

How Capitalism Was Built and the Current Financial Crisis

Anders Åslund
Senior Fellow

Peterson Institute for International Economics
FOR, Warsaw, June 7, 2010

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

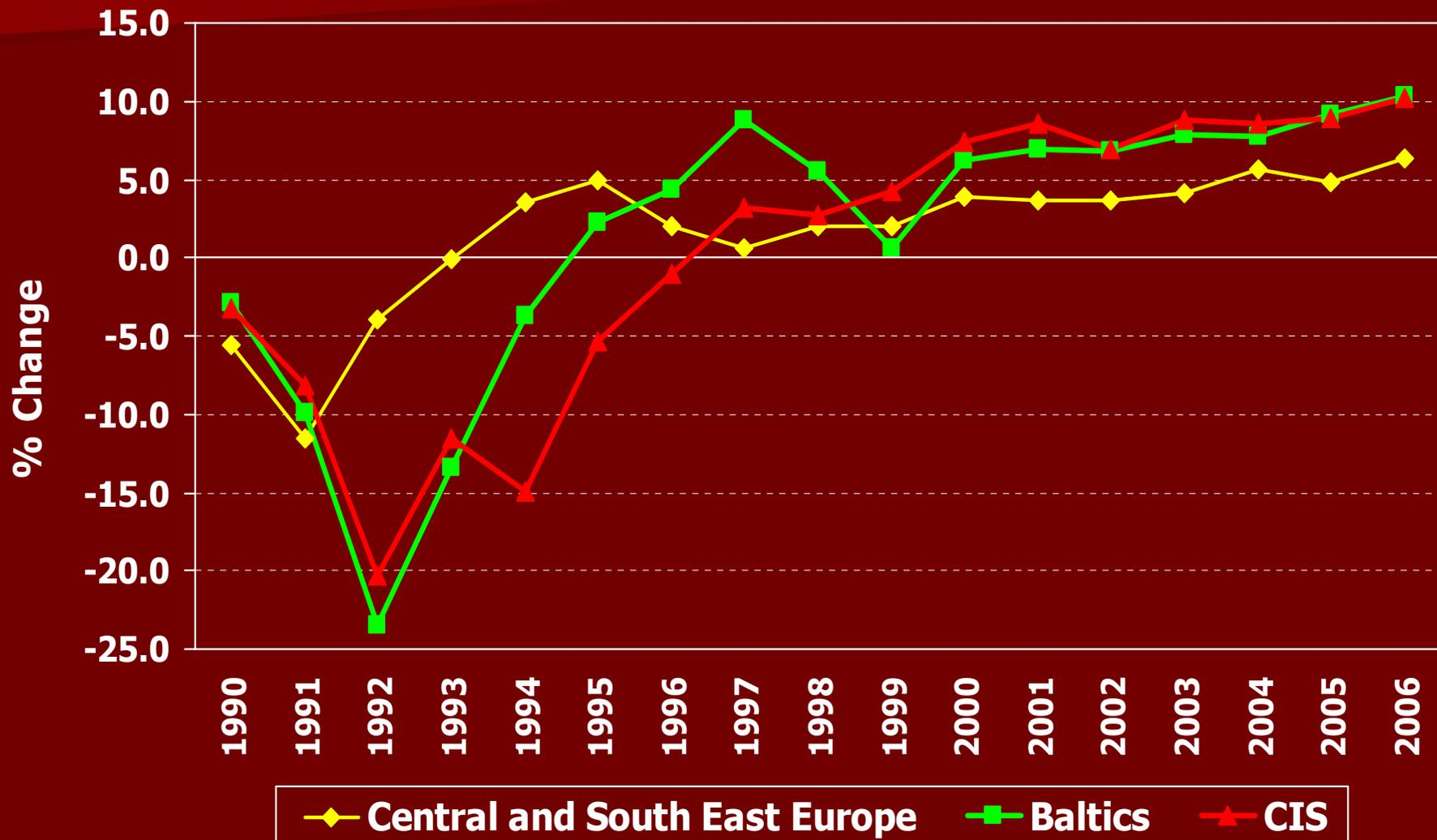
Thesis 2: We Do Not Know How to Build a Democracy

