TRANSITION STRATEGIES IN EMERGING ECONOMIES: DEBATES, CHALLENGES, AND LESSONS LEARNED

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Introduction

Transition Economy was a policy goal envisioned to elevate living standards for 15 republics that had been part of the Soviet Socialist Republics and were previously governed by a centrally planned economy until the 1990s. Although the general aim was to transition from a centrally planned economic structure, where production and consumption were centrally planned, to a market economy where supply and demand determine outcomes, there were significant debates about the strategic plans needed to achieve this goal.

The transition process towards a market economy in these countries coincided with the time when globalization discussions were intensifying in other countries with free-market economies. The reduction of state interventions in labor and capital markets resulted in imbalanced flows of labor and capital from less developed regions to more developed ones, leading to both regional and intra-country disparities. Comparisons between these countries are challenging due to their unique socio-economic structures (Öztürk, 2006).

Countries historically and sociologically close to the European Union seemed to navigate the transition process more successfully, while other regions struggled to transition to a liberal economy with similar success. The success factors underlying the transition vary, and it is challenging to precisely calculate the positive impact of each factor. It's essential to acknowledge that each country has unique conditions.

The transition struggles in former Soviet Union and Eastern European countries lasted longer than initially anticipated. Many of the Central and Eastern European countries pursued the transition process concurrently with their accession to the European Union, benefiting from financial aid from the EU budget.

In the early 1990s, privatization, macroeconomic stabilization, price liberalization, and institutional reforms were identified as the foundations of the transition economy. However, the specific strategies for rapidly achieving trade liberalization were less discussed.

Definition of Transition Economy

One of the crucial factors defining economic success is the continuous growth of production. Policymakers in transition economies connect the positive impact of growth in production to the well-being of everyone. Havrylyshyn and Wolf outlined the meaning of the transition with the following characteristics:

- Freeing prices in the market while ensuring the most efficient use of resources.
- Using indirect and market-focused tools for macroeconomic stability.
- Achieving effective corporate governance and economic efficiency through privatization.
- Implementing stringent budget constraints that provide incentives to enhance efficiency.

- Establishing an institutional and legal framework to secure property rights, rule of law, and transparent market entry regulations to enhance productivity.

The usage of the term "Transition Economy" in the modern sense began in the second half of the 20th century to describe the collapse of the socialist economies in the Soviet Union and the countries of Eastern and Central Europe, signifying the radical political, economic, and social transformation of society.

The unexpected fall of the Berlin Wall led to the introduction of the term "Transition Economy" without any pre-existing theories or transformation strategies. The lack of any significant private enterprise in socialist economies, where privatization methods, the roles of institutions in the privatization process, and how to overcome budget constraints in the transition to a new structure were left unanswered. The exact beginning of the transition process is a subject of significant debate among economists.

As political and military power collapsed in the countries of the Eastern Bloc, the former command economies transferred economic decision-making mechanisms to the private sector. Thus, the term "Transition Economies" emerged to describe the economic transition from a command economy to a free-market economy. The economic interests of these countries required financial institutions equivalent to those in advanced Western countries to finance the changes in the product and service sectors. In the short term, they had to face some economic risks, termed as "bitter pills," to treat long-term economic interests. In some cases, these bitter pills had more harmful consequences than the diseases they were intended to cure, leading to resistance and even support for a return to the previous system.

In the Western world, there is a saying, "No pain, no gain." It emphasizes the fact that the majority of the population in these countries had to face difficulties such as inflation, unemployment, increased crime rates, and poverty in the short term during the economic transformation process. For example, one of the striking problems was the sudden increases in prices of goods and services. The artificial price system set by the Council for Mutual Economic Assistance collapsed as prices were allowed to rise in line with market economies. This led to inflation, which had destructive effects on the majority of the population, hindering savings, eroding limited capital, and even impeding the emergence of small-scale private enterprises. The problem intensified for two main reasons: the widening purchasing power gap between foreign nationals and citizens due to the increase in the cost of living and the inability of existing underdeveloped financial institutions to allocate capital beyond the power of public institutions for the realization of capital.

