Stefan F. Stefanov, Associate Professor, Ph.D.

THE NEO-LIBERAL PLATFORM OF THE TRANSITION TO MARKET ECONOMY – SPECIFICS AND CONSEQUENCES

The subject of analysis is the nature of the market reforms in the Central and East European (CEE) countries and especially the strong influence of the Washington Consensus as a set of neo-liberal policies that was imposed by the International Monetary Fund on developing and transition countries during the third wave of globalization of the world economy.
The consequences of the neo-liberal policies are investigated mainly in the following aspects: i) as a source of misalignment of means and goals in the market reform agenda; ii) as a factor retarding the building of genuine market institutions in the region; iii) as a generator of negative shocks on both external and internal aggregate demand eventually causing a deep and long-lasting recession; iv) as one of the reasons for increasing poverty, inequality and corruption in the economy of transition countries.

JEL: F02; N20; P51

The current third wave[1] of globalization of the world economy started at the beginning of the 1980s. Very soon – at the outset of the 1990s - it acquired new dimensions and features which need profound and comprehensive theoretical consideration. The following are among the new fundamental developments:

a. The process of transition from the centrally-planned to a market economy has also entered a stage of globalization. Its start was given in the end of the 1970s in China and after a decade it spread to the Central and East European (CEE) countries. Although in practice the experience which had been accumulated in those two regions constituted two different variants of one and the same process (of one and the same system change), the methods of its implementation and the results that followed differed tremendously. This caused a strong confusion in the sphere of economic theory which has not yet been overcome. A manifestation of this confusion is the fact that many theorists continue – some of them deliberately and others maybe unintentionally - to lay emphasis on the differences of accumulated experience in the two regions. In this way they try to avoid the need to determine the underlying common basic features and characteristics as a prerequisite for understanding the nature of the transition to a market economy.

b. A second fundamental development concerns the activity of the international economic institutions - namely the International Monetary Fund (IMF) and the World Bank (WB) - as providers of financial and technical assistance to developing countries under market reforms. What actually

[1] The first wave of globalization occurred during 1870 - 1914, the second lasted from 1945 to 1980 and the current third wave started in 1980. See: Globalization, Growth and Poverty: Building an Inclusive World Economy. The International Bank for Reconstruction and Development, 2002, p. 24.

happened was that their specific approach to the design and implementation of market reforms in Latin American countries in the 1980s, named "Washington consensus", had also entered a stage of globalization. During the 1990s it spread into the world economy by means of the IMF conditionality and became the main source of neo-liberal prescriptions for the design and implementation of market reforms in CEE countries. The disruptive forces generated by the Washington consensus, and especially by the shock-therapy as its most essential emanation, affected strongly the countries which were dependent on the financial and technical assistance of the IMF. However, the market reform in China was an exception. It was designed and implemented independently – by the Chinese authorities who laid the emphasis on the principles of pragmatism and gradualism.

c. The activities of the IMF during the Asian financial crisis in 1997-1998 constitute a further manifestation of the globalization of the Washington consensus. By means of the IMF conditionality its neo-liberal prescriptions were imposed on the newly industrialized countries regardless of the fundamental differences which characterized the East Asian economies as compared to Latin America.

The expansion of the Washington consensus approach to market reforms in countries whose economies differ fundamentally from the Latin American ones certainly did not prove its effectiveness. It was rather a proof of the considerable benefits derived by its authors and proponents from its implementation on a global basis as well as of their strength and capacity to impose it as an official doctrine of the international economic institutions. Another confirmation of the above conclusion is to be found in the publications of G. Kolodko who is considered to be a key architect of the Polish economic reforms; he was Poland's First Deputy Premier and Minister of Finance from 1994 to 1997. He stressed on the fact that, despite the very specific conditions of transition in CEE countries, the IMF and the World bank continued to follow the policy prescriptions of the Washington consensus, imposing its stamp on the market reform under the motto: "Liberalize as much as you can, privatize as fast as you can, and be tough in fiscal and monetary matters!"[2]

In the above context the tremendous differences between the two variants of the practical implementation of the transition to a market economy in CEE countries and in China appear mainly as "policy-induced", namely as generated by the application of different approaches to the design and implementation of the market reform – the neo-liberal approach in CEE countries and the pragmatic approach in China.

The transition to a market economy in China started in 1978 (see Table 1) and laid the beginning of a very rapid economic growth which continued during

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[2] *Kolodko, G. W.* Economic Neoliberalism Became Almost Irrelevant. - Transition, June 1998, Vol. 9, N 3, p.1 (http://www.worldbank.org/html/prddr/trans/june1998/kolodko.htm).

the following decades, characterized by low inflation and financial stability. In contrast the results of the first ten years of transition in CEE counties were strongly disappointing. The start of the market reforms generated a recession of unprecedented dimensions, which exceeded the painful records of the Great Depression of 1929-1933[3]:

- 10 years after the beginning of the transition, the group of countries preparing for accession to the European Union, could not reach the level of real GDP produced in 1989;
- In 2003 real GDP surpassed the level of 1989 only in Hungary, the Czech Republic, Poland, the Slovak Republic and Slovenia;
- The indicators for Lithuania, Latvia, Estonia, Bulgaria and Romania were characterized by very low values. In 1999 the real GDP of those countries was considerably lower than its 1989 level and could not reach the latter even in 2003 (with the exception of Estonia);
- The consequences of the shock therapy applied in the CIS countries – especially in Russia and the Ukraine – were disastrous.

This comparison raises the following two questions.

First, is it the fast economic growth or the deep recession that should be identified as a regularity, inherent to the initial stage of the transition to a market economy?

