

IMPACT OF INITIAL CONDITIONS ON TRANSITION PROGRESS: THE CASE OF MONTENEGRO

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Abstract

Shortly after the transition started an important debate was initiated over the length of the process and on the factors that influence advancement of a country in transition reforms. It appeared that transition progress has to be understood as an endogenous phenomenon that is affected by the initial conditions of the country in question. Moreover, economic performance also depends on inherited conditions as well as on the transition progress of a country while the latter should be also regarded as endogenous in itself. From this standpoint the case of the Montenegrin economy is analysed, since Montenegro is among transition laggards, predominantly because of a substantially delayed start of reforms. Firstly, broader assessments on transition progress are presented, mostly based on the EBRD indicators. Since the actual success of reforms conducted as well as their speed and pace of implementation, cannot be estimated correctly unless inherited conditions are taken into consideration, several models have been specified and estimated that could show how and to what extent initial conditions affect the transition progress of transition economies. The results obtained for the entire set of transition countries are subsequently applied to the case of Montenegro. The results lead to a conclusion that reforms in the country proceeded at a faster pace after the 1999 but were primarily directed to privatisation and liberalisation issues while institution building is slightly delayed and stays below an accessible level regarding initial and inherited conditions in Montenegro.

Key words: Transition, transition progress, initial conditions, institutional development, Montenegrin economy, comparative analysis

JEL Classification: C52, P 27, P 30, P 52.

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Introduction

Shortly after the transition had started a huge debate began over the length of the process and the factors that influence advancement of a country in transition reforms. The first ideas suggested that initial conditions may affect transition progress but if a country is decisive in its reforming endeavours it will be rewarded by a faster recovery from expected recession while the impact of initial conditions will diminish over time (de Melo, 1996, 1997; Sachs, 1996). Further investigation has shown that this was an over-optimistic view. It appeared that transition progress has to be seen as an endogenous variable, or in other words that it is affected by the initial conditions. Hence, growth rates and economic performance could depend on inherited conditions of a country and on transition progress but the latter should be regarded as endogenous in itself (Stiglitz, 1999; Popov, 2000; Hoff and Stiglitz, 2005; Godoy and Stiglitz, 2007 and from a somewhat different angle Krueger and Ciolko, 1998; Heybey and Murrell, 1999; Fallcetti *et al.* 2005 and many others).

In a recent paper (Cerovic and Nojkovic, 2009) with a colleague of mine I have demonstrated how and why initial conditions affect both reforms and growth in transition countries even after almost two decades since the transition process started. We have also shown that many countries are still far away from a full market economy model although this cannot be attributed to the unwillingness and/or reluctance of their policy makers: the majority of the countries conducted reforms at the pace that is –more or less– the most appropriate considering their inherited circumstances. All these findings demand assessment of the progress in reforms of each country from the standpoint of their inherited conditions. In that way only, we may clarify whether a country is lagging behind a desired level of transformation for some objective reasons or through its own mistakes and/or insufficient commitment.

In this paper I shall analyse the case of the Montenegrin economy. The subject is of particular interest since it is well known that Montenegro is among transition laggards, predominantly owing to a very delayed start to the reforms. Although it started somewhat earlier when compared with Serbia –with which Montenegro was in a union during the nineties, and was suffering the same ruinous effects of the dominant political options in that period– it is nevertheless in a substantial delay if compared with other transition countries from south-eastern Europe. For that reason it is essential to assess how transition is developing now and what can be taken as realistic expectations regarding the near future. Parallel to this it is important to consider to what extent the reforms have been balanced regarding, particularly, institutional developments and what could be taken as an impact of inherited state of affairs or maybe, as an impact of improper policies.

The paper is organised in three major parts. In the first section transition progress achieved so far in the Montenegrin economy will be reviewed and analytically assessed. The second section will explore transition progress as an endogenous phe-

nomenon and basic analytical results on the issue will be presented. Finally, in the third part the results of empirical testing will be applied to the Montenegrin case and the present transition progress of the economy will be re-assessed from the standpoint of inherited conditions and their impact on reform implementation.

