How Capitalism Was Built and the Current Financial Crisis

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ISSUES

1. What reform worked best?
2. Lessons from privatization?
3. Impact of democracy on the economy?
4. What does the current crisis say about transition?
Thesis 1: We Know How to Build a Market Economy

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

- Only 10 of 21 postcommunist countries are democracies
- Only the implantation of EU institutions has bred democracy
- No intellectual contribution
Official GDP Growth:

1. Collapse Bred Misery
2. Capitalism Brought Growth

% Change

Central and South East Europe
Baltics
CIS
GDP per Capita in PPP, 1990, 1998, and 2005

- **Central Europe**:
  - 1990: 12,000
  - 1998: 13,000
  - 2005: 15,000

- **Baltics**:
  - 1990: 10,000
  - 1998: 11,000
  - 2005: 13,000

- **South-East Europe**:
  - 1990: 8,000
  - 1998: 9,000
  - 2005: 10,000

- **CIS**:
  - 1990: 5,000
  - 1998: 6,000
  - 2005: 7,000
Why Was Postcommunist Transition So Hard?

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

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

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

Central and Eastern Europe

CIS reformers (Russia, Ukraine, Moldova, Armenia, Azerbaijan, Georgia, Tajikistan, Kazakhstan, Kyrgyz Republic)

CIS non-reformers (Belarus, Uzbekistan, Turkmenistan)
Early Privatization: Early Growth
Private Sector as % of GDP

% of GDP


Central and Eastern Europe  
CIS Reformers  
CIS Non-Reformers
Has Privatization Been Overdone? NO

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

Private Sector as Share of GDP

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

R² = 0.6395

Countries: Turkmenistan, Uzbekistan, Belarus, Tajikistan, Azerbaijan, Kazakhstan, Armenia, Kyrgyzstan, Russia, Bulgaria, Georgia, Ukraine, Romania, Latvia, Lithuania, Poland, Estonia, Hungary, Slovakia, Czech Republic, Slovakia, Czech Republic.
More Privatization = Less Corruption, 2006

Graph showing the relationship between the Transparency International Corruption Perceptions Index and the private sector as a share of GDP for various countries. The graph includes countries such as Ukraine, Russia, Georgia, Moldova, Romania, Latvia, Lithuania, Czech Republic, Slovakia, Estonia, Hungary, Bulgaria, Poland, Belarus, Turkmenistan, Uzbekistan, Tajikistan, Azerbaijan, Kazakhstan, Armenia, Poland, Slovakia, and Kyrgyzstan. The R² value is 0.5034.
Democracy: Best Weapon against Rent-Seeking

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

World Bank/EBRD Structural Reform Index (0=low, 1=high)

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

Countries: Uzbekistan, Turkmenistan, Belarus, Azerbaijan, Tajikistan, Armenia, Kyrgyzstan, Turkmenistan, Belarus, Uzbekistan, Tajikistan, Kazakhstan, Armenia, Turkmenistan, Belarus, Uzbekistan, Tajikistan, Kazakhstan, Armenia, Turkmenistan, Belarus, Uzbekistan, Tajikistan, Kazakhstan, Armenia, Turkmenistan, Belarus, Uzbekistan, Tajikistan, Kazakhstan, Armenia, Turkmenistan, Belarus, Uzbekistan, Tajikistan, Kazakhstan, Armenia, Turkmenistan, Belarus, Uzbekistan, Tajikistan, Kazakhstan, Armenia, Turkmenistan, Belarus, Uzbekistan, Tajikistan, Kazakhstan, Armenia.
More Democracy = Less Corruption, 2005

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

Transparency International Corruption Perceptions Index (0=highly corrupt, 10=highly clean)
Is the European Union the best solution? - Probably

EU provided the standard of a normal society to accession countries:
- transferred all institutions
- reinforced democracy
- opened market
Current Financial Crisis

- Global overheating: loose monetary policy and financial regulation
- Global imbalances
- Issues: exchange rate and leverage, not transition itself
A Long Boom 2000-2008 Ended in Drastic GDP Falls

Source: EBRD, IMF, JP Morgan, CISstat, Eurostat
Good Budget Balance before Crisis, Still Reasonable

Source: EBRD, JP Morgan, CISstat. 2009 data for Ukraine excludes Naftogaz
Poland Had No Crisis

No GDP decline because of excellent Central Bank policy:

- Inflation targeting: persistent low inflation because of positive real interest rates
- Floating exchange rates impeded currency inflows
- Checked credit expansion and house prices
- Regulated down mortgages in euro

Good institutions work only with good leadership: Leszek Balcerowicz
Lessons: Exchange rate crucial

1. The currency boards cannot impede monetary inflows (Baltics and Bulgaria)

2. Inflation targeting works well (Pol & Cz)

3. The euro credible even when unilaterally adopted as in Kosovo and Montenegro

Seize the euro or pursue inflation targeting
Conclusions

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

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