FRAMEWORKS FOR CHANGE OF ECONOMIC STRUCTURE OF COUNTRIES IN TRANSITION

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ABSTRACT

The topic of economic, political and social transition has attracted attention of many scholars and researchers over the past decades. The purpose of this paper is to analyze transition process in light of structural changes of transition economies. The authors argue that transition should and can be taken as an opportunity for optimization of economic structure and leveraging national competitiveness on the global market. Special focus was given to Croatia and former socialist countries in Europe.

Key words: economic structure, transition, optimization

1. INTRODUCTION

When it comes to social and economic turmoil, late 20th century, namely the nineties, was equally dramatic as the beginning of the century. Both periods were marked with radical changes in the socio-political systems in a number of European countries. The nineties brought changes to former socialist countries; member countries of the Warsaw pact and countries that were part of the former Yugoslavia. The changes related to the process of transition from socialism to democracy (in political terms) and from command economy to free-market economy (in economic terms). In line with that, political, economic and social aspects of the transition process will be discussed in the paper.

From the political perspective, socialism, often defined as a single-party political system, was abandoned, and democracy as a multiparty system was introduced. However, the most important changes have occurred in the economic system within which centrally planned economy got replaced with free-market economy. As part of the shift in economic system, privatization of state-owned companies took place. Privatization is considered to be an indispensable condition of adopting free-market approach and it represents the most complex phase of the transition process. Due to its complex nature, but also some oversights and irregularities that accompanied the process of privatization, almost all transition countries experienced a rise in social issues. Social turbulences were closely linked to an increase in unemployment that resulted from the changes in economic structures, companies' restructuring, downsizing and sometimes even closing down entire companies.

The aim of the paper is to analyze changes in economic structures that set in as an integral part of transition process. The authors investigate trends and directions of these changes as well as the degree of their influence on national welfare and living standard. Additionally, the authors look for patterns of changes in order to determine whether the transition processes in various countries share some similarities or they should be viewed as off-the-cut phenomenon that differs from country to country.

2. TRANSITION PROCESS AS THE OPPORTUNITY FOR ECONOMIC STRUCTURE OPTIMIZATION

Socio-political and economic changes caused by the process of transition in ex-socialist countries can be considered to be revolutionary. However, there was no doubt about whether the transition should or should not happen, and democracy was the only reasonable path to pursue. The only doubts were related to how those changes should be implemented, especially in case of transition to free-market economy. However, the major economical problems that were present in the transition countries prior to the start of transition, served as the catalysts of the transition process. Moreover, the old economic and political system was not able to find solutions for the problems and the need for a change was evident. ‘Government denied private initiative as a basic form of continuous innovativeness, technological changes and improvement of organization and management activity. In the long term, planned economy caused suboptimal allocation of resources along with the underemployment of working factors (unexploited capital, inefficient labor force).’[1]

As previously noted, the economic situation at the time was unsustainable. There was an evident need to either make radical reforms within the existing system or build a new system, which eventually happened. A lot of factors influenced that process. From the internal standpoint, the authorities were not willing to implement such reforms, while from the broader perspective, globalization started to spread its influence on socialist countries. Combined effect of transition and globalization generated a brand new geopolitical and economical situation in Europe.

What was the meaning of those processes for transition countries? They meant liberation from the downsides of old system (obsolete technology, inefficiency, poor competitiveness on foreign markets, etc.) which led to recession. ‘Recession most intensively struck industries with high added value, such as machinery production, electro industry (including military equipment production), textile and leather production, wood processing industry and metal

[1] Ivo Družić: Hrvatski gospodarski razvoj, Politička kultura i Ekonomski fakultet u Zagrebu, Zagreb, 2003 str. 140.

production.'[2] On the upside, new opportunities arose; transition countries got a chance to import new technologies, know-how and capital as well as to take advantage of an open access to western markets. This was the opportunity to optimize and modernize irrational economic structure. All in all, transition countries were in a perfect position to take advantage of current trends and increase their national competitiveness. The idea was to foster changes in two directions - production and service sector. In case of the former, attention was drawn to industry restructuring in terms of abandoning business activities with low efficiency and stimulating the ones with high efficiency. In case of service sector, the main goal was to strengthen the overall sector. 'Structural changes following transition should ensure an increase in added value which would consequently induce better allocation of resources. With all that accomplished the process of reindustrialization could start. In line with that, much higher expectations were held for foreign direct investment. However, statistics show different results.'[3]

What happened is that some countries failed at strategic managing of transition process and directing investments to the preselected sectors. In the first phase, instead of greenfield investments, the ones that dominated were portfolio investments, especially in financial (banking) sector. Not long after, most of the banks in transition countries fell under governance of foreign investors. In most cases, portfolio investments in production sector included restructuring of current business units, specialization for a certain type of products and integration with parent company. Management and R&D functions were mostly kept centralized at parent company. In Republic of Croatia there are several examples of such companies: Pliva, Končar, Erikson-Nikola Tesla, etc. Prominent companies became integrated parts of other company's business systems while once well known brand became almost invisible. There are similar cases in other transitional countries as well. Even if they received greenfield investments, those were mostly aimed to increasing commercial capacities and less to production. Those relatively unattractive industries like textile, wood and metal often got close down. All that led to a situation where once dominant sector have lost its throne while service sector (financial and commercial) have gained significance.

In some transition countries, in later stages of transition, the situation improved (Poland, Czech Republic, and Slovakia). Unfortunately, in countries like Croatia, expected changes failed to occur. This was due to the fact that those countries did not seize the opportunity to improve its economic structure supervened upon transition.

3. CHARACTERISTICS OF ECONOMIC STRUCTURE CHANGES IN TRANSITION COUNTRIES

When discussing changes of economic structures of transition countries, most of the authors take capitalist economies from Western Europe as a basis for comparison. They make the assumption that all characteristics of transition countries are due to the nature of planned economies that once dominated those countries.

To settle a debate of why are post-communist countries still so different, four postulates have been proposed (Gros, Suhrcke, 2000.). They go as follows:

[2] Alena Nesporova: Zaposlenost i politika tržišta rada II tranzicijskim gospodarstvima, Rev. soc. Polit., god. 7, br. 2, str. 183-196, Zagreb 2000., str.183

[3] Ivan Teodorović i Goran Butorac: Strukturne promjene industrijske proizvodnje i komparativne prednosti Hrvatske u međunarodnoj robnoj razmjeni, Ekonomija, 13 (1) str. 221 – 246, str. 227

1. Centralized planning prefers heavy industry and ignores service sector;
2. Centralized planning implies big investments in infrastructure and human resources;
3. Savings accumulation is not a priority;
4. Lack of legal and institutional framework to support market economy.

When analyzing transition process, several factors need to be taken into consideration: initial conditions of the country, governmental policies and regulations, and environmental factors such as pool of national resources and level of development.

Initial conditions vary from one country to another and are very important in analyzing transition process of a certain economy. For instance, not all countries had pursued socialism for the same period of time (former SSSR countries experienced more than 70 years of socialist regime). Furthermore, geographical distance varies as well (countries from Middle and Eastern Europe are much more uniformed among one another and are located close to Western Europe). Soviet republics (Estonia, Latvia, Lithuania, Ukraine) significantly differ from members of Warsaw pact (Poland, Hungary) in terms of income per capita[4], level of economic development, share of labor force employed in agriculture compared to heavy industry[5], participation in foreign trade, pool of resources as well as idiosyncrasies in resource allocation under centralized economy.

Studies on transition process contain a wide variety of indicators, ratios and eventually criteria for grouping the countries. Grouping is carried out in three categories: Middle and Eastern Europe (CEE), Baltic countries, and the rest of former SSSR countries. In Middle and Eastern Europe there are two groups; early reform adopters (Croatia, Czech Republic, Hungary, Poland, Slovakia, Slovenia) and late reform adopters (Albania, Bulgaria, Macedonia, Romania).

At the beginning of transition process in 1990s common characteristics in transition economies are: complete domination of public ownership over private ownership (share of private sector in former SSSR countries is less than 10%, and in Middle and Eastern Europe less than 20% of total ownership), public control over foreign trade, high percentage of secondary education enrollment, large investment in education and, unfortunately, decline in production from 1990 onwards. The economic collapse was accompanied with inflation and liberalization.

4. COMPARATIVE ANALYSIS OF ECONOMIC STRUCTURE OF TRANSITION COUNTRIES AND SOME TRADITIONAL CAPITALIST COUNTRIES

Structural changes in transition economies can be observed from two points of view; as changes in structure (production, employment, export etc.) and in behavior, or in other words, influence of one variable onto another (e.g. production vs. employment, FDI vs. export and/or import, etc.).

[4] World development indicator.: GDP per capita in Albania in 1989 was 629USD, relative to GDP per capita of Estonia (6475USD), Croatia (6919USD) and Slovenia (11525USD).

[5] UNDP Human Development Report, 1997.: Share of workforce employed in agricultural sector in some transition countries in Europe was fairly small (Czechoslovakia 11%, Hungary 15%, Poland 27%, Romania 29%). The largest share of workforce employed in agriculture was recrded in Albania – 56%.

In terms of changes in production structure and employment structure of transition countries, several conclusions can be made regarding period from 1989 to 1999 (Landesmann, 2000.):

Deagrarisation and reagrarisation. Most Southeastern Europe countries have experienced a decline in agricultural sector, though few exceptions exist. Some countries recorded an increase in size of workforce employed in agriculture (Romania and Bulgaria) as a result of crisis in industrial sector. Phenomenon of “reagrarisation” was short-termed, caused by aforementioned crisis in industry and limited employment capacity of service sector.

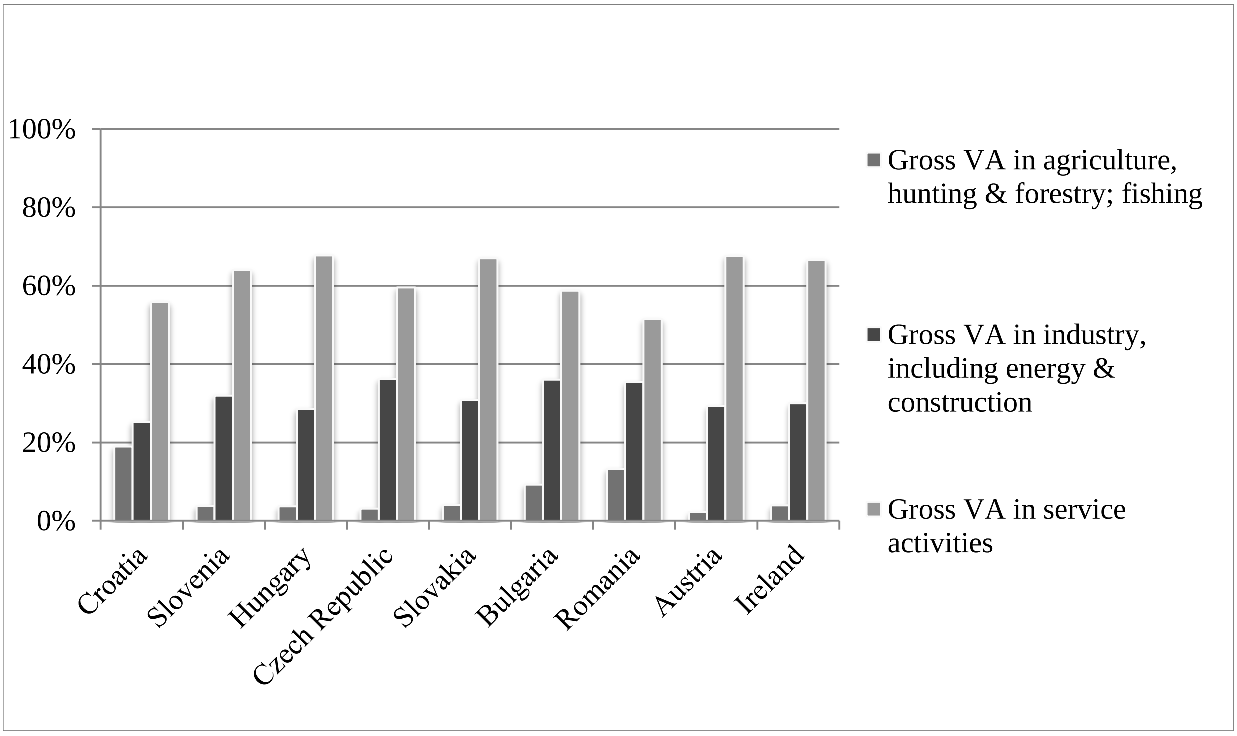
Deindustrialisation. In general, there is an absolute decline of employment in industry (production, mining, water and electricity supply, and construction). However, there are several exceptions to the rule; for example Hungary and Czech Republic recorded a recovery after initial decline. Many transitional countries of Southeast Europe managed to increase a size of employment in industry (e.g. Czech Republic, Slovakia and Hungary have highest rate of employment in industry while Czech Republic, Slovenia, Romania and Poland have highest share in added value). Additionally, it should be pointed out that in case of Romania, low level of productivity in agricultural sector caused an increase in share of industry in total value added despite very low level of productivity in industrial sector.

Tertiarisation. Current trends show that transition economies are catching up with western countries when it comes to development of service sector. Besides, it should be noted here that much of an increase of service sector in western countries is due to reclassification of economic activities and the fact that many non-service businesses outsourced a significant portion of their service activities to the service sector. The growth of service sector was most evident in Czech Republic, Hungary, Slovakia and Slovenia, while Romania, Poland and Bulgaria showed only modest improvements. All in all, employment in service sector could not compensate the loss in other two sectors.

The underlying assumption is that foreign direct investment (FDI) positively influence levels of efficacy of domestic companies and consequently boost growth of transition economies through knowledge and technology transfer (Bogdan, 2009). However, common conclusion is that FDI itself does not necessarily have positive influence on economic growth, but that is rather in connection with other variables such as financial growth, human capital, quality of bureaucracy etc. Borensztein, DeGregorio and Lee (1998) argue that FDI is in positive correlation with economy growth in countries that already have adequate human resources. Thereby, human resources become key attributes for determination of technology transfer benefits. In line with that, if human capital affects domestic economy throughout FDI, it is likely that effects are stronger in industries with skilled labor force (Bogdan, 2009).

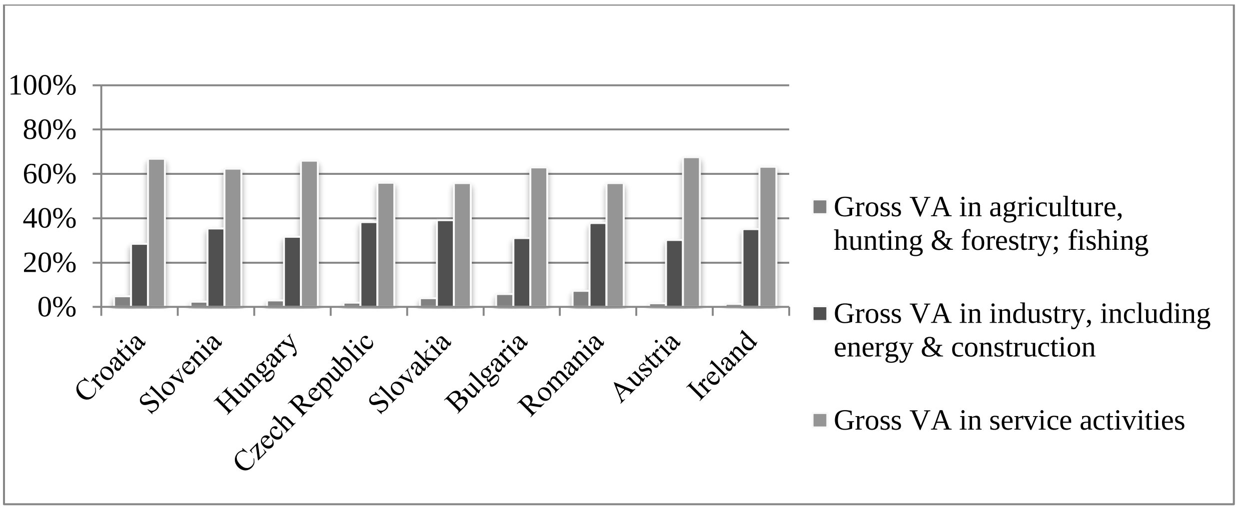
This analysis considers main economic indicators; Gross value added (GVA) in three main economic sectors, employment in sectors, influence of FDI flow in GDP, and all that comparing some transition countries in Middle and Southeast Europe (including Croatia) with few developed capitalist countries (Austria, Ireland).

