent seeking. [...] projects in Haiti have a record of unusually low ratings for outcome, institutional development and sustainability. Based on these findings, the outcome of Bank assistance to Haiti since 1986 is rated unsatisfactory, if not highly so. The program’s institutional development impact has been negligible, and under current circumstances, the sustainability of what little has been accomplished is unlikely. It would be hard to argue that, with a few exceptions, the country is any better off for having borrowed at all.

The World Bank complained about the professional and technical skills of the Haitian public administration, but even more about the fact that about half of the government current expenditures came from accounts outside the budget, and that it was ‘virtually impossible to identify their actual use, beneficiaries, or impact’ (World Bank, 2002, p. 4) – exactly like in the Duvalier era (cf. Lundahl, 1979, Ch. 8).

Still, it took less than a year and a half before one of the international financial institutions, the IMF, believed that it would be possible to con-
tinue the reform effort. At the end of 2002 and the beginning of 2003, GDP was falling, exports were declining with 10 per cent per annum, gross domestic investment and savings were falling, the budget deficit was increasing, the balance-of-payments situation was deteriorating, Haiti’s international reserves were on their way towards depletion and the gourde was sinking like a stone vis-à-vis the US dollar (IMF, 2003, p. 17). Nevertheless, in August 2003 the IMF reported that the government had begun to implement a number of stabilizing measures that would serve to bring the fiscal deficit down from 5.5 per cent of GDP (October 2002–March 2003) to 2.7 per cent, including the abolition of petrol subsidies and the introduction of cash management in government (April–September 2003), that the unbudgeted accounts would gradually be phased out and that the central bank had tightened monetary policy to bring down the rate of inflation which had increased to 37 per cent on an annual basis in March 2003 (IMF, 2003).

As it happened, these hopes never materialized. Haiti was instead thrown into an acute political crisis where the government had little time for anything but the struggle for survival. As we know, the struggle failed. Round three in the history of stabilization efforts has come to an end. Round four can begin.

The causes of failure: the political situation

Why was the reform process derailed again – for the third time? In order to answer this question we once more have to look at the Haitian political scene. Again, politics took over and distorted the reform process severely. Since the 1990 presidential elections the political scene has been controlled by a number of parties and groupings emanating from the *Lavalas* grass-root movement that catapulted Jean-Bertrand Aristide into the presidency. Parties outside this circle have not had much influence, with the exception of the years of military government that followed the 1991 coup against Aristide, when some of them responded to the initiatives of the military. The past handful of years have been characterized by a fight between the members of the original *Lavalas* movement (cf., e.g., Jean and Maesschalck, 1999, for details). Apart from Aristide, and in spite of his dominance, a number of other political leaders appeared on the scene. The most important one was Gérard Pierre-Charles, a former top name of the old Haitian Communist Party, turned social democrat, who after decades of exile in Mexico returned to Haiti in 1986, joined the popular movement and endorsed the candidacy of Jean-Bertrand Aristide for the presidency. Pierre-Charles, who is an independent and experienced political thinker, supported Aristide without letting his own identity be erased. An example of this is his effort to construct a modern political party instead of maintaining a group of followers who amorphously respond to the will of a great leader.
Pierre-Charles’ organizational bent manifested itself during Aristide’s exile, when the *Oganizasyon Politik Lavalas* (OPL) was created, within the larger, loosely structured *Lavalas* mass movement. When Aristide came back from his exile he found himself facing a structured party which, even though it did not encompass all the *Lavalas* members, counted with a large group of young people who were convinced of the virtues of the organization as a political resource, not least the collegial leadership and the opening for new leadership. Aristide had to accept the existence of the OPL, which, with presidential and municipal elections coming up in 1995, was moreover the strongest of the *Lavalas* groupings. This fact explains the creation of the *Bò Tab La* coalition controlled directly by Aristide and Préval, an organization which, however, attracted fewer followers than the OPL. The latter, which responded more to its own leaders than to Aristide, became the majority party in parliament. Aristide undoubtedly took notice of this fact, founded yet another political organization, *Fanmi Lavalas*, in November 1996, and registered it as a political party in January 1997. From that moment on tension began to be generated between the OPL and the rest of the *Lavalas* movement. The OPL faced the *Fanmi Lavalas* in the April elections, the point when it came to a definitive break between the two factions.

**The Préval government**

René Préval was elected president in December 1995 and assumed power in February 1996. Since the OPL had a majority in parliament, according to the constitution this party had the right to nominate the prime minister. This created a difficulty for Préval, since logically the position should have been filled by Pierre-Charles, who was never proposed, however. It is not quite clear what happened, but there are strong indications that Aristide raised a number of obstacles against the nomination of a political competitor and forced a negotiation process that dragged out for more than two months.

The outcome of the negotiations was the appointment of Rosny Smarth, another OPL leader. Smarth, a well-known intellectual, who took part in the social struggle from the first moment in 1986, is the brother of William Smarth, a priest who is close to Aristide. The Préval–Smarth government launched a programme which was a continuation of the one following the agreement signed in Paris before the return of Aristide. In Haitian political circles it was expected that the programme would meet with obstacles on the part of the militant *Lavalas* groups, because it would be implemented by a prime minister who had already distanced himself from the trunk of the *Lavalas* tree. It was also expected that Aristide counted on the government losing popular support in the implementation process and that this loss of support would make it easier for himself to make a comeback in the next presidential elections.
During its first year the new government gave an impression of paralysis and inability to initiate the reform process. The extent of social conflict escalated. Important sectors mobilized in order to present their demands, for example teachers and health-care personnel. In some municipalities disturbances took place because their employees had not received their regular salaries for several months. The opposition against the government was headed by the militant elements among the supporters of Aristide. In addition, a group of dismissed policemen and military began to use violent means to ensure that they received a series of benefits which they had been promised. Insecurity and fear began to spread among the general population which did not receive any protection from the police against the increase of common delinquency, drug traffic and political crime.

To summarize the year, it was a case of a worried prime minister who was intent on carrying out the reform programme, a president who hardly showed that he was in favour of the government programme and who did not defend himself against the attacks made by his political ‘twin’. In parliament the OPL majority supported the Smarth cabinet, while the Aristide supporters founded an anti-neoliberal group which in turn influenced twenty-four other independent deputies. Thus, a hard fight developed in this political arena as well. Parliament was converted into one more stage of confrontation.

From the anti-neoliberal group came an initiative to attack the prime minister for selling the national patrimony and reducing the national sovereignty. Although Smarth was able to defend his government programme, the attacks weakened his position and marked a further step towards rupture among the forces that were supposedly allies within the larger Lavalas setting. The critics demanded the resignation of Rosny Smarth – openly and strongly in public manifestations. The confrontations were also accompanied by clear signals of an opening breach between Préval and Smarth.

The year 1997 began with a heated discussion of the parliamentary and municipal elections that were to take place in April. That event divided the old Lavalas allies openly. Aristide and his Fanmi Lavalas presented separate candidates, opposing those of the OPL. In fact, these two groups prepared themselves for the first time to measure their strength in public. In the election campaign Aristide himself took part in some provinces, strengthening his candidates and attacking those of the OPL.

Electoral participation turned out to be extremely low. Only 5 per cent of the population entitled to vote went to the urns (Jean and Maesschalck, 1999, p. 99). Strong accusations of fraud were made by the OPL which in addition accused the Conseil Électoral Provisoire (CEP) of dealing with blank and void votes in an unconstitutional way. The CEP had already been pointed to as a group in favour of Aristide. Because of this, the alleged irregularities contributed to strengthening the attacks of the opposition
against this electoral tribunal. The OPL devoted itself to demonstrating the existence of mechanisms of electoral fraud, appealing to national and international instances, with ample and repeated accusations, because the interpretation made by the CEP could make it lose the parliamentary majority it had conserved up to that point. The fight of the OPL against its old family made it change its name to Organization Pèp kap Lite, maintaining its old acronym but emitting a clear signal that the Lavalas movement had shrunk.

However, the most important element of the crisis was that the prime minister found himself forced to intervene against the CEP, requesting a declaration with respect to the demands made by the OPL and the other opposition parties. Since the CEP did not pay any attention to Smarth’s demands the prime minister made it known that he could not declare the victory of the Lavalasians and stepped down from his post to force a clarification of the alleged electoral fraud. Rosny Smarth resigned on 9 June 1997 and thereafter concerned himself only with current routine matters, waiting for a new prime minister to be nominated. Since no such nomination took place, on 20 October Smarth left his office and asked his ministers to do the same. The country was left without government and with institutions that were in shambles. This accentuated the immobility that characterized René Préval who did not show any signs of being ill at ease with the anomalous situation in which his government found itself.

It would take an entire year before the president began the process of replacing Smarth. The first candidate to be presented was Éricq Pierre, an employee of the Inter-American Development Bank. The whole issue turned into a farce: Pierre had no political base whatsoever in Haiti; it was hinted that he did not know the realities of the country; he was seen as a mere puppet of the international financial organizations; he failed to meet the constitutional requirement of five years’ continuous residence in Haiti before taking office; and there were uncertainties surrounding his citizenship, and about his real first name, of which there were three versions in more or less official documents. Parliament turned him down by forty-three votes against nine. In the end Pierre did not even become a footnote in Haitian political history. His candidature was followed by that of Hervé Denis, a professor at the state university who had just won the elections for the rectorate and who resigned from this post to be proposed as prime minister. He was rejected by parliament as well. Finally, all participants in the process accepted the current minister of education, Jacques Édouard Alexis. After a series of difficulties in the process of nomination and approval, with complicated debates in parliament with president Préval himself involved, the appointment of Alexis was accepted by both chambers on 15 December 1998.

On 11 January 1999 Préval did not take part in the opening of parliament. His absence was received with violent manifestations by Lavalasians resulting in physical aggression against members of the legislature. The
same day the president declared that parliament was dissolved, and initiated a new stage for his government, with a prime minister but without a government programme duly approved by parliament, as prescribed by the constitution.

By this act the president left the OPL representatives without power at a time when they supported the efforts of the new prime minister to prepare the new, eagerly awaited, parliamentary elections. Also, the composition of the Conseil Électoral Provisoire was changed and, as it seems, all important sectors agreed that new elections had to be held. (It is symptomatic that no judicial body has been able to intervene and solve the conflict surrounding the 1997 elections.) The new elections were originally scheduled for 19 March 2000, to be followed by presidential elections towards the end of the year.

In the end, the parliamentary elections dragged out until 21 May as a result of administrative difficulties and outright irregularities. They were held with a voter participation of some 60 per cent, but in an atmosphere of suspicion and accusations, and, as could be expected, they were characterized by all kinds of irregularities, to the point where the president of the CEP, Léon Manus, felt he had to leave the country together with his family to be able to denounce the fraud when the time came to count the votes. His position was backed by the OAS observers present in Haiti during the elections. In the second round, less than 30 per cent of the registered voters bothered to show up (Fatton, 2002, pp. 115–18).

The return of Aristide

Instead of clearing up the national political panorama, the May 2000 parliamentary and municipal elections contributed to the deepening of the contradictions between government and opposition. The opposition parties got closer to each other until they had managed to create Convergence Démocratique. This grouping demanded that the May elections be repeated. Later its demands were radicalized to the point where it insisted that President Préval step down and that a government be formed that could organize new parliamentary and presidential elections.

The negotiations did not produce any agreement. Instead Préval pushed the preparations of the presidential elections in November. The fairness of these elections was questioned by Convergence and in the end they were boycotted, which left the road open for the one awaited candidate, Jean-Bertrand Aristide, who as expected won the presidency and in addition the nine senator seats that had to be filled in the same elections. Together with the ones gained in May they completed the absolute majority in parliament and at the municipal level.

The election of Aristide made the political situation visibly worse since the position of Convergence had been that of protesting the legitimacy of the election of Aristide. It proceeded to proclaim its own provisional
president and refuted the legitimacy of Aristide. Even though the opposition was powerless it had a strong impact in the international community which, in turn, withdrew its support for Aristide and deepened the isolation of the country.

René Préval’s government ended as it started, strongly criticized because of its lack of legitimacy due to the institutional conflicts that took the country into great social and political turmoil. Civil insecurity was widespread. Armed groups with evident support from the government provoked and terrorized the opposition and the population in general. A crisis broke out inside the national police which made its own chief go into exile because of fear for his security and that of his family. The Conseil Électoral Provisoire was accused of being controlled by Lavalas. The international community lacked enough confidence in the government to disburse aid, because it felt that the Haitian administration could not manage the resources with transparency. The population in general did not perceive that the government had any interest in fighting poverty, improving the education and public-health systems, or increasing employment opportunities, providing only a very limited number of public works. Wide circles even believed the popular tale that Préval governed badly to facilitate the election of Jean-Bertrand Aristide in 2000.

