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# Political Stability and Consensus: Keys to Sustainable Transition

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# Contents

Abstract .......... 4

1 Introduction .......... 5

2 Transition Path from Plan to Market .......... 6

3 Political Stability, Consensus and the Reform Process .......... 8

4 Policy Implications .......... 11

References .......... 12

Notes .......... 13

Rupinder Singh

# Political Stability and Consensus: Keys to Sustainable Transition

## Abstract

After a decade of moving from plan to market economies, variations in the rate of economic reforms and performance are evident for transition countries. For many, stabilisation of economic fundamentals has given way toward the issues of creating deeper institutional and structural reforms. The evidence of successful transitions indicates a positive link between liberalisation and economic performance. However, the evidence does not fully capture the domestic country-specific choice of political regime and the degree of social consensus. This paper, part of a two-paper series, argues that these are important explanatory variables for the rate of transition chosen by a country and for sustained reforms for fast-reformers. Political stability and consensus correlate with a faster reform effort. Political instability and lack of consensus, corresponding to conflict zones, correlates with delayed reform. Evidence from transition countries shows that the countries in the latter group, e.g. countries in the Caucasus, shift to a fast-track reform process once political stability and consensus replace internal conflict. In contrast, countries with political stability but lack of consensus remain relatively stagnant in their rates of economic reforms and economic growth.

**Keywords:** Transition, Political stability, Consensus

**JEL Classification Numbers:** E0, E6, F0, O0, O1, O2, P2

# 1 Introduction

This paper sets out with two aims. First, we are interested in providing, based on the evidence thus far, a transition blueprint for policy-makers that identifies the key conditions that ensure the sustainability of the reform process. Second, we aim to derive a policy-relevant model that displays the interlinkages between the different stages of reform in a dynamic context – a task taken up in a complementary paper.[1]

The Russian economic and financial crisis shows that focus upon stabilisation and accompanying economic measures aimed at introduction of the market mechanism *per se* are not a panacea for sustainable growth. Moreover, instances such as Albania and Bulgaria highlight the fact that that adverse developments can both derail stabilisation programs and lead to social unrest – a phenomenon also seen in non-transition countries such as Indonesia.

One policy issue therefore is the desirable and feasible segmentation of short-term reforms that can be implemented with relative speed and longer term reforms such as institution building for a market system in the form of laws, retraining of bureaucracies and overhaul of tax, banking and accounting standards.[2]

The second issue, and one that has received greater attention since the Asian Crisis in 1997 and 1998, has to do with the social dimension of reform. The embodiments of this debate include the World Bank's Comprehensive Development Framework[3] and criticism of the "Washington Consensus," which loosely stated argues against imposition of a reform agenda out of synch with the social circumstances of the economy in question and the potential social costs of implementation. For transition countries, the reform process underlying transition from plan to market has been underway for a decade. Patterns of success and failure have been catalogued. Thus, a faster reform effort corresponds to the propensity of liberalisation from a command economy as prescribed by the Washington Consensus.

The emerging "post-Washington Consensus" also applies to transition countries. First, the focus on structural issues in the form of greater transparency, better corporate governance and improved compliance and supervision of financial institutions apply with perhaps greater weight to transition countries, given their relative stage of development.[4] Second, the focus on the human dimension of reform and the need for effective social safety nets for the "losers" of the reform effort is equally valid for transition countries.

The critical issue regarding the social dimension is its link with the goal of sustainable economic growth for transition countries. Fast-track reforms undertaken by transition countries are the same countries where the reform process was "owned" domestically. As argued in Singh,[5] external conditionality in the form of the carrot of EU accession may be a catalyst in this process for countries in central Europe and the Baltics. Yet for conditionality to succeed, there must be compliance and, more fundamentally, a genuine demand for change.

Section 1 presents evidence on the transition from plan to market. Economic performance is measured against choice of economic policy, where different measures are used to measure the degree of liberalisation. In general, the evidence shows a positive relationship between fast liberalisation and return to low inflation and economic growth.

The stance of the political regime, consensus for reform and rate of reform are taken up in Section 2. Tabulating transition countries in four groups on the basis of degree of democratisation and economic stance in 1995, the changing contours of the political regime and consensus (PRC) and reform mix are established in a four-sector diagram. Actual country movements are represented.