This issue is important, because in a large number of publications – by laying particular emphasis on the experience of CEE countries – the deep recession is represented as an intrinsic feature of the initial stage of transition and even a special term has been invented for the purpose, namely "transitionary recession".

However, there are also good reasons to table the following antithesis as a reflection of the experience of the market reform in China and it seems to be much more plausible:

In a broader historical context the process of transition is a fundamental systemic change manifested in the transformation of a less efficient economic system (the centrally planned economy) into one (the mixed market economy) which ensures a more efficient allocation and utilization of the national resources. Consequently, it should generate an acceleration of economic growth and an improvement of the living standards from the very beginning of the market reform.

It is obvious that in the light of the above statement a conclusion should be drawn that the market reform strategy, implemented in the CEE countries as a whole, has been inefficient and perverse.

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[3] The magnitude and duration of the transition recession was, for all countries, comparable to that for developed countries during the Great Depression, and for most of them it was much worse (see Transition - The First Ten Years. Analysis and Lessons for Eastern Europe and the Former Soviet Union. The International Bank for Reconstruction and Development, 2002, p. 3).

Table 1

Selected characteristics of transition countries

Transition Country/Group	Year Transition Began	Starting Date of Stabilization Program	Real GDP in 1999 (Indices, 1989=100)	Real GDP in 2003* (Indices, 1989=100)	Average Inflation 1989-1999	1999 EBRD Average Transition Indicators**	PPP GDP per Capita, 1999
EU accession countries (excluding Baltic's)	*1991*	*Mar-91*	*95*		*35.5*	*3.3*	*10,009*
Bulgaria	1991	Feb-91	67.0	87.3	68.4	2.9	4,812
Czech Republic	1991	Jan-91	94.0	108.3	7.8	3.4	13,408
Hungary	1990	Mar-90	99.0	115.1	19.7	3.7	11,273
Poland	1990	Jan-90	128.0	134.6	49.2	3.5	8,832
Romania	1991	Jan-93	74.0	92.4	76.1	2.8	5,798
Slovak Republic	1991	Jan-91	101.0	114	14.3	3.3	10,255
Slovenia	1990	Feb-92	105.0	119.9	12.9	3.3	15,685
Baltic countries	*1992*	*Jun-92*	*68.0*		*33.5*	*3.2*	*6,850*
Estonia	1992	Jun-92	78.0	99.6	24.3	3.5	7,909
Latvia	1992	Jun-92	56.0	86.7	35.1	3.1	5,893
Lithuania	1992	Jun-92	70.0	85.2	41.0	3.1	6,750
Other Southeastern European countries	*1990*	*Jun-93*	*77.0*		*3,331.8*	*2.5*	*3,651*
Albania	1991	Aug-92	93.0	123.6	33.4	2.5	2,897
Bosnia and Herzegovina			93.0		13,118.0	1.8	1,014
Croatia	1990	Oct-93	80.0	91.00	100.0	3.0	6,793
Macedonia, FYR	1990	Jan-94	59.0	81.4	75.6	2.8	3,903
*Commonwealth of Independent States****	*1992*	*Aug-94*	*53.0*	*74.4*	*149.1*	*2.3*	*3,337*
Armenia	1992	Dec-94	48.0	89.6	106.5	2.7	2,469
Azerbaijan	1992	Jan-95	47.0	70.2	233.2	2.2	2,404
Belarus	1992	Nov-94	81.0	102.0	162.4	1.5	6,485
Georgia	1992	Sept-94	31.0	38.2	17.9	2.5	3,950
Kazakhstan	1992	Jan-94	61.0	93.3	77.3	2.7	4,351
Kyrgyz Republic	1992	May-93	61.0	78.4	22.3	2.8	2,419
Moldova	1992	Sept-93	31.0	41.3	16.5	2.8	1,847
Mongolia	1990		93.0		46.5	2.8	1,573
Russia	1992	Apr-95	55.0	77.0	88.0	2.5	6,815
Tajikistan	1992	Feb-95	29.0	47.7	688.5	2.0	1,045
Turkmenistan	1992		61.0	106.9	4.9	1.4	4,589
Ukraine	1992	Nov-94	35.0	51.9	169.4	2.4	3,276
Uzbekistan	1992	Nov-94	97.0	111.0	304.5	2.1	2,157
East Asia	*1986*		*178.0*		*17.1*	*2.1*	*2,042*
Cambodia	1990		162.0		6.3	2.5	1,261
China	1978		252.0		8.1	2.1	3,709
Lao P.D.R.	1986		185.0		28.6	1.8	1,385
Vietnam	1986		197.0		25.4	1.9	1,815

* Economic Survey of Europe. 2004, N 1, p. 190.

** Simple average of eight component transition indicators, used by the European Bank for Reconstruction and Development. For details see World Economic Outlook. International Monetary Fund, October 2000, p. 134.

*** Data include Mongolia.

Source. World Economic Outlook. October 2000. International Monetary Fund, p. 89.

Second, what was the reason for the implementation of an inefficient, pro-recessionary market reform strategy in CEE countries?

Obviously this was not due to the set of incidental and inessential factors[4] often referred to in recent publications. They can explain only some of the details – for instance, why the so-called "transitionary recession" has been deeper and longer in countries like Bulgaria and Romania in comparison with the Czech Republic, Hungary, Poland, etc.

The basic reasons must be traced back more profoundly. They concern the fundamental conditions and factors which have determined the design and choice of the market reform strategies in CEE countries on the one hand, and in China – on the other hand. China had chosen, implemented and developed its market reform strategy independently, by laying down pragmatism and gradualism as its basis, and thus creating the conditions for a stable and dynamic growth of the real GDP and the national welfare.

