

RULE-OF-LAW :NEW PARADIGM AFTER FAILED WASHINGTON CONSENSUS- OR NATURAL FOLLOW-UP TO ITS SUCCESS?

The case of transition economies since 1989

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Economists became fascinated by the rule-of-law after the crumbling of the “Washington Consensus” [which] held that the best way for countries to grow was “to get the policies right” on for example budgets and exchange rates. But the Asian Crisis shook that confidence. What had gone wrong?... They concluded that...if the rules of law were a mess, no amount of tinkering with macroeconomic policy would produce the desired results. ¹

I. INTRODUCTION

In the past decade or so it has become conventional wisdom that developing effective institutions (INST) which ensure application of the rule of law (ROL) is the most important task of economic policy in a country. This new emphasis is seen in discussions for all economies, be they low income, emerging markets, transition economies, and indeed after the October 2008 financial crisis even in advanced high-income economies. The new paradigm has a two-step logic. First, the Washington Consensus (WC) crumbled or failed not only in East Asia but also in Latin America and at least some of the transition economies like Russia and Ukraine, leading to the consensus that institutions are more important. Second, in the case of transition economies most of which have gone a long way to liberalize their economies , institutional development lags far behind²- indeed as Gersl (2006) shows, this appears to be true even in the leading, early reformers of Central Europe like the Czech Republic.

On the face of it the view that institutions are important seems unassailable—indeed I do not argue they are unimportant or less important. But the view that the WC failed

¹ The Economist, Mar. 15, 2008, p. 83, “Briefing. Economics and the rule of law.”

² Havrylyshyn (2008 b) shows it has gone far is all but a handful of laggards like Belarus, Turkmenistan and Uzbekistan.

seems inconsistent with the history of macrocosmic developments in transition economies since 1989. Similarly, the argument that transition economies lag behind on institutions, while on the surface factually evidenced, raises the question as to why most of them appear to have been doing quite well in growth performance for the past 8-10 years.³

Given these inconsistencies, I argue in this paper a dissenting view at least for the case of the post-communist countries since 1989. On the first step of the above logic, I suggest that the WC did not fail, on the contrary it was remarkably successful in the post-communist period in achieving stabilization and an initial liberalization. Kornai (2006) has made this point far more eloquently. For Central Europe and the Baltics (CEB) this took a mere five years or so; in the Commonwealth of Independent States and in South-East Europe this was somewhat slower, nevertheless sometime in the second half of the nineties even these countries had essentially stabilized and largely liberalized. In effect, the high inflation and financial instability had been the binding constraint to economic growth in the early nineties, and once overcome the new binding constraint became ROL. Hence the emphasis on INST was not so much an alternative to the WC, as the natural next step in the sequence of transition reforms.

As to the second point, the continuing lag of INST, it is doubtless true that for countries not yet members of the EU-in SEE, in the CIS- the level of institutional development lags far behind. But for CEB countries whether or not there is a lag depends on the bench

³ True, several have run into difficulties needing stabilization support from the IMF, but this may be more a reflection of the general global situation than of some unfinished transition business. I do not pursue this still-evolving issue here.

mark for comparison. If one uses the criterion that transition is complete when the former communist country takes on characteristics comparable to “similar” market economies,⁴ the CEB may already be at INST levels comparable to those of middle income or even upper-middle income countries. A preliminary analysis of indicators that can be compared to this relevant group is presented here.

From a narrowly intellectual point of view there may be an even stronger defense of the WC. Anyone who has been closely involved in the process of post-communist transformation will be aware that the formal “agenda” for transition reforms laid out by proponents of the WC always included several institutional and rule of law components – a good representation was in Fischer and Gelb (1991), reproduced as Figure 1. It is factually incorrect to suggest WC ignored institutions, but criticism such as that of the Economist above, while “factually incorrect” is in practice valid and realistic, because there is little doubt that the WC in action emphasized the macro policy elements and paid only minimal lip-service to some key institutions- at least in the early years.

Thus while it is appropriate to remind oneself that conceptually WC has a broader agenda including institutions, I nevertheless agree in practice it has been an approach emphasizing primarily stabilization plus the basics of market liberalization. But even on this narrower definition, I argue its application in transition economies has been on the whole more of a success than a failure. Has this been harmful to growth by diverting attention away from institutions and the rule of law? In the case of transition economies I

⁴ This definition and applications are elaborated in Havrylyshyn (2008b).

will again argue it was not as big a failure of the WC as often thought, and also show that the institutions are now following stabilization more or less on the timetable of Figure 1. Importantly, it will be shown that institutions are improving much more rapidly in countries that undertook early stabilization and liberalization efforts than in those that delayed or reversed. This suggests that WC and institutional development are not at all in contradiction to each other, but where there is a reform commitment they are entirely compatible.

The rest of the paper is organized as follows. Sec. II reviews the macroeconomic stabilization experience of transition economies during the nineties, and presents some indicators of the switch to market-oriented instruments of fiscal and monetary policy. Sec. III analyses several indicators of quality of institutions and rule of law comparing as much as possible to “similar “ market economies-with special attention to the financial sector of most relevance to the new member states. A key novelty here is that I propose the relevant benchmark comparators are not advanced economies like the EU-15 , but upper-middle or middle income ones for CEB countries , lower-middle, or low-income for South East Europe and CIS countries. Sec. IV presents a tentative explanation of how it is possible for a country to have the strong economic growth seen in transition economies while INST development lagged behind. Briefly the argument is in the spirit of rational expectations: economic agents are not only knowledgeable but reasonable, and do not expect the transition from communism to the market to be immediate, therefore unlike academic analysts they look not at the absolute level of INST but at the pace and

consistency of change. Finally, Sec. IV summarizes and points to areas of potentially useful further research.

FIGURE 1. ELEMENTS OF THE WASHINGTON CONSENSUS

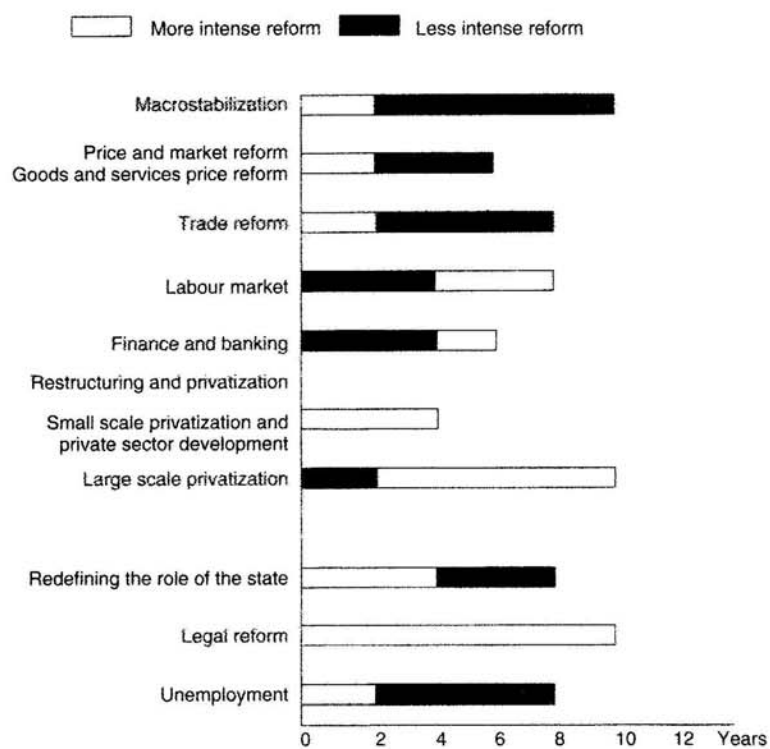


Figure 1.1 An illustration of the Washington Consensus. Reproduced from Stanley Fischer and Alan Gelb, 'The Process of Socialist Economic Transformation', *Journal of Economic Perspectives*, vol. 5, no. 4, Fall 1991, with the permission of the authors and the editors of the journal.

II. SUCCESSFUL IMPLEMENTATION OF WASHINGTON CONSENSUS

II.1. A Review of Inflation Stabilization in the Nineties.

The experience of stabilizing high and in some countries even hyper-inflation in the first half of the nineties is well known and thoroughly studied. The presentation here is not to propose any new interpretations of the consensus, but to review the main trends briefly. Table 1, 2 and 3 give an overview by broad country groups of the three main statistics: annual inflation, budget deficits, and broad money growth rates.

TABLE 1. ANNUAL INFLATION SELECTED YEARS

	1992	1994	1995	1998	2002	2007
CEUR (V4)	445 (22.7)	39 (18.0)	21 (16.3)	8.0 (10.9)	2.8 (3.0)	3.6 (3.9)
BALTICS	1,020	38	29	3.0	2.1	6.1
SEE	228	77	39	23	10.6	4.6
CISM	1,055	2,656	325	13.1	8.9	9.0

Sources: IMF International Financial Statistics online; Cottarelli and Doyle (2001).

The country groupings in this paper are based not on geographic criteria often used, but on an analysis of similar transition experience.⁵ Thus Central Europe includes not only the Visegrad Four, but also Croatia and Slovenia. And the CISM group (moderate reformers) excludes three CIS countries where progress to market rules continues to be very limited even to the present day. By the mid-nineties, the Baltic countries become so similar to those of Central Europe that they are often now lumped together into a CEB grouping. On inflation trends it is for example clear that very early on they were more like former USSR republics with a value over 1,000 % per annum, it is also clear they very quickly converged to the CE experience with rates in low double digits within two years and similar single digit rates thereafter.

It is also useful to note that in the first years within the broader definition of CE, the Visegrad Four (V4) still stand out, experiencing considerably lower inflation of about 23% in 1992; by 1994-95 Croatia and Slovenia had essentially achieved stabilization aims and thereafter inflation in all six countries was broadly similar. The convergence of the Baltics towards CE on this dimension was equally fast and until the most recent years they had a superior performance. What is more notable for present purposes however is the comparison with CIS countries. At the start of transition about 1992, inflation was as high on average in the Baltics as in the other former USSR countries, over 1,000% per annum. But the Baltics almost immediately began stabilization efforts while the others

⁵ Elaborated in Havrylyshyn (2006)

delayed them for 1-3 years, with the result being a sharp cut of inflation in the Baltics in contrast to a worsening in the CISM.⁶

In the present paper I argue that by about 1998-2000 the “macro transition” -defined as not only achieving inflation control but also the widespread use of market-oriented macro policy instruments -was largely over for most countries, even in the CIS. Thus the relevant period of stabilization was 1992-1998. but data for 2000 and later is shown in the first two tables to capture the period where inflation becomes less a monetary phenomenon but more likely a “Phillips Curve “ relation with growth recovery and capital inflow effects creating upward pressure on prices. The details of this later period are however beyond the scope of the paper.

