An Overview of Transition to Market Economy

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presented at the seminar held by the OECD and the Ministry of Foreign Affairs
to present the OECD's publiaction "The Baltic States - Regional Economic Analysis"
April 28, 2000

First of all, I would like to thank the organizers for providing me with the opportunity to share my views on the transition process in the Baltic States. Also, let me congratulate the authors and organizers of the OECD study on The Baltic states with producing the analysis. It is a considerable input into the discussion on economic reforms in these countries, including Lithuania.

I would like to structure my brief presentation by suggesting to you a number of statements, or hypothesis, on the aspects of economic reforms, elaborating further some issues that are only mentioned in the study.

Proposition 1. Transition to market economy has been to a large degree influenced and structured by the other two parallel processes, namely globalisation and European integration.

What does this mean? First, the end of the Cold war for the Baltic States meant not only the freedom and ability to choose the path towards a democratic society and the market economy; it also marked the end of the division of the world into two competing blocks, and the beginning of the rapidly increasing international flows of goods, capital, ideas and people facilitated by advancing technology. As the New York Times journalist Thomas Friedman has noted with a dose of exaggeration, "The symbol of the Cold war system was a wall, which divided everyone. The symbol of the globalisation system is the World Wide Web, which unites everyone". Finally, it also meant the end of division of Europe and the integration of the CEECs into the EU. The integration process for the Baltic States started in the first half of 1990s with the Free trade agreements and Europe agreements being signed with the EU. Since then, integration has been proceeding with as remarkable speed as the transition itself. Currently all three Baltic States are negotiating the accession terms with the EU and implementing numerous bilateral and unilateral integration measures.

Proposition 2. Globalisation, or increasing links between nation states, companies and individuals, facilitates the transition to the market economy of the Baltic States and other countries of this region by providing more opportunities to adopt the best practices of other countries.

This OECD study itself is a good example of globalisation at work and exchange of ideas about reforms. Globalisation facilitates the economic reforms and functioning of the markets in general by providing capital, expertise, technology and other means that reduce transaction costs, increase efficiency and provide the benefits of the open market to an increasingly larger share of population. Globalisation also encourages external liberalization and the opening up of the reforming economies and facilitates trade and the division of labour. At the same time, it does not seem to alter so far the economic fundamentals such as the comparative advantages of the countries, but illustrates them in a world of decreasing relative transportation and communication costs and increasing trade. As the OECD Study suggests, the Baltic States illustrate very well the validity of the concept of comparative advantage. This should be stressed in the background of intellectual climate in Lithuania which could be well characterised by the question that was raised several years ago by world famous US economist Paul Krugman - "why don't intellectuals understand comparative advantage?"

Proposition 3. Globalisation can limit the autonomy of economic policy but this in many cases might be a factor that makes the governments more accountable, their policy more transparent and economic competition more effective.

Globalisation has its set of rules that revolve around opening, deregulating and privatising your economy. These processes are currently taking place not only in the transition countries, but also in most OECD countries and other places of the globe. They reflect the prevailing consensus on the economic policy and more efficient way of business both inside the countries and internationally. What is important is what Thomas Friedman calls "the democratisation of technology", which enables more people to reach further distances, faster and cheaper than before; "the democratisation of finance" which enables not only some banks but many individuals to participate in the capital markets and hold the sovereign debts of many countries; and "the democratisation of information" which shows us how ahead or behind we are in comparison to the other reforming countries. These factors increase control over government policies, making them more accountable to their people. At the same time, governments are punished more severely for their inappropriate economic policy decisions and have stronger incentives to create more favourable climate, whether regulatory or fiscal, for investments and business in general. In the Baltic States, however, we are only starting to see these processes at work.

Proposition 4. Integration into the EU has structured the transition process in the Baltic States. It has provided a time-frame and incentives for reforms through linking the progress in transition reforms with the EU accession criteria.

Integration into the EU has exerted a positive impact on transition reforms in the Baltic States in a number of ways. First, by signing the Free trade agreements and the Association agreements the Baltic state have committed themselves to the liberalization of trade with the EU and implementation of some other reforms such as competition policy within a clear timetable. Afterwards, these committments have many times prevented the authorities in Lithuania from reintroducing barriers to trade. The goal of EU membership has also acted as a major incentive for signing the main three trilateral trade agreements between the Baltic States. In general, the EU accession, or "Copenhagen", criteria of the functioning market economy and capacity to withstand competitive pressure within the EU have provided a considerable push to continue economic reforms in the Baltic States. To some extent, the Progress reports of the European Commission have reflected the progress of these countries not only in preparing for EU accession negotiations and membership but also progress in transition reforms.

Proposition 5. Integration into the EU has impacted positively on the main elements of transition reforms in the Baltic States - stabilization, liberalization, privatisation and institutional reforms.

The impact of integration on economic reforms in the Baltic countries has been both direct and indirect. It had an indirect positive impact on stabilization by emphasising the importance of conditions for the stable economic environment in the Agenda 2000 and regular reports. It had a direct positive impact on liberalization by removing barriers to trade and encouraging economic cooperation in the region and joining the WTO. It had an indirect positive impact on privatisation by encouraging continuing this process. And it also had direct and indirect positive impact on creating the market institutions, for example, by supporting establishment of financial institutions, reforms of the public finance system and public administration.

Proposition 6. The impact of the further adoption of EU acquis communautaire, in particular the norms regulating process standards such as environment or labour relations, on economic growth in the Baltic states is uncertain.

One of the conditions for being admitted into the EU is the transposition and the implementation of the EU acquis cummunautaire in the candidate country. This includes also the rules governing the Single market and the common policies. During its half a century history, the EU has developed a vast body of norms regulating the economic activities in the Single market, including quality standards of products and production processes. As some experts (Baldwin, R., Francois, J., Portes, R.) have concluded, the acquis is a sub-optimal choice of rules for the transition economies that are in different stages of economic development. Therefore, in order to reduce uncertainty and possible investment needs, which might strain the budget and put too large a regulatory pressure on enterprises, the authorities of these countries need to have a clear and grounded strategy of acquis implementation. The acquis requiring significant investments by the enterprises and state has to be implemented later. Further, there are two questions of the impact of EU regulation. First, is its impact on the competitiveness of Lithuanian enterprises, because the fast implementation of some EU norms might diminish their competitive advantages inside the Single market? Second, there is an issue of the administrative ability of the regulatory institutions in the Baltic States to observe the principles of proportionality of means to achieve the aims defined in the directives, not to impose a disproportionate burden on enterprises, to implement the regulations properly and not to be captured by interest groups. The credibility of properly implementing the EU membership requirements in the context of transition is equally or even more important than the speed of integration.

Proposition 7. The linkages between transition, globalisation and integration make the argument about the interdependency of transition reforms even stronger. The experience of the Russian crisis in the Baltic States illustrates this point very well.

As the OECD Study confirms, all the variables are interdependent and reforms in all areas have to be implemented in parallel. Otherwise for example, liberalization of trade without liberalizing and privatising the infrastructure sectors or creating conditions for the financial institutions might not bring all the benefits to the economy. The impact of the Russian crisis, being to some extent unavoidable due to intense trade of the Baltic states with Russia have been aggravated by the legacy of incomplete structural reforms and inadequate response of the state authorities. Were the sectors such as energy, agriculture, social protection reformed and conditions for effective competition not distorted by soft budgetary constraints and regulatory barriers, the adjustment of the economy to the external shock would have probably been easier, although not without short-term costs. One should hope that this lesson has been learned and there are indications of this.