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

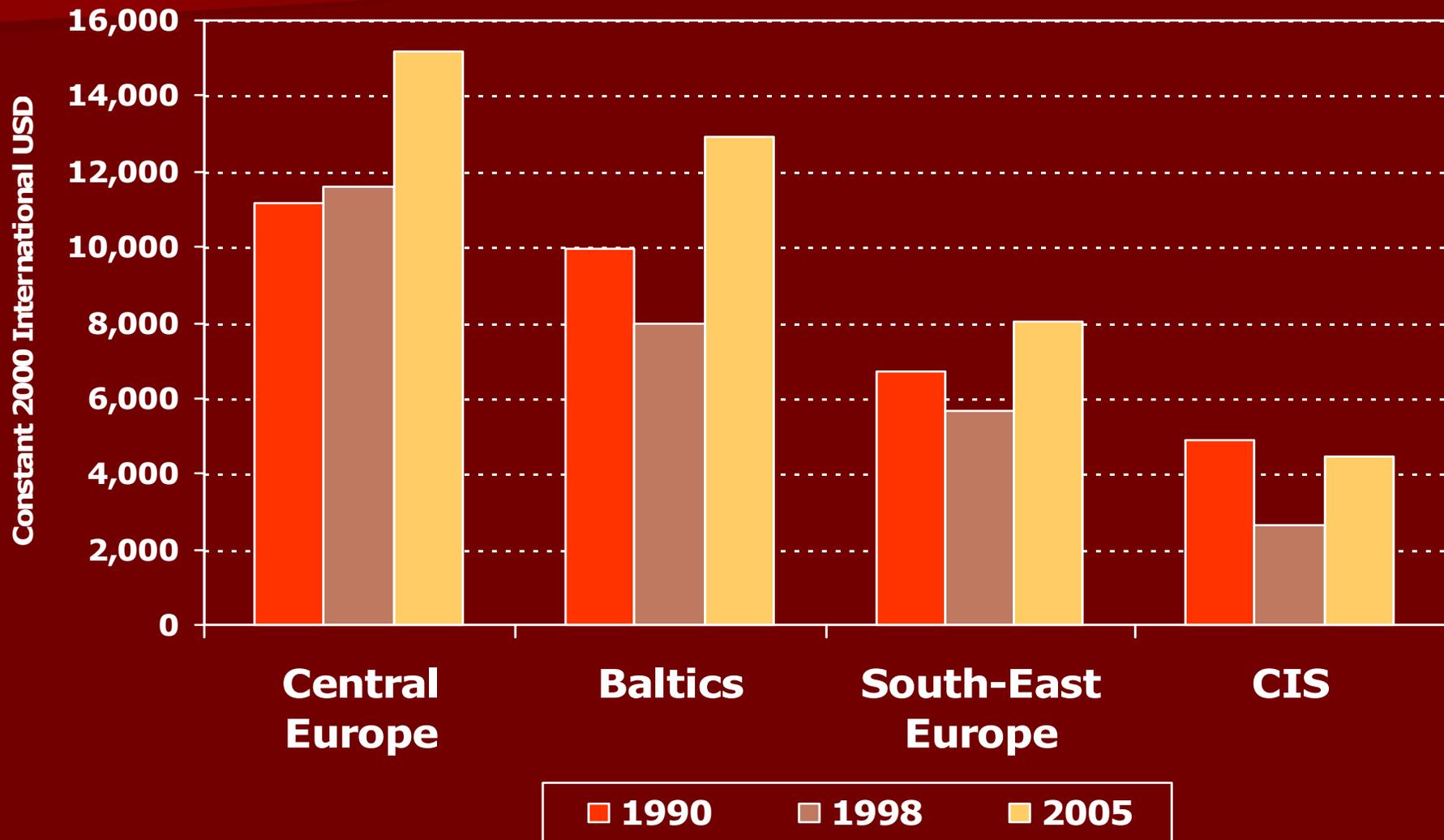
Official GDP Growth:

1. Collapse Bred Misery

2. Capitalism Brought Growth



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

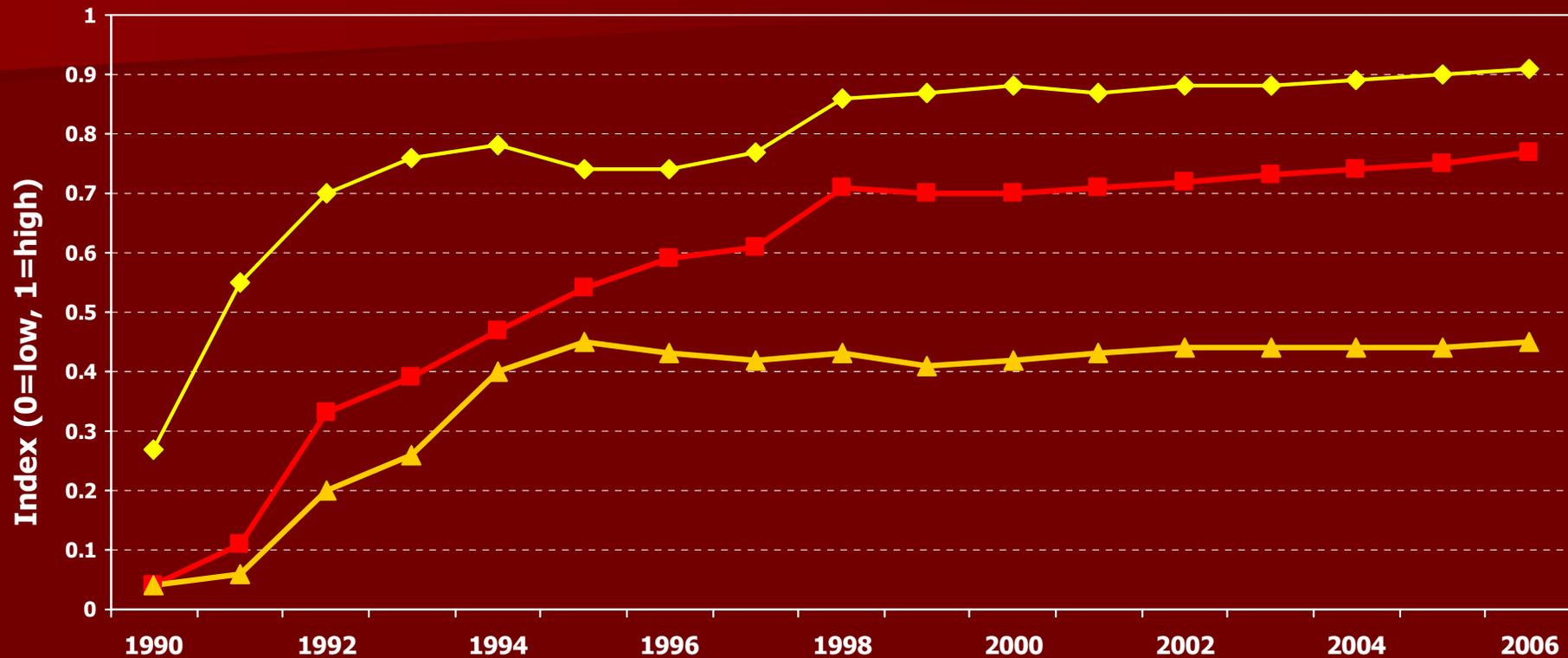
- Gradual Gorbachev reforms bred extraordinary rent-seeking