Montenegro: transition progress

We may start our analysis by assessing the achieved overall progress in implementing reforms in Montenegro. A good starting point in measuring achievements of the Montenegrin economy is a set of transition indicators regularly published by the European Bank for Reconstruction and Development (EBRD). Though sometimes criticised for their theoretical and/or policy grounds, the EBRD indicators nevertheless, represent the most developed and the most comprehensive measuring tools for the reviewing reforms within transition economies (see: Appendix).

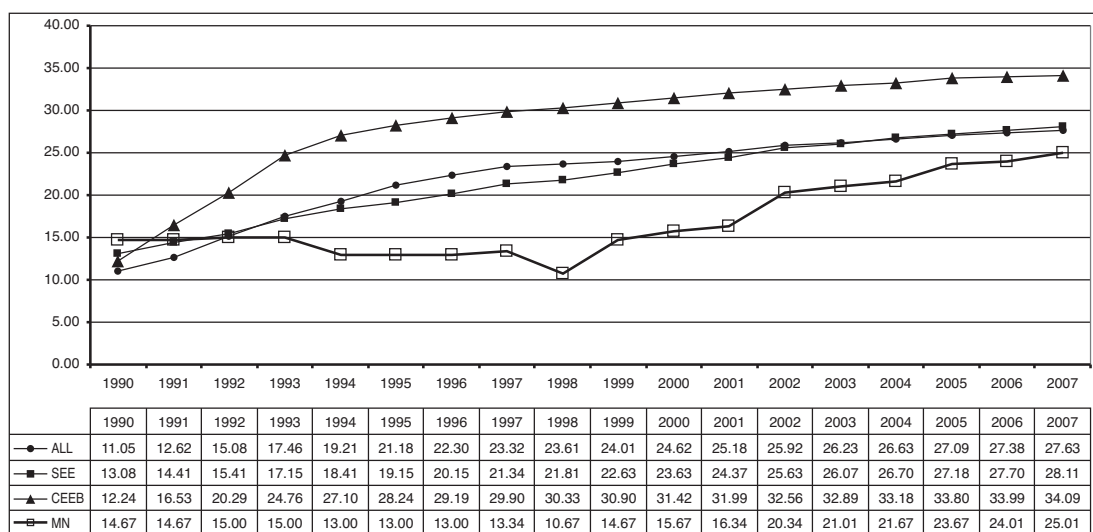
In the analysis I shall use the database for the period 1990-2007 which was previously established in conducting a project on the Montenegrin economy¹ but has never been published. However and whenever possible, the data will be renewed and will take into account the period of the two years that followed.

In Graph 1 and in the table below the path of Montenegrin transition (MN) is presented by means of the EBRD indicators (sums of nine indices ranging from 1 to 4.33) together with the data for all transition economies (ALL), Central and Eastern Europe and Baltic countries (CEEB) and for those from the Balkans or South-eastern Europe (SEE).²

At a glance it is evident that the graph and the table presented point to some very specific features of the Montenegrin transition. Firstly, it is remarkable that Montenegro had a relatively better starting position in terms of institutional arrangements when compared with all other groups of countries. This is due to the reforms previously taken under the self-management system as well as the initial reforms of the last Yugoslav Government in 1989 and 1990 and it shares this inherited advantage

1. The project was conducted by the consortium of three faculties of Economics (Podgorica – Montenegro, Belgrade – Serbia and Ljubljana – Slovenia) for the Government of Montenegro and was exploring the outcomes of the privatisation process until 2008. The database I refer to has been covered in the Booklet 2 that I had produced with the assistance of two younger colleagues (A. Nojkovic and B. Ristic).

2. It should be noted that in the SEE data I have included Slovenia, that is usually grouped within the CEEB. The reason for this re-arrangement comes from the fact that Slovenia has been a part of former Yugoslavia and consequently has shared some common characteristics at the initial stage of reforms with other ