CHAPTER – III

THEORETICAL BACKGROUND OF THE TRANSITION ECONOMIES

3.1. Background of Transition in Eastern and Central European Economies in 1989

3.1.1 EBRD’s Indicators of Transition
3.1.2. Research on Economies of Transition
   i. Path of Transition Economies
3.1.3. The Importance of Transition for Economies
3.1.4. Pre - Transition Economies and initial Conditions in Eastern and Central European Economies

3.2. How Transition process began in European Countries

3.3. How European countries have achieved consistent Economic Growth and Development: Successful stories of some Transition Economies.

3.4. Lessons that can be drawn from European Economies

3.5. Conclusion
“Perhaps the most useful criterion for assessing success in the transition is the sustainable recovery of output, which can be achieved only by controlling inflation and liberalising markets”.

Oleh Havrylyshyn and Thomas Wolf (1999)

3.1. Overview

Economic Transition is a dynamic historical process, imposing change on almost every element of society (IMF, 1999). Since 1989, Central Eastern European (CEE) economies had been undergoing the transition from central planning to free market economy and capitalism (Haslach, 1992). In this process, a number of countries have undergoing rapid transition, while some have achieved only marginal success in this regard. Since, transition economies attached great importance to output growth, the discernable outcome has been the improvement in the living standard of the people of these countries. Privatisation has now become a highly popular concept. The disinvested companies, as also privately owned firms, are generally can seen to outperform State-owned enterprises (SOEs). As a consequence, in middle-income and lower-income countries, privatisation appears to have yielded positive results (John Nellis, 1999).

Governments in transition economies need to choose the most optimum ones from the array of reforms before them. The stylised approach is classified by: (a) Rapid reform, undertaking as many reforms as possible in the shortest possible time; and (b) Change, by way of partial and phased reforms. Each approach is associated with its own characteristic pattern of risks and rewards. A country undertaking economic and political reforms, has before it a range of reform policies and outcomes.

Among the reforms strategies, the all-out approach aims to replaces central planning with the rudiments of a market economy in a single stroke of reforms. These include: rapid price and trade liberalisation, accompanied by an economic stabilisation programme to restore and maintain price stability. Any reform seeks to minimise the duration of the unavoidable pain and quickly sever the links between the state and the productive system to guard against backslide and stagnation. EBRD has identified three main categories of transition objectives which describe how a project may contribute to the process of transition. These are: (a) Structure and extent of markets; (b) Institutions and policies to support markets; and (c) Market-based behaviour patterns, skills and innovation.

Europe’s trade began during the time of Dutch Merchants in coastal India and China, and the trade followed fed a growing European fascination with Asian cultures and
aesthetics. In fact, the historical and economic perspective of both countries had risen which was later on interrupted by the colonial period, Cold War and economic autarky in the twentieth century. Thus, transition economics, well being human life time - it’s shifted to the global economics architecture (Peter Mandelson, 2007).

Let us now consider the Central Eastern European countries. Poland and Czech Republic are the successful models of economic transition. In China, reform began in 1978 with institutional market oriented economic policies, while in India these stared in 1991. Reforms began as a gradual step toward market orientation in India.¹

Table 3.1: Existing Conditions of Transition Economies at the onset of Reforms

<table>
<thead>
<tr>
<th>Region/ Countries</th>
<th>Industrial Sector</th>
<th>Service Sector</th>
<th>GDP</th>
<th>Inflation</th>
<th>Monetary overhang</th>
</tr>
</thead>
<tbody>
<tr>
<td>East-Europe (1989)</td>
<td>Stagnant</td>
<td>Stagnant</td>
<td>Stagnant</td>
<td>Moderate to high</td>
<td>Considerable</td>
</tr>
<tr>
<td>India (1991) Democracy</td>
<td>Growing</td>
<td>Booming</td>
<td>Growing</td>
<td>Moderate</td>
<td>Low</td>
</tr>
<tr>
<td>China (1978) Communist</td>
<td>Booming</td>
<td>Growing</td>
<td>Growing</td>
<td>Low</td>
<td>Considerable</td>
</tr>
</tbody>
</table>

Table 3.1; explain economic indicators of Europe, India and China. In China’s case it was the manufacturing sector. India services sectors export-led growth brought about a painful economic change in Europe. The successful completion of the Doha Round and the maintenances of the WTO agreements, led to be an effective integration with global trading. Thus, global trading system helped to establish reciprocal access to their growing markets since of EU exports is a key system dynamic EU trade policy.

Europe and China at the initial stage of transition negotiated on trade and entered into investment agreement on certain issues which it would ensure a significant role play by China and key focus of resources for EU trade policies for the predictable future. By the decision of FTA with EU, and later on India had helped reduce many of the barriers. India also an encouraging European investment that can be an import sources for capital for India.

¹ More detail, since 1989, Central and Eastern European Countries including Poland and Hungary, have been in the process of transition from planned economies by the agreement of G24 countries (group of 24 Countries in the Development Assistance Committee of the Organization of OECD and International Organization), Japan provided assistance to these countries for transition. The transition in Poland, Hungary, Czech Republic and Slovakia has shown significant progress and joined the OECD. However, N.A Khan et. al., (2009), discussed the aftermath of introduction of market-oriented reforms in China, market-oriented policies by India by the agreement of IMF, World Bank.
Although European public policies have addressed the need to face the impact of economic change and adoption, it would also be require comprehensive demonstration of reciprocity from India and China. EU trade policy is the means of both delivering the reciprocity and securing European openness that legitimises the demands EU makes of others. Europe stands to gain hugely from the economics strength by the cheap inputs, and as a source of investment in liquidity-rich global capital markets (Peter Mandelson, 2007).

