A Reinterpretation of the Market Transition Process in CEE Economies in the Light of Recent Theoretical Developments

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Abstract

The paper draws on recent developments in the analysis of markets to explore the way in which markets and competition operate. Comparisons are made between neoclassical optimisation theory, dynamic theories of competition, institutional and cultural theories, and economic applications of complexity theory. A synthesis of these approaches is then used to gain an understanding of the divergent paths of economic transition in the Central and Eastern European economies since 1989. Although not prescriptive in its policy implications, the paper suggests explanations for these countries' different experiences of economic transition. These explanations may in turn have more general implications for the process of economic development.

Key Words: market, reform, competition, CEEC

Introduction

There have been a number of comprehensive studies of the economic reform process in the Central and Eastern European transition countries in recent years [1, 2]. These studies have generally concentrated on the impact of different approaches to economic reform on the performance of the transition economies. Evaluation of the transition process has included assessments of privatisation, company restructuring and macroeconomic stabilisation policy on the development of companies, competition and macroeconomic performance. The purpose of this paper is not to reiterate this approach, but rather to reinterpret some of the evidence in order to gain greater understanding of the market transition process. The scope of this study is limited to an analysis of the way in which markets develop. It does not attempt to make value judgements about the merits of particular approaches to economic reform. Its aim is simply to understand the process better. More general implications for economic development may arise out of the study, but its main focus is on the development of markets in the CEE countries during the transition to market democracy after 1989. In order to do this, recent developments in competition theory are used to provide an explanation for the way in which markets have developed in these countries.

Recent Developments in Competition Theory

The predominant economic model for the analysis of competition from the 1950s to the 1970s was the structure conduct performance (SCP) paradigm [3]. The SCP paradigm uses the neoclassical theory of the firm to postulate that a highly concentrated market structure leads to monopolistic conduct which in turn leads to performance that is harmful to society's economic welfare. This approach spawned numerous attempts to measure the welfare loss from monopoly power and still provides part of the rationale for competition policy, especially in relation to the abuse of a dominant position. In fact, monopoly power is regarded as an example of market failure. The 1970s and 1980s brought greater emphasis on the analysis of market conduct rather than market structure (the so-called New Industrial Economics) and further developments in the neoclassical tradition. Notable among these were the Chicago School reinterpretation of conventional entry barriers and performance, and Baumol's contestable markets theory [4]. Contestable markets represent a significant departure from the SCP paradigm in that market structure is regarded as irrelevant provided there are no sunk costs or regulatory entry barriers.

Dynamic theories of competition have been around much longer, but have witnessed a revival in recent years. Perhaps the most ardent proponent of the dynamic approach to competition during the post-war years has been the Austrian economist, F.A.Hayek [5]. 'Austrians' view competition as a continual process of entrepreneurial discovery, where innovative producers gain monopoly power as a reward for their success, but may lose it just as quickly if they fail to respond to their customers and competitors. This approach helps to explain how competition works in dynamic markets where SCP's more static view may be inappropriate. Austrian theory takes a free market view of the concept of market failure, arguing that what we call market failure is often the failure to allow markets to

operate freely (as a result of overregulation, for example). However, the economics of asymmetric information suggest that markets may fail, or at least work imperfectly, in the presence of information asymmetries between buyer and seller [6].

The development of institutional economics is also transforming our understanding of the way markets and economies work [7]. Whilst the precise impact of political, economic, legal and social institutions is still unclear, it is undoubtedly the case that markets and competition work differently within different institutional frameworks. For example, if a used car dealer is allowed to sell defective cars without any legal redress, his behaviour will be very different from what it would be if he were faced with strict legal liability. Even local customs and practices (what North describes as informal institutions) may affect the local working of markets. In fact, the study of culture in its broadest sense is increasingly being incorporated into economic analysis [8].

One further development should perhaps be mentioned: insights from the scientific theory of complexity are gradually being applied to the study of economic systems and, by extension, to the working of markets [9]. An economy may be described as a 'complex adaptive system'. A complex system is a structure made up of many elements that operate independently and also interact with each other, absorbing information from their surrounding elements. Complex systems and their individual elements adapt or evolve over a period of time. In many cases, a complex economic system such as a market is able to absorb information and adapt with relatively little disruption. In other cases, a small change in one of its elements may bring about an amplified fluctuation in another element. Thus, financial markets may react in an apparently exaggerated way to new information. Our understanding of complex economic systems is far from complete, but complexity theory may help to explain how volatile situations may arise.

Indicators of the Development of Efficient Markets in the CEE Accession Countries

For the purposes of this study, nine criteria have been selected to provide an evaluation of the way in which markets are developing in the CEE countries. The study has been limited to the eight CEE countries that acceded to the European Union in May 2004. The choice of criteria has been somewhat arbitrary, but each criterion is considered to be an important element of the working of an efficient market. Clearly, additional criteria could have been included. A larger number of criteria may have affected the overall picture to some extent, though a reasonably clear pattern emerges from aggregation of the nine criteria used. In any case, the data is intended to illustrate the application of competition theory rather than to offer a definitive analysis of the working of markets. The nine market evaluation criteria are listed below and each country is awarded a score from 1 to 8, with 1 representing the 'best' performer in relation to a particular criterion and 8 the 'worst' performer. The scores are then aggregated and averaged to provide an average market evaluation score for each country (Table 1). These average scores are then correlated graphically with each country's average real GDP growth rate from 1997-2005 (Graph 1). Whilst GDP growth is a crude measure of economic performance, it might be expected that economies with more efficient markets would growth at a faster rate than those with less efficient markets. The graph suggests a reasonable degree of correlation between the average market evaluation scores and average real GDP growth rates.

Selected Market Evaluation Criteria for CEE Accession Countries

Technology Activity Index (TAI)
Change in the Technology Activity Index, 1995-2001
Inward FDI Stock, % of GDP, 2003
Potential Growth Rate, 2001-05
Change in Potential Growth Rate, 1998/2000-2001/2005
Change in Total Factor Productivity (TFP), 1998/2000-2001/2005
Volatility in GDP Growth, 1997-2005
Number of Days Required to Start a Business, 2003
Change in Number of Days Required to Start a Business, 2003-05

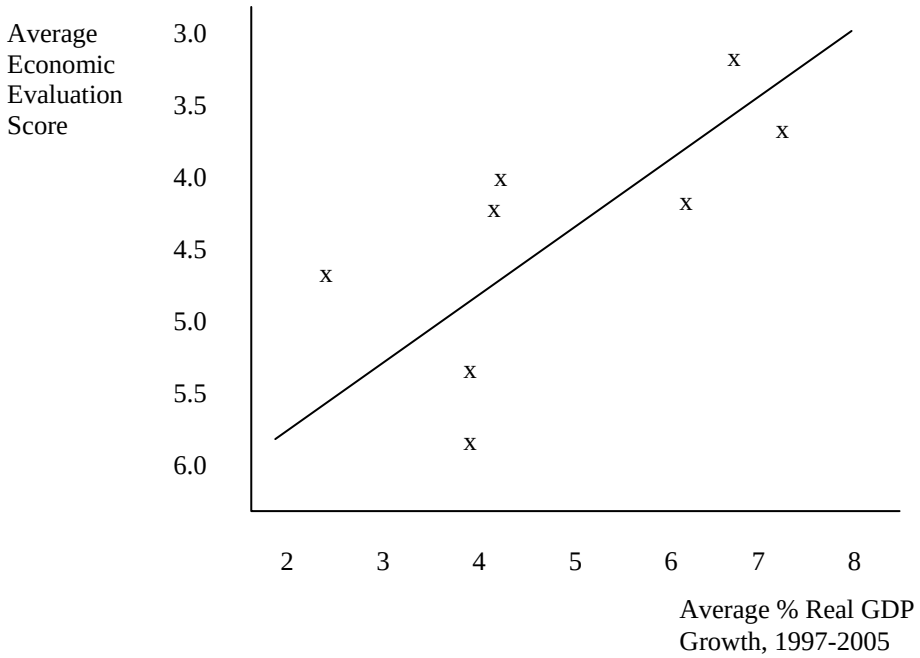
Source: EC Occasional Paper (May 2006), 'Enlargement, two years after: an economic evaluation'

Table 1: Market Evaluation Scores for EU Accession Countries

Market Evaluation Criteria	CZ	EST	H	PL	LT	LV	SLO	SK
TAI	4	2	3	6	5	8	1	7
Change in TAI,	2	6	5	8	4	1	6	3
Inward FDI stock	3	1	2	6	6	5	8	4
Potential growth rate (PGR)	8	2	5	7	3	1	6	4
Change in PGR	4	1	6	7	2	4	6	3
Change in TFP	6	1	7	5	3	1	7	4
Volatility in GDP growth	6	7	1	4	8	5	2	3
Days to start a business	5	7	4	2	2	1	6	8
Change in days to start a bus.	4	2	3	7	5	7	6	1
Total Score	42	29	36	52	38	33	48	37
Average Score	4.7	3.2	4	5.8	4.2	3.7	5.3	4.1

Key: 1 = 'Best' Performer, 8 = 'Worst' Performer

Graph 1: Correlation Between Economic Evaluation and Economic Growth



Interpretation of the Market Reform Process in the light of Developments in Competition Theory

Four key aspects of the market reform process have been identified to facilitate the application of competition theory.