After the unexpected collapse of the order in Eastern Europe, the widespread assumption in the Western world was that the region would rapidly transition to a free-market economy and eventually catch up to Western living standards. The expectation was based on the assumption that these countries had been lagging behind primarily due to their socialist political and economic structures. However, these expectations did not materialize as quickly as anticipated, and the path to a market economy became more challenging than initially thought.

Key Features of Transition Economy

1. **Price Liberalization:** One of the primary steps toward a market economy is the liberalization of prices. Instead of being centrally planned, prices are determined by market forces of supply and demand. This allows for a more efficient allocation of resources.
2. **Macroeconomic Stabilization:** To ensure economic stability, indirect tools and market-focused mechanisms are employed. This includes managing inflation, controlling fiscal policy, and stabilizing currency values.

3. **Privatization:** The transition process involves moving from state ownership to private ownership. This aims to enhance corporate governance, increase economic efficiency, and encourage entrepreneurship.
4. **Budget Constraints:** Implementing strict budget constraints is crucial to incentivize efficiency. This involves limiting government spending and encouraging economic agents to operate within their means.
5. **Institutional and Legal Framework:** Transition economies need a robust institutional and legal framework to secure property rights, uphold the rule of law, and establish transparent market entry regulations. This fosters a conducive environment for economic productivity.

Challenges in Transition Economy

The path to a market economy involves numerous challenges, and the specific difficulties faced can vary across countries. Some common challenges include:

1. **Resistance to Change:** Transitioning from a centrally planned economy to a market economy requires significant changes in mindset and practices. There may be resistance from individuals and institutions accustomed to the old system.
2. **Inflation and Economic Risks:** The liberalization of prices can lead to inflation, impacting the purchasing power of the population. Additionally, economic risks such as unemployment and increased crime rates may emerge during the transition.
3. **Privatization Issues:** The process of privatization, while essential, can face challenges. Determining the appropriate methods, addressing issues of fairness and transparency, and managing the shift from state to private ownership require careful consideration.
4. **Legal and Institutional Gaps:** Establishing a robust legal and institutional framework is crucial. Gaps in legal systems and institutions can hinder the protection of property rights, enforcement of contracts, and overall economic stability.
5. **Social Disparities:** Transition periods can exacerbate social disparities. Certain groups may bear the brunt of economic changes, leading to increased inequality.

Conclusion

Transition economy represents a critical phase in the economic evolution of countries moving from a centrally planned system to a market-oriented one. While the overarching goal is to improve living standards and achieve economic growth, the challenges in this process are multifaceted. Successful transition requires a combination of well-planned policies, effective institutional frameworks, and societal adaptation to change. The experiences of various countries in transition underscore the importance of context-specific approaches and continuous evaluation of strategies to address evolving challenges.

The onset of Transition Economies

In the earliest years of transition, the central focus of public policies in Central and Eastern Europe and the Soviet Union was on liberalizing trade and promoting it through macroeconomic balance, price liberalization, privatization, restructuring of enterprises, and institutional reforms. Following the sudden liberalization of trade, exports and imports were released. In order to facilitate Foreign Direct Investment and other capital investments, the exchange rate also needed to be liberalized. Economists had differing opinions on which models transition economies would adopt to achieve these trade balances. Additionally, transition economies engaged in various regional trade partnerships, such as the European Union and other regional cooperation alliances.

The concept of transition economies has been used to refer to different transition processes at different times. One set refers to traditional transition economies, encompassing the transition process in sub-Saharan Africa, some Asian, and Latin American countries. The other set refers to the post-communist countries emerging after the collapse of communism, including Eastern and Central European countries, countries that separated from the Soviet Union, and China. These countries share the common feature of transitioning from centrally planned economies to market economies. However, we will focus on the transition in post-communist countries.

Over the past decades, the experiences of the region's countries have provided lessons. At the beginning of the transition process, tariff rates on exports and imports were significantly hindering trade in countries under the control of a centrally planned system. After the dissolution of COMECON in 1991, which affected all regional countries, price liberalization and the creation of convertible currencies led to the removal of strict controls on exchange rates, facilitating policies to attract foreign direct investments.

