University of Toronto
Munk Centre for International Studies
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Controversies in Global Politics & Societies

Occasional Paper • No. VII • 2007

Economic Recovery in the Commonwealth of Independent States: Oil, Reforms, Rebound – or All of the Above?

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CONTROVERSIES IN GLOBAL POLITICS & SOCIETIES

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ISBN 978-0-7727-0836-6
ISSN 1715-3476

Library and Archives Canada Cataloguing in Publication

Havrylyshyn, Oleh
Economic Recovery in the Commonwealth of Independent States: Oil, Reforms, Rebound – or All of the Above? / Oleh Havrylyshyn

(Controversies in global politics & societies, ISSN 1715-3476 ; no. 7)
Includes bibliographical references. ISBN 978-0-7727-0836-6

1. Former Soviet republics – Economic conditions – 20th century.
2. Europe, Eastern – Economic conditions – 1989-. 3. Europe, Central – Economic conditions – 20th century.
I. Munk Centre for International Studies II. Title. III. Series.
HC336.27.H39 2007   330.947'0009049   C2007-905862-0

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2007 ISBN 978-0-7727-0836-6

Economic Recovery in the Commonwealth of Independent States: Oil, Reforms, Rebound – or All of the Above?

by
Oleh Havrylyshyn

All transition countries experienced a sharp decline in output in the early 1990s. Central Europe and the Baltics began to recover around 1993–95, while GDP decline continued elsewhere. Econometric analysis of growth determinants explained this by the fact of earlier inflation stabilization, market liberalization, and institutional development, though there was disagreement in the literature as to the effect of initial conditions and the sequencing regarding liberalization and institutions. Since 2000 there has been not just a recovery but a growth surge in the Commonwealth of Independent States, even though it still lags behind on the three key policy determinants of growth. The energy boom in the region can explain only part of the growth in the region and is more relevant to energy exporters such as Russia. The post-transition recovery is best explained by a threshold model: recovery starts when a certain threshold level of stabilization, liberalization, and institutional development is reached. The levels reached by CIS countries around 1999–2000 were in fact very similar to those that the early reformers of Central Europe and the Baltics had attained just before their GDP growth restarted. The empirical comparisons reveal two important facts that are relevant to debates on the role of institutions and liberalization. The level of institutional development needed to restart growth is not only similar but surprisingly low for all the countries. Also, the sequencing was in all cases exactly the same, with liberalization moving much more quickly than institutions in both rapid and lagging reformers. Not a single instance exists of liberalization being delayed to allow faster introduction of institutions.

1. INTRODUCTION

Transition countries in the European and Eurasian region all experienced a significant decline in output throughout the 1990s. While the extent of the decline is sometimes disputed because GDP measures used during the Soviet era cannot be compared with those of the market regime that followed, there is no doubt that all countries in this region underwent a "transitional recession." It is also agreed that the recovery came relatively early for Central Europe and the Baltics (CEB), which hit bottom from 1992 to 1994. Others countries, in particular many members of the Commonwealth of Independent States (CIS), saw a continued decline through much of the 1990s; starting in 1999–2000, however, the latter not only began to recover but in fact experienced a growth surge, with annual GDP growth rates between 6 and 10 percent and sometimes more.

Many econometric studies in the late 1990s undertook to explain differences in output performances, as part of efforts to understand both the reasons for differences in declines and the timing of recoveries. This literature was often based on the traditional literature on growth empirics, which had three main phases. Beginning with the Solow model of the 1950s, early growth theory focused on factors of production – capital, labour, natural resources – and their productivity. Revived interest in growth in the 1980s as exemplified by Barro and Sala-i-Martin (1995) inquired into a much broader range of conditions for higher factor accumulation and productivity, such as endogenous innovation and the expansion of human capital. Johnson and Subramanian (2005), in a useful survey of institutions, note that to answer these questions, "attention … turned increasingly to institutions."

Surprisingly, some of the key findings in the traditional literature did not seem to apply to transition countries; in particular, these studies found that factor inputs and human capital were at best insignificant and sometimes generated negative rather than positive effects. Though disagreements remained regarding how growth in

This paper was originally prepared for presentation at the Seventh Annual Global Development Conference, St. Petersburg, Russia, January 19, 2006. I am grateful for suggestions offered by Lucio Vinhas de Souza, Marek Rohozynski, and Waldemar Skrobacki, participants of a seminar presentation at the Munk Centre, October 2006, and for the comments provided by two anonymous reviewers. Nikola Milicic provided valuable research assistance for this paper.

transition countries can be explained, a certain amount of consensus emerged that the most important determinants were as follows: early stabilization, good progress on market reforms, and initial conditions. These seemed to explain why CEB recovered early whereas the CIS continued to decline. The role of institutional development was more ambiguous: it was little explored in these studies, and the results varied. When the CIS growth surge began, this consensus did not provide a fully satisfactory explanation because these states were still far behind CEB in reform progress. Alternative factors such as soaring oil prices were often viewed as the explanation.

Thus the literature leaves us with one puzzle and one unexplored dimension. The puzzle is why many CIS countries where reforms continued to lag behind the CEB group experienced a growth surge beginning about 2000, with rates much higher than CEB countries enjoyed in mid-1990s. The unexplored dimension concerns the role played by institutions in explaining the growth recovery not only in the CIS after 2000, but also among the CEB group in the 1990s.[1] This paper has two objectives. First, it proposes explanations for the CIS growth surge and discusses how these relate to the earlier consensus on transition growth. Second, it examines more closely the sequencing of institutional development relative to other policy reforms – in particular, stabilization and market liberalization. This will allow some tentative conclusions to be drawn regarding the link between institutions and growth during the transition period.[2] Two related issues are not discussed here: How soon did countries recover to their previous GDP peaks? And what explains performance beyond this recovery?

