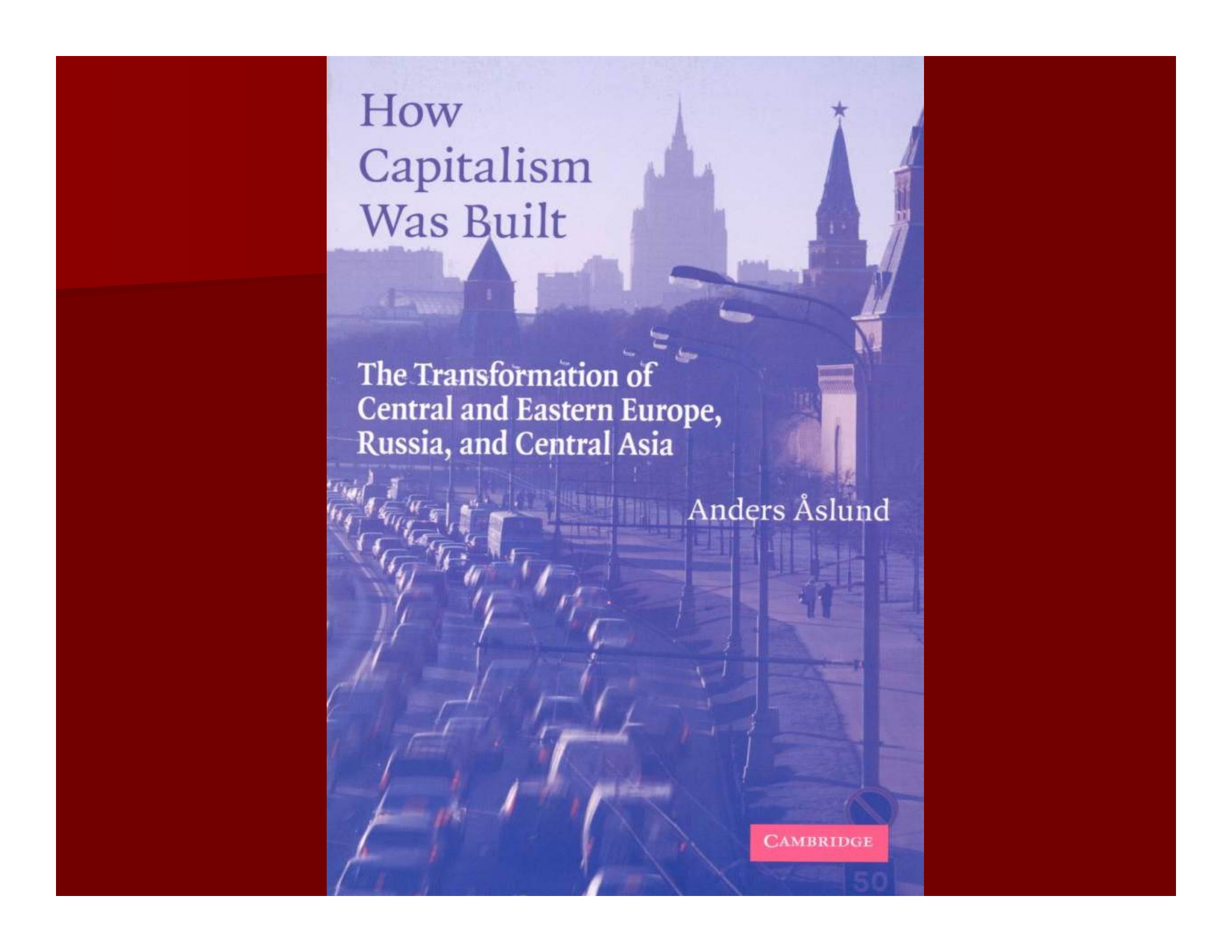


How Capitalism Was Built

The Transformation of Central and Eastern
Europe, Russia, and Central Asia

Anders Åslund
Senior Fellow

Peterson Institute for International Economics
Washington, DC, September 19, 2007



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ISSUES

1. What reform worked best?
2. Lessons from privatization?
3. Impact of democracy on the economy?
4. Role of Western aid?
5. Future: high, sustainable growth

Thesis 1: We Know How to Build a Market Economy

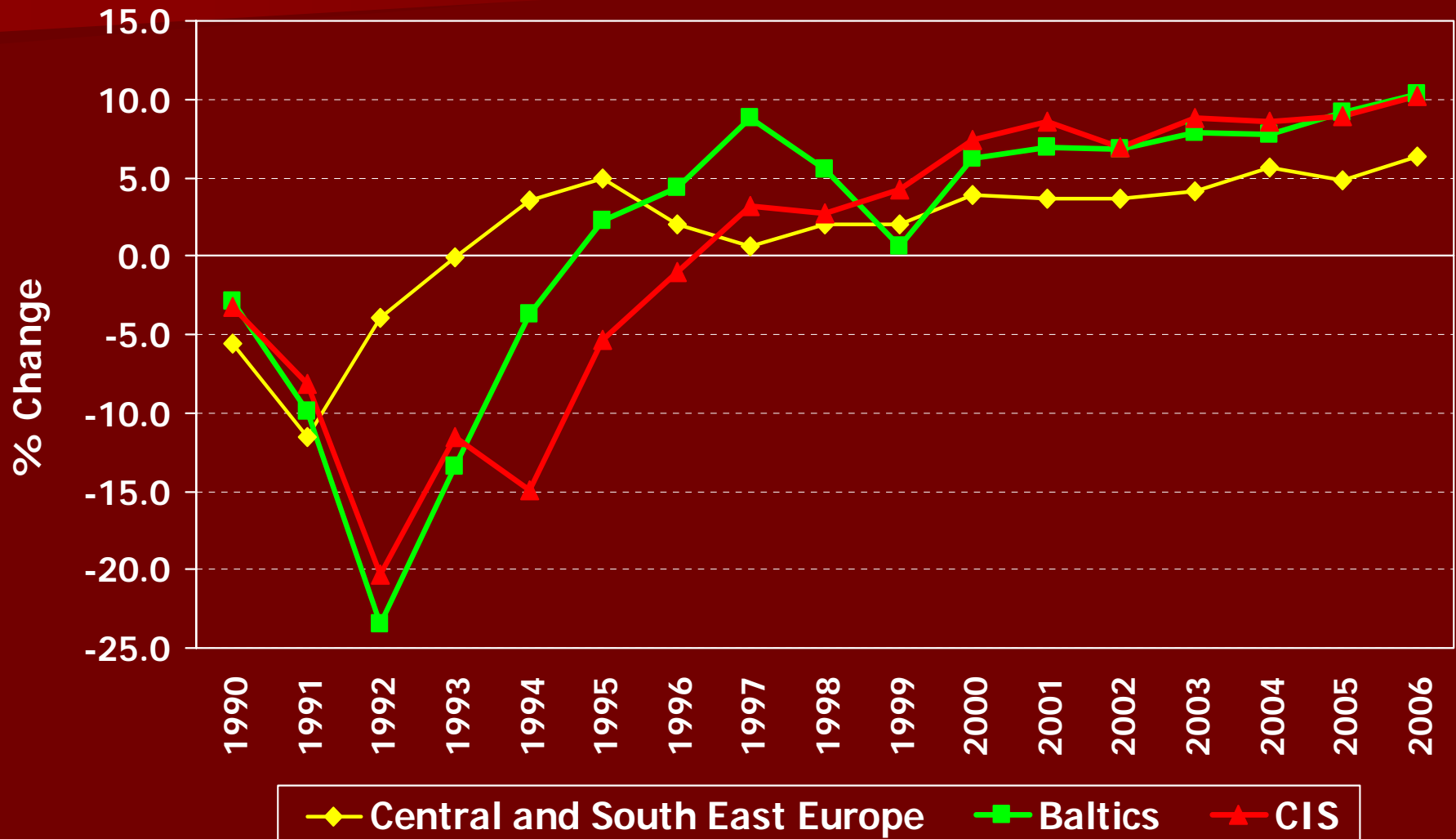
- 18 of 21 postcommunist countries have become market economies
- Radical market reforms worked best

