Building Market Economies in Europe
Lessons and Challenges after 25 Years of Transition

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As prepared for deliver

Introduction

Good morning. It is a great privilege to be here among so many distinguished guests and old friends, and to commemorate such momentous events and achievements with you. And let me thank President Belka for hosting us here in Warsaw, and his kind offer to share the 4th Annual NBP Conference on the Future of the European Economy with the IMF, so that we could celebrate this important anniversary together.

Having been involved myself from the early days of Poland's reforms, it's always a pleasure to come back to Warsaw. Every time I come the city is changed, sometimes dramatically so. One change of course is this fantastic new stadium. And I understand that if I'd waited another few weeks I could have hopped on the new metro line to get here. In this regard Warsaw continues to show the kind of dynamism that we can only dream of in cities of the US or Western Europe.

We have good reasons to celebrate the 25th anniversary of the 1989 changes here in Warsaw. There is Poland's size and its importance in the region. There is the role Poland played in the transition story. For me, there is the role of Polish determination; determination to end the communist regime, going back well before 1989; determination to take on an ambitious economic transition; and determination to do what was needed to join the EU as early as possible, and once there, to take their place at the table in European policymaking.

Of course, Poland is only one of more than 20 countries we are discussing today, and each has had its own eventful journey, and seen extraordinary changes in the space of a generation. I can only scratch the surface of these many transition stories in these opening remarks. So I would like to offer three snapshots. First the initial transition period 25 years ago; next the situation now; and finally to try to look forward 25 years ahead.

1989

Looking back, it is tempting to believe that it was natural, even inevitable, that countries in this region would travel the path they have. But in 1989, at the outset, nothing seemed inevitable about this transition. The communist period left countries with what we at the IMF might call significant macroeconomic imbalances and structural problems. But those labels hardly capture the legacy of the communist period.

Jeff Sachs and I, like many in the IMF, had each worked in Latin American countries in the 1980s, so we had seen inflation and sovereign debt problems. But for us, walking around Warsaw in the summer of 1989 was surreal. Sitting with key Parliamentarians from Solidarity, just days after the sweeping and historic election victory, we heard that their plan was to use the newly gained majority in the Sejm, the Polish parliament, to force the communist government to carry out reforms and bear responsibility for its legacy. At the time, one could understand that impulse. We saw people waiting in lines outside grocery stores that had but a pyramid of canned goods piled in the window.

But as we met with government officials and Solidarity leaders, we found that what you could not see was even worse. The economy was weighed down by a huge monetary overhang, the result of a flood of money financed deficits for the budget and state owned enterprises, combined with price controls that prevented the money from being inflated away. This deteriorating conjuncture was piled on top of a system of endemic resource misallocation and massive waste based on state owned enterprises – what Professor McKinnon dubbed value-subtractors -- with no meaningful budget constraints producing the wrong goods, incentivized by nearly free energy, an unsustainable exchange rate, and the COMECON trade system, and accounting unsustainably for 80 percent of Poland's exports. In the fall of 1989, as controls broke down, and the monthly inflation rate edged up into double digits, money changers one block from the central bank offered more zlotys for our dollars with every new day.

Within Poland, as across the region, there were few economists or policymakers with a deep understanding of market economics; and even fewer prepared for the complex task of transformation from central planning to the market. In fact, this knowledge did not really exist in the West either – not in the IMF, not anywhere. As Yavlinsky succinctly put the transition challenge: the communism turned an aquarium into fish stew; it is harder to turn fish stew into an aquarium.

The wholesale economic changes required went far beyond the Fund's traditional macroeconomic expertise, and experience was not readily available. For example, experts came from the UK, explaining how "privatization" had worked in Mrs. Thatcher's reforms. But the UK experience-- discrete sales of large state firms, within the world's most stable legal and governance framework and based on valuations of assets in a clear economic and financial framework -- had very little in common with the challenge facing Central and Eastern Europe. Here, the vast majority of enterprises, of every type and condition, needed to be put in private hands in what was largely a legal vacuum, with nonexistent capital markets, and often deep macroeconomic instability.