Figure 1. Gross Value Added per sector in 1995 (USD mil.)



Source: UNECE Statistical Division Database, compiled from national and international (CIS, EUROSTAT, IMF, OECD) official sources.

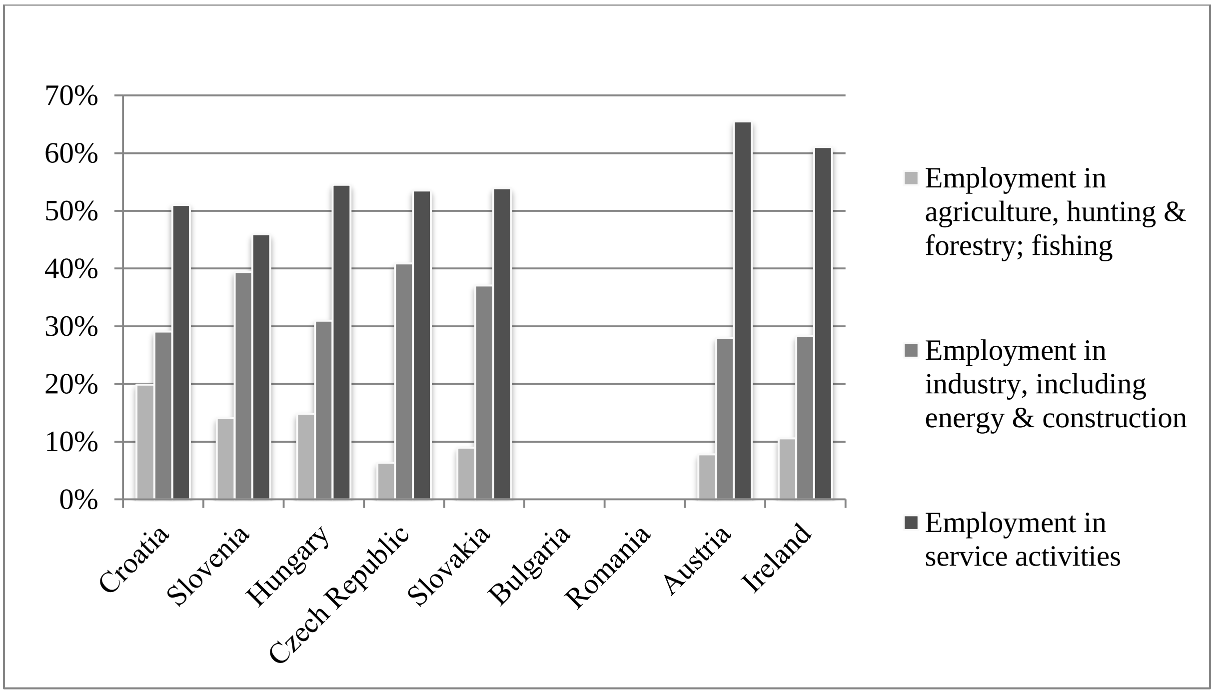
Figure 2. Gross Value Added per sector in 2007 (USD mil.)



Source: UNECE Statistical Division Database, compiled from national and international (CIS, EUROSTAT, IMF, OECD) official sources.