Thesis 2: We Do Not Know How to Build a Democracy

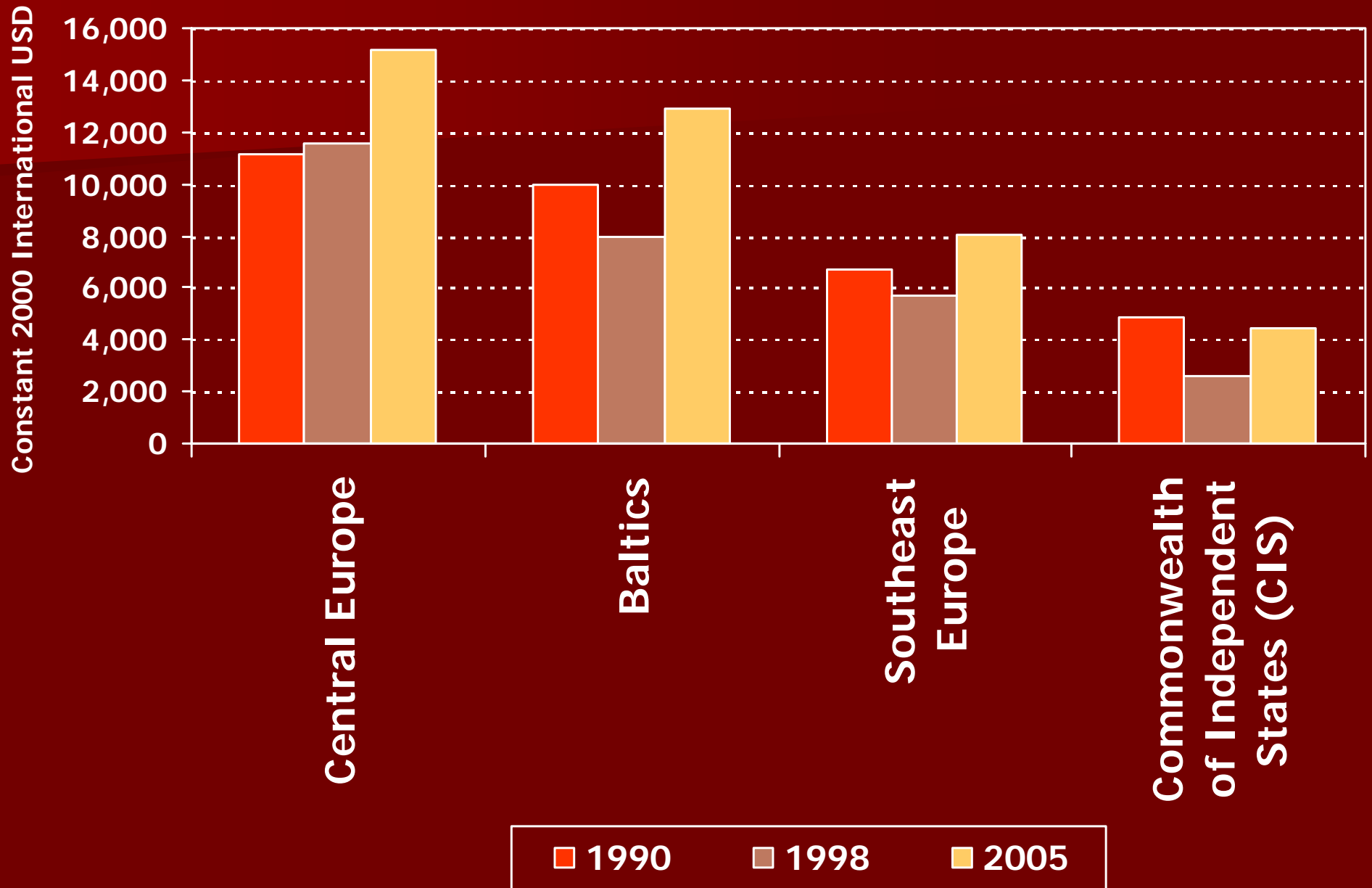
- Only 10 of 21 postcommunist countries are democracies
- Only the implantation of EU institutions has bred democracy
- No intellectual contribution

Official GDP Growth:

1. Collapse Bred Misery
2. Capitalism Brought Growth



GDP per Capita in PPP, 1990, 1998, and 2005



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

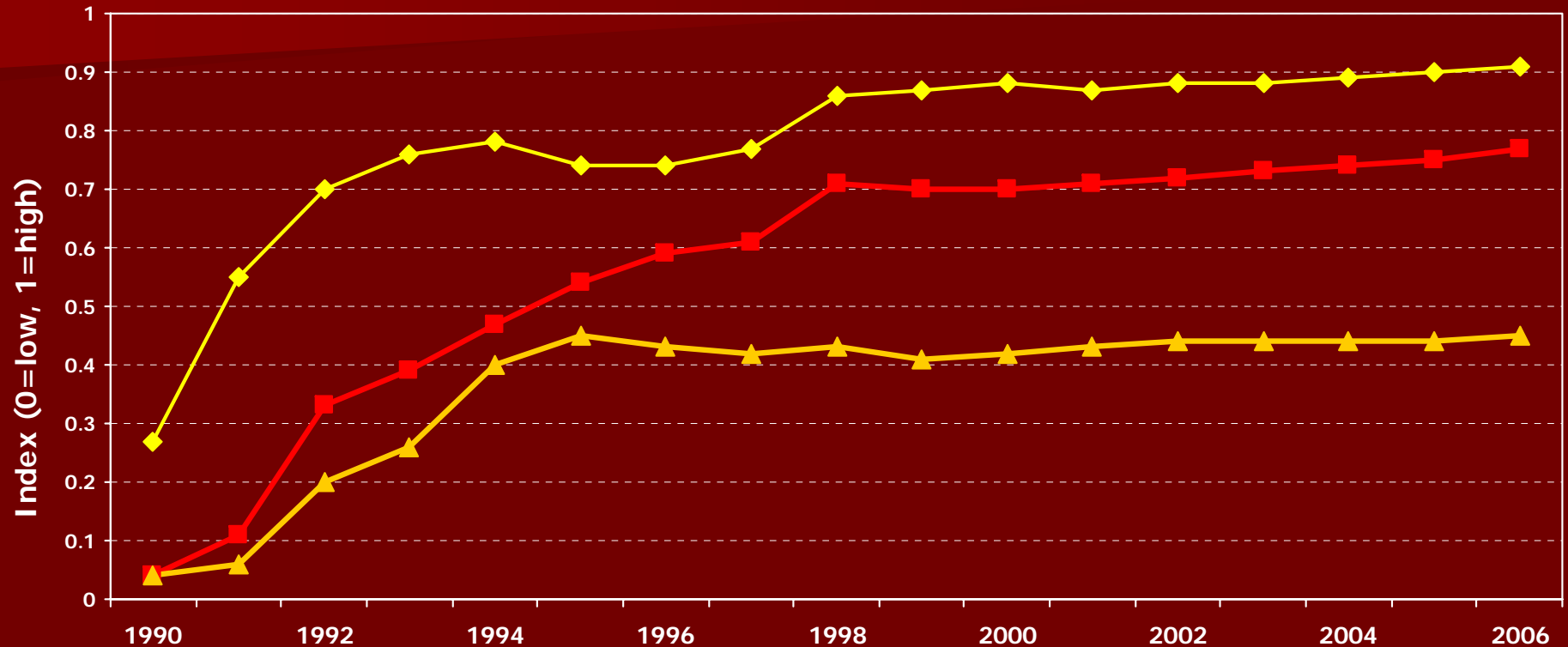
- Gradual Gorbachev reforms bred extraordinary rent-seeking

Cure:

Radical, Comprehensive Reforms

1. Quick Deregulation
2. Defeat Inflation
3. Fast, Extensive Privatization

1. Structural Reform Index: Early Reformers: Early Growth

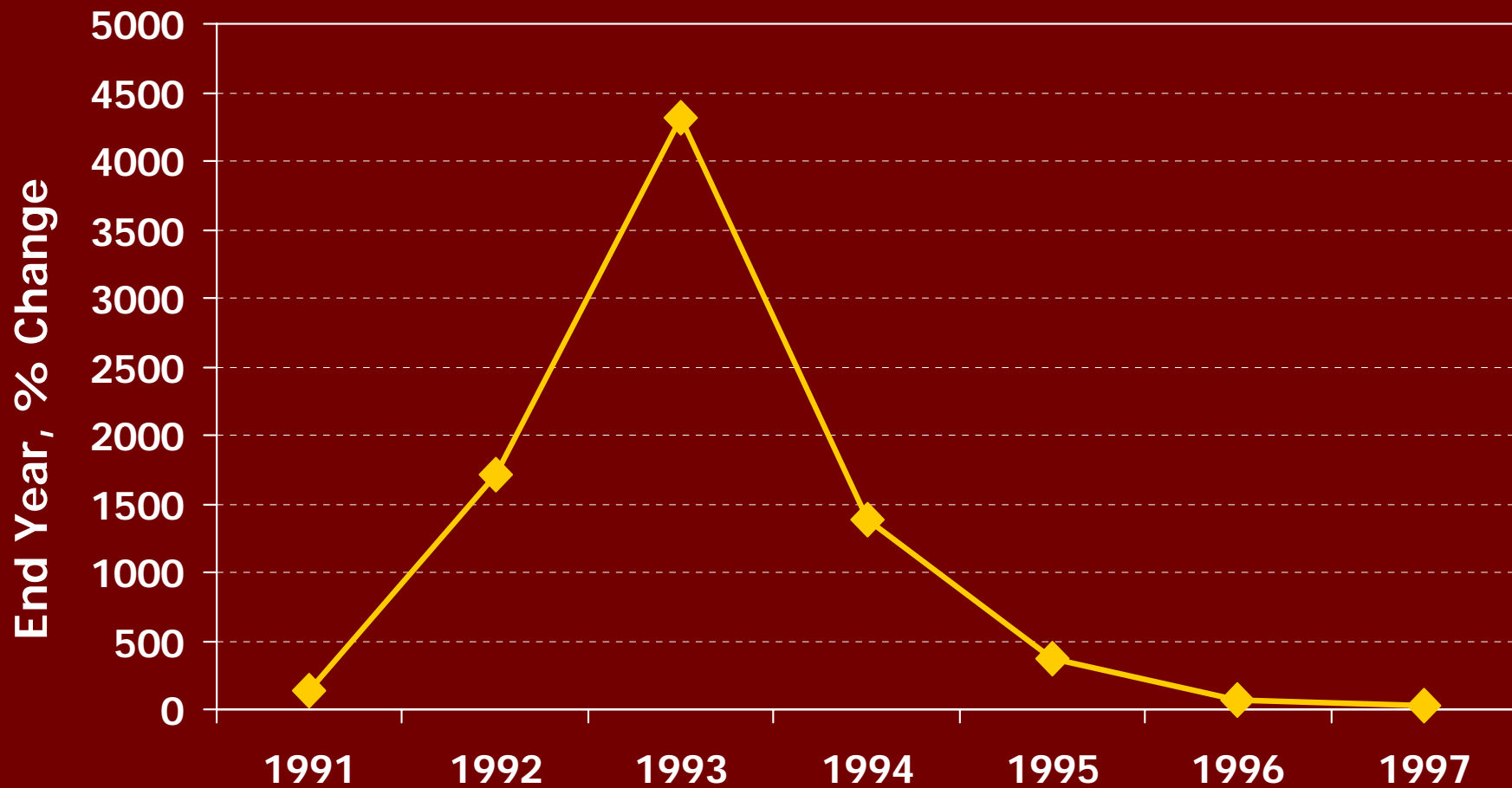


◆ Central and Eastern Europe

■ Commonwealth of Independent States (CIS) reformers (Russia, Ukraine, Moldova, Armenia, Azerbaijan, Georgia, Tajikistan, Kazakhstan, Kyrgyz Republic)

