

Where do we Stand a Decade After the Collapse of the USSR?

by Vladimir Popov

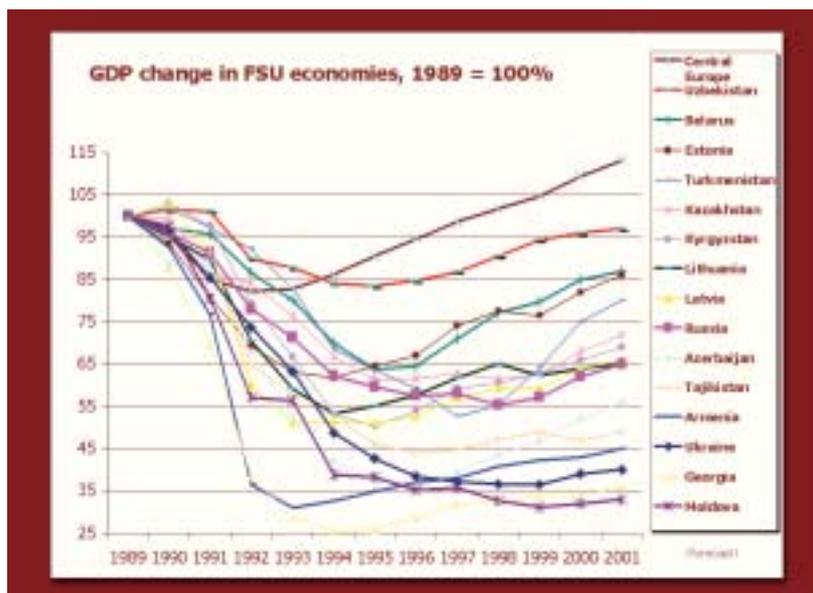
The economic performance of the successor states of the former Soviet Union (FSU) has been disappointing. GDP has fallen by roughly 50 per cent in the FSU from its pre-recession level of 1989 (see Figure). Investment fell by even more. And income inequality has greatly increased—so that most people have seen a real income decline—and life expectancy has dropped sharply (death rates have risen by about 50 per cent).

Russia's GDP fell by 45 per cent over 1989-98 and death rates increased from 1 per cent in the 1980s to 1.5 per cent in 1994. They stayed at this high level thereafter, which is equivalent to over 700,000 additional deaths annually, a population loss that is equivalent to a major war.

In FSU states that were severely affected by conflict (Armenia, Azerbaijan, Georgia, Moldova and Tajikistan), GDP was only 30 to 50 per cent of its pre-transition levels by the late 1990s. Even in the Ukraine (which wasn't affected by military conflict) GDP fell by nearly two-thirds (see Figure).

This output loss is unprecedented in recent history. During the Second World War the national income of the USSR fell by 20 per cent over 1940-42. But national income recovered its 1940 level by 1944 and—despite falling again by 20 per cent over 1944-46 as military industry was converted—it was 20

per cent above its 1940 level by 1948. GDP in Western countries fell by an average of 30 per cent during the Great Depression (1929-33). But by the end of the 1930s it had recovered its pre-recession levels.



Explaining the Severity of the Output Collapse

Why has the FSU experienced one of history's worst declines in output and living standards? Is the collapse due to initial conditions and circumstances (i.e. predetermined and hardly avoidable)? Or do poor policy choices play a greater role?

Most other transition economies did better than the FSU states. In Eastern Europe, the fall in output continued for 2-4 years and totalled 20 to 30 per cent. But at least Central Europe is now above its pre-transition output level. In China and Vietnam there was no transformational recession at all—on the contrary, economic growth accelerated from the start of reform. Was the exceptional length and depth of the FSU recession inevitable?

There is considerable disagreement about which policies are at fault. Those advocating shock therapy emphasise policy inconsistency: in particular the inability of governments and central banks to fight inflation in the early 1990s. In contrast, supporters of gradual transition blame the attempt to introduce a conventional shock therapy package.

The WIDER book *Transition and Institutions: The Experience of Late Reformers* (edited by G. A. Cornia and V. Popov, OUP 2001) offers an alternative perspective. It argues that the speed of reform *per se* (shock versus gradual transition) did not matter a great deal.

Instead, the depth and length of the recession had three main causes. First, greater distortions in the FSU's industrial structure and external trade patterns on the eve of the transition. Second, the collapse of state and non-state institutions, which occurred in the late 1980s and early 1990s, resulting in crisis management instead of organised and manageable transition. Third, poor economic policies: macroeconomic instability and import substitution, irrespective of whether the reforms were gradual or radical.

Supply-Side Shock Caused by Correcting Severe Distortions

The FSU recession partly arose from the need to reallocate resources in

order to correct the distortions inherited from the era of central planning: an over-large military sector; overindustrialisation and underdevelopment of the service sector; inefficient trade flows between the former Soviet republics and between the USSR and Comecon countries; and the excessively large size and poor specialisation of industrial enterprises and farms.

These distortions were generally more pronounced in FSU than in Eastern Europe—and more so than in China and Vietnam. The larger the distortions, the greater the reduction of output that was to be expected. The effects are those of an adverse supply shock (like the USSR's post-war recession caused by the conversion of its defence industries or the world recession resulting from the 1973 and 1979 oil price hikes).