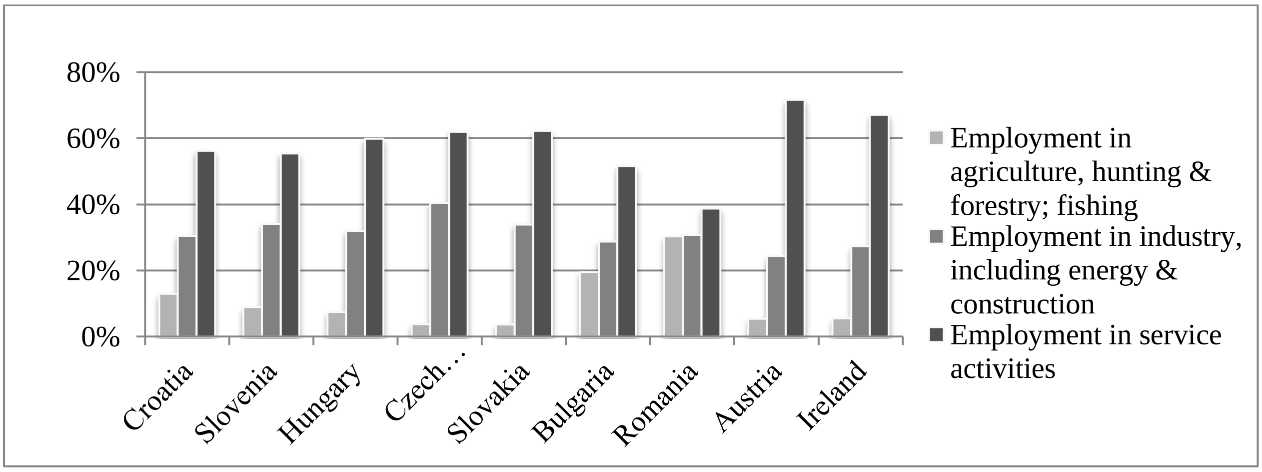
Gross value added (GVA), as a measure of the value of goods and services produced in an area, industry or sector, in this comparison for 1995 and 2007 shows significant decline in agriculture (Croatia, Bulgaria, Romania and even Ireland) and growth trend in service sector, especially in countries such as Croatia and Romania. GVA in industry, energy and construction however is considerably higher in Slovakia, due to strengthening of the automotive and metal sector.

Figure 3. Sector employment in 1995 (% of total employment)



Source: UNECE Statistical Division Database, compiled from national and international (CIS, EUROSTAT, IMF, OECD) official sources.

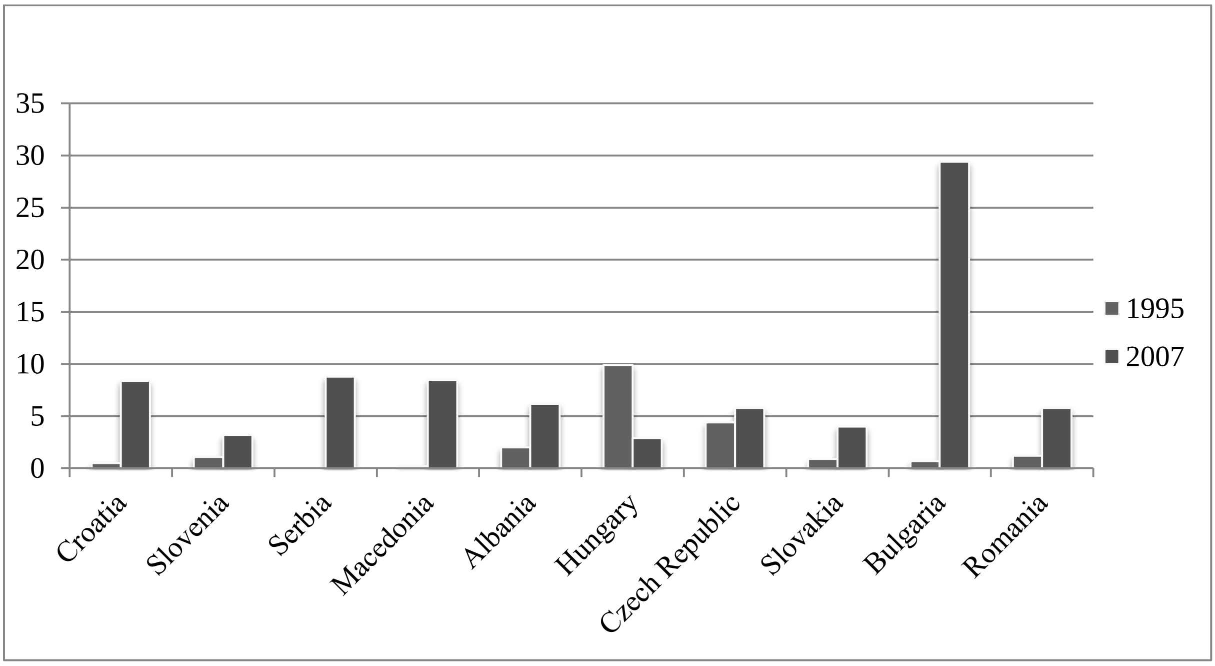
Figure 4. Sector employment in 2007 (% of total employment)



Source: UNECE Statistical Division Database, compiled from national and international (CIS, EUROSTAT, IMF, OECD) official sources.

Consequently, employment in agriculture and related economic activities also show descending trend on one side, and growth of the employment rate in service sector.

Figure 5. Inward FDI flows to GDP, %



Source: UNECE Statistical Division Database, compiled from national and international (CIS, EUROSTAT, IMF, OECD) official sources.

