

Stuck in Transition? Or Continued Great Divide?

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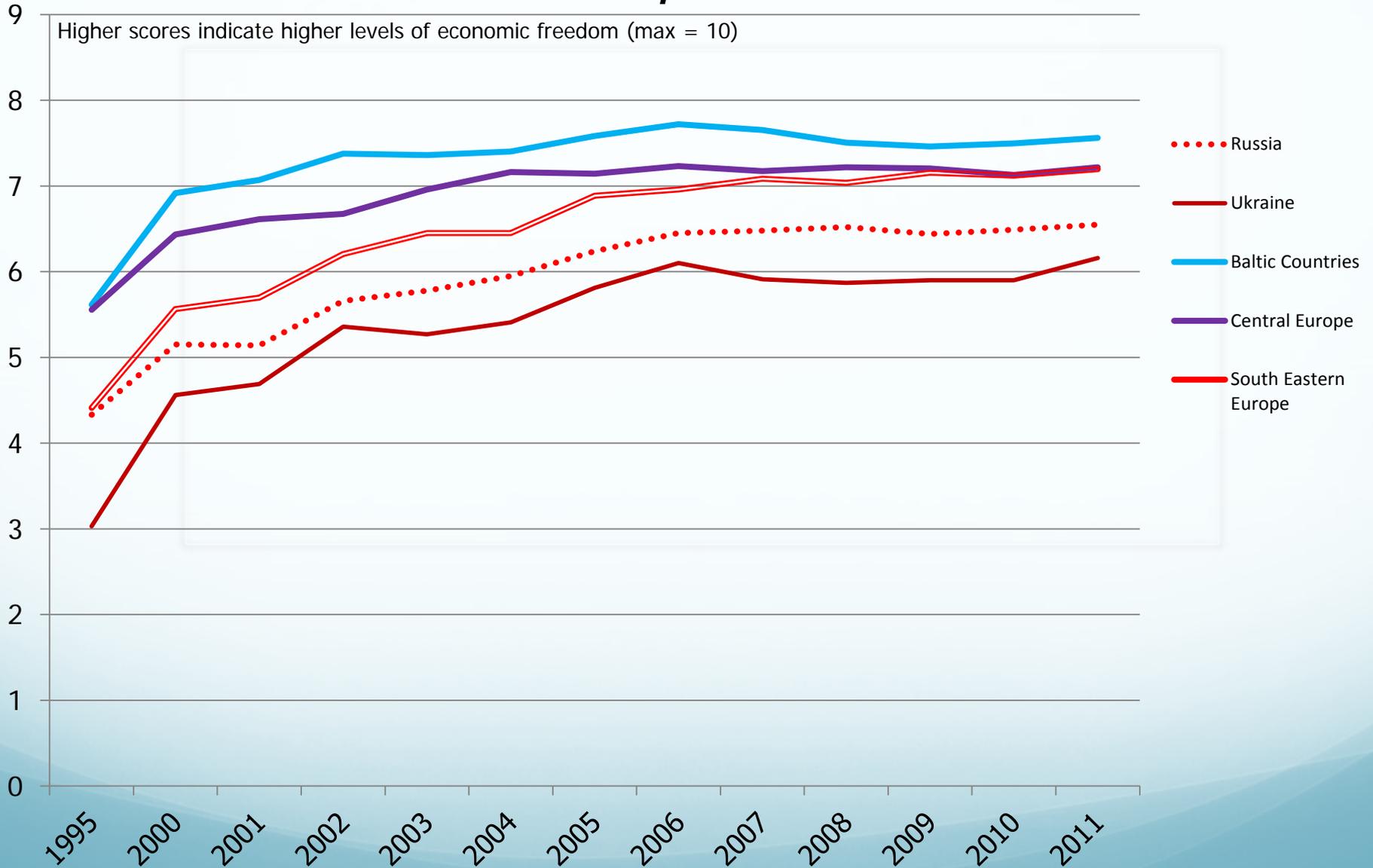
Transition Report 2013

Two key conclusions:

1. Structural reforms started to reverse in 2013 for the first time
2. Economic convergence is likely to stall if new reforms

But what is the nature of the problem?

Economic Freedom in Transition Countries, 1995-2011



Central and Eastern Europe: Concerns

- Reversal of pension reforms: mainly Hungary and Poland
- Reversal of energy reforms
- Higher taxes; Slovakia and Czech Republic have abolished flat income taxes

More populism and less liberalism

Central and Eastern Europe: Causes

- People are tired of economic crisis, fiscal tightening and lower growth
- Seven of ten center-right governments have fallen in the last year or so

But most incumbent governments lose elections because corruption remains the dominant theme, and the incumbent left is likely to lose because of falling growth

= good hope for new reforms

Former Soviet Union

- Key concern: Near stagnation in Russia, Ukraine and Belarus
- Cause: Crony and state capitalism – state capture by small corrupt ruling group
- Coming problem: Commodity boom is ending and reducing export revenues

FSU is stuck in a corruption trap requiring regime change in three major countries

Divide CEE-FSU Remains

While CEE has some problems with corruption, FSU's very nature is corruption. Origin: Initial transformation:

1. No timely Western financing for Russia
2. Hyperinflation in FSU because of maintained ruble zone
3. Radical transformation in CEE vs gradual in FSU
4. Democratization in CEE but not in FSU
5. Soviet distortions of trade, prices & structures
6. Rent seeking in FSU vs profit seeking in CEE
7. EU supported CEE but not FSU: Trade, assistance, EU norms & education

Future Outlook

CEE is in a temporary middle-income trap

- Needs to improve higher education, develop r&d & develop financial markets
- Will have to relearn the need for market reforms
- Likely to change governments in next elections

FSU is stuck in predatory authoritarianism

- No obvious way out short of regime change

The divide between CEE & FSU is not diminishing