This paper contributes to the literature by using the additional years of data as a test of the earlier conclusions and as evidence providing new insights. Two key conclusions come out. First, despite the role of special one-time effects such as a surge in oil prices, the timing of the CIS recovery is best explained by the same factors as the earlier recovery in CEB: a minimum threshold of reforms was reached relating to stabilization, liberalization, and institutional development. Second – and this is a new insight – in all transition countries,

[1] Another puzzle, not addressed here, is the apparently strong performance in three CIS countries where reforms moved very slowly: Belarus, Turkmenistan, and Uzbekistan.
[2] The analysis here builds on and updates. See Havrylyshyn (2006, pp. 59–62).

whatever the speed of policy reforms, institutions lagged behind stabilization and liberalization.

Section 2 of this paper reviews the empirical literature on determinants of recovery in transition – in particular stabilization, liberalization, initial conditions, and institutional development. Section 3 considers what lies behind the post-2000 growth surge in the CIS and how this conforms to the earlier literature. Section 4 turns to institutional development, inquiring in particular about its sequencing vis-à-vis liberalization. Finally, Section 5 summarizes the policy implications of this study.

2. A REVIEW OF THE LITERATURE ON GROWTH IN TRANSITION

Several recent surveys on growth in the transition countries, based mainly on cross-country studies, point to a broad consensus roughly as follows: standard factor inputs are not important; prior stabilization of inflation is vital; market liberalization and structural reforms are statistically significant; and good institutions do matter.[3] Some controversy remains: Does budget control matter directly or as a factor in controlling inflation? Does privatization alone have a positive effect, or does it also need adequate institutional change? It is generally agreed that unfavourable initial conditions negatively affect growth prospects, but several studies have found that this effect recedes with time. It is widely agreed that good institutions are important, but *how* they matter, which ones are most important, and to what extent they should precede or follow other policy reforms are all open questions.[4] Consider five core explanations: factor inputs, stabilization, liberalization, initial conditions, and institutions.

Factor inputs continue to play a large role in explanations of growth in most countries even as other explanatory variables have been added by the new growth economics (Barro and Sala-i-Martin 1995). It is not, then, merely a matter of moving the economy toward a higher production-possibility frontier (PPF). More important,

[3] This section draws on Campos and Coricelli (2002) and Havrylyshyn (2001).
[4] Some, including this author in Havrylyshyn (2006), infer from the econometric studies of growth that rapid reformers generally fared better than gradual reformers. Others disagree, and the debate continues, though it is beyond the scope of this paper.

substantial efficiency gains are captured by correcting the severe inefficiencies of the communist period in two steps: first, by moving to the existing PPF; and second, by moving along this PPF to the optimum allocation point that reflects the country's international comparative advantage. In other words, the first years of growth after the transition recession do not involve long-term movements from an equilibrium position on a low PPF to an equilibrium position on a higher one; rather, this movement constitutes a short-term adjustment from a non-equilibrium inefficiency point below the PPF to an equilibrium on the PPF. Even the most optimistic views of transition in 1989 recognized that this adjustment would take several years – and it would seem that in many countries it is not complete even today.[5] So it is not surprising that available econometric studies that do not go beyond the late 1990s show insignificant and often negative results for the factor inputs (i.e., capital and labour). Some tentative evidence suggests that as transition nears completion among the advanced reformers, investment (but not yet labour) begins to play its conventional role.[6]

That *financial stabilization* is a prerequisite for growth recovery is not a surprising result, nor has it been controversial. Even critics of the Washington Consensus agreed on the need for stabilization. Some observers have argued for the use of exchange rate anchors as the centrepiece of any stabilization strategy; however, the econometric evidence on the effectiveness of anchors is inconclusive.[7] In the 1990s, effective stabilization often meant a devaluation of the real exchange rate. Some countries (the ones with currency boards, such as Estonia, Lithuania, and Bulgaria) achieved stabilization using an anchor. But many Central European and later most CIS and SEE countries achieved it without an anchor, though some had crawling/adjustable pegs (Poland), and some maintained a de facto proximity to a peg (Croatia). Arguably, Russia had a peg until 1998 (Owen and Robinson 2003), with limited success in stabilization. Ukraine's stabilization came without a clearly defined regime.

[5] Gros and Steinherr (2004, pp. 116–27) use several quantitative measures to show that after ten years the transition was perhaps almost over for some of the CEB countries, but was far from over in Southeast Europe (SEE) and the CIS.
[6] See for example Havlik (2006).
[7] Williamson (2005) discusses whether anchors should be seen as part of the Washington Consensus or not.

Liberalization of markets and *related structural reforms* also show up as key determinants of growth during transition. In light of the argument that the main driver of early growth is the reallocation of resources to more efficient uses, this is not surprising. But strong statistical significance is generally found only for broader measures of market reforms, such as the transition index of the European Bank for Reconstruction and Development (EBRD), less so for individual components. Thus, price liberalization alone is significant in only a few studies. In most, privatization also shows itself to be insignificant – although occasionally significant in relation to a few parameters.[8] This suggests that it is the combined effect of several policies that matters when it comes to creating new opportunities for efficient resource allocation and encouraging more rational decisions by the new private sector. There emerges a clear consensus (a) that transfer of ownership alone has at most some small positive effects, and (b) that significant benefits come only with the parallel development of competitive market institutions. Some studies have found that rising exports also contribute to growth, but this may be only a proximate cause, in the sense that early export success resulted from early liberalization, which allowed reallocation to new markets, which attracted foreign investors to build a low-labour-cost platform for exports to nearby Europe.

Initial conditions have been measured using various yardsticks, including degree of (over)industrialization, the defence industry's share of the economy, the number of years under communism (a proxy for market memory), distance from Europe, the presence of war or civil conflict, and so forth. Because the possible number of measures of initial conditions is so large, it is not surprising that the results of such studies vary according to the variables chosen, the period chosen, and econometric parameters. De Melo, Denizer, and Gelb (1997) found that initial conditions played a strong role. However, Havrylyshyn and van Rooden (2002), using the same measures but with access to additional years of data, point out that even when this was true in early years, the statistical significance of initial conditions declined over time; Bakanova, Vinhas de Souza, and Abramov (2004) found the same. In the same spirit, Zinnes,

[8] While many surveys of privatization effects exist, this particular point is perhaps most thoroughly explored in the econometrics of Zinnes, Eilat, and Sachs (2001).