Institutional Collapse Magnified the FSU Output Collapse

Institutional capacity includes the government's ability to enforce rules and regulations, collect taxes, protect property and contract rights, and provide law and order. The failure of FSU states to perform these traditional tasks imposed costs on companies and therefore reduced growth.

To put it differently, the Gorbachev reforms of 1985-91 failed not because they were gradual, but because the state's institutional capacity weakened, undermining its ability to control the transition process. The Yeltsin reforms in Russia, as well as reforms in most other FSU states, were so costly not because of shock therapy, but because of the collapse of the institutions needed to enforce law and order and carry out the manageable transition.

The collapse of the USSR's state institutions that started in the late 1980s (and which continued in the successor states in the 1990s) explains the extreme length, if not the



Many elderly people have been hit hard by economic transition

extreme depth, of the FSU's recession. The exceptions—Uzbekistan, Belarus and Estonia—only prove the rule: the share of government spending in GDP in these countries did not decline as much as the FSU average.

In contrast, strong institutions explain much of the success of gradual reforms in China and shock therapy in Vietnam—in both cases strong authoritarian regimes were preserved and the institutions of central planning were not dismantled before the creation of new market institutions. Robust institutions also explain much of the relative success of radical reforms in Eastern Europe, especially in Central European countries (where strong democratic regimes succeeded in creating new market institutions).

Weak Institutions led to Weak Policies

Given the inability of the state to enforce its regulations, economic policy could hardly be 'good'. Institutional capacity depends not only on the efficiency of the public administration, but also on the existence of a degree of social consensus that enables governments to carry out policies that are opposed by particular interest groups and lobbies. As a result, weak state institutions usually imply import substitution and populist macroeconomic policies (subsidies to non-

competitive industries, budget deficits resulting in high indebtedness and/or inflation, together with overvalued exchange rates). These have a devastating impact on output.

In much of the FSU macroeconomic policy was far from prudent: specifically, high inflation in the first half of the 1990s and exchange-rate based stabilization leading to the excessive appreciation of real exchange rates and currency crises in 1998-99. Industrial policies still favour energy intensive industries, thereby hiding (but not resolving) structural inefficiencies. In Russia, domestic fuel and energy prices are only 20 per cent of their world levels. If these prices were allowed to increase to the world level (i.e. if restrictions for oil and gas exports were lifted), then a painful restructuring leading to a recession would result. If they are not increased, energy intensity levels will remain among the highest in the world. Eventually, policy-makers will have to bite the bullet and it will be painful.

Recent years have seen a resumption of growth in the FSU. After the pain of devaluation, the Russian economy grew at 3.2 per cent in 1999, 7.8 per cent in 2000, and hopefully 5 per cent in 2001. But this recent growth must be put in perspective. In 2001 Russia's GDP was still only 65 per cent of its 1989 level (after falling to 55 per cent in 1998). In contrast, China grew at 7 to 8 per

cent between 1997 and 2001 (and by 10 per cent annually over 1989-96), so Russia is falling rapidly behind. China's GDP is now 240 per cent of its 1989 level, demonstrating that transition—if it is well-designed and executed by strong institutions—can yield considerable benefit. This was unfortunately not the case in much of the FSU.

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The editors of *Transition and Institutions: The Experience of Gradual and Late Reformers*, Giovanni Andrea Cornia (left) and Vladimir Popov, present the book to an audience in Moscow on 5 November 2001. The launch was chaired by Tony Shorrocks, Director of WIDER. The book launch was attended by Russian economists, academics, local and international media and government representatives.

WIDER was originally established to study the economies of developing countries. After the start of transition to a market economy in Eastern Europe and the former Soviet Union, WIDER launched research projects into institutional transition, the emergence of small and medium sized enterprises, regulation of the new market economy, transition's social dimensions, and the mortality and demographic crisis in transition countries.

WIDER research publications on transition include:

The Mortality Crisis in Transitional Economies, Edited by Giovanni Andrea Cornia, and Renato Panicià, WIDER Studies in Development Economics, Oxford University Press, 2000

From Shock to Therapy: The Political Economy of Postsocialist Transformation, by Grzegorz W. Kolodko, WIDER Studies in Development Economics, Oxford University Press, 2000

Democratic Reform and the Position of Women in Transitional Economies, Edited by Valentine M. Moghadam, WIDER Studies in Development Economics, Clarendon Press Oxford, 1994

Post-Communist Reform: Pain and Progress, Olivier Blanchard, Maxim Boycko, Marek Dabrowski, Rudiger Dornbusch, Richard Layard and Andrei Shleifer, WIDER World Economy Group 1992 Report, MIT Press USA, and UNU Press in Japan and South East Asia, 1993

Reform in Eastern Europe, Olivier Blanchard, Rudiger Dornbusch, Paul Krugman, Richard Layard and Lawrence Summers, WIDER World Economy Group 1990 Report, MIT Press, USA, 1991

Please contact the publishers for information on ordering these books.

The FSU's output loss in the 1990s exceeds that of the USSR in WWII and of Western Countries in the Great Depression of the 1930s

Correcting the distortions associated with central-planning led to a large supply side shock in the FSU

This was magnified by institutional collapse which turned transition into a chaotic process that raised business costs and undermined growth

And weak institutions led to weak macroeconomic and industrial policies that reduced output even further

Russia's output in 2001 was 65 per cent of its 1989 level, whereas China's output is 240 per cent of its 1989 level