Cure:

Radical, Comprehensive Reforms

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

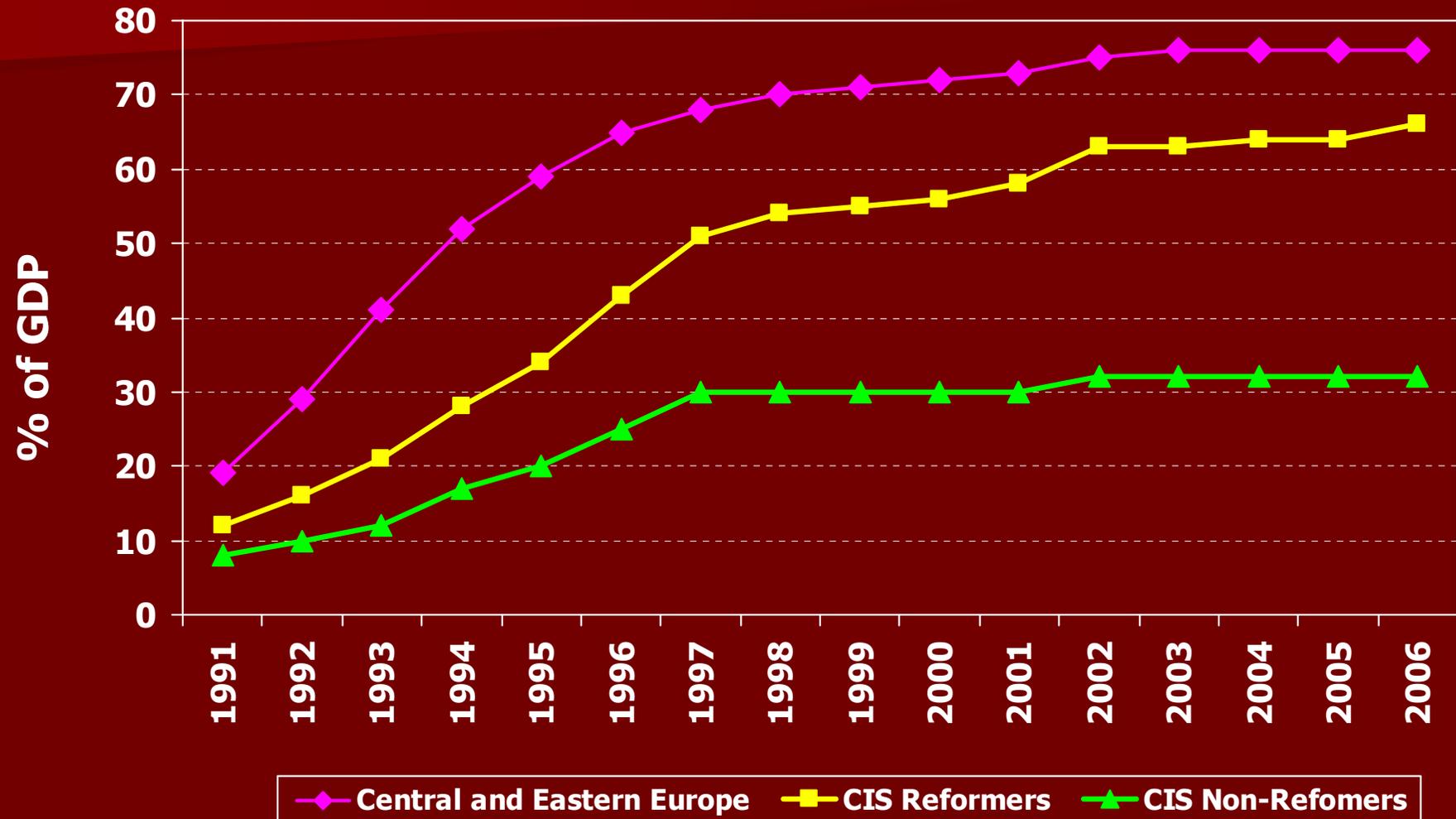
Structural Reform Index: Early Reformers: Early Growth