Eilat, and Sachs (2001) distinguished immutable initial conditions (geography, history) from changeable ones (degree of industrialization, share of defence) and found that the latter mattered little after a short time.

It is widely agreed that institutions are important for sustained growth. Yet most econometric studies relating growth with institutions find that neither market liberalization, nor stabilization, nor institution building has overwhelming explanatory power; instead, all of them matter in a complementary fashion.[9] This last econometric result teaches, perhaps, a humble lesson both to big-bang reformers and to gradualists.[10] Advocates of rapid reform by now understand that it was not enough to recognize conceptually the role played by institutions – the fact that they developed much more slowly in some countries than in others may reflect that they were given less (i.e., insufficient) weight in policy recommendations.[11] The lesson for gradualists: it was indeed necessary to move early on stabilization and liberalization, and probably there would have been little growth had institutional development been launched first, with the other two elements following. Section 4 elaborates on these issues.

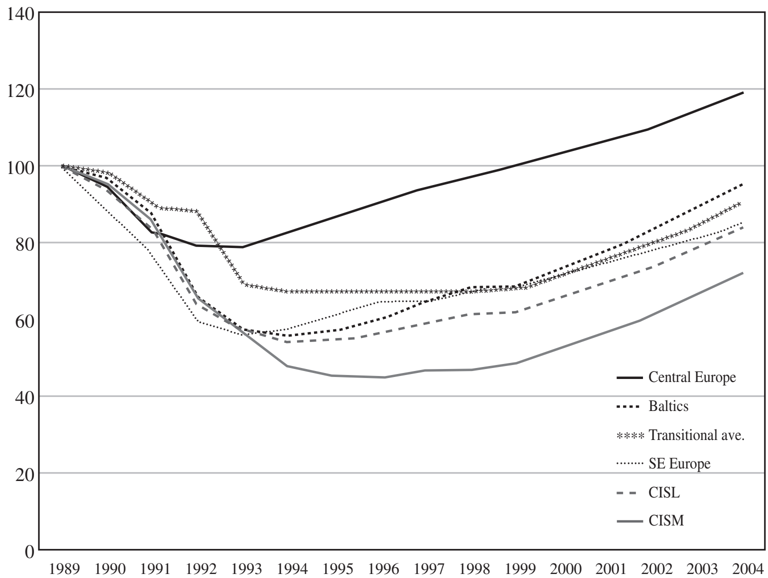
3. THE POST-2000 SURGE IN CIS GROWTH

The transition process that began in 1989 in Central Europe, perhaps around 1992 for the Baltics, and generally later for the CIS countries, was accompanied by a transitional recession with a strong decline in GDP (see Figure 1).[12] Just how big this decline was, and what portion of it was attributable to continued socialist-era

[9] Any empirical estimate of institutional effects is fraught with difficulties. Institutions comprise many vaguely defined elements that are highly correlated with one another, with liberalization actions, and with omitted variables. Thus econometrics has a high risk of false attribution. The real problem is that we have not yet correctly identified the most important institutions. I am grateful for this point to one of the anonymous reviewers.
[10] Kolodko (2004) provides a succinct review of the early debates between proponents of gradualist-institutionalist and big-bang strategies of transition.
[11] International financial institutions (IFIs), such as the World Bank, the IMF, and the EBRD, are often criticized for ignoring institutions; Williamson (2005) and Havrylyshyn (2006) argue that this is a straw man, as many of their writings mention institutions being part of the package. A more reasonable criticism is by Moers (1999): the IFIs recognized institutions but paid too little attention to them in early years.
[12] The groupings shown reflect the degree of progress in transition as measured by the EBRD, following the analysis in Havrylyshyn (2006).

distortions rather than the inevitable adjustment costs of reforms, is still very much in dispute.[13]

Figure 1. Index of GDP by Country Group, 1989–2004



While this dispute is beyond the scope of the present paper, two points merit brief attention. First, since any significant reforms in the CIS countries could not even have begun before the breakup of the Soviet Union in late 1991, the proper benchmark year for the index of GDP should be no earlier than 1992, which of course means the bottom that was reached about 1996–97 would not be as low as 55 to 60 percent of the transition start year but rather higher. Second, any estimated adjustments made to GDP values or index do not change the fact that the CEB states recovered earlier than the CIS states and had achieved by 2004 a much higher GDP.

[13] Kornai (1994) shows why some decline was inevitable: socialist distortions, once corrected by using market prices, reveal inefficient sectors where production must be cut, but reallocation to new efficient sectors takes time – hence rising unemployment and declining output. But output declines that occurred before price reforms are a result of problems with socialism, not transition. Havrylyshyn (2006) cites studies that estimate this portion at between 20 and 50 percent of the observed decline.

The general pattern is seen in Figure 1. Central Europe and the Baltics started to recover between 1992 and 1994; those CIS countries that made moderate progress in reforms (CISM in the figure) began to recover only after 2000, after a prolonged decline in the 1990s. Indeed, there was a surge after 2000 with growth rates well above 5 percent per annum, sometimes over 10 percent. As Table 1 shows, the average for CISM was well above that for Central Europe and even the Baltics. Notably, the CISL countries, where progress in reforms was very limited, saw a decline in growth rates after 2000, having apparently – as discussed later – performed better than the CISM group in the 1990s.

