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25 Years on the Way to Market Economy: Progress or Regression. The Case of Lithuania

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ABSTRACT

After the collapse of central planned economy in Central and Eastern Europe, all affected countries experienced dramatic change towards the market economy. Seemingly, market economy could bring prosperity and plant “american dream” in Central and Eastern Europe. However, the way towards market economy of every country became not that easy as was thought primarily. Different models of transition period did not bring rapid results, however. “Shock Therapy” or gradualist approach was the central pillar of debates of economists and politicians. However, none of them could predict the exact consequences to the development of economies. The official approach to market economy was considered liberalization. The creation of extremely important preconditions for transitions was lacking. The most important market institutes such as social capital, human resources were not created timely which caused long social economic consequences to countries’ development. Lithuanian experience of transforming economy and integration to EU is analyzed in the paper. Lithuanian experience might be applicable to other potential candidate countries. In order to identify the level of development such indicators were selected: competitiveness index, rate of social exclusion and at risk of poverty, GDP growth rate, minimum wage and others.

1. Introduction

So far, there is a disagreement on the reasons why communism in Central and Eastern Europe collapsed – social economic system based on the state means of mass production and societal control over economic processes. It is surprising that sociological and economic polls suggest that there were very few economists who were able to predict the collapse of communism. Even a distinguished political scientist such as Z. Brzezinski claimed that communism can sustain itself long enough (Brzezinski, 1989). Without going more in details underlying the causes of these complex phenomena, in this article we are going to analyse the Lithuanian transition to a market economy in comparison with some other countries in transition. The aim of the article is to analyse Lithuania transition to a market economy and formulate insights for perspective of these complex economic and social processes.

Achieving the aim six tasks has been set:

- Provide Lithuanian economic characteristics of period of two economic system’s interaction.
- Discuss about the economic transformation disputes at that time.
- Characterize the directions and methods of Lithuanian economic transformation.
- Discuss the specifications of Lithuanian integration in European Union.
- Discuss Lithuanian economic situation in regional and global context.

Lithuania rooted its sovereignty a thousand years ago was incorporated in Soviet Union where centrally planned economy was strictly dominated. Being average agrarian country between two world’s wars, in post war period became one of the leading industrialized economies in Soviet Union round out five productive economies. On other hand, in the context of developed western economies Lithuania’s social and economic indicators seemed quite poor. Because of geopolitical global circumstances Lithuania lost its independent economic model of own development for some time.

Extensively developed economy in Soviet Union collapsed and perhaps it was the main reason of it. It was necessary to direct the economy to free market oriented model of development and it was impossible without elimination of communistic political system (Kornai, 1992).

After the collapse of enormous and extremely difficult social and economic system mainly two approaches were possible to transition to liberal market economy: „gradualistic“ approach or “step by step” or „shock therapy“ or extremely rapid destroy of old social and economic structures and provision to liberal market economy‘s „invisible hand“ . According to Nobel prize laureate Joe Stiglitz “invisible hand” is invisible because it is not there. Gradual transformation dominated in Belarus, Central Asia, in Russia after 2000, for some time in Bulgaria and Rumania.

2. Periodization of Lithuanian Transition to a Market Economy

In Lithuania as in other Baltic states without long discussions the neoliberal imitation to transformation was chosen. Imitational orientation means that Western economic models were trying to adopt and neoliberalisation – associated with deregulation process almost in all fields of economic activities. That is to say in the beginning of the privatization process two thirds of state owned capital was privatized only in two years. According many scholars, privatization should be the last stage of transition to market economy, only then when market economy institutes are created: social capital, human capital, rule of law, social trust, entrepreneurship skills etc. (Marangos, 2005). Of course, these processes take place decades as well as transition to market economy and require certain preconditions. Unfortunately at the time, political elite, some economists and probably the most important society were dreaming that neoliberal economic model would bring by itself (probably society was persuaded by Adam Smith’s “invisible hand” panacea and governing elite by strong international financial institutions pressure) fast transition to market economy, achieving Western economic indicators and quality of living for all social groups.

In our opinion, Lithuanian transition to the market economy could be periodized in some stages. The first period started on the Restoration of Independence Declaration Day in 11 03 1990 till 1995 when Lithuania officially declared the willing to become a member of European Union. This period was marked by politicized decisions of economic policy, too rapid and chaotic privatization process very often influenced by criminal structures. Hyperinflation (in 1992 it was 1163%) was struggled only introducing national currency – Lithuanian litas. Many analysts acknowledged that the exchange linking to the U.S. dollar and the Currency Board regime was the most rational solution helped to stabilize the economy.