On the contrary, the choice and accomplishment of market reform strategies in CEE countries was based on the neo-liberal Washington consensus approach imposed by international economic institutions - mainly by means of the IMF conditionality mechanism. This experience culminated in the implementation in some of the countries of the so-called "shock-therapy" as an extreme version of neo-liberalism which caused a real disaster to their economies[5].

The above statement may be confirmed by Jozeph Stiglitz' conclusion: "Globalization and the introduction of a market economy has not produced the promised results in Russia and most of the other economies making the transition from communism to the market. These countries were told by the West that the new economic system would bring them unprecedented prosperity. Instead, it brought unprecedented poverty: in many respects, for most of the people, the market economy proved even worse than their Communist leaders had predicted. The contrast between Russia's transition, as engineered by the international economic institutions, and that of China, designed by itself, could not be greater: While in 1990 China's gross domestic product (GDP) was 60 percent that of Russia, by the end of the decade the numbers had been reversed. While Russia saw an unprecedented increase in poverty, China saw an unprecedented decrease."[6]

Further analysis in this article focuses on the peculiarities of the third wave of globalization of world economy as an external environment of the process of

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[4] Several characteristics of the countries at the start of transition may have affected economic performance over the past decade: geography (such as endowment of natural resources and the proximity to Western markets), years spent under central planning, and the nature of economic development under socialism (such as the extent of overindustrialization, military output, and repressed inflation). See Transition - The First Ten Years. Analysis and Lessons..., 2002, p. 11.

[5]. See *Stefanov, St.* The Competitiveness of the Bulgarian Economy. - South-East Europe Review for Labour and Social Affairs, Nomos Verlagsgesellschaft, Baden-Baden, October 2001, Voll. 4, N 3.

[6] *Stiglitz, J.* Globalization and Its Discontents. W.W. Norton & Company, 2002, p. 6.

transition to a market economy. The main objective is to explain in what way and to what extent its specific mechanisms and prevailing ideological bias of the leading actors – namely the Washington consensus approach – have affected and influenced the understanding of market reforms in CEE countries, the design of their goals and instruments as well as the interpretation and assessment of their results and consequences.

The Washington consensus as an ideological platform of the third wave of globalization

Contemporary literature is characterized by a lively controversy and ambiguity in the interpretation of the nature and peculiarities of the third wave of globalization and of its impact on the economies of developing and developed countries. However, there is no doubt that the principal role in the process belongs to the richest and best developed countries, members of the G-7, and especially to their leader – the USA, including also international organizations working under their control such as the International Monetary Fund, the World Bank and some other institutions of a similar type. This explains the domination in the third wave of globalization of the neo-liberal doctrine and the set of development policies evolving from it which came to be known as "Washington consensus".

The term "Washington consensus" was invented by John Williamson on the occasion of the structural crisis in Latin American countries during the 1980-s[7]. According to him it included "the set of policy reforms which most of official Washington thought would be good for Latin American countries and could be summarized in ten propositions:

1. Fiscal discipline.
2. A redirection of public expenditure priorities toward fields offering both high economic returns and the potential to improve income distribution, such as primary health care, primary education, and infrastructure.
3. Tax reform (to lower marginal rates and broaden the tax base).
4. Interest rate liberalization.
5. A competitive exchange rate.
6. Trade liberalization.
7. Liberalization of FDI inflows.
8. Privatization.
9. Deregulation (in the sense of abolishing barriers to entry and exit).
10. Secure property rights."[8]

By inventing this term John Williamson had probably intended to describe a purely technocratic policy agenda. But very soon it came to be used mainly as a manifestation of the neo-liberal ideology implemented into the shock-therapy which

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[7] *Williamson, J.* What Should the Bank Think About Washington Consensus? Institute for International Economics (www.iie.com).

[8] Ibid., p. 2.

was imposed on many developing countries by means of the IMF conditionality. Therefore, John Williamson had some reasonable grounds to make a complaint about the following: "the term is often being used in a sense significantly different to that which I had intended, as a synonym of what is often called "neoliberalism" in Latin America, or what George Soros (1998) called "market fundamentalism."[9] However, now is the time to warn the readers that, despite objections by John Williamson, the term "Washington consensus" will also be used in the present publication as a synonym of neo-liberalism.

John Williamson explained the "mission" of the set of Washington consensus policies in the following way: "The three big ideas here are macroeconomic discipline, a market economy, and openness to the world (at least in respect to trade and FDI). These are ideas that had long been regarded as orthodox as far as OECD countries are concerned, but there used to be a sort of a global apartheid which claimed that developing countries came from a different universe which enabled them to benefit from (a) inflation (so as to reap the inflation tax and boost investment); (b) a leading role for the state in initiating industrialization; and (c) import substitution. The Washington Consensus said that this era of apartheid was over."[10]

Further, a description follows from a paper by James Crotty[11] of the historic context which gave birth to the Washington consensus doctrine as well as to the consequences of its application in Latin American countries. It sheds additional light on its nature and mission and helps understand why during the 1990-s the international financial organizations and especially the IMF started to implement its prescriptions on a global scale.

"Since Neoliberal policies were not favored by the majority of the developing world's people, they had to be forced on them. The Third World debt crisis was ideal for this purpose, because it made developing country governments desperate for the funds needed to avoid debt default – and the USA controlled all important funding sources. In return for US, IMF and World Bank financial assistance (which was immediately recycled to multinational banks), affected governments were pressured to adopt the Neoliberal policies incorporated in the "Washington Consensus." They were forced to remove controls on capital flows and on trade, end industrial policy, liberalize domestic financial markets, opening them to penetration by foreign banks, sell their vast holdings of valuable public corporations -- preferably to foreign companies, end support for organized labour, cut subsidies to the poor, and adopt inflation-fighting or "austerity" monetary and fiscal policies to

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[9] *Williamson, J.* What Should the Bank Think About Washington Consensus…, p. 1.
About the discussion on the approach of "market fundamentalism" see World Economic Outlook. International Monetary Fund, October 2000, p. 92.