Political stability and consensus correspond to the choice of fast reform. These initial conditions are not modelled in economic studies, which means that evidence showing the link between performance and choice of economic stance must be implicitly based on the segments associated with political stability and consensus. By extension, the evidence for lagging reform and lagging performance is conditioned on the domestic choice of a lower level of political stability and/or reduced democracy and a lower level of social consensus.

*The policy implications sketch out that sustainable economic reform must focus upon the overarching need to win internal support for reform. Transition countries lagging in their reform efforts also need to achieve a more stable political environment by moving faster.* These considerations are likely to become more pressing in the second decade of transition as the more timely and politically contentious internal reforms come to the fore of reform agenda.

## 2 Transition Path from Plan to Market

Table 1. From Plan to Market. The Common Legacy and Systemic Change during Transition

| **Common Legacy** | **Changes Occurring during Transition** |
|---|---|
| 1. Macrobalance by direct control | Macroeconomic <u>destabilisation</u> |
| 2. Coordination through plans | <u>Output declines</u> resulting from disruption in the co-ordinating mechanism |
| 3. Little private ownership | <u>Output gains</u> from private ownership and private sector growth |
| 4. Distorted relative prices | Microeconomic and sectoral <u>reallocations</u> |

*Source: de Melo et al. (1996)*

Table 1 shows the common legacy facing countries at the outset of the transition process and the economic costs of amending the economic model towards market status and use of indirect instruments of economic policy. Within the transition literature, a number of authors have examined the relationship between economic performance and choice of economic policy (Sachs 1996, Fischer et al. 1996, de Melo et. al, 1996, Åslund et al. 1996, Krueger and Ciolko 1998), summarised in Table 2. The EBRD uses a similar indexation. In these papers, liberalisation is measured as an index that is then used to explain differences in performance, where weights are given for different policy changes. Such analysis shows that fast liberalisers experienced a faster rebound in output and, on average, lower rates of inflation after the initial rise in inflation.

One criticism of this approach (Krueger and Ciolko, 1998) is that such a composite may itself be endogenous to output decline and may therefore overstate the role of policy. A separate consideration concerns the starting position for the transition process. Åslund et al. (1996) find marked differences between the relatively slower reformers of the former USSR and the

relatively faster reformers in central Europe. They conclude that initial conditions are important determinants of performance, in particular, the legacy of the planned system and the weight of the military-industrial complex.

Table 2. Comparison of Regressions Predicting Performance in Transition Economies and Liberalisation

| Paper | Dependent Variable | Index of Liberalization | Coeff. Estimate of liberalisation[a] | Control Variables |
|---|---|---|---|---|
| Sachs | Growth in 1995 | EBRD[b] | 0,77 (4,84) *** | None |
| | Growth (1989 - 95) | | 0,62 (3,74) *** | |
| de Melo | Average growth (1989 - 94) | CLI[c] | 2,60 (4,7) *** | Per-capita income in 1989 and dummy variable for countries subject to regional tensions. |
| | Inflation (1991-94= | Log(CLI) | 0,88 (2,3) | The log of the drop in output and repressed inflation. |
| Fischer | GDP growth (1992-94) | CLI | 7,42 (3,54) *** | The fiscal balance, incomein 1991, fixed exchange rate, and trade disruption in 1992. |
| | Log inflation | CLI | -0,97 (-2,97) | |
| Aslund | Growth in 1995 | CLI | 3,5; 3,3[d] (4,4; 2,4) ***, ** | Dummy variables for countries of the former Soviet Union and for countries subject to regional tensions. |
| | Growth (1989-95) | CLI | 0,13; 0,0[e] (4,33; 0,0) *** | |
| | Unemployment | CLI | 4,3; 1,7[e] (6,1; 1,7) ***,* | |

*Source: Krueger G and M Ciolko, 1998.*

a: t-values in parentheses.
b: The EBRD's index of liberalisation
c: The cumulative liberalisation index as described in de Melo *et. al*, 1996.
d: The first value for the Aslund *et. al* (1996) estimates excludes the control dummies.
The second value is the estimate including both dummy variables.

* Significant at the 95% level.
** Significant at the 97.5% level.
*** Significant at the 99% level or greater.

A further criticism is that analysis based on standard economic models has not fully taken into account the interlinkages between political regimes and economic policies – initiation and sustainability. This is taken up in the following section.