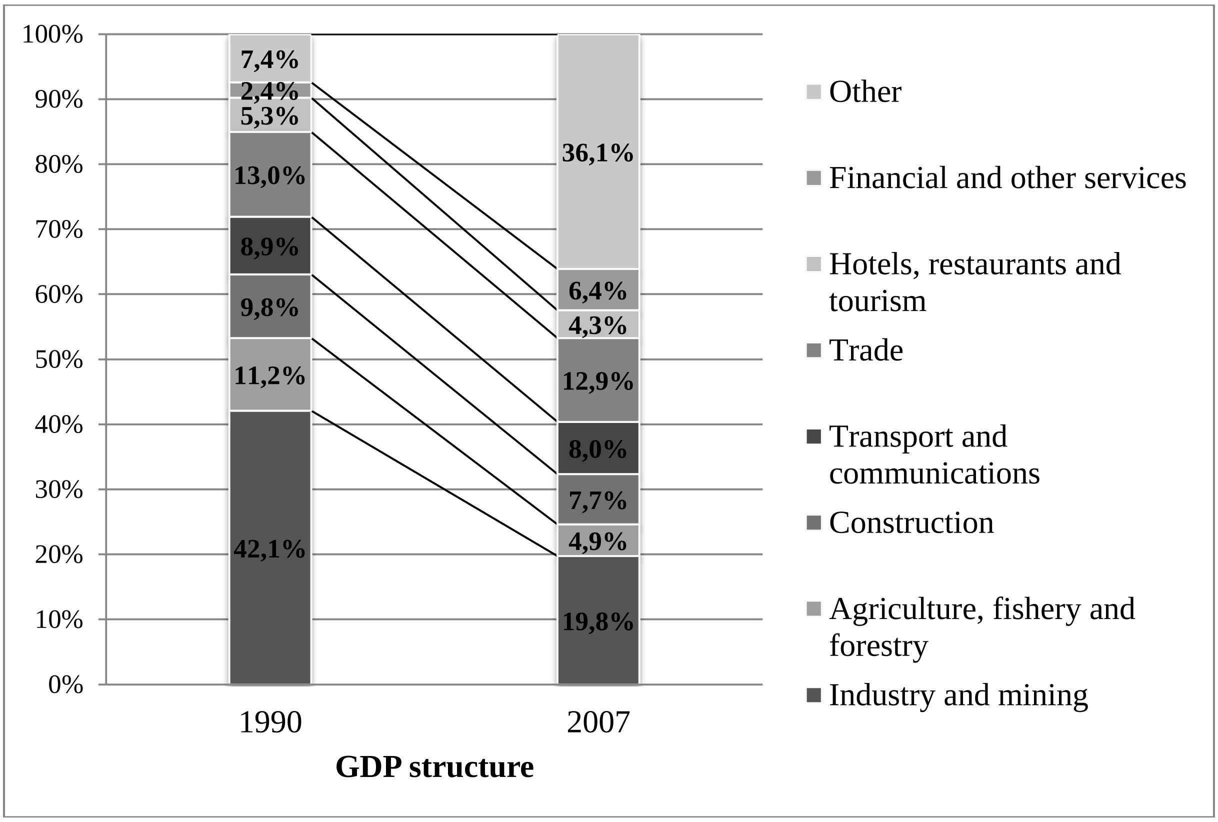
FDI chart reflects huge differences in timing of when some countries of the South Eastern and Central Eastern Europe became – or stopped being attractive to investors. While Bulgaria, Macedonia and Croatia had negligible FDI flow in 1995, in 2007 there a period of sizeable foreign investments coming to these countries have started. The increase in inflows coincided with the accession of central European states to the EU in 2004, and is even considered as a „gold rush“ (2003-2008) for that part of Europe. Sectors which attracted the most of the FDI were real estate, energy (coil, oil and natural gas), transportation, metal and automotive industry.

5. THE PROCESS OF CHANGING ECONOMIC STRUCTURE OF THE REPUBLIC OF CROATIA

The beginning of final decade of the 20th century in Croatian history was marked out with the declaration of sovereignty and independence in political, social and economic terms. The process of transition from socialism to capitalism as well as the acceptance of democracy as the new form of governmental rule was influenced by the characteristics of previous political regime and the state of devastation caused by the war. At that time, the economy was characterized by high unemployment rate (relative to other transition countries), limited supply of long-term capital, poor competitiveness of the domestic economy, and a relatively low standard of living.

By far the largest contribution (42.1%) to Croatian gross domestic product in 1990 was made by sector of manufacturing and mining (Figure 6). Within this industrial sector, several specific industries accounted for their respective shares in GDP; food products industry (15.3%), manufacture of electrical equipment (7.4%), textile manufacturing (7.2%), chemical products industry (7.1%), manufacture of metal products (6.9%), machine industry (5.6%), and generation, transmission and distribution of electricity (5.5%). Those specific industries were equally significant based on the criterion of their share in social product as well their share in total number of employees. In addition to the industrial sector of manufacturing and mining; trade (13%), agriculture, fisheries and forestry (11.2%), and construction (9.8%) made largest contributions to Croatian GDP at the time.