The early years of transition brought many challenges. Except for China and Vietnam, all countries experienced significant declines in their GDPs. Countries that were more prepared for transformation were relatively more successful. Poland hit the bottom of its contraction in 1992, entering a period of rapid growth. The Czech Republic, Hungary, Slovakia, and Slovenia started to grow after 1993. Some countries, such as Russia, Yugoslavia, and Macedonia, either entered the development process very late or never entered the growth phase. During the transition process, many countries faced high unemployment rates, which persist to this day. Changes in economic policies and reforms have caused significant damage to the health sector and social standards of these countries. Even today, the development of these sectors progresses very slowly. The private sector also struggles to provide suitable solutions to these problems. The transition brought about social injustice and poverty. Increases in corruption, bribery, and crime rates have also been observed.

Countries undergoing the transition process designed their transition policies according to two different approaches. The first is the path of implementing the transition process quickly. These countries anticipate sudden liberalization in prices and trade along with stabilization programs. Flexible exchange rate policies allow international trade without causing sudden declines in the domestic real sector. However, international competition puts pressure on the national economy. The sudden opening of a closed economy to the international market led to the privatization of public enterprises and reforms to eliminate monopolies in industry and change accounting standards. Various reforms were also implemented in tax laws, legal regulations, and public service regulations.

Despite the initial positive outcomes of these reforms, they led to economic bottlenecks that slowed down the transition process. Differences emerged between theory and practice. For example, while privatizing companies can be done in the short term, establishing a corporate governance understanding that promotes a market economy and transforming legal and financial systems takes a long time. The success rates of countries adopting this approach are linked to their levels of democracy. Countries that embraced democratic values were better prepared for the transition period.

The second approach can be described as the gradual reform method. In this approach, based on specific sectors or local experiences, reforms are adopted step by step. Partial reforms in the target sectors of the market are implemented in the long term without abolishing central planning. The reallocation of resources occurs proportionally from less efficient sectors to more efficient sectors. As a result of this approach, only some countries, such as China and Vietnam, achieved reasonable results.

Scope of Transition Economies

Today, countries commonly referred to as transition economies are a total of 24, generally grouped into two categories. Nine of them are countries in Central and Eastern Europe (Albania, Bulgaria, Czech Republic, Croatia, Hungary, Poland, Romania, Slovakia, Slovenia), and the other 15 consist of three Baltic republics (Latvia, Lithuania, Estonia) and 12 member countries of the Commonwealth of Independent States (Azerbaijan, Belarus, Armenia, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Russia, Tajikistan, Turkmenistan, Uzbekistan, and Ukraine).

The discussion on transition strategies has primarily revolved around four main groups. One group consists of proponents who believe that the strategy is generally successful when implemented effectively, and that problems mainly arise as a result of shortcomings in implementation. They are the protagonists of the reform strategy actually pursued. The other three groups, while generally agreeing with the market-oriented reform strategy, have reservations about certain features of its implementation. They believe that the proposed sequencing and pace of reforms are incorrect, advocating for a more gradual institutional development instead of emphasizing radical reform. This debate has recently intensified, fueled by a series of articles reexamining these issues in light of cumulative evidence from the first decade of transition.

In addition to privatization, the debate on the implementation of reforms has focused on macroeconomic stability. This discussion centers on the adoption of tight fiscal and monetary policies. Critics argue that such policies initially exacerbate the decline in production, contributing to barter and borrowing problems. Others claim that the initial decline in production is largely a result of initial conditions and external shocks, and that tight macroeconomic policies lay the foundation for a faster and more robust recovery later. This argument is particularly relevant for the countries of the Commonwealth of Independent States (CIS), where hyperinflation made stability an urgent priority and external resources were limited. Finally, some argue that decisions to use early "windows of opportunity" to advance reforms were successful in Central and Eastern Europe, but the slower recovery of production in the CIS and ongoing disruptions indicate a failure in adequately implementing the strategy.

2.6.1. Washington Consensus

There was no pre-prepared reform package for the transition from centrally planned economies to market economies, given the absence of prior experiences with such transitions. The consensus, known as the Washington Consensus, was formulated by John Williamson in 1989 as a reform package for Latin American countries and has since become a historical reference. This consensus, also known as the neo-classical economic development policy, is considered a one-size-fits-all prescription for all developing countries. There are two different views on the speed of reforms in the transition process: one advocates the "big bang" or shock therapy method, and the other favors an evolutionary approach aiming for gradual reforms.