The erosion of institutions and the lack of social cohesion

During the entire period without a prime minister (i.e. without legitimate government) the political institutions were badly hurt, since the cabinet remained incomplete and the president assumed control over the entire state apparatus, including the municipal bodies. This situation, as we have seen, led to the suspension of foreign aid – a vital component in the reform process and in the efforts to balance the government budget and create investment. Foreign investors as well had said goodbye to Haiti and the local entrepreneurs lived in an atmosphere of crisis that affected their daily activities and made it difficult for them to become internationally competitive. The prime-minister problem continued. Blamed for the economic situation, Aristide’s first choice, Jean-Marie Chérestal, had to resign from office after pressure from Aristide’s supporters in January 2002, and it took almost two months before the successor, former Senate head Yvon Neptune, could be inaugurated.

The deterioration of the social situation was also a matter of concern. The lack of authority and efficiency within the police created a situation where delinquency was on the rise and politically motivated crimes were frequent, as when the sister of the president was hurt in an attempt against her life in January 1999. It was estimated that the extent of drug traffic was rising and that part of the police force had been corrupted by the drug dealers (Rohter, 1998). Few people turned to the police for protection and fewer yet to the courts to claim justice. Instead, the possession
of arms was increasing among the civilian population who found that it had to devise the necessary means of protection itself.

The main challenge facing Haitian society when Aristide came into power or the second time was to transform its political culture from confrontation to agreement. It had to overcome the atmosphere of political terror that the country had been experiencing since the fall of the dictatorship and which had led to the paralysis of public-sector performance and had contributed to the deepening of the social and economic crisis.

The Haitian population was feeling a certain fatigue which it expressed in political demobilization, by the lack of faith in the possibility of solving its problems through political participation, especially in the elections. The widespread non-participation in the elections from 1995 onwards bears eloquent testimony of this fact. Wide circles of civil society criticized the institutional vacuum that prevented them from developing initiatives that they consider important for the development of the country, both in the productive field and in social action in general. This is very important if we keep in mind that in many social areas state action was minimal and in certain instances even lacking altogether.

Haiti went through a long period of political instability caused by different forms of lack of legitimacy in the exercise of power: coups, electoral fraud, ignorance in parliament and inefficiency of government entities. All this led to a distancing from the constitutional norms, leaving the 1987 constitution aside – a constitution that was considered as one of the main achievements of the popular movement in the transition to democracy. Criminal acts went unpunished. The judicial inefficiency provided an opportunity for many groups to take justice into their own hands and this, in turn, produced a chain of crimes which generated a vicious circle of insecurity.

The loss of credibility

The Haitians were hostages of two political factions at war with each other. The institutions and mechanisms created by the constitution ceased to function. This was the case with the parliament, the judiciary and the Conseil Électoral Provisoire. In similar situations in other countries in the region institutions like the Church have played a conciliatory and mediating role. In Haiti, this proved impossible, due to the conflict between Aristide and the Church, which culminated in his expulsion from the Salesian order in 1988. What this means is that Haiti moved into a situation that had much in common with the nineteenth-century political order, what Samuel Huntington once termed a praetorian society, one where

social forces confront each other nakedly; no political institutions, no corps of professional political leaders are recognized or accepted as the legitimate intermediaries to moderate group conflict. Equally
important, no agreement exists as to the legitimate and authoritative methods for resolving conflicts.

(Huntington, 1968, p. 196)

It may thus be symptomatic that only a slim majority (55 per cent) of the respondents in one of the few political surveys that have been made in Haiti (America’s Development Foundation, 1997) pointed to tolerance and respect as important factors in the political process.

The survey is revealing in other respects as well. No less than 89 per cent considered that those responsible for the political situation had no interest in the problems of the population and thought that both national and local leaders did in fact not represent the interest that they claimed to represent. (In the Haitian carnivals they are regularly represented as *Grands mangeurs*; cf. Jean and Maesschalck, 1999, p. 103.) Politics in Haiti was once more the concern, not of the population at large, in a democratic fashion, but of a limited group of people, dominated by the most militant circles. This finding is obviously also of great relevance when it comes to explaining the extremely low voter participation during the 1997 elections, and so is the finding that no less than 80 per cent had registered as voters but no more than 10 per cent had participated in political events called by parties or other political groups. The potential voters simply lacked confidence in the parties and their leaders. (Curiously enough, the confidence in the police was much higher, albeit far less so in the most crime-infested zones, notably the capital, than in the countryside.)

It should be noticed that the poll demonstrated that Haitians know what their citizens’ rights are and what the obligations are of the state and the political parties. If people do not vote for the traditional political leaders and parties it is because they have no confidence in them. The population recognizes the importance of counting with democracy as a resource for the organization and political management of the country, but it also understands that its leaders do not make adequate use of it.

To conclude that when Aristide began his second presidency Haiti was in the middle of a crisis with respect to democratic values is no exaggeration. The Haitian population is aware that its political leaders often abuse it. Inevitably the question follows of whether the crisis will lead to demands for a different type of political leadership, with effective participation of civic organizations not related to the political parties and more respect for the ideas expressed by the constitution.

It was not only the acute deadlock that conveyed an impression of illegitimacy of the political process. The economic and social situation mattered too. The lack of efficient solutions of elementary problems that have been demanded by the population ever since the inauguration of the present president weighed heavily. Deeds matter more than words when the majority of the population is below the poverty level. Without concrete results it became impossible to create an atmosphere of confidence. With
two political groupings doing their utmost to put obstacles in the way of each other, paralysis and despair spread instead, to culminate in the devastating vortex of 2003–4 that ousted Aristide and put the Haitian democracy and economy back on square one.

The role of Aristide

So far, hardly anything has been said about the protagonist on the Haitian political scene, Jean-Bertrand Aristide, and his role in the political havoc. It is, however, well known that Hamlet cannot be played without the participation of the Prince of Denmark, so it becomes absolutely indispensable to comment on his probable motives and strategy as well. There is not the slightest doubt that Aristide dominated Haitian politics ever since he decided to run for the presidency in 1990 until his fall in February 2004.

The Jean-Bertrand Aristide who came back to Haiti in 1994 had little in common with the Ti Legliz priest sketched in Amy Wilenz’ The Rainy Season (1989), or for that matter with the naive portrait painted by Irwin Stotzky (1997). By 1994, he was a seasoned politician intent on recapturing the presidential power he once held, and did not hesitate when it came to altering the rules of the political game when this served to advance his position. Much in the same way as the ANC in South Africa united the anti-apartheid forces, Lavalas in Haiti was instrumental in gathering the democratic opposition against the threat that Duvalierism would continue even without Duvalier. Thereafter, however, the popular movement more and more acquired the appearance of a traditional Haitian political party, i.e. an organization which exists only to project its leader on the political scene and which is therefore completely subservient to him. Aristide knew that he had charisma and did not hesitate to use it on his followers. He never seemed to have accepted that he was deprived of three years of his presidential period by the 1991 coup and through the Lavalas militants made it known that he would not mind a corresponding prolongation.

The test balloon failed, however. The international community did not accept any alteration of the constitution, and, as we have seen in the foregoing, within Haiti forces were at work building up structures that could countervail one-man power. A second-best solution thus had to be sought and, with the 1995 elections approaching, Aristide, at a fairly late stage, faute de mieux, chose to support his former prime minister, René Préval. Five years, however, is a long time for a power politician to remain in the background. Political events easily acquire their own dynamics, taking off into unexpected directions. It is easy to slide into oblivion if you are not at the centre of attention. The safety-first rule to apply for someone who is planning a comeback therefore is to be visible and demonstrate that country cannot do without him or her. To do so in a positive way may be difficult for a person who has no formal power. The option of resorting to non-creative destruction is much easier.
This appears to have been the road chosen by Aristide: making life difficult for his successor, so as to make the inevitable comparisons with himself unfavourable for Préval and facilitate his return to the presidency in 2001. It was not difficult to find a suitable issue: the economic reform programme, especially the privatization of state enterprises, that Aristide himself had endorsed before his return to Haiti in 1994 (Schultz, 1997–8, p. 75):

No sooner had the turmoil of August 1996 [which involved political arrestations and a violent clash with the ultra right] begun to die down than former President Aristide attacked the Préval administration, claiming that the machinery of government had become loaded down with corruption and disorder, and that certain politicians had become blinded by power and had given up on the people. An economic coup was underway, he asserted; privatization was a trap that had sown division, confusion, and conflict within Lavalas. If order were to be restored, there must be good relations between the Lavalas in power and the Lavalas out of power.

That the strategy was successful is quite clear. Préval could not defend himself against the attacks, lacking an independent political base, and he has been accused of being a ‘président de doublet, un président par défaut’ (Jean and Maesschalck, 1999, p. 110), i.e. a mere puppet, with the strings pulled by Aristide, who did not have to take any official responsibility for what his successor did.

Aristide returned to the presidency in February 2001, but his return did not improve the situation. On the contrary. Haiti had to live in a political climate characterized by uncertainty and terror that made negotiation between the parties difficult, and things deteriorated visibly after the return of Aristide. The situation with respect to human rights grew worse. Journalists were murdered and radio stations were closed. Deputies and state functionaries abused their powers and nothing was being done to prevent them. Leading officials, including the prime minister and the minister of the interior, were accused of corruption. Various Lavalas deputies were accused of crimes and beatings. Increasingly the political scene was transferred to the streets where Chimères and other criminal bands could play a leading role.

Aristide himself demonstrated little political tact in dealing with the security problem in Haiti. At the end of June 2001 he called for zero tolerance of crime. This immediately led to summary executions by the police and criminal vandalism by street gangs. The attack on the presidential palace produced only retaliation – against the wrong group. No efforts were made to find out which group was responsible. No arrests were ever made and the government was strongly suspected of having been involved in the actions.
The lack of responsible action after the attack on the palace unfortunately was not an isolated instance. On the contrary, the complete unwillingness to negotiate with the opposition and come to some kind of compromise or *modus vivendi* with it would characterize the rest of Aristide’s presidency as well. As Peter Dailey (2003, p. 43) has pointed out, ‘his attention was almost wholly consumed by the internal political struggle’, and the aim of the struggle was destruction of the adversary, in the worst Haitian political tradition. This, for example, explains the fraud in the 2000 elections (Fatton, 2002, p. 120):

It is clear that at least since 1997 Fanmi Lavalas has been seeking a hegemonic position that can only be obtained by controlling at a minimum two-thirds of parliament – the threshold required to introduce major change in the 1987 constitution. Aristide … [was] thus establishing the terrain for an imperial presidency through the electoral omnipotence of Fanmi Lavalas. […] This is why fraud became necessary to ensure both the annihilation of the anti-Lavalasian parties and the two-thirds majority for Aristide. An overwhelming victory in the first round was thus the means to that end. The logic was simple: while in the first round Fanmi Lavalas had an easy task since it faced a thoroughly divided opposition, in the second round things could have fallen apart because it would have had to contend against a single and possibly united anti-Aristide front. In these circumstances the final outcome might have diluted the scope of Lavalas’s victory, making the coveted two-thirds majority an impossibility.

The above puts a heavy responsibility on Aristide for what has happened in Haiti since 1996, since it amounted to sacrificing long overdue reforms on the altar of personal ambitions.

It is clear that the Haitian political institutions lack legitimacy. This is demonstrated by the breakdown of the electoral process, the parliamentary crisis, the repeated confrontations that we have witnessed since 1997 and the final degeneration into an uprising largely directed by criminal elements. However, we also have to add another source of illegitimacy: the lack of efficiency in the solution of elementary problems that have been demanded by the population since the actual government assumed power. Capability and efficiency are indispensable instruments for creating confidence among the population.

Haiti has been facing a leadership crisis for several years. People need new political leaders capable of displaying a different way of acting, efficient mechanisms for the participation of the social sectors that do not belong to any party and an increased respect for the constitutional obligations. However, when we look at the new leaders produced by the dominant *Lavalas* party in the recent past we find that although the faces were new the leaders came out of the old structures of a traditional,
authoritarian, saincure political culture, ignorant of democratic rules, respect for the adversary and very much stuck in corruption and violence. We may almost speak of a lumpen proletariat that reproduced the same mechanisms that it rebelled against.