Table 1. Annual Growth of GDP since 1998

	Recovery years	GDP Index (base 1989)	1999	2000	2001	2002	2003	2004
Central Europe	92–94	95	2.4	3.7	3.5	3.3	3.2	4.5
Baltics	94–95	67	0.1	6.0	7.0	6.3	5.7	6.7
SE Europe	93–95	82	1.0	5.0	3.6	4.1	4.1	4.8
CISM	98–00	50	4.2	8.8	6.4	5.5	6.7	8.0
CISL	96–98	70	4.8	9.4	8.2	5.4	5.3	5.3

Source: EBRD, *Transition Reports,* various years. For 2003 the CISM average excludes the Kyrgyz Republic because of the one-time effect of a gold-mining accident that caused annual growth to fall from a 5–6 percent trend to -0.5 percent. Central Europe includes Hungary, Poland, the Czech Republic, Slovakia, Slovenia, and Croatia. The Baltics are Estonia, Latvia, and Lithuania. Southeast Europe includes Bulgaria, Romania, Macedonia, Albania, Bosnia-Herzegovina, and Serbia-Montenegro. The CIS Moderate Reform states include all of the CIS except Belarus, Uzbekistan, and Turkmenistan, which come under the CIS Limited Reforms group. The logic of these groupings is based on Havrylyshyn (2006).

It has been popular to attribute this growth surge to the luck of higher world oil and gas prices. This explanation only goes so far, however, and in particular cannot be the whole story for the six countries in the group that *import* energy. The price rise was certainly a boon to the exporters and is surely part of the reason for their high growth rates.[14] Kazakhstan and Azerbaijan have seen several years of growth of about 10 percent per annum or more. But as Ahrend (2006) and Owen and Robinson (2003) show, the growth was as much attributable to an increase in production levels as to the price rise, especially for the Central Asian exporters. Furthermore,

[14] See Ahrend (2006).

there are several other explanations that analyses have shown to be at least as important. Before reviewing these alternative explanations, consider the argument of a spillover for energy importers.

There is no doubt that increased domestic demand in Russia and among the Central Asian energy exporters spilled over to stimulate exports from their neighbours. As an example, Ukraine's food-processing industry experienced a sharp revival of exports to Russia after a decade of decline. But the spillover can explain only part of the growth in the other countries; it certainly is not enough to explain why they had growth rates as high as or even higher than the energy exporters – surely the terms of trade loss should have kept their rates lower. Furthermore, the spillover effect declined over time; the diversification of trade away from intra-CIS trade continued, and for many in the region the share of exports to Russia had fallen from well over 50 percent in the 1990s to less than 33 percent by 2002.[15] In other words, their export boom was just as strong in other directions, to the EU and Asia.

The first non-oil explanation relates to the achievement of macro stability – in particular, control of inflation. As demonstrated by Vinhas de Souza and Havrylyshyn (2006), in Russia, Ukraine, and to a lesser extent Belarus, increasingly sensible fiscal and monetary policies began to be implemented in the mid-1990s, with inflation rates declining as a result. By 1999 inflation in the CIS countries, especially the CISM group, while still high, had fallen to low double-digits, similar to levels reached in the CEB countries only five years earlier.

The second important non-oil explanation is devaluation. Owen and Robinson (2003) demonstrate that even for Russia, oil was not the whole story – at least as important were the beneficial side effects of the 1998 financial crisis, which entailed a real exchange rate devaluation, initially about 50 percent. Their analysis demonstrates that there was strong growth in other sectors of the economy, some but not all of which was a spillover effect from energy exports. Most of the other CISM currencies eventually followed the ruble devaluation, hence also benefiting from this effect on growth of export- and

[15] See Elborgh-Woytek (2003).

import-substituting domestic production. The latter is especially important. A devaluation of 40 to 50 percent was enough to make rather expensive the newly popular consumer imports with their non-Soviet packaging and attractive marketing. This created an incentive for domestic producers to retool the old Soviet factories for modern packaging and better quality control, in order to compete against many Turkish, Polish, and Chinese products. The consumer demand effect then led to a resurgence of investment in domestic industry, further adding to growth.

Berengaut and colleagues (2003) discuss various possible factors behind the growth surge in Ukraine. These include, besides oil spillover and devaluation and stabilization, the simple possibility that Ukraine (and others) had fallen so low that the rebound, when it came, was bound to be strong. It is useful here to recall the very high growth rates (5 to 10 percent) in the mid-1990s, when war and internal conflicts subsided in countries such as Azerbaijan, Armenia, Georgia, and Tajikistan. They also point to distinct budget-hardening policies under the more reform-minded Prime Minister Viktor Yushchenko and his energy minister, Yulia Tymoshenko, especially with regard to implicit energy rents and subsidies. Owen and Robinson (2003) describe a similar hardening in Russia under President Vladimir Putin, with regional budgets subordinated to the federal one, tax collections greatly increased, oil revenues prudently used to pay off substantial portions of the external debt – which fell from over 60 percent of GDP in 1999 to about 17 percent in 2005 – and a buildup of foreign reserves approaching $200 billion.

This surge in growth seems broadly inconsistent with the econometric consensus described in Section 2: that earlier stabilization and greater liberalization plus institutional development make for higher growth. If this were true, the CEB countries, which were still much more advanced in structural reforms in 2000, should have continued to enjoy the highest growth rates. In fact, their growth declined, to an average far below that of the CISM, as seen in Table 1. However, this is too static an interpretation of the relation between level of market progress attained and growth. An alternative interpretation is to think of the effects of transition reforms on the restart of growth not as a simple linear, homogeneous relation, but rather as a threshold effect; that is to say, for growth to restart after the transitional recession, a country needs to achieve some minimum threshold level of stabilization, liberalization, and institutional development.

Since the CEB countries were first to recover, they serve as a useful benchmark for the possible threshold levels of stabilization, liberalization, and institutional development. This paper addresses one simple, concrete question: *By 1999, had the CISM reached the same values for these three dimensions as the CEB countries had in the year before their recovery?* Table 2 provides an unequivocal answer: YES! Consider each of the policy areas.