In late 1989, a fierce debate broke out over what came to be called gradualism versus shock therapy. Many gradualists here and abroad argued that the structural flaws of the economy would frustrate attempts at liberalization, and therefore that reforms should be implemented in a gradual, sequenced way. But for others—including key figures such as Leszek Balcerowicz here in Poland and later Yegor Gaidar in Russia—understanding the nature of the problem meant the opposite: reform was a seamless web that could only succeed if all the changes happened together, because liberal prices, improved governance, and a stable economic and financial environment were needed to reinforce one another; little could be achieved with a partial reform. I got a lesson in gradualism attending a meeting during Leszek's first week at the Finance Ministry with 25 staff around a huge conference table, the purpose of which was to decide how much to adjust each controlled price that month. I left after two hours as they worked their way through wood products.

The evidence from the past 25 years has vindicated the seamless web theory of transition. There is an enduring debate about whether living standards fell sharply, or whether official statistics over-counted the disappearance of worthless industries and over-counted the rise in prices of goods that had been unavailable. There is no doubt that some reforms took much longer than anticipated, including privatization, both of banks and companies. But it seems clear that the countries that made sweeping changes, and that kept at reform and stabilization have done well. Countries that followed a more gradual path suffered from the decline of the old industries, and did not get the boost from the growth of new firms. And in some countries bouts of macroeconomic instability repeatedly undermined reforms and sapped political momentum.

In trying to understand what enabled the more successful efforts, four factors stand out: First, the reformers themselves. People mattered in the history of economic transition. Courageous politicians and reformers stepped forward and took on the challenge of designing reforms and explaining their consequences to a wary public. Second, the reform strategies. As I just suggested, reforms that addressed the key imperatives of liberalizing prices, stabilizing finances, privatizing state assets and building governance frameworks did best. Third, the gravitational pull from Western Europe. The EU provided capital, trade opportunities and funding. But perhaps as important, the promise of a return to Europe provided a motivation to help policymakers justify and implement difficult reform steps and to ward off policy approaches inconsistent with European integration. In Poland, for example, governments came and went, but reform marched ahead. And fourth, external support. Friendly countries provided a stabilization fund for Poland on the first day of its reforms. The IMF, World Bank, EBRD, and others helped relieve financial pressures on governments trying to implement structural reform amidst trying macroeconomic circumstances. In some key cases, creditors provided the restructuring needed to overcome onerous debt overhangs. And Poland's stabilization fund was later recycled to support the privatization of nearly all the banks.

2014

Let me say a few words about the present. We are here today in a region transformed and reintegrated into Europe and the global economy. Several Central European countries, including Poland, have achieved per capita GDP levels—in purchasing power parity terms—that put them on the lower rungs of the income ladder of the Eurozone and climbing. People, even those too young to know the difference, have opportunities and horizons unimaginable during the communist period. Living standards, and ways of living, are fundamentally changed. These changes have been incremental, so it can be easy to forget how enormous they are. The photographs at the start of the report we have circulated for this conference provide some stark reminders.

But the picture is not all rosy. A number of countries, especially in the Balkans and the Commonwealth of Independent States (CIS), are still far from completing transition, and have gone through repeated cycles of hope followed by crisis. Slow growth has meant that income levels lag way behind, and the risk of renewed crisis looms again as they struggle with legacies of high public debt and deficits, external imbalances, and debt overhangs affecting companies and banks.

Nor, of course, is everything rosy in the countries that have progressed furthest in transition. These days, there is much to take into account in joining the ranks of advanced countries, given the aftermath of the global financial crisis and the spillovers that come from deep trade and financial integration. Western Europe retains its magnetic pull, but countries must now exercise caution as demand for their exports is less dynamic, as disinflation poses a threat, and as some like Poland consider the timing of joining the Eurozone. Just as with Western Europe, growth in Central Europe has slowed sharply since the global financial crisis. The pace of reform has slowed in many places, and even reversed course in some, thus far isolated, cases. The region risks a vicious circle of weak growth, disillusionment and retreat from market-oriented policies.

