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After the Fall: Globalizing the Remnants of the Communist Bloc

by Julia K. Carter

The pace of globalization has quickened in the past two decades, driven by technology that makes it cheaper and easier to share information across borders. Faster economic integration has coincided with an ideological shift pushing countries to shed layers of government intrusion and promote economic freedom.[1]

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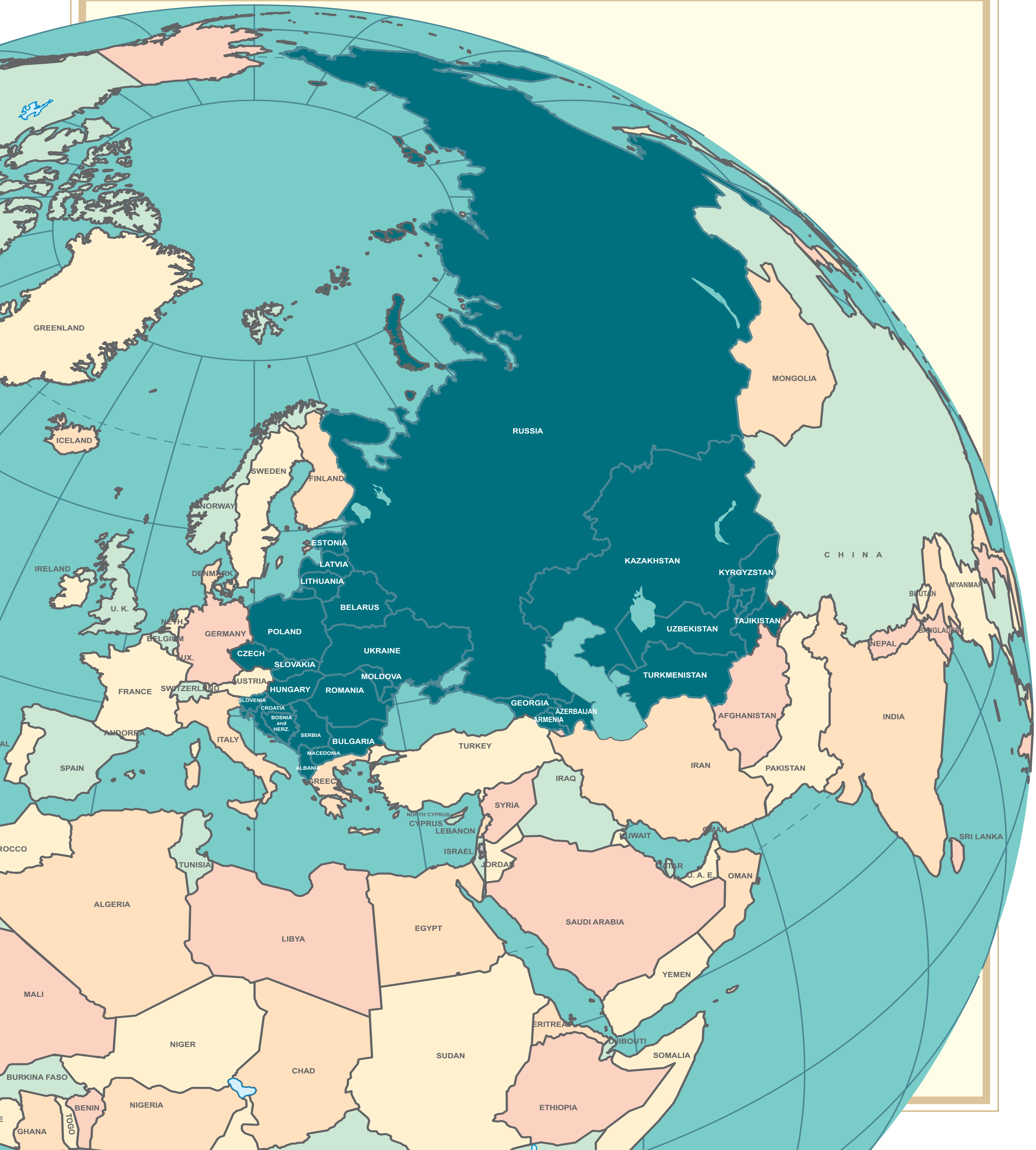
In this cauldron of economic change, China and India have taken center stage with their rapid growth and booming exports. Meanwhile, with less fanfare, the 27 nations once under Soviet hegemony have also been trying to redefine themselves. They form a vast region—stretching from the Baltic Sea to the Mediterranean, from Germany to central Asia—that broke free from decades of communist rule more than 15 years ago.