[10] *Williamson, J.* Did the Washington Consensus Fail? Institute for International Economics, (www.iie.com) p. 2 – 3.

[11] *Crotty, J.* Trading State-Led Prosperity for Market-Led Stagnation: From the Golden Age to Global Neoliberalism. Department of Economics, University of Massachusetts. May 2000, p. 10-12.

slow growth and raise unemployment. The deep recessions that followed the adoption of Neoliberal policies cut imports, while high unemployment lowered wage costs and export prices. These developments, in concert with widespread exchange rate devaluations, eventually generated the trade surpluses needed to maintain interest payments on foreign debt, thereby ending multinational banks' solvency crisis. Of course, the human costs of this strategy were incalculable. Growth halted across much of the Third World, to be replaced by deep recession. Poverty and deprivation spread widely; the 1980s is referred to in Latin America as the "Lost Decade." Per capital income growth in Latin America, which averaged 3.5% a year from 1966 through 1973, fell to 0.4% between 1974 and 1990.

From the early 1980s on, the US government, enthusiastically supported by the international financial institutions they dominate, by multinational corporations and banks, by elites in most developing countries, and, somewhat more reluctantly, by European governments, relentlessly pushed its Neoliberal agenda around the world.

By the 1990s Neoliberalism had even begun to penetrate East Asia. Japan permitted significant domestic and extensive international financial market liberalization in the late 1980s, creating the preconditions for the great stock market and real estate bubble of the period. When the bubble burst in 1990, a decade of slow growth followed, which led, in the insane logic of Neoliberalism, to even greater pressure for liberalization. Meanwhile, in the mid 1990s Korea came under great pressure to liberalize from the US, its own elites, and the OECD, who made financial liberalization a condition for entry. The Korean government deregulated its hitherto tightly controlled domestic financial markets, removed control over short-term capital flows, and ended its coordination of domestic investment.

Foreign money poured into Korea in this period, fueling over-investment and creating the preconditions for the outbreak of financial crisis in late 1997 and deep recession in 1998."

J. Crotty tries to explain in his analysis *why* the institutions and policies associated with Neoliberalism have generated such a disappointing economic outcome. He concludes that this was due to the forces, deeply rooted in it, that had slowed global aggregate demand growth, which in turn became the major cause for the low growth rates of output and income, and the high unemployment rates of the period.[12]

There is one more important conclusion to be drawn. As many analysts have pointed out, the economies of East Asian countries differ very much from the economies of Latin American countries. This certainly required that during the Asian financial crisis of 1997-1998 a specific approach had to be implemented in conformity with the concrete conditions and necessities to cure the crisis. However, the fact that the IMF continued to implement the neo-liberal prescriptions of the Washington consensus can only be a proof that in its activities the IMF had been

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[12] *Crotty, J.* Op. cit., p. 25.

guided not by the specific needs of the East Asian countries but by the interests of the authors and proponents of the Washington consensus.

In support of this conclusion I shall cite the following interesting remark by John Williamson: "Let me emphasize that the Washington Consensus as I conceived it was in principle geographically and historically specific, a lowest common denominator of the reforms that I judged "Washington" could agree were needed in Latin America as of 1989. But in practice there would probably not have been a lot of difference if I had undertaken a similar exercise for Africa or Asia rather than Latin America, and there was still a lot of overlap when I revisited the topic (with regard to Latin America) in 1996 ... This doubtless made it easier for some to interpret the Washington Consensus as a policy manifesto that its adherents supposedly believed to be valid for all places and at all times - which takes us on to consider the alternative interpretation of the concept that has become so popular in recent years."[13].

The impact of Washington consensus on market reforms in CEE countries

The confusion of ends with means in the market reform

There is an issue which has often been debated upon currently, concerning the adequate structuring of goals and means on the market reform agenda. Some profound distortions in this sphere have been observed by famous economists like J. Stiglitz and G. Kolodko, and their conclusion is that they have been generated by the Washington consensus doctrine.

For instance here follows a very clear statement by Kolodko, who pointed out, that "the lack of success of policies based on the early Washington consensus is also due to the confusion of the means of the policies with their ends."[14] What is more, in his opinion: "A sound fiscal stance, low inflation, a stable exchange rate, and overall financial stabilization are only the means of economic policy, while sustained growth and healthier standard of living are its ends."[15]

Further on, Kolodko has come to the conclusion that it is the confusion of policy means and goals which had caused most of the failures during the initial stage of market reform in the CEE region: "Yet after several years of exercising these policies, neither growth nor a higher standard of living has been achieved in the transition countries."[16]

The main reason for the "confusion" of goals and means on the market reform agendas of CEE countries is the fact that they have been designed in line

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13 *Williamson, J.* What Should the Bank Think About Washington Consensus?..., p. 4.

14 *Kolodko, G. W.* Ten Years of Postsocialist Transition: the Lessons for Policy Reforms. The World Bank. Development Economics Research Group, p. 6 (http://www.worldbank.org/html/dec/Publicaiions/Workpapers/wps2000series/wps2095/wps2095.pdf).

15 Ibid.

16 Ibid.

with the Washington consensus doctrine as an emanation of the interests of its proponents[17]. The latter perceive the CEE region mainly as the subject of assimilation by the neo-liberal model of globalization with the purpose of deriving the ensuing economic benefits (which is very similar to the way they had perceived East Asian countries during the financial crisis in 1997-1998). Therefore, in their interpretation the transition process acquires the status of a means, of an instrument for achieving *their own aims*. That is why the status of *fundamental goals* on the market reform agenda is assigned to *instruments* like "shock-liberalization of prices and trade", "deregulation of the economy", "fast privatization", as well as to the implementation of restrictive monetary and fiscal policies. In fact these are the real goals of the proponents of the Washington consensus because through their realization transition countries are eventually dragged into the orbit of the neo-liberal model of globalization.

