

# The Transition Journey: Some Lessons and Many Surprises<sup>1</sup>

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As I look back on about 25 years of personal engagement in what has been called “The Transition” I can share with you six lessons:

1. Expect the unexpected!
2. Breaking up is hard to do.
3. Regional integration – yes! Regional cooperation – maybe, but mostly, no!
4. Good macro fundamentals are easy – after the big crisis of the 1990s.
5. Structural, institutional and governance reforms take more than a generation – or forever.
6. It’s a miracle: The IFIs can work together – sometimes.

## 1. Expect the unexpected!

Let’s start with the surprises. Back around 1988, when we started in the World Bank under Stan Fischer’s able guidance to think about the changes happening in what were then called the “socialist economies”, we understood many of the looming reform issues quite well, judging from what we know today. But we had no clue about how quickly the fundamental changes would come about or how severe the economic impact would be, much worse than the Great Depression or what we see in Southern Europe today. And talk about “unexpected”: After a visit to the Berlin Wall in March 1990, when it was to everyone’s surprise already breached, I made a bet with a friend that the two Germanies would not unite during the 1990s – a bet I had lost hands-down six months later. Then after many years of wishful thinking that a turn-around in economic fortunes might be just around the corner, the East-Asia and Russia crisis happened – and this on the heels of Euromoney awarding Anatoly Chubais the award of Best Finance Minister of 1997! In 2003 the Bank and IMF published a retrospective analysis of macroeconomic projections used by the institutions in their programs for the region. We found that we had been systematically erring on the optimistic side. I suspect if one had looked back in 2007 and done the same analysis one would have found that the IFIs had been too pessimistic between 2000 and 2007. Which brings us to the unexpected global crisis of 2008/9, unexpected even though Kazakhstan with its crisis in 2007 could have served as the canary in the mineshaft. Of course, fortunately our worst expectations about the likely bad impacts on the countries of the Caucasus and Central Asia were fortunately again off the mark. So, the lesson for the macro economists and, I might add, for the political experts is: better be humble! The lesson for governments is: bank on resilience and flexibility, and make sure you put in place some social safety nets for the rainy days. It will help your people and your political survival.

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## **2. Breaking up is hard to do.**

So why were the first 10 years of transition so tough? Three fundamental reasons, aside from “distance to Düsseldorf”: it was a transition of the political system, a transition of the economic system, and an economic disintegration process, all wrapped into one. In the late 1990s and into the early 2000s many economists, including our famous colleague Bill Easterly, earned their spurs running regressions testing the impact of the first two sets of factors, but none of them satisfactorily explained the depth of the transition recession in the Former Soviet Union. I argued in 2005 that this was due to their forgetting about the third fact: disintegration. Which of course is a bit ironic, since we know that divorces tend to be expensive, and since we economists love to extol the virtues of integration. Here’s a question for us today: have the costs of Soviet disintegration left such a deep scar in our minds that we think the break-up, or even the partial dismemberment of the Eurozone, seems unthinkable?

## **3. Regional economic integration – yes; regional cooperation – maybe, but mostly, no!**

But there were people who worried about disintegration in 1991 and 1992. Think about the ill-fated efforts to maintain the Ruble Zone and the almost as ill-fated efforts to establish an integrated Community of Independent States. Moreover, in years since, there were plenty of grand presidential proclamations, summit-level meetings and efforts to organize regional initiatives and even organizations, especially in and with Central Asia. In fact, of course, virtually nothing was done to cooperate effectively to prevent the new borders from turning into new, high economic barriers. Despite these barriers there has been regional economic integration in the sense that CIS countries’ trade and financial flows with each other have recovered, in some cases quite rapidly, and there is now a discernible (and, I argued in the past, predictable) trend towards super-continental integration across the entire Eurasian economic space from Shanghai to Lisbon. But there have been very few successful regional initiatives. Nevertheless, let’s not despair: the fact that there have been few cross-border hostilities in the last 20 years in the FSU is a miracle of historic proportions (not to mention the mostly peaceful internal transitions in the new countries); the fact that for the most part the freedom of movement of people between Russia and the other CIS countries was retained is a significant achievement. And we need to give some credit to the efforts of the Central Asia Regional Economic Cooperation Program (CAREC) for the fact that it developed (and is now seeing to the implementation) a regional transport corridor strategy in Central Asia. Finally, the newly established Customs Union is quite a surprise, which no one familiar with the history of failed regional economic cooperation initiatives had expected. Whether and how much it is for the better, remains to be seen.

