# Marko Škreb: The transition process - it's all about people, isn't it?

Text of the Jacques de Larosière Lecture given by Mr Marko Škreb, Governor of the Croatian National Bank, at the EBRD Ninth Annual Meeting, held in Riga, Latvia, on 21 May 2000.

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Mr President, ladies and gentlemen,

Let me first of all say how deeply honored and humbled I am to be chosen to deliver this year's Jacques de Larosière lecture[1] on the occasion of the Ninth Annual Meeting of the EBRD. It is a special honor not only for me, but for my country, Croatia, as well. Let me thank you all for this. It is a privilege to deliver this lecture after only two distinguished central bank governors: Hanna Gronkiewicz-Waltz two years ago and Jacob A Frenkel last year. Which reminds me that right now I am breaking one of the main BIS rules: "Never speak after Jacob Frenkel". My only hope is that the time lag of one year is long enough for your memories to fade.

Making a speech to honor Mr de Larosière is an enormous challenge. I have always been very impressed by his work and his distinguished domestic and especially international career. I met Mr de Larosière for the first time in 1996 (after I became the governor of the central bank) and have managed to stay in touch regularly since then. Even in the very difficult moments in Croatia's history during periods of international political isolation, we managed to have a very honest and professional relationship, which today I respect even more than I did then. For me the highlight in our relationship happened last year when Mr de Larosière accepted the invitation to give the keynote speech at the traditional Vth Dubrovnik Conference on Transition Economies organised by the Croatian National Bank. Definitely, his knowledge, experience and insight into the transition process were invaluable to the Conference. The title of his lecture was non-pretentious (like the man himself): "Transition Economies", but his messages were very strong and deep (again, like Mr de Larosière himself). In his concluding remarks Mr de Larosière, among other things, had the courage to point out some of the negative human facets of transition, for example: "… in some countries the human costs of transition have been high, for instance in terms of male life expectancy ..., growing inequalities of income and increased poverty." (de Larosière, 1999, p.10).

Of course, there are many positive human sides to transition. What I would like to do today is neither present to you a comprehensive survey of transition as there are numerous articles entitled: "Ten years of transition …", nor give some new empirical evidence about causalities between the main variables in the transition process. I would simply like to share with you some of the experiences I have had as a policymaker in transition, experience of course gained in my own country - Croatia. Beside this I will try, by asking questions, to make you reflect for a moment on some simple ideas. For example, one of the questions to which I am looking for an answer is whether we have in the past consistently checked our progress in transition not only against other countries or international standards, but against what must be the ultimate goal of the transition process - increasing the wellbeing of the people.

My lecture is divided into three parts. First, I will try to answer a simple question: What is transition all about? The second part will discuss what the main "ingredients" are in the process of achieving rapid and sustained growth and will focus on human and social capital. In the third part I will discuss some obstacles to transition the way I see them, which means as a central banker. I will end by summing up my remarks.

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## 1. What is the transition process all about?

Numerous researchers have analysed in depth the transition process in terms of speed of reforms, their sequencing, results and possible outcomes, but rarely do we ask ourselves the simple questions like: Why has transition started and why are we involved in it? Without elaborating the answer in detail, let me offer just one possible answer. Socialism (as defined in Kornai, 2000), the predominant system in countries where EBRD operates today, has imploded, has collapsed. This system was not able to meet the growing demands of the population for a better life, that is to say: raising living standards, and the development of a civil society and political freedoms. In a globalized world, information on living standards and developments of civil society and political freedoms from the neighbouring West could not be hidden any more from most transition economies, and discontent grew. The political conditions for change are symbolized in the fall of the Berlin Wall. This created huge expectations among people in the countries of formerly socialist economies. The expectations of the population at that time were that there would be a rapid catch-up with the western standard of living (including political freedoms as well). With regard to the speed of catching up in terms of economic wellbeing, this turned out to be a naïve view.

The main goal of any economic policy should be to increase the welfare of the population, which includes a sustained and high growth of GDP and a desirable distribution of income. In other words, we want welfare to increase; we want people to be better off. Not many people should have trouble agreeing with that statement. Today, indeed, there is evidence that the dual goals of growth and equality of income distribution are mutually compatible (Wolf, 2000).