The distortion of the balance between means and goals on the market reform *agenda* caused by the Washington consensus is further transmitted to the set of criteria used to assess the progress of transition. Here the stress is laid on indicators measuring the extent of liberalization, the share of private sector in GDP, the fiscal deficit, the rates of inflation and so on. Hence a secondary role and importance is assigned to the principal goals of economic development and economic change which may be summarized as ensuring full employment, improvement of the living standards, increasing of the national welfare, etc. In this way non-transparency starts to prevail not only in the process of the design and planning of the market reform but also in the measurement and interpretation of its results.

Data on Table 1 confirm these conclusions. They show a very curious phenomenon! In the period of transformation China had achieved the highest growth rates of the real GDP (the index of real output growth in 1999 was 252% as compared to 1989) and of the living standards, accompanied by the lowest rate of inflation (with the sole exception of the Czech Republic). But this unprecedented development success gets a very low mark. The value of the indicator that has been used by the European Bank for Reconstruction and Development for measuring the progress in the market reform is only 2.1! This is really striking and difficult to perceive because it is one of the lowest ratings shown on the table. And what is more, it is lower than the "mark" of Ukraine (2.4) – the country where the first stage of the market reform caused an unprecedented economic catastrophe (in 1999 the real output growth amounted to only 35% of the 1989 level).

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[17] G. Kolodko has also pointed out that "aside from intellectual controversies and different normative values - there are also different political, economic, and financial interests involved. Otherwise it would be impossible to interpret why erroneous policies had continued, in many cases, even after it was obvious that they were wrong. These were the cases, for instance, with early liberalization and stabilization policy in Poland in 1989-1992, the neglect of corporate governance in the Czech Republic in 1993-96, the Russian privatization of 1994-98, executed with the active involvement of politically connected informal institutions, and with fraudulent Albanian financial intermediaries in 1995-97, which were tolerated until the whole economy eventually collapsed." (*Kolodko, G.* Ten Years of Postsocialist Transition..., p. 17).

It becomes evident that according to the methodology, used by the EBRD to measure and assess the progress of market reforms, economic growth and the improvement of the living standards are not considered to be strategic goals, and hence a criterion for measuring progress. On the contrary, in line with the Washington consensus doctrine, the primary role is assigned to indicators measuring the extent of privatization, liberalization, deregulation of the economy and so on.

J. Stilitz shows the negative impact of the confusion of policy goals with policy means on the market reform in the CEE region: "A part of the problem also rose from confusing means with ends: taking, for instance, privatization or the opening of capital accounts as a mark of success rather than means to the more fundamental ends. Even the creation of a market economy should be viewed as a means to broader ends. It is not just the creation of market economy that matters, but the improvement of living standards and the establishment of the foundations of sustainable, equitable, and democratic development."[18]

The distortions induced by the Washington consensus in the market reform strategies of the CEE countries show up clearly in the light of the pragmatic philosophy of the market reform in China. The criteria by which the reform progress is measured in this country are concentrated on the acceleration of economic growth and the improvement of living standards. Its quintessence may be illustrated by the well known aphorism: "it is not important whether the cat is black or white (e.g. – what the value of the indicators measuring liberalization, privatization or deregulation is); it is important that it can catch mice (e.g. that it can "produce" improvement of living standards)."

The comparison with the Chinese experience also shows that transition may be a success story when the goals and means of the market reform are determined and designed in a pragmatic way and as a synthesis of the long-term national interests. In the light of the above conclusions, and reasoning the picture of the process of transition to a market economy in China looks strikingly different. Never mind how paradoxical it may seem, and despite the ruling position of the communist party, the design and planning of the market reform agenda is not grounded on ideological prejudice and prescriptions. It is implemented independently, without the interference of international financial organizations and is soundly based on pragmatism and gradualism. At the same time the active participation of the country in the third wave of globalization is perceived and interpreted by the national authorities not as a goal, but rather as a means of the successful performance of the market reform.

Interpreting the transition to a market economy as an economic improvement

In order to overcome the indicated distortions it is needed to put the analysis of the market reform on an adequate methodological basis by eliminating the

[18] *Stiglitz, J.* Whither Reform?: Ten Years of the Transition. Paper prepared for the Annual Bank Conference on Development Economics. Washington D.C., April 28-30, 1999, p. 3.

disturbances and interference of the neo-liberal ideology of Washington consensus. This would enable us to analyze transition in the context of the welfare economics laying the emphasis on the long-term national interests of the transition countries which are striving to maximize their welfare – namely as an economic improvement or as a process in which a less efficient economic system (the centrally planned economy) is transformed into a more efficient one (the market economy).[19] According to the criterion, developed by Vilfredo Pareto, "any reallocation of resources involving a change in goods produced and/or their distribution amongst consumers, could be considered an improvement if it made some people better off (in their own estimation) without making anyone else worse off."[20]

When considered in such an analytical perspective the transition from a centrally planned to a market economy acquires the status of a fundamental (system) change, which affects the interests of the whole nation and its success depends on the availability of adequate motivation at different levels of the national economy. In the light of welfare economics such a fundamental change would be justified (would make sense) and would be rated as an improvement under Pareto's criterion, if it could generate an increase of the welfare and living standards of some groups (or individuals) of the population which would not be at the expense of other groups (or individuals).

It follows that the implicit common consent in favor of such a system change should be based on the optimistic welfare expectations of the whole nation, including broad masses of the population as well as the ruling political and economic elite. These expectations could be met if the system change could generate a combination of a steady growth of the real GDP and low inflation rates.