It is widely agreed even by the strongest critics of the WC that the very quick stabilization achievements (once started!) were not difficult to explain: “ sizable fiscal tightening –with a corresponding tightening of money creation through credit to the government... [although] the link...was weaker in moderate inflation cases.”⁷ This basic story line is evidenced in the budget numbers of Table 2, and the broad money growth shown in Table 3.

⁶ As an indicator of the stabilization effort, IMF programs were started in all three Baltic countries in mid-1992, and in the others between mid-1993 and early 1995. See Cottarelli and Doyle (2001).

⁷ *Ibid.* p.25. Critics who recognized the stabilization success include Roland (2001) and Stiglitz (1999).

TABLE 2. BUDGET DEFICITS -% OF GDP

	1992	1994	1995	1998	2002	2007
CEB	4.9	2.1	2.4	1.4	3.2	2.1
SEE	10.1	5.8	3.9	4.1	4.1	1.1
CISM	18.0	8.3	5.7	4.8	1.1	0.9

Source: as in Table 1

Table 2 does not distinguish amongst the Visegrad Four, Croatia, Slovenia, and the Baltics, as the differences in budget deficits are too small to matter- the early higher inflation outside the V4 is better understood in the off-budget activities, that is directed credits to state enterprises which of course meant monetary emissions. Thus in Table 3 one sees for 1992 money growth in V4 of about 40% , and in the Baltics over 200%-but the difference disappears by 1994. Croatia and Slovenia (not shown separately) also saw rates well over 100%. The delay in stabilization efforts by most CIS countries is reflected in the still high budget deficits in 1994 and even 1995, corresponding to the continued inflation seen in Table 1.

While the difference between the deficits in 1995 and 1998 do not appear large enough to explain the sharp drop of inflation from triple to double digits, the underlying story is again the off-budget activities, which were finally sharply cut back under the 1993-97 range of stabilization programs. This is better reflected in the considerable slowdown of money growth seen in Table 3 from a still high 139% in 1995 to 37% in 1997.

TABLE 3. BROAD MONEY GROWTH 1992-1997

	1992	1994	1995	1997
CE	(31) (V4only)	43	31	28
BALTICS	225	46	12	38
SEE	135	75	43	126
CISM	420	543	139	37

Source: as in Table 1

That inflation during the transition was largely if not entirely a monetary phenomenon is evidenced in many early empirical studies including Cottarelli and Doyle (2001) already mentioned, and DeMelo and Denizer (1999) who for example conclude that in inflation equations for the nineties “the lagged variable explains close to half of the current inflation, with much of the remainder explained by money growth.” Those that criticized the overly tight monetary policy for contributing to output collapse, like Calvo and Coricelli (1993), do not contradict the inflation-money link, indeed they implicitly confirm the “largely a monetary phenomenon” interpretation.

.[[[[Calvo, G. and F. Coricelli, (2001), “Output Collapse in Eastern Europe: The Role of Credit,” in M. Blejer *et.al.* (eds.), Eastern Europe in Transition: From Recession to Growth.” World Bank Discussion Paper no.196, Washington DC : World Bank}}]

This close correspondence of inflation and money growth is evident by comparing Tables 1 and 3. Table 3 also clearly shows some of the unique features of different country groups. While the Baltics become very like Central Europe by 1995, in the first year or two the burden of Soviet-period enterprise debts was more similar to that of other USSR republics, hence money growth and inflation are still very high in 1992. Stabilization began almost immediately and by 1994 the picture looks more like CE, while in sharp contrast CIS countries delay stabilization and money growth even increase somewhat as does consequently inflation. Only when stabilization efforts are undertaken from 1994 onwards do we see a curtailment of money growth and control of inflation. Of great importance is that the lag between the start of stabilization and reduction to inflation to about 50% or less *is very similar in late stabilizers to what one saw for the early stabilizers*. In the latter this was sometimes very quick (3-6 months) but sometimes more than one year-the same is found for the late stabilizers in CIS and SEE. This similarity is more consistent with “success” than “failure” of the WC, at least its narrow interpretation given by the Economist citation. The possible failure of WC in promoting institutional improvements is taken up in Section III, with one exception: the change to more market-oriented policy instruments related to fiscal and monetary actions of governments.

II.2. First Steps of Institution-Building: Adopting Market-Oriented Policy Instruments

A somewhat forgotten element of institution building has been the task of setting up the main agencies of government macro economic management that are found in all market economies, namely a central bank that has money creation instruments appropriate to a

market with commercial banks rather than Socialist –type banks which were more accounting houses, a treasury to centralize and make transparent the process of collecting revenues and spending government budgetary allocations, a Ministry of Finance unrelated to any central planning actions but focused on proposing appropriate fiscal policies through annual budgets and then implementing them as per approval of a legislature. That this was quietly but quickly and effectively done is not disputed but also not given much prominence in the debates on the transition. In this section I will use a number of available indicators to show that the process of creating market-oriented economic policy instruments is certainly completed in CEB countries, and close to it in the others.

The concepts of institutions and rule of law suffer from an uncomfortable tension between the inability to describe in precise analytical terms what they mean and a widely held confidence by economists that you know a good institution when you encounter it.⁸ The present paper very much recognizes the vagueness of the term, and makes no pretense to resolve the issue. Indeed, the coverage in this section of the quality of policy instruments used by governments, is not naturally distinguishable from the effectiveness of the rule of law covered in Section III. The separation is nevertheless made to allow a feasible presentation of many pieces of data on these closely related concepts.

⁸ Dani Rodrik of Harvard is quoted in the Economist article as being if not the only economist to recognize this imprecision of definition, “maybe the first one to confess to it.” I do not know who keeps such a confessional list so I take with a grain of salt this “pioneering “ attribution-but the point is well taken: any analysis of institutions should retain a large degree of humility given the imprecision of the concept.

Three categories are treated in Section II.2: some overall indicators of Government Effectiveness; quality of fiscal and budget management; and quality of monetary and financial sector policy. An important dimension of the presentation here is that transition country values for such indicators will be compared not necessarily to advanced industrial economies like the EU 15 but rather to what I argue is the appropriate benchmark, countries at a similar level of development.

II.2.a. Overall Government Effectiveness

A relatively simple measure which broadly illustrates the “modernity” of government is the amount of bribes as percent of sales that firms pay to get government business done. The EBRD Transition Report 2005 reports values from the well-know BEEPS Survey; they rank-order countries as follows: mature market economies (0.4 % paid by private firms to government bureaucrats), CEB (0.6) ,SEE 0.95), CIS (1.3.). A bar chart scaled from 0.0 to 1.4 for these groups makes it seem like even CEB has long way to go. But consider two counter points: given margins of error, is 0.6 % so much worse than 0.4%? When the average for a group of middle income economies (defined later) is calculated from original data, it turns out to be at least as high as the CEB numbers, ranging from 0.5-1.0. Overall transition economies do not look so bad.

A more direct measure is the World Bank’s Governance Indicators summary measure of “Government Effectiveness”, described in the website and in particular the paper of Kaufmann and Kraay (2008). Using the online website and selecting country groups, it is easy enough to construct the charts presented here showing respectively the percentile rank for the Government Effectiveness indicator by country and below it for

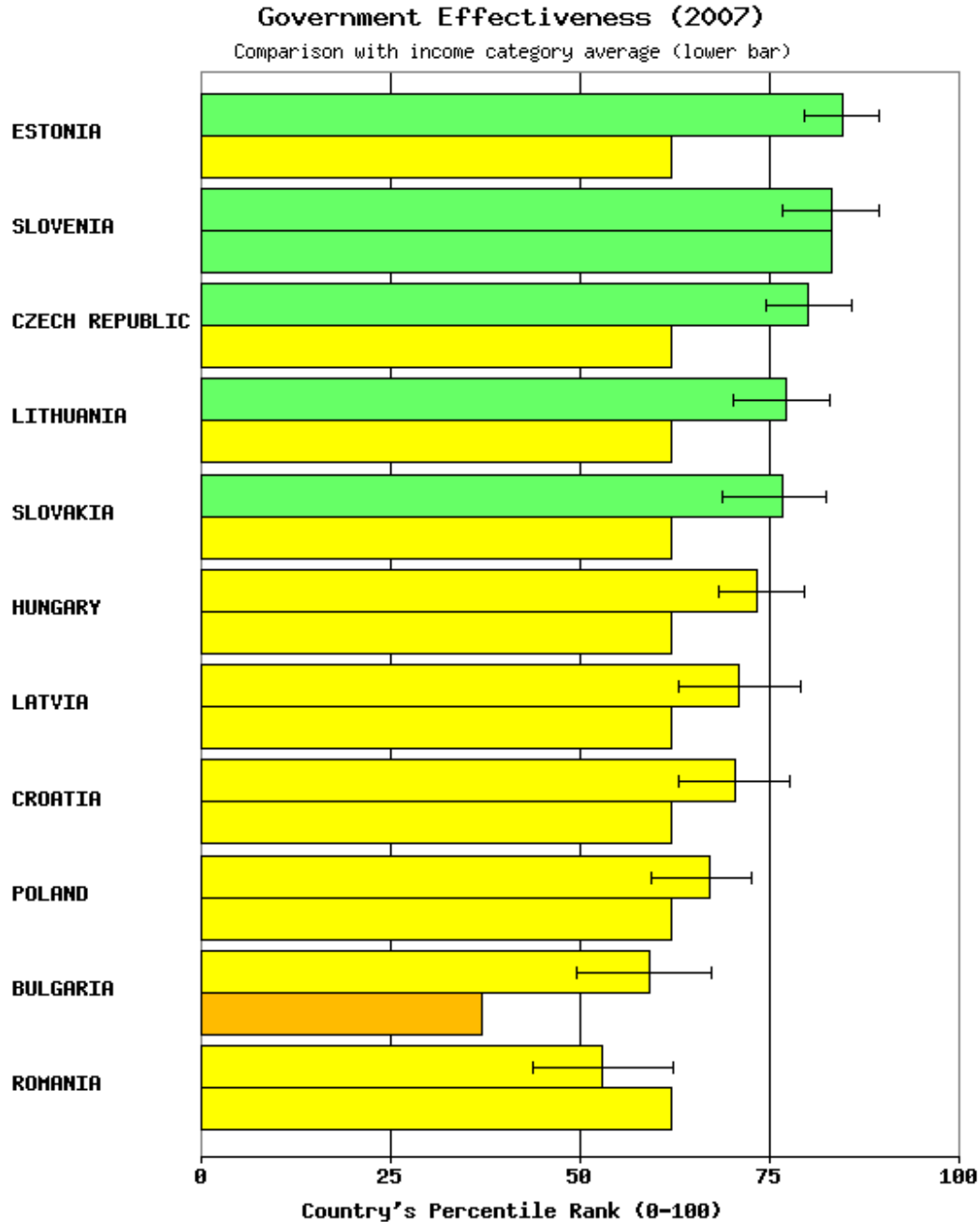
comparable income countries; Figures 2,3,4 are respectively for CEB countries plus Bulgaria and Romania (i.e. the new EU members); eight CISM countries , and eight East Asian countries.