## 3 Political Stability, Consensus and the Reform Process

The link between the choice of political regime or level of democracy and growth patterns has been examined by a number of authors. Barro (1994) argued that political freedom is a luxury good, and this has echoes for countries in transition at the outset of reform set against economic difficulties, particularly those in the CIS and separated geographically, historically and culturally from Western Europe. On the other hand, some analysts have argued that democracy and growth are mutually reinforcing. Indeed, there exists, as Barro argues, evidence of a non-linearity in that greater democratisation goes with enhanced growth at low levels of political freedom, but depressed growth when a moderate level of political freedom is attained.

The importance of suitable political conditions for sustainable reforms within a country is examined by Åslund et al. (1996). The authors distinguish among five groups of transition countries in three bands defined by the degree of democratisation (libertarian governments, radical structural reforms and liberalisation). The country allocations, as of 1995, within the five groups are displayed in Table 3.

Table 3. Political Regime and Choice of Transition*

| Groups | Features | Countries in Transition |
|---|---|---|
| 1 | Democratisation and liberalisation | Albania (1992), Czechoslovakia (1991), Estonia (1992), Latvia (1992) and Poland (1990) |
| 2 | Democratisation and slower reforms | Bulgaria, Hungary, Lithuania, Kyrgyzstan and Russia |
| 3 | Ex-Communists Delayed reforms | Belarus, Moldova, Kazakhstan, Romania, Turkmenistan, Ukraine and Uzbekistan |
| 4 | Conflict zones Delayed reforms | Armenia, Azerbaijan, Georgia and Tajikistan |

*Source: Derived from Åslund et al.(1996).*
** Czechoslovakia devolved into successor states of the Czech and Slovak Republics in 1992.*

Group 1 countries are displayed with dates of start of "radical reform." It is interesting to note that Albania is classified in Group 1, a country which destabilised economically and as a consequence socially and politically, while both Bulgaria and Russia – countries that underwent subsequent dislocation are placed in Group 2.

Table 3 therefore highlights the link between political regime, economic policy and through the country's track record on economic reform, its position on the transition from plan to market.

The segmentation of Table 3 highlights the key ingredient of political stability and social consensus, through the choice of democratisation and liberalisation, for the reform process to be irreversible. The links are presented in pictorial form in Figure 1 below:

Figure 1. Political Stability, Consensus and Reform Process

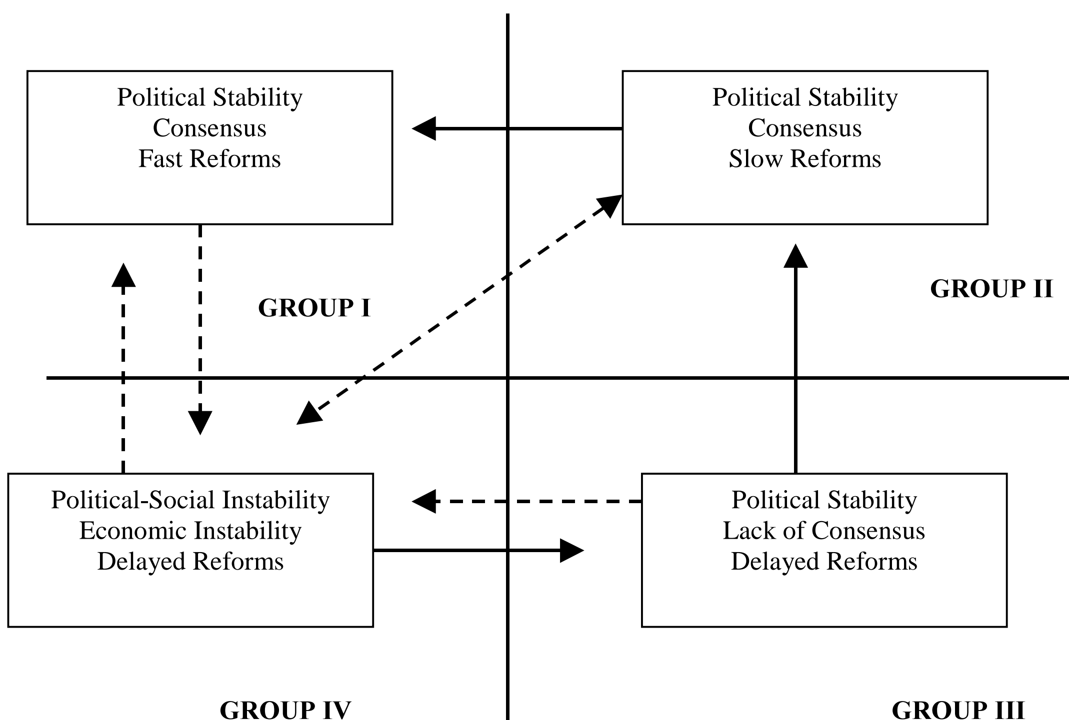
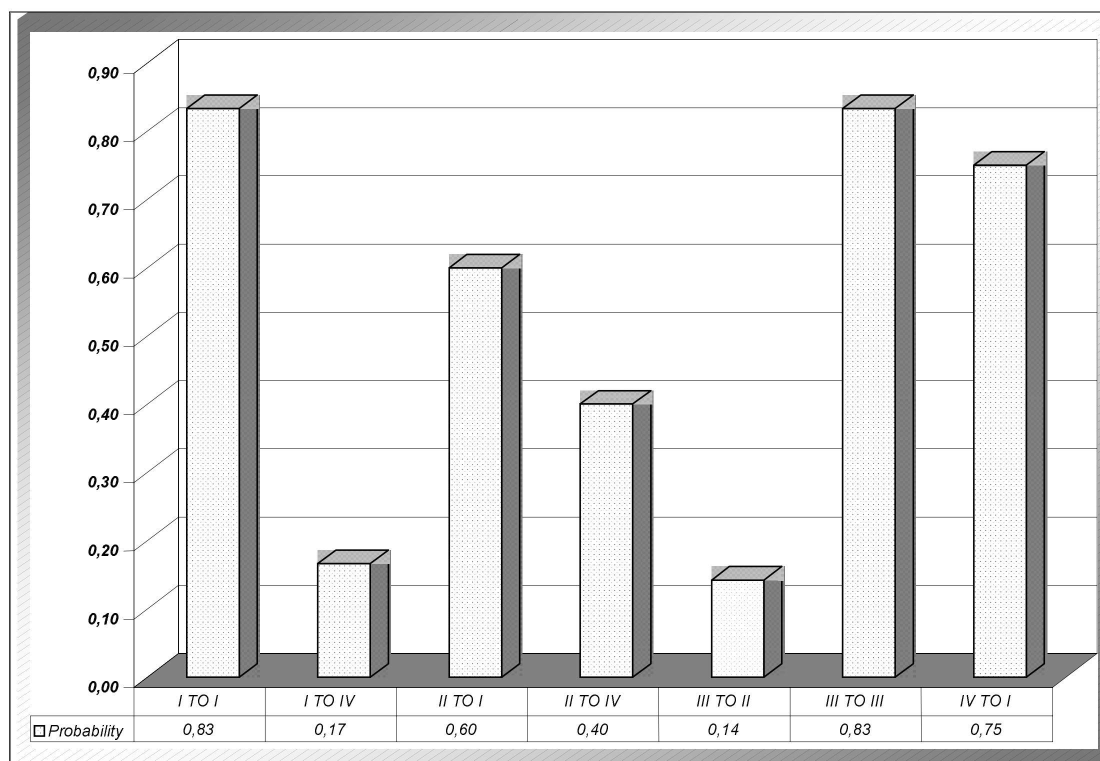



Figure 1 is a basically a diagramatic reformulation of Table 3, substituting variables of political stability and consensus for democratisation. The switch is useful in highlighting the possibility of in-conflict countries such as those in the Caucasus undertaking rapid reform efforts and moving directly from Group IV to Group I, but without necessarily complete democratisation.

There are 4 segments in Figure 1. Political stability and social consensus are preferable to either political instability and/or lack of social consensus. Thus, a country's preferred choice of location is the upper-half of Figure I (Groups I and II). By corollary, the segment represented by Group III is preferable to the segment represented by Group IV. Solid lines show these preferences. The dashed lines indicate what has transpired or may transpire (Group III to IV transition).[6] As argued below, while initially preference may be given by a transition country for slower reforms (Group II) to faster reforms (Group I), over time the preference shifts to a faster transition path, making Group I preferable to Group II status.

Figure 1 shows that the trend has been for Group II countries to move towards Group I. Group III countries, in the main controlled by former Communist elites, have moved gradually toward reform. However, there remains the possibility of a country isolated from external financing and without access to raw materials, such as Belarus, moving towards economic dislocation from Group III to Group IV. Equally, the diagram underscores the possibility of a country in Group I or II derailing – the Albanian and Russian examples – and a shift from Group II to Group IV.