## **4. Good macro fundamentals are easy – after the big crisis of the 1990s.**

One of the more remarkable areas of progress over the last 20 years is the progress that the transition economies have made in establishing solid macro fundamentals. Surely, there remain risks, but all-told the countries and the IMF can be pleased as they look back over the last 10 years in particular and see how much macroeconomic stability is now the rule, rather than the exception. Even the financial crisis of Kazakhstan of 2007, triggered by the early disruptions of international financial markets and then reinforced by the

global crisis of 2008/9 (although with underlying causes of overheating in the run-up), was relatively quickly and sensibly addressed. The fact that Kazakhstan, like Azerbaijan, had established a well-managed natural resource fund of course helped deal with the crisis. The reasons for the good macro fundamentals in the FSU, as in many other developing countries, can perhaps best be traced back to the fall out from the East Asian and Russian crisis of the late 1990s, which left a deep commitment among the governments of the developing world not to be caught again in such a crisis. The fact that the advanced countries were not able to avert the global crisis of 2008/9, which originated in their backyard, is not only a disaster, but also a terrible irony. Two important questions now arise: First, whether and how the advanced industrial democracies overcome their political dysfunctions to find their way back to a sensible approach to domestic economic policy making. And second, whether and how the transition economies can institutionalize their sound macroeconomic management, so it is not simply a short-term reaction to the earlier crises.

##### **5. Structural, institutional and governance reforms take more than a generation – or forever?**

Perhaps this was predictable, but the “second generation” reforms were a lot more difficult to implement than foreseen. Fischer and Gelb in their well-known paper in *Journal of Economic Perspectives* (Fall 1991) showed a timeline lasting ten years for all aspects of reform, including the structural, institutional and governance aspects. That time line was appropriate for the Central European and Baltic countries that were under the pull of the prospect of joining the EU. But for the CIS countries the time horizon looks a lot longer, and for some perhaps indefinite, at this time. Indeed, the EBRD Transition Indicators show that little progress has been made in these areas in the CIS countries in the 2000s. This perhaps should not be surprising, if one considers how many developing countries had been stuck in what now is sometimes called the “middle income traps.” Nonetheless, it is disappointing to see that so many countries in the region seem bent on following the example of Latin America of the second half of the 20<sup>th</sup> Century. The EBRD and World Bank promoted some very interesting work on the political economy of transition which was reflected in the 2002 World Bank report entitled “Transition: The First 10 Years.” It helped explain the political factors that have contributed to the stalling of reform. I might have missed it, but since that time I have seen no similarly insightful analysis of the political economy of the transition. This is too bad, in my view, because the countries in the region really need to understand what's holding them back. To paraphrase Acemoglu and Robinson from their much discussed book *Why Nations Fail?*: it's not likely to be that leaders and policy makers haven't been given enough good advice. One may not agree with all that Acemoglu and Robinson have to say, but their focus on understanding political and economic institutions surely is the right one.

##### **6. It's a miracle: The IFIs can work together – sometimes.**

For reasons that are not entirely clear to me, an unusual thing happened in the late 1990s and early 2000s in the work of the IFIs on the CIS countries. We actually worked together on a number of important issues. And here I don't mean just that our teams on the ground worked together on specific country programs when the need and opportunity arose – and when the personalities of the teams were compatible. We also promoted joint

regional initiatives that did, I believe, contribute more as a whole than each of us could have done on our own. I already mentioned the joint work by EBRD and the World Bank on the political economy of transition. And these two institutions have cooperated for many years now on the BEEPS (Business Environment and Enterprise Performance Survey). Then there was the CIS-7 Initiative, which John and I promoted starting in 2001 after September 11, with a view to provide special support to the seven poorest countries in the CIS. AsDB and EBRD joined in. This initiative in turn set the stage for a long-lasting partnership among six international agencies (we added UNDP and IsDB to the group) on issues of regional cooperation in Central Asia, starting in 2003, under the banner of CAREC, with AsDB in the lead. I may be wrong, but my impression is that the degree of cooperation that we enjoyed ten years ago among the IFIs is no longer as tight or focused on regional issues, which – if I am correct – would be too bad. I think much can be gained from a more proactive mutual engagement by these institutions.

In conclusion, I am actually quite hopeful that the CIS countries will break out of the middle income trap they may have begun to slip into, not least because out of the six lessons I have mentioned, more than half, maybe all, point to a better future: the break-up is over and the broken-up parts are being brought back together in the context of Eurasian integration, if more slowly than desirable; the macro fundamentals are good; and if we should expect the unexpected, then maybe we will see real progress in structure, institutional and governance reforms in the coming years; and if this conference is a good harbinger of the future, we'll see a lot of cooperation among the international institutions.

Thank you!