One other, regrettably topical, word on historical determinism. It was not inevitable that the freeing of Central Europe and the breakup of the Soviet Union would be as peaceful as it was. This was perhaps the single greatest achievement of the transition. Nor was it inevitable that the breakup of Yugoslavia would be as violent as it was. In both cases the outcomes were the result of deliberate decisions and actions by leaders and their people. This is important to remember as we see conflict in the region. There is nothing inevitable about war in Eastern Ukraine, except that it will harm the people who live there. It is up to all sides to ensure that peaceful solutions are sought out and adhered to.

2039

If we look forward another 25 years, to 2039, what will this region look like? We take up that question in the final panel today, so let me just offer a few thoughts. I do hope that we all meet again here in Warsaw in 2039. Let's hope the economics of transition will have become just a part of the economic history curriculum, alongside a module on central planning. We know that success would mean the remaining Balkan countries have all joined the EU, and that the region is fully integrated into European supply and trade chains. In the good case scenario, European growth will have been driven to an important extent by rapid growth and dynamism coming from convergence of Central and South European countries toward advanced economy levels. For that to have happened, the EU itself would have to have become much better integrated than it has been in the past few years, truly a single market for goods and services, including financial services. And all countries in the region should have shared fully in technological change and modernization of infrastructure.

But just as with the past 25 years, none of that is inevitable. The slowdown in growth now evident in the region translates for now into a slowdown in the pace of convergence with Western Europe. What would happen if this subdued rate of convergence continues? By way of illustration, with the growth performance we have seen since the global financial crisis, in 25 years the average CEE country will have per capita GDP– even in purchasing power parity terms – of only about two-thirds of the EU15 level. And there would be a huge range within this average. The Baltics would be at par with Western Europe. Central Europe as a whole would still be some way short, at a bit over 80 percent. And average income levels for the Balkans and CIS countries would still be less than half of the EU15 level. It would take a 1 percentage point increase in growth across the region, sustained for a quarter century to permit convergence to the average EU15 level by 2039. Let that be a goal.

These are crude extrapolations, of course. But they are dramatically different from the kind of extrapolations we would have made just a few years ago, during the mid-2000s boom, when convergence within a generation seemed like a birthright across the region. The crisis, and the disappointing recovery since, has reminded us that, convergence is instead something to be worked for, just as it was 25 years ago. If countries are to overcome their pasts, they need to press harder on market-oriented reform.

To revitalize the convergence process, a stronger commitment to market-based policies is needed, if countries in the region are to achieve the income levels they would aspire to a generation ahead—whether we are talking about those where transition is more, or less, completed. Priorities differ across countries, as set out in our regular consultation reports with each. But we see two broad themes. The first, in a number of countries, is a renewed focus on macroeconomic and financial stability, to rein in persistent deficits and increasing debt, and to address rising levels of bad loans in banks. The second, more broadly, is to raise the pace and depth of structural reforms, in areas such as the business and investment climate, governance, access to credit, labor markets, public expenditure prioritization and tax administration. This region, as with most others around the world, also faces daunting demographic challenges over the next 25 years. The populations of 2039 will be grayer, but that does not mean they have to be less dynamic – instead the reverse, if negative impacts on fiscal sustainability and growth are to be avoided.

Finally, from the point of view of the IMF, I would say that no region of the world is closer to our hearts. The institution was very deeply involved in the initial reform efforts in virtually every country. Our program involvement gradually tapered off in the early 2000s, while over time, naturally the EU has become the principal external point of reference for many countries. With the crisis in 2008 we suddenly found ourselves thrown back into program work in multiple countries. These programs have in turn mostly ended. But we remain very closely engaged in a number of individual program cases, in our surveillance work, and in technical assistance and training.

So for the Fund as well as the region these have been 25 very eventful years. We have had the pleasure of witnessing and supporting the truly historic achievements in this region since 1989. And we are ready to do what we can to make the next 25 years just as impressive.