3.1.1. EBRD’s Indicators of Transition

The European Bank for Reconstruction and Development (EBRD) has developed a set of indicators which are used to measure the degree of transition in a market economy and the progress of transition. The classification system was originally created in the EBRD’s 1994 Transition Report, but it has been refined and amended in 1998. With the help of these indicators, EBRD measures the level of transition of the economies as: less, high and complete transition. The main EBRD’s transition indicators are:

- Large-scale privatisation
- Small-scale privatisation
- Governance and enterprise restructuring
- Price liberalisation
- Trade and Foreign exchange system
- Competition policy
- Banking reforms and interest rate liberalisation
- Securities markets and non-banking financial institutions
- Infrastructure reforms.

3.1.2. Research on Economies of Transition

When the Berlin Wall was brought down on November 9, 1989, thousands of people expressed their joy as they felt that the wall stood out as a symbol of the division of Germany. A sizable number of economists have been studying the process of transition from socialism to capitalism in the former socialist economies. The field is called-‘transition economics, or transformation economics’. This process, interesting for research on transition, has grown over time, but the main focus is on transition policies. It was mostly dominated by policies which had attempted to influence various aspects of
economic transition policies. The overall transformation of the economic institutions in the countries concerned has brought about a complete change in the economic condition of the people. In the 20\textsuperscript{th} century, transformation is tremendously influenced by technological progress. Research on the subject—both theoretical and empirical has increased. Further, for research on Europe, the Centre for Economic Policy Research (CEPR) has set up, together with its traditional programme cells, divisions to study areas, such as international macroeconomics, industrial organisation, trade, public policy finance, and labour. Also, a number of economic research institutions was established. These include the Center for Economics Research and Transition (CERT) at Heriot Watt University in Edinburgh and the Stockholm Institute for Transition Economics (SITE) at the Stockholm School of Economics.

As we are into the second decade of the third millennium, there still remain the major challenges of bringing about prosperity and growth, and well-working market institutions in the poorest countries in the world. The capitalism objective is to improve the level of prosperity and development as in the advanced industrialised countries.

Though academic research has been increasing in the area of economic transition, many policy advisers feel that transition economics still remains a subject of controversy. It is noteworthy that, while transition policies have been largely unsuccessful in Russian, these have been very successful in China. The Title of some books on Russia, are: \textit{How Russia Became a Market Economy}, Aslund, 1995; \textit{The Coming Russian Boom}, Layard and Parker, 1996; \textit{The Success of Russian Economic Reforms}, Granville, 1995; Gerard Roland, 2009. Open debates and serious research are, therefore utmost importance of to help formulate adequate policies for a successful transition to capitalism (Gerard Roland, 2000).

\textbf{(i). Path of Transition Economies}

The transition strategy is being adopted by developing countries to improve their status from poverty to wealth and to help “developing and transitional countries ‘jump from the kingdom of necessity to the kingdom of freedom’”. After that, countries sought to develop ‘a Comparative-Advantage Defying’ (CAD) strategy”. The developing countries leaders desired to catch up with the developed countries, but that was not always possible due to scarcity of resources. Although under-developed countries have relative abundance of labour and natural resources, these countries were diverting resources away
from labour-intensive industries towards capital-intensive ones (iron to steel). Initially, East Asian governments did not choose a CAF-strategy but later on adopted that due to resources constraints and spontaneous development. The faster way to achieve that goal was to employ Soviet style planning and, if did not survive the CAD strategy, the other substitute was “Comparative Advantage Following (CAF) strategy”, based on a bottom up development model which creates a higher value for consumers. The comparative advantage is required for getting rid of distorted prices, liberalising trade, and allowing the non-state sector to grow. It was like successfully emerging market economies, especially in East Asian countries which faced ‘backwardness’ only when they adopted a CAF strategy and opened their economies to foreign trade and investment. Lin at recognised that strict adherence to a CAD strategy that dominated social thought at that time - resulted in spreading government failures in developing countries. After that, he advocated seeking seek the alternative strategies for measuring the CAD strategy, which he calls a “Technical Choice Index (TCI)’. CAD strategy has less economic freedom and more corruption and has a volatile economic growth, inequalities than in countries that adopted a ‘Comparative Advantage Following’ (CAF) strategy”. Lin does not fully support the so-called Washington consensus – a list of policy recommendations for transition economies.

“In the long run, the aggregate of decisions of individual businessmen, exercising individual judgment in a free economy, even if often mistaken, is less likely to do harm than the centralised decisions of a government and certainly the harms is likely to be counteracted faster”.

The fundamental goal of economic development is to make the benefits of expanding open to people. By allowing the politicalising of ‘coordination’, such decisions reduce economic freedom and increase the power of governments. Hong Kong’s is the freest economy in the world because it has limited government and trade liberalisation small government and big market. The Scotsman, Adam Smith and Hayek spoke about the ‘importance of freedom and the ability of markets to self-correct through myriad adjustments’. East Asian economies were able to take advantage of their ‘backwardness’, only when they adopted a CAD to CAF strategy and opened their economies to foreign trade and investment, with the following aims:

- To provide incentives to follow a CAF strategy by granting state owned enterprises (SOEs) more autonomy.
To shift from single-track price system to allocation system to a dual-track system,
To allow full liberalisation in those sectors that are firmly on the market track, and
To undertake legal reforms ‘to strengthen market institutions’ during the transition process.

3.1.3. The Importance of Transition for Economics

The above theories explain the process of economic transition function and reaction to reforms and large-scale transformation. Successful institutions of capitalism are already present in advanced economics, while in developing economies, such institutions are absent. The transition experiences have helped to accelerate various changes in the economies. In the initial stage of transition, the policy advice in Washington consensus, laid strong emphasis on: (a) Liberalising prices, (b) Tight monetary policy and balanced budgets to stabilise the macro economy; and (c) Privatising state-owned enterprises, in order to induce profit maximising behaviour. However, transition has forced us to think about institutions not in a static, but in a dynamic, way.