Second period (1995-2004) of Lithuanian transition to the market economy could be described as integration of Lithuanian economy to European and global structures. Quite soon after intensive negotiations Lithuania became a member of international institutions such as International Monetary Fund, World Bank and World Trade Organization and after meeting many economic and legal requirements a member of European Union in 2004. During this period Lithuanian economy experienced a few perturbations. The first crises occurred in 1995-1996 when half of operating banks at that time bankrupted causing harsh economic and social consequences in fragile economic system. Second crises happened in the second part of 1998 and 1999. This time the reason was external – financial crisis in Russia. The social and economic consequences of that crisis could be compared with global financial crisis 2008- 2012, especially 2009. However, this crisis brought positivity in thinking and Lithuania started diversifying its export markets to Western countries and looking for new export and marketing channels. That is not said about imports in energetic sector. Having created energy sector during planned economy time economy of Lithuania became very depended on energy supply from Russia.

However rapid recovery of Russian market influenced rapid growth of Lithuanian export recovery and growth. Worth mentioning that data suggest the similar results of Lithuanian economic recovery after 2008 financial crisis. That is to say economy stopped falling and started recovering only when main export markets recovered in that number Russian market as well. More than 60% of GDP is created from exports in Lithuanian economic system. Coming back to analysing period one must said public finance was over pressured because government took responsibility to finance too many public administrative functions having not focused on sustainable economic development. Under every elected government not making differences in political ideology structural reforms were really lacking. It is assumed that similar situation is seen in other post-communist countries in transition.

Period from 2004 till 2008 global financial crisis could be named as „economic intoxication“ period based on bubbles mainly in real estate sector. Also it is a period of “lost opportunities” to implement structural reforms mainly in economic systems, business environment, health care and educational system and social protection and social insurance system. This period was marked by European Union structural funds financial instruments usage for economic development and Scandinavian banks’ lending (in Lithuania all main banks are Scandinavian). Varying by years European Union financial injection was around 1/3 of the state budget income. The reduction of income taxes, some products VAT was contributed too rapid economic growth instead implementing contra-cycle economic policy – increasing taxes, accumulating financial reserves. Moreover, easy housing loans were marketing aggressively that made many underestimated own opportunities and risks. All this political blindness brought high rates of inflation estimating more than 10% and in the light of financial crisis Lithuania appeared with no “financial buffer” that could mitigate the negative consequences of global economic downturn. High inflation rate was the main reason why Lithuania was not able to introduce Euro in 2007, what did Slovenia at that year. Meanwhile Estonia six years before crisis had budget surplus and accumulated around 10% of the state budget yearly estimating 2 billion Euro state reserve in the light of crisis that made it meet Maastricht criteria and introduce Euro in 2011 (Latvia introduced Euro in 2014, Lithuania is expected to introduce in 2015).

Enormous financial injections and government's indulgence to some of social groups did not reduce the rate of emigration. During Lithuanian transition to the market economy more than

0,5 million people have emigrated leaving population just of some less than 3 million people. Not much promising situation of economic development and lack of social mobility as well as borderless regional and global opportunities encouraged especially young people to leave their homeland estimating the highest net emigration rate in European Union. However, according to Lithuanian Central Bank data, yearly emigrants transfer around 1-1,4 billion Euro to their families contributing 3-4% to GDP.

The whole external and internal factors influenced 2008-2012 financial crisis and its response to it. The bottom line of which was in 2009 when the rate of GDP fell down by 17% in Lithuania, domestic consumption fell down by 1/3. In Latvia economic downturn was even more complicated – GDP went down by 18% that made Latvia apply to IMF for loans on strict conditions (however, Latvia successfully repaid loan with interest rate), in Estonia by 14%.

Austerity measures taken during 2008-2012 financial crisis will be discussed in the future, however it is necessary to notice that Lithuanian one of the highest economic growth before crisis was marked by one of the highest rate of downturn followed by one of the highest rate of growth of recovery in EU. Strict austerity measures were taken. The main characteristics of them are following:

- VAT increase from 18% to 19% and later to 21%;
- almost all eliminations of tax reliefs;
- the increase of excise;
- the cut of public expenditure on pensions, wages of civil servants, social transfers etc;
- radical cut in state investment projects.

In Latvia similar measures were taken (Davulis, 2012, pp. 134-147). According to Nobel prize laureate Paul Krugman all these measures are absolutely opposite ones that US did during The Great Depression in 1939-1932.