The first conclusion is that the CEB countries all have a percentile value that is *higher* than the comparable income group of the entire WBGI sample (??? Number ???), hence it is possible to argue that they have “completed” the transition on this dimension, even if they are still behind more advanced economies like EU-15. Secondly, on a more specific (and demanding ?) comparison with the East Asian tigers (Fig.3.),the CEB also looks very good, only Singapore and Hong Kong being distinctly better. The newest members Bulgaria and Romania , are far less advanced, but still over the 50th percentile rank (which none of the CIS but Georgia surpass), and they comparable reasonably favorably with the similar income group.

The picture is far less bright for the CIS countries. Only Georgia exceeds 50th percentile, and only Georgia , Armenia, and Kyrgyz republic do better than the comparable income average. In all others , not only is the rank well below 50th percentile, it is also lower than the comparables average. That gap is particularly striking for Russia.

It is of interest to note that China had a value of about 46%, much below the CEB but similar to the CIS , and importantly well above the 37% average for its comparator group.

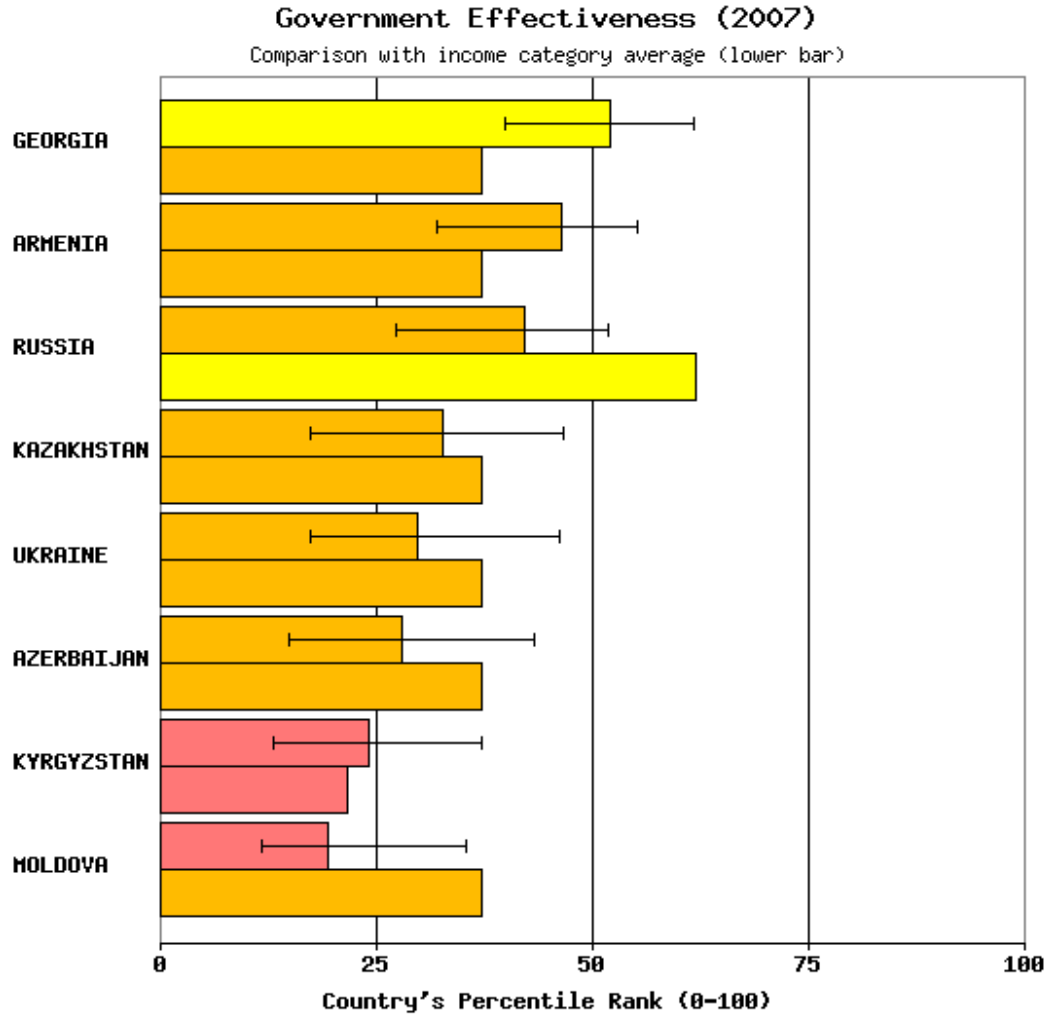
FIGURE 2. GOVERNMENT EFFECTIVENESS: NEW EU MEMBERS



Source: Kaufmann D., A. Kraay, and M. Mastruzzi 2008: Governance Matters VII: Governance Indicators for 1996-2007

Note: The governance indicators presented here aggregate the views on the quality of governance provided by a large number of enterprise, citizen and expert survey respondents in industrial and developing countries. These data are gathered from a number of survey institutes, think tanks, non-governmental organizations, and international organizations. The aggregate indicators do not reflect the official views of the World Bank, its Executive Directors, or the countries they represent. The WGI are not used by the World Bank Group to allocate resources or for any other official purpose.

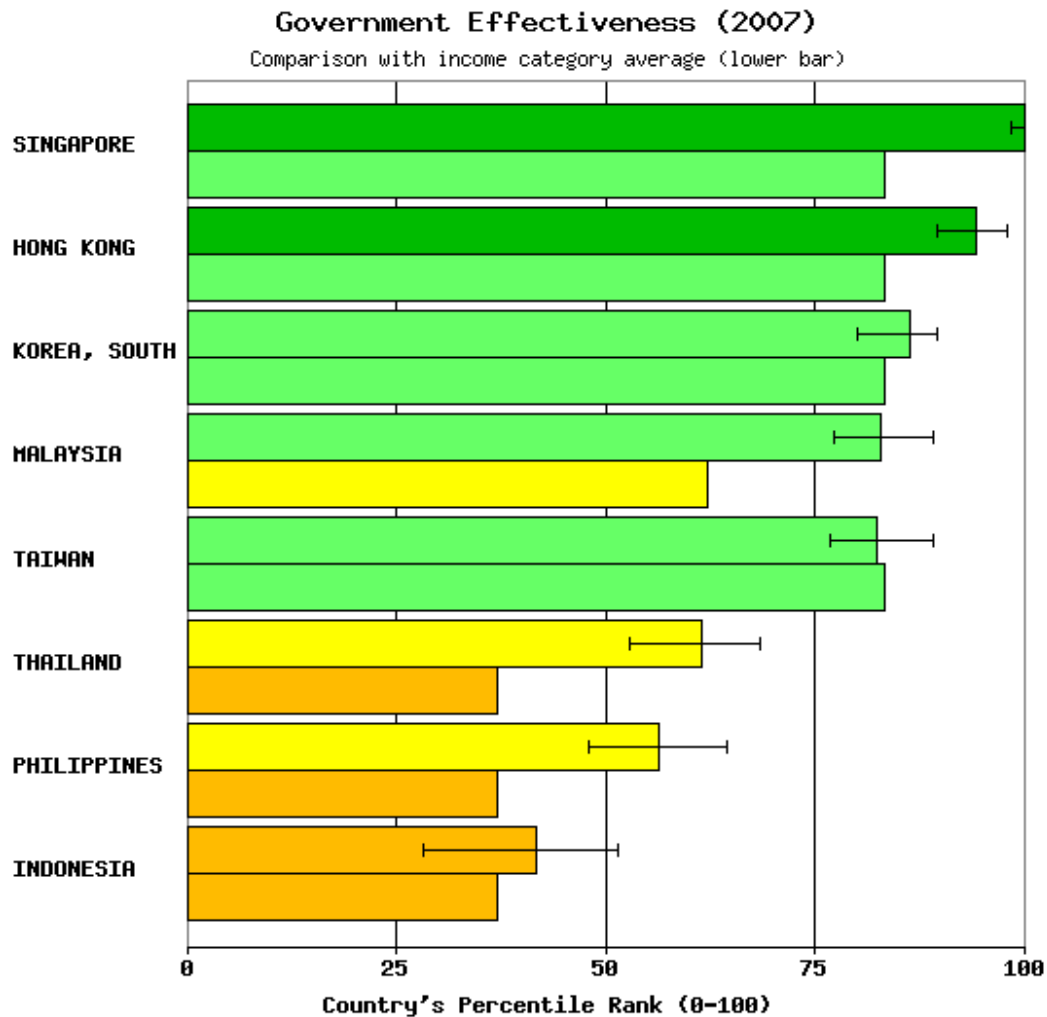
FIGURE 3. GOVERNMENT EFFECTIVENESS: CIS COUNTRIES



Source: Kaufmann D., A. Kraay, and M. Mastruzzi 2008: Governance Matters VII: Governance Indicators for 1996-2007

Note: The governance indicators presented here aggregate the views on the quality of governance provided by a large number of enterprise, citizen and expert survey respondents in industrial and developing countries. These data are gathered from a number of survey institutes, think tanks, non-governmental organizations, and international organizations. The aggregate indicators do not reflect the official views of the World Bank, its Executive Directors, or the countries they represent. The WGI are not used by the World Bank Group to allocate resources or for any other official purpose.

FIGURE 4. GOVERNMENT EFFECTIVENESS: EAST ASIAN COUNTRIES



Source: Kaufmann D., A. Kraay, and M. Mastruzzi 2008: Governance Matters VII: Governance Indicators for 1996-2007

Note: The governance indicators presented here aggregate the views on the quality of governance provided by a large number of enterprise, citizen and expert survey respondents in industrial and developing countries. These data are gathered from a number of survey institutes, think tanks, non-governmental organizations, and international organizations. The aggregate indicators do not reflect the official views of the World Bank, its Executive Directors, or the countries they represent. The WGI are not used by the World Bank Group to allocate resources or for any other official purpose.

II.2.b. Fiscal and Budget Management

We start again with a simple overview indicator, incidence and frequency of dealing with tax authorities from the BEEPS survey, as reported in the Transition Report 2005. While in mature markets each year 31% of firms deal with tax authorities on average 1.6 times per year, the values for CEB are 48% ,1.3 times, SEE 72% 2.7 times, and CIS 75% 3 times per year. CEB is not very different from mature market economies, and it turns out from calculations using original data much better than comparable middle income economies with values of 42 % and 2.4 occasions. Even the SEE and CIS are not much worse than that.