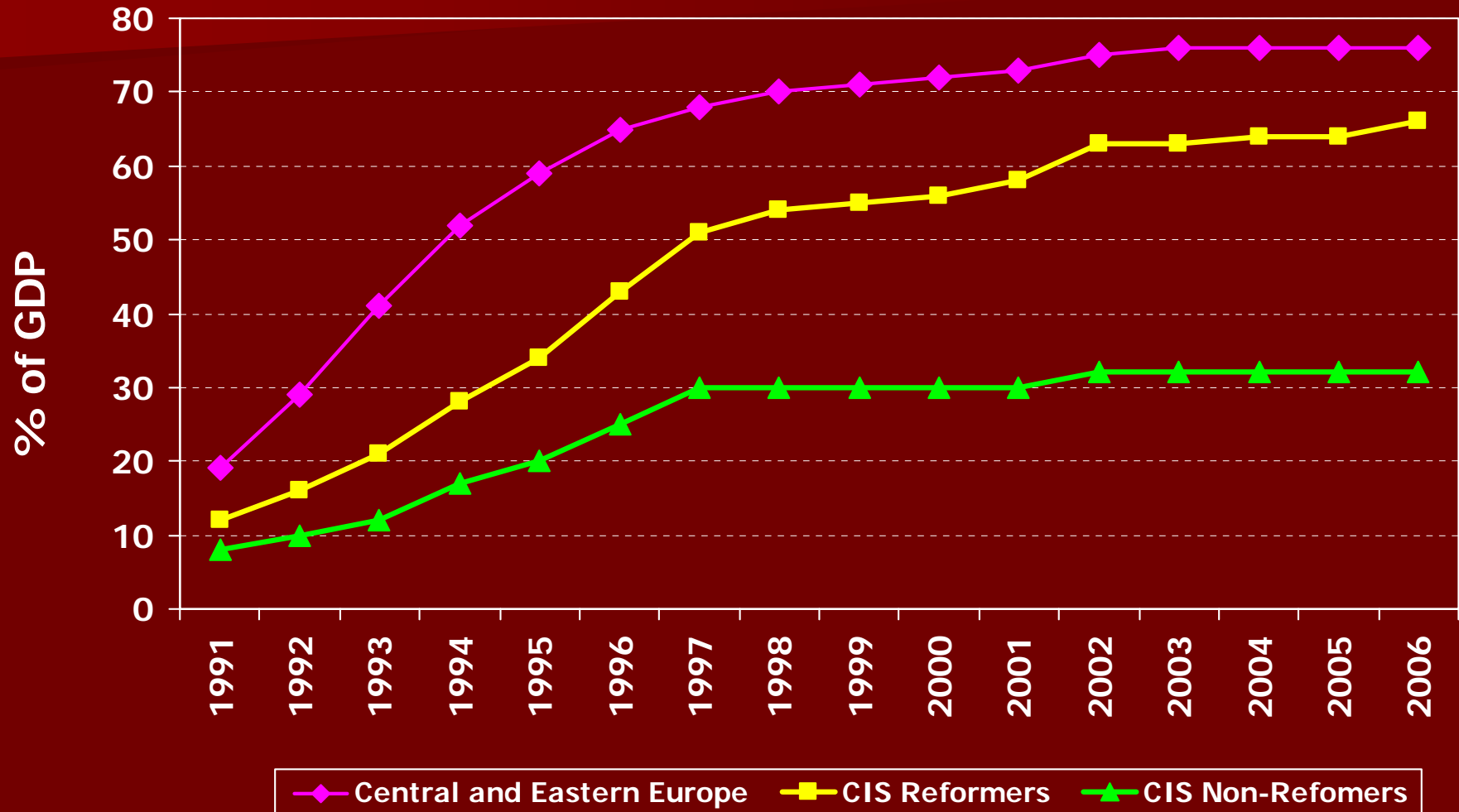
▲ CIS non-reformers (Belarus, Uzbekistan, Turkmenistan)

2. No Growth until Inflation under Control: Hyperinflation in the Commonwealth of Independent States



3. Early Privatization: Early Growth

Private Sector as Percent of GDP



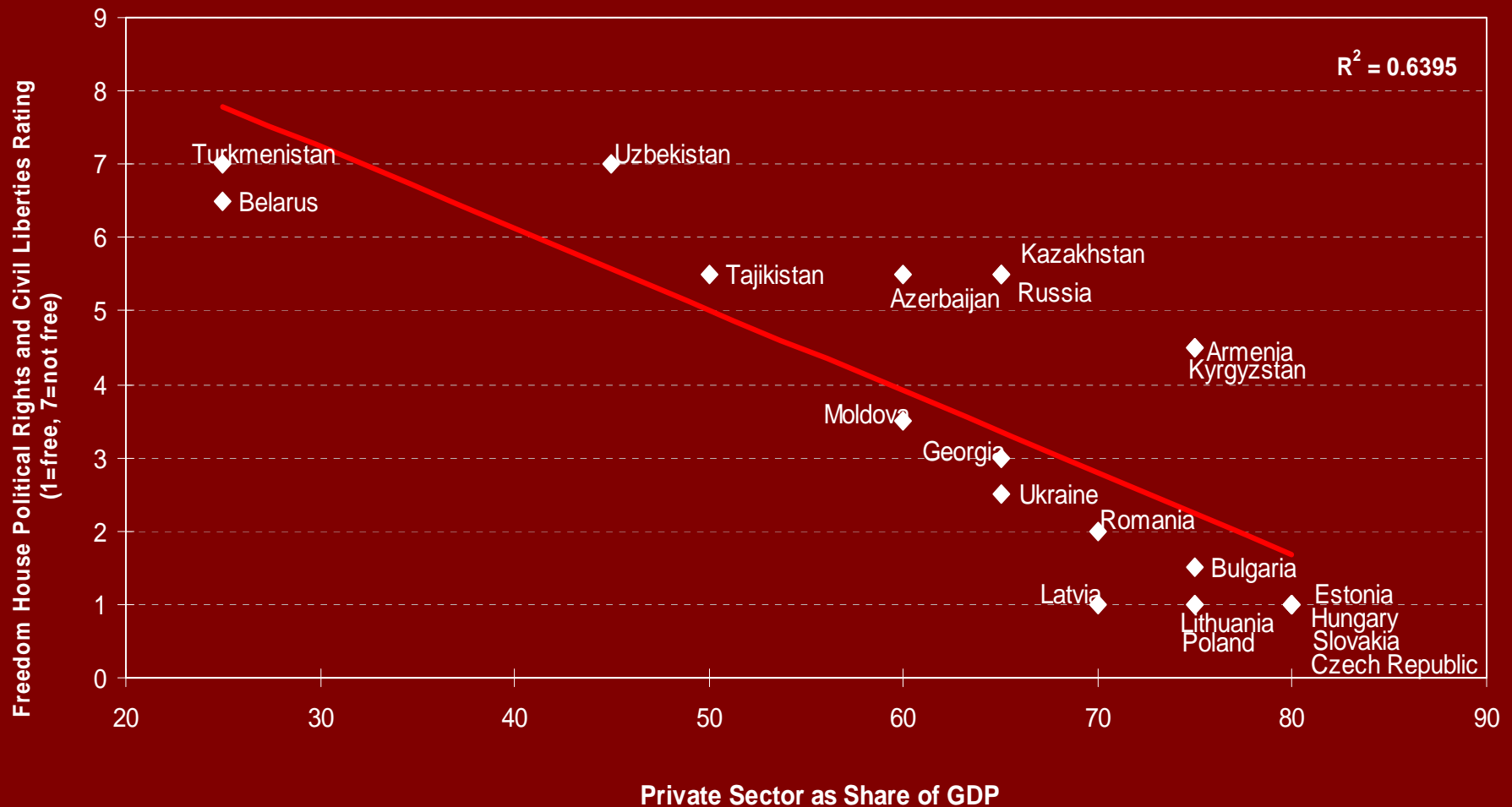
Has Privatization Been Overdone?

NO

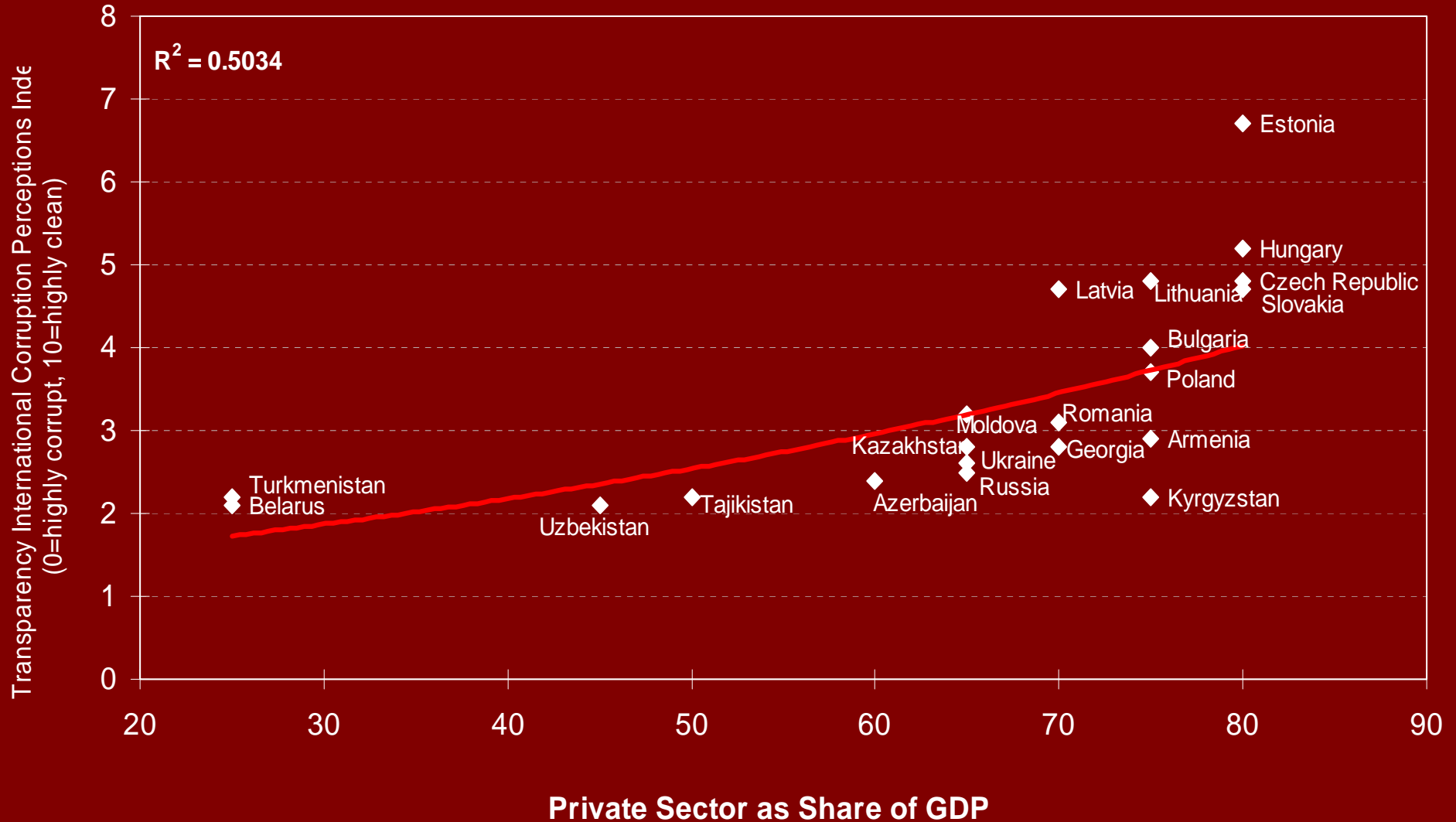
Predominance of private sector:

- precondition for market economy
- precondition for democracy
- limits corruption

Democracy and Privatization Go Together, 2005



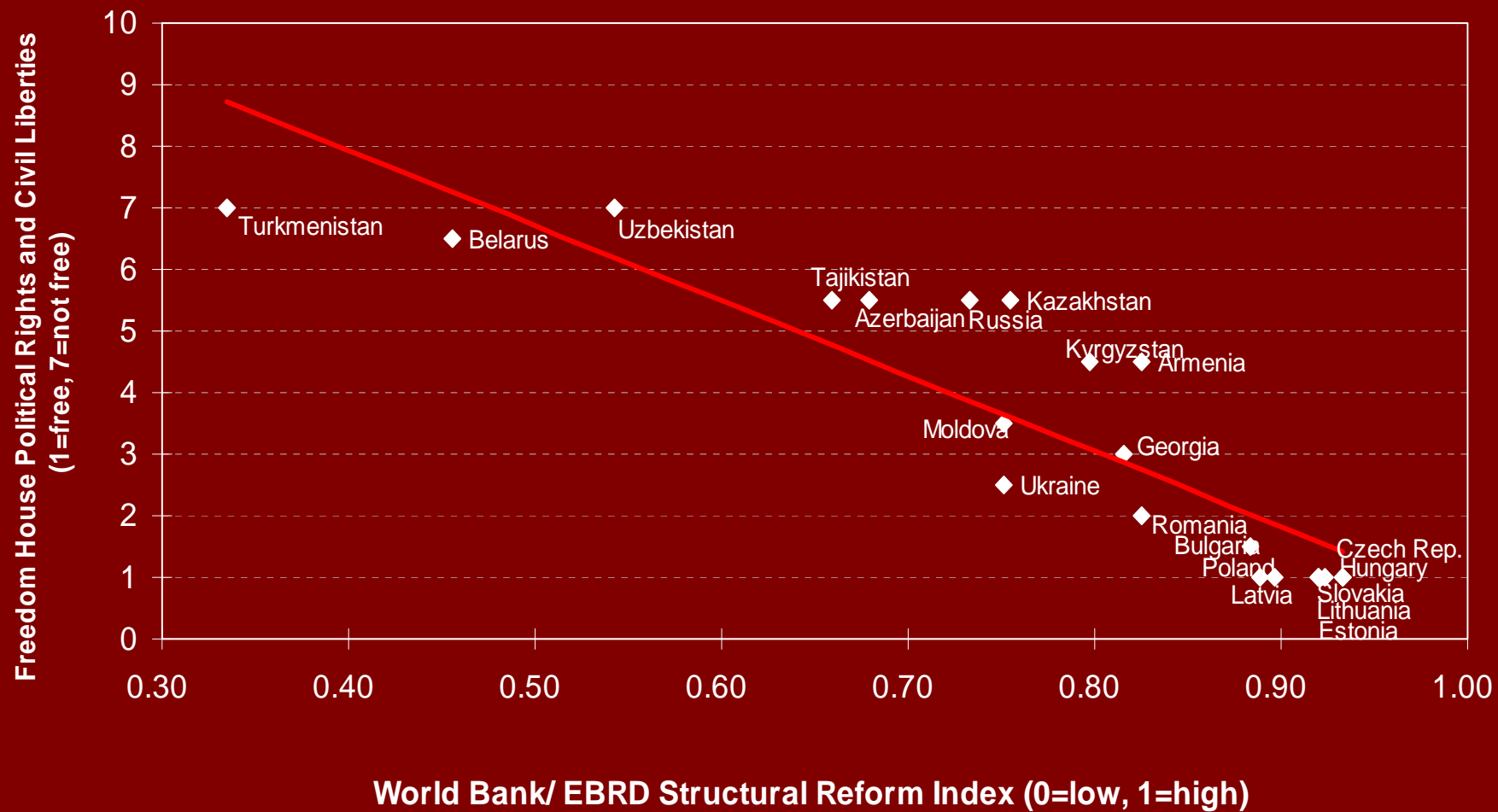
More Privatization = Less Corruption, 2006



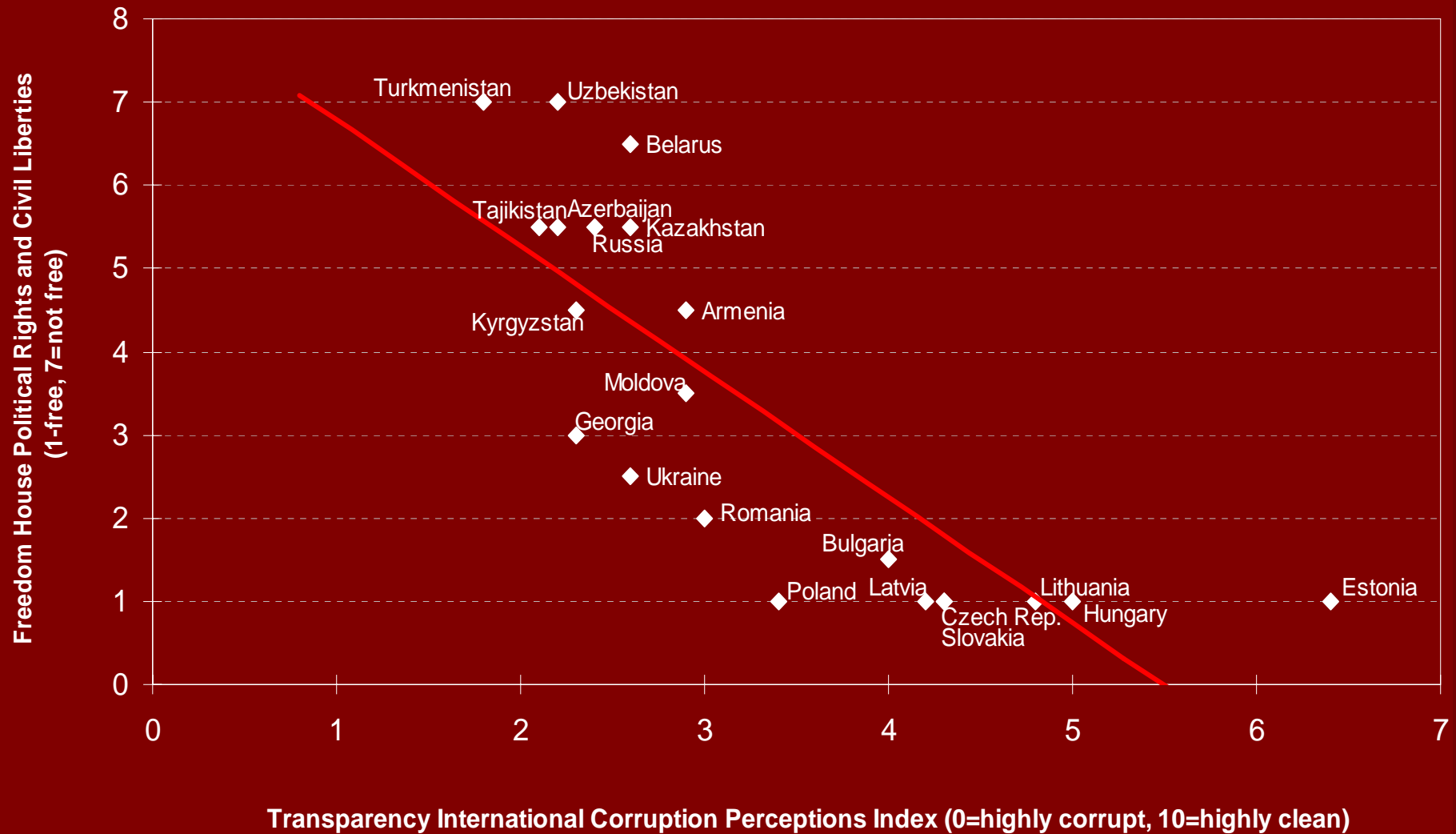
Democracy: Best Weapon against Rent-Seeking

- Democracy and market reform positively correlated
- Democracy and privatization go together
- Democracy reduces corruption