In this context the *minimum requirement* which has to be met is that the system change should be translated in such a kind of economic growth which would allow:

first, to retain the level of welfare of the different groups (or individuals) of the population, which had been attained under the former (the centrally-planned) economic system;

second, the simultaneous increase of the inequality and diversification of incomes within the limits which are typical of a contemporary mixed market economy.

The application of this methodological approach in the transition analysis emanates the answers to many important questions. For instance, it becomes clear what should the principal criterion for proving the optimality of the market reform strategy be – as optimal should be considered the one which ensures the

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[19] Both theoretically and empirically it has been proved that the latter is capable of a much more efficient allocation and utilization of available resources, leading to a higher level of prosperity of nations.

[20] Collins Dictionary of Economics. Second edition. Harper Collins Publishers, 1993, p. 562.

maximization of national welfare by establishing stable and dynamic real GDP growth. To be more specific, Pareto's concept implies that in order transition to become an *improvement*, real GDP should start to grow from the very beginning of the market reform in order to generate the resources needed for the improvement of living standards.

Otherwise, e.g. if real GDP starts to fall, the living standards of certain groups of the population could increase only through the mechanisms of redistribution - at the expense of the living standards of other groups of the population. In such a case the systemic change would have to be characterized not as an economic improvement but as an *economic deterioration.* Taking all this into consideration it becomes clear that the widely spread statements about the inevitability of the transition recession as an intrinsic feature of the initial stage of the market reform is most likely generated by the desire to conceal the real causes for the implementation of the inefficient reform strategy in the CEE region – i.e. the Washington consensus.

The delay of the institutional reform

The next distortion of the market reform strategy in the CEE region concerns the method of combination and implementation of its three main pillars:

- first pillar (institutional) – the construction of the administrative, legal, judicial and financial institutions of the market economy and the creation of the conditions for their efficient functioning (The proper functioning of the judicial system is of a paramount importance);
- second pillar (liberalization) – liberalization of prices and trade and deregulation; financial stabilization;
- third pillar (privatization) – privatization and restitution of large and small enterprises.

The thorough analysis of the experience of market reforms in the CEE region and China leads to the conclusion that of the three pillars priority should be given to the institutional one because it is the main instrument through which the redistribution mechanism of the centrally planned economy could be wiped away and a competitive business environment created at a time when privatization had not yet developed on a mass scale. By the way, this is one of the main methods by which economic growth has been spurred in China from the very beginning of the market reform.

The inevitable distortion that logically follows from the neo-liberal ideology of the Washington consensus is the shift of the priority from the institutional pillar to the liberalization of prices and trade, financial stabilization and privatization. This is the most important reason for the deep recession in the CEE region, induced by the neo-liberal spirit of shock-therapy. And it is certainly not a coincidence that on John Williamson's list of policy recommendations included in the Washington consensus, the only recommendation concerning the institutional aspect of the market reform ("Secure property rights") occupies final position.

Shock-therapy, as an emanation of the neo-liberal ideology exploits the myth, that as a result of fast privatization which "produces" private owners, automatically follows that the whole massive building of market institutions will emerge. So what is urgently needed at the beginning of the transition is just clean the construction site, i.e. destroy and eliminate the institutions of the centrally planned economy and pull the state out of it.

Here is what Kolodko points out on this occasion: "Prematurely or too extensively downsized government is not strong enough and then the market expands in the informal sector (shadow economy), while difficulties mount in the official economy. Then profits accrue to the informal sector, but the revenues fall in the official sector, with all the negative consequences for the budget and social policy. Thus the market works in a way where profits are privatized, but the loses are socialized in a politically unsustainable way."[21]

When considering the link between this distortion of the reform strategy and the Washington consensus one should remember that the latter emerged as a reflection of the situation in Latin American countries in the 1980s. But the fact that these countries are at a low level of development does not deny the fact that they have market economies where market institutions are available. Hence the underestimation of the institutional pillar by the Washington consensus is not as fatal from the point of view of Latin American economies as it is from the point of view of CEE countries.

The negative shock on external demand

As it has already been mentioned, the negative impact of Neoliberalism on the economies of Latin American and East Asian countries was due to the forces, that had slowed global aggregate demand growth. It became the major cause of the low growth rates of output and income, and the high unemployment rates of the period.

Similar negative impacts on aggregate demand are also inherent to the market reform strategy implied in the CEE region. For instance the beginning of the transition process was characterized by a massive negative shock on the external demand in the transition countries. It was provoked by the elimination of the Council for Mutual Economic Assistance (CMEA) and the preferential trading arrangements that had been in force among the member-countries. However, obviously that was a consequence of the political bargain concluded in Malta by the leaders of the USA and the former USSR.

The withdrawal of the former USSR from the policy of dictation was an important political acquisition for the rest of the CEE countries but they had no other choice except to pay in terms of an economic downturn, induced by the collapse of their exports to the region. The elimination of duty-free trade and the multilateral clearing system of payments in the region deprived most of the big

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[21] *Kolodko, G. W.* Ten Years of Postsocialist Transition..., p. 27.

enterprises of their export markets in the former CMEA region and turned them into loss-makers. These changes generated negative current account balances and increasing fiscal deficits especially in countries like Bulgaria due to the high extent of their specialization as exporters to the region and the former USSR and as importers of raw materials and fuels from the latter.

There was another reason which contributed to the inevitability and intensity of the negative shock on regional trade and hence on external demand in the national economies of the region. Due to the neo-liberal type of conditionality the financial and technical support programs of the IMF (and other international organizations) were based on a specific country-by-country approach, which often caused strong trade diversion and export loss effects.