A finer measure from the BEEPS survey is “Tax Administration Constraint” ; Table 4 shows author’s calculations for the average index in each of the groups used here,; the index takes values of 1.0 (worst) to 4.0 (best). The usual rank ordering appears with CEB being only slightly worse than East Asia, CISM the worst but far lower than many other developing countries, and SEE in the middle. **[[do 2000 and discuss change]].**

TABLE 4. TAX ADMINISTRATION CONSTRAINT

	EASIA	CEB	SEE	CISM
2000	-	-	-	-
2005	1.67	1.99	2.24	2.65

for lower income countries eligible for the World Bank’s low interest and grants programs, a Policy and Institutional Assessment is available which includes two indicators of relevance here: quality of budget and financial management , and effectiveness of revenue mobilization, BUDQUAL ,REVMOB, respectively in Table 5, for 2007. Both the SEE and CIS countries of this category have indicators somewhat better than all other low income countries. This may overstate the achievements in the transition cases, as the rest of the sample includes many countries in Africa with very low incomes, but the values above 3.5 (some cases of 4.5 the top score) are not just in the upper range of the sample but include many least developed countries. Their values may often reflect a much longer history of working with international aid givers and a consequent evolution of conformable procedures and standards in budgets.

TABLE 5: BUDGET AND TAX POLICY QUALITY

	ALL LOWY	SEE	CIS
BUDQUAL	3.1	3.5	3.6
REVMOB	3.4	4.0	3.5

The last “indicator” of standards in fiscal management is constructed from the IMF ROSC reports (Report on Observance of Standards and Codes) that has been done fairly

regularly since about 2000 for many member countries. There is no ranking or scoring done by the IMF on the rationale that such a score if public might engender a financial crisis, hardly an event that the IMF wants to encourage. It is therefore not possible to do as in the above tables from World Bank ratings. However, some degree of familiarity with IMF report language (“IMF speak” it is sometimes called) permits the reader to draw comparisons. The author has selected a number of CEB countries and some upper middle income comparators and put them in a very rough rank-order for quality of fiscal management; but the most useful information in these tables may be the excerpts of key phrases in the Reports with author’s editorial italics for emphasis , as often what words are not used is as important as the ones used.

TABLE 6. IMF ROSC REPORTS .SELECTED COUNTRIES

COUNTRY BY RANK	NOTIONAL “GRADE”	KEY PHRASES
CHILE	B+/A-	Noted <i>high</i> degree of transparency ;recommend consolidating good practices
CZECH REP.	B+	1999 Report concluded CZ meets <i>many</i> of the requirements; updates report steady improvement
PORTUGAL	B+	Meets code in <i>several</i> areas, making progress,..still several areas to strengthen transparency and management
LATVIA	B+	Achieved <i>many basic</i> requirements..leader in adopting improved practices...efforts underway

		to improve transparency
MEXICO	B/B+	has made considerable <i>progress</i> ..nevertheless authorities acknowledge need for further action
HUNGARY	B/B+	<i>Increased</i> transparency since 2001 in a number of areas...however transparency <i>not served well</i> by transaction reducing <i>measured</i> deficits... moving items off-budget
LITHUANIA	B/B+	Meets <i>many</i> requirements of Code...still <i>much</i> room for improvement in <i>key</i> areas
S.KOREA	B/B+	meets best practices in <i>many</i> areas...falls short in some <i>key</i> areas
CROATIA	B/B+	meets code in <i>number</i> of areas.. <i>major</i> weaknesses remain
GREECE	B	Has <i>made</i> progress in meeting requirements/much still needs to be done...greater challenges remain
POLAND	B	Transparency has <i>improved</i> in recent years .. <i>generally</i> inline with standards..still some <i>outstanding issues</i>

Table 6 can speak for itself .especially in the words of the last column cited directly from the individual country reports. The notional grades and ranking is entirely the judgment of the author and can easily be disputed. It is meant only to give a very rough assessment allowing one to draw the main comparative conclusions . The message seems clear: CEB countries are not distinctly worse in the IMF ROSC assessments than many important upper middle income emerging market countries, perhaps only Chile coming

out ahead. It is even more striking that the assessments for Greece and Portugal, longstanding EU members are by no means superior.. While the table does not include any of the CIS countries, a reading of them suggests much lower rankings than the group above-that is to say the CEB has apparently reached upper middle income country standards in fiscal management, but CIS countries remain far behind.

II.2.c. Monetary and Financial Sector Management

The transition from central plan to market necessarily required not only liberalization for enterprise decisions, but also a switch of government instruments to market-oriented ones. In the monetary policy area this included elimination of directed credits, use of indirect instruments like reserve requirements, refinance windows, discount rates of interest, Lombard facilities, issue of Government paper, etc. Demelo and Denizer (1999) already provided an early review showing that as early as end-1994, twelve countries were using such market-oriented to a high or substantial degree, another 6 moderately, and only seven –all CIS- to a low degree. This continued to move forward of course, unfortunately no comparable analysis has been done for later years. However, many country specific studies of monetary and banking sector developments exist and generally conclude that by 2000 or so, even most CIS countries had seen their monetary policy “mature” to predominant use of indirect instruments.⁹

⁹ Barisitz (2008), Bakker and Chapple (2003), and Vinhas de Souza and Havrylyshyn (2007) contain many such studies.

The Heritage Foundation Index of Economic Freedom provides some insight in its “financial freedom” indicator—though this overlaps with the rule of law indicators discussed in Section III.

TABLE 7. FINANCIAL FREEDOM INDEX

	EASIA	CEB	SEE	CISM
1996	54	63	35	43
2000	55	61	35	39
2007	53	70	60	50

The very high level of financial freedom attained in the CEB countries already by 1996 exceeded somewhat that in East Asian countries (though these varied a lot from values of 70-90 in Honk Kong and Singapore to 50 in others), and kept increasing while post-1997 crisis effects led to some regression in East Asia . Civil conflicts in SEE constrained liberalization in financial operations in all but Bulgaria and Romania, where the index was no lower than 50 even in 1996, and quickly rose to 60-70.

The CISM saw a very slow increase and remains relatively low, partly reflecting important reversals in Russia where it fell from 70 in 1996 to 40 by 2007, as many of the liberalizing moves done in 1992-94 were gradually reversed and increased government

regulations imposed.¹⁰ In contrast Georgia, Kazakhstan and Ukraine undertook steady liberalization raising the index from 30 in 1996 to 50-60 by 2007.

The most comprehensive assessments of the financial sector workings are to be found in the IMF FSSA (Financial System Stability Assessment) reports begun at about the same time as the ROSC studies noted earlier. They do not just focus narrowly on monetary policy effectiveness, but are much broader, aiming at giving a good picture of risks of financial instability. As for the ROSCs there is no scoring, but the text of the reports usually provides clear messages to the knowledgeable reader. I have constructed Table 8 on the same criteria as Table 6, roughly ranking several countries and giving the key text phrases that allow any reader to make inferences.

TABLE 8. IMF FSSA REPORTS –NOTIONAL RANKING

COUNTRY BY APPROX RANK	NOTIONAL “GRADE”	KEY TEXT PHRASES
CHILE	B+/A-	Banking system <i>sound</i> well-supervised..low non-performing loans... could absorb <i>sizeable</i> shocks
HUNGARY	B+/A-	<i>final</i> stages of transition...one of <i>most</i> developed and diversified fi. Systems CEE...no major threats
CZECH REP/	B+	<i>Near the completion</i> of reforms addressed at earlier crisis...considerable progress made,non-performing loans <i>appear</i> manageable...challenges remain
S.KOREA	B+	noteable <i>progress made</i> improving supervision, reforming regulatory frame... <i>but</i>

¹⁰ This is well documented in the annual Transition Reports of the EBRD, and also studied in Owen and Robinson (2003)

		supervisory independence could be strengthened...non-bank sector progress less pronounced
LATVIA	B+	system is well capitalized ...noteable significant share of non-resident deposits ... need to continue closely monitoring these ... <i>fairly</i> resilient to shocks
GREECE	B/B+	<i>Appears largely</i> sound and resilient...but challenges from rapid credit growth, exposure to unfamiliar risks...insurance firms <i>weak</i>
POLAND	B/B+	<i>Has been</i> modernizing considerably , <i>approaching</i> international standards...fin. system faces a <i>range</i> of challenges
MEXICO	B/B+	Sound implementation of <i>macro</i> policies , US links, made fin.system <i>more</i> resilient... but still has to resume sound lending
LITHUANIA	B	No <i>immediate</i> risks due to sound macro in CBA ...exposures <i>appear manageable</i> .. recommend focus on legal and regulatory framework
CROATIA	B-/B	System is <i>more</i> resilient and <i>better</i> prepared ... severe macro shocks can cause difficulties...non bank less developed
ICELAND	B-	Rapid evolution of financial market... outpacing regulatory frame...significant vulnerabilities exist ... emergence of macro imbalances

As with the fiscal management assessment in Table 6, the rank-order I have proposed in the first column is at best indicative and not the main point of the table; that is to be seen in the last column citing selected text from the reports which readers can judge themselves. For my purposes, the main conclusion to be drawn from Table 8 is the same as for Table 6: the advanced transition countries of CEB are fully comparable to upper

middle income emerging markets ,and indeed in company with some of the higher income countries.

Had this paper been written a few months ago it would not have occurred to the author to include Iceland in the above list—far beyond the “comparable level of development” criterion. But given the problems of Iceland, it seems of some interest to include its FSSA. As is seen, its language is far sharper and more negative than for any of the others in this selection , suggesting the IMF assessments are perhaps more prescient and accurate than many recent critics had been claiming before mid-2008. The reader might counter that Hungary too has had to take an IMF program, so why was this not foreseen? Part of the answer may be –and I do not pretend expertise on individual cases—that there the problem has been more fiscal, and in fact in the ROSC assessment in Table 6 Hungary does not so well . In any event such most-recent events are well beyond the scope of this paper.

The main point of Section II is to show three things. First , that the macroeconomic stabilization part of a WC approach has in all transition countries been very successful, essentially achieved by mid-nineties in Central Europe and the Baltic countries, but also largely achieved in SEE and CIS countries by the end of the decade. Secondly, all countries except Belarus, Turkmenistan and Uzbekistan have made considerable progress implementing market-oriented macro-management instruments, both in fiscal and monetary-financial domain. Third , on the macro-policies institutions , it would appear that CEB countries have completed this transition and arrived at levels entirely

comparable to market economies of middle and upper-middle income of development; others still lag behind .

An important cautionary note is warranted on the third point. While the “success” of the CEB macro-transformation is commendable and needs to be recognized, this by no means implies countries are free from macro economic problems and risks. The recent history of falling short on euro-adoption criteria and now renewed financial crises in some cases, attests fully to the fact that *the end of transition does not mean the end of problems*. It can only mean, at best, that the nature of macro problems is no longer that inherited from the socialist period , but rather the problems are those common to all market economies when policy management is misguided or falls short, or is driven astray by populist political tendencies. Whether the problems of a “mature” economy are more or less difficult than those encountered during the transition is basically irrelevant.

III. INSTITUTIONS AND RULE-OF-LAW: THE NATURAL FOLLOW-UP TO STABILIZATION

The preceding section has demonstrated that ,at least in transition countries, the WC did not “crumble” but was eventually fairly successful in its first aims of financial stabilization and basic liberalization. There has indeed been a shift of emphasis to rule-of-law and the underlying institutions that need to develop for sustained growth, but this shift was not as the Economist citation suggests due to a new awareness after the failure of WC, rather it was a very natural next step in the sequence. One way in which this “natural sequencing” will be seen below is that for all transition countries, significant

progress on the first steps of improving institutions was achieved even before stabilization was fully in hand.