Ten Basic Principles of the Washington Consensus:

1. Achieving an acceptable budget deficit without resorting to inflationary taxation.
2. Reducing politically motivated public spending and redirecting it towards essential areas such as health, education, and infrastructure.
3. Implementing tax reform by reducing marginal tax rates and broadening the tax base.

4. Financial liberalization with the ultimate goal of freeing interest rates.
5. Implementing a free exchange rate policy to increase exports.
6. Replacing quantitative trade restrictions with tariff reductions, gradually lowering tariffs up to 10%.
7. Eliminating obstacles to foreign direct investment.
8. Privatization of state-owned enterprises.
9. Removing regulations that hinder competition.
10. Protection of property rights through legislation .

2.6.2. Evolutionary-Institutional Strategy

A more fundamental criticism of market fundamentalism is that it has largely underestimated both the importance and the difficulty of creating the institutional infrastructure needed to support market economies. According to this view, building effective institutions is a lengthy process that requires a lot of trial and error, suggesting that the transition should be carried out in an evolutionary manner, adapting existing institutions pragmatically and gradually to new needs, as seen in China. According to this perspective, market fundamentalism is flawed because it eliminates useful institutions that could be beneficial in the early stages of transition and underestimates the longer and more challenging process of ensuring the enforcement of laws. (Staff, 2000; 93).

The speed of reforms, privatization methods, the role of the government, and the structure of the financial system are among the various areas of debate. Transition also necessitates significant institutional changes. The focus has shifted from assuming that successful capitalist institutions existing in advanced economies are also present in transition economies to addressing questions about how to accelerate reforms, how institutions evolve, and what solutions exist to avoid getting stuck in inefficient institutions. Thus, the emphasis shifted from market freedom and price contracts to laws, social and political environments. Proposed solutions to questions such as how to expedite reforms, how institutions evolve, and how to deal with inefficiencies in existing institutions started to emerge. Consequently, unexpected surprises emerged during the transition.

- Production decline following the liberalization of prices in ways economists did not predict.
- Incidents of corruption surging before the privatization of state enterprises.
- Emergence of mafia influence in some cases instead of a free market.
- Disintegration of countries and wars (Yugoslavia, USSR, Azerbaijan).
- China's economic success due to its reforms over a 20-year period, leading to significant growth and prosperity (Roland, 2003: 4-8).

Examining the experiences of transition economies reveals that Central European countries achieved successful results with the Washington Consensus method. Their success can be attributed to the already strong economic and institutional structures, as well as the effects of the European Union membership process. However, the same success cannot be claimed for the Russian Federation, which chose the transition path with the same method. Russia's economic turbulence serves as a clear example that the Washington Consensus method is not universally applicable to all countries. It would be a mistake to attribute China's economic successes solely to the same method. China's achievements are more explainable through the evolutionary-institutional approach.

In conclusion, when applied, strict macroeconomic policies successfully stabilized the respective economies, thus providing necessary conditions to continue the transition process. The debate over the optimal sequencing and pace of reforms has moved beyond the initial emphasis on "evolutionary" versus "shock therapy." Critics of the "big bang" approach argue that the emphasis on speed destroys valuable organizational arrangements among existing enterprises, contributing significantly to the collapse of production. This collapse, when combined with the liberalization of prices and deep cuts in government spending, has led to sharp increases in poverty and income inequality. (Staff, 2000; 93).

Moreover, considering the inherent uncertainties in the nature of transition, some argue, especially in the case of Russia, that poorly sequenced reforms solidified vested interests and hindered further reform. However, other researchers counter these criticisms, pointing out that production began to decline before the transition, organizational arrangements inherited from central planning were not suitable for the market, and in most cases, privatized firms were restructured more rapidly than those remaining in state hands. Additionally, they note that the most unequal wealth allocations and significant increases in income inequality and poverty occurred mainly in countries where reforms were only partially implemented and could be manipulated by vested interests for their own gains.

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