The negative shock on external demand generated a peculiar vicious circle. It emerged in the CEE region as a situation bearing strong resemblance to the structural crisis in Latin American countries during the 1980s, which eventually provoked the "invention" of the Washington consensus. How did that happen? On the one hand, it turned out that the design of the market reform in CEE countries in conformity with the neo-liberal prescriptions of the Washington consensus had induced in their economies the "virus" of the Latin American disease – extremely strong dependence on a specific "medicine", called "foreign investments". They became a vital necessity for CEE countries as a means of the privatization (at a very low cost) and reconstruction of the large enterprises which had previously been transformed into loss-makers. On the other hand, the most reliable way of buying the "medicine", namely - attraction of foreign investments needed, was to continue diligently the implementation of the neo-liberal prescriptions of the Washington consensus. In that way the CEE countries were forced to compete actively among each other in their efforts to attract foreign capital. And those of them that failed to attract enough foreign investments in due time (like Bulgaria and Romania) were doomed to a much longer and deeper recession.

The country-by-county approach of the international organizations during the third wave of globalization has been an expression of the dominance of neo-liberalism. It strongly contrasts the constructivism of the 'Marshall Plan'-type of conditionality which prevailed during the second wave (1945-1980) of globalization and especially during the period of post-war reconstruction of Western Europe and Japan. This is due to the fact that the latter puts an accent on the reciprocal trade-creation effects as a driving force behind the economic growth in the reforming countries. It was in line with the implementation of the industrial policy and the concept of dynamic comparative advantages as an emanation of the Keynesian doctrine which was dominant during that period.

The negative shock on internal demand

The Washington consensus also contains the potential for a collapse of *internal* demand. It was activated at the very beginning of the market reform in

Bulgaria (on 1.01.1991) by means of the shock-liberalization of prices and trade. The latter induced an inflationary shock which caused a collapse of the real incomes and of the real wealth of the broad masses of the population, resulting in a steep fall of internal demand.

Further on I will try to explain in more details the mechanism by which the Washington consensus generated the fall of internal demand and how this phenomenon influenced the essence of the market reform. Here again Pareto's concept will be very useful for solving the issue – but in a slightly modified form. In line with it, the system change (namely the transition from the centrally planned economy to the market one) should be considered as an economic improvement if the market reform is designed and implemented in a way that makes it possible:

first, to increase the living standard of some groups (or individuals) of the population;

second, to retain the level of welfare of the other groups (or individuals) of the population, that had been attained under the former (the centrally-planned) economic system.

These requirements concerned all forms of assets constituting national and individual wealth, including bank deposits and cash money.

Let us first elaborate on the second part of the requirement. In economic literature discussing centrally-planned economies bank deposits are often interpreted as money which is deposited in banks because the centrally planned economy functions inefficiently and cannot provide a sufficient commodity backing for the issued money stock. Consequently these "forced savings" are considered as a manifestation of repressed inflation in an economy, characterized by fixed prices. In other words, as IMF experts like to say in line with the Washington consensus doctrine, this money constitutes the so-called "monetary overhang". Therefore, it has to be eliminated through a shock-liberalization of prices and trade which would let prices soar to their equilibrium level. However, this concept contains one of the most destructive distortions induced by the Washington consensus into the market reform strategies in CEE countries.

A further question to be answered is:

How should the "monetary overhang" be treated from the point of view of transition if the latter is interpreted as an economic improvement?

The answer is as follows: the money that has been accumulated in cash and in bank deposits during the period of the centrally-planned economy may be qualified as an "overhang" only in a very narrow sense, namely in respect to the goods on *commodity markets*, where merchandise is offered to households. And this is true - under socialism the commodity backing of money owned by households was to be found only on the commodity markets, because households were deprived of access to resource markets. It was the central planning authority that was in charge of the allocation and utilization of economic resources and households were not allowed to use their savings in the form of investments. But it is also true - in the broader context of the system's change – that the accumulated savings could have acquired sufficient commodity backing if households were allowed free access to the resource markets.

The central idea here is that domestic savings that had been accumulated under the centrally planned economy had to be considered a strategic source of internal investment and a driving force of vital importance for the successful start of the market reform. Meeting this requirement is of crucial importance for the realization of the system's change in the shape of Pareto's economic improvement.

The above conclusions are in deep contrast to the market reform experience, especially in some of the CEE countries. In Bulgaria, for instance, the shock-therapy devastated almost in no time a considerable part of the accumulated wealth of the broad masses of the population and through the smashing negative shock on internal demand the economy was pushed a decade back. At the same time the economy was demonetarized and made strongly dependent on the inflow of foreign direct investments. An adverse situation emerged: instead of creating favorable conditions for the revival of the spirit of entrepreneurship as it happened in China and for the establishment of a middle class of owners of small and medium enterprises, the opposite was done – conditions were created for the elimination of entrepreneurship opportunities for ordinary people. Entrepreneurship motivation was substituted for the motive of survival by all possible means.

The Issue of poverty, corruption and crime

It is clear from the present analysis that due to the negative shocks on internal and external demand during the first stage of transition, the economic recession in the CEE region became inevitable. And it is also clear why it was much deeper and longer for countries – like Bulgaria and Romania - that did not succeed in attracting enough foreign investments in due time. In this connection there is one more question to be answered, concerning the countries that are lagging behind, namely the countries whose real GDP is still below the level of 1989 (see: Table 1):

How could the necessary resources be provided for the motivation of the broad masses of the population as well as of the ruling elite, to implement the market reform?

This issue should be considered in two specific aspects:

a. How to provide the resources for the motivation of the broad masses of the population?

b. How to provide the resources for the motivation of the political and economic elites in charge of the implementation of the reform?