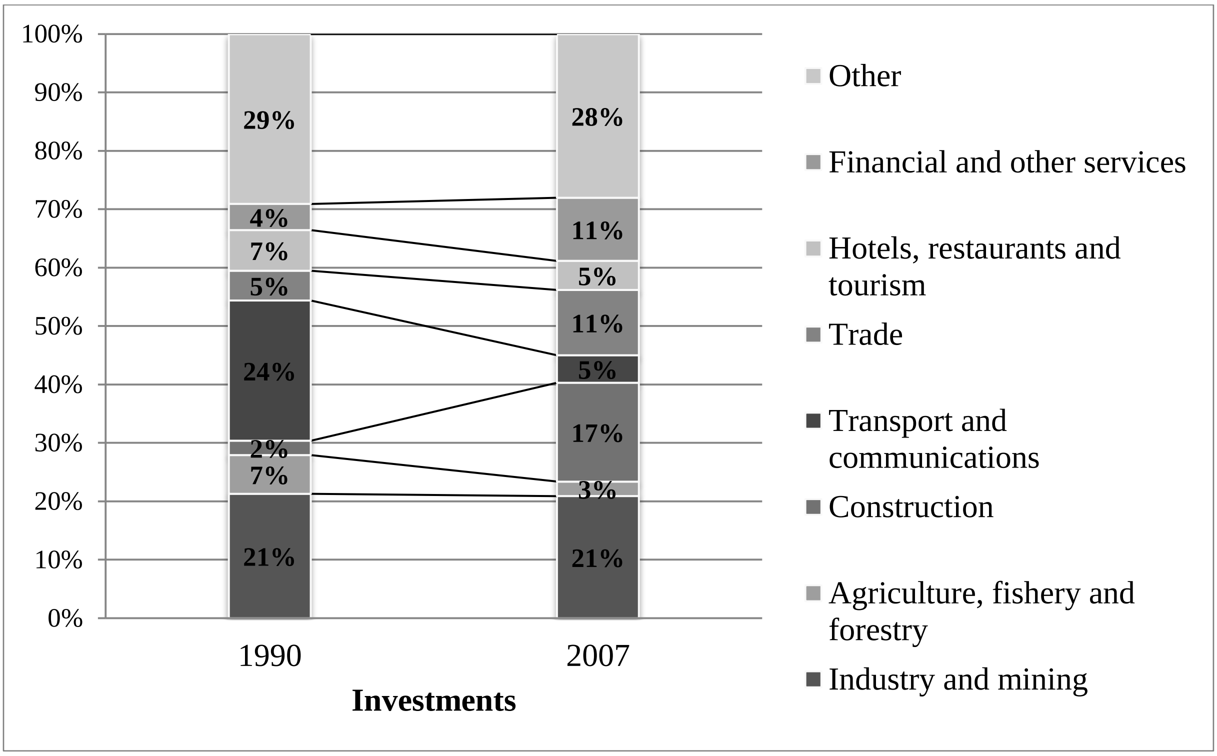
Figure 6. Comparison of Croatian GDP structure in 1990 and 2007



Source: Croatian Bureau of Statistics - Statistical Yearbook 1992 and 2007

The success of the transition process is to a certain extent determined by direct foreign investments. The main benefits of FDI, such as the introduction of new technologies and capital inflow, should ultimately result in higher general level of efficacy within an economy, increase in value added, new jobs creation and higher rates of economic growth. However, there are certain prerequisites that need to be met to ensure the success of transition process. Those prerequisites go as follows: an adequate level of education and quality of human capital, efficient and effective legal, administrative and bureaucratic system, infrastructure at place and developed financial system. Croatia did not meet all of these conditions, nor did it have a clear strategy and vision of a further development. As a result, investment flow was directed primarily to sectors such as trade, construction and financial sector, while at the same time, industrial sector, that represented the main economic growth driver at the time, attracted only minor portion of investments (Figure 7).

Figure 7. Comparison of Investments in Croatia in 1990 and 2007



Source: Croatian Bureau of Statistics - Statistical Yearbook 1992 and 2007

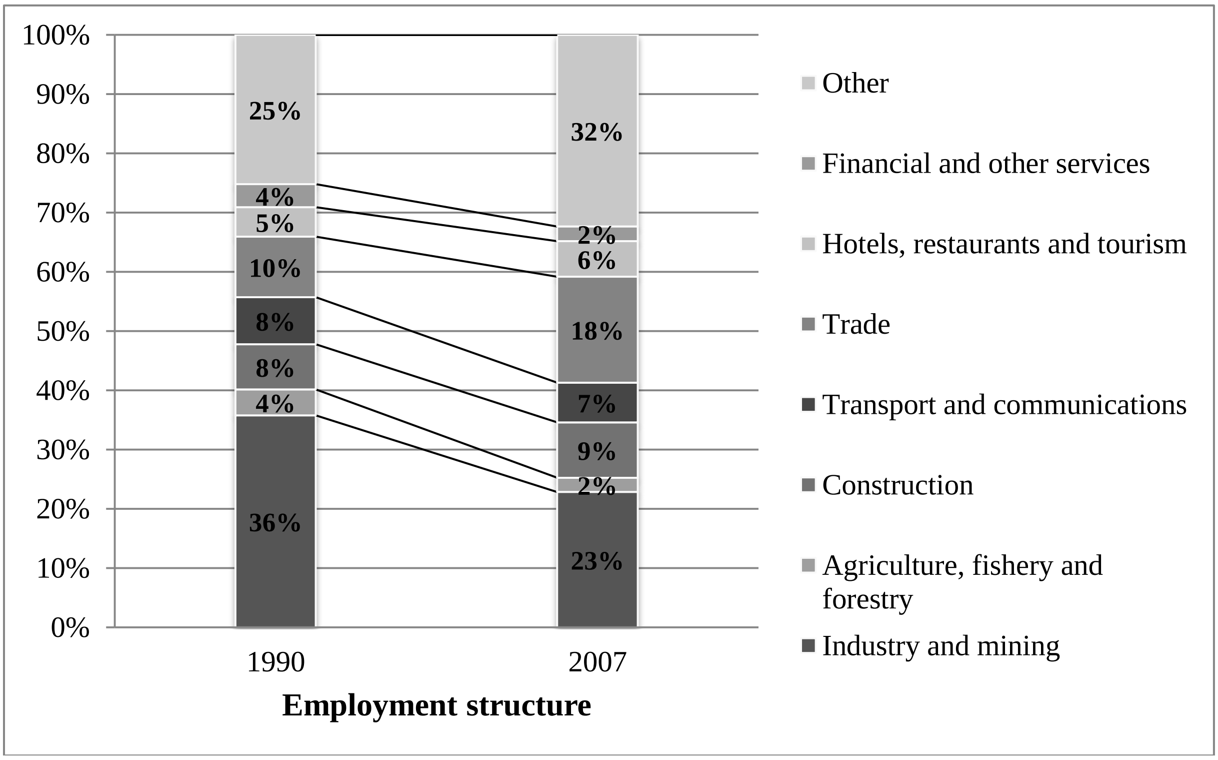
Despite initial advantages of Croatian industrial sector relative to sectors of majority of other transition countries in Central and Eastern Europe, economic structure of Croatia in 2007 offers completely different picture from the one in 1990. The relative proportions of industry, agriculture, fishery and forestry in the total GDP are more than cut in half, while the relative proportion of financial services increased in the same period. In the context of the industrial production, two notable shifts took place. On the one hand, food products industry and paper production recorded an increase in their relative shares; while on the other hand, relative shares of textile industry and chemical products industry dropped during the same period. Many industrial sectors lost their competitive advantage between 1990 and 2007, and this negative trend was especially visible in case of textile industry and leather footwear manufacturing. Textile fiber and fabric industry, once the most important export-oriented industrial sector, lost its international edge due to increasing liberalization of the domestic market, the fragmentation of production, increasing labor costs, and poor protection of domestic production (Buturac, 2007). Besides, export competitiveness analysis revealed the modest increase in export competitiveness of machine industry, stagnation of chemical industry and oscillation in shipbuilding.