After the fall of Aristide Haiti is in the most difficult situation since the fall of the Duvalier regime. The international community had to intervene in 1994, to rid the country of an undesirable military regime. Ten years later, the international community is back in Haiti. This time, it will have to remain in place a great deal longer, not repeating the 1994 mistake of thinking that once the culprits had been removed democracy would make advances almost automatically and economic and social development would follow. It must ensure that the process of instituting democracy, good governance, stable institutions and reforms is not derailed again, but this cannot take place without the positive cooperation of the Haitians themselves, notably the politicians. Now both the opposition and whatever remains of the Lavalas structure must assume a different kind of responsibility. History has always been one of the foremost obstacles to change in Haiti (Lundahl, 1992), but if it reproduces itself again, producing nothing but another selfish, corrupt and irresponsible government, the descent into hell is inevitable, and, as usual, the losers are the common man and the common woman.

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Notes

1 The poverty line in this case is calculated as the local cost of reaching the minimum calorie standard recommended by the FAO (2,240 calories daily per capita) with a diet that corresponds to the food expenditure percentages of the average household (called the indigency line) together with non-food expenditure so that the share of food in total expenditure corresponds to the average for poor rural households (with both total expenditure and food expenditure close to the indigency line) (Wiens and Sobrado, 1997, p. 3).

2 Defined in purchasing power parity terms at 2000 prices. For the methodology behind the calculation, see Pedersen and Lockwood (2001).

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MPCE (Ministère de la Planification et de la Coopération Externe) and PNUD
Introduction

In 1994, the Secretariat for Analysis of Swedish Development Assistance (SASDA) commissioned Mats Lundahl and I to analyse the effectiveness of Swedish aid to Nicaragua (Behar and Lundahl, 1994; hereafter it will be referred to as “the 1994 report”). At that time, the main concerns of both donors and creditors were Nicaragua’s large macroeconomic imbalances and the clear incapacity of the country to meet its debt-service obligations. As a consequence, the macroeconomic part of the report was devoted to the analysis of a crucial aspect of the Nicaraguan economic process, namely the relationship between the total inflow of foreign aid and the evolution of the foreign debt. Two other central issues in the analysis were the rationale of the adjustment and economic-reform programme implemented by the government that emerged from the 1990 elections, as well as its social consequences. The programme was (and still is) supported by the donor community which, as is well known, includes many of Nicaragua’s creditors.

As concerns the external debt, the 1994 report described the situation in terms of a state of total external insolvency. At the end of 1989, the deficit on the current account was US$630 million, which was equal to more than 40 per cent of GDP. The accumulation of external payment arrears, in turn, amounted to US$3,700 million, the equivalent of twelve years’ worth of exports; and the outstanding debt totalled US$9,600 million. Four years later, Nicaragua’s payment capacity had not improved, and the prospects of economic recovery were still very dubious. Against this background, it is thus not surprising that the 1994 report was critical about the way in which all parties involved had managed the debt problem. One main conclusion was “unless something can be done about the debt situation and the aid dependency associated with it, Nicaragua will face enormous difficulties when it comes to attaining growth in Nicaragua”. Moreover, “debt reduction in the form of rescheduling and debt forgiveness is a key element when it comes to tracing out a viable economic development strategy for Nicaragua”. As stated in the report, this
was a pre-condition for foreign assistance in the form of project support. Accordingly, the main recommendation to the Swedish authorities was to move from concentrating aid on conventional projects and programmes to practising active multilateralism, that is, working for coordinated debt forgiveness among the international donor community.

We are about to mark the tenth anniversary of the end of the civil war in Nicaragua. In April 1990, the US-backed candidate won the elections and this paved the way for the pacification of the country and the normalization of diplomatic relations with the US administration. The latter ended the undertaking of covert and overt military actions against Nicaragua, including support to the Contra army, and changed radically its policy strategy towards the country. At the time when the government headed by Violeta Chamorro took office, the US government lifted the trade embargo and assisted in the demobilization of the Contras. Furthermore, it ceased its diplomatic obstruction of bilateral and multilateral financial flows to the country and instead actively supported the organization of the donor conference in Rome in June 1990. This was the beginning of a political-economic process characterized by significant increases in grants and concessional loans, rescheduling of the debt, and the implementation of a comprehensive structural adjustment programme. Ten years later, substantial progress has been made in stabilizing the economy and implementing market-oriented reforms. The Nicaraguan economy is now growing at almost 5 per cent and inflation has fallen to a rate of 13 per cent.

These improvements in economic performance notwithstanding, poverty continues to be a widespread phenomenon in Nicaragua. According to World Bank estimates, 44 per cent of the population live on less than US$1, and about 75 per cent live on less than US$2 per day. The new administration which took office in 1997 and the multilateral agencies have designed a strategy for poverty alleviation in which investment in human capital is stressed, but the fact is that the share of education and health expenditures in GDP are well under their 1985 levels. The external debt is, on the other hand, still a major conflictive issue for both the government and the donor community. A recent IMF report states that additional debt-reduction operations are needed in order to allow “a reduction in Nicaragua’s debt burden to sustainable levels and a normalization of relations with all creditors” and further “… [Nicaragua’s] debt burden indicators are among the highest of all the HIPC [Heavily Indebted Poor Countries] cases” (IMF/IDA, 1999). Those assertions provide a motive for returning to some of the issues raised by the 1994 report.

**Stabilizing efforts and elusive growth**

Between 1991 and 1994, Nicaragua was implementing a structural-adjustment programme directed by the IMF and the World Bank, the
main positive results of which were a radical reduction in the inflation rate and the stabilization of the foreign-exchange market. On the other hand, economic performance was very deceptive. GDP continued to contract, the balance-of-payments situation did not improve, and, as a consequence, the uncertainty about the ability of adjustment policies to ensure economic stability had increased by the end of the period. A central factor here was the worsening of the debt crisis. The inconsistency of the stabilization efforts in relation to the behaviour of relevant variables is made apparent in Table 14.1. Keep in mind that stabilization measures placed special emphasis on devaluation, restrictive credit policy, considerable cuts in public expenditure, the liberalization of trade and the privatization programme.

As shown in the table, the efforts to restrain domestic credit and public expenditure, as well as to liberalize trade, were successful during the first three years of the period. This certainly contributed to reducing inflation to manageable levels, but the fact is that at the end of 1993, real GDP decreased by 0.4 per cent, manufacturing production and investment stagnated, export growth declined, and inflation pressures increased. In this context, the stabilization issue became a matter of real concern for both the Nicaraguan authorities and multilateral agencies.

That concern was registered in the 1994 report in the following terms: “It was clear that further adjustment would prove difficult to accomplish, not only because of the increasing social costs it would entail ... but also because of declining cash inflows”. The first problem related to the emergence of a declining trend in real wages as well as negative rates of private consumption growth at the end of. In the state of political unrest that prevailed in Nicaragua this implied very strong pressures on the democratically elected government. Note that previous figures are for a country whose income per capita increased from US$610 during the Somoza period (1970–75) to US$720 during the first Sandinista period (1980–5), and then declined to US$410 in 1990 after ten years of war, economic blockade, and natural disasters.

The second problem, namely, the worsening of balance-of-payment conditions, is illustrated by the figures in the last panel of Table 14.1. They give insight into the role of the foreign-debt crisis in the creation of macroeconomic uncertainty and instability during the period under review. As reported in the table, the massive debt accumulated during the 1980s continued to increase during the early 1990s, despite substantial debt relief through debt-reduction and rescheduling agreements with the members of Paris Club and multilateral agencies, and despite significant increases in grants and concessional loans. Nicaragua’s external insolvency emerges clearly from the figures in the last row of the table. By the end of 1993, the outstanding debt including arrears amounted to US$11 billion, while the debt stock and the debt service paid amounted to 300 and 2,500 respectively in per cent of exports of goods and non-factor
services. Note finally that debt payments accumulated during the period attained a record of more than US$3 billion. As a consequence, the total financial gap was increased by 70 per cent between 1989 and 1993, from US$3.7 billion to US$6 billion. Capital inflows in the form of official grants as well as public and publicly guaranteed long-term capital amounted to nearly US$450 million on average during the period, but as

| Table 14.1 Stabilization efforts, socio-economic performance and external finance, 1990–3 |
|---------------------------------|--------|--------|--------|--------|
| Net credit to central government | –      | 100.0  | 67.8   | 59.9   |
| Nominal exchange rate            | n.a.   | 100.0  | 115.0  | 141.0  |
| Interest rate                    | –      | 19.4   | 20.3   | 20.3   |
| Import-tax rate                  | –      | 43.2   | –      | 12.3   |
| Economic performance             |        |        |        |        |
| Total expenditures               | 34.6   | 26.9   | 28.2   | 27.4   |
| Public budget deficit            | 31.0   | 7.9    | 8.4    | 8.6    |
| Annual growth of GDP             | –0.1   | –0.2   | 0.4    | –0.4   |
| Annual growth of manufacturing GDP | –1.5  | 6.4    | –5.1   | 0.0    |
| Annual growth of private investment | 184.8 | –2.1   | –      | 53.6   |
| Annual growth of exports of goods | 8.1   | –16.2  | 9.4    | 4.2    |
| Annual growth of consumer prices | 3,246.9 | 865.6  | 3.5    | 19.5   |
| Resource balance                 | –290.0 | –486.9 | –609.8 | –448.8 |
| Change in net international reserves | –197.8 | 11.0   | 5.1    | –79.2  |
| Social indicators                |        |        |        |        |
| Annual growth of per capita GDP  | –2.5   | –3.0   | –2.1   | –3.3   |
| Annual growth of per capita private consumption | –14.2 | 37.6   | 0.0    | –3.6   |
| Changes in real wages            | 64.9   | –4.5   | 11.4   | –6.3   |
| Labour under-utilization         | 23.1   | 26.4   | 28.2   | 30.9   |
| Public expenditure on education  | 5.1    | 4.8    | 4.7    | 4.4    |
| Public expenditure on health     | 5.0    | 4.2    | 4.2    | 3.9    |
| External debt and financial flows |        |        |        |        |
| Total disbursed external debt    | 10,715.4 | 10,312.5 | 10,792.1 | 10,987.3 |
| Official grants cash             | 101.8  | 354.8  | 132.0  | 73.3   |
| Official grants tied to specific projects | 91.0   | 210.1  | 169.9  | 169.4  |
| Official grants debt forgiveness | 0.0    | 259.0  | 53.0   | 147.7  |
| Arrears: principal              | 382.7  | 438.3  | 681.9  | 479.8  |
| interest                        | 0.0    | 1,059.2 | 184.4  | 115.2  |

Source: Behar and Lundahl, 1994

Notes
a Constant prices.
b Index numbers, 1991 = 100.
c Percentages of GDP.
d Lending rate.
e Average of nominal rates.
f Millions of current dollars.
stated in the 1994 report, the prospects of increased aid were uncertain. Here, the report was pointing to the increasing scarcity of public resources in industrialized countries and the urgent need for supporting economic growth in other regions, especially Eastern Europe. These two factors would impose a constraint on donors for maintaining support to countries, such as Nicaragua, which have already received massive financial assistance but failed to resume growth.

In summing up the macroeconomic analysis of the 1994 report, the authors drew the conclusion that both Nicaragua and the donors had been involved in ever-increasing debt negotiations, policy-conditioned aid, and recessive adjustments, which unintentionally perpetuated the present situation of extreme aid dependency and external insolvency. This, they meant, implied that “there was simply no way of getting Nicaragua back on a growth path without working on further renegotiations of the country’s foreign debt, and this, clearly, included debt forgiveness”. To what extent Nicaragua’s events in the late 1990s confirmed this assertion is the subject of the following section.

**Achieving external solvency as a means to recover growth . . .**

In June 1994 the first ESAF-supported programme was approved. It was followed by a new three-year agreement starting from 1998, subsequent to the change of administration in early 1997. The two ESAF programmes stressed the need to strengthen fiscal and monetary policies. It included additional cuts in public employment, the elimination of remaining price controls, and further advances in the liberalization of foreign-exchange and trade systems. As for the World Bank-supported structural programme, the main reforms included privatization of state enterprises, the establishment of an independent banking superintendency and the normalization of property rights. In sum, there was a deepening and enhancing of the objectives stated in previous agreements with the multilateral agencies.

**Managing domestic conditions**

At the end of 1998, substantial progress had been made in reducing macroeconomic imbalances and recovering growth. These achievements can be grasped in Table 14.2.