In reality, nobody can tell for sure how transitional the transition is, or whether the countries engaged in this process will end up transformed into successful capitalist economies. However, development policies were formulated decades ago, with the objective to ‘help the under-developed economies to catch up with the industrialised countries’.

The outcomes are strongly dependent on the initial set of institutions that from the starting point of transition. The necessary transitional devices adopted by Chinese for more successful transition include, as a dual-track liberalisation and Township and Village Enterprises (TVEs) (Qian, in press, Roland, 2000). However, the question arises whether such measures are stepping-stones towards better institutions or have they created vested interests that block further institutional transition. Institutional perspective, research in transition can help to improve: (i) Understanding of capitalism; and (ii) Large-scale institutional changes. Transition is clearly narrower and can even partly be seen as a subset of those fields. Economic Transition is a history in the making and will sooner or later become a sub-field of economics theory. However, research on transition cannot
develop successfully purely as a field of its own. It must be developed in interaction with various other fields of economics to gain from the various angles provided by the different fields of specialisation. Research on transition can then be simply broken up to the appropriate fields of specialisation–macroeconomics, industrial organisation finance, trade etc.

**The main objectives of transition:**

Objectives:

- To improve allocation efficiency and the creation of a competitive market environment open to the world economy.
- Stabilise the macroeconomics, which is necessary for correct functioning of the price mechanism.
- To provide better incentives and corporate governance arrangements, through, encouragement of entry of new private firms and the creation of an entrepreneurial class.
- Creating government institutions “adequate” for a market economy. For running the institutions, there is need for political and institutional stability and protection of private property rights from encroachment (EBRD).

3.1.4. Pre - Transition Situations

is only one of the dimensions of transition in large-scale institutional changes. In addition, transition must have change without economic disturbance, and continue to fulfill the population’s needs. To sustain the magnitude of the changes implied by transition; political support needs to be continuously maintained during the reforms process, to avoid policy reversals (Gerard Roland, 2000).

The post-1989 experience in China is that the political and economic circumstances differed from that of Europe. Kornia (1993), and other economists stated that before 1989, many did not predict the output fall. However, there were good surprises of restructuring inside SOE’s. Many economists advocated fast privatisation, because of the fear that the alternative of no privatisation, or slow privatisation, would be much worse. Although a few years after the Communists had been evicted from power by the democratic revolutions of 1989, former Communists came back to power via the ballot box in Lithuania (1992), Poland (1993), Hungary (1994), and Latvia (1994). Though the successful development of the non-state sector, especially the Township and Village Enterprises (TVEs), came as a surprise because of its unclear property rights structures, accepting the fact that it should not distract us from knowledge and understanding of transition processes still remains limited and happens mostly “after the fact”.

b. Initial Transition Situation

An important fact about socialism is that there was not really a consistent plan at the level of economy. Planning was not only an iterative process, but also a cumulative one. The point of departure for the plan in period t+1 would be the achieved level of production in period t. Planning is an incremental process, known as “planning from the achieved level” (in Russian Planirovanie to Dostignutogo Urovnia, Birman, 1978), it consistently aims to achieve a general equilibrium. Ministries not only played a crucial role in planning, but also tried to response to perceived shortages by enterprises. Thus, this mechanism played a key role in preventing general output collapse in the absence of markets.

Socialist economies, indeed, had a history of market-oriented reforms before the fall of Communism. However, the most immediate consequence of such reforms was

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2. To create development markets, including financial markets, enforcement of property rights, legal and political changes along with enterprise privatisation and restructuring.
wage drift and soft budget constraints prevailed, in enterprises under reforms under socialism. These increased pressures from below led to a further weakening of the planning system and of the central authorities who yielded to demands of enterprises. An increase in enterprise demand started leading to serious macroeconomic imbalances that the “classical” socialist planning system had been able to prevent. These consequences were: increased foreign borrowing or increased shortage and forced savings. Some countries have had a history of reform before to transition and faced to serious macro-economic imbalances. These called for a stabilisation package, like the one adopted by Hungary, Poland and Yugoslavia. Other countries like German Democratic Republic, Czechoslovakia and Romania, that did not have reforms before, had to face issues like imbalances and stabilisation problems in the initial stages of the transition process.

The institutional legacy is different from country to country at the outset of transition. Their dependence on skill helps to rebuilt institutions. The CEE government agency dealing with international trade developed a familiarity with market based contract law. Sometimes, the absence of an institutional legacy can actually be an advantage. On the other hand, implementing new institutions requires large human, technical and financial resources in all countries undergoing the transition process. Thus, due to this, the new states face a massive additional burden.

**Countries that embarked on transition from very different starting points**

- Most reforms are inherently slow. Though formal privatisation was accomplished in one or two year, fundamental changes mean that large firms usually take a long time to stabilise.
- The second model of piecemeal and phased reforms starts with localised experiments, which are expanded, as anticipating successes emerge. This strategy relies on this big scope to gain large productivity gain from the very beginning, in partial reform. As a result, as incomes rise, there is need to build momentum for further, more difficult, reforms in a self-reinforcing manner so as to be able to sustain the reform over an extended period. This approach was summarised by Deng Xiaoping’s phrase, “feeling the stones to cross the river”. Moreover, the path followed by China, in the initial reforms in 1978, was to open the door to joint ventures. After that, reforms concentrated on the rural economy. The household responsibility system, new rural township and village enterprises (TVEs) emerged and were encouraged to operate on market principles. By 1984, reforms had
spread to the urban economy. Trade and foreign investment reform were then launched. Reforms had accelerated in 1994 and 1995, particularly those concerning taxes, company law and foreign trade.