- ◆ 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



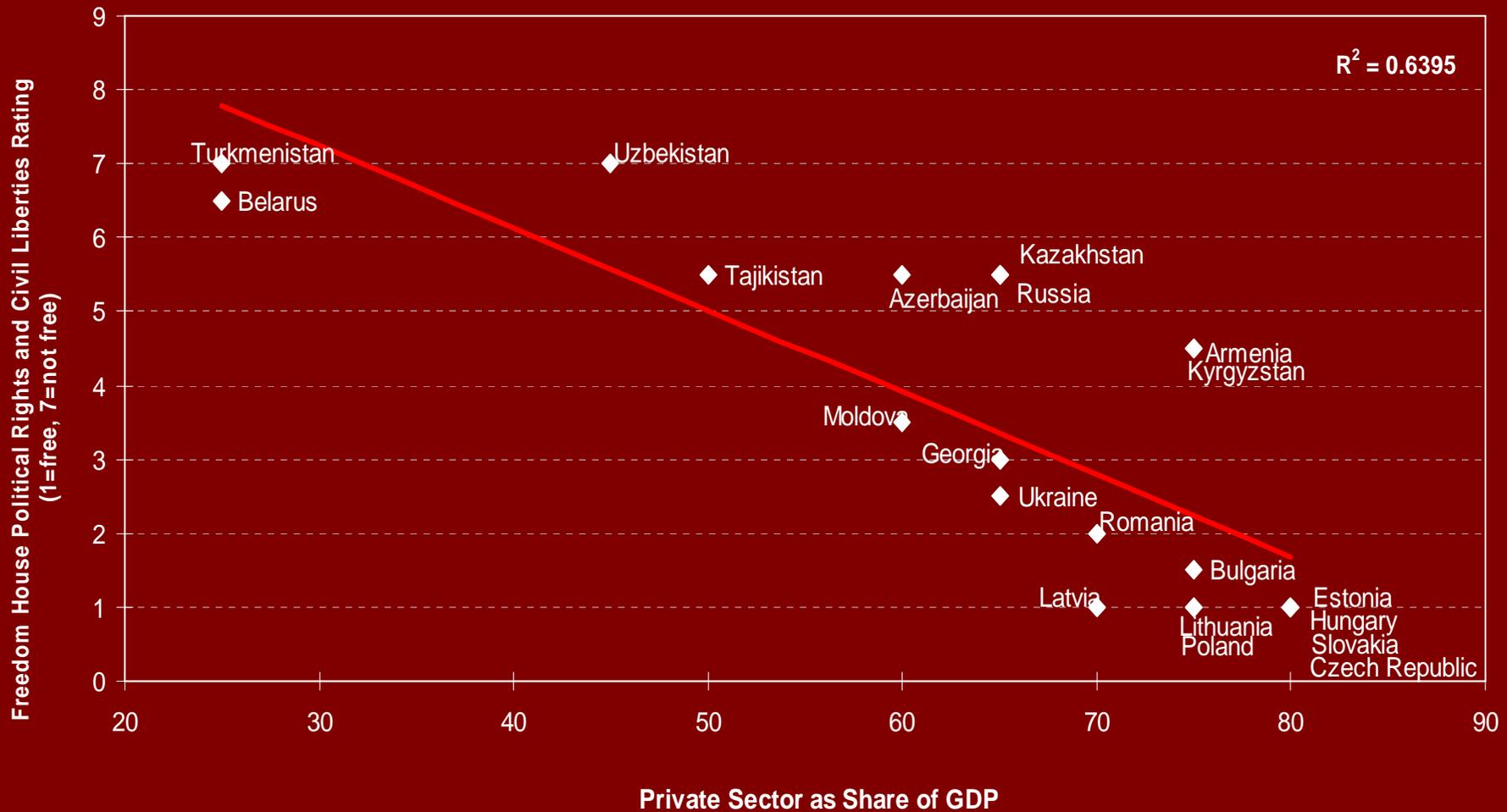
Has Privatization Been Overdone?

NO

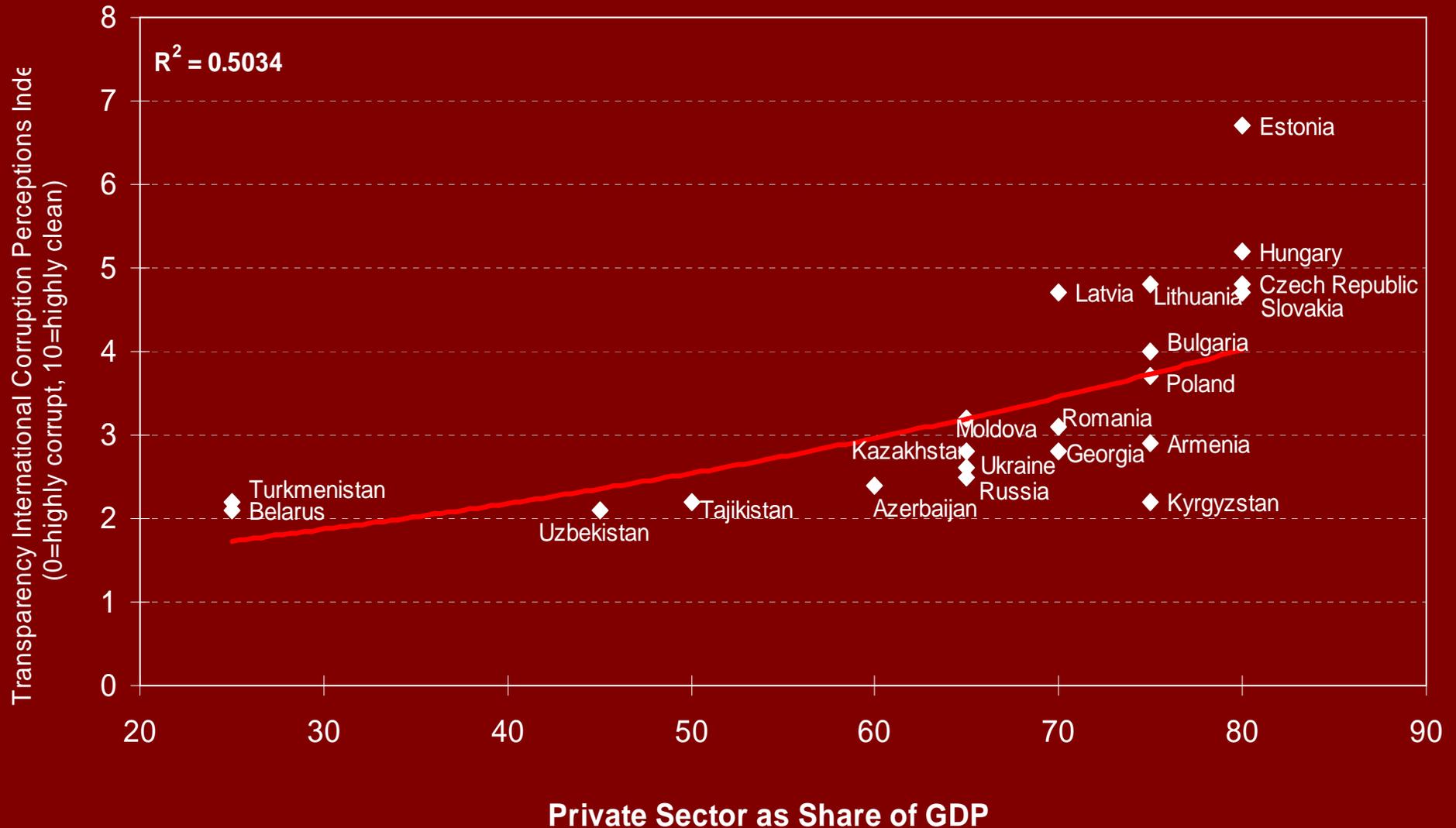
Predominance of private sector:

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

Democracy and Privatization go together, 2005



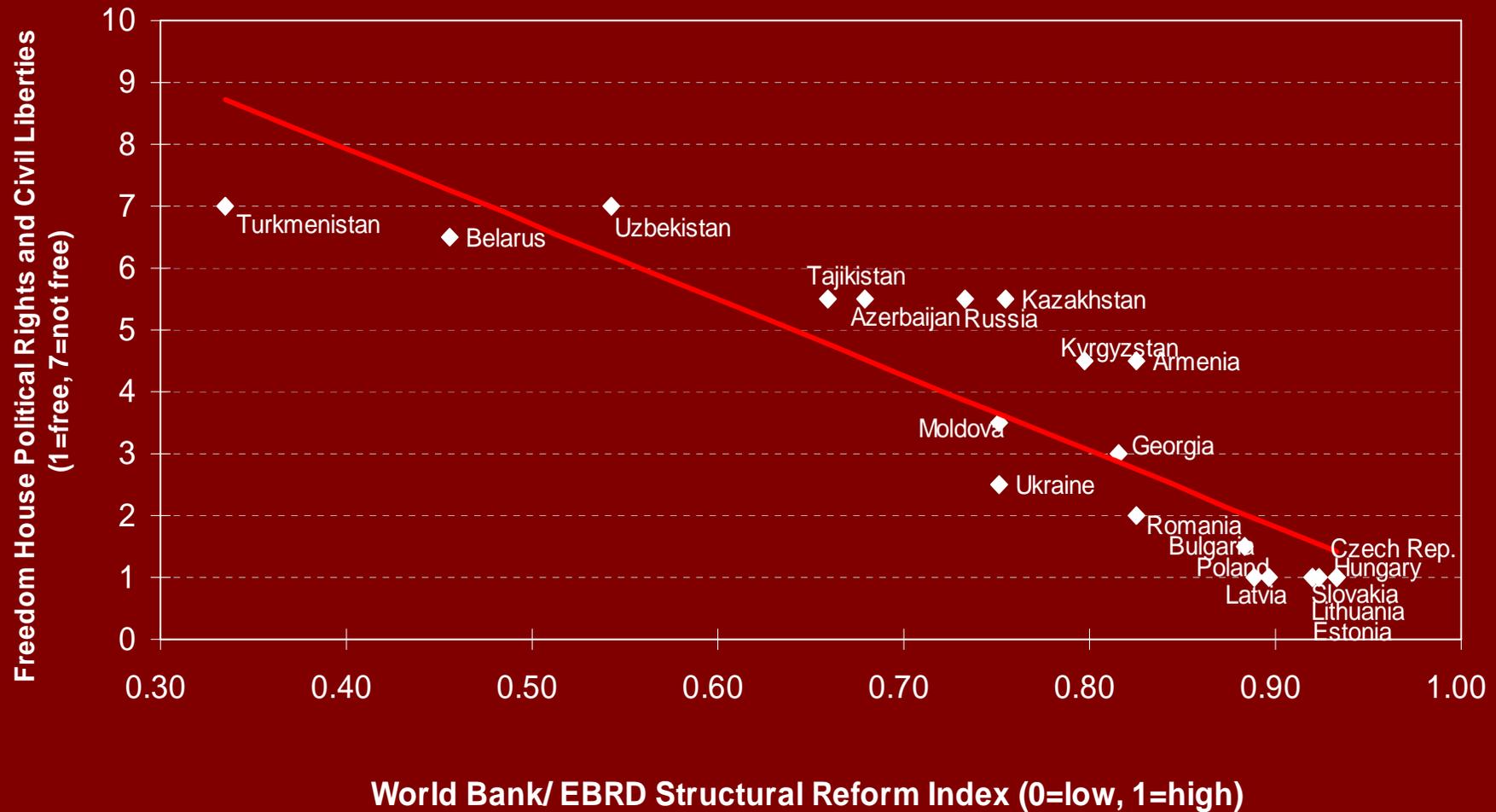
More Privatization = Less Corruption, 2006