Note for instance the drop in public budget deficit from 11.2 per cent of GDP in 1995 to 2.2 in 1998. This can be compared with the corresponding average figure of about 8.5 per cent for the 1991–1993 period. The improvement took place through both a major increase in public-sector savings from 1.7 per cent of GDP in 1996 to 5.6 per cent in 1998, and higher tax pressures, from 25 to 30 per cent in the same period. Note
further that Central Bank credit to the central government as measured in real terms continued to decline. Conversely, the growth of commercial banks’ credit to the private sector accelerated notably at the end of the period. There is no doubt that the successful reduction of public deficit described above, together with prudent monetary and exchange policy as well as the close monitoring of credit operations, were central factors

Table 14.2 Stabilization efforts, socio-economic performance and external finance, 1995–8

<table>
<thead>
<tr>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Net credit to central government&lt;sup&gt;a&lt;/sup&gt;</td>
<td>84.9</td>
<td>62.6</td>
<td>69.4</td>
<td>63.5</td>
</tr>
<tr>
<td>Nominal exchange rate&lt;sup&gt;b&lt;/sup&gt;</td>
<td>111.9</td>
<td>125.5</td>
<td>140.5</td>
<td>157.4</td>
</tr>
<tr>
<td>Interest rate&lt;sup&gt;d&lt;/sup&gt;</td>
<td>20.5</td>
<td>21.1</td>
<td>21.6</td>
<td>21.9</td>
</tr>
<tr>
<td>Import-tax rate&lt;sup&gt;c&lt;/sup&gt;</td>
<td>12.0</td>
<td>–</td>
<td>–</td>
<td>6.8</td>
</tr>
</tbody>
</table>

Fiscal and Macroeconomic performance

| Total expenditures<sup>c</sup> | 34.1  | 33.2  | 33.1  | 31.3  |
| Public budget deficit<sup>c</sup> | 11.2  | 14.2  | 7.1   | 2.2   |
| Annual growth of GDP<sup>a</sup> | 4.3   | 4.7   | 5.1   | 4.0   |
| Annual growth of manufacturing GDP<sup>a</sup> | 2.8   | 2.4   | 3.8   | 2.1   |
| Annual growth of private investment<sup>a</sup> | 13.7  | 35.4  | 51.2  | 13.3  |
| Annual growth of exports of goods  | 11.4  | 11.7  | 30.9  | 1.0   |
| Annual growth of consumer prices   | 11.1  | 12.2  | 7.3   | 18.5  |
| Resource balance<sup>f</sup>      | −443.0| −443.0| −544.0| −687.0|
| Change in net international reserves<sup>f</sup> | −20.1 | 125.1 | 232.0 | −62.7 |

Social indicators

| Annual growth of per capita GDP<sup>a</sup> | 1.2   | 1.6   | 2.0   | 0.9   |
| Annual growth of per capita private consumption<sup>c</sup> | −0.2  | −0.4  | n.a.  | n.a.  |
| Changes in real wages                  | 1.9   | −1.7  | −2.0  | −7.0  |
| Labour under-utilization               | 28.7  | 27.6  | 26.5  | 24.8  |
| Public expenditure on education<sup>c</sup> | 4.6   | 4.7   | 5.1   | 4.9   |
| Public expenditure on health<sup>c</sup> | 4.8   | 4.6   | 4.0   | 3.7   |

External debt and financial flows<sup>f</sup>

| Total disbursed external debt | 10,248.4 | 6,094.3 | 6,001.0 | 6,287.1 |
| Official grants cash          | 79.5     | 61.9    | 21.5    | 7.7     |
| Official grants tied to specific projects | 147.5 | 200.2  | 172.6   | 186.7   |
| Official grants debt forgiveness | 1,452.7 | 4,208.1 | 103.7   | 138.6   |
| Arrears: principal           | 402.0    | 265.0   | 88.0    | 45.0    |
| interest                     | 220.0    | 202.0   | 93.0    | 114.0   |

Source: IMF, 1999

Notes

- a Constant prices.
- b Index numbers, 1994 = 100.
- c Percentages of GDP.
- d Lending rate.
- e Average of nominal rates.
- f Millions of current dollars.
behind the situation of relative price stability which prevailed during the period. In my opinion, this is one of the most distinctive achievements of the stabilization programme. Finally, note that at the end of the period inflation rose again. However, it is reasonable to conclude that this increase is not due to a failure in the stabilization programme, but rather to the Hurricane Mitch and its adverse effects on agricultural production and economic infrastructure.

Tangible evidence of success is also visible in the real sector of the economy. As emerges from the table, GDP grew steadily, at an average rate of 4.5 per cent during the period, with private investment and exports also increasing but in a more irregular manner. It should be remarked that with most of the public and financial sector reform now implemented, future expansion of investment and production will depend more on private-sector participation than on the activities of government agencies. This is already happening. By 1998, the share of public-sector employment was 5.3 per cent, that is less than one fourth of the corresponding figure from 1990, while the share of public-sector banking system in total deposits contracted from 100 per cent in 1990 to 43 per cent in 1995 and 5.3 per cent in 1998. As for private investment, the trend during the 1990s was one of strong and continuous growth (see Tables 14.1 and 14.2), but it should be noted that initial figures for the period were very low. By 1992, gross domestic investment in per cent of GDP was 19.3, with the private sector accounting for 9.9 per cent. Corresponding figures for 1997 were 30.9 and 17.5 per cent respectively. Note, however, that domestic savings financed about 20 per cent of total investment that year. Even if this implies an improvement as compared with the situation prevailing in the early 1990s, when national savings remained negative, the fact is that foreign savings, notably aid, still had to shoulder the major part of capital formation in Nicaragua. The 1994 report wondered about the relationship between the savings gap and aid, and, more specifically, the extent to which aid was replacing domestic savings or alternatively allowing the government to expand public sector consumption. This question remains open.

Along with public-sector reforms and deregulation of the foreign exchange and financial markets, significant steps towards the liberalization of trade were taken during this period. Tariff reduction during the 1990s has lowered the level of nominal protection from 43.2 per cent at the beginning of the decade to 12 per cent in 1995 and 6.8 per cent in 1998. At the same time, the level and the dispersion of the tariff structure have been reduced and import prohibitions have been eliminated. This has perhaps improved the conditions for export growth, but it inevitably has raised imports to record levels, with the consequence that the country continued to run large trade deficits during the whole period. By 1998, the trade deficit (goods and non-factor services) amounted to US$699 million, or more than twice the amount of official grants disbursed that
Restoring external solvency

At the end of 1996, the IMF and the World Bank estimated the stock of Nicaragua’s external debt to be US$6,094 million, which implied a reduction of US$4,200 million from the previous year’s amount. The reduction was the result of the agreement with the Paris Club reached in March 1995, which provided for flow reschedulings on Naple terms, as well as a number of rescheduling agreements with other official bilateral creditors in 1995–96. As emerges from Figures 14.1 and 14.2, these agreements led to a dramatic improvement in the conventional indicators of debt burden. Total debt in per cent of GDP contracted from 638 per cent in 1994 to 280 per cent in 1998. Corresponding figures for service obligation were 250 and 173 per cent respectively (see Figure 14.1).

Consider now the evolution of the two debt-service-to-export ratios displayed in Figure 14.2. Without any doubt, debt relief was the key factor in the sharp decrease in the nominal service-obligation-to-export ratio from 1995. As for the service obligations actually paid, there is also a declining trend, which is mainly due to improved export performance. Certainly, the amount of debt-service paid increased steadily during the 1990s to a peak of about US$450 million in 1997. Export growth (only goods) in turn accelerated from a rate of 1 per cent on average in the early 1990s to about 13 per cent on average in the late 1990s. As a consequence, the gap between the two ratios contracted notably in 1997 and 1998. Thus, there is some evidence of Nicaragua’s growing ability to restore external solvency at the end of the period. Moreover, it seems clear that debt relief was a necessary condition to stabilize the balance of payments and recover economic growth, meaning increased production, exports and investment. The question is whether such debt relief, combined with additional structural reforms, is sufficient to increase payment capacity, and attract new capital and investment in the next years. A look at operational procedures recently adopted by the World Bank and IMF for debt and debt-service reduction may illuminate the issue.

In their assessment of Nicaragua eligibility for assistance under the Initiative for Heavily Indebted Poor Countries (HIPC), the two multilateral organizations concluded that assuming the “full use of traditional rescheduling mechanisms... Nicaragua’s external debt ratios will remain at unsustainable levels”. The IMF/IDA report refers here to its projections of external debt ratios using the baseline scenario, which assumes the implementation of the last tranche of the 1998 debt-reduction agreement in March 2001. Based on these assumptions, and according to the report’s debt estimates and calculations, the net present value (NPV) of debt-to-
exports ratios would contract from 600 per cent in 1998 to 440 per cent in 2001, while the debt-service ratio would decline from 32 per cent in 1998 to 16 per cent in 2000. This ratio would increase again to more than 20 per cent in subsequent years. In the framework of the recently enhanced Initiative for HIPC, it implies that Nicaragua would qualify for the benefit of additional debt relief equivalent to 66 per cent of NPV of total debt after reschedulings. IMF/IDA calculations indicate that this would reduce the NPV of debt-to-export ratio to 150 per cent, that is, to the level

Figure 14.1 Total debt and service obligations in per cent of GDP.
established in the previously mentioned framework to define debt sustainability. Such an operation would reduct the face value of Nicaragua’s external debt export to half of its present value or to a fourth of its 1994 value. In sum, multilateral organizations and bilateral creditors have explicitly acknowledged the *de facto* insolvency of Nicaragua, and started coordinated and effective actions to cope with the problem. After a decade of these actors denying the perverse logic of the aid-debt-servicing circle described in the 1994 report, one may say, paraphrasing a statement by the President of the World Bank, that this is “very good news for the poor of Nicaragua”. Thus, are there still reasons for being anxious about future developments, or more specifically, for doubting the long-run consistency of means and goals in the current economic reform program?

*Figure 14.2 Service-obligations-to-exports ratios.*
or improving social conditions as a means to develop

If one looks at Nicaragua’s economic developments in the last years, the answer is that criticism and uncertainty are no longer justified. Certainly, growth has recovered, and substantial progress has been made in reducing macroeconomic imbalances. Moreover, all this has been achieved in the context of an overly indebted economy. Thus, it seems reasonable to expect that further reductions in debt stock will allow more growth and stabilization. The fact is, however, that the converse is also true. That is, high rates of economic growth and export expansion are necessary in order to transform external solvency, however it is defined, at a given point in time in longstanding debt sustainability.

In IMF/IDA analysis of the issue, GDP and export volumes are assumed to grow at average rates of 6 and 7 per cent respectively from 1999. Investment and national savings are also assumed to grow. These assumptions are exogenous to the analysis but contingent upon the successful implementation of on-going economic reform programs. In the IMF/IDA baseline scenario, that is, without further debt reduction and no financing gap after 1999, interest and amortization payments amount to about US$400 million on the average during a nine-year period. Assuming that HIPC debt relief would reduce these payments to US$300 million, this implies that additional resources for US$100 million would be available to finance social development programmes during the period. Here I make the strong assumption that other external flows oriented towards these programmes maintain their present levels. I further assume that the link between debt-relief and poverty reduction as stressed in the HIPC initiative implies that debt relief savings are exclusively used to attain the latter objective in the framework of public expenditure. At this point, the question emerges as to whether it is sufficient to make the assumed GDP and export-growth rates endogenous in the long run.

The principle underlying this question is that poverty or, for that matter, inequality levels are not only a final outcome of growth but also have an independent role to play in reducing macroeconomic imbalances and assuring growth. From this perspective, investments in human capital in the form of improved provision of health services and schooling are fundamental to increase the growth potential. Moreover, that effect would be more visible and easier to produce in those countries with very poor social performance, that is, with a high degree of illiteracy and low coverage of public health-care services. The existence of such a double linkage between growth and inequality, including the initial level of absolute poverty has been explicitly recognized in IMF/IDA documents. Thus, we need to return to Nicaragua’s social indicators in order to approach the issue. These are displayed in Table 14.3. For a comparison, social indicators for Costa Rica are also included in the table.

What the figures in the table show is merely the social gap between two
neighbouring countries, which, certainly, are at very different stages of economic development. The table, however, gives an idea of the effort that Nicaragua should make in the social sector in order to reduce the economic and social gap between the two countries.

Because of its low-income level, Nicaragua’s annual per capita expenditures in health and education are very low, about US$17 and US$22 respectively. Compare this with Costa Rica, which boasts corresponding figures of 161 and 142. Assume now that human capital is a differentiated factor of production and that, consequently, an increase in its marginal efficiency contributes to improve macroeconomic performance. Assume further that education and health indicators approximate the level of human-capital formation at a moment in time. Based on these assumptions, improvements in those indicators and successful economic reform are necessary and sufficient conditions to produce the outcome stated in IMF/IDA projections, that is, a growth rate of 6 per cent or a GNP per capita growth of about 2 per cent between 2000 and 2008. Accordingly, Nicaraguan expenditures on health and education should be substantially increased during this period. Of course, the question is, to what extent?