There are two model routes in a planned economy. However, this does not mean that all countries are in a position to choose between them. Let us examine the Soviet experience in the regards:

- The earlier attempts at partial reform, in the country failed to raise efficiency, largely because they were restricted to only some countries.
- The second, more important reason why gradualism was not an option in CEE and the Soviet Union was that, by the second half of the 1980s, the Soviet planned economy was disintegrating from within. In 1986, the Soviet Union launched political rehabilitation and economic restructuring. These led to inflation and foreign indebtedness - rather than higher productivity.

Thus, beside the factor of macroeconomic disequilibrium for choice of reform path, the influence of political, historical, culture and geographic factors can also be very important. In China, the Communist party emerged mainly from internal political movements.

3.2. How Transition process began in European Countries

By the beginning of the 1990s, the continent of Europe found itself completely shaken up by political and economic upheavals. The fall of the Soviet Bloc, which had divided the continent for over four decades, brought about a completely new economic order, with the hitherto Soviet Bloc making the transition to capitalism. Central Eastern European countries transformed their economies in the early 1990s. In the process of economic transition, a stimulating period of capitalism followed. The end of the totalitarianism was seemed as the beginning of a new golden age of economic prosperity.

The combination of socialism and capitalism was inspired by the economic system of Western countries, such as Sweden and France, which has been relatively successful in combining the advantage of socialism with the dynamics of the free market. Although they risked popular discontent and many years of economic austerity, most countries found that the only way to overcome decades of economic mismanagement was transition to a free-market economy, with currency convertibility and the markets were to
be allowed to make all the decisions - no matter how painful (Randy Charles Epping, 1995, pp.104-106).

3.2. a. An Evolution of European Economies in Transition

In European, the stronger expression of popular discontent in 1989, was the fall of the communist regimes. The people of Eastern Europe were unhappy with the economic inefficient system. This led to revolt against the socialist system. After the Second World War, Communist Eastern Europe was largely on the periphery of Western European economic development, whereas the rests of the regions were largely undeveloped. The Second World War had led to large scale destruction. Later, the Communist Party assumed power and was very successful in rebuilding the economic infrastructure and to bring a higher rate of economic growth during 1950-1973. However, 1973 onwards, the picture changed drastically. During in the 1980s, governments were struggling to stave off the recession. The early 1980 saw three significant issues specific to Eastern Europe, which made it that much more difficult for the Communist regimes to survive. These were (i) Eastern European countries had a centrally planned economy, which meant that all attributes would be controlled and allocation of resources done accordingly, (ii) In 1970 and early 1980s, the economics of Eastern Europe had maximised their ability to supply the technology and services, that would lead to sustained economic growth. The East European states had to turn to World markets, and (iii) The third issue that made it difficult for the East European Communist government to respond to the worldwide Economic slowdown of the 1980s, was that all their economies were connected to Soviet economy, both through trade and joint ownership of enterprises.

These economic problems of the 1980s put significant pressure on price control. Therefore, Communist governments had raise prices suddenly. These events led to the creation of the independent trade union solidarity in 1980. On the positive side, infant mortality rates dropped to nearly one-third in most of the regions. Prior to the mid-1980s, these governments were neglecting the issue of environment to industrial pollution and environmental degradation. Many opposition parties in Eastern Europe in 1989 launched environmental movements. Thus, the Communist regime fell and these states began the transition to a capitalist economic system. This kind of pressure played an important role in the break–up of each country (Center for History & New Media, Powered by Omeka, 2007-2010).
One of the reasons for the failure of these countries was the absence of market institutions, which made it difficult to construct appropriate political, legal economic and commercial structures needed for a free market economy (Blawatt, 1995; Tyson et. al., 1994; Smallbone and Welter, 2001; Mugler, 2000; Warner and Daugherty, 2004). Other European countries had a large number of entrepreneurial, small business activities and a strong private sector (Blanchflower, Oswald and Stutzer, 2001; The OECD observe, 1999).

**Progress and Outcomes**

Outcomes of progress can be discerned by assessing different paths of reforms, initial conditions and history, politics, economics and institutional starting points. To assess progress, we shall now look at some of the broad dimensions: liberalisation, property rights and private ownership, institutions and social policies:

(i)  *Liberalisation:* its covers three areas domestic price and markets, foreign trade and currency convertibility, and openness to new business entry. In 1995, newly countries in CEE and the NIS were essentially market economies, with open trade, current account convertibility, and liberalisation policies towards new entry and private business. However, one year is for too short a period to capture the economic impact of the process of liberalisation.

(ii) *Ownership reforms:* in this area, these have been great changes. In CEE and the NIS, the private sector now accounts for over half of economic activity. China has also diversified substantially toward a wide variety of forms. The successful transition involves initiating a process of change towards an efficient pattern of ownership, though institutional reforms have also been affected by initial conditions. However, outcomes of transition require both economic grants and social policy reforms.

(iii) *Economics and Social outcomes:* The success of policies depends on the interplay of reforms across a number of areas. Among advanced reforms, vigorous stabilisation programmes have paved the way for reduction in inflation and a resumption of growth as reforms have taken hold. Production has shifted from industrial to service and trade has been reoriented towards world markets. In addition, FDI inflows have risen sharply. The social impact of transition has also been different. Falling output and rising income
disparities has led to large increase in poverty and growing insecurity in many countries.

At the onset of the reforms, there was a great scope for reallocating the labour source. Any study on financial development of the country takes into account the conditions obtaining at the onset of transition. Also, the right reforms mix need to reflect the initial state of affairs.

### 3.3. The Successful Transition Economies Experiences: Poland, Czech Republic

Transition from a command economy to a market oriented economy is a dynamic and difficult process that involves several stages of transformation. These transition stages differ, based on the political and socio-economic background of individual states (Rita O. Koyame-March, 2011). Towards the end of the Cold War, the World seemed poised to fall into another deep seated polarisation, in between developed and the developing world. This approach can help in bridging the gaps in standards of living and employment opportunities and social security for the citizens of the countries concerned.