1. The Broad Approach to Political and Economic Reform

In political terms, each of the eight CEE accession countries has been generally pro-reform. This was less the case in Russia, Ukraine, Belarus and some of the other former Soviet republics. However, the early stages of reform were pursued more avidly in Poland, the Czech Republic and Hungary than, until 1998, in Slovakia for example. Given the importance of institutions, it might be expected that political and economic reforms go hand in hand in order to achieve the maximum benefit [10].

In the early 1990s the fast-track reformers, Poland, Hungary and Czechoslovakia, seemed to make the most progress. This may be explained in terms of the rapid removal of price controls and market entry barriers (domestic and external trade liberalisation), something that is supported from different perspectives by both neoclassical and dynamic theories. Some countries pursued a 'big bang' or 'shock therapy' approach, notably Poland and in some respects the Czech Republic, though the long-term differences between this approach and the

gradualist approach adopted by Hungary seem to be minimal. In some respects, Poland may even have suffered from the more 'chaotic' effects of the shock to its complex economic system. Both approaches were an attempt to establish a fully functioning market economy, one by 'shocking' the system into action, the other by allowing each reform to have a managed impact on the other elements of the economic system. The effectiveness of macroeconomic stabilisation policies, notably in the Czech Republic and Slovakia, may also have helped to minimise the disruptive effect of the reforms.

2. The Quality of Institutions

The importance of having efficient institutions is widely recognised. Equally, the persistence of inefficient institutions may have a long-term detrimental effect [11]. The effect of 'bad' institutions is equivalent to the effect of numerous small (or large) shocks in complexity theory or market distortions in dynamic theory. These shocks may initiate perverse or uncontrollable effects or prevent dynamic competition from providing the right incentives to entrepreneurs. Culture, trust and belief systems are also thought to have a significant effect on the behaviour of market participants [12]. Trust, or mistrust, has played an important role in several CEE countries, especially as a result of the high level of corruption and the large informal economies in some countries, but also because of the uncertainty surrounding the transition process. Zak and Knack argue persuasively that a low trust environment tends to reduce the level of investment and rate of economic growth [13], though Beugelsdijk contends that observed measures of trust may in fact reflect the effectiveness of institutions [14]. In the context of institutional economics, however, trust may be viewed as an informal institution which, although more difficult to measure than formal institutions, may nevertheless have an identifiable effect. Mistrust may also be a consequence of information asymmetries.

3. Privatisation and Company Restructuring

Privatisation was encouraged by international agencies and advisors both as an essential step towards the creation of a market economy and as a symbol of commitment to reform. Czechoslovakia, and later the Czech Republic, rushed to transfer the majority of its state-owned enterprises to the private sector through mass voucher privatisation, small-firm privatisation and strategic foreign joint-ventures. Hungary rushed to find foreign investors to take over its ailing, or in practice its more viable, enterprises. Poland was quick to liberalise its economy but slower to privatise. Whilst private ownership is a necessary prerequisite for a market economy, experience has taught us that it is by means sufficient. In fact, competition theory supports the view that private ownership will not achieve market efficiency without the possibility or threat of competition. This point is made forcefully by contestable markets theory. With hindsight, we also now know that the Czech Republic's success with voucher privatisation was tempered by the fact that many of the vouchers were invested in investment funds (or voucher privatisation funds) managed by state-owned banks and that company restructuring often did not take place [15]. The most successful economies seem to have achieved the combined benefits of privatisation, liberalisation and macroeconomic stability, though even the new fast-track reformers, the Baltic Republics, have achieved their rapid economic growth at the expense of a high degree of growth rate volatility, suggesting significant interaction between elements of the complex system.

4. External Liberalisation

The ability to attract foreign direct investment (FDI) suggests a well-functioning host economy. However, Hungary's dash for FDI helped to create a two-tier economy of successful foreign-owned companies and struggling domestic companies in the early years of transition. FDI is also attracted to regions able to offer agglomeration economies, such as Western Slovakia and Bratislava in particular, leaving lagging regions behind [16]. Empirical support for the benefits of trade liberalisation is mixed, but there is evidence of a positive growth effect from export diversification [17]. More generally, open economies are likely to benefit more from globalisation if government policies and the institutional infrastructure are supportive in creating incentives to enable firms to adjust to global competition [18]. The global economy clearly provides a good example of a dynamic economic system, with all the adjustment processes and potentially aggravating shocks that such a system implies.

Conclusion

This paper set out to explore alternative explanations for the often volatile process of market transition in the CEE accession countries. Some evidence has been found of the positive effect of market efficiency and competition theory seems to provide explanations for some of the expected and unexpected effects of the market development process. Above all, we should not be surprised by the volatility of the fast-track reform economies, but should encourage them to take a balanced view of the need for reform policies and appropriate institutional incentives. Whether these tentative findings have wider relevance for economic

development outside Central and Eastern Europe is a more open question.

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