This section presents a number of different indicators for institutional quality and effectiveness of ROL, including the EBRD index of transition broken down into the purely liberalizing and institutional components, the Heritage House freedom of Investment Index; and from the WBI data set the percentile rank indices for Regulatory Framework and Rule of Law. As noted earlier some of the indices shown in Section II already partially reflected institutional quality as well.

III.1. The EBRD Index of Transition

In Table 9 the EBRD Index of transition is divided in 2 components : liberalization elements (LIB) and institutional quality elements (INST). The former include small privatization, price liberalization , foreign exchange and trade liberalization; the latter include most of the other s in EBRD but not large-scale privatization or infrastructure. While other indices of institutions, rule of law are far more elaborate than those of the EBRD, INST here turns out to correlate very well with such other indices and has the overwhelming advantage of being available in a time-series since about 1991-2.¹¹

¹¹ These computations are described and discussed in more detail in Havrylyshyn (2008a).

TABLE 9

**EBRD Transition Progress Index
Liberalization (LIB) Institutions (INST)**

		1994	1999	2005
Central Europe	LIB	3.7	4.2	4.3
	INST	2.7	3.1	3.3
Baltics	LIB	3.7	4.1	4.3
	INST	2.3	2.9	3.2
S.E. Europe ^{1/}	LIB	3.0 (n.a)	4.0 (3.9)	4.1 (4.0)
	INST	1.7 (n.a)	2.2 (1.9)	2.5 (2.3)
CISM	LIB	2.2	3.7	3.9
	INST	1.4	2.1	2.2
CISL	LIB	1.9	2.0	2.3
	INST	1.4	1.6	1.5

While institutions lagged behind liberalization in all countries, and CEB was much ahead of the others on all reforms, it is also clear that considerable advancement on institutions took place even before the achievement of stabilization in all but the lagging CISL group. Recall the index ranges from 1.0 to 4.3, with 3.0 reflecting a state where market orientation is becoming dominant if not yet complete. By 1994 when stabilization was nearly complete in CE, the value of INST was approaching 3, though in the Baltics this came slightly later by 1999. By 2005 both of these groups were well over 3.0—an update to 2007 shows only a slight increase to 3.4. In the CIS stabilization was not done till about 2000, but there was clear forward progress on INST by then, as distinct from the CISL cases (Belarus, Turkmenistan, Uzbekistan) where soviet-style institutions continue to dominate. With exception of the latter group, the pattern over time is common: stabilization comes early and once started takes only a few years to

succeed, basic liberalization is simultaneous, while only modest beginnings are made on institutions. After stabilization INST advancement accelerates in CEB , but not necessarily elsewhere. Why is it that rapid stabilizers also subsequently move faster on institutions that late and slow stabilizers? This may be beyond the present scope, but a possible answer explored elsewhere is that those who are committed to institutional reform recognize the need to move first and quickly on stabilization; those that claim to be committed to a gentle more social-economy strategy (CISL cases, Ukraine in early nineties ,etc.) are committed neither to stabilization nor institutional reform; note how little INST reform occurs in the CISL.

A more relevant puzzle here is the fact of an early growth recovery in CEB by mid-nineties when INST values were all below 3.0, and a similar recovery in CISM after only modest gains on INST? This would seem to contradict the Economist citation that “ if the rules of law were a mess... no amount of tinkering with macroeconomic policy would produce desired results.” In fact in a purely *post-hoc* sense, stabilization in transition countries with limited institutional progress seemed to be sufficient for growth to recover quite strongly. Sec. IV will explore some possible answers to this question.

II.2. Investment Freedom

Another partial indicator of the quality of market institutions is the index of “Investment Freedom” compiled for many years by Heritage House. It has the advantage over EBRD measure of allowing a comparison with non-transition economies at different levels of

development . Table 10 summarizes these values for 1996,2000,2007 in a comparison with East Asian countries.

TABLE 10. INVESTMENT FREEDOM INDEX

	EASIA	CEB	SEE	CISM
1996	63	66	46	40
2000	68	68	55	46
2007	55	69	58	41

The table gives a picture fairly analogous to earlier comparisons. CEB countries are well ahead of SEE and CISM –CISL is not shown because their story has been fully “told “ in the EBRD indices above. Surprisingly they are in about the same range as East Asia and in fact in latest period perhaps ahead due to some reversals there after the 1997 financial crisis—a fact already evidenced in the Financial freedom Index in Table 7. In SEE one sees continued progress probably related to the political and economic stabilization there in the past decade and the incentives of potential EU membership. In these tables SEE still includes Bulgaria and Romania and certainly some of the increase is attributable to these two. However , the trend upward is also seen in all other countries. In the CISM one sees the same long lag as EBRD INST index showed, but even more so a decline since 2000 attributable to some tightening of foreign investment procedures –often in

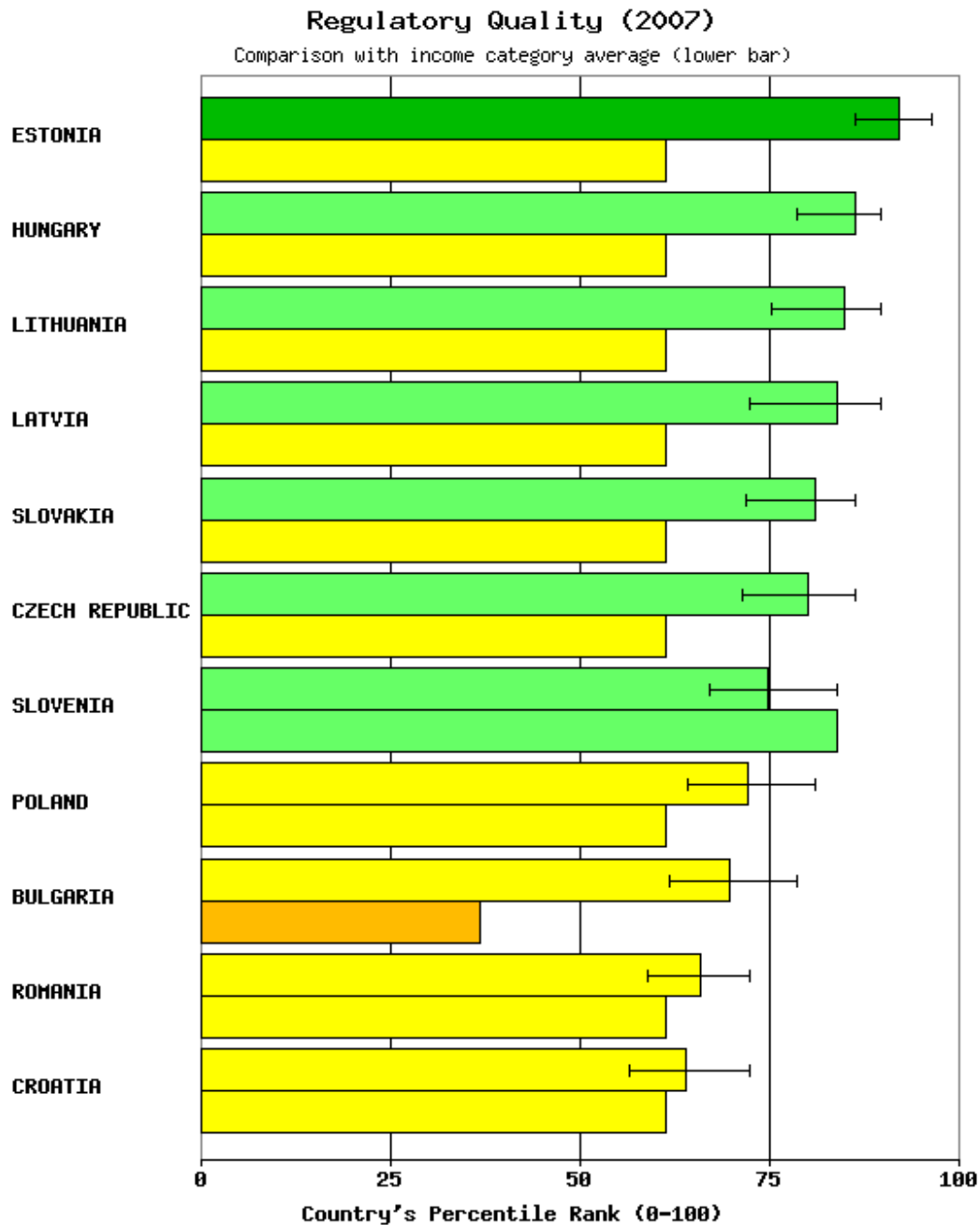
application rather than formal, law- in several countries : Russia, Moldova, Ukraine. Only Georgia saw forward progress.

III.3. *Overall Indices of Regulatory Framework and Effectiveness of Rule of Law*

The much more comprehensive indices of governance now provided for over 200 countries and territories by the World Bank have become the international standard for institutional and rule of law assessments. In this section I extract from their data bank comparison charts for regulatory quality (REG) and rule of law (ROL) in 2007 comparable to Figures 2,3,4 shown earlier.

In Figures 5,6,7, one observes for regulatory quality much the same pattern established so far in the present paper by other indicators . CEB countries and even the most recent EU members Bulgaria and Romania are far ahead of even the most advanced CISM countries (Armenia, Georgia) . (Figures 5 and 6). As before, CEB is very similar to east Asian countries, (Fig.7) with the leading ones in both groups ranking higher than the 75th percentile , the less advanced ones generally above 50th percentile, and almost all having a ranking higher than the comparable income group. (The lower bar for each country.) The only exceptions to the latter point are Taiwan and S.Korea, but for both the margin of error at 95% confidence as calculated by WBGI(line at end of each country's bar) covers the difference.