The new bipolarism in the stalled Doha negotiations emerged to provide reforms for global institutions, in the confrontation about human rights and even in the different approaches to fighting terrorism and for building peace and security. Development assistance is at the heart of this new polarisation. Policy makers argue that it would lead to global disarray. The third approach aims for development assistance policies to explain the effectiveness of the Official Development Assistance (ODA).

Three main indicators affect the relative success of a transition processes. These are: historical background, initial conditions and reform policies initiated towards the transition (Rita O. Koyame-March).

**The secret of European Success: towards a New synthesis**

There are two common threads that can be seen at work in all cases of success, and that can be spelt out in the argument as the main factors explaining the effectiveness of aid in relation to growth. These include: (a) Aid promotes economic integration, i.e.,

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3. (i) DA stimulates and supports the integration of national and local economics at the international level; both globally and regionally.
(ii) Determines institutional reforms and sound economic policies at the appropriate level of government (global regional, national and local), and leaves the private sector to play its fundamental role.
the elimination of barriers to economic activity, the enlargement of the market and its smooth functioning; and (b) The application of the subsidiary principle, in that aid stimulates private players (business and civil society), and evolves responsibility towards the lower level of governments. In addition, subsidiary implies that “institutional assignment”, i.e., taking policy decisions in the level that is appropriate for that decision (Abdu Chowdhury, Paolo Garonna, 2007).  

The Central and Eastern European countries (Poland, the Czech Republic, Slovakia and Hungary, known as the Visegrad four) have rapidly transformed their economies to the point where the transparency of the legal structure provider relatively easy access to CEEC resources and markets; and the prospects for medium, long term stability and growth (Richard, E Stern, 2008).  

Many studies concluded that the three central European countries - Czech Republic, Hungary and Poland - are the success stories of transition (Vladimir Popov, 2009; Rita O. Koyame - Marsh 2011). However, the successful transition economies chosen for this study are: (a) Poland, and (b) Czech Republic.  

Figures 3.1, 3.2 & 3.3, depict the transition indicators during the period of 2005 – 2011 in Poland and Czech Republic. Poland’s GDP growth rate and inflation has been fluctuating over the period and especially in 2008-2009, trends decreased due to the financial recession. Czech GDP sharply declined in 2007-2009, and inflation rate also decreased during the recession period. One other important indicator, i.e., unemployment rate steadily decreased in 2007-2009. However in 2010, the unemployment rate trends appreciated. FDI trends are gradually declining in recession period in both countries. In 2010, Czech Republic FDI net inflows sharply raised , while in Poland, FDI trend was sluggish moving up. Table 2 explains the economic indicators of both countries. We can also be seen from table; (Appendix-3.I).  

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Figure 3.1: GDP growth % and Inflation rate from 2005 - 2011

Sources: IMF, 2012, P = Poland, C = Czech Republic

Figure 3.2: Unemployment Rate (%)

Sources: IMF, 2012.

Figure 3.3: FDI net inflows (% GDP)

Sources: World Bank Indicators, 2012.
(a). **Poland:**

During the 1990s, Poland had become the transitional ‘Guinea Pig’ for Big bang/shock therapy and it adapted rapid and comprehensive reforms, to bring about macroeconomic stabilisation and tackle the near hyper-inflation. In 1989, inflation was very high in Poland. The “Secret” of Poland’s success, is that it was the only country in Europe without recession in 2009. The potential of performance economic characters, such as: (i) Strong market institutions (ii) A resilient economic growth, (iii) Strong economic policies during crisis situations; and (iv) High levels of trust in the government was very much in evidence.

**Liberalisation of Prices:** On January 1st 1990, most prices were liberalised. After 1990, 90 per cent of prices were determined by the market and there was significant increase in controlled prices as well (Balcerowicz et. al., 1997; 138). There was a high degree of encouragement for hard currency exports (a surplus on the convertible currency current account of the balance of payments was achieved in 1990). Poland is generally regarded as proof of the virtues of rapid and comprehensive change (in November 1996, Poland become a member of the OECD). The first stage of stabilisation in the beginning of 1990 was quite successful in bringing down monthly inflation of 30 to 50 per cent to 3 to 5 per cent. Unfortunately, due to political instability and untimely loosening of monetary and fiscal policies, the inflation control process in subsequent years was rather slow (Balcerowicz et. al., 19997; 142). On March 11, 1994, Poland and the London club of Commercial banks signed an agreement in principle to reduce (by 42. 5 per cent) and reschedule the $ 13.2 billion debt over a thirty year period. However, Poland is one of the EU’s lowest personal and corporate tax regimes within five years, following parliament approval of a controversial tax-cut package. The tax-cut is a crucial element in stimulating economic growth (Balcerowicz et. al., 19997, p. 276).

The initial pension reforms had a positive impact on capital market development. As a result, these were a rise in saving culture among the workforce. But, mid-2010 opens pension funds were reduced from 7.3 per cent of gross salaries to 2.3 per cent on May 2011. Polish private bond market remained underdeveloped; the government bonds have high liquidity market, which extends to very long maturities. These bonds are important for private and government for a long-term funding (EBRD, 2011, pp. 146).
Labour market reforms: many economists feel that labour market reforms have not taken place in Poland. Employer’s social security payments have been helping to finance one of the world’s most flexible disability pension schemes. Also, social safety nets exist.

Enterprises reforms: Privatisation, in the broad sense, has been quite rapid in comparison with that in other countries. Of course, most growth has occurred due to the efforts of the private sector and state enterprises. Bankruptcy of some large enterprises has been seen, but many of them have undertaken radical divestitures - by selling off or leasing out substantial part of their assets. The privatisation of large enterprises continued to be hampered due to by political uncertainty and change of governments. On March 18, 1993, the Sejm rejected the privatisation programme involving around 600 medium size and large enterprises. The actual member of enterprises on the mass privatisation list has fluctuated. The share of the enterprises was to be allocated in a complex system of lottery rounds, beginning July 17, 1995.