Whether policymakers are always fully aware of the ultimate goal to promote the welfare of the people is another question. Policymakers in transition face many challenges and bold decisions. Let me mention just a few. Whether to privatize rapidly or not? Whether to open up the economy at once or retain external controls for some time? Whether to aim at zero inflation or not? The main point is that those (and other similar) questions should not be answered only from the viewpoint of either ideology or academic debate, but should be answered in the light of the fact that they are only means to achieve the ultimate goal of increasing the welfare of a people in each country in transition. I would argue that policymakers tend to forget this and think of measures in transition as the goal in itself. For example, sometimes they are proud of rapid privatization regardless of its effects.

The second danger is that policymakers do not care about the ultimate objective at all. Sometimes, politicians do things in order to enrich themselves, their family or friends, instead of increasing society's welfare. Such behaviour is called a "bad" political culture (Hillman and Swank, 2000). It has to be stressed that those societies perform badly. Corruption is endemic, tax evasion high, resources are misallocated, growth lower, and inequalities higher.

In the transition process people are sometimes forgotten. And here I do not refer only to the poor or deprived, but people in general. Therefore we, the policymakers, have to ask ourselves whether we have consistently checked our progress against what must be the ultimate goal of the transition process.

My message here is not only that transition policies should ultimately benefit the people, but that the people have to understand why reforms are necessary and what kind of reforms we should pursue. In short they have to understand what the policymakers are doing. Let me stress that because of the legacy of socialism this goal is even more challenging in transition. Usually people are both averse to risk and have a high discount rate about the future. In socialism those two behavioral patterns seem to be even stronger. People who have spent part of their lives in a socialist system and came out of it only ten years ago, on average tend to be even: a) more risk averse and b) have stronger preferences for the present.

a) In socialism the notion of risk and its consequences were almost unknown. One can think of socialism as a big insurance company. No bankruptcies, no unemployment, no financial markets, no volatility whatsoever, very little choice (both for households and companies) as almost everything was laid down by the central plan. Most risks (which always exist) were taken by society as a whole (socialized) and were not individualized. Or, vice versa, individual decisions rarely affected individual wellbeing. In a market environment there are so many more decisions to be taken and almost each of them is associated with risk and its consequences.

b) In socialism there was no reason to worry too much about the future. Free schools, free education, free health insurance, no unemployment, secured pensions, in short very few incentives to take a long-term perspective on life. Questions like: How am I going to finance my children's education? Should I save for my old age? Will I be able to afford a mortgage if I'm unemployed? were very rarely asked under socialism. So, it was comfortable to think only about the present, as someone else - "the socialist system" - would take care of the future. The same reasoning could be applied to companies. Why worry about the long-term market developments, when the almighty central planner would take care of that?

For those reasons it is even more challenging for policymakers in transition to explain their goals and actions clearly to the population than it would otherwise be.

In reality we do not seem to have acted consistently in pursuit of these goals of whether transition benefits the people and whether they understand the process. Sometimes the people get left behind and we embark on a reform without asking whether it fulfils the ultimate goal of raising people's living standards. Moreover, we can fall into the trap of measuring our success in piecemeal reforms without asking whether the whole spectrum of economic relations have moved forward together. Therefore, we must bring the people forward with the reforms and ensure that they are politically accepted. If this is not the case, it may become a big obstacle to rapid transition (as I will explain further in due course).

Which reminds me of an old joke that we used to tell during socialism, and it goes something like this. During a preparatory seminar for future members of the then almighty Communist Party the local Party Secretary explained to the group of candidates that the future belongs to socialism and that socialism is the most advanced system in the world. A young candidate asks a question referring to permanent meat shortages under socialism: Mr Secretary, if we are so advanced how come there is no meat in our shops? The swift answer was: "My dear comrade, we are advancing so quickly into the future that the cattle can't keep up with us".

I am not I arguing for slower reforms in transition, on the contrary, but let us not forget in our rush to market economies that transition is done for the benefit of the people.

## 2. What "ingredients" do we need to achieve sustained, rapid growth?

Economists agree that for transition to be successful we need sustained growth. Therefore, the question of what needs to be done in transition ultimately leads to the question of what causes growth? The literature on growth has been expanding lately, but most work on transition agrees that macroeconomic stability linked with structural reforms is essential to growth (Wyplosz, 1999; Fischer and Sahay, 2000). And it is equally true that most transition economies have responded positively to the combination of the two and after a sharp decline in GDP today have positive growth.