Table 2. Threshold Values for Growth Recovery: Inflation, Liberalization, Institutions

	CEB values at recovery	CISM values 1999
Inflation (annual %)	34.0	25.7 (13.1 in 1998)
TPI–LIB (EBRD index)	3.3	3.7
TPI–INST (EBRD index)	1.9	2.0
TPI–All	2.55	2.7

Source: Author's calculations using EBRD *Transition Reports,* various years; explanations in text.

Stabilization in the CISM countries had pushed inflation down to about 25 percent, even lower than the average for the CEB. This achievement reflects the brightest spot on the CISM policy record: a widespread macro stabilization by the end of the 1990s. While Russia and Ukraine still experience inflation of 10 percent plus, many other countries in this group are in the single digits, reflecting vastly improved management of fiscal and monetary policies. Budget balances have been in surplus for energy exporters, and as already noted, this windfall has been applied prudently. Even energy importers have had occasional surpluses, or at worst low deficits.[16]

The EBRD's transition progress indicator (TPI) had already by 1999 reached values in the range 3.5 to 4.0 for most CEB countries, but prior to their recovery this was a much lower value: 2.55. As of 1999 the CISM value averaged 2.7 – that is, it had reached the benchmark minimum threshold. Since the literature reviewed in Section 2 emphasizes the importance of some minimal institutional development to complement the effects of liberalization, it is useful to break

[16] Vinhas de Souza and Havrylyshyn (2006) describe these achievements and conclude that these countries can now give more emphasis to liberalization and institutions.

down the TPI into two components, liberalization (LIB) and institutions (INST).[17] It is clear in Table 2 that the CEB threshold levels had been reached by the CISM in 1999 – indeed, they had been surpassed for the LIB measure. In most CISM countries the CEB threshold had actually been reached around 1997; and consistent with the minimum threshold hypothesis of this paper, they had begun to show the first signs of a turnaround, with either very low negative growth rates or slightly positive ones. However, the beginning of the recovery trend was halted by the 1998 financial crisis in Russia. From this, one can conclude that the restart of growth in the CISM countries can be explained by their having finally reached a sufficient degree of progress toward a market economy to stimulate local economic activity. Indeed, levels of progress in the three main policy areas were remarkably similar to those reached by the CEB countries before their recovery.

In summary, we see that essentially all the CISM countries have achieved considerable progress on all three of the most important determinants described in the transition literature reviewed in Section 2. Progress is greatest for stabilization, less so for liberalization (structural reforms), and least for institutional development. Stabilization, as ever, requires continued vigilance, but budgets, monetary policy, and inflation levels are broadly under control.[18] Liberalizing reforms still have a long way to go toward a fully functioning market economy level – a level essentially achieved in most of the CEB countries – but even by 1999 the EBRD index of liberalization had already surpassed the levels attained in CEB between 1992 and 1994. Similarly, institutional development had reached the threshold levels seen in the CEB countries prior to their recovery. Thus the CISM had reached a threshold level sufficiently high to stimulate growth recovery, similar to what had happened in CEB before 1995. Given the additional push from the energy boom, the post-1998 devaluations, and the much lower output levels reached, the pace of CISM recovery since 2000 was much stronger than seen in the mid-1990s for CEB.

[17] The definitions are elaborated in Section 4.
[18] The nearly universal populist attitudes of the early 1990s have been replaced by a strong consensus that fiscal discipline is essential. Gros and Steinherr (2004, p. 244) comment on the Russia 1998 crisis as follows: "Russia did not collapse: the lesson that hyperinflation has very high social and political costs had been learned by the new/old leadership, including the president of the Central bank, Mr. Gerashchenko, who had presided over the inflationary early 1990s."

The apparently superior performance of the CISL countries, at least until 2000, requires some attention. The official GDP values as used in Figure 1 and Table 1 show that for these countries the decline was not as deep and that the turnaround came a little earlier. Similarly, the UNDP Human Development Index, which comprises many measures of well-being beyond GDP per capita, declined less in the CISL group than in the CISM.[19] But the superior performance by the CISL countries is not seen in stabilization – indeed, even *official* inflation values have been much higher in CISL countries. In addition, there have been doubts about the accuracy of the statistics for these still very Soviet-like environments. Uzbekistan's latest Article IV review (IMF 2005) notes that officially, CPI inflation was 3.7 percent; however, IMF staff estimates were in the range 9.1 to 15.5 percent. At the same time, GDP growth rates have fallen back since 2000, a trend opposite to that observed in the CISM countries. The earlier estimates of poverty rates in Turkmenistan of 20 to 30 percent were well below the levels of 50 percent-plus in countries such as the Kyrgyz Republic, Moldova, and Tajikistan, but recent World Bank estimates reverse the relationship, with the rates in Turkmenistan being much higher than in the others. In summary, the superior performance of the CISL countries in the 1990s compared to the CISM countries was perhaps overstated by statistical errors, but even if this was not the case, since 2000 the performance on economic and social indicators has clearly been better in the CISM countries. It would be too big a jump to conclude that the slow but forward-moving reforms in the CISMs were clearly superior to the very limited reforms among the CISLs. But it would be equally too big a jump to conclude that their apparently superior performance makes them an example of a successful gradualist approach. That they were not will be seen in the analysis of institutional developments in Section 4.[20]

4. THE ACTUAL SEQUENCING OF INSTITUTIONS AND LIBERALIZATION: SOME LESSONS

The importance of institutional development and its relative sequencing vis-à-vis other policy reforms has been and will continue to be a hotly debated matter. This paper does not aim to engage in

[19] Havrylyshyn (2006, ch. 3) explores this in detail.

[20] Nevertheless, in the CISL group Belarus remains something of a puzzle deserving of closer study.

the debate, but merely to describe the actual path followed in the transition countries since 1989. Perhaps this will provide some tentative lessons. But first I review the main issues raised by the institutions literature.