Poland’s growth has been supported by domestic consumption, labour market trends and public investment. During 2010, the privatisation process was accelerated by the government. Privatisation process has continued to move forward due to favourable market conditions, especially power companies, energy sector and the Insurance sector. Public - Private - Partnership (PPPs) law was passed in 2009. Hence, a large infrastructure is required for upgrading the rapid absorption of EU structural funds. Also, for the period, 2007 - 13 (EU) budget gave more focus to structural funds (EBRD, Report 2011, pp. 146).

Foreign Trade: quantitative trade restrictions and export submission requirements were removed in 1990. There have been several upward revisions in imports tariffs after the sharp reduction in 1990 (EBRD 1994: 33). In June 1995, Poland accepted current account convertibility, in agreement with the IMF. The major focus on current account convertibility exits, with limits on residents’ capital account transactions. In 1996, input surcharge was abolished. There is an extensive intervention in the markets for farm products. There are also, price support, export subsidies, credit guarantees and managements of state reserves. The effect of above schemes in Poland is that the country has maintained some restriction on short-term portfolio flows. Initially in 1998, the foreign exchange market was liberalised. Thereafter, the full capital account liberalisation occurred in 2000.
Liberalisation has led to elimination of all restrictions in foreign exchange transactions between banks and non-banks. The EU and other developed markets accounts for more than 70 per cent of foreign trade. In addition, Warsaw Exchange, in 2010, also attracted significant interest from portfolios. The country ranks 70 out of 183 countries in the World Bank’s Business Survey 2011 (EBRD Report, 2011, pp-146).

Macroeconomic stabilisation involved the following:

1. A strict fiscal policy, coupled with drastic reduction in subsidies.
2. A tight monetary policy. The confidence of the financial markets has become reinforced. There is now also greater independence for the banks.
3. Income policy: a general wage indexation was introduced in July 1989, in private enterprises sector. Money wage increase over a centrally progression tax. The 1994 strategy for Poland’ sought to find an agreement on settlements in the public sector through “Tripartite commission”, representing trade union representatives and the government. A multi pillar system operation, encompassing social insurance fund, mandatory pension funds, and additional voluntary insurance, was launched in 1999.
4. The exchange rate was initially used as a monetary anchor. Poland has gradually been able to consolidation the exchange rate, stabilisation controlling regime and even undertook occasional nominal revaluation. As of 16 May 1995, the Central Bank was able to set daily rates within a band of 7% on either side of a fixed mid-rate and to intervene in the interbank foreign exchange market. The Monetary Policy Council, the coordinating monetary policy was helping the country to free the currency from its central bank (p. 27).

Foreign direct investment: In the beginning, FDI growth was disappointing, but slowly picked up pace. In Poland, three to six years extension was granted to priority sectors for large investment in 1993. These were effects in Hungary, Poland, the Czech Republic and Slovakia during the period 1991-93. On March 15, 1996, the country approved the liberalising rules and certain special licences were given to sensitive economic sectors, including financial services, wholesale trade in imported commuter goods real estate and the production of armaments. Also, Poland has opened its first free enterprise zone in 1996.
During 2011, Poland maintained an impressive growth, supported by the exports of industry, and its banking sector remains stable. Additionally, the country is providing a flexible environment for investment, foreign direct investment inflow and portfolio investors (like BoP) (EBRD Report, 2011, pp-146).

(b). Czech Republic:

The beginning of the transition was generally characterised by the tight credit transition. In 1991, total credit growth was lower than inflation (Anderson and Kegels; 1998). As a result, the credit flows rapidly shifted from public sector enterprises towards private enterprises. It is a pluralist multi-party parliamentary representative democracy, a member of the European Union, NATO, the OECD, the OSCE, the Council of Europe and the Visegrád Group. The Czech Republic became the first among Central and Eastern European Countries to join the Organisation for Economic Cooperation and Development (OECD). The Czech Republic is the first former member of the COMECON to achieve the status of a developed country, according to the World Bank analysis. A large part of the economy had been privatised, include banks and telecommunications. The 2009 survey, in cooperation with the Czech Economic Association, found that the majority of Czech economists favour continued liberalisation in most sectors of the economy.

By the end of 1995, the Czech Republic had progressed in the “Early post transformation study”. In October 1995, the Czech government fully liberalised all account transactions and freed capital account transactions, thus achieving convertibility by the agreement of IMF Article 8. During the period 1993-97, the Czech economy had achieved impressive, results like low unemployment, decreasing inflation and stable exchange rates (Engene Nivorozhkin, 2003).

The Czech Republic has become the number one economic and political success story in Eastern Europe. It has had a remarkably successful and rapid transition, while using subsidies to avoid sudden, large-scale bankruptcies due to lay-offs. David Ottaway (IHT, May 28 1995, p 5) suggested two possible reasons for this: (i) Reforms took place in the Communist Party; and (ii) the economy incorporated trade unions as partners, heavy, state spending on social welfare measures and subsidies to reduce unemployment. However, important sectors such as Government sector and business policy will shift increasingly from the macro to micro level, concentrating, about all, on the restructuring of the industrial sector.
**Financial policy:** The new West European type taxation system was designed to widen the tax base and shift the burden from enterprises to individuals. The introduction of VAT on January 1, 1993, to aim to bring the general VAT rates into line with those of Western Europe (Deutsche Bank, Focus: Eastern Europe, on August 31, 1993). Wages are regulated through a tax on ‘excessive increases’ law introduced in 1991/92, later on reintroduced in 1992. However, the regulation was not successful in 1995.