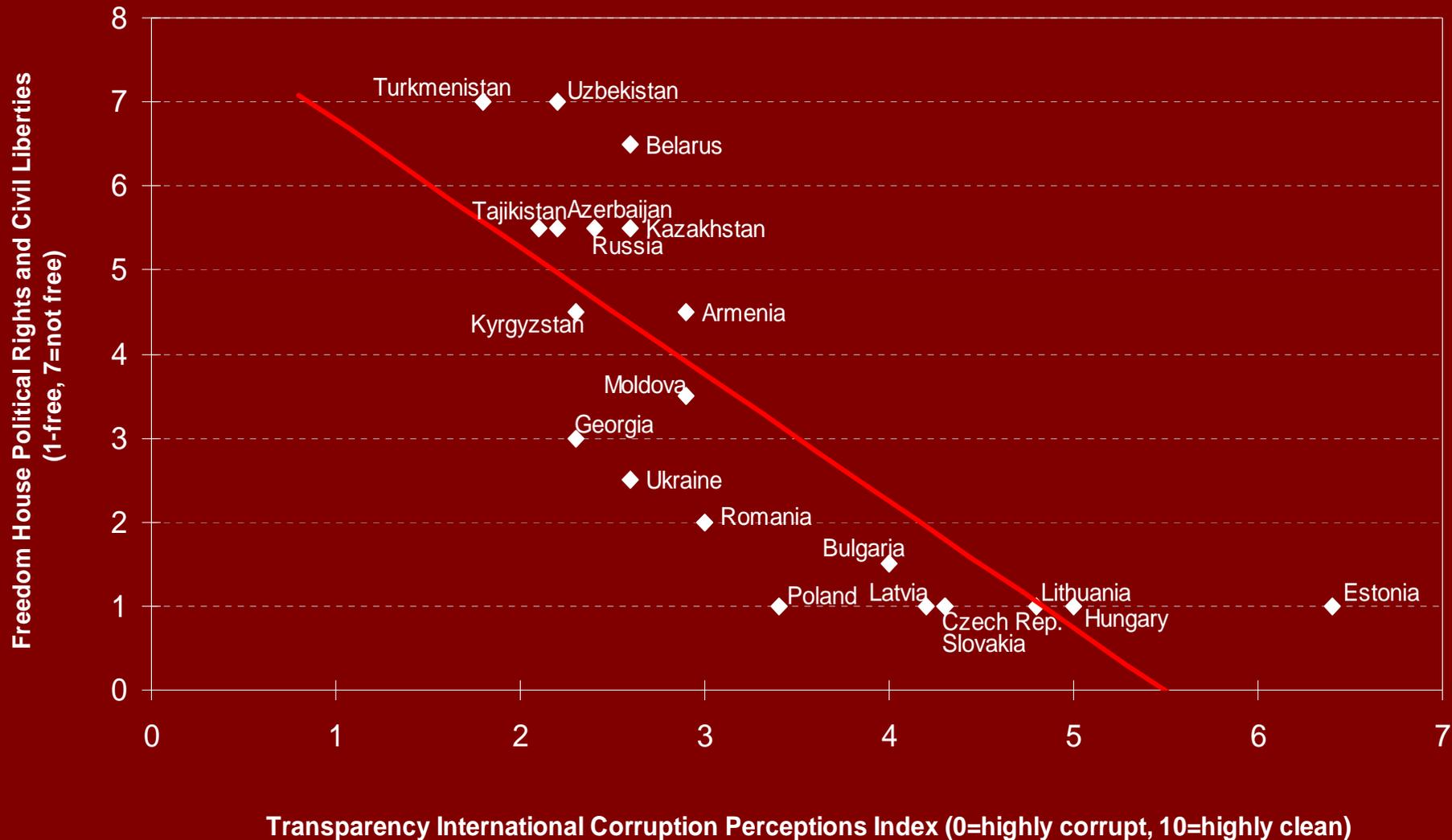
Democracy: Best Weapon against Rent-Seeking