Key Issues Relating to Institutions and Growth[21]

That institutions matter is not in dispute in the literature, but three big questions remain very difficult to answer:

- Is a minimum critical mass required to stimulate growth?
- What are the most important market-enhancing institutions?
- Should those institutions be developed before, during, or after the main steps of stabilization and liberalization?

Regarding the first issue, no attempt has been made to quantify this, perhaps because the nature of institutions makes their many elements non-additive. This paper's novel contribution is that it estimates for transition countries the threshold that needs to be reached prior to recovery from the transition recession. The second and third questions are addressed only tangentially.

There is considerable disagreement on the relative importance of different institutions as well as on their sequencing, though a World Bank (2002) study lists institutions that should come early, some that can be developed at the same time other reforms are introduced, and others that can be allowed to evolve over a much longer period. The first category includes elements such as the state's ability to enforce basic law and order, as well as market-oriented laws and government agencies: a central bank, a finance ministry that enforces budget discipline, a separate treasury for transparent and uncorrupted implementation of budgets, regulatory agencies for enforcing codes of commercial behaviour, and an anti-monopoly regulator.

Sequencing of institutions and liberalization was a hotly debated issue in the transition discussions of the 1990s and continues to be a favourite topic for those who criticize the supposed failures of the Washington Consensus. These critics highlight the rush that

[21] Comprehensive overviews are found in World Bank (2002) and Johnson and Subramanian (2005).

was involved in liberalization and privatization, blaming the lack of prior institutional development for the poor results. In retrospect, this debate has been too theoretical and as a result has tossed many red herrings in the path of practical solutions. It will be useful at this point to define some concepts. *Transition* aims to establish the basis for a market economy through policies covering stabilization, liberalization, and institutions. *Liberalization* is easier to define: it includes freedom of private activity (either de novo or with privatized state assets), market determination of prices, and liberalized international trade and finance. *Institutions* are necessarily a vaguer concept. Broadly, they cover the "rules of the game" for a market economy and include such elements as a commercial code, judicial procedures for settling disputes and bankruptcies, fair trade regulations covering monopolies, stock market dealings, and technical and sanitary standards. Perhaps surprisingly, there has been little debate about the accuracy of quantitative estimates for institutions, though it is generally agreed that indices should measure not only the legal existence of institutions but also their effectiveness. The debate has always been over the relative sequencing of liberalization and institutions – it widely agreed that financial stabilization must come early. Gradualists argue that liberalization should be slower, to allow institutions to be put in place. Big-bang proponents counter that this is impractical and that it risks allowing opponents of reform to capture the process. Part of this latter argument is based on the pioneering work of Douglass North and other institutionalists, who emphasize that institutions evolve over long periods of time. Big-bang proponents reply that it is surely not sensible or even possible to delay all liberalization measures until "adequate" institutions have been put in place. This paper tries to cast some light on the debate using a retrospective examination of the actual sequencing followed since 1989.

The Path and Sequencing of Institutional Development since 1989

Many quantitative measures of institutional development are available for various types of institutions, which are then often averaged into an overall index. These are largely measures of the effectiveness of institutions as perceived by local business and/or academic experts, both domestic and foreign; hence they can be criticized for the inaccuracies of subjectivity. However, this very subjectivity may paradoxically provide a better measure of the strength of these institutions than objective measures regarding the existence or nonexistence of formal laws and regulations. This is because looking only at laws “on paper” tells one little about the effectiveness of their implementation. Kremlinologists observed that in Soviet states, informal rules were far more important than paper laws; for example, private economic activity was largely banned, but as Handelman (1994) elucidates, the existence of underground economic activity and a “Soviet mafia” speaks volumes about what the real “law” was. North (2006) emphasizes three levels of institutions: formal ones, their informal counterparts or complements, and enforcement ones. Recognizing this, the surveys from which data now come have usually been designed carefully to reflect all of this by relying on perceptions of affected agents and expert observers.

Early compilations of such synthetic indicators of market institutions were carried out by Freedom House, the Heritage Foundation, and Transparency International with its well-known Corruption Index. More recently, a comprehensive compilation of various sources and many new indicators has been assembled by the World Bank (Kaufman, Kraay, and Mastruzzi 2004); this is being updated in annual surveys of the business or institutional climate – the “BEEPS” exercise carried out jointly with the EBRD. Such an approach attempts to reflect the problem of informal institutions (which vested interests quickly develop to subvert the original policy intentions[22]) and the issue of enforcement by asking practitioners and experts such questions as “How easy is it to do business?” and “How much is bribery a problem?”

An early comparative assessment for transition countries was done by Weder (2001). Table 3 summarizes her results for 1997–98 for the main country groups. Values for 2003 using a different scale are calculated from a World Bank study. Taken at face value, the numbers in Table 3 suggest three broad conclusions. First, in the late 1990s transition economies were still far from the level of institutional quality prevailing in the advanced industrial countries, though the most advanced ones of the CEB group were at the same level as the leading emerging market countries of the developing world. Second, the rank ordering of institutional development by country group was the same as that for progress toward free

[22] Alina-Pisano (2006) gives many examples of such “institutional facades” in the post-communist period.

markets as measured by the EBRD; this will be even clearer in Table 4. Third, the rank ordering has remained the same in the five years since.

Table 3. Quality of Institutions in Transition Economies, 1997–98 and 2003

	Weder 1997-98	Developing countries in same range	World Bank 2003
Central Europe(1)	–6.0	Chile, Korea, South Africa	0.45
Baltics	+4.0	Uruguay, UAE	0.34
SE Europe	–2.8	India, Lebanon, Pakistan	–0.19
CIS moderate reforms	–6.1	Peru, Burkina Faso, Guatemala	–0.65
CIS limited reforms	–10.3	Kenya, Haiti, Laos	–1.24
Average industrial countries	+12.6		n/a

Sources: Weder (2001) and Beck and Laeven (2005). Note that the two use different scales.