3. Progression or Regression?

After the collapse of planned market economy every country had to adopt to new market rules and specifications. It was almost impossible to make the right decisions not only for politicians but for economists as well. Every post-communist country choose its own path on the way to market economy. After 25 years of colourful changes the authors of the article think that it is the right time to make some assessment on processes that were controversial at that time.

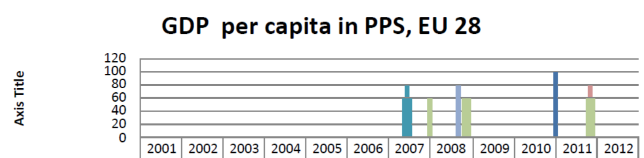
Table 1 shows the dynamic of global competitiveness index presented by World's Economic Forum. That is to say three Baltic states were not taken into account in 2000. The number of assessed countries was expanded from 58 in 2000 to 148 in 2014. The methodology of global competitiveness index was reviewed a few times during analysed period but the authors of the article make assessment in the framework of officially provided methodology. Comparing global competitiveness index 2000 and 2014 the significant change is determined. Only one country's (Lithuanian) competitiveness has improved over 14th years. Some others' competitiveness index have slightly deteriorated (Poland, Estonia). Two of transition countries' competitiveness has fallen by 10 positions (Latvia, Check Republic). Other countries' in transition competitiveness have fallen more than double behind more than 30 additional countries (Hungary, Slovak Republic). How Lithuania has remained its competitiveness over 14 years while other countries' competitiveness deteriorated and some of them deteriorated a lot?

Table 1: The dynamics of the global competitiveness index (World Economic Forum reports 2000-2014)

	Country/Year	2000	2001	2003	2004	2006-2007	2007-2008	2008-2009	2009-2010	2010 - 2011	2011-2012	2012-2013	2013-2014
1.	Lithuania	n/d	**49**	40	36	39	38	44	53	47	44	45	**48**
2.	Latvia	n/d	**42**	37	44	44	45	54	68	70	64	55	**52**
3.	Estonia	n/d	**27**	22	20	26	27	32	35	33	33	34	**32**
4.	Poland	**41**	41	45	60	45	51	53	46	39	41	41	**42**
5.	Hungary	**32**	26	33	39	38	47	62	58	52	48	60	**63**
6.	Czech Republic	**34**	35	39	40	31	33	33	31	36	38	39	**46**
7.	Slovak Republic	**36**	39	43	43	36	41	46	47	60	69	71	**78**

Notice: in 2000 global competitiveness ranking was estimated out of 58 countries comparing with 148 countries in 2014

Figure 1 shows GDP per capita in PPS for the last decade. Before coming on track Lithuania was ranked 6th among 7 places leaving only Latvia behind by GDP per capita in PPS comparing with the average of EU GDP per capita in PPS.



	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
EU (28 countries)	100	100	100	100	100	100	100	100	100	100	100	100
EU (27 countries)	100	100	100	100	100	100	100	100	100	100	100	100
Czech Republic	73	74	77	78	79	80	83	81	83	81	81	81
Hungary	58	61	63	63	63	63	62	64	65	66	67	67
Slovakia	53	54	56	57	60	63	68	73	73	74	75	76
Poland	48	48	49	51	51	52	55	56	61	63	65	67
Estonia	47	50	55	58	62	66	70	69	64	64	69	71
Lithuania	42	45	50	52	55	58	62	64	58	62	68	72
Latvia	39	41	44	47	50	53	57	59	54	55	60	64

Figure 1: GDP per capita in PPS in EU-28
Source: Eurostat database, 2014

Estimating only 42% of average GDP per capita in EU, over decade Lithuania has improved achieving more than two thirds of GDP per capita of average created in EU. From 6th position Lithuania is placed the third in post-communist countries in transition list. However Czech Republic is a country creating the highest value added, it is listed only 46th out of 148 countries in global competitiveness index list. Over decade Latvia remained the seventh of analysed post-communistic countries transformation. Even though Latvia was a country of one of the highest growth rate, Latvia's progress seems to be sluggish (see table 1).

