A Clear Model for Reform

Jonathan Kimball

The difference in economic development between the many former Soviet bloc countries that have opened their markets on the way to joining the European Union (EU) and the few that have not done so is sharp and revealing.

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This Audi plant in Gyor, producing 50,000 autos annually, reflects Hungary's embrace of foreign investment.

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Seventeen years after the fall of the Berlin Wall, liberal, free market democracies have firmly taken root in Central and Eastern Europe, including in the Baltic States of the former Soviet Union. The Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, and Slovenia are all members of the European Union, which Romania and Bulgaria also joined on January 1, 2007. While EU membership demonstrates international recognition of the region's monumental transformation, the trade liberalization that was a critical part of the accession process will have an even greater impact on the well-being of the region's population over the long term.

In contrast, the former Soviet states of Belarus, Moldova, and Ukraine, geographically the most western of the non-EU members of the former Soviet Union, have not adopted trade-liberalizing policies to the same extent, and thus they have not reaped the same rewards. In fact, while their economies have grown during the past 15 years, they have not benefited from the same influx of capital and foreign investment as their neighbors to the west. This can be partly explained by differing historical circumstances, a lack of political commitment for reform, and, maybe most importantly, the nonexistence of a persuasive outside force pushing for trade liberalization, such as the likelihood of EU membership. But what has been most missing is a serious commitment to eliminate the nontariff barriers that greatly inhibit the growth of trade and foreign investment. These nontariff barriers act as a protectionist wall, favoring local companies with the knowledge and connections that lead to increased market share.

Only after Romania and Bulgaria, for example, began seriously addressing nontariff barriers—such as weak intellectual property rights enforcement, bloated bureaucracies that inhibited the ability of companies to work with the state, nontransparent procurement systems, and widespread corruption—did their economies turn around, foreign investors flood into the markets, and export-led growth take off.

The model to be followed for countries like Moldova, Ukraine, and Belarus is very clear. It is that of Central and Eastern Europe. The Central and East European economies have expanded specifically because they have opened their economies to foreign competition, reduced the state's influence on the economy, and introduced far-reaching structural reforms. Examples of key reforms implemented in the region include the following:

- **Tariff reductions:** Reducing tariffs was an important means of injecting competition into

the market. Higher-quality and less-expensive goods force inefficient companies out of the market and demand innovative and efficient production methods from companies that remain.

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Economic expansion has proceeded more slowly in Belarus than in its neighbors that have opened their markets to trade and investment.

- **Price liberalization:** Although politically difficult, freeing prices was critical to implement market pressures on producers of everything from consumer goods to energy. Eliminating subsidies also allowed foreign products to enter the market without having to face additional barriers to free competition.
- **Privatization:** Reducing the state's role in controlling the means of production allowed companies to respond effectively to the cyclical nature of the market. Privatization also allowed the state to rid itself of loss-making companies that placed a significant strain on the state budget, and it attracted foreign investors to the region's economies.
- **Establishment of independent regulatory bodies:** Reducing the state's influence over regulatory decisions was critical to the establishment of a predictable market economy. Corruption and political influence are too easily exercised when the state has significant input in the market. This is especially important in the financial, telecommunications, and energy sectors.
- **Sound fiscal and monetary policies:** Controlling inflation has been critical to developing a market that is predictable and stable. At the same time, limited, effective, and accountable government expenditures have been highly important to direct and soften the effect of the introduction of market principles.

The results have been highly impressive. According to the International Monetary Fund's *World Economic Outlook* database for September 2006, the average gross domestic product (GDP) per capita (in purchasing power parity terms) in Central and Eastern Europe increased by 112 percent between 1993 and 2005. In contrast, the average growth of GDP per capita in Belarus, Moldova, and Ukraine during the same period was 48 percent.

In addition, foreign investors have been attracted by these far-reaching reforms. Whether entering the economies via privatization, joint venture, or "greenfield" investment in new sites, foreign investors have brought jobs, know-how, and significant tax revenue to the transitional economies. As a result, during the same time that bloated state-owned industries were streamlined or liquidated, foreign investors, attracted by the predictability of a transformed economy, have helped fill the employment gap. While some of the above-mentioned reforms have been implemented in Belarus, Moldova, and Ukraine, the lack of a true commitment to the enforcement of the new laws and regulations has led to lower levels of foreign investment.

The economic transitions of the new members of the European Union are far from over. Throughout the region, corruption still needs to be reduced, bureaucracy must be trimmed, public procurements must be made more transparent, and other nontariff barriers must be tackled. However, trade liberalization and the extensive structural reforms implemented since 1989, which have resulted in strong, impressive economic growth, are unlikely to be reversed. This predictability—lacking in Belarus, Moldova, and Ukraine—creates a business climate that attracts domestic and foreign capital, leading to jobs, economic growth, and a stronger, wealthier middle class. These are all prerequisites for a modern, global economy. ■