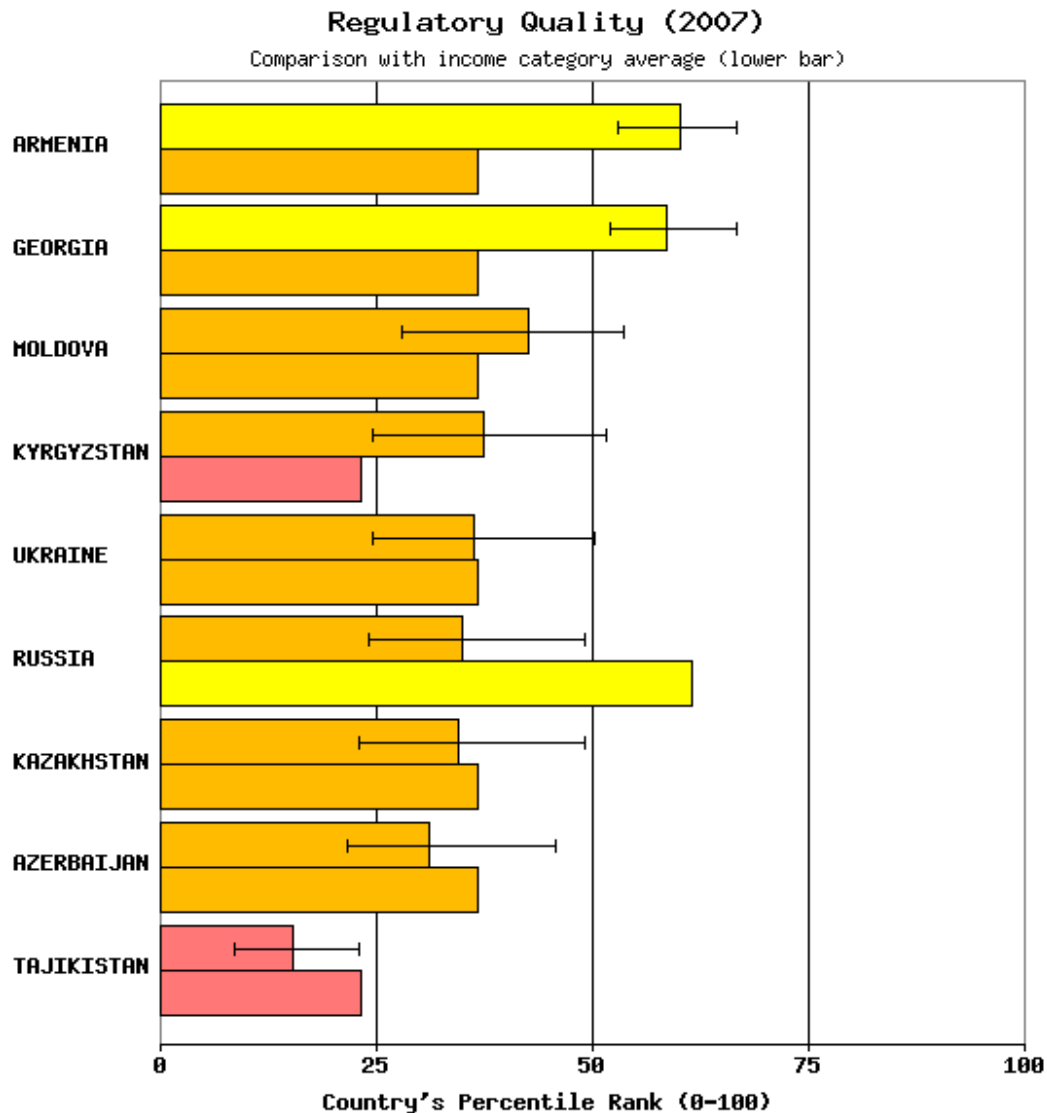
FIGURE 5: REGULATORY QUALITY NMS



Source: Kaufmann D., A. Kraay, and M. Mastruzzi 2008: Governance Matters VII: Governance Indicators for 1996-2007

Note: The governance indicators presented here aggregate the views on the quality of governance provided by a large number of enterprise, citizen and expert survey respondents in industrial and developing countries. These data are gathered from a number of survey institutes, think tanks, non-governmental organizations, and international organizations. The aggregate indicators do not reflect the official views of the World Bank, its Executive Directors, or the countries they represent. The WGI are not used by the World Bank Group to allocate resources or for any other official purpose.

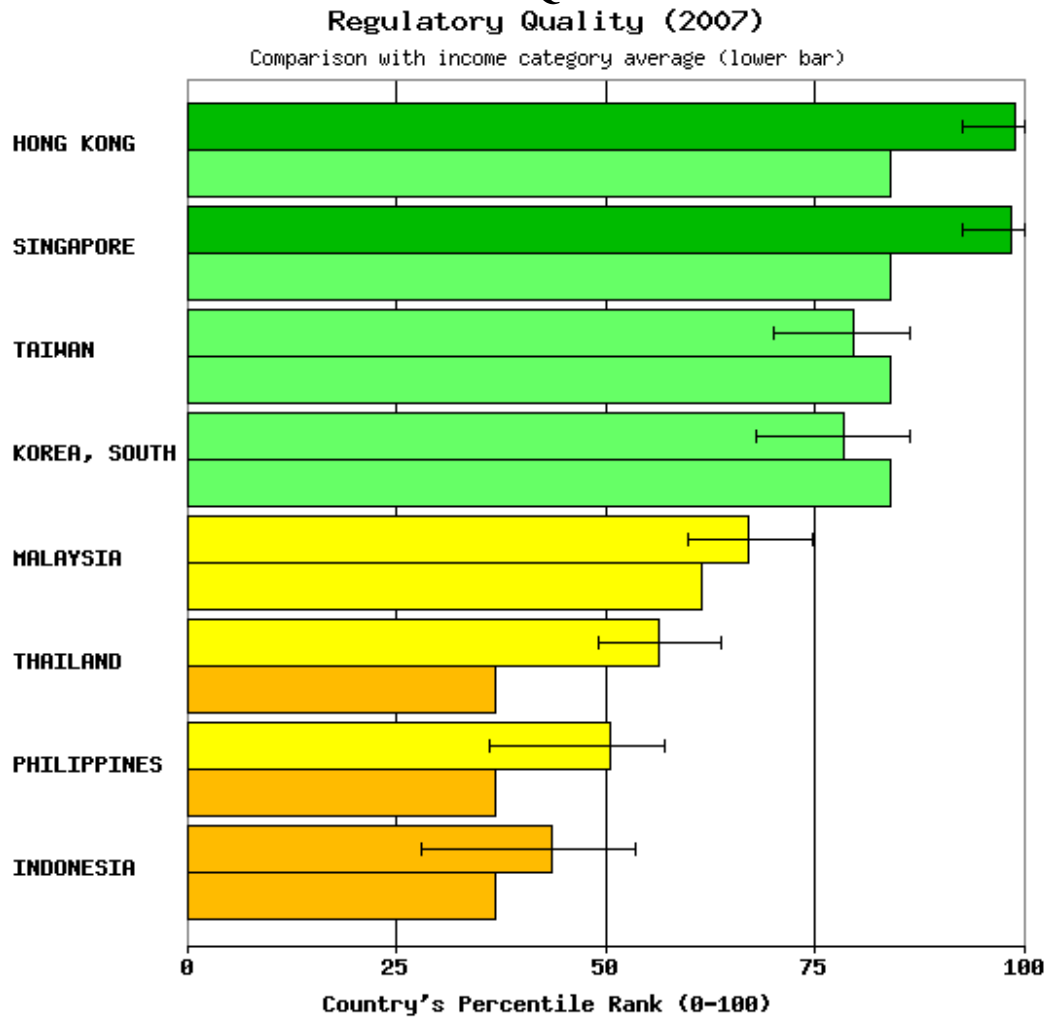
FIGURE 6: REGULATORY QUALITY CISM



Source: Kaufmann D., A. Kraay, and M. Mastruzzi 2008: Governance Matters VII: Governance Indicators for 1996-2007

Note: The governance indicators presented here aggregate the views on the quality of governance provided by a large number of enterprise, citizen and expert survey respondents in industrial and developing countries. These data are gathered from a number of survey institutes, think tanks, non-governmental organizations, and international organizations. The aggregate indicators do not reflect the official views of the World Bank, its Executive Directors, or the countries they represent. The WGI are not used by the World Bank Group to allocate resources or for any other official purpose.

FIGURE 7: REGULATORY QUALITY EASIA



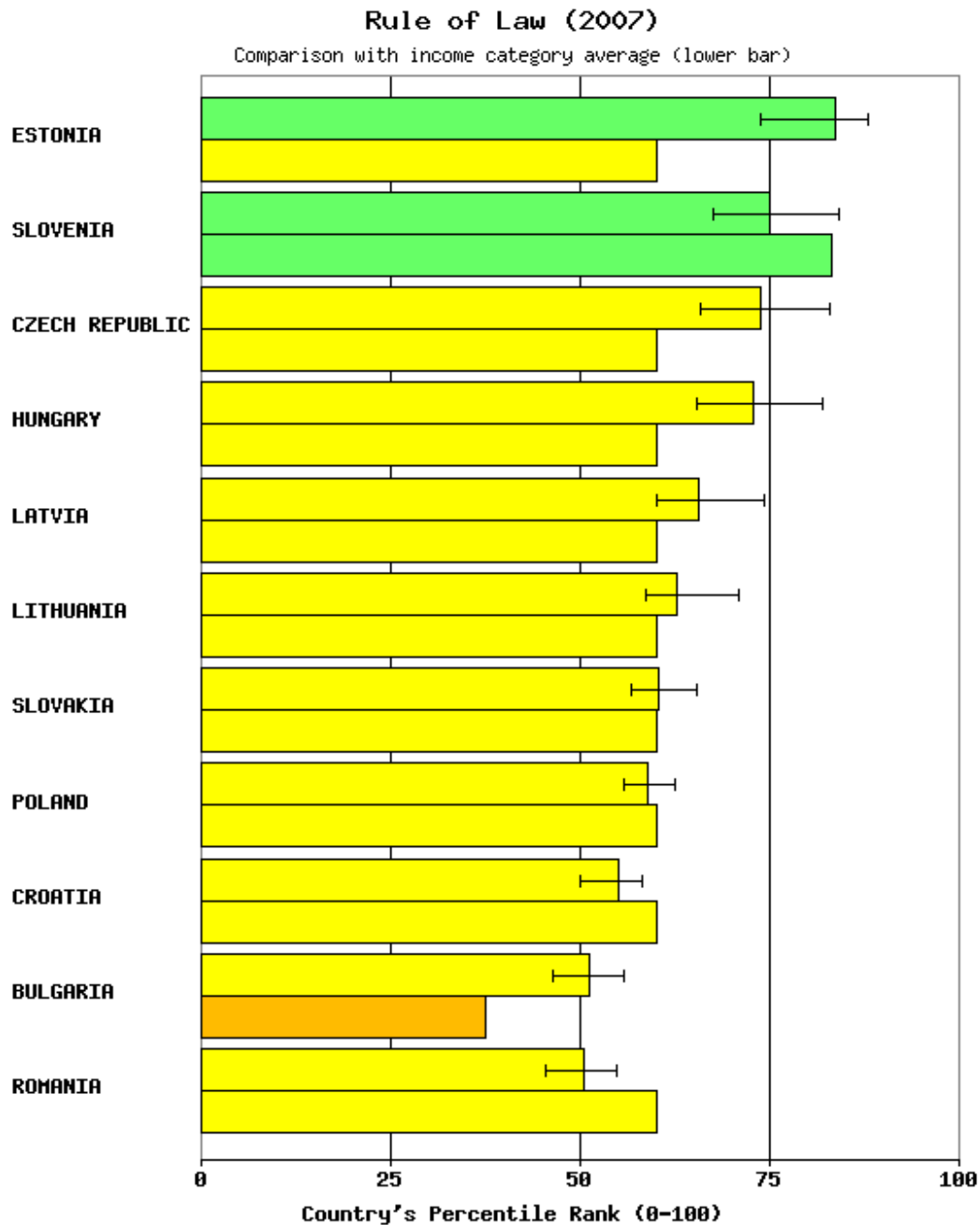
Source: Kaufmann D., A. Kraay, and M. Mastruzzi 2008: Governance Matters VII: Governance Indicators for 1996-2007

Note: The governance indicators presented here aggregate the views on the quality of governance provided by a large number of enterprise, citizen and expert survey respondents in industrial and developing countries. These data are gathered from a number of survey institutes, think tanks, non-governmental organizations, and international organizations. The aggregate indicators do not reflect the official views of the World Bank, its Executive Directors, or the countries they represent. The WGI are not used by the World Bank Group to allocate resources or for any other official purpose.