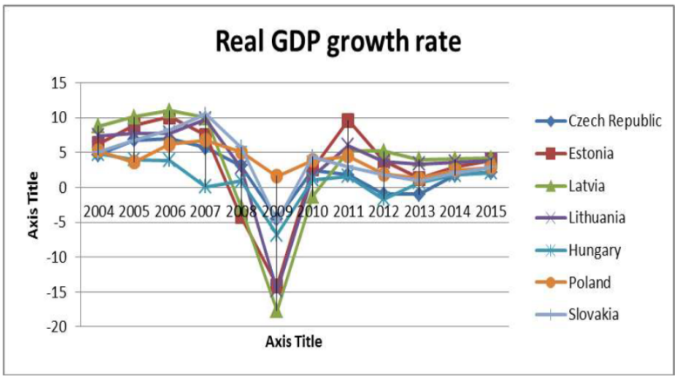


Figure 2: GDP growth rate
Source: Eurostat database, 2014

Baltic countries real GDP growth rates were the highest ones in all European Union estimating the growth of 7-8% rate on average. Accession to EU encouraged FDI in all countries. However the Baltic states were not exception among other countries. That is to say the growth was based on housing credits and supporting export initiatives very hardly investing in new technologies and innovations. Because of deep financial downturn in 2008- 2009 Baltic states experienced one of the highest falling GDP rate in EU – Lithuania 17%, Estonia 14%, Latvia 18%. Only Poland remained a country which did not experience recession and during the peak of financial downturn Poland's GDP growth rate was 1%. That is to say, Poland's government twice devaluated zloty that made polish export competitive in European markets. Separate from Poland, Lithuania did not have even theoretical chance to devaluate Lithuanian Litas because of its exchange linking to Currency Board model. Moreover, devaluation of Litas could bring harsh social consequences – during housing credit boom most of mortgages were taken in Euro, Lithuania imported 95% of oil and 100% gas. On contrary, as it is characterized above, newly elected government took strict austerity measures.

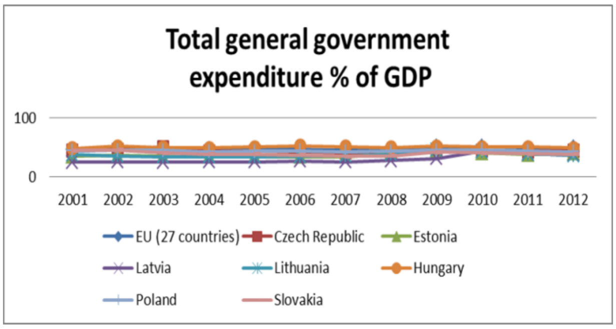


Figure 3: Total general government expenditure % of GDP
Source: Eurostat database, 2014

Some scholars argue that countries those had less state's intervention to post-communist countries in transition did better. However, figure 3 suggests that it is controversial enough to directly address to governments' spending and quality of living or competitiveness index at least in post-communist world. Among other post-communist countries Lithuania has relatively small government spending rate, however as analysed above Lithuania's competitiveness is ranked the highest among analysed countries. On other hand, Hungary's spending rate seems the highest one, however in competitiveness ranking Hungary performance seems to be poor enough. Czech Republic government spending is relatively high enough almost being the same as the average spending of EU members, however competitiveness is fell down sharply during the last decade. Meanwhile Slovakia's government expenditure had been diminishing till crisis period more than 10% from 2001 till 2008, however by at risk of poverty and social exclusion rates Slovakia seems to be the most sustainable post-communist country among others despite the fact that it is the worst ranking country in competitiveness index among other countries in transition.

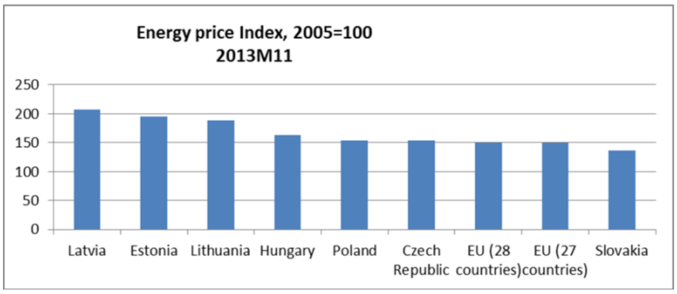


Table 4: Energy price index 2005=100
Source: Eurostat database, 2014

As figure 4 shows energy price index has doubled in some countries over the last 8 years. Baltic states heavily rely on imported energy resources and the prices for imported energy resources is one of the highest not only among post-communist countries but in EU itself. For some Lithuanian sectors it might be critical to its existence. For instance, for one company of chemical industry the cost of gas composes more than 70% of final cost. Any fluctuations in energy prices might be crucial for competitiveness in the region. However, Lithuanian government has adopted Export Development strategy where diversification of new less energy depending industries are promoted. In many national strategic documents Lithuania is positioned as “Baltic Sea Service hub”. Diversification of export structure mainly encouraging such sectors like tourism, medicine, architecture, IT, transportation and some others will make Lithuania less depended on energy price fluctuations.

In all countries in transition minimum wage has increased over the last 10 years. Baltic states and Slovakia had a lowest minimum wages among other post-communist countries. All these three countries did higher progress increasing minimum wage (see figure 5).