### Table 14.3 Social Indicators for Nicaragua and Costa Rica

<table>
<thead>
<tr>
<th></th>
<th>Nicaragua Actual</th>
<th>Track record</th>
<th>Costa Rica actual</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total population</strong></td>
<td>4.7</td>
<td>–</td>
<td>3.5</td>
</tr>
<tr>
<td><strong>GNP per capita</strong></td>
<td>450.0</td>
<td>540.0</td>
<td>2,680.0</td>
</tr>
<tr>
<td><strong>Protein intake as per cent of requirement</strong></td>
<td>48.9</td>
<td>55.0</td>
<td>67.8</td>
</tr>
<tr>
<td><strong>Poverty gap at $2 a day</strong></td>
<td>39.7</td>
<td>25.0</td>
<td>19.4</td>
</tr>
<tr>
<td><strong>Health indicators</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Life expectancy at birth</td>
<td>68.1</td>
<td>69.0</td>
<td>76.5</td>
</tr>
<tr>
<td>Mortality rate, infant</td>
<td>46.0</td>
<td>28.0</td>
<td>13.7</td>
</tr>
<tr>
<td>Safe water</td>
<td>62.0</td>
<td>70.0</td>
<td>86.9</td>
</tr>
<tr>
<td>Hospital beds per 1,000 inhabitants</td>
<td>1.3</td>
<td>1.5</td>
<td>2.0</td>
</tr>
<tr>
<td>Inhabitants per physician</td>
<td>1,725.0</td>
<td>1,500.0</td>
<td>1,200.0</td>
</tr>
<tr>
<td><strong>Education indicators</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Illiteracy</td>
<td>36.6</td>
<td>20.0</td>
<td>9.6</td>
</tr>
<tr>
<td>Net enrolment primary</td>
<td>77.3</td>
<td>83.0</td>
<td>89.9</td>
</tr>
<tr>
<td>Primary survival rate</td>
<td>43.0</td>
<td>60.0</td>
<td>84.2</td>
</tr>
<tr>
<td>Pupil/teacher ratios</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Primary</td>
<td>38.0</td>
<td>35.0</td>
<td>30.0</td>
</tr>
<tr>
<td>Secondary</td>
<td>34.0</td>
<td>28.0</td>
<td>18.0</td>
</tr>
<tr>
<td><strong>Public social expenditures (% of GDP)</strong></td>
<td>11.3</td>
<td>22.0</td>
<td>17.6</td>
</tr>
<tr>
<td>Health</td>
<td>3.7</td>
<td>8.0</td>
<td>6.0</td>
</tr>
<tr>
<td>Education</td>
<td>4.9</td>
<td>10.0</td>
<td>5.3</td>
</tr>
<tr>
<td>Social welfare</td>
<td>2.7</td>
<td>4.0</td>
<td>6.3</td>
</tr>
</tbody>
</table>

Sources: IMF, 1999; WB, 2000
Table 14.3 shows a tentative minimum track record to be achieved in this area. It also shows the public social expenditures consistent with the track record: Nicaragua’s social expenditures per capita must increase from US$50 to 120. These figures are of course very rough estimates, but they are no more arbitrary than other thresholds used in official debt sustainability assessments. Moreover, note that since the scale of human-capital development in Costa Rica is considerably larger than that of the poorer and less-developed Nicaragua, the interaction of public social expenditures with economic growth and the efficiency of the former radically differ from one country to the other. Accordingly, I have made adjustments in order to compare. In Table 14.3, I let the share of Nicaragua’s social expenditures in Costa Rica’s corresponding figure increase from 12 to 25 per cent. It would require that Nicaragua devote real resources to the social sector equivalent to 22 per cent of its GDP, which is more than Costa Rica does. But again, is that not completely justified in view of the large differences in human-capital stock between the two countries?

The next question is how to finance these investments? Financial resources from debt-payment savings in the context of the HIPC initiative would allow an increase in social expenditures equal to US$20 per capita. Assuming that additional US$30 can be financed by a reallocation of government expenditures and other external financing, this would leave a social deficit, as I will call it, of US$40 per capita, that is, about 7.5 per cent of GDP or 23 per cent of central-government expenditures. The total financial gap in that scenario is about US$200 million a year. Alternative sources are additional aid in the form of more debt-relief operations and concessional loans and grants, or more national savings. In IMF/IDA calculations, the latter are assumed to increase to about 12 per cent of GDP, but I see these savings as a complement to foreign direct investment, which, in IMF/IDA analysis, is also assumed to increase up to a level of about US$400 million a year. This leaves us with the first option, additional aid. In my opinion, the optimal choice in that case is to distribute the financing of the social deficit in two exactly equal parts, US$100 million to extra debt relief and US$100 million to concessional loans and grants. In sum, what is required now is to reduce the NPV debt/export target considerably below the HIPC target of 150 per cent.

Some concluding remarks

This essay has examined the problem of debt sustainability in Nicaragua. Some preliminary conclusions are at issue. Nicaragua’s macroeconomic performance has improved in the last years. Fiscal imbalance and the level of external liabilities, as compared with that prevailing in past years, have been considerably reduced, which has contributed to further improvements in the balance-of-payments situation. All this has increased the likelihood of Nicaragua achieving debt sustainability in the next years.
External support has played a central role here. A number of debt-rescheduling agreements have been implemented and additional ones are in process of implementation. This, combined with high aid flows and a successful economic reform programme, has stabilized the exchange market and reduced inflation to manageable levels, allowing the Nicaraguan economy to recover growth.

The most problematic of debt-sustainability indicators are those concerning the level of human-capital investments, which in this essay have been associated with the level of public social expenditures, especially for education and health. In the context of the region, Nicaragua emerges unfavourably in a comparison of such indicators. A simple exercise based on current differences between Nicaragua and the more developed Costa Rica, as well as assumptions about a minimum track level in that area, raise serious doubts about the ability of Nicaragua to achieve debt sustainability in the present decade. This is true when referring the analysis to the framework provided by the current HIPC initiative, but also to the proposed enhancement of that initiative. Clearly, the results of the analysis are very sensitive to the underlying assumptions regarding the impact of human-capital improvement on economic growth, and the efficiency of public social expenditures. But my assumptions are not more arbitrary than others utilized in similar exercises by multilateral organizations. My main conclusion is that the stock of the Nicaraguan debt has to be reduced to an amount consistent with a NPV-debt-to-exports ratio lower than the 150 per cent threshold used in the above-mentioned initiatives. Otherwise, the country will face insurmountable difficulties in maintaining economic growth and external solvency in the future.

Notes
1 This includes the implementation of the second and third tranches of the rescheduling agreement with Paris Club creditors reached in April 1998, similar stock-of-debt operations from non-Paris Club creditors and additional buyback operations on commercial debt.
2 The IMF/IDA report estimates lower debt-service payments on average by about one-third.
3 This is the increase projected by the IMF/IDA in their baseline scenario.

References
15 The political economy of policy failure in Zambia

Arne Bigsten and Steve Kayizzi-Mugerwa

Introduction

In Africa, Zambia presents a stark example of the combined effects of external shocks and domestic policy failures. Following a post-independence decade of robust growth, per capita income started to fall in the mid-1970s, with the collapse of copper prices. For a while the government, which had increasingly emphasised state controls in both resource allocation and investment, tried to postpone adjustment. It depended on borrowed money, which led to serious foreign indebtedness. Towards the end of the 1970s, it became obvious that economic reforms were necessary to revive the economy and preserve social welfare. During the 1980s, Kaunda’s government initiated a series of structural-adjustment programmes, with the support of the international financial institutions. However, under serious domestic opposition, especially from miners on the Copperbelt, the government invariably failed to implement important components of the reform packages.

In 1991, a newly formed political party, the Movement for Multiparty Democracy (MMD), won power on a reform platform. The new government undertook an extensive macroeconomic and market liberalisation programme. Many of the policies adopted were of the “stroke of the pen” type such as the freeing of the exchange rate and lower tariffs. Still, the government also embarked on an ambitious privatisation programme, which was declared among the most successful in Africa, that is before the government was embroiled in the difficulties related to the privatisation of the mining conglomerate, Zambia Consolidated Copper Mines (ZCCM). In spite of the liberal policies, the investment response has been poor, and per capita incomes have continued to decline.

This essay discusses why reforms were harder to implement than anticipated and looks at the impact of the failed policies on the economy. While the problem of slow or poorly implemented reforms was largely a result of inadequate policies, and thus to blame on domestic politics, Zambia also faced an extremely severe debt burden during the reform period. Part of the policy challenge was thus to devise a policy that dealt
adequately with the issue of debt, while at the same time making optimal use of donor aid. With respect to both aid and debt, the role and behaviour of donor and international financial institutions have been important. We will, thus, also address the question whether another type of donor–recipient relationship could have contributed to a better policy outcome.

Theoretical aspects

Recent years have seen a number of attempts to explain the causes of persistent policy failure in Africa in general and among resource-rich Sub-Saharan countries in particular (see, e.g., Sachs and Warner, 1997; IMF, 1998). Among the most recent debates has been that related to geography. It has been argued that countries in the tropics have a disadvantage in being located in an area prone to both disease and adverse weather shocks. This has slowed down the accumulation of human capital and the development of a dynamic agricultural sector. The impact of reform policies has thus been limited and in any case not beyond reversal. This debate is related to the earlier ones on the Dutch disease impacts of mineral production. As in the case of geography, the ownership of huge mineral deposits exposes the economy to patterns of domestic behaviour on which it has little control. First, to exploit the resources, government undertakes huge initial investments, which are largely irreversible. The huge size of the commitment ensures that resources continue to flow to the areas where mineral exploitation is concentrated, often at the expense of the other regions of the country. The mining activity by itself also has relatively little forward or backward linkages that can stimulate more broad-based development (Hirschman, 1958). The ‘encashment’ of mineral incomes is also bound to have a huge impact on the urban sectors and on the fiscal standing of the government. During mineral booms, most governments behave as if the inflows of resources are permanent, with new projects, including import-substituting ones embarked on. The basic economic structures are thus distorted, with the protected industry expanding, while agriculture and unprotected manufacturing contract. When the boom turns to bust, the country becomes very vulnerable.¹

However, while the issues of geography and Dutch disease imply that some of the negative policy outcomes are unavoidable, it is being increasingly argued that bad policies aside, there are also a number of institutional issues that impinge on growth. For many African countries a central question is, therefore, what might be required for growth-supporting institutions to develop. A government whose primary concern is its own short-term survival is unlikely to develop institutions and regulations that are good for economic growth. With special interest groups at centre stage, trying to push through their demands or pursuing various rent-seeking
activities, the implied distortions are bound to lead to static inefficiency. Resources are thus wasted and investors become cautious. A notion that has been central in the analysis of the Asian success stories is that of “shared growth”, arguing that if they are to participate actively, the mass of the population must benefit from growth. However, it is not only the general population that must be included, but also competing elites must be allowed to take part. To achieve the benefits of shared growth, therefore, there is need for a bureaucracy of high quality, which is sufficiently independent of pressure groups.

The political economy of reform also relates to the recent democratic transition in Africa, once seen as the beginning of a new economic dispensation. However, Africa’s new multiparty democracies remain extremely vulnerable, not least because of the still poor performance of the economies (Bratton and van de Walle, 1997). Where the economic and social conditions are not conducive to democratic behaviour, the survival of the new governments will partly depend on the commitment and goodwill of the new political elite and partly on the commitment to the democratic process of the ordinary citizens. None of this can be taken for granted, however. Of its own volition, the political elite is often unwilling to allow democratic rights. However, direct pressure from the international community has sometimes been more disruptive than helpful. Moreover, the international financial institutions have not been very accurate in their projections of either economic trends or the political behaviour of recipient governments. Deaton (1999) shows, for example, that the projections of copper prices done by the World Bank from the first half of the 1970s onwards have been wildly exaggerated. Civil societies in Africa, including religious organisations, trade unions and other movements, are thus faced with the formidable task of mobilising the population towards the culture of democracy and accountable government, with few means and little precedent.

The Kaunda years, 1964–91

Zambia, as its first President Kenneth Kaunda once remarked, was born with a copper spoon in its mouth. Its recent history, notably after Independence in 1964, has been intertwined with the fortunes of firms in the mining sector, especially those on the Copperbelt. The mining companies were traditionally the most important employers in the economy, and copper itself was the biggest generator of foreign exchange. It thus provided the basis for the import-substituting industrialisation efforts that the government had embarked on in the 1960s. The Zambian government considered the sector so important for its development that the mines were nationalised by the beginning of the 1970s. Above all, however, miners and other workers in the mines became, with time, among the most vocal and politically active groups of employees in the
country, with much influence on wages and employment policies throughout the rest of the economy.