Czech Banking sector played an active role with the active cooperation of the corporate foreign banks and investment markets. Also, domestic banks had promoted the consolidation of the National Bank in 1993. But this policy did not work out, and after EU membership, the restrictions were lifted in 1996 (Engene Nivorozhkin, 2003).

**Price liberalisation:** The only remaining significant price controls relate to utility charges, rents and public services. In addition, market-up are closely regulated in the energy sector (EBRD 1994; 23).

**Privatisation:** By the end of 1992, former large state industrial enterprises were broken up, mostly into three independent enterprises, either prior to or during the privatisation process (United National Economic Commission for Europe.1994:167). The average number of employees per industrial enterprise is 1,665 and in 1990s this has fallen to 360 (Transition, July-August, vol. 5, no. 6, p. 21). The second and final wave of large scale (voucher) privatisation involving 861 enterprises was completed on 25 November 1994 (EBRD, 1995; p.55).

Mass privatisation, the large banks have become, through their investment funds, the most significant owners of the privatised sector (Brom and Orenstein, 1994:893). However, even in the implementation of mass privatisation, the investment funds have maintained liquidity, and have taken a long-term and active role in enterprise management and are acting like ‘real Owners’ (p. 917). In Europe, the private sector’s share of GDP rose from close to zero in 1989 to about 18 per cent in 1992 and some 50 per cent in 1993, and also it is growing fast (UNECE) for Europe 1994:168, The Economist Survey, 13 March, 1993, p.10). By the result of privasation, by mid-1993, the private sector accounted for 40 per cent of GDP; it accounted for 1 per cent of employment in 1989 and over 30 per cent in 1992 (Employment Observatory, 1993, no.5. pp. 1, 26). Anthony Robison (FT, 13 September 1994, p. 2) cites an official estimate that around 80 per cent of the economy was privatised by the beginning of 1995. Some 80 per cent of
GDP is now in the hands of the private sector, but the Government still owns an average of 40 per cent of privatised companies through the National Property Fund (The Times, Survey, 2 May 1995, p.11). In 1995, privatisation process in Czech Republic was completed, and it was boosted by the share of domestic product. Today, the private sector accounts for 76 per cent of the county’s GDP (Engene Nivorozhkin, 2003).

**Foreign trade:** Capital account transactions remain in control of the government (EBRD, 1994: 24). From January 1, 1995, the country was being allowed to exchange for hard currency. On 1 October 1995, a new foreign exchange law came into force, which conforms to Article 8 of the IMF’s guidelines on convertibility. The law covers: current account transactions, full convertibility and partial liberalisation for capital account transactions. The Czech Republic officially became a member of GATT in mid-April 1993. On June 3rd 1993, the EU and the Czech Republic initialed a bilateral association agreement to succeed the one with the erstwhile Czechoslovakia. On October 4th 1993, a trade and cooperation agreement was signed (which needed to be ratified by the Czech parliament). It involves more rapid liberalisation of trade in industrial goods then previously (Deutsch Bank Focus: Eastern Europe, 1993, no. 91, p.9).

**FDI:** FDI and portfolio investment have gradually risen since transition began in 1990 to over $5 billion. Industrial output is relatively low due to the lack of support of the government; the general philosophy of the government is to leave things to the market. During the period in late 1992 to May 1995, a total of 4,500 bankruptcy petitions were filed, but only 600 bankruptcies were declared (Engene Nivorozhkin, 2003). The exception of tax advantage and subsidy benefits for inward foreign investments (Frances Williams, FT 28 September, 1994, p.6), though, the government remains very strong in its refusal to grant tax privileges to domestic or foreign investors (Transition, July-August 1994, vol. 5, no. 6. P.21). No wonder, the country eliminated nearly all special incentives in 1993 (EBRD 1994; 125). There are free economic zones. Enterprises which are more than 30 per cent foreign-owned are exempted from customs duty for one year (p. 127). According to World Bank (2012), FDI inflows have been decreasing in recent years 2005-2011.
3.3. Lessons that can be drawn European Economic Transition

A lot of literature on transition economics, especially Eastern and Central Europe economies, is available and we can draw lessons and policies regarding newly emerging transition economies. The following issues are significant (World Bank, 2002)\(^6\):

- In order to have a market-oriented economy, liberalisation of price is a must.
- Price liberalisation, however, has the potential of causing higher inflation initially, when it is instituted. Policy makers must use tight fiscal and monetary policies to curb inflation, otherwise it will become pervasive.
- While the initial conditions that prevailed at the start of transition are critical in explaining output decline early in the transition, market-oriented policy reforms have played a significant role in promoting subsequent economic growth.
- The civil society has a role to play when it comes to commitment towards implementation of reforms policies.
- Policy makers cannot postpone the pain of liquidating and restructuring the old sector, until the cushion provided by new enterprises is in place.
- Policy makers must create an environment that disciplines old enterprises into releasing assets and labour and encourage new enterprises to absorb those resources and undertake new investments.
- External economic shocks should be expected to occur and disrupt growth. Policymakers should take necessary measures to correct the effects of external shocks without delay.
- Adopting second generation reform policies is necessary, in order to correct any mistakes or shortcomings of early reforms policies. New enterprises stand to gain from further reforms.
- Developing legal and regulatory institutions to oversee enterprise management, though time-consuming, is important.

In fact, transparency and accountability should be high on priority in transition economies to facilitate efficiency, social cohesion and of economic growth.

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The European Experiences:

The major basic stories concerning the European experience of ODA and economic growth are:

(i) Eastern Europe as a main donor and source of funding to support development in other parts of the world
(ii) Eastern Europe promoting economic reforms in the policies of its members at the community, national and regional level (Garonna, 2006).

However, response of two stories, in ODA result is a mixed impact on ODA. And second; is the most extraordinary success story of the last 50-60 years.