- 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



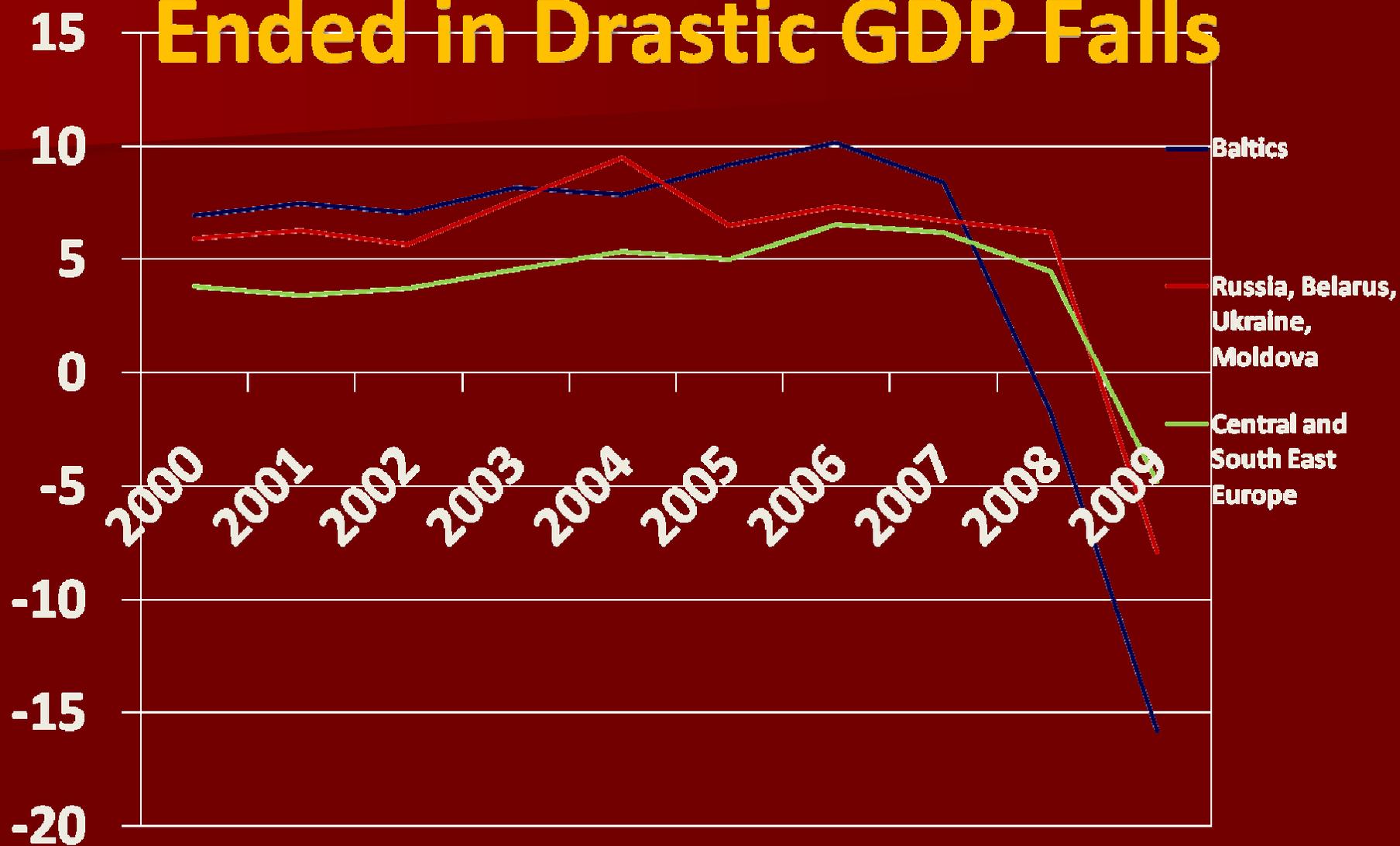
Is the European Union the best solution? - Probably

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

Current Financial Crisis

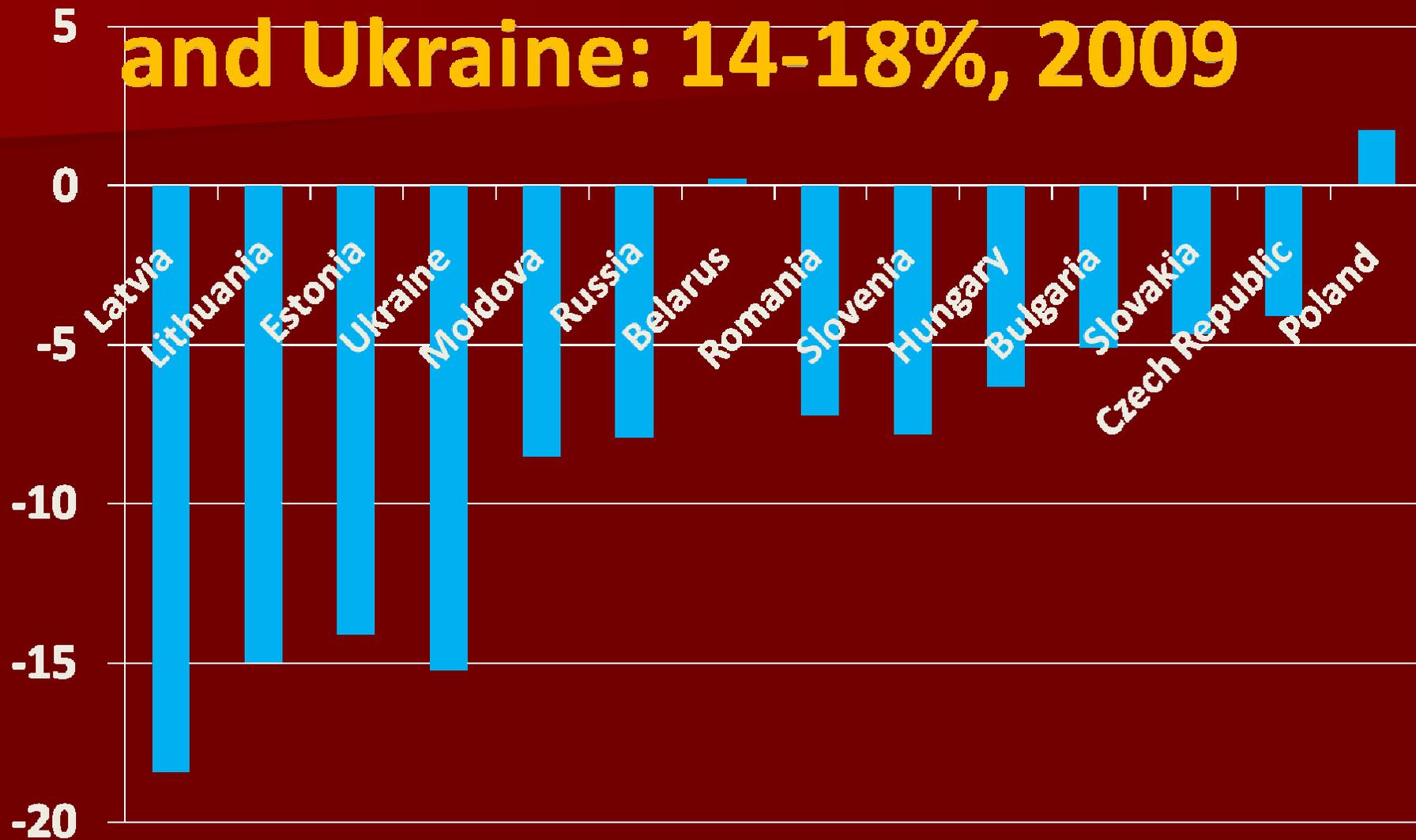
- Global overheating: loose monetary policy and financial regulation
- Global imbalances
- Issues: exchange rate and leverage, not transition itself