Former Communist Bloc Countries



A half century or more of state control had left the former Soviet bloc economies backward and isolated—in need of major transformations. Freed from communism, nearly all these countries sought a path to prosperity that lay in emulating the West's open, free market economic model.

They didn't march in lockstep. Estonia, the Czech Republic and other central European countries have made significant progress in becoming global players. Russia and most of the former Soviet republics continue to struggle with the vestiges of their communist pasts. The Asian giants' great strides have led to questions about the pace and depth of the former Soviet bloc's capitalist transformation. Before dismissing its transition as a failed experiment, it is important to weigh the progress made and obstacles still faced on the road to capitalism.

Toward a New Era

The Soviet Union's demise sent shock waves across a significant economic space.[2] Today, the region includes 169 million workers and 403 million consumers, with per capita purchasing power of $7,100 a year, just below the world average of $8,200.[3] All told, the region produces $2.9 trillion a year—about 5.4 percent of the global economy.

By contrast, the U.S. employs 138 million workers to meet the needs of 297 million consumers. Western Europe has 160 million workers and 393 million consumers.[4] While roughly equivalent to the former communist countries in labor force and population, both the U.S. and Western Europe are far more prosperous, with economies at least four times larger. The glaring differences in living standards between the West and the Soviet bloc were a key factor in discrediting communism.

How have the former communist nations done in forging open, market economies capable of prospering in a globalizing era? A.T. Kearney Inc. and *Foreign Policy* magazine calculate an annual globalization ranking to measure the degree to which 62 countries are enmeshed with the rest of the world.[5] It consists of four parts: economic integration through trade and investments; technological connectivity through the Internet; personal contacts through phone calls, tourism and remittances; and political engagement through treaties and international organizations.

The Czech Republic and Slovenia ranked above Germany in 2006, largely because of higher trade-to-GDP ratios and more international tourism (*Table 1*). Hungary rounded out the top 20 most globalized countries, and Croatia came in ahead of France, Portugal and Spain. Slovakia, Romania, Poland and Ukraine did better than such countries as Mexico and Argentina, but Russia ranked well below them.

By opening once-closed economies, China and India have become powerful symbols of globalization. However, both ranked below the ex-Soviet bloc countries. Although China came close on foreign direct investment and United Nations peacekeeping missions, it was lower on international tourism and political treaties. India trailed on many measures, but trade and tourism represented the widest gaps. The Kearney/Foreign Policy ranking doesn't cover the rest of the former communist countries, although reports suggest Estonia and perhaps others have achieved a high degree of globalization.

The globalization measure suggests the former communist countries still have far to go. No country is close to Singapore, Switzerland, the U.S. or Ireland at the top of the rankings. Only Slovenia has made a significant move up the globalization ladder since the first index in 1998. The rest of the countries are about where they were in the pecking order, although some might have made absolute progress because overall globalization has been rising.

Table 1
2006 Globalization Rank, Selected Countries

Rank (out of 62)	Country
16	**Czech Republic**
17	**Slovenia**
18	Germany
20	**Hungary**
22	**Croatia**
23	France
24	Portugal
25	Spain
26	**Slovakia**
30	**Romania**
33	**Poland**
39	**Ukraine**
42	Mexico
43	Argentina
47	**Russia**
51	China
61	India

NOTE: Former Soviet bloc countries are in bold.

SOURCE: A.T. Kearney and *Foreign Policy.*

The Index of Economic Freedom, calculated by the Heritage Foundation and *The Wall Street Journal*, gauges the extent to which nations allow markets to operate.[6] Its components include freedom to trade, openness to foreign investment, burdens of government regulations and taxes, sound monetary policy and enforcement of property rights.

No ex-Soviet bloc economies were among the seven nations classified as "free" in 2007. Only Estonia and Lithuania did well enough to rank as "mostly free"—the index's second best category. They're joined by Japan and most of Europe outside the United Kingdom and Ireland. The two Baltic republics had historic ties to Western Europe, and their communist rule began during World War II, a generation behind Russia and other parts of the former Soviet Union.