There are good reasons to assert that the principle precondition for the start of the reform is the availability of resources for the motivation of the ruling elite. This is true because in a situation when the resources for the motivation of the broad masses of the population are absent, the elite could compel them to co-operate by means of appropriate political instruments ant techniques. That is why the question to be asked could finally be modified in the following way:

How is it possible to provide the resources for the motivation of the ruling elite under the conditions of a steeply declining real GDP?

The answer stems from the very essence of the neo-liberal reform strategy. As it was shown it is characterized by an accelerated elimination and destruction of the institutions of the previous economic system and a delay in the creation of the institutions of the new economic system. Hence in the economy there emerges a specific institutional vacuum ("institutional deficiency"). To say it more precisely, a specific "institutional reversal" occurs where it becomes possible to convert the *normal, "constructive", functions* of legislature, the judicial and executive powers aimed at creating and supporting the rules and conditions for increasing the national wealth and prosperity of the population into *"destructive" functions*, aimed at the redistribution in favor of the ruling economic and political elite of the national wealth that had been created under the former economic system and during the period of transition. This was achieved through the implementation of the redistribution-biased reform strategy, or to say it shortly – the redistribution strategy.[22]

In this way a mechanism was created for self-financing of the elite in charge of the implementation of the neo-liberal transition strategy. This mechanism became an institution in itself and was characterized by the rent-seeking behavior of the public administration and soft judicial constraints against crime in all its diversified forms.

What are the implications of the redistribution strategy and what are the symptoms of this disease?

The short and reasonable answer is: a combination of increasing poverty and extreme differentiation of incomes. Data on table 2 are very indicative of this phenomenon. For instance, the countries from Central and Southeast Europe and the Baltics, characterized by the lowest level of real GDP in 1999 (Table 1) compared to 1989 like Latvia, Lithuania, Estonia, Bulgaria are also characterized by the highest values of the Gini coefficient and the record-holder is Bulgaria.

This trend becomes even more obvious when the CIS countries are included in the comparison. It is an expression of the high intensity of redistribution in these countries and is a demonstration of one more core aspect of the neo-liberal model of transition:

In countries, characterized by mixed market economies redistribution is aimed at helping the poor and the indigent and to a certain extent it diminishes the inequality of incomes, while in countries applying the neo-liberal strategy of transition redistribution performs the opposite function – by switching wealth in favor of the elite it creates poverty and increases the inequality of incomes.

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22 For a detailed analysis of *redistribution-biased reform strategy* see *Stefanov, St.* Op. cit.

Table 2

Changes in inequality during the transition, various years (Gini coefficient of income per capita)

Countries	1987-1990	1993-1994	1996-1998
Central and Southeast Europe and the Baltics (CSB)	*0.23*	*0.38*	*0.41*
Bulgaria	0.23	0.38	0.41
Croatia	0.36	-	0.35
Czech Republic	0.19	0.23	0.25
Estonia	0.24	0.35	0.37
Hungary	0.21	0.23	0.25
Latvia	0.24	0.31	0.32
Lithuania	0.23	0.37	0.34
Poland	0.28	0.28	0.33
Romania	0.23	0.29	0.30
Slovenia	0.22	0.25	0.30
CIS	*0.28*	*0.36*	*0.46*
Armenia	0.27	-	0.61
Belarus	0.23	0.28	0.26
Georgia	0.29	-	0.43
Kazakhstan	0.30	0.33	0.35
Kyrgyz Republic	0.31	0.55	0.47
Moldova	0.27	-	0.42
Russian Federation	0.26	0.48	0.47
Tajikistan	0.28	-	0.47
Turkmenistan	0.28	0.36	0.45
Ukraine	0.24	-	0.47

Source. Transition - The First Ten Years. Analysis and Lessons for Eastern Europe and the Former Soviet Union. The International Bank for Reconstruction and Development., 2002, p. 9.

The implementation of the redistribution strategy of transition faced a serious problem – due to the fall of the real GDP under the pre-transition level and the lack of resources to motivate the broad masses of the population, the latter had started to mistrust the credibility of the market reform. At the same time the ruling elite was interested in prolonging the process and inclined to apply some kind of political means for the mobilization of social activity. In this context the most suitable political form of government seemed to be some kind of a dictatorship, furnished with the appropriate despotic mechanisms for the oppression of people's discontent, widely used in Latin American countries. But it seemed to be inappropriate for the CEE countries because of the Copenhagen criteria that had to be observed in the process of accession to the EU. Because of this in countries like Bulgaria a variety of instruments were and are being used as a substitute for the despotic regime that was needed for the oppression of people's discontent. They generated the following practices:

The monopolization of the market of political ideas and party coalitions on the supply side and the creation of a specific political oligopoly. The aim of the political elite was to reach and sustain a bipolar or three polar system of alternation and joint participation in government as a means of the continuation of the redistribution reform strategy.

The deactivation of the broad masses of population and forcing them into a state of apathy and social pessimism through the generation of an atmosphere and feeling of discouragement, hopelessness and despair. A very efficient instrument for the achievement of the above goals have proved to be the "treatment" of social activity with the shock-therapy of massive street crime and also by means of the deactivation of the judicial system and the demonstration of unpunished violation of law by the political and economic elite.

The comprehensive utilization of the values of liberalism – through the creation of opportunities for the dissatisfied as well as for the ambitious and talented (mostly young) people to freely emigrate from their motherland in order to help them fulfill abroad their dreams of a better life. At the same time they turn into a considerable source of capital inflows into the country to help their relatives and friends in their struggle to survive. The evolution of these practices has generated some indirect effects - the domestic political and economic elite perceives the financial transfers of emigrants as a means of filling in the gap in the deficit of the balance of payments which in turn is an important prerequisite for the prolongation of the redistribution market reform strategy.

3.IV.2003