A Long Boom 2000-2008 Ended in Drastic GDP Falls



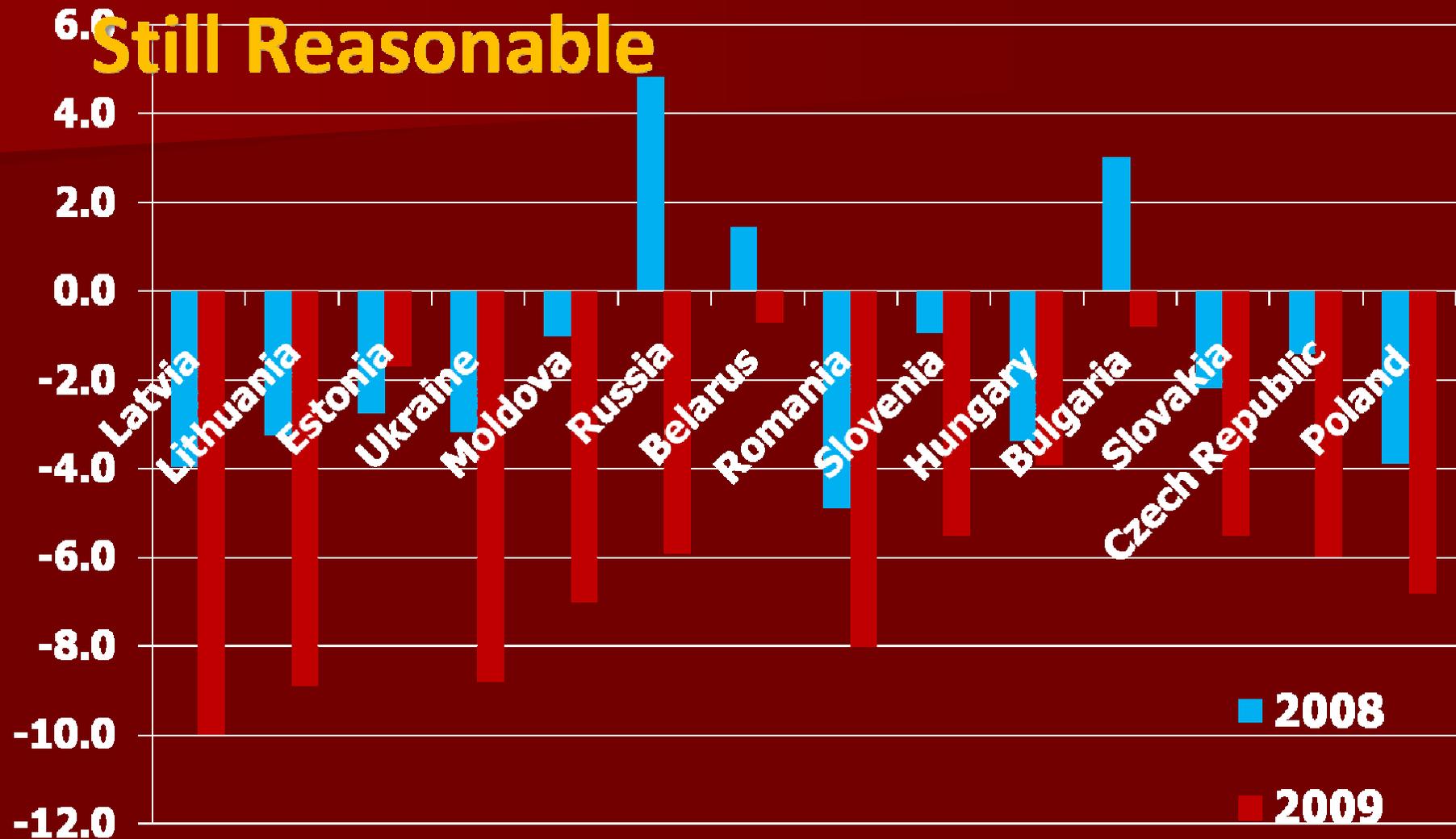
Source: EBRD, IMF, JP Morgan, CISstat, Eurostat

Big GDP Declines in Baltics and Ukraine: 14-18%, 2009



Source: 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