Structural divergence in economies in transition[1]

by
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The 20th anniversary of the events of 1989 is an opportune time to take stock of the major structural changes in the region. Trends and patterns of structural transformation experienced by initially fairly similar countries have received little attention in the debate about transition, which has mainly focused on macroeconomic stabilization, market reforms, and institutional change. During the socialist era the communist states explicitly attempted to reduce differentials in economic development and human wellbeing among states, regions within states, and social classes. The transition has led to a new structural differentiation among these countries, cancelling the efforts at "leveling" made in the socialist era and seemingly paving the way to a "return to the past".

Forced structural convergence during the socialist era

The heterogeneity of the transition countries has distant origins and is rooted in dissimilar endowments of natural resources, geographical location, and historical and cultural developments over several centuries. Under socialism an "equalization of outcomes" agenda was pursued by compressing wage distribution, socializing the profits of state-owned enterprises, subsidizing key consumption items, and providing universal pensions, family benefits, and free *de jure* (if not *de facto*) health and education. The development pattern was also very similar. While differences in natural endowments affected somewhat the division of labour among the socialist economies (by emphasizing, for instance, manufacturing in Central Europe and cotton farming in Central Asia), everywhere the emphasis was placed on industry (particularly heavy industry), large enterprises (*kombinati)*, and science and technology. In turn, cross-country differences were reduced by the use of 'socialist prices' (often equal to one tenth of world prices) in trade among the socialist economies, generous transfers from the USSR budget to poorer Soviet republics (equal, for instance, to a third of Uzbekistan's GDP in 1991), and the funding of major infrastructural projects directly from Moscow.

Convergence during the socialist era is evident in key welfare indicators like infant mortality, life expectancy at birth, and the quantity (if not the quality) of schooling, especially in the first 30 years after World War II. There was a (real or apparent) convergence in the planned rates of output till the end of the 1970s, although convergence in per capita incomes remained elusive.

Policy convergence after the mid-1990s

In the early years of transition there were important differences in policy approaches and economic outcomes, with most Central European and Baltic economies recording better results than those of Southeast Europe and the Commonwealth of Independent States (CIS). Yet, from the mid-1990s, the EBRD's overall liberalization index[2] (which measures the extent to which transition economies are approaching a standard model of market economy) suggests—with the exception of 'neo-Soviet' Belarus and Turkmenistan—a steady convergence in policy approaches as gradualist reformers intensified their efforts, 'catching up' with the fast reformers. As a result, cross-country convergence is evident since the mid-1990s in key macroeconomic indicators, such as the budget deficit/GDP, public debt/GDP and inflation, possibly as a result of the emphasis placed by governments and the International Monetary Fund

[1] Abstracted from the paper "Transition, structural divergence, and performance: Eastern Europe and the Former Soviet Union over 2000-2007" presented by the author to the UNU-WIDER Conference "Reflections on Transition: Twenty Years after the Fall of the Berlin Wall", Helsinki, 18-19 September 2009