With the global recession of the 1970s copper incomes fell dramatically. The government was initially not willing to adjust, but borrowed large amounts of money to maintain the copper mines and the public sector, in the process building up a large debt. Zambia tried to deal with the external shock not by serious economic adjustment but with increased regulations. Notably, in an attempt to halt the decline in real wages, the government tightened the regulation of consumer prices and expanded its subsidies on basic commodities. A system of import licensing and administrative foreign-exchange allocation was introduced. In 1980, subsidies claimed as much as 20 per cent of the government budget. The control of prices for basic commodities also meant that many state-owned companies made losses, which were covered via the budget.

The first adjustment programme, with IMF backing, was introduced in 1978. This Action Programme led to a certain measure of stabilisation, but the government failed to maintain reform momentum. Another structural-adjustment programme was embarked on in 1983, with the major goal of correcting price distortions. Included was the decontrol of interest rates, deregulation of prices, and general reduction of tariffs. The government also sought to reform the parastatals, as well as the taxation system. A notable feature of the programme was its emphasis on raising agricultural production, which would be achieved by agricultural producer-price increases. However, as in earlier attempts, the success of the new programme was conditioned on support for the policies by the elite and urban dwellers. This was doubtful, since the switch from administrative controls to market forces directly threatened groups in charge of the control apparatus and to whom the rents accrued.

Inflation and money supply were under control during the Action Programme, but around 1983 inflationary pressures re-emerged. The government then tried to control demand. It froze wages as well as government employment, and managed, thereby, to reduce the fiscal deficit during the first years of the programme. In the debate, much of the blame for the increase in inflation was put on the rapid depreciation of the exchange rate. The latter became a focal point in the power struggle between those in favour of continued economic controls and those who supported liberalisation. The government embarked on a crawling-peg system, and in 1985 it introduced a fully fledged auctioning of foreign currency. However, by mid-1986, speculation and excessive borrowing from the commercial banks to purchase dollars led to a rapid depreciation of the Kwacha, which in turn led to rampant inflation and loss of purchasing power for wage earners. The food riots in the Copperbelt showed how explosive the situation was becoming. The main problem with the reforms was thus that they tended to undermine the position of the ruling party’s main political constituencies (see Bates and Collier, 1993).
Following broad criticism of the reform programme, President Kaunda replaced key members of his economic policy team in April 1986. The shift culminated in May 1987 in the abandonment of the IMF-supported adjustment programme altogether, putting an end to the most sustained reform attempt during the Kaunda era. With the IMF-backed programme blamed for increased malnutrition and death among the population, the government instead introduced the New Economic Recovery Programme (NERP). This implied a partial return to the command economy. Growth was to be through “own resources”. Among the policies advocated were: 1) a fixed exchange rate, which would be determined by a foreign-exchange allocation committee; 2) price control of some twenty-three “strategic” commodities; 3) fixed interest rates; 4) a ceiling on debt servicing at 10 per cent of export earnings. Thanks to reduced government spending and the moratorium on debt service, the NERP resulted in a reduction of the fiscal deficit. However, the need to finance the bumper harvest of 1988 put pressure on public expenditures once again. In January 1989 food coupons were introduced in an unsuccessful bid to eliminate food subsidies, but without hurting the poorest households.

It was now becoming increasingly clear that UNIP’s heterodox policy approach was not working. Thus in July of 1989 the government decontrolled prices for all goods except maize and several elements of the liberalisation package of the 1980s were reintroduced. The result was a fairly comprehensive structural-adjustment programme with traditional instruments, such as tight monetary and fiscal policies, used in an attempt to stabilise the economy. As opposed to the new abandoned NERP, structural adjustment was to be achieved through increased reliance on market prices and trade liberalisation. Accompanying these were further reforms in the civil service and the parastatal sector.

After some initial progress, the programme almost collapsed in late 1991 due to the pending presidential and parliamentary elections. The government began to backtrack on reforms, as it switched to a short-term policy aimed at winning the support of important electoral groups. The removal of subsidies on maize and fertilisers was put on hold, there was little progress on privatisation, and money-supply growth remained above programme targets, while serious overruns on most of the expenditure targets, caused mainly by large salary increases to civil-service employees in the run-up to the elections, disrupted the fiscal integrity of the budget. Consequently, most donors, including the World Bank, froze their support to the programme just before the elections in 1991.

When evaluating developments during this period, it is clear that copper dependence had become a source of economic inflexibility and external shocks. The culture of subsidies, ranging from food to housing, which the large mineral incomes had helped to sustain, became a serious liability in this era of economic disruption and diminished growth. The
subsidies enjoyed by urban consumers had become broadly accepted entitlements, which the government could only remove at high political cost. The import-substitution industry, which had thrived on high tariffs, became a major victim of the decline of the copper sector. Rationing of goods and services became the order of the day, and a powerful committee was set up to allocate foreign exchange to “priority” sectors and needs. As a result, rent-seekers became a powerful group, able to exercise their veto on any prospective reforms.

In politics, the affluence generated by a rapidly growing economy in the 1960s had enabled the government to exercise broad patronage and for the President to experiment with a version of a socialist approach to development which he called “Humanism”. It espoused the importance of the government’s lead in development, and in 1973 the country became a one-party state. But even after the government had reluctantly embarked on macroeconomic reforms in the 1980s, with support from the World Bank and the IMF, the partiality for government controls persisted. By the mid-1980s there were already a number of reform-minded technocrats in place at the Ministry of Finance and the Bank of Zambia, but they received very limited support from the political leadership. There was an ideological commitment to the state-controlled system, with leading bureaucrats and politicians remaining unconvinced that an outward orientation would generate economic growth. There was still considerable faith in structuralist ideas and the benefits of pursuing an import-substitution industrialisation (ISI) strategy (Kayizzi-Mugerwa, 1997).

Reforms under the MMD since 1991

The opposition won the elections in 1991 on a liberal platform. It wrote in its election manifesto that “the government restricts itself to rehabilitate and build economic infrastructure with a small public sector in the midst of a basically private enterprise economy” (MMD, 1991, p. 14). The new party was a fairly broad coalition of trade unions, business interests, intellectuals and students. It is the ultimate irony of Zambian politics that Kaunda’s successor, Chiluba, would emerge from among employees of the mining sector, raised on the Copperbelt. The new government took advantage of its broad popular support and tried to distinguish itself from the old government that was associated with economic controls and lack of credibility in managing the reform process. As soon as it was elected, it introduced its Economic Reform Programme (ERP) with the goal of arresting the economic decline. Over the 1980s the Zambian economy had declined by close to a third. The donors responded to the government’s efforts by resuming their support to Zambia, with aid, at close to US$1.5 billion, reaching its all-time peak in 1992.

During the first two years there was rapid liberalisation of the external
trade and payments system, and a movement towards a market-determined exchange rate. A policy of rapid depreciation was initiated, with the rate of retention of export proceeds increased from 50 per cent to 100 per cent. Further liberalisation saw the government adopting a negative list for imports under an Open General Licence system, as opposed to a detailed one used earlier. A system of bureau de change was introduced together with an official crawl in October 1992. In December of the same year, the exchange-rate system was unified and determined by the bureau de change rate. During this year the Kwacha experienced a real depreciation for the first time since 1986 (Adam et al., 1993a). By March 1993, most foreign-exchange controls on current transactions had been removed. From early 1994 the currency became fully convertible. In 1996 the government even allowed the ZCCM to retain its foreign-exchange earnings and to supply the market directly if it so chose. Over a period of five years all licensing and quantitative restrictions on imports and exports were removed, and the tariff structure was rationalised. The maximum rate came down from 100 per cent to 25 per cent and the number of bands from eleven to four. Thus, already by 1994, Zambia had one of the most liberal foreign-exchange regimes in SSA.

Donors responded to this by agreeing a substantial debt reduction for the country of US$0.8 billion in 1993. Since then, with the deterioration of the policy environment, debt write-offs have been limited and the stock of debt has begun to increase again. Still, the debt service itself has declined due to the shift to loans of a more concessionary nature. However, the country is far from a sustainable debt position.

Although the combined effects of a large devaluation, decontrol of prices and a highly liquid economy had led to high inflation, the government had regained a measure of control by mid-1993. Inflation has since fallen substantially, though remaining fairly high (Table 15.1).

The programme has implied a tight fiscal and monetary policy. A cash budget was introduced in 1993. This meant that expenditures would be based on available funds, with the Bank of Zambia no longer in a position to support deficit financing (Mwenda, 1999). This would make it impossible for the government to resort to money printing to cover expenses. In a situation with serious problems of time-inconsistency, and thus of discre-

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<tbody>
<tr>
<td>Low income urban</td>
<td>110.0</td>
<td>97.6</td>
<td>178.3</td>
<td>182.7</td>
<td>53.1</td>
<td>35.8</td>
<td>42.0</td>
<td>23.3</td>
<td>23.7</td>
</tr>
<tr>
<td>High income urban</td>
<td>95.7</td>
<td>104.4</td>
<td>150.0</td>
<td>176.1</td>
<td>57.5</td>
<td>35.3</td>
<td>39.2</td>
<td>24.9</td>
<td>24.9</td>
</tr>
<tr>
<td>Non-urban</td>
<td>104.8</td>
<td>95.3</td>
<td>169.0</td>
<td>188.1</td>
<td>53.6</td>
<td>34.2</td>
<td>46.3</td>
<td>24.7</td>
<td>24.8</td>
</tr>
</tbody>
</table>

Source: Central Statistical Office, Quarterly Statistics.
tionary fiscal policies, this may have been the best option available. Still, compliance has been less than perfect and the Bank of Zambia provided some short-term bridging finance (Adam and Bevan, 1996).

Aside from the cash budget, the government has also attempted to balance the budget by increasing revenue. In 1993, a Revenue Board was introduced, with a value-added tax (VAT) put in place in July 1995, while user fees have been introduced for most social services. Still, the government has failed to increase resource mobilisation significantly (Table 15.2).

The most important part of the budget-balancing process has been expenditure reduction, though. Adam et al. (1993a) argue that the fiscal squeeze in Zambia has been virtually unmatched in Africa and that it has been undesirably tight. Capital expenditures have been reduced, subsidies have been eliminated, military spending was reduced, and the civil service experienced severe real wage reductions. However, the financial liberalisation implied that interest charges on domestic debt were raised (Table 15.3).

Together with the Economic Recovery Programme for the period 1991 to 1995, there was also a Rights Accumulation Programme (RAP) supported by the IMF. At the end of 1995 the government had made enough progress under RAP to resume borrowing from the IMF. This was the first time that Zambia had actually completed an agreement with the Fund.

During the first half of the 1990s, the government liberalised both maize and fertiliser marketing, eliminating the associated subsidies. This

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**Table 15.2 Revenue in per cent of GDP**

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<tbody>
<tr>
<td>Total revenue</td>
<td>24.6</td>
<td>32.9</td>
<td>33.0</td>
<td>26.3</td>
<td>30.2</td>
<td>29.0</td>
<td>26.8</td>
<td>24.8</td>
<td>24.5</td>
</tr>
<tr>
<td>(revenue and grants)</td>
<td>24.6</td>
<td>32.9</td>
<td>33.0</td>
<td>26.3</td>
<td>30.2</td>
<td>29.0</td>
<td>26.8</td>
<td>24.8</td>
<td>24.5</td>
</tr>
<tr>
<td>Grants</td>
<td>4.3</td>
<td>14.2</td>
<td>14.7</td>
<td>10.5</td>
<td>10.1</td>
<td>9.2</td>
<td>6.1</td>
<td>5.0</td>
<td>6.4</td>
</tr>
<tr>
<td>Grants/Total</td>
<td>17.5</td>
<td>43.0</td>
<td>44.5</td>
<td>40.0</td>
<td>33.0</td>
<td>31.7</td>
<td>22.3</td>
<td>20.0</td>
<td>26.0</td>
</tr>
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</table>

Source: Central Statistical Office, Quarterly Statistics.