A dozen former communist countries have achieved "moderately free"

Chart 1

What's Holding the Bloc Back?

(Heritage/WSJ Index of Economic Freedom)

SOURCE: The Heritage Foundation/Wall Street Journal 2007 Index of Economic Freedom.

Fiscal freedom is a measure of the burden of government from the revenue side. It includes both the tax burden in terms of the top tax rate on income (individual and corporate separately) and the overall amount of tax revenue as a portion of GDP.

Monetary freedom combines a measure of price stability with an assessment of price controls. Both inflation and price controls distort market activity. Price stability without microeconomic intervention is the ideal state for the free market.

Trade freedom is a composite measure of the absence of tariff and nontariff barriers that affect imports and exports of goods and services.

Freedom from government is a measure of the extent of government expenditures and prevalence of state-owned enterprises. Ideally, the state will provide only true public goods, with an absolute minimum of expenditure.

Freedom from business regulation is the ability to create, operate and close an enterprise quickly and easily. Burdensome, redundant regulatory rules are the most harmful barriers to business freedom.

Financial freedom is a measure of banking security as well as independence from government control. State ownership of banks and other financial institutions such as insurer and capital markets is an inefficient burden.

Labor freedom is a composite measure of the ability of workers and businesses to interact without restriction by the state.

Investment freedom is an assessment of the free flow of capital, especially foreign capital.

Property rights is an assessment of the ability of individuals to accumulate private property, secured by clear laws that are fully enforced by the state.

Freedom from corruption is based on quantitative data that assess the perception of corruption in the business environment, including levels of governmental legal, judicial and administrative corruption.

status, including the Czech Republic, Georgia, Hungary, Slovenia and Bulgaria. They share the category with the likes of France, Mexico and Brazil. The 10 countries that haven't reformed as much are classified as "unfree," including Poland, Ukraine and Russia. Belarus and Turkmenistan rank toward the Heritage/WSJ index's bottom as "repressed" economies. Their ways of doing business haven't changed much since Soviet times—government interference and ownership are widely practiced. The Heritage/WSJ index doesn't track Serbia and Montenegro.

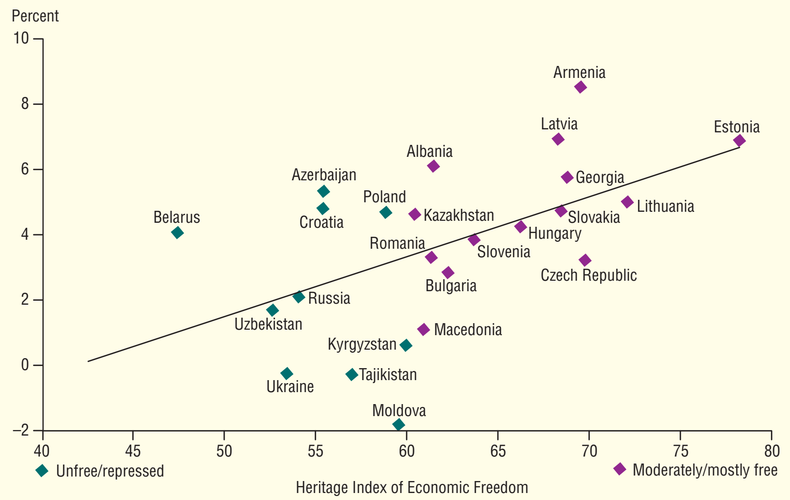
Like the Kearney/Foreign Policy ranking, the economic freedom measure finds few global stars among the remnants of the Soviet empire. Among the 19 countries Heritage/WSJ has tracked for at least a decade, Armenia and Georgia improved the most, rising from repressed to the cusp of mostly free. Poland and the Czech Republic haven't risen in the rankings, despite their favored position abutting Western Europe.