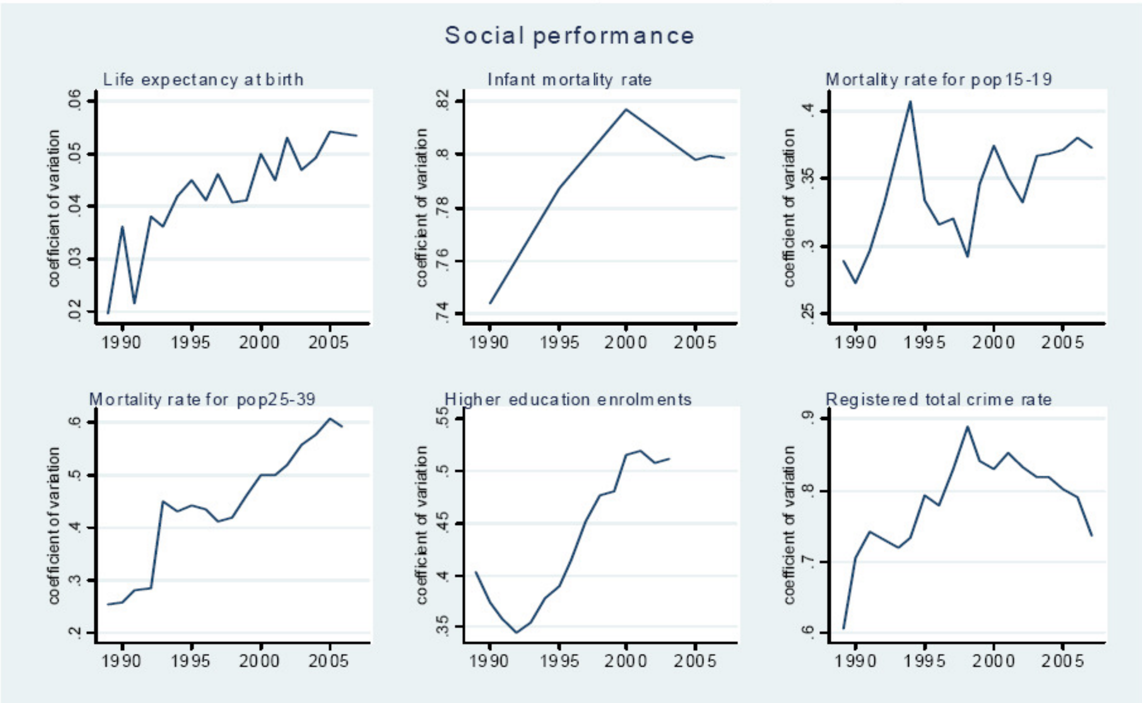
[2] EBRD stands for European Bank for Reconstruction and Development

(IMF) on macroeconomic stabilization, and of the convergence requirements to be fulfilled by countries aspiring to enter the EU. Even 'heterodox countries' (like Uzbekistan and Belarus) show today low deficit/GDP, public debt/GDP and (official) inflation rates.

But persistent divergence in most economic and social outcomes

Despite this gradual convergence in policy approaches, the economic performance (measured in terms of per-capita GDP, income distribution, and investment rates) of these transition economies diverged sharply during the traumatic transformational recession of the 1990s. The Central European countries and Uzbekistan were less affected, while the countries of the South Caucasus, Ukraine, and Moldova were most affected. Since the late 1990s, the entire region experienced a rapid recovery which was interrupted only by the food-fuel-financial crisis of 2007-2009. Such convergence in growth rates of per-capita GDP did not, however, lead to overall convergence, and the reduction in differences in per-capita GDP, investment rates and income inequality within the region were modest. Greater divergence was observed also for demographic variables affecting long term prosperity, such as, fertility, aging, and the death rate of the working age population. Even more pronounced was the increase in cross-country variation of key welfare indicators, particularly during the years of transformational recession (Figure 1).

Figure 1: Trends in the coefficient of variation of selected social indicators, 25 countries (1989-2007)



Note: the coefficient of variation is a statistical measure of dispersion, defined as the ratio between the standard deviation and the average.

In turn, while the "rule of law index" improved slowly on average for the region as a whole, from 2002 its cross-country variation increased. This suggests that after an initial general improvement, political institutions in the region started to diverge, with strong democratic regimes emerging in Central Europe and the Baltics, while illiberal democracies developed in parts of the former Soviet Union, and "authoritarian regimes", characterized by a lack of fair and free elections, no rule of law, and recourse to authoritarian measures by the executive, put down (or preserved) deep roots in Turkmenistan, Uzbekistan, and Belarus. All in all, the data point to divergence in 12 of 13 key economic, social, demographic and welfare indicators during the difficult transformational recession of the 1990s. This divergence was only partially offset during the recovery of 2000-7, which witnessed further divergence in six of these 13 indicators, hysteresis (i.e., stagnation or only partial return to the 1989 level after the worsening observed of the initial years) in five cases, and convergence in two cases.