In terms of banking sector, Croatia was among transition countries with the highest rise in market shares of foreign banks. In period between 1997 and 2000, market share of foreign banks jumped from 4% to 84.1% (followed by Poland and Slovak Republic who experienced an increase from 18.6% to 65.7% and from 26% to 65.4% respectively)[6]. In spite of evident improvements in banking sector (enhanced regulations and supervising system), security market development has still been lagging behind.

[6] Source: Bank Austria Creditanstalt Economic Department, the Banker, July 2002.

Another important indicator of economic development in transition countries the quantity and structure of foreign direct investment and its impact on national economy. For instance, FDI played a significant role in the restructuring of the national economies in Central and Eastern Europe such as the ones of Poland, Hungary and Czech Republic. Major takeaways from their examples are following: FDI should be primarily export oriented (to help local producers to adjust to foreign competition) and the production should be organized in a way that producers operate close to each other (to take advantage of productivity spillovers) and sell on different markets (Sgard, 2001). The aim of foreign direct investments is to boost productivity and export as well as to increase employment rate. However, the injection of foreign capital does not guarantee that all these positive effects will happen. Positive results of FDI depend on both – the amount and quality of attracted capital, and host country characteristics. Unfortunately, Croatia has pretty much failed at both. Despite relatively high FDI per capital, Croatia has attracted less FDI than most of other transition countries in both relative and absolute terms. When considering FDI structure, the picture gets even worse. Most of the investments went to service (telecommunications and financial services) and trade sector (retail and wholesale trade), while industry and manufacturing sector received only smaller portion of investment. However, some authors argue that the FDI structure is partly due to timing as Croatia became attractive to foreign capital relatively late (Šohinger, Galinec, Škudar). Overall, the positive effects of FDI bypassed what once was a cornerstone of Croatian economy and redirected the restructuring process at the expense of industrial sector.

Figure 7. Comparison of employment structure in Croatia in 1990 and 2007



Source: Croatian Bureau of Statistics - Statistical Yearbook 1992 and 2007

Influence of FDI on overall level of employment in Croatia was twofold. While greenfield investments did create new jobs, investments in acquisitions of Croatian companies (kind of investment that dominated transition process in Croatia) resulted with job losses in most cases. Eventually, the overall effect was negative, especially when it comes to industrial sector that attracted only smaller portion of greenfield investments. Moreover, those few newly established enterprises in industry sector recorded rather low levels of sales revenues and number of employees.

6. CONCLUSION

The process of transition can hardly be described from the black-and-white point of view. Depending on the timing of the changes, quality of the human capital, national pool of resources and several other factors, some countries managed to came out of the recession stronger, while the others have still been struggling with the rising unemployment, decrepit industrial sector, and lack of clear strategy for economic development. Besides, it should be noted that transition cannot be viewed from the economic view only, but the systematic approach needs to be taken in order to get a clear picture of economic, institutional and social changes.

This article provides a framework for analyzing those changes and offers some insights into good and bad practices of ex-socialist countries. One of the key takeaways from the transition process is that strong infrastructure and effective institutions are necessary prerequisites for attracting foreign investors. The sooner the country created an attractive environment for investors to come, the faster was its development. Furthermore, for FDI to really boost national economy, a strategic approach needs to taken. New technologies, know-how and capital brought by foreign investors should be directed to the industries with high value added. In addition to that, examples of Hungary and Czech Republic show positive relationship between SME activity and recovery process. All in all, a transition is a multidimensional process that requires tuned participation of government and private sector to achieve sustainable growth.

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