Decomposing the overall economic freedom rankings shows that the former communist countries are doing well on avoiding onerous taxes—even a bit better, in fact, than the seven free countries (*Chart 1*). They've nearly brought themselves up to the world standard in monetary discipline, openness to trade and limited role of government in the economy. The mostly or moderately free begin to diverge from the unfree and repressed in other aspects of economic freedom—reducing red tape for business, deregulating the financial sector, increasing flexibility of labor markets, welcoming foreign investment, protecting property rights and fighting corruption. At the same time, both groups' scores decline, falling well below the standards of the free nations. The property rights and corruption readings for the unfree and repressed countries are particularly disappointing, compared with both the region and the free nations.

Eight former communist countries joined the European Union in 2004: the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia. In January, Bulgaria and Romania became the EU's 26th and 27th members. The countries benefit from unrestricted trade, investment and tourism within the EU, and membership should encourage further globalization and reform. Perhaps more important, strong ties to Western Europe create a bulwark against the backsliding that plagues Russia and several other former Soviet states.

The Kearney/Foreign Policy globalization rankings cover too few countries for analysis, but the Heritage/WSJ data provide a reasonably good basis for examining the former communist countries' divide. Globalization and economic freedom are closely linked—simply put, market-oriented countries tend to be more open—so the freedom measure should capture at least some of the region's integration into the world economy.

Chart 2
Freer Economies Grow Faster
(12-year annual growth in inflation-adjusted per capita income)



NOTE: Data for Bosnia and Herzegovina, Serbia and Montenegro, and Turkmenistan were not available.

SOURCES: The Heritage Foundation/Wall Street Journal 2007 Index of Economic Freedom; World Bank, World Development Indicators database, per capita income, 1993–2005.

Leaders and Laggards

Initial conditions after the Soviet Union's demise varied. Some countries could reconnect historic ties to Western Europe. Others depended on Russia's economy and aligned themselves with the Kremlin. Nations had different labor forces and industrial mixes. However, all had a chance to choose between swift reforms and slow adjustments. As countries regained sovereignty, they diverged not only on the pace of reform but also on economic performance.

By several broad measures, the freer economies are doing better. From 1993 to 2005, seven mostly or moderately free nations were among the region's 10 fastest growing in terms of real per capita income. More telling, perhaps, Ukraine, Tajikistan and Moldova, all unfree, actually saw their economies contract over this period. Overall, growth is highly correlated to economic freedom (*Chart 2*).

Per capita income in the 14 moderately or mostly free former communist bloc countries was $11,373 in 2005, one and a half times the $7,992 in the 12 countries ranked as either unfree or repressed (*Table 2*). The freer countries do better at preserving their currencies' value. Mostly and moderately free countries average relatively low inflation of 4.6 percent, compared with 10.2 percent for the unfree and repressed countries. The five nations with the lowest Kearney/WSJ scores suffer double-digit inflation, topped by Uzbekistan's 21 percent. Keeping central banks independent from government influence fosters the monetary restraint necessary for price stability. EU mandates for low inflation provide additional discipline for the 10 nations that have joined the economic bloc.

Despite a spotty record on economic reform, the ex-Soviet bloc nations have made some strides in globalizing. From 1997 to 2004, exports and imports as a share of GDP rose in all but four of the 27 countries. A dozen of them posted gains of 20 percent or more, led by Serbia and Montenegro at 69 percent, Georgia at 67 percent and Poland at 52 percent. Trade, moreover, has diversified, particularly for the central European nations. They're now tied more closely with Western Europe than with the former Soviet bloc countries.

A few countries are doing well in the highly diversified services trade. As a share of GDP, it's 40 percent in Estonia, 38 percent in Croatia and 30 percent in Bulgaria. International tourism receipts are 47 percent of Albania's exports and 41 percent of Croatia's. In some countries, however, increased trade reflects economies dominated by natural resources. Oil and natural gas as a share of exports was 82 percent for Azerbaijan, 50 percent for Russia and 26 percent for Belarus—all unfree.

The region has become an attractive destination for foreign capital, by and large eclipsing China and India. The ex-Soviet bloc nations received $72 billion in direct investments in

2005, or 7.9 percent of the world total. Inflows were about the same as China's and far more than India's $7 billion. Portfolio investments in debt and equity securities averaged $15.8 billion over the past five years, outpacing China's $9.2 billion and India's $7.2 billion.