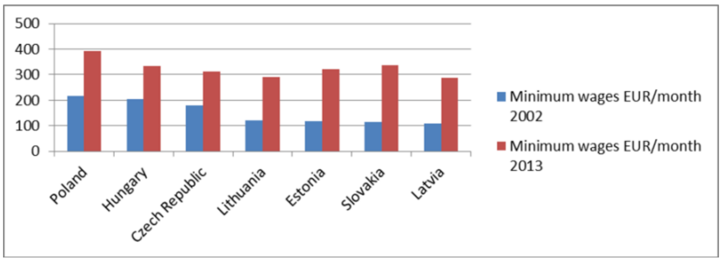


Figure 5: Minimum wage growth in %, 2002-2013
Source: Eurostat database, 2014

Hungary, Poland and Czech Republic had less progress but they had different starting positions for the development. Even though Slovakia raised minimum wage the most as much as 200% of primary wage it lost its competitiveness on contrary than Lithuania. That is to say that very few people are employed in exporting sectors in Lithuania. Czech Republic has increased minimum wage modestly, however its GDP per capita is the highest among post-communist countries and social exclusion rate is the lowest.

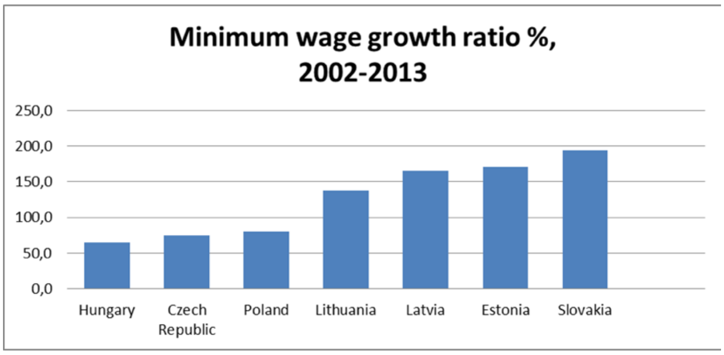


Figure 6: Minimum wage growth ratio
Source: Estimated by authors, 2014

However, starting current debates in Europe on minimum wage raises the essence of European social model of development. Raising minimum wage in export oriented sectors might bring negative consequences in losing export markets for some countries. On other hand, competitive advantage of some countries based just on primary raw materials and cheap labour force cannot be tolerated in global market any more. Moreover, that kind of model of development does not come along with spirit of competitive and social Europe idea.

Despite the rapid growth, Lithuania and Latvia experienced a high enough rate of social exclusion (according to Eurostat definition of Social exclusion). Financial crisis increased the level of social exclusion in Latvia, Lithuania, slightly in Hungary, Estonia and Czech Republic, meanwhile in Slovakia the level of people at risk of poverty remained the same and in Poland slightly improved.

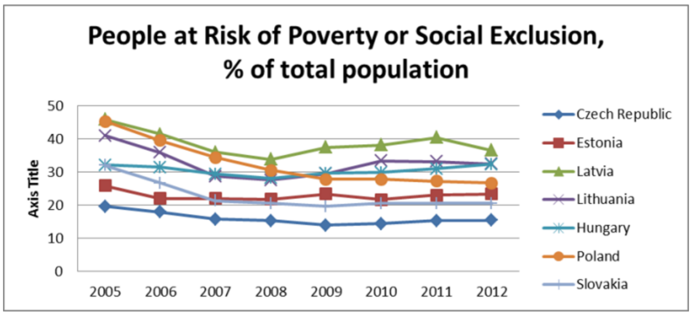


Figure 7: People at risk of poverty or social exclusion, % of total population
Source: Eurostat database, 2014

Financial crisis has showed that every economy of post-communist transformation is differently elastic to economic shocks. In authors’ opinion, it is one of the most important parameter indicating the health of economy and the level of sustainable development.

4. Conclusion

Centrally planned economy in Central and Eastern Europe was a great social and economic experiment in human history. However, miscalculation of its governance and geopolitical circumstances made this system collapse. It is almost 25 years later from the beginning of social economic transformation in Central and Easter Europe. Every country introduced market economy elements, however approaches and speed of transformation varied bringing controversial and unexpected results. Having analyzed different variables it is concluding that there was no one universal approach to the market economy. There is no just one indicator that could suggest the right or bad economic policy at that time. Authors conclude that one of the most important factor of transition is the length of period of transition. Countries that started transition earlier such as Czech Republic they have less social exclusion and more stable economy, less social economic fluctuations, more smoothly face with external economic shocks.

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