The ROL indices when compared give a broadly similar picture but with one important difference. While in East Asia the percentile rank for each country is quite similar to that of the REG index, for the transition countries it is distinctly lower. In the CEB only Estonia and Slovenia reach the 75th percentile, and the lagging countries are not much above the 50th percentile. This means that the comparison with similar income group is less favorable than for other indicators shown earlier in the paper. Nevertheless one cannot say CEB lags behind their comparators—they are at about the same percentile. Note that on ROL the East Asian countries also do not show the clear lead above comparators that were shown for GOVEFF (Fig.4) or for REG (Fig. 7.). The ROL charts illustrate very dramatically how far the CISM countries have to go to reach international standards of institutions. In Figure 9 one sees they are generally well below the 50th percentile, several below the 25th-note Russia at about 15th- and in most cases have rankings distinctly lower than the similar income group.

But the bottom line is once again clear: for Regulatory Quality and Rule of Law CEB countries are more or less in the same ranking as those of East Asia, which the present paper argues is a more appropriate comparator group than the most advanced high income economies such as the EU15.

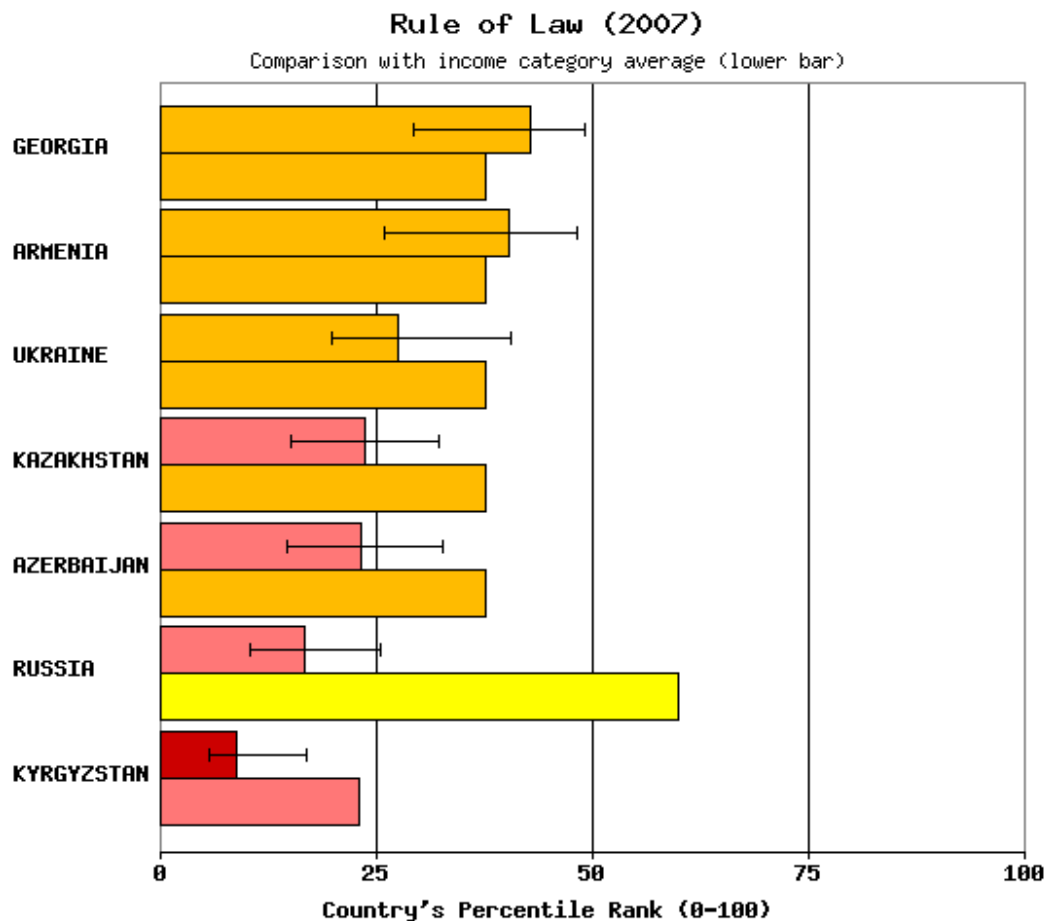
FIGURE 8. RULE OF LAW: NMS



Source: Kaufmann D., A. Kraay, and M. Mastruzzi 2008: Governance Matters VII: Governance Indicators for 1996-2007

Note: The governance indicators presented here aggregate the views on the quality of governance provided by a large number of enterprise, citizen and expert survey respondents in industrial and developing countries. These data are gathered from a number of survey institutes, think tanks, non-governmental organizations, and international organizations. The aggregate indicators do not reflect the official views of the World Bank, its Executive Directors, or the countries they represent. The WGI are not used by the World Bank Group to allocate resources or for any other official purpose.

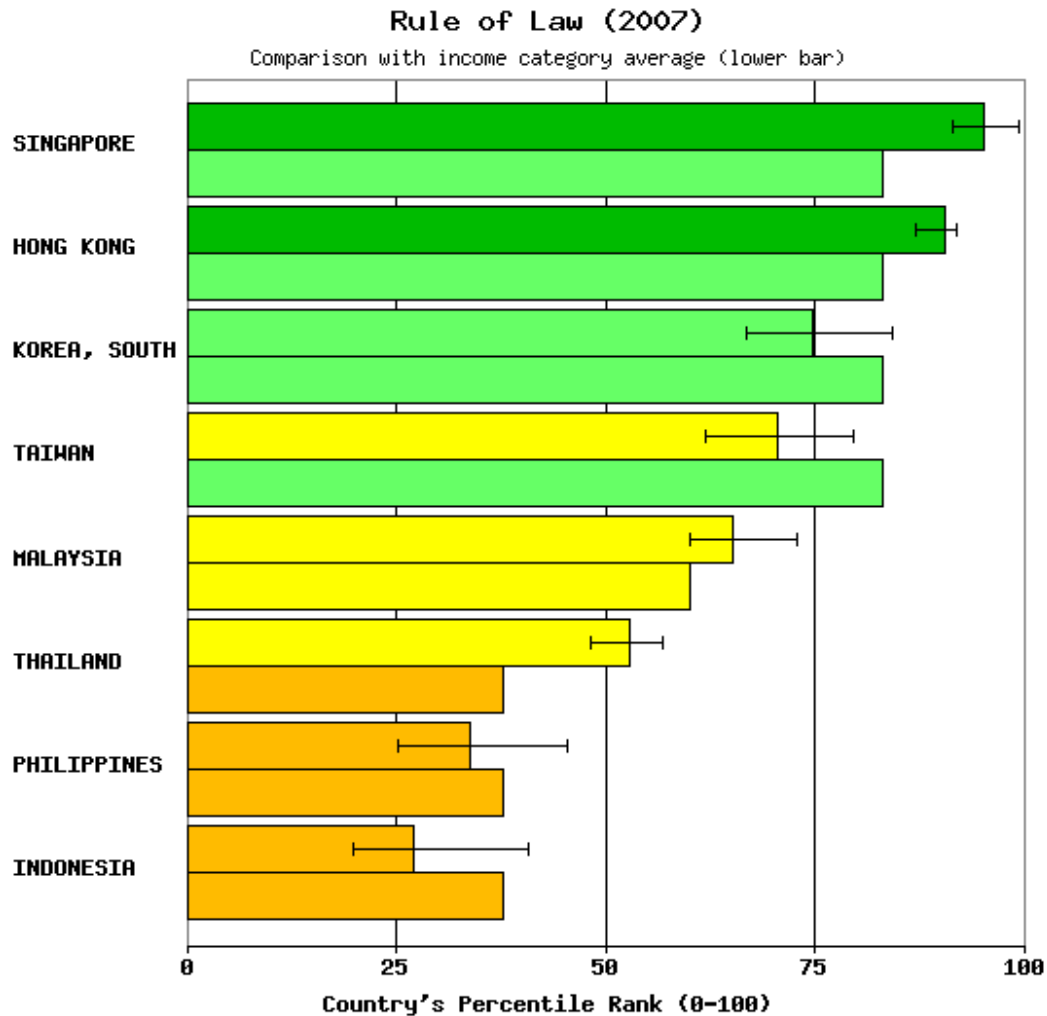
FIGURE 9. RULE OF LAW: CISM



Source: Kaufmann D., A. Kraay, and M. Mastruzzi 2008: Governance Matters VII: Governance Indicators for 1996-2007

Note: The governance indicators presented here aggregate the views on the quality of governance provided by a large number of enterprise, citizen and expert survey respondents in industrial and developing countries. These data are gathered from a number of survey institutes, think tanks, non-governmental organizations, and international organizations. The aggregate indicators do not reflect the official views of the World Bank, its Executive Directors, or the countries they represent. The WGI are not used by the World Bank Group to allocate resources or for any other official purpose.

FIGURE 10: RULE OF LAW : EASIA



Source: Kaufmann D., A. Kraay, and M. Mastruzzi 2008: Governance Matters VII: Governance Indicators for 1996-2007

Note: The governance indicators presented here aggregate the views on the quality of governance provided by a large number of enterprise, citizen and expert survey respondents in industrial and developing countries. These data are gathered from a number of survey institutes, think tanks, non-governmental organizations, and international organizations. The aggregate indicators do not reflect the official views of the World Bank, its Executive Directors, or the countries they represent. The WGI are not used by the World Bank Group to allocate resources or for any other official purpose.

IV. HOW GROWTH CAN OCCUR WITH IMPERFECT INSTITUTIONS

Were one to take the Economist citation heading the paper literally, the stabilization achievements of transition economies (Sec.II) should not have been enough to allow the robust growth actually seen since 1994-5 in CEB and since 2000 in CIS, because institutional development and rule of law were still at a very low level then.(Table 8). This section attempts to provide a tentative explanation broadly in the spirit of rational expectations. But first let me address a popular explanation for the CIS growth surge since 2000, namely the high price of energy products.

IV.1. Do Energy Prices explain the CIS Growth Surge?