We have learned as well that the growth process is much more complex than was anticipated at one time. We know that the future success of reforms depends very much on elements like: institution building, contract enforcement, rule of law, etc. To explain the complexity of growth in transition a little bit I will use two concepts: a) human capital and b) social capital.

### *a) Human capital*

Let me immediately start by quoting Lucas (1993) on what causes growth: "The main engine of growth is the accumulation of human capital - of knowledge - and the main source of difference in living standards among nations is difference in human capital" (p.270). So, if we want sustained growth we must promote the accumulation of human capital in transition economies.

The next question is: How does the accumulation of human capital happen? Obviously, there are many ways in which human capital is accumulated but, to mention just a few: it happens in schools, in other forms of training, particularly on-the-job, in research institutes, etc. Therefore it seems reasonable to argue that transition economies should pay special attention to formal education, and other forms of training and research. As the empirical evidence suggests (Flanagan, 1998), return to schooling began to rise rapidly during the transition. Relatively soon, they approximated those in many market economies. Under central planning, the main distortions in human capital formation were the overvaluation of vocational training and the undervaluing of university education. However, the transition process has quickly started to correct this shortcoming of socialism.

Formal schooling need not be the main factor in developing human capital. Let me just mention that according to Lucas (1993), the most central feature of human capital accumulation for growth is learning on the job (learning by doing). For this to happen, we need both managers and workers to be constantly exposed to new challenges, to move up on the "quality ladder". In the globalized world of today it seems that one of the best ways to be exposed to new challenges is by exporting. An old Latin saying could be paraphrased into: "Exportare necesse est, vivere non necesse est".[2] By opening up the economy, we are promoting human capital, which in turn is essential to growth.

A similar approach can be used to argue for more foreign direct investments (FDI) in transition economies. FDIs bring not only physical capital, but: new organization, know-how, etc which then increase "domestic" human capital. That is why strategic investors with new knowledge are so important for overall growth.

Let me be a little provocative and state that unfortunately multilateral institutions rarely talk about human capital explicitly. For example, the EBRD Charter (quoted after Bronstone, 1999) does not mention developing human capital as EBRD's role. A bureaucratic answer might be that that is not its mandate. But, according to the EBRD's Transition Report: "The EBRD seeks to foster the transition to an open market-oriented economy and to promote private and entrepreneurial initiative in all 26 of its countries of operation". (EBRD, 1999, p. vi.) If we agree that human capital is so important in transition, I ask myself how we can achieve this ambitious goal without knowing more about the level and development of human capital in its countries of operation? Does the EBRD have a set of measures of human capital in transition countries (both cross-country and time series), maybe invent a new index on human capital (like the broadly quoted one for privatization), a separate chapter in the Transition report? Please, let me assure all EBRD governors, management and staff that these remarks are made only in good faith in the hope that we will all reflect upon them a little bit.

In a more general framework let us ask ourselves the following question: Have we done enough in the past to achieve this goal? I doubt whether a lot of people in this room (and policymakers in transition economies in general) will say yes without hesitation. Based on the experience in my own country, Croatia, I would say that we have unfortunately somewhat neglected the development of human capital in the last ten years of transition.

### *b) Social capital*

New literature is trying to explain the complexities of various phenomena by social capital (Collier, 1998, Fukuyama, 2000). It is clear that for growth we need not only physical and human capital, but quality social capital as well. Social capital can be described as features of social organisation, such as norms, trust, networks, etc., that facilitate coordination and cooperation among the group for the mutual benefit of the group. A group can be anything from a household to the nation. In the production process it is an addition to physical capital (machines, tools) and human capital (accumulated knowledge). Social capital can enhance the benefits of both investments in physical and human capital.

One may distinguish between government social capital and civil social capital. Government social capital encompasses government institutions that influence people's ability to cooperate and get mutual benefit out of it. Examples are: the rule of law, enforceability of contracts, civil liberties. Civil

[2] The original Latin saying is: Navigare necesse est, vivere non necesse est.

social capital includes: common norms, values, informal groups or networks that influence the ability of people to work together.