We will now focus on the latter assistance policies, to draw lessons of wider applicability. There are several experiences that can be considered characteristic of the European successes in supporting economics integration. Here are the main points:

(i) EU enlargement: support for candidate countries.
(ii) EU regional policies aimed at supporting industrial restructuring, entrepreneurship, innovation and competitiveness.
(iii) The single market; policies aimed at supporting the elimination of barriers, the adoption of standards, the better regulation of markets, so that there can be a level playing field across the entire European economic space.
(iv) Policies aimed at giving a role to private players, the social partners, the voluntary sector, the research community, opinion makers, etc., including the role of Public-Private Partnerships.
(v) While framing policies, give a role play to regional and local governments, local communities and stakeholders; and
(vi) Policies transferring responsibilities from national level to the community level, as in the case of trade (Abdur Chowdhury and Paolo Garonna, 2007).

The Major reasons for, the economic success of Central European countries (Vladimir Popov, 2009), are as under:

1. Optimal policies are context-dependent, they are specific for each stage of development. For instance, one policy in economy cannot always succeed in another economy.
2. Though both countries have the same level of development, reforms needed to stimulate growth can be different; they depend on the previous history and on the path chosen.

3. Finally, introducing this ‘missing ingredient’ should not result in the destruction of other preconditions for growth. The art of the policymaker is to create markets, without causing government failure, as has happened in many CIS countries.

3.5. Conclusion

Europe’s trade with China and India began during the time of Dutch Merchants and still continually maintains a good relationship. Also, European countries continue to the main trade partners with China and India. Since 1989, Central and Eastern European Countries, including Poland and Hungary, have achieved significant progress in transition. In the after math of the transition, Poland, Hungary, Czech Republic and Slovakia have joined the OECD. Also, market-oriented reforms were launched by China in 1979, while India in 1991 with market-oriented policies by the agreement of IMF, World Bank (N.A. Khan, et. al., 2009).

The Czech Republic and Poland are the Central Eastern European countries, which experienced transitional recession in the early 1990s and an enormous increase in inflations rate. In the present context, we can imply that the foreign aid and development assistance are necessary for poverty reduction, debt relief and the efficient economic development. Successful stories in Europe are due to efforts towards poverty reduction and integration the market through sustainable economic growth. The secret of success is towards economic integration and the adoption of economic reforms at the local, national and regional conducive to economic growth.

The story of the success and failure of transition is not necessarily the story of steady shock therapy and unsteady gradualism. The major plan of the post-socialist transformation “novel” is the preservation of strong institutions in some countries and the collapse of these institutions in others. Thus, the story of the success and failure of transition depend on government failure (like weakness of state institutions), not about the market failure (liberalisation).
### APPENDIX -3.I

Table 3.2: Selected Economic Indicators of Poland, Czech Republic - 2005 to 2011

<table>
<thead>
<tr>
<th>Years</th>
<th>Economic Indicators</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>Poland</td>
<td>GDP growth (%)</td>
<td>3.61</td>
<td>6.22</td>
<td>6.78</td>
<td>5.12</td>
<td>1.60</td>
<td>3.94</td>
<td>4.35</td>
</tr>
<tr>
<td></td>
<td>Agriculture % GDP</td>
<td>4.53</td>
<td>4.29</td>
<td>4.33</td>
<td>3.73</td>
<td>3.65</td>
<td>3.54</td>
<td>--</td>
</tr>
<tr>
<td></td>
<td>Industrial % GDP</td>
<td>30.71</td>
<td>31.11</td>
<td>31.64</td>
<td>31.54</td>
<td>31.74</td>
<td>31.63</td>
<td>--</td>
</tr>
<tr>
<td></td>
<td>Inflation (annual %)</td>
<td>2.124</td>
<td>1.033</td>
<td>2.492</td>
<td>4.215</td>
<td>3.45</td>
<td>2.514</td>
<td>4.268</td>
</tr>
<tr>
<td></td>
<td>FDI net inflows (% of GDP)</td>
<td>3.39</td>
<td>5.82</td>
<td>5.56</td>
<td>2.83</td>
<td>3.02</td>
<td>1.94</td>
<td>3.39</td>
</tr>
<tr>
<td></td>
<td>Population %</td>
<td>38.207</td>
<td>37.949</td>
<td>37.641</td>
<td>37.555</td>
<td>37.47</td>
<td>37.388</td>
<td>37.308</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>GDP growth (%)</td>
<td>6.752</td>
<td>7.02</td>
<td>5.735</td>
<td>3.099</td>
<td>-4.695</td>
<td>2.739</td>
<td>1.655</td>
</tr>
<tr>
<td></td>
<td>Agriculture % GDP</td>
<td>3.03</td>
<td>2.60</td>
<td>2.46</td>
<td>2.54</td>
<td>2.27</td>
<td>2.40</td>
<td>N.A</td>
</tr>
<tr>
<td></td>
<td>Industrial % GDP</td>
<td>37.87</td>
<td>38.21</td>
<td>38.44</td>
<td>37.61</td>
<td>37.70</td>
<td>37.65</td>
<td>N.A</td>
</tr>
<tr>
<td></td>
<td>Inflation (%)</td>
<td>1.843</td>
<td>2.543</td>
<td>2.862</td>
<td>6.339</td>
<td>1.033</td>
<td>1.464</td>
<td>N.A</td>
</tr>
<tr>
<td></td>
<td>Unemployment rate</td>
<td>7.927</td>
<td>7.148</td>
<td>5.32</td>
<td>4.392</td>
<td>6.662</td>
<td>7.279</td>
<td>6.7</td>
</tr>
<tr>
<td></td>
<td>FDI net inflows (% of GDP)</td>
<td>9.32</td>
<td>3.87</td>
<td>6.09</td>
<td>3.04</td>
<td>1.51</td>
<td>3.50</td>
<td>9.32</td>
</tr>
</tbody>
</table>

Sources: World Bank Development Indicators, and IMF, 2012.