Figure 2. Probability of Transition between Groups




*Source: Author's calculations.*

Initial country preferences within the political stability/consensus and economic reform mix notwithstanding, countries in transition have shifted within sectors, as highlighted by the shaded lines. The probability of transition between groups is derived and shown in Figure 2, based on the original number of countries in each group and country status thereafter. Of the original six countries, only one, Albania moved to the worst-case Group IV sector.[7] From Group II, Hungary, Lithuania and Kyrgyzstan moved to Group I, while Bulgaria and Russia moved to Group IV. Of the original 7 countries in Group III, only one, Romania is classified as having moved to Group II. Finally, of the original four Group IV countries, we classify all but Tajikistan to have moved: Azerbaijan to Group I, Armenia and Georgia to Group II.

While there is some degree of subjectivity, for instance, in Romania's advance from the sector representing Group III to that representing Group II and Tajikistan's retention in Group IV given some evident economic reforms, the qualitative aspects of the exercise underscore some clear lessons. First, it is possible for even a nominally advanced reforming country to derail. Second, it appears from the evidence that countries in the second group have accelerated reforms to move to Group I, possibly through conditionality imposed externally, either from multilateral agencies or domestically in an attempt to move towards EU accession. Third, countries in Group III have remained static, suggesting reform inertia on the one hand, and lack of developing pressure groups for reform on the other. Fourth, any economy in Group IV is likely to move out of this zone, and given the economic imbalances, likely to take up faster reform, as has been witnessed for the three countries in the Caucasus. Finally, countries in Group III are either those in Central Asia or those like Moldova or Belarus. The Central Asia states (Uzbekistan, Kazakstan, Turkmenistan) are partly able to sustain slow-

reform policy choices thanks to their resource endowments though they, too, have suffered from spillover effects from the Russian crisis. Moldova or Belarus are not and therefore likely to move from Group III to Group IV.

## 4 Policy Implications

Political stability and social consensus for reform are not luxury goods. They are the adjuncts to the successful undertaking of economic reform, be it in the context of stabilisation, liberalisation of internal and external markets or the longer-term institutional overhaul and introduction of new practices to support the market mechanism, both informative and allocative.

The conventional blueprint for economic reform as defined by Table 1 considers the legacy borne from the collapse of the planned economy in the form of economic imbalances, top-heavy state sector and barriers to the functioning of the price mechanism. Transition is mapped out then through corrections to these symptoms, measured in economic models of transition and in econometric evaluation of reform against economic fundamentals. However, there are two fallacies with this approach.

First, initial conditions are partially or fully endogenous to the measures. More fundamentally, the domestic choice of a transition country of its political regime and extent of social cohesion define the rate of economic reform and therefore are an important initial condition, which existing economic studies do not integrate. This paper shows, through observation of evidence from transition countries, that political stability and social consensus and faster reform are mutually reinforcing. Lack of either corresponds to a lower rate of transition. Improvement in either correlates with a faster reform effort. A country's choice of reform effort may reflect country-specific factors such as the inherited market and industrial infrastructure and the distortions in the economy imposed from the length of time under collectivism.[8]

Second, there is now a recognition among both practioners and advisors from multilateral organisations of the distinction between first and second generation reforms. Initial reforms include stabilisation of price and exchange rate variables through appropriate adjustments in fiscal and monetary stances. Second generation reforms include moves to open up economies through liberalising measures and separate reforms to improve the institutional make-up as well as to introduce and effectively implement the market-supporting legal and financial codes. A separate paper considers the link between first and second generation reforms and the choice of political regime and degree of social consensus.

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## Notes

[1] Singh, “Transition and Transit to a Market Setting: A Model Guide,” forthcoming, BOFIT. See also Laurila and Singh (2000) for a model outlining structural reform.

[2] Ibid. These are identified as first and second-generation reforms.

[3] http://www.worldbank.org/cdf/

[4] For latter, see Singh, “Bank Regulation, Compliance and Enforcement,” Discussion Paper, BOFIT 1999.

[5] Ibid (footnote 1).

[6] As argued below, Belarus may be one such country.

[7] The group is taken as six by segmenting the Czech and Slovak Republics.

[8] Ickes, in a comment to Åslund et al (1996), argues that the more negative-value-adding firms there are or larger the agricultural sector or shorter the history of collectivism, the easier it will be to pursue radical reforms.