Both of them resolve, i.e. overcome the collective action problem (the prisoner's dilemma). Trust, as promoted by social capital, reduces uncertainty and thus reduces transaction costs. This is all clearly beneficial for growth, so we may conclude: the more quality social capital there is the higher growth will be.

In this lecture I will not elaborate the concept of social capital any further. My intentions are to focus narrowly on the issue where I think my comparative advantage may be, namely central banking, and its role in promoting social capital. It is not very common to associate central banks with the development of social capital, but I would argue that by forcefully pursuing its functions the central bank is increasing social capital especially in transition economies.

Central banks are usually associated with two main functions: macroeconomic stability or more precisely price stability which today is considered the principal mandate of a central bank and financial stability, which is usually narrowed down to banking system stability. Not all transition central banks are responsible for banking supervision, but most are.

First let me explore the idea of increasing social capital by pursuing price stability. Today, most transition economies have managed to have relatively modest inflation after the initial outburst of inflation and even hyperinflation. But it is worth remembering that inflation is always a constant threat, it is never dead, only tamed. Central banks must continuously send a credible message that complacency will not set in and that price stability is their main long-term objective. People must always be reminded that inflation is a tax. And this tax is: undemocratic (rarely approved or discussed in the Parliament), regressive (a heavier burden is put on the poor; those that cannot protect themselves from it), and economically inefficient (high inflation inhibits economic growth and ultimately reduces budgetary revenues). And an inflationary environment creates the wrong incentives. In a highly inflationary environment incentives to produce are reduced. For entrepreneurs to take a decision to produce (the "make it" approach) and not redistribute (the "take it" approach) one needs a long-term stable environment. Therefore by maintaining price stability the central bank gives a clear incentive to gain experience in production, not in redistribution. Per contra, by not carrying out its main function, but letting inflation rise in the economy, the central bank gives incentives to engage in redistribution and in higher than necessary transaction costs to avoid the inflation tax.

Let me illustrate this with some Croatian experience. In the twenty years preceding independence (from 1971 to 1991 - Croatia at that time being part of former Yugoslavia), average inflation was 69% per annum. In 1992 and 1993 the average yearly inflation was more than 1000%. Similar trends remained until October 1993, when the Stabilisation program was launched. From my personal experience I can assure you that in a highly inflationary environment a household's objective is to avoid the inflation tax. Currency substitution and "shopping around to find old prices" are the main behavioral patterns, not long-term planning. The same can be said for production. What is the purpose of getting a monthly 2% efficiency gain in some production process if monthly prices change more than 20%? The same principle applies if monthly inflation is more than 4% as it was in Croatia (on average) in the two decades preceding independence. Throughout that period GDP was either stagnant or falling.[3] GDP started to increase only in 1994, after prices were successfully stabilized.

The costs of inflation are relatively well analysed in the literature, so there is no need to analyse them any further, but let me reiterate that it is important that the incentives in a country help people produce new wealth and not put their efforts into redistributing it. Inflation favors predation over production.

The second important function of the central bank is a stable financial or, more narrowly, banking system. But, banking crises have affected a large number of countries and almost none of the transition economies escaped them (Frydl, 1999). A lot of transition economies passed through two banking

[3] The dramatic fall in GDP in Croatia in the early nineties cannot be attributed to inflation alone. It was not even the main contributor. The disintegration of former Yugoslavia, war and transition were taking place at the same time.

crises: the first was the crisis of the old banks with their legacy (dubious assets) from the previous economic system. The second crisis occurred in banks founded after changes in the economic system that were not able to remain viable, because of either weak management and/or increased competition in the market as the transition period progressed.

Croatia followed that pattern. The first banking crisis, the crisis of the old banks, as they were called, started with the beginning of the transition process (and even before it), and is even now ending with the sale of the rehabilitated state banks to foreign strategic investors. The costs of this crisis, brought about by the legacy of the past and as is too often forgotten, by the enormous consequences of the war, can be estimated at about 23% of GDP. These high costs are typical of countries caught up in a war, like Kuwait and Israel in parts of their histories.