Business integration has grown rapidly in the former Soviet bloc. Mergers and acquisitions increased from 13 deals valued at $34 million in 1989 to 367 deals valued at $15.2 billion in 2004. Such multinationals as General Electric, Vodafone and Ford, along with thousands of other companies, have put down roots in Romania, the Czech Republic, Hungary, Poland and other countries.

National financial industries have emerged as well. As a share of GDP, the former communist countries' private-sector lending grew from an average of 20.6 percent in 1998 to 29.3 percent in 2005. Russia had $4.9 billion in initial public offerings in 2005—2.9 percent of the world total and more than Germany's $4.7 billion. Poland wasn't far behind with $1.5 billion in IPOs. Stock markets are thriving. The capitalization of the region's 6,000 public companies has climbed to nearly $1 trillion.

Technology advances globalization by facilitating cross-border communications. Mostly or moderately free nations make up eight of the 10 former communist countries with the most secure Internet servers per 1 million people and telephone subscribers per 1,000 people (*Table 3*). The most technologically connected countries include Estonia, Slovenia and the Czech Republic, and they've become key players in outsourced business services.

Among the nations once part of the Soviet empire, faster growth and price stability go along with greater economic freedom—a result consistent with other parts of the world. Rising trade, investment and connectivity suggest movement toward integrating into the world economy, another worldwide trend. The region, however, remains poorer and less globalized than many early 1990s optimists had hoped.

Table 2

Freedom and Prosperity

	Economic freedom index (100 = best)	Annual per capita income (dollars)	Consumer price inflation (annual percent)
Moderately/mostly free		**11,373**	**4.6**
Estonia	78.1	12,986	4.1
Lithuania	72.0	10,924	2.7
Czech Republic	69.7	16,658	1.8
Armenia	69.4	3,319	.6
Georgia	68.7	2,303	8.3
Slovakia	68.4	12,537	2.7
Latvia	68.2	10,244	6.8
Hungary	66.2	14,453	3.6
Slovenia	63.6	19,661	2.5
Bulgaria	62.2	6,118	5.0
Albania	61.4	3,998	2.4
Romania	61.3	6,882	9.0
Macedonia	60.8	4,990	.5
Kazakhstan	60.4	6,109	7.6
Unfree/repressed		**7,992**	**10.2**
Kyrgyzstan	59.9	1,204	4.3
Moldova	59.5	1,300	11.9
Poland	58.8	10,909	2.1
Tajikistan	56.9	834	7.1
Azerbaijan	55.4	3,552	9.7
Croatia	55.3	10,793	3.3
Bosnia & Herzegovina	54.7	5,014	1.9
Russia	54.0	8,116	12.6
Ukraine	53.3	4,269	13.5
Uzbekistan	52.6	1,270	21.0
Belarus	47.4	5,454	10.3
Turkmenistan	42.5	4,750	10.7
Serbia & Montenegro	Not ranked	4,330	17.3

NOTE: GDP-weighted averages.

SOURCES: The Heritage Foundation/Wall Street Journal 2007 Index of Economic Freedom; World Bank, World Development Indicators database; International Monetary Fund, World Economic Outlook 2006.

Obstacles to Overcome

Why hasn't the former Soviet bloc

made more progress toward globalization and economic freedom? Just about all nations accept these concepts in principle, but the path from closed, protected markets runs over rough terrain, with political as well as economic hazards.

Countries are more likely to embrace globalization and economic freedom if they expect to benefit with jobs, growth and higher living standards. History shows global capitalism delivers—but not always in the short run. Communism left a legacy of shoddy production techniques, underemployment and high costs, so the ex-Soviet bloc nations faced hurdles in a global marketplace.

Labor markets are telling. The former communist countries average 9.9 years of schooling per person age 25 and over, a big edge over China's 5.7 years and India's 4.8 years. Although the region's workers are better educated than their competitors in China and India, they're also more costly—even taking into account their higher productivity. According to the Conference Board, for every dollar a U.S. employee earns, a worker gets 73 cents in Poland, 63 cents in the Czech Republic and 58 cents in Hungary.[7] China's and India's unit labor costs are much lower—at about 20 percent of the U.S. costs.

While the ex-Soviet bloc compares favorably with many low-wage nations in educational achievement, it doesn't match Western Europe or the U.S. in years of schooling or instructional quality. The former communist nations occupy an awkward middle—not developed enough to compete with the U.S. and Western Europe, not cheap enough to vie with China and India.