In Section 3, I indicated that all countries have seen significant economic recovery by now (Table 1) and that this is related to all reaching a minimum threshold of reforms in the three main policy areas: stabilization, liberalization, and institutions. That this has happened despite very low levels of institutional development (Table 3) suggests that the critical mass of institutions needed before recovery is not very high. It is important to emphasize that this does not speak to the long-term sustainability of growth, which according to the literature requires continued progress to much higher levels.

To illustrate this more fully, Table 4 presents data of the actual sequencing over time between institutional reforms and liberalization reforms. Some methodological clarification is needed. While the more in-depth measures used for Table 3 do in some cases go back to earlier years, there have been many changes, and linkages of different measures by different sources would be needed, with all the errors this entails. So instead I use the simpler TPI indicators, which go back to the early 1990s and have the dual advantage of same-source consistency and same scaling for both the liberalization index and institutions. The well-known ten components of the TPI can be grouped in two categories: those indicators which measure market liberalization (EBRD's initial phase reforms) and those which involve institutional changes (ERBD's second-phase reforms). Table 4 shows values for LIB (liberalization) and INST (institutions) for three years: 1994, 2000, and 2005. LIB includes price liberalization, foreign trade liberalization, and small-scale privatization; INST comprises the rest of EBRD's indicators: governance and enterprise restructuring, large-scale privatization, competition policy, banking and financial sector reform – which together can be thought of as institutional reforms.[23] Indeed, in its own analysis the EBRD (2003) broadly equates second-phase reforms with institutional development. The EBRD measure is a good proxy for other, more elaborate indicators, as it has a very high rank correlation of 0.93 with the World Bank indicators used in Weder (2001).

Table 4. EBRD Transition Progress Index (TPI), Selected Years, Liberalization (LIB) vs. Institutional Development (INST)

		1994	2000	2005
Central Europe	LIB	3.7	4.2	4.3
	INST	2.7	3.1	3.3
Baltics	LIB	3.7	4.1	4.3
	INST	2.3	2.9	3.2
SE Europe[1]	LIB	3.0 (n/a)	4.0 (3.9)	4.1 (4.0)
	INST	1.7 (n/a)	2.2 (1.9)	2.5 (2.3)
CISM	LIB	2.2	3.7	3.9
	INST	1.4	2.1	2.2
CISL	LIB	1.9	2.0	2.3
	INST	1.4	1.6	1.5

Source: Averages calculated from EBRD *Transition Reports,* 2000 and 2005, country tables. Liberalization is the average of the following indicators: price liberalization, foreign exchange, trade liberalization, and small-scale privatization. Institutional reforms comprise governance, competition policy, banking reforms, and financial sector reforms.

1 For Southeast Europe the first number excludes Bosnia-Herzegovina and Serbia-Montenegro; the number in brackets includes these two.

23 Their index of infrastructure reform is arguably not relevant to either, and I have excluded it. It typically has values lower than liberalization and about the same as institutional development.

Two facts are clear from the data in Table 4. First, throughout the region, no matter how quickly or how slowly liberalization proceeded, institutions lagged far behind. By 2005 even the most advanced reformers of the CEB group, which had reached LIB values of 4.3 – that is, they had essentially completed the process of achieving full liberalization equivalent to existing market economies – still had INST values of about 3.2 to 3.3, well below the maximum. The other groups were even further behind, with the rank ordering for INST exactly the same as the rank ordering for LIB. The observed sequencing is consistent with the conclusion that growth can begin even when institutional development lags behind liberalization. This relative sequencing also suggests that where the will and the capacity existed to move quickly on liberalization, there was an equal will and capacity to move forward on institutional development – and vice versa.

The second important fact is that there was not a single instance of a country following the theoretical path of an institutionalist-gradualist strategy, with institutions preceding or at least moving in parallel with market liberalization.[24] The slower pace of reforms in some countries is sometimes attributed to their more difficult social and political conditions. This may explain slower liberalization, but it cannot explain why institutional development was even slower. This is true not only for the more gradual reformers of the CISM group, but also – importantly – for the three CISL countries, where the political leadership often stated that they were pursuing a more gradual path to reforms to avoid the trauma of shock therapy of the sort suffered by their neighbours. Here, many outside observers point to the "success" of Belarus in maintaining better growth performance (see Table 1). Just how well these three countries avoided the transition recession and the social costs of reform is not discussed here, but one thing is clear: none of them used the opportunity of gradual liberalization to move ahead with institutional development – indeed, they moved even more slowly on institutions than the CISM countries.[25] I argue below that the most plausible interpretation of the observable facts on liberalization-institutions sequencing concerns the sincerity of commitment to

[24] The table's group averages are calculated from individual country values as in EBRD, but are not shown here to save space.
[25] See Havrylyshyn (2006).These three countries also lag very far behind in measures of democracy and civil society.

reform. National leaders who pushed for rapid liberalization were also sincerely committed to later institutional development; national leaders who argued for delays in liberalization were not sincere in their commitment either to prior institutional development or to real liberalization.

The observed lag and slower pace of institutional reforms compared to liberalization is consistent with the hypothesis stated earlier that *institutional reforms cannot be implemented as quickly as many components of liberalization.* But logically it is also consistent with a key criticism of the Washington Consensus: that institutions were not given enough emphasis early on. This debate cannot be resolved easily, as there is no benchmark that reflects the useful commandment of Vaclav Klaus: "Reform as fast as possible." The evidence is therefore easily used by both gradualists and big-bang proponents in support of their arguments. This dilemma merits a closer look; to that end, let us compare the time patterns across groups.

By 1994 the CEB countries had reached the very high LIB level of 3.7, broadly comparable to many mixed economies in the West. By 1999 this had increased substantially, and by 2005 it had reached the maximum 4.3 rating of the EBRD index. It is especially notable that the Baltics, having started later than the others, had already caught up to them by 1994 and kept pace from then on in the final liberalization drive.