During the first half of 1998 the second banking crisis became visible in Croatia. The then government made a decision to rehabilitate two banks which represented about 7% of the total banks' balance sheet. Bank rehabilitations are payed out of the budget. The Croatian National Bank required that bankruptcy proceedings be started in nine banks and four savings banks, while it withdrew the operating permit from one branch of a foreign bank, one bank and six savings banks. This has imposed high budgetary costs for the payment of insured savings deposits in banks in which bankruptcy proceedings have been started. The total costs of the second banking crisis could be estimated at about 4% of GDP.

The costs of the first and the second crisis represent about 27% of Croatia's GDP in 1999. It is obviously a very heavy burden on the economy. The costs mentioned are fiscal costs, borne by the taxpayers. Economic costs are certainly higher.

If regulation and supervision are inadequate, bad banks will emerge or proliferate more than otherwise would be the case.[4] This will not only impose costs on the budget, but the economy will suffer as such banks will not be efficient financial intermediaries. For example, banks may allocate resources (loans) not according to market principles and good banking practices, but in the aim to "favor" themselves (management), their relatives, friends, connected businesses, with other people's money. Asset stripping, simple theft and similar activities can easily develop within and around banks. All those features will benefit only the few. As long as management of banks "can get away with murder" they will continue to behave in such a way.

By creating a stable environment (both macroeconomic and financial) the central bank favours the long-term perspective. People should expect stability in prices and in the financial system, take a long-term view and get involved in long-term wealth creation and not only short-term redistribution gains.

## 3. Obstacles to transition - a personal account

Certainly, there is a long list of obstacles to rapid transition. Besides, I am sure that each one of you present here would have a different list of obstacles. Today I will elaborate only on two of them, which I consider important from my own experience. They are: a) rent-seeking behavior, and b) lack of broad political support for reforms (which I partly discussed before).

### *a) Rent-seeking*

If private returns on predation are larger than private returns on production, this will send "wrong" incentives to people and society will not develop in the desired direction. Therefore we have to make every effort to "get the incentives right". This is not an easy exercise. Socialism and, sometimes even more, early transition, have created vested interests and it is understandable that every socio-economic

[4] In no way am I trying to imply that the main cause of the banking crisis is inadequate supervision and regulation. But, they can certainly deepen banking problems.

group will fight either to preserve their status quo or try to "grab" even more. The problem is especially exacerbated if the prevailing mentality in a society as a whole is the "take it" and not "make it" philosophy.

Every change is a redistribution, redistribution of power and relative wealth. Transition by definition is a change. People on average resist change. I have called this the Newtonian Law of Transition, namely: "Every action creates a reaction." (Škreb, 1998). This resistance to reform (changes) is probably "time-dependent" and positively correlated with the time spent in transition. In the early stages reforms are more general (macroeconomic stabilization) and there is much more support for them. In the later stages "transition fatigue" starts to develop, and disappointment with slowness (or even a decline or stagnation) in the rise of living standards is more and more present. On top of this, structural reforms imply microeconomic changes (usually labor-shedding). This is a challenge to the status quo. These are some of the reasons why structural reforms are so much more difficult to implement and slower than glamorous macroeconomic stabilization programs or measures like the announcement of a new currency, a new exchange-rate regime or a new central bank governor.

Based on Croatia's experience I would like to say that some important large-scale privatizations and foreign direct investments were either postponed or abandoned because of resistance from workers and local communities. They both preferred the imaginary safety of the status quo. The conventional wisdom is that government ownership (the status quo) should ensure at least minimal wages and job security. By contrast, private ownership of a company means job uncertainty for employees, as they have observed in many cases of privatized companies that labor-shedding took place. We should be aware that workers will not automatically embrace privatization and restructuring of their companies in spite of the fact that they are very often carried out in their interest or are the only option for the company to stay alive.

The same can be said for the case of banking crisis resolution in Croatia. Based on my own experience, any resolution is bound to be faced with strong resistance and delays. First, the budget (i.e. the Ministry of Finance) will not willingly accept that it has to pay for the costs of banking crisis resolution. Second, the management of the banks will try to change the banking problem resolution and not shoulder the costs of their actions. They have clear vested interests in the bank as it is (their high salaries, their influence through credit allocation, the wish to hide previous decisions, etc). Third, depositors (households and companies) will make every effort to minimize their losses and get someone else to bear the costs of the problem. Fourth, the owners of banks will try to put political pressure on the government to bail them out. Fifth, there is the personnel of the bank, because they know that either all or part of them will lose their jobs. Sixth, politicians will try to minimize the problem in the hope that it will not hurt their "image".