Integrating into the world market involves more than education. Nations need improved infrastructure, particularly for transportation and communications. Foreign investors expect effective financial institutions, efficient regulatory regimes and protection of property rights. In themselves, new laws may not be enough. Former communist countries must hone their business skills and rediscover such capitalist virtues as entrepreneurship.

Building the foundation of a market economy takes time—longer than many had anticipated in the euphoria of communism's collapse. For the most part, the ex-Soviet bloc countries have delayed or slowed globalization and economic reform while addressing the backlog of development needs. Other impediments have led to foot-dragging on globalization and reform. In some countries, corruption has been thwarting reform, with entrenched interests protecting their turf, even if it means opposing poli-

Table 3
Now Connecting…

	Secure Internet servers (per million people)	Fixed-line and mobile phone subscribers (per 1,000 people)
Moderately/mostly free	**24.8**	**981**
Estonia	101.9	1,260
Slovenia	79.1	1,278
Czech Republic	41.7	1,392
Latvia	37.8	937
Hungary	30.0	1,217
Lithuania	21.7	1,235
Slovakia	18.4	1,027
Bulgaria	8.7	966
Romania	5.4	673
Georgia	4.5	337
Armenia	1.3	260
Kazakhstan	.9	350
Macedonia	.5	642
Albania	.3	154
Unfree/repressed	**7.1**	**566**
Croatia	39.6	1,065
Poland	22.0	777
Moldova	3.6	391
Bosnia & Herzegovina	3.3	507
Russia	2.4	508
Ukraine	1.3	545
Kyrgyzstan	.6	106
Belarus	.5	578
Azerbaijan	.5	333
Uzbekistan	0	79
Turkmenistan	NA	82
Tajikistan	NA	46
Serbia & Montenegro	2.3	910

NOTE: Population-weighted averages.

SOURCE: World Bank, World Development Indicators database.

cies that might benefit economies as a whole. A few nations suffer from what economists call the resources curse: the neglect of broad development needs as the state profits from oil or other natural wealth.

Undoing the corrosive legacy of communism has proven a daunting task. A decade and a half after the fall of the Soviet Union, an economic divide has formed along Russia's frontier. In countries to the east, except the Baltic republics, economies haven't broken free of government shackles. Countries to the west, further along toward globalization and economic freedom, have oriented themselves toward Europe, with many joining the EU. The vast economic space that was once the Soviet empire is likely to bear the marks of this split for decades to come.

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Notes

[1] See "Racing to the Top: How Global Competition Disciplines Public Policy," Federal Reserve Bank of Dallas, 2005 Annual Report.

[2] Until 1991, eight countries composed what used to be called the communist bloc: the U.S.S.R., Albania, Bulgaria, Czechoslovakia, Hungary, Poland, Romania and Yugoslavia. Not all of them had been communist since 1922. Several countries came under communist influence during World War II. The U.S.S.R. splintered into Armenia, Azerbaijan, Belarus, Estonia, Georgia, Kazakhstan, Kyrgyzstan, Latvia, Lithuania, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine and Uzbekistan. Czechoslovakia split into the Czech Republic and Slovakia. Yugoslavia disintegrated into Bosnia and Herzegovina, Croatia, Macedonia, Serbia and Montenegro, and Slovenia.

[3] All gross domestic product figures in this report were calculated as an average of the U.S. dollar measure and the purchasing power parity international dollar measure, which come from the World Bank's World Development Indicators database.

[4] Western Europe refers to Switzerland and the 15 members of the European Union prior to the 2004 and 2007 expansions.

[5] A.T. Kearney/Foreign Policy Globalization Index 2006, available at www.atkearney.com and www.ForeignPolicy.com.

[6] The Heritage Foundation/Wall Street Journal 2007 Index of Economic Freedom, www.heritage.org. The index does not cover Serbia and Montenegro. The Fraser Institute also produces an annual study of economic freedom around the world, which generally agrees with the Heritage/WSJ index but covers only 18 of the 27 countries studied.

[7] "Competitive Advantage of 'Low-Wage' Countries Often Exaggerated," The Conference Board, Executive Action Series no. 212, October 2006.

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