**Table 15.3 Selected expenditures by functional classification in per cent of total expenditure, 1990–8**

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<tbody>
<tr>
<td>General public services</td>
<td>24.9</td>
<td>26.1</td>
<td>35.6</td>
<td>28.1</td>
<td>28.9</td>
<td>25.9</td>
<td>13.4</td>
<td>15.4</td>
<td>16.1</td>
</tr>
<tr>
<td>Defence</td>
<td>15.6</td>
<td>10.1</td>
<td>12.8</td>
<td>7.8</td>
<td>8.4</td>
<td>7.9</td>
<td>6.4</td>
<td>6.3</td>
<td>9.6</td>
</tr>
<tr>
<td>Health</td>
<td>10.3</td>
<td>5.9</td>
<td>6.2</td>
<td>8.4</td>
<td>8.8</td>
<td>9.2</td>
<td>9.4</td>
<td>11.1</td>
<td>10.8</td>
</tr>
<tr>
<td>Education</td>
<td>9.3</td>
<td>10.9</td>
<td>9.1</td>
<td>9.7</td>
<td>9.9</td>
<td>11.3</td>
<td>13.5</td>
<td>13.8</td>
<td>14.4</td>
</tr>
<tr>
<td>Debt service</td>
<td>5.9</td>
<td>6.6</td>
<td>11.8</td>
<td>24.1</td>
<td>20.4</td>
<td>12.8</td>
<td>17.2</td>
<td>13.1</td>
<td>11.4</td>
</tr>
</tbody>
</table>

Source: Central Statistical Office, Quarterly Statistics.
was a sweeping change that the government of the 1980s had had problems undertaking. Agricultural liberalisation was a highly controversial issue. The Kaunda government had introduced pan-territorial pricing to keep the prices of maize high also in peripheral regions. It then introduced maize subsidies to keep both producers and consumers happy. However, the poor agricultural response to reforms under the MMD could be blamed on poor policy sequencing. The sector was liberalised before macroeconomic stabilisation was achieved. The private sector was, for example, not ready to step in and buy the bumper maize harvest in 1993, while interest rates on government securities rose to 300 per cent. The government was forced to return to the agriculture market as a buyer, putting severe strain on the budget of 1994. In spite of this, and other implementation problems, the broader reforms remained on track.

Most of the labour-market controls were also removed, but the most far-reaching liberalisation efforts were in the financial sector. The government freed interest rates in September 1992 and liberalised the Treasury bill market in January 1993. The immediate effect was a rise in interest rates and positive real rates were achieved in mid-1993 (Table 15.4). In February 1994, the government removed controls on the capital account for foreign payments.

The monetary stance has been to restrict the growth of money supply. The attempts were not very successful, however, until about 1993 when institutional reforms were introduced at the Bank of Zambia (Adam et al., 1993b). Money supply growth has since then been contained.

A Technical Committee on Privatisation was set up already in 1990, but no privatisation was undertaken before Kaunda’s departure. Even after the MMD came in, progress was slow until about 1994, largely due to the very weak support for privatisation in the cabinet. The Zambian Privatisation Agency (ZPA) was launched in 1992, but by the end of 1993 only two firms had been privatised. During 1994 the donors pressed for more rapid reform. One serious conflict concerned Zambia Airways, which at the time received a subsidy from the government equal to about 1 per cent of GDP. Flights to Europe were often crowded with non-paying passengers such as ministers and their relatives. During the run up to the Consultative Group meetings in 1994, donors forced the government to close the airline. In the course of that year, two significant sales were made, that of Chilanga

| Table 15.4 Monetary aggregates per cent, 1990–8 |
|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|
| Velocity of money | 3.9  | 3.6  | 5.4  | 7.5  | 7.1  | 6.4  | 6.0  | 6.3  | 6.5  |
| Bank rate        | 34.0 | 42.0 | 54.0 | 122.5| 24.8 | 51.5 | 69.8 | 23.3 | 43.6 |
| Inflation        | 107.0| 97.7 | 165.7| 183.8| 54.6 | 34.9 | 43.1 | 24.4 | 24.5 |

Source: Bank of Zambia.
Cement and Zambia Breweries at US$5.4 and US$15.8, respectively. In the second half of 1995 the privatisation process gathered momentum, with the giant Zambia Sugar sold at US$36.8. By the end of 1997 as many as 224 companies out of a total portfolio of 275 had been privatised. It was not until 1996, however, that the government acceded to the privatisation of ZCCM, the major asset. A very difficult process of tendering ensued, with the parties failing to reach foreclosure. The government lifted the ZCCM privatisation out of the Zambia Privatisation Agency and assigned it to a former head of the company. During 1998, ZCCM was losing one million dollars per day. There was finally an agreement at the end of 1999, which ironically meant that the bulk of the mining assets would revert to the original owner, the Anglo-American Corporation. The drawn-out process for the privatisation of the mines had serious consequences for the economy, including the aid embargo imposed by donors in a bid to elicit progress on privatisation (World Bank, 1996).

The Public Sector Reform Programme was launched in 1993 with the aim of cutting the civil service by 25 per cent over a three-year period, making it possible, thereby, to increase remuneration. However, while 15,000 contract employees were retrenched already in 1992, there has been no further retrenchment. Between 1991 and 1996, the civil service actually increased. The government argues that the social cost of retrenching civil servants is too high to make it a viable reform option. Still, the bloated and inefficient public service remains a serious growth constraint. The administrative capacity has also deteriorated further due to the heavy toll of HIV/AIDS.

GDP growth has been uneven during the reform period (Table 15.5). There has been drought, which has affected agriculture, while manufacturing output has been affected by the monetary squeeze, low internal demand and the parastatal reform. Manufacturing production had, by 1997, not yet returned to its 1991 level. The population growth rate fell from 3.1 per cent to 2.4 per cent per year over the period. Per capita incomes fell by more than a quarter between 1990 and 1998. The mining industry has faced problems throughout (Table 15.6), and the production problems of ZCCM have continued to affect GDP negatively. From 1993, mining production has shown a negative trend, even as the government

| Table 15.5 GDP and sector growth rates, 1990–8 (change in per cent) |
|------------------|-----|-----|-----|-----|-----|-----|-----|-----|-----|
| Total GDP        |−3.4|−0.6|  2.1|−0.2|−8.6|−2.3|  6.6|  3.3|−2.0|
| Non-agriculture  |−2.5|−1.4|  7.4|−6.6|−12.3|−7.8|  8.2|  5.1|−1.2|
| Non-mining GDP   |−2.4|  1.4|−0.1|  1.8|−12.5|  2.8|  7.2|  3.5|−0.8|
| Real GDP per capita index |100.0| 96.4| 95.6| 92.6| 81.6| 73.6| 76.5| 77.5| 73.2|

Source: Central Statistical Office, Quarterly Statistics.
was trying to privatise the mines (Table 15.7). We also note that terms of trade developments have shown a declining trend, largely driven by negative changes in copper prices (Tables 15.7 and 15.8). Finally we may also note that there has not been any significant recovery of investment in Zambia (Table 15.9).

Table 15.6 GDP by sector of origin at current prices, 1990–8 (in per cent of GDP)

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</thead>
<tbody>
<tr>
<td>Agriculture, forestry and fishing</td>
<td>18.2</td>
<td>15.8</td>
<td>21.3</td>
<td>30.5</td>
<td>13.5</td>
<td>16.2</td>
<td>15.5</td>
<td>16.3</td>
<td>17.3</td>
</tr>
<tr>
<td>Mining and quarrying</td>
<td>9.0</td>
<td>8.4</td>
<td>5.6</td>
<td>8.8</td>
<td>16.7</td>
<td>14.4</td>
<td>12.1</td>
<td>9.9</td>
<td>6.1</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>31.9</td>
<td>33.3</td>
<td>33.2</td>
<td>25</td>
<td>9.8</td>
<td>9.9</td>
<td>11.8</td>
<td>11.8</td>
<td>11.4</td>
</tr>
<tr>
<td>Utilities</td>
<td>5.4</td>
<td>5.9</td>
<td>5.7</td>
<td>5.5</td>
<td>9.2</td>
<td>9.1</td>
<td>9.1</td>
<td>9.3</td>
<td>9.7</td>
</tr>
<tr>
<td>Construction</td>
<td>3.9</td>
<td>3.8</td>
<td>3.7</td>
<td>2.6</td>
<td>5.0</td>
<td>4.1</td>
<td>3.5</td>
<td>4.5</td>
<td>5.1</td>
</tr>
<tr>
<td>Wholesale and retail trade</td>
<td>9.6</td>
<td>11.6</td>
<td>7.1</td>
<td>9.3</td>
<td>14.8</td>
<td>14.6</td>
<td>17.5</td>
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<td>16.9</td>
</tr>
<tr>
<td>Financial and real estate</td>
<td>9.7</td>
<td>9.1</td>
<td>11</td>
<td>10.2</td>
<td>14.8</td>
<td>17.2</td>
<td>16.6</td>
<td>16.5</td>
<td>18.6</td>
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<td>Public sector</td>
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<td>8.0</td>
<td>8.4</td>
<td>7.1</td>
<td>8.0</td>
<td>9.0</td>
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Source: Central Statistical Office, Quarterly Statistics.

Note
Utilities include electricity, gas and water as well as transport and communications.

Table 15.7 Sales of minerals: from ZCCM’s book balances, 1990–8

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<tbody>
<tr>
<td>Sales</td>
<td>1.47</td>
<td>1.42</td>
<td>1.34</td>
<td>1.43</td>
<td>1.01</td>
<td>1.11</td>
<td>1.08</td>
<td>0.97</td>
<td>0.85</td>
</tr>
<tr>
<td>LME price</td>
<td>90.00</td>
<td>80.00</td>
<td>78.00</td>
<td>65.00</td>
<td>79.00</td>
<td>100.00</td>
<td>78.00</td>
<td>78.00</td>
<td>56.00</td>
</tr>
</tbody>
</table>

Source: ZCCM. The price series is from IMF (1999), IFS, and is in US cents/pounds.

Table 15.8 Terms of trade, 1990–8

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<tbody>
<tr>
<td>Terms of trade index (1990 = 100)</td>
<td>100.0</td>
<td>105.9</td>
<td>94.5</td>
<td>82.4</td>
<td>89.1</td>
<td>99.5</td>
<td>76.8</td>
<td>93.4</td>
<td>83.8</td>
</tr>
<tr>
<td>Annual change (%)</td>
<td>10.7</td>
<td>5.9</td>
<td>-10.7</td>
<td>-12.8</td>
<td>8.1</td>
<td>11.7</td>
<td>-22.8</td>
<td>21.6</td>
<td>-10.3</td>
</tr>
</tbody>
</table>

Source: IMF.

Table 15.9 GDP by type of expenditure, 1990–8 (in per cent of GDP)

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<tbody>
<tr>
<td>Public consumption</td>
<td>14.8</td>
<td>16.2</td>
<td>17.9</td>
<td>13.0</td>
<td>14.0</td>
<td>16.3</td>
<td>18.1</td>
<td>16.6</td>
<td>15.7</td>
</tr>
<tr>
<td>Private consumption</td>
<td>68.7</td>
<td>75.4</td>
<td>82.8</td>
<td>75.8</td>
<td>74.4</td>
<td>76.4</td>
<td>73.4</td>
<td>75.4</td>
<td>78.9</td>
</tr>
<tr>
<td>Investment</td>
<td>17.3</td>
<td>11.0</td>
<td>11.9</td>
<td>15.0</td>
<td>12.7</td>
<td>13.1</td>
<td>14.8</td>
<td>13.6</td>
<td>14.0</td>
</tr>
<tr>
<td>Trade balance</td>
<td>-0.7</td>
<td>-2.6</td>
<td>-12.6</td>
<td>-3.8</td>
<td>-1.0</td>
<td>-5.8</td>
<td>-6.2</td>
<td>-5.5</td>
<td>-9.0</td>
</tr>
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</table>

Source: Central Statistical Office, Quarterly Statistics.
The poor development of the economy has also been reflected in employment figures (Table 15.10). Paid formal-sector employment is actually lower in 1998 than it was in 1990, and in particular we note the dramatic decline in industrial employment, including mining. The industry sector is now quite marginalised in the Zambian economy.

The economic decline is also reflected in the deterioration of a range of social indicators. For example, under-five mortality fell during the 1970s from 180 per thousand to 149, but then increased to 197 in 1994. By 1997 there had been a slight reduction to 189.

It has been argued by Rakner et al. (1999) that, aside from the external shocks, the poor performance of the economy is due to lack of a coherent strategy for economic growth. It also seems quite likely that the slow reform of the mining sector, that always was politically difficult, did cost a lot in terms of lost momentum and financially in terms of subsidies throughout the 1990s. This foot-dragging also sent the wrong signal to potential investors about the government’s reform commitment.

It is also clear that the debt burden is still a serious threat to the economy. There has of late been some progress on this front, however. In 1999, bilateral donors at the Paris Club expressed a willingness to write off up to two-thirds of their claims on the country, while there seems to be some support for speeding up Zambia’s route to HIPC status.