Every decision on the bank resolution problem is a redistribution problem. There are always welfare losses for some interest groups, so we should be aware that such decisions will create very strong lobbying, corruption, ruthless behaviour, a fight to preserve vested interests, etc. Needless to say, all such behavioral patterns mean using scarce resources to influence the outcome in a redistributive way, and not use them to produce new wealth. To overcome this problem policymakers must make sure that they have the "incentives right" and have a clear set of rules to diminish the scope of discretionary decision-making which always gives room for rent-seeking.

### *b) Support for policies*

Ultimately sound economics is sound politics as well. But the problem is that economic measures may take time to bear fruit. In other words reforms usually have immediate costs and the benefits are (sometimes) distant. Let me stress again that policymakers must educate the public at large to get their support. If this is not the case, it may be a serious obstacle to rapid transition.

With the benefit of hindsight and from the perspective of a central banker I would say that in the past we lacked not so much sound economic decisions but good public relations for our policies. This is especially true in the case where the central bank initiated bankruptcy procedures or withdrew licences for 25 banks which was something unheard of in Croatia in the last fifty years. Let us not blame only people or politicians for their resistance to those measures. New economic policy is like a new product. It is the responsibility of the producer - the policymakers - to overcome the information assymetry and inform the consumers - the population and the politicians - of the benefits of this product (bankruptcies in the banking system) and sell it successfully. If central banks in transition economies want to be successful they should be much more “customer-oriented” and educate the public and politicians about the benefits of their main products: price stability and financial stability. Otherwise, they risk a weak demand for their services.

Without clearly explaining the goals of reforms to the people, policymakers put at risk the necessary support for changes. This is a very challenging and long-term task as it is easier to get people out of communism than communism out of people. This problem is nothing new in history. It is not without good reason that it took Moses forty years to bring his people from slavery in Egypt to the promised land (simply to replace the entire generation), a trip that could be completed in weeks (Hillman, 1999). It is therefore our duty to make the journey in the transition desert as short as possible.

## 4. Summing up

Transition has been a tremendous and exciting project in the last ten years, as well as an invaluable experience for all of us who took part in it in one way or another. Out of it we have learned a lot, not only about how economic systems function or how to initiate economic changes, but we have learned about human nature as well. So, let us keep in mind that the transition process is done for the people and by the people. They happen at the same time: the main objective of transition (we have to increase their welfare), the main engine of transition (through human and social capital) and the main constraint to more rapid transition (rent-seeking behaviour and lack of political support).

Therefore, in my view, policymakers have to ask themselves constantly the following three questions:

a) whether they have consistently checked progress in transition against what must be the ultimate goal of the transition process;

b) whether they have done enough to nurture human and social capital, as without those ingredients economies will grow slower than they might; and

c) whether they have anticipated and tried to overcome the obstacles to transition, since one should expect resistance to change and one should not expect broad understanding for every measure taken.

Finally, ladies and gentlemen, in honour of Monsieur Jacques de Larosière, I have chosen to conclude this lecture with a French saying: “Le bonheur, disait M… n’est pas chose aisée. Il est très difficile de le trouver en nous, et impossible de le trouver ailleurs.” (Sebastien Roch Nicolas dit Chamfort - 18th century French Philosopher.)

Applied to transition economies Chamfort’s words can mean that we of the transition economies must realize that our happiness lies within us. We must look inside our respective countries and find specific answers to our problems for the better future.

Naturally, we should not neglect looking outside as well. There is not a single doubt in my mind that for transition to be successful countries need to open up, promote foreign direct investment as much as possible, extensively use foreign technical assistance, embrace transfers of knowledge, participate and benefit from globalization, and, last but not least, exploit to the maximum the beneficial role of international financial organizations in general and the EBRD in particular as this institution was created for us. All those elements are necessary. But, it is my strong belief that the ultimate test of a successful transition lies within us. Why? Simply because, it’s the people’s transition, isn’t it?

Thank you very much for your attention.

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