There is no doubt that the sharp increase in energy prices at the turn of the decade at a minimum added directly to the magnitude of growth recovery in the CIS energy exporters-Azerbaijan, Kazakhstan, Russia , and Turkmenistan . It was no doubt also a catalyzing factor in stimulating growth of non-energy sectors of these countries and through import-spillover effects even to the neighbouring CIS countries that import energy. However, it cannot have been and was not the whole story.¹²

The oil and gas importers like Ukraine, Moldova, Caucasian countries, Kyrgystan might of course have benefited somewhat in first years of the boom in energy exporters , through increased import demand for food and consumer products in

¹² The main points of arguments that follow are based on Havrylyshyn (2008a) which also cites many other studies on the question of oil, price and growth; two important ones are Roland (2006) for Russia and Berengaut *et.al* (2003) for Ukraine.

particular. But given the negative terms of trade effects it was not conceivable that these countries could have positive spill over benefits beyond 2-3 years , strong enough to have growth rates fairly similar to those in the energy exporters. Indeed for these countries and even for Russia a lot of the recovery was widespread and not just an oil-price spillover; more surprisingly it was of a character similar to the recovery in the CEB in mid-nineties.

That is to say, the CIS had by about 1999-2000 achieved an equivalent position to the CEB in 1994-5 on three pre-conditions for growth: sufficient stabilization, sufficient liberalization ,and sufficient institutional development. Assume that the levels for these three dimensions reached in CEB “reveal’ the minimum threshold to engender recovery from the transition recession. In the year preceding recovery in CEB, inflation averaged 34.0%, the LIB index was 3.3, and the INST index 1.9.¹³ The values for CISM countries (excluding the three lagging reformers) were by 1999 respectively: 25.7%, 3.7, 2.0—not very different, and in the case of INST not only below the EBRD’s 4.0 mark of a nearly complete transformation , but even well below 3.0. One way to interpret this is to say that in CIS recovery came not just due to oil prices, but because stabilization and market reforms had advanced far enough to stimulate growth as in the CEB five years earlier. Berengaut *et.al.* (2003) provide a nice “accounting” for growth determinants noting reforms were sufficiently advanced stabilization achieved to recover; the rates were (as elsewhere in CIS) much higher than in CEB because a much lower bottom had been reached, and without question

¹³ This is much lower than the 1994 value shown in Table 9, because most of these countries started growth earlier m, in several cases in 1992-3.

the coinciding energy boom added a few points. Many analysts have also noted the substantial devaluation after the mid-1998 Russian crisis and how it resulted in beneficial import-substitution reviving many industries.¹⁴ There is no arguing with this, but the post-1998 devaluation must be considered part of the stabilization—without it, inflation which did bounce up in 1998-99, would have continued at a high level, that is to say there would not have been sufficient stabilization.

IV.2. Rational Agents Act in Growth Mode on Expectations About Rule of Law

That growth in transition restarted and has continued while rule of law and good institutions are still far from ideal, is a historical fact. Why were agents in the economy prepared to undertake production, investment, and consumption decisions in the direction of growth? If they were rational they “knew”¹⁵ that in , for example the Czech Republic in 1993 before growth recovery institutions were still much weaker than in market economies (INST was 2.67).But they also “knew” that in three short years these institutions had changed dramatically from communist period ones to move a long way in the direction of market oriented ones. (The INST index jumped from 1.0 in 1990, to 1.75, 2.0 and 2.67 – faster than any other transition country save Poland.¹⁶)

The analytical inference to be drawn here is that the benchmark of rational economic agents is not necessarily absolute values of institutional achievement compared to other countries but their judgment on what is possible to achieve in one, five ten, twenty years

¹⁴ Kadochnikov (2006) analyses the extent of import-substitution in Russia after 1998.

¹⁵ I mean here of course not the literal sense of knowing values of the EBRD or World bank indices, but understanding what is going on around them.

¹⁶ In a fine sense, even faster: Poland started two years earlier reaching 2.67 in five years; CZ started a bit later but caught up in three years. These distinctions may or may not be meaningless; the imprecision of EBRD index makes such fine-slicing questionable; but rational economic agents in CZ were surely aware in 1990 Poland had leaped ahead, and were also aware three years later CZ had caught up.

and their assessment based on recent policy actions of the governments commitment and ability to achieve the possible. Thus, the *pace and consistency of change is far more important than the absolute value of any statistical indicator*. The closer their expectations are met the more they will behave in a positive ,growth-stimulating fashion. An analogous interpretation applies to stabilization achievements. Rational agents may not be aware of the academic historical studies suggesting the breaking point between inflation that is negatively correlated to growth (too high) and one where the cause-effect and sign are reversed , is about 40%., as for example in Bruno and Easterly (1995) .¹⁷ But they do understand that inflation cannot be brought from 3 digits to one digit levels immediately, so they become confident , as in Poland by the achievement of cutting 1990 inflation of 586% to 70% in one year—and thus act in a way that contributes to a growth recovery in 1992. More, they continue to retain a reasonable confidence for the next seven years before inflation is gradually –but importantly to the argument *consistently-* down to single digits.

These same rational agents also consider and understand what is the nature of the government and its commitment/ability to keep the transformation moving forward at the feasible pace. Thus the strong fiscal discipline finally brought about by the Putin administration in Russia helped raise agents expectations. Similarly, the period of Yuschenko’s Prime Ministership in Ukraine 2000-01 in itself raised confidence levels, which to some extent were confirmed by the actual actions of the government, for

¹⁷ Other studies find it to be as low as 20-25%-but this is not critical to the main point of my argument.

¹⁷ Berengaut et..al. (2003) elaborate on this, noting the substantial role played by Energy Minister Tymoshenko, sometimes said to be a former “oligarch ‘ of energy sector

example reducing considerably the rent-seeking opportunities in energy sector.¹⁸

Another example I will note only briefly is the well-known fact of substantial FDI coming into the EU candidate countries well in advance of actual membership. The rationale of these investors was probably that by 1995 or so when candidacy progress was evident, they could expect that in future these countries would have high quality rule of law in future, and naturally it would be better to be first on the ground.¹⁹ The OECD (2008) Economic Survey ; Czech Republic provides considerable analysis of the degree to which rational agents have viewed with confidence and optimistic expectations the evolution of government policy, including the ups in early nineties the bit of a down in mid nineties and the rebounds in recent years. Gersl (2006) while showing that EU entry conditions at first had effect only on stimulating formal rules, but not immediately on effective implementation and informal rules. Nevertheless he concludes optimistically that “EU pressure ... may have a disciplining effect on the enforcement of formal rules.” It would seem that domestic and foreign economic agents broadly share this optimism, not only in Czech Republic but in many transition countries where we see continued high growth rates.

In short, it is necessary to recognize that economic agents who will make the decisions that do or do not result in growth recovery, higher or lower growth, sustained or unsustainable growth, behave rationally and do not wait for a completed transformation on macro stabilization, or market liberalization or improved institutions assuring rule of

¹⁹ It has been demonstrated econometrically that positive announcements about membership [prospects led to higher FDI. **FIND REFERENCE.**

law. Like the foreign investors who came into EU candidate countries well ahead of the Acquis Communautaire conditions being met and the consequent accession in 2004, domestic agents also rationally move on their expectations of future progress, hence historically exactly as one saw, well before the completion of transition.

V. SUMMARY AND CONCLUSIONS

This paper has considered applicability to transition countries of the growing conventional wisdom that the Washington Consensus failed, and in its place has been put a new paradigm, the centrality of institutions and rule of law. It argues to the contrary that in the post-communist region, the Washington Consensus has in fact been quite successful, and that increased emphasis on rule of law is not so much a new paradigm as a natural follow up to successful first steps of stabilization and liberalization.

A number of principal conclusions can be drawn. First, stabilization was achieved quite quickly in an entirely orthodox fashion once the serious efforts began. As the CEB countries were the first to apply fiscal and monetary remedies in the years 1988-1991, they were the first to achieve inflation control and recovery of growth, in the years 1992-94. In South East Europe and the CIS there were considerable delays and reversals, but they too achieved stabilization and growth revival in the last years of the nineties. Second, there is no question that in all these countries, institutional improvements towards effective rule of law lagged considerably, and indeed even to the present day they are far from complete.

But a third conclusion qualifies this last point somewhat. If completion of transition is defined as reaching an equilibrium position similar to comparable market economies, I conclude that on the institutional dimension the CEB countries have more or less completed transition, while the others indeed have not. This is evidenced by comparing a large number of institutional and governance indicators not with the most advanced high income countries, but with comparable middle income level countries. Thus, the CEB is seen to have values for these indicators very much like those of upper middle income countries, including the economically very successful East Asian Tigers. The SEE and especially the CIS countries are not as consistently in the range of comparable countries, but neither are they distinctly behind—it depends on the country and the indicator.

A fourth conclusion from the analysis is that on the eve of economic recovery in transition countries—early nineties for CEB, late nineties for CIS—institutional development was very little advanced, even in the CEB countries. Thus the stark assertion of the Economist article interpreting the new paradigm to the effect that as long as rule of law was poor good macropolicies would have no effect on promoting growth, is simply wrong for the transition countries. In all cases growth recovered and has been reasonably well sustained long before rule of law became solidified.

This last finding raises a puzzle of how this can be. In the present paper I have only proposed a very brief and tentative explanation: rational economic agents understand institutions take much longer to develop than results of stabilization policies, and act not on the basis of attained achievements but expectations, which in turn are based on recent

history of pace and consistency of government policy. If they are satisfied reforms are proceeding as fast as feasible, they do not concern themselves with the fact that the absolute level of achievement is still far behind other market economies., and therefore make decisions that lead to growth.

Finally let me note a handful of directions for future research indicated by these findings. The World Bank data on governance indicators contains a vast amount of data that is much more detailed than the aggregates used in this paper like Regulatory Quality and Rule of Law. Probing into the components of these aggregates may reveal which of them are considered more important to economic agents , i.e. are there “leading” indicators of Rule of Law? An aspect of this worth pursuing concerns the distinction between formal rules and implementation-plus in formal, application, as for example noted in the Gersl (2006) paper. The better standing of CEB on Regulatory Quality compared to Rule of Law may be due to implementation; the first indicator broadly contains more formal sub-indicators, the other many implementation ones. By separating formal from informal sub-indicators much might be revealed. Furthermore the detailed components allow closer focus on different sectors of the economy : international trade, banking and finance , etc. This permits a much finer analysis of how the evolution of banking and finance institutions may have differed from others , and allow estimating impact effects. On a more theoretical plane, developing a more precise model of rational agent reactions to government policy would be very interesting and perhaps could reduce the vagueness of what institutions are. One possible hypothesis that could reconcile some of the different interpretations is that for economic growth to recover after a crisis of any sort , agents

look first to see stabilization and at most a modest beginning on institutions. For growth to be sustained at high levels, agents then expect to see a catch-up by institutions. The evidence I have presented in this paper for transition economies is consistent with such a hypothesis, it is not however a complete test founded on a rigorous rational expectations model . That remains to be done.

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