Southeast Europe lagged somewhat behind, though not nearly as far behind as the CIS group, which in 1994 was well below the level of SEE (no 1994 data available for war-torn Bosnia-Herzegovina and Serbia-Montenegro). Indeed, at the mid-1990s point the gap between the CISM and CISL is invisible. That quickly changed, however, and by 1999 the CISM countries' progress was evident: they had surged ahead in liberalizing measures and had achieved about the same position as the CEB countries had reached five years earlier. Section 3 showed that it was not just a coincidence that CISM's output recovery began after that group reached about the same level of TPI as had been reached by the CEB countries before their recovery. What is striking is that by 2005, though the CISM countries had not yet caught up to the liberalization levels of Central Europe, they were very close to the 4.0 mark, reflecting reasonably well-functioning market mechanisms, if not yet institutions. The nearly stagnant process of liberalization for CISL countries and the even greater lag for institutions is particularly evident in Table 4.

What, then, does the comparison across countries imply for the debates over the relative importance and sequencing of stabilization, liberalization, and institutions? First, note that the degree of institutional reform reached before growth started was not that high in the CEB. Indeed, even by 2003 the level of development of institutions still had a long way to go in the advanced countries, yet no major damage to the performance of the economies seems to have occurred. Johnson and Subramanian (2005) propose that, generally, good economic policy alone can give growth a start, but sustained growth requires improved institutions. The case of Central Europe seems to fit this hypothesis especially well. In the first recovery phase, 1993 to 1998, GDP grew after the surge of liberalization but then slowed as institutional reform lagged. As this picked up, stronger growth returned after 1999. Second, there is not a single instance of slow liberalizers moving ahead more rapidly (or even at the same pace) with institutional reforms, as a true institutionalist-gradualist strategy would imply. On the contrary, those countries that liberalized the quickest also moved the quickest on institutional reforms, albeit with a lag.

The EBRD makes the point that partial liberalization creates "winners … who block further progress in reforms" (EBRD 2000, p. 30). Perhaps the most salient point here is that the slow reformers were not slow reformers for the reasons stated by politicians urging gradual liberalization – that is, because "the economy is not ready for market operations" and "to avoid the huge pain of shock therapy." If that were the real motivation for gradual reform, we would have seen after 15 years at least a few cases of institutional reform moving faster than or as fast as liberalization. There is not a single such case; on the contrary, where liberalization has been very slow, as in CISL countries, institutional development has been even slower.

In retrospect, this political economy of winners points to the main problem with gradualist arguments. Recall that proponents of gradualism were motivated by the idea that liberalizing too quickly ahead of institutional developments would be less effective and create more dislocation and pain. In theory, and using mathematical models, this has been shown to be a stronger argument than the big-bang one.[26] In practice, however, gradualism has been less effective than rapid reforms at preventing the flourishing of rent-seeking activities, which have often led to the oligarchic regimes and the capture of the state by vested interests. As I argue elsewhere (2006), the economics of rent seeking not only explain this well, but lead to the further prediction that these vested interests freeze further transition, both the liberalization and institutional components.

5. CONCLUSIONS

This paper addressed the CIS growth surge since 2000, asking whether this was due to oil, reforms, rebound, or all of the above. Technically, all of these factors played a role. But the timing of the long-delayed recovery in the CIS countries seems to be explainable by the very same policy factors as for the CEB countries earlier: sufficient progress in stabilization, liberalization, and institutions, the same factors that the econometric literature of the 1990s emphasized. Indeed, it is striking that in the CIS countries, before their recovery, the levels of indices measuring each of these three policy areas reached magnitudes very similar to those of the CEB countries. However, the special factors of the oil boom and the rebound from very low levels of GDP are important in understanding why the CIS recovery resulted in much higher growth rates. This solves the puzzle.

The unexplored dimension of the role of institutions was a second theme in this paper. The low levels of the institutional development threshold for all countries, even those of the CEB, raise an important question about the sequencing of institutions. This paper described the actual path followed by countries and pointed to some tentative conclusions. First, all countries, regardless of the speed of reforms or the chosen strategy, moved much faster on stabilization and liberalization than on institutions. Second, those which liberalized very slowly are still lagging today, and most important, their lag on institutions is perhaps even greater. Third, in all countries the growth recovery came when the level of institutional development was still very low, while liberalization was far more advanced.

[26] Although mathematical models with different assumptions do show big-bang superior in some situations. Havrylyshyn (2006, ch. 2).

For all countries, the recovery threshold is found to be about 3.7 on the EBRD index – that is, 80 percent toward a full-fledged market – in the category the EBRD defines as a "reasonably well-functioning market economy." For institutions this growth threshold was only 2.0 for both groups of countries – a mere one-third of the way to the market economy benchmark. The analysis here is too limited for policy conclusions to be drawn, but the results certainly point to the following two hypotheses:

- Not a single transition country followed in practice the theoretical ideal of the institutionalist-gradualist strategy – that is, "develop institutions before liberalizing" – either because this was not possible to do quickly enough or because the political elite used the "science" to justify a gradual approach for reasons of self-interest.

- Growth recovery appeared to be launched by establishing a solid program of stabilization and liberalization and only a very modest initial development of institutions.

The above conclusions do not speak to the issue of sustained growth, which doubtless requires continued progress on institutions. They do, however, suggest the need for a more balanced approach to any policy recommendations pertaining to the sequencing of liberalization and institutions. The recognized pioneer on institutions theory, Douglass North, has many times emphasized that institutions take a long time to develop; hence, while they must be given careful attention – perhaps more so than was the case in the 1990s – these efforts must not be used as a reason or excuse to delay the good policies that can be put in place more quickly. In the words of Vaclav Klaus, for each of the transformation elements in postcommunist countries, "one should move as fast as possible."

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University of Toronto
MUNK CENTRE
For International Studies
At Trinity College

ISBN 978-0-7727-0836-6
ISSN 1715-3476

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