



# THE BALTIC SEA REGION

**Cultures, Politics, Societies**

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# INTRODUCTION

*Hans Aage*

The transition from plan to market following the revolutions of 1989 in Eastern Europe and the former Soviet republics has been a major challenge for economics as a scientific discipline. Western economists were traditionally mostly concerned with predicting the effects of small, marginal changes in the western-type mixed market economies, and they were not well prepared for giving advice concerning deep and fast systemic changes of the basic structures of the economy.

However, contrary to previous revolutions, the transition in Eastern Europe and the former Soviet republics apparently was not fuelled directly by requests for redistribution of power and wealth, but first of all by a desperate wish for economic growth. Therefore, the advice of economists has been asked to an unprecedented degree concerning the account of symptoms, clarification of diagnosis, and prescription of medicine. The advice of economists is sometimes compared to medical treatment in the days of old (Krugman, 1994:9), and the comparison is particularly incisive for the transition economies, which have consulted western economists not only concerning details of economic policy, but also concerning the transplantation of vital internal organs of society. The recommendations have been characterised by strong opinions in spite of theoretical perplexity, by general support to the prevailing view in spite of contemporary dissenting evaluations, and by willingness to accept radical treatment with harsh methods in spite of the admitted immediate relapse due to economic bleeding. Thus the issue comes up, whether the disease or the treatment causes most harm. All this is very much like medical treatment in the first half of the 19th century, before the great advances in medical science.

The cardinal question concerns the proper balance between individual decisions in the market and collective, hopefully democratic, decisions in the political system, i.e. the question of the market vs. the state, and the gist of the economists' message was that "the government must stop restricting and directly controlling private commercial activity" as stated in the World Development Report in 1996 (World Bank, 1996:110). Subsequent events and extensive economic research, theoretical as well as empirical (cf. Chap. 46 for more details), has shown that this conclusion was probably premature or at least too simplified.

The content of the following chapters is mostly devoted to the topical issues of economic policy and systemic change in transition economies in the Baltic region, with occasional references to the system of economic planning before 1989 and to western-type market economies (e.g. in Chap. 50 on EU enlargement), but systematic treatment of economic policy and the Scandinavian welfare states is missing. The reader will find information on these issues in other parts of the book, particularly in the section on social conditions and on democracy. For systematic, theoretical descriptions of different economic systems the reader is referred to broader texts on comparative economics (Gregory & Stuart, 1992; Rosser & Rosser, 1995; Isachsen et.al., 1992).

Economics is not an exact science, and its subject is so intertwined with purely political preferences that it is particularly difficult – and important – to draw a distinction between 1) what we know, 2) what we believe, and 3) what we wish and hope for. Indeed, this is the main precondition for scientific analysis, and when this distinction is given up, then there emerges a mixed product called ideology, which was well-known in the former planned economies and

which is not unknown in western democracies either. Therefore, it is recommended that the reader appraises the following chapters (as well as other treatments of economic questions) with a critical, open mind. The authors of the following chapters also present their different evaluations of various matters, but hopefully in a sufficiently transparent and well-founded way, so that they will prove useful for the reader.

Chap. 46 summarises the 10 years of transition experience, and its evaluations take issue with prevailing views concerning the growth performance of the former planned economies and the transition economies. It is argued that the large differences in production experience during and following the unprecedented deep transition depression can be mainly ascribed to differences in initial conditions and economic policy, rather than to differences in the speed and scope of market reforms.

A main element of market reforms is analysed in Chap. 47, namely privatisation, which means that the rights of control and of residual income are transferred into private hands. Various methods of privatisation (direct sale, voucher mass privatisation, insider ownership by managers or employees) in the Baltic countries, Poland and Russia, as well as institutional reforms and changing governance structures are described. Restructuring and economic performance are usually considered superior, when ownership is private, preferably by foreigners or other outsiders rather than by insiders, but empirical data demonstrate complications in this general picture.

An increasingly important source of investment and restructuring is foreign direct investment, the topic of Chap. 48. Particularly in Estonia and Poland, foreign direct investment has increased steadily in recent years. The various effects, such as the transfer of technology and knowledge and the generation of exports, and conditions for beneficial spillovers are discussed. As motivations for foreign investors, low labour costs and natural resources are often secondary to gaining access to large, unsaturated markets. Two cases of foreign direct investment are presented, in Latvia by a Danish textile enterprise, and in Poland by a Danish manufacturer of packaging for the dairy and fruit juice industry.

Chap. 49 discusses a closely related aspect of international integration, namely trade. The transition has had a strong impact upon the amount and composition of international trade. Particularly the Baltic countries and Poland have redirected their trade towards western countries, and imports have increased more than exports, so that substantial foreign trade deficits have materialised. Trade patterns of all the countries in the Baltic region are described, and more general observations on welfare gains from trade, on trade restrictions and on possible effects of EU membership are discussed.

EU enlargement is further considered in Chap. 50, with special reference to the motivations and interests of the various parties. It is argued that for existing EU members, advantages of enlargement are mainly political, but that accession countries have economic interests that are dependent upon EU policies concerning the common agricultural policy and the EU budget for structural funds. EU membership also entails costs, and in relation to EU requirements for environmental protection the costs could be substantial.

The environment – the topic of Chap. 51 – is an increasingly important and costly policy area. Before 1989, energy consumption per capita in the socialist countries was on a par with countries in Western Europe, but efficiency was lower, pollution higher, approximately as in western countries 20-30 years earlier, and more concentrated in a few heavily polluted areas. After 1989, pollution and resource consumption declined following the decline of production. The Baltic states, Russia and Poland contribute significantly to the pollution of the Baltic Sea, although not more than the Nordic countries, and in the 1990s the amount of pollution has decreased, partly because of falling production in the Baltic states and Russia, and partly

because of improvements in environmental protection due to environmental investments, the introduction of new policy instruments, and international environmental cooperation.

The decline of production in the early phases of transition became larger than expected, particularly in the former Soviet republics, and the necessary restructuring of production also required flexibility and relocation of the labour force. This is addressed in Chap. 52, based upon a theoretical analysis of the labour market. Employment decreased, but mass unemployment did not appear, because it was mitigated by other types of adjustment: some employees were not laid off, but received low wages; others left the labour force; still others worked in the unofficial sector; and generally real wages were reduced as a means of labour market adjustment. Consequently, a serious poverty problem has emerged. Still, unemployment is a political issue, and there is a need for more active, rather than passive, labour market policies.

Besides the chapters mentioned above, some chapters in other sections of the book are relevant for the analysis of economic issues, of which two should be mentioned briefly here:

Chap. 40 analyses population trends in the whole Baltic region, including Germany, as well as some observations concerning the development of living standards. In the region it is only Denmark, Finland and Poland that have small positive rates of natural population increase; in all the other countries it is negative, but in some cases it is mitigated by positive net immigration. The transition has had disruptive effects upon the demographic processes, and fertility rates have declined, particularly in the former Soviet republics. Mortality rates have also increased in some cases.

Chap. 24 directly addresses the cardinal question of transition, namely the question of the market vs. the state. The economic system is discussed in relation to the general problem of democracy and four types of democratic decision are described: individual decisions in the market, collective decisions in the political process, self-management democracy, and a fourth type labeled professionalisation, i.e. that decisions are entrusted to independent bodies subject to strict regulations. The basic economic functions of government are considered, and it is argued that the virtues of liberalism and private activity might well be overrated at this time and that the role of the state needs to be considered.