The birth of structurally different country clusters

With the transition, all countries of the region underwent radical structural changes such de-agrarianization, a decline in heavy industry, a large drop in energy consumption per unit of value added, an expansion of transport and telecommunication services and of 'other services' (i.e., finance, real estate, tourism, business and personal services) and a sharp increase in labour mobility across sectors and borders. As a result, in 2007 migrant remittances accounted for 13-25 percent of GDP in seven countries of the region and for a staggering 36 percent of GDP in Tajikistan. A formal cluster analysis for 2006 (the last year with complete data) revealed four structurally heterogeneous country clusters with dissimilar factor endowments, patterns of specialization, institutions, growth engines and prospects for efficiency-welfare gains. These are:

1. ***Countries dependent on the export of manufactured goods***, supported in most cases by large inflows of foreign direct investment and financing by foreign banks, such as the Czech Republic, Hungary, Poland, Slovenia, Slovakia, Belarus and Ukraine.
2. ***Countries with mixed and service oriented economies*** (the Baltic states, Bulgaria, Romania, the Former Yugoslav Republic of Macedonia, and Georgia) with an important share of output and employment in 'other services' in the Baltics, tourism in Croatia, and informal low value added services in the other countries.
3. ***Countries that are commodities exporters*** (Russia, Azerbaijan, Turkmenistan, and Kazakhstan), strongly dependent on world commodity prices and demands, and suffering to some extent from the "Dutch disease".
4. ***Countries for which an initial dependence on official development assistance has given way to a reliance on migrant labor,*** depending in this way for their growth on large and steady inflows of remittances (Albania, Armenia, Kyrgyzstan, Moldova, Tajikistan, and Uzbekistan).

Since 1996 more than half of the 25 countries studied witnessed a change in their economic specialization, mainly as a result of a move away from manufacturing and towards other specializations such as commodity exports, migrant remittances, and services. This growing structural differentiation is accompanied by fairly consistent differences in economic and social indicators (e.g., levels and trends in per-capita GDP, investment rates, income inequality, state institutions, the rule of law, life expectancy at birth, old-age dependency rates, and so on).

Economic and social performance by country cluster

How did the different clusters perform during the current decade (before the crisis of 2008-2009)? Did the changes in economic specializations affect growth in per-capita GDP? Standard theory suggests that economic performance depends on the stocks of productive factors (physical and human capital), public expenditure/GDP, rule of law, initial per-capita GDP in 1990-1993 (as countries with a low income levels can grow *ceteris paribus* faster than wealthier ones), and unused productive capacity. Regression analysis confirms these hypotheses. A most interesting finding is that—after controlling for all these factors—belonging to the group of commodity exporters raised the GDP growth rate by 3-4 percentage points a year in relation to the manufacturing exporters. This (medium term) result runs contrary to economic theory, which suggests that "Dutch disease" and distortions in income distribution typical of commodity exporters reduce (long-term) GDP growth. The analysis further shows that belonging to the clusters of 'mixed and service-oriented' and 'aid-remittances dependent' economies reduced the growth of per-capita GDP in relation to the 'manufacturing exporters', though this effect is small (between 0.5 and 1.5 percentage points a year) and not robust.

As for social performance (proxied by life expectancy at birth), one might have expected that—with substantially faster GDP growth—commodity exporters would perform better also in this area. Interestingly, after controlling for the usual determinants of life expectancy at birth (per capita income, inequality, level of education, demographic factors, and public health expenditures), the opposite was found to be true. Belonging to this cluster entailed a loss of life expectancy at birth of 4-4.5 years, in relation to the clusters of manufacturing exporters and mixed, service-oriented economies, while the cluster of aid-/remittance-dependent countries showed a small but non significant better performance of 0.5 to 1.3 years vis-a-vis the manufacturing exporters. Faster (oil-driven) growth, in other words, in no guarantee of better governance and welfare level—just the opposite.

Concluding remarks

During the last 20 years the economies in transition in Europe and Central Asia experienced considerable divergence in practically all economic, social, demographic and political dimensions. While this trend was particularly marked during the years of the transformational recession, very limited re-convergence was observed during the subsequent economic recovery. As a result, the countries of the region are a much more heterogeneous group than at the end of the socialist era. During the 2000-2007 period these countries recorded surprising trends in performance, which run against economic theory. The clusters with the fastest growth were not those which most reformed their economies and political institutions, but commodity exporters and aid-/remittances-dependent countries where, however, social indicators improved less than in other clusters.