The politics of reform

In 1991 Kaunda was replaced as President in a free and (reasonably) fair election. Zambian citizens played a major role in the change of regime as protesters against the old one and as supporters of the new Movement for Multiparty Democracy (MMD). Less than half the electorate participated in the election, however. With a near clean sweep of the votes, and with the autocratic legislation of Kaunda still intact, the new government soon came to abuse its power. Fear of an opposition plot to grab power in 1993, in favour of Kaunda, led to the declaration of a state of emergency. The MMD then changed the constitution to bar Kaunda from running in future elections. This met extensive opposition from the domestic press,

<table>
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<th>Table 15.10 Paid employment by sector (thousands), 1990–8</th>
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<tr>
<td>Public</td>
</tr>
<tr>
<td>Industry</td>
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<tr>
<td>Agriculture</td>
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<tr>
<td>Other</td>
</tr>
<tr>
<td>Total</td>
</tr>
</tbody>
</table>

Source: Central Statistical Office, Quarterly Statistics.
civil society, opposition parties and donors. However, the government went ahead all the same. This then introduced a crisis of confidence in the country, with the government’s economic-policy credentials differing markedly from the democratic ones it was keen to establish.

Far from establishing a normal and democratic process of change of government, the second election of 1996 was instead boycotted by many opposition parties. Between the two elections, however, a gap seemed to have emerged between the incumbent parliamentarians and the constituents, and independent candidates managed to make inroads. Kees van Donge (1998) argues, however, that the opposition’s attempts to use NGOs and donors to further its interests were not very successful. The charged political atmosphere finally led to a coup attempt in 1997, to which Chiluba responded both with the re-imposition of a state of emergency and the placing of Kaunda under house arrest.

The MMD government had initially come in with a team that was committed to political reform, which over the years was replaced by younger and less experienced ministers, but with a stronger commitment to the President. Rakner et al. (1999, p. 35) argue that “the conduct of the elections proved that the Chiluba government was willing to compromise the rule of law, was intolerant of criticism and willing to exploit its majority position and control of government resources to undermine its opponents”.

Other signs of a more autocratic approach are the possession by the President of a special account for “charitable donations”. This is funded directly via the budget and is used to make very visible presidential donations to schools, churches, etc. It is thus largely a conduit for the purchase of political support.

In spite of the setbacks there is still an independent press in Zambia, and the turn-out in the 1996 elections was not worse than in 1991, indicating absence of voter apathy, while the local elections of 1998 were peaceful. There is also a fairly independent judiciary that has helped to keep politicians in check, while the Law Association and other elements of civil society have criticised the government for imposing constitutional reforms from above.

**Donors and reform**

There are three aspects of the aid-reform relationship that may be considered in our discussion of Zambia: the impact of aid on the initiation of reform, on the policy content, and on the effectiveness of implementation. The content of reform packages has largely originated from IFIs or has been based on the standard Structural Adjustment package, with limited original Zambian input. This has led to an ownership problem. With policy-making regarded as the exclusive preserve of the government, local groups have historically been excluded from policy debate. Still,
while aid cannot buy policy change, there is evidence that conditionality sometimes has helped push reform forward, for example, with regard to privatisation (see, e.g., discussion on Tanzania in Bigsten et al., 2001). In a recent evaluation of global Swedish aid, White (1999) has argued that it is mainly domestic political considerations that determine economic and political reform, not donors. A number of studies have shown that ownership is very important for policy efficacy, and that conditionality conflicts with ownership.

The negotiations with the IFIs under Kaunda were difficult, since their demands implied a critique of the “socialist” economic management pursued by Zambia. The reforms were thus at odds with the ideology of the ruling party, which therefore resisted it for as long as possible. The behaviour of donors varied over the different phases of the reform process. It is very hard to say for certain whether aid made reforms possible, but it may have induced them, at least in the sense that the government saw their adoption as a way of accessing aid. In this case, the government undertook them unwillingly, with resultant foot-dragging and policy reversals.

During the 1990s, the policy environment improved considerably, both with regard to content and implementation. Still investments and growth have not been sufficient to raise per capita incomes, indicating that the reforms had no positive impact on average living standards, so far. It is not easy to determine to what extent this is to blame on structural shortcomings, such as a generally low level of competence or merely lack of commitment on the part of the government.

Will reforms be sustainable without aid? The answer hinges on whether aid actually buys reforms or whether reforms can be undertaken willingly, seen as the best option available. It is likely that the ineffectiveness of the policy implementation is partly to blame on the current aid relationship. Bilateral donors and the IFIs have been at odds several times and this lack of co-ordination has reduced their clout. Bilateral donors withheld balance of payments support after the exclusion of Kaunda from the 1996 elections, and once again when progress on the privatisation of the mines failed to materialise. There have also been complaints on governance issues. With regard to the regular aid programmes, however, the bilaterals have continued to pay up, while a major concern of the IFIs was to see to it that Zambia continued to service its debts. Thus while there is need for improvement in the country’s governance structure, changes in the nature of the donor–Zambia relationship are necessary, with a view to enhancing ownership and mutual responsibility (for further discussion, see Collier, 1997, 1999).

Thus, while it is clear that aid to Zambia has not had a strong pay-off in terms of growth, constructing a realistic counter-factual of what would have happened if there had been less aid is extremely difficult. Donor support has exerted two kinds of influences on the country, that on the
supply of external resources and on policy formation. Disentangling the two effects is crucial for assessing the impact of aid on growth. While the policy environment in Zambia, as normally defined, has certainly improved in the past decade, there is as yet no strong evidence that aid inflows have had a better growth impact in the past decade than in the 1980s.

**Discussion**

Most developing countries embark on reform under conditions of extreme economic fragility, lacking the resources necessary to buy the support of important socio-economic groups. One major distortion in Zambia, at the start of its reforms, was that of an overvalued exchange rate, which derived from the country's pursuit of protectionist trade policies. Thus while there are a whole range of studies that show that openness is important for growth (see, for example, the review of the African evidence by Collier and Gunning, 1999a), there are high short-run political costs attached to the policy change. There were also costs related to the imposition of financial discipline, as illustrated by the introduction of the cash budget. While it helped raise fiscal integrity, it led to trade-offs between, for example, expenditures on health and education and support to the mines, with the former taking precedence in recent years. The cash budget was also circumvented by the government in at least two ways (Stasavage and Moyo, 1999): first, the government resorted to suppliers' credit, with domestic producers accumulating government debt; another was to let the Bank of Zambia pay off some of the government’s foreign debt, thereby building up the central bank’s claims on the government.

The above issues indicate that political pressures tend to lower policy commitment. Does this then reflect in lower investment? Although some African countries have managed to attract foreign investment in the past decade, international equity flows have almost completely bypassed Zambia. Since the investors’ risk assessment depends on the credibility of policy reforms (Chibber et al., 1992; World Bank, 1996), the persistent policy uncertainty in Zambia has caused investors to take a cautious attitude. The high level of indebtedness also raises the risk of policy reversal. Investment expansion thus requires long-term macroeconomic stability, and for this to be credible, debt burdens have to be manageable.

Zambia’s experience also highlights the importance of policy sequencing. As pointed out above, agricultural reforms were undertaken before macroeconomic stability was achieved, reducing the extent of the agricultural response. Related to this was the slow rehabilitation of the road network, making market access very difficult. Collier and Gunning (1999b) have argued that Zambia undertook financial-adjustment measures, when in fact a fiscal-stabilisation effort was what was required. Zambia’s financial liberalisation was thus premature and had a negative
effect on the economy. The move to capital-account convertibility and interest-rate liberalisation was also undertaken before stabilisation had been achieved. Inflation thus shot up, while real tax receipts declined. The government then reduced government expenditures by even more than planned.

However, ultimately policy implementation depends crucially on the nature of domestic institutions and politics (Dollar and Easterly, 1999). Dollar and Svensson (1998) find that the success of SAPs has depended on domestic institutional and political variables, such as rate of disbursements, and not on variables controlled by the World Bank, with democratically and newly elected governments tending to be more willing to implement reforms. In the early 1990s, Zambia moved towards democracy. While studies of the relationship between democracy and growth have been largely inconclusive, growth seems somewhat more likely to occur in countries where the population enjoys a degree of civil and economic liberties (see the review in Alesina and Perotti, 1994). In any case, political instability has a clearly negative effect on growth.

Still, the growth process will not become self-sustaining unless the recipient country has a reasonable measure of control over the policies being implemented. It is thus important that the reform process is not too heavily dependent on donors. The reform programme launched by the MMD started off with sweeping reforms of trade and exchange-rate policies, and within a year it had launched a serious stabilisation effort. However, from about 1993, the reform process stagnated, the main problem areas being privatisation, public-sector reform and governance. The limited progress here is explained by the effects, some contradictory, of domestic political competition as powerful groups vied for the control of the political and economic agenda, making it difficult for the government to send out coherent signals or to show commitment. Evidence shows that the latter is imperative if reforms are to be effectively implemented or have a significant impact (IMF, 1998).

The other aspect highlighted by Zambia is the difficulty of developing on a sustainable basis an active civil society. While many NGOs were engaged in the fight for democracy, feeling it to be their task to help in the dismantling of the one-party state, once they had achieved their goal they ceased to operate or became simply less effective. Few have found it worth their while to continue to work towards the development of a democratic citizenship through political advocacy, monitoring of the government and education of citizens (Bratton et al., 1999). This absence of a “watch dog”, in a political environment dominated by the ruling MMD, probably partly explains the persistent charges of laxity and corruption in government.

It is also illustrative to look at the sources of opposition to the reforms under the MMD. The labour movement was the most vocal opponent of the government in the last years of the Kaunda regime and thus became a
natural ally of the new government. In retrospect, however, removing Kaunda from office after close to 30 years in power seemed more important than scrutinising the future policies of the MMD. As would be expected of a mass political movement, many of the original support groups had distanced themselves from the government already in the first year of the MMD’s assumption of power. The labour movement has in the past decade been reduced in size, weakened by a poor labour market and new legislation against strikes (White, 1999).

There was also potential opposition from the business community, which lost protection during the 1990s. However, it was mainly the smaller firms that were opposed to reforms, while the larger ones were mostly in favour. Moreover, the main beneficiaries of the former controls were state firms, which had by the early 1990s become seriously weakened. It was clear that these would suffer much more if the economy failed to recover from that state it was in during the early 1990s.

Public-sector workers have not been a strong force against reform either. Those that have been retrenched have largely been lower-grade workers who lacked voice, while those higher up in the hierarchy survived. The upper echelons of the civil service have also managed to preserve a reasonable standard of living, in spite of low salaries, through other means, for example access to foreign travel or to donor-initiated activities.

So who have been the winners? The political conflicts have not been primarily about the content of policy but about the division of the spoils enabled by access to business opportunities in the form of tenders or privatised businesses. Since the new political parties essentially consist of the same group of people as in the old system, the government cannot pursue the reform agenda without regard to the need for political support.

Conclusions

Although many elements of the reform package had been tried earlier, it was only the MMD government (since 1991) that pursued them on a sustained basis. In terms of macroeconomic stabilisation and market reform, the new government initially achieved a lot, and in spite of the implementation difficulties the reforms have remained on track. However, the government has been much less successful in terms of institutional reforms, especially in the areas of public-sector reform and governance. Even its privatisation efforts ultimately proved hard to complete. We argue that the latter type of reforms have more clear-cut costs for stakeholders and were, therefore, more likely to be resisted.

With regard to the poor growth results, it is plausible that the country is yet to establish the level of confidence that is required to attract sufficient amounts of domestic and foreign investment. In spite of the
move towards multiparty democracy, the political process has been much harder to change in Zambia than was envisaged in the early 1990s. The political sphere thus continues to be the main stumbling block to durable reform.

With regard to the role of donors, aid to Zambia, or even its temporary withdrawal, has been a poor basis for inducing reform. The challenge for donors is therefore how to move away from policy conditionalities and instead to ensure that the country evolves an environment where aid can be more effective. Recipient countries need to feel that they are in control not only of the policy content of their reform programmes, but also of the pace of implementation. Ensuring a high degree of ownership on the part of host governments is the best way to enhance programme sustainability.

Acknowledgements

Thanks are due to Robert Keller for his comments.

Notes

1 Sachs and Warner (1995) show that countries with a high share of resources in their exports in 1971 grew slower than the average between 1971 and 1989.
2 The presentation draws on Andersson et al. (2000).
3 For a discussion of the Swedish aid relationships with Zambia, see Adam et al. (1994).

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