Democracy and Market Reform Go Together, 2005



More Democracy = Less Corruption, 2005

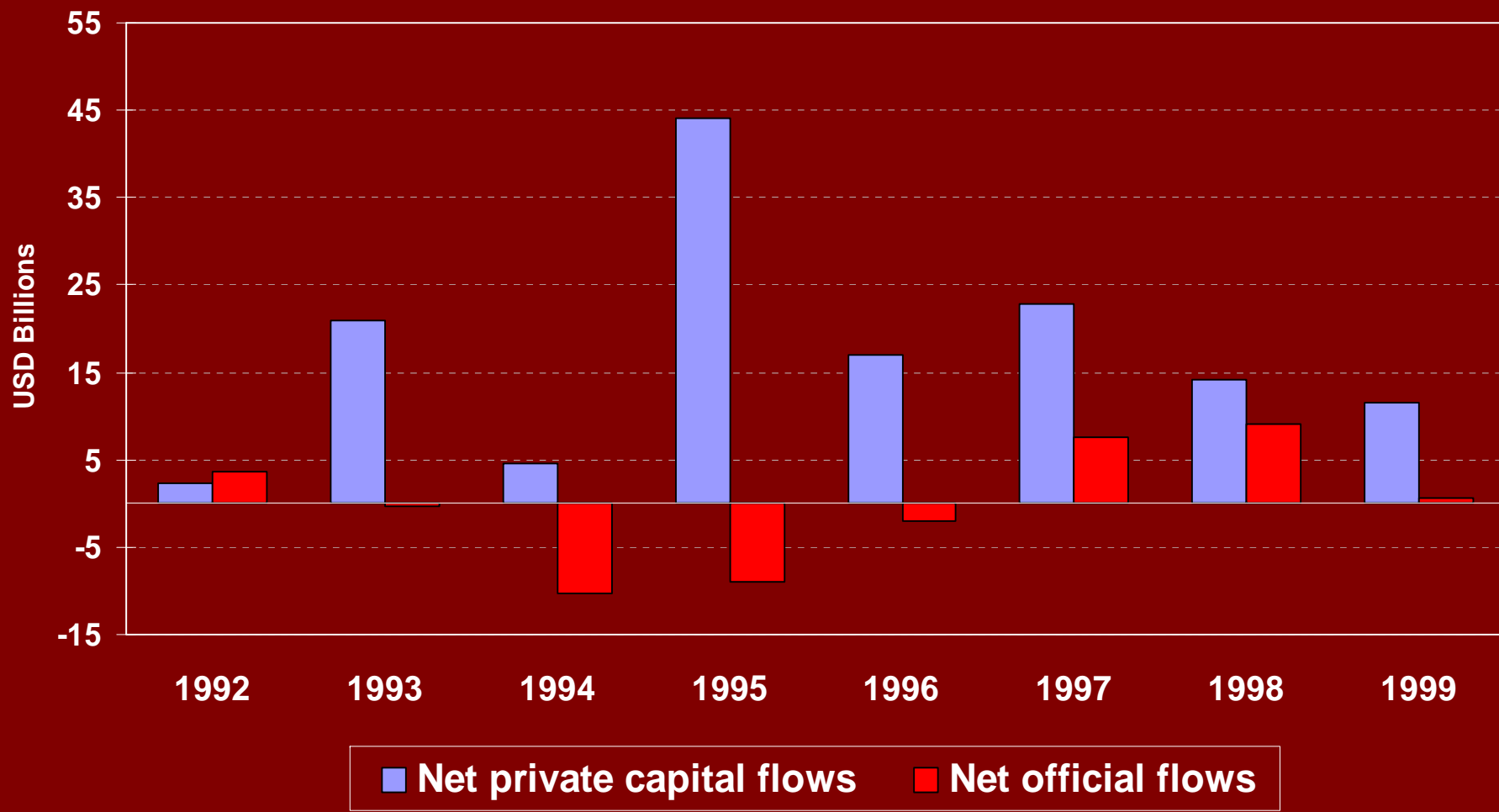


Has Western Aid Been Excessive?

NO

- It barely existed: Western governments received more in debt service on old communist loans than they gave in loans and grants to the postcommunist countries in 1993–96
- Total grant assistance to the region = a couple of billion dollars a year
- US peace dividend (the reduction in US military expenditures) amounted to a \$1.4 trillion in 1990s (3 percent of US GDP in 1999)

Countries in Transition: Net Capital Flows, 1992–99



U.S. Peace Dividend, 1992–99

	Percentage of GDP	Current Dollars (billions)
1992	1.1	69
1993	1.5	98
1994	1.9	132
1995	2.2	160
1996	2.5	192
1997	2.6	211
1998	2.8	238
1999	2.8	259
TOTAL		1 359

Is the European Union the best solution?—Probably

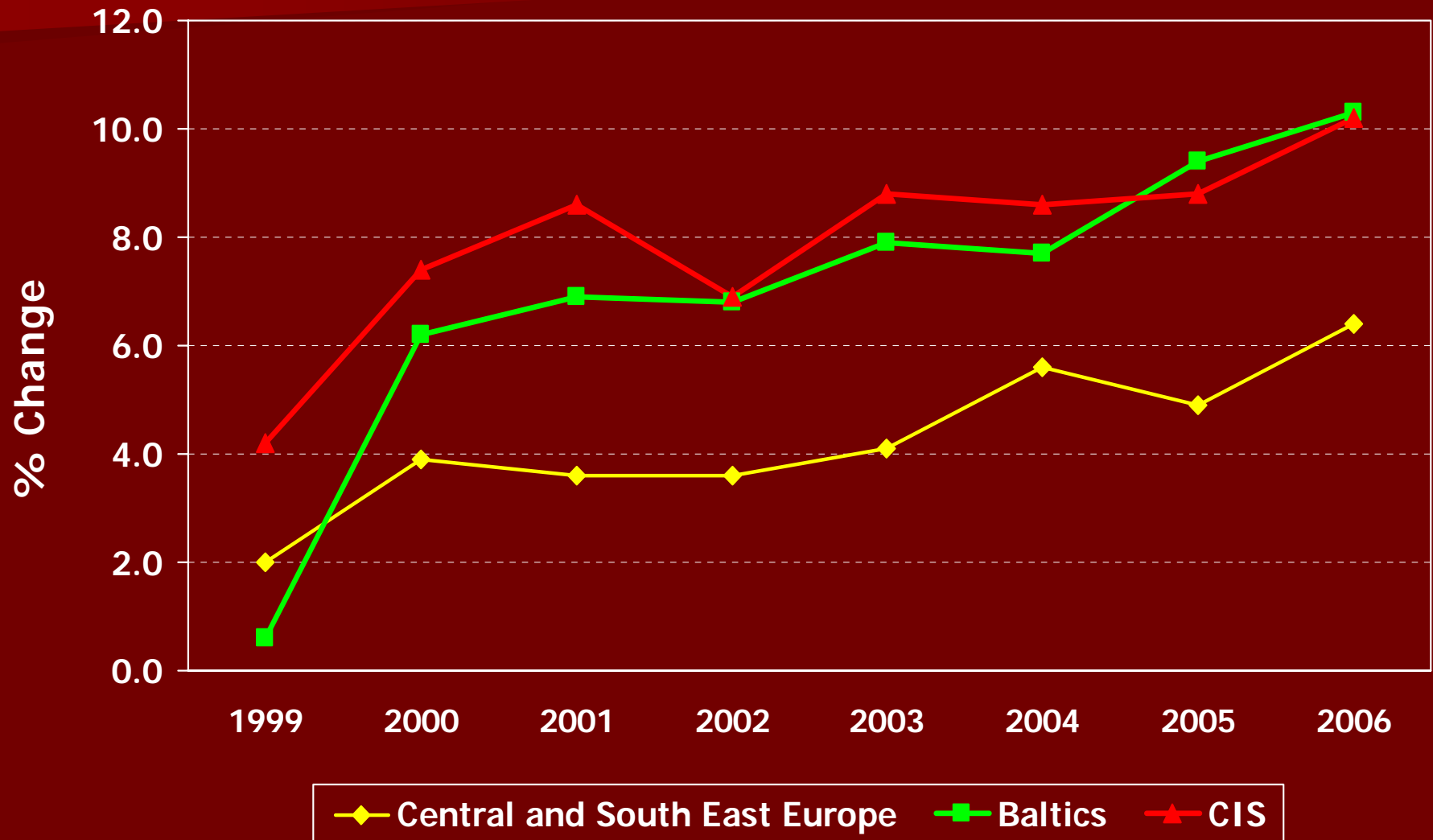
- European Union provided the standard of a normal society to accession countries:
 - transferred all institutions
 - reinforced democracy
 - opened market

Has Sustainable Economic Growth Been Achieved?

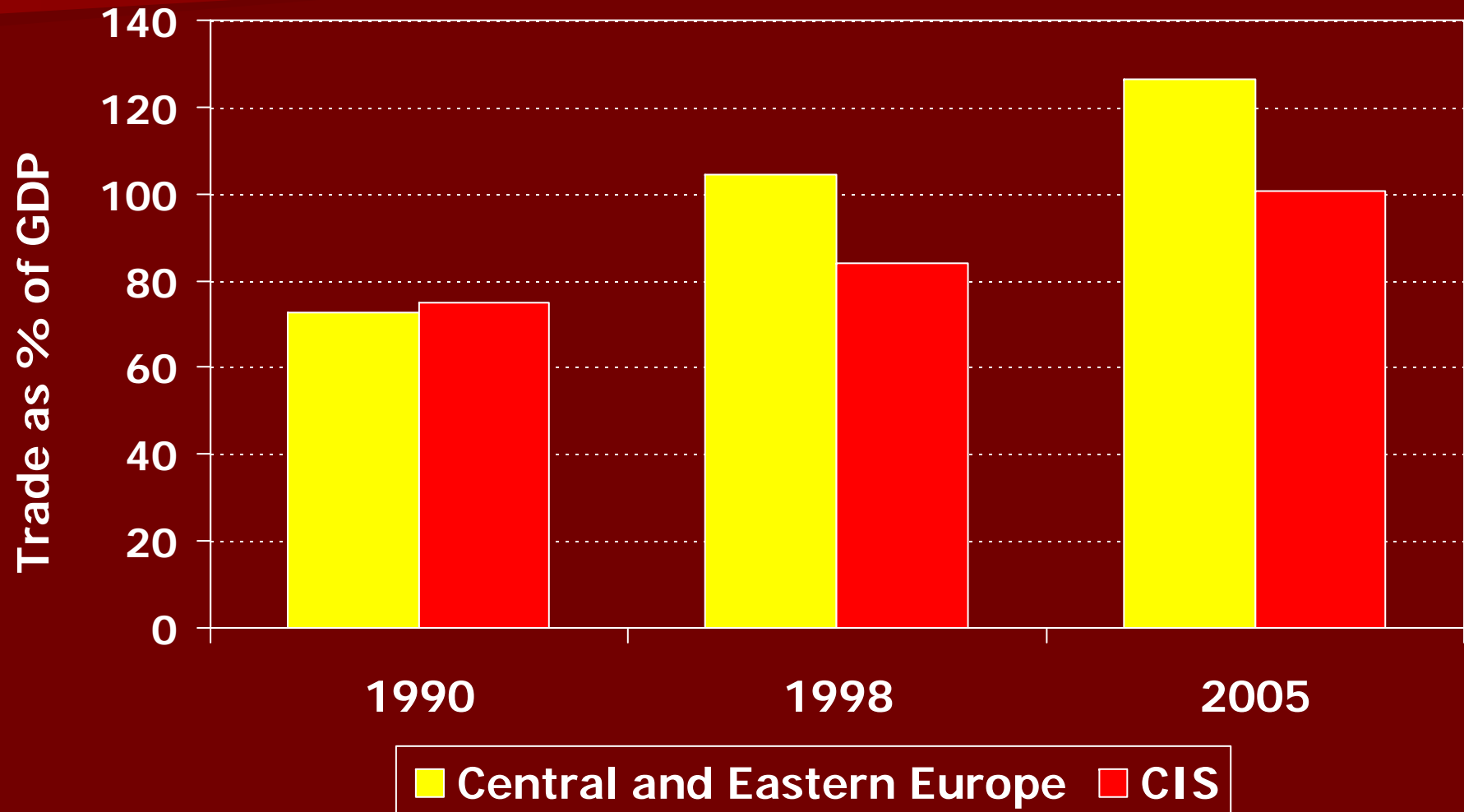
Probably

- Since 2000, former Soviet region:
average growth 8 percent a year because of
 - Sound macroeconomic policies,
 - structural reforms,
 - sharp cuts in public expenditures,
 - low exchange rates, and
 - commodity boom
- Star performers: Baltics, Armenia, Azerbaijan, and Kazakhstan

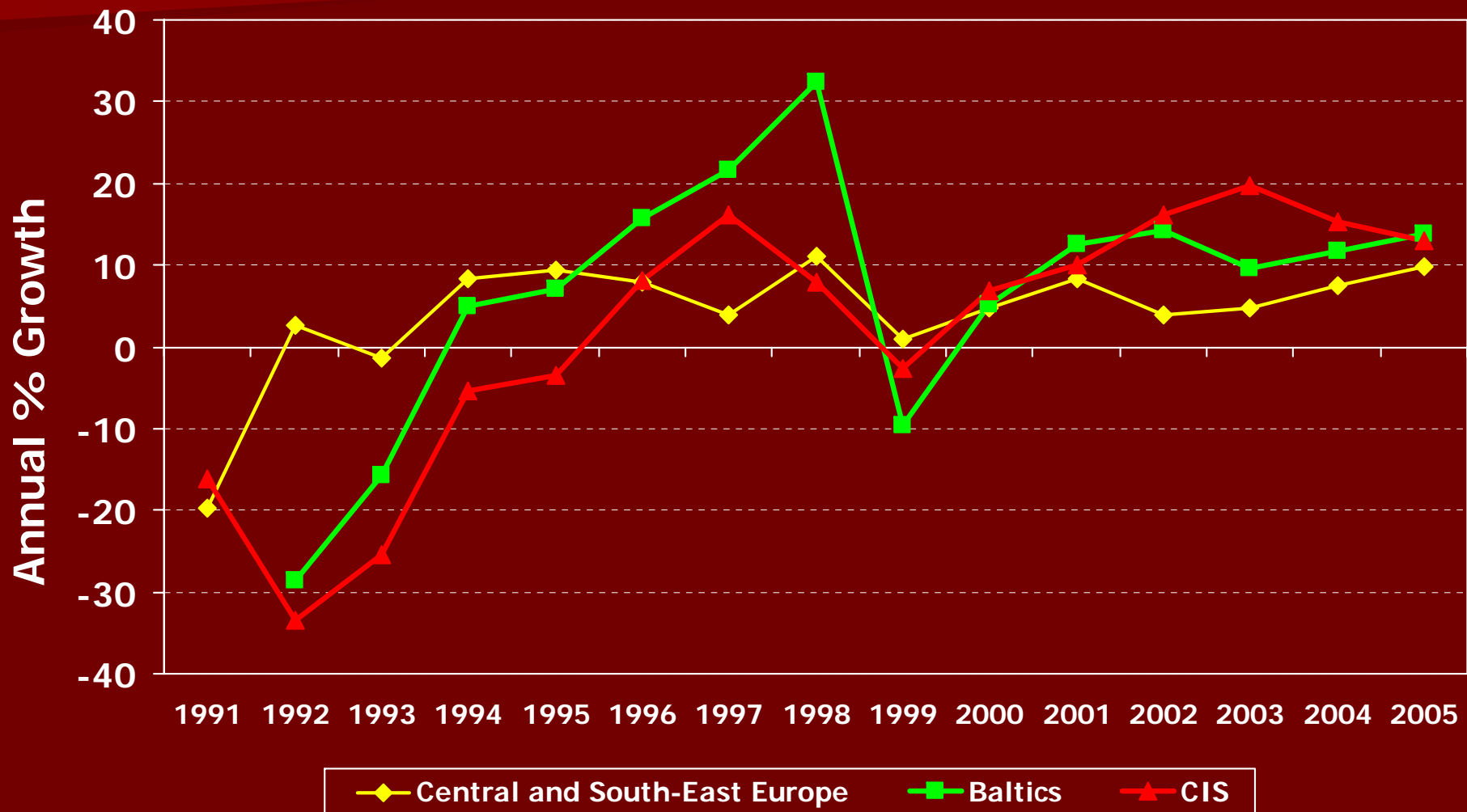
Official GDP Growth, 1999–2006



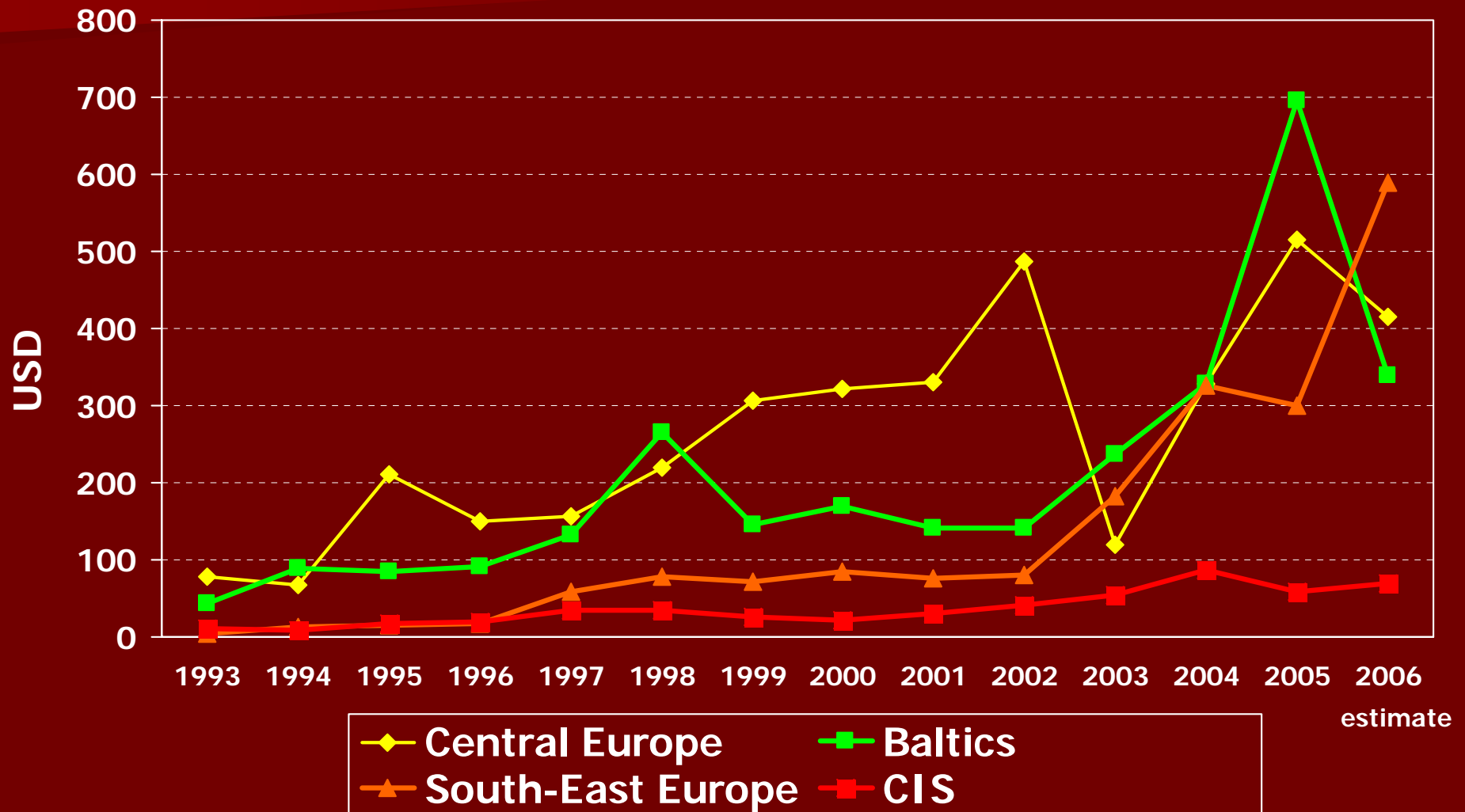
Openness of the Economy: Great and Growing



Gross Fixed Investment: Rising with Growth



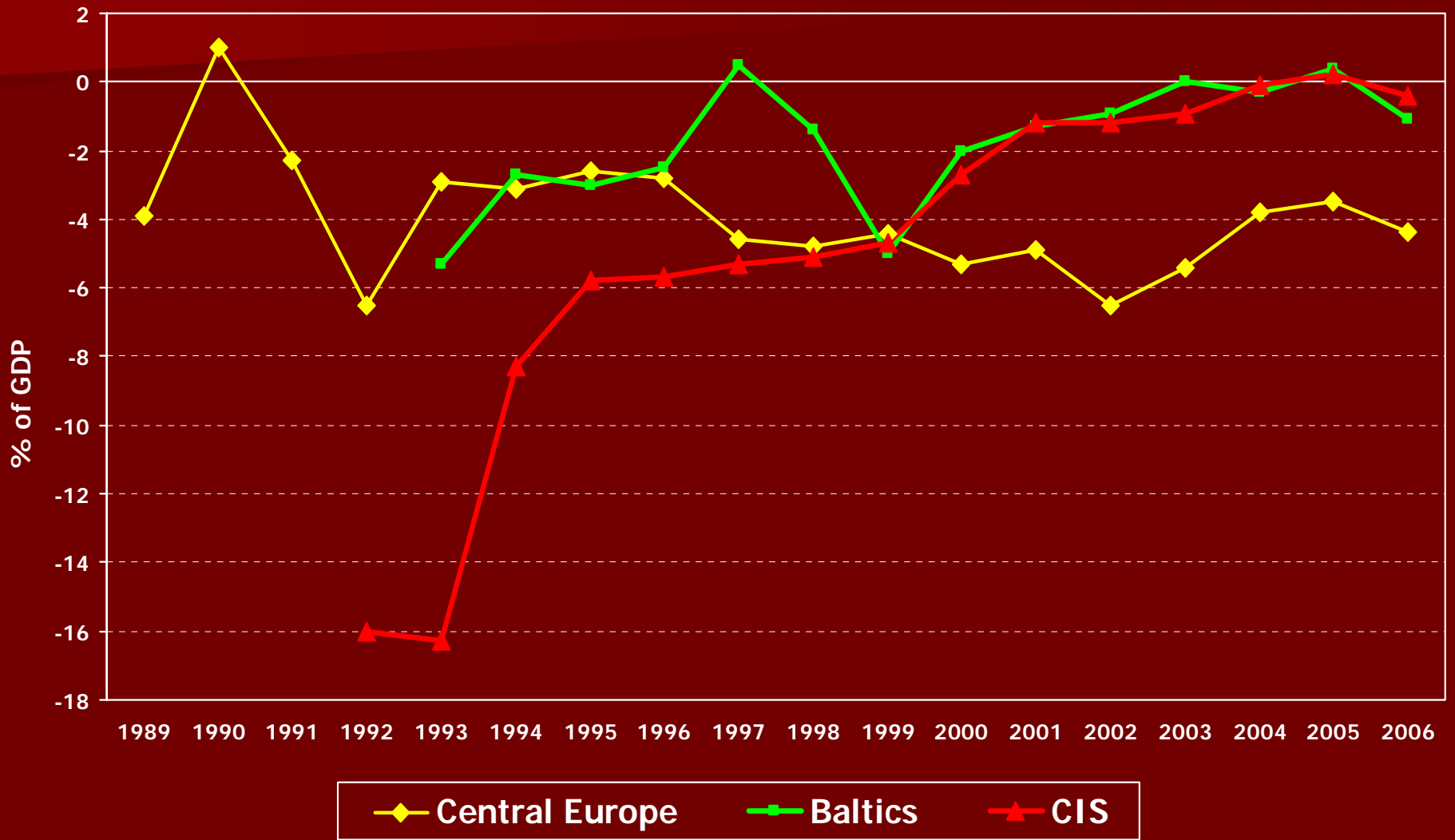
Foreign Direct Investment: Rising Net per Capita, 1993–2006



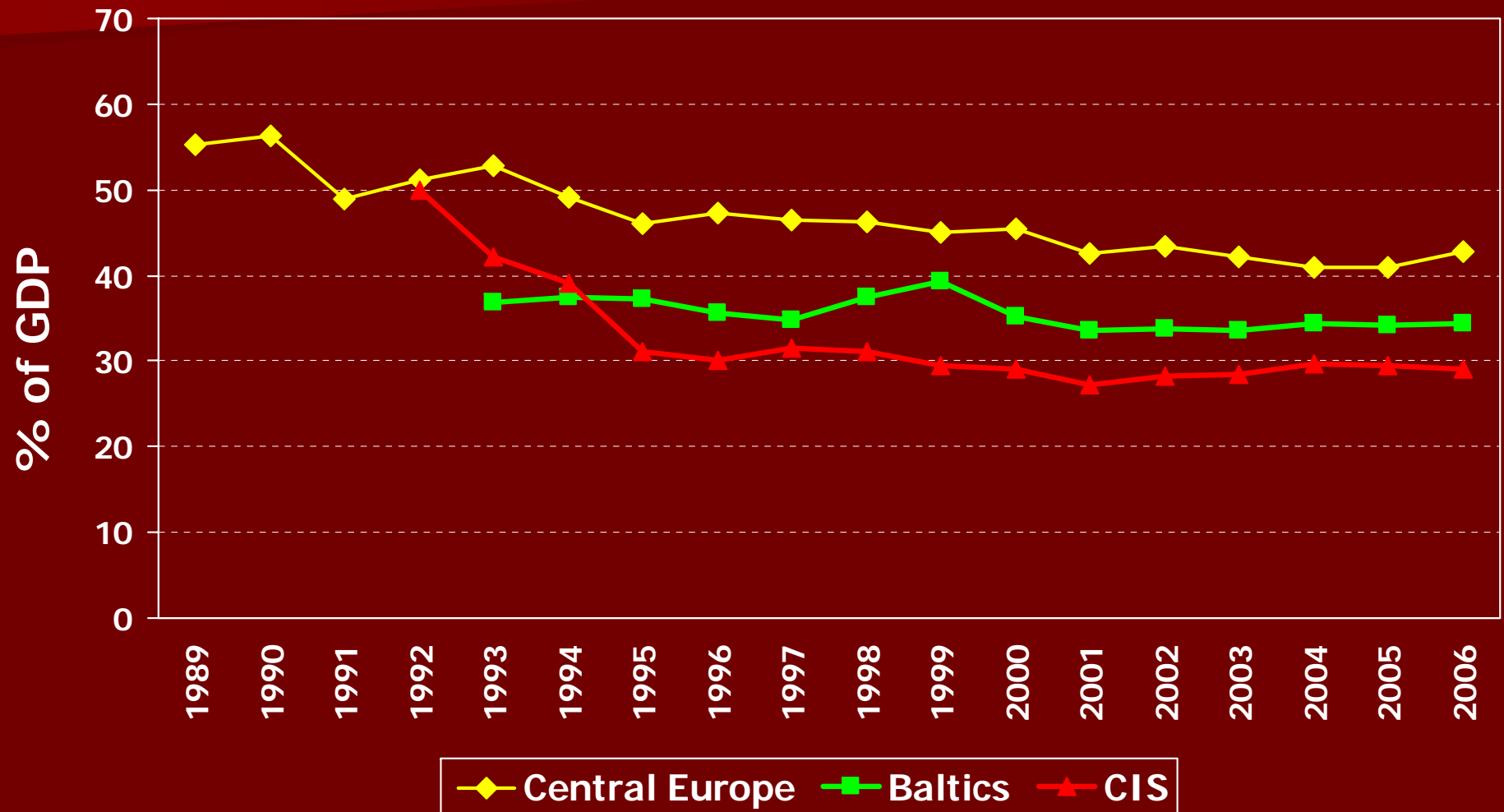
Concerns

- **Low Central European Growth:**
 - high taxes and large budget deficits
 - large social transfers
 - over-regulation of labor and agricultural markets
- **CIS Countries:** Uncertain property rights and risk of renationalization

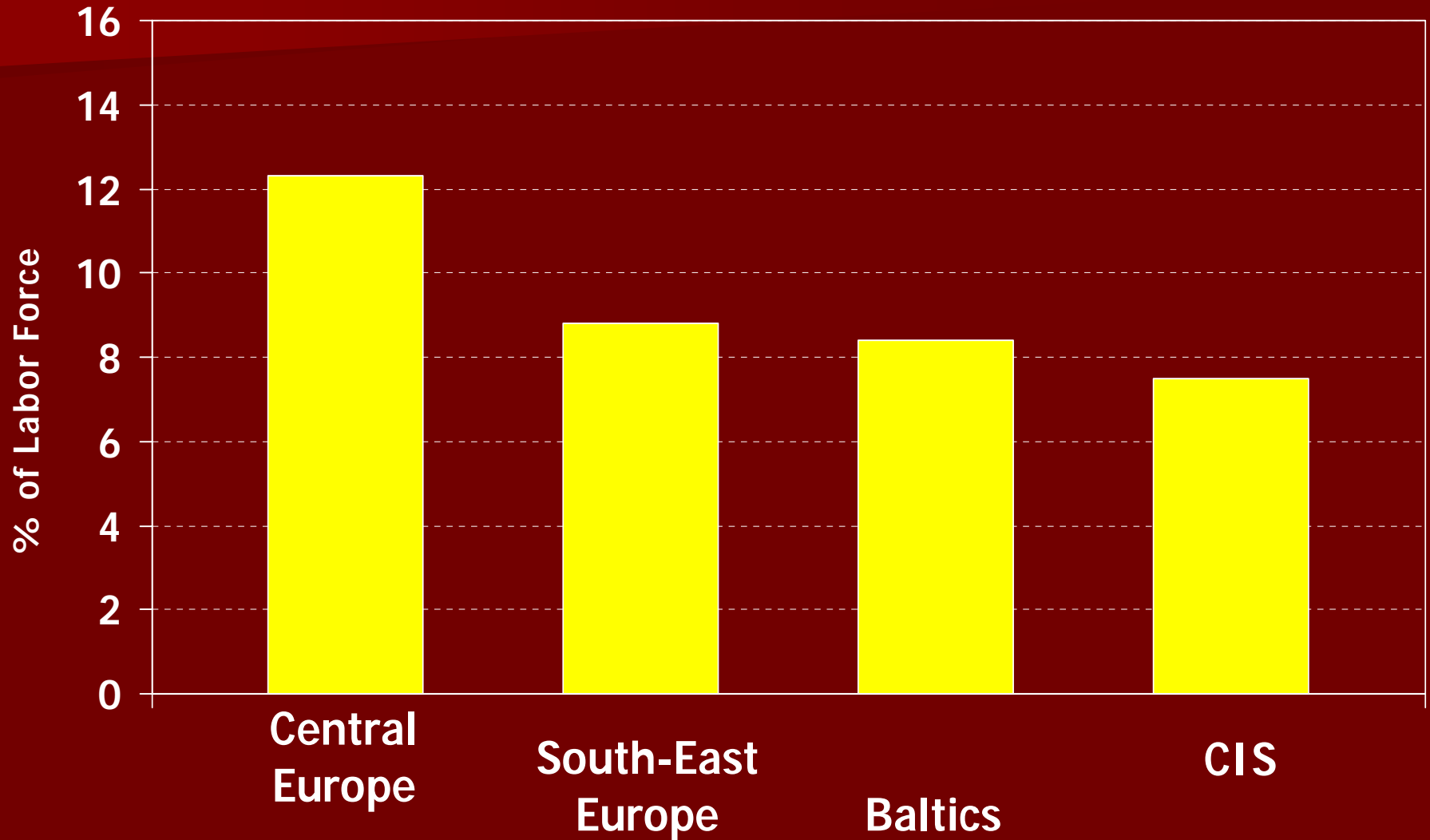
Fiscal Balance, 1989–2006



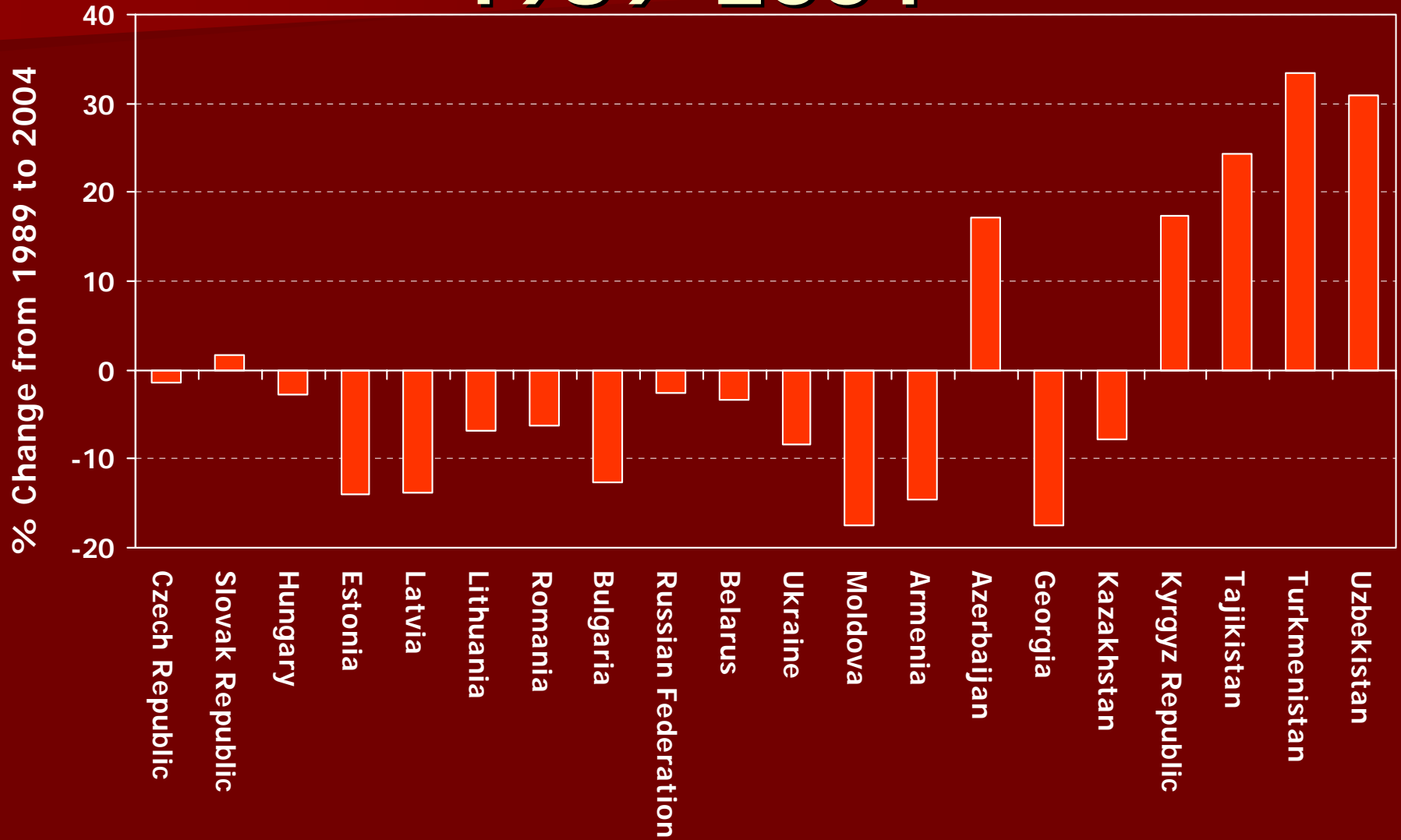
Public Expenditures: Too High But Lowest in CIS



Freest Labor Markets and Lowest Unemployment in the East, 2005

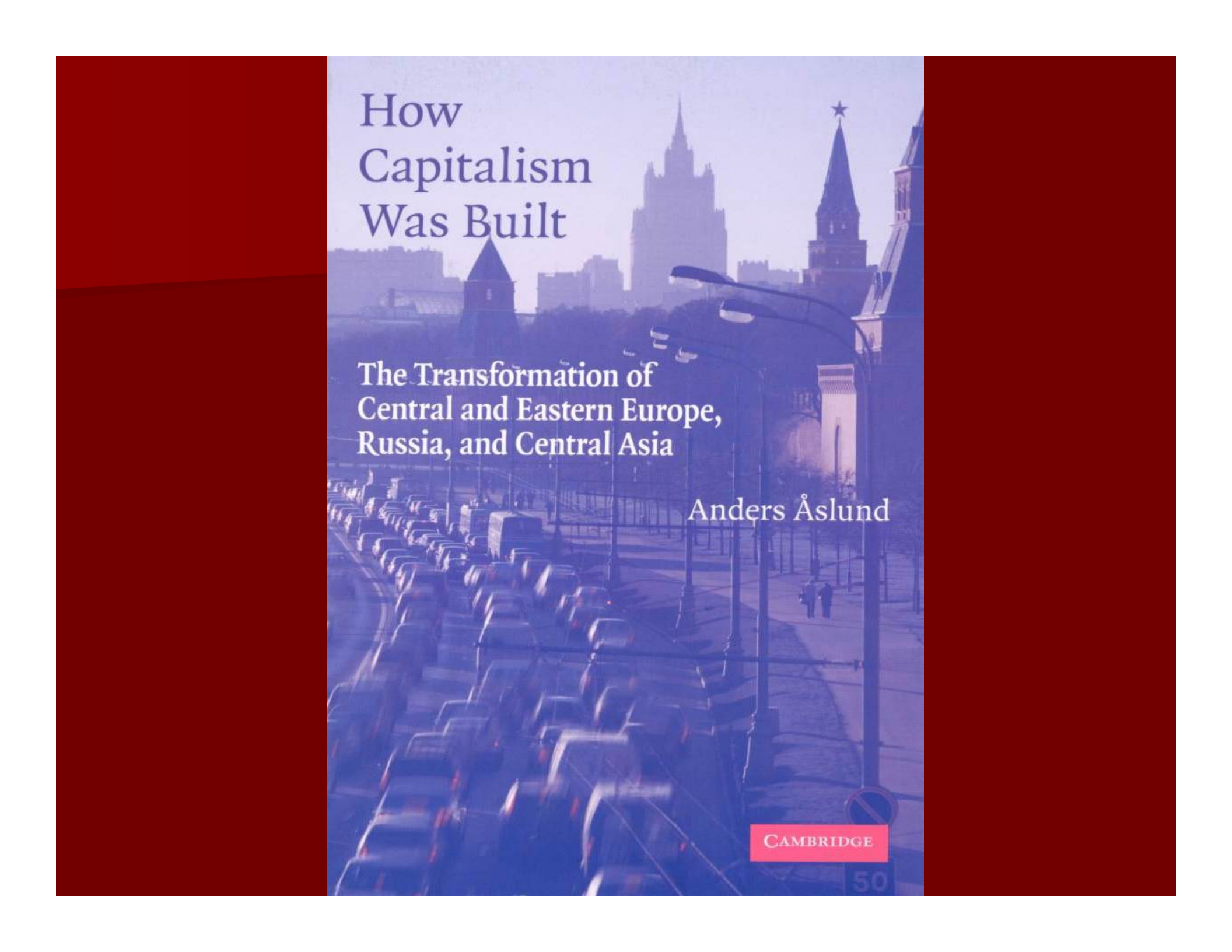


Threat: Declining Population in Southeast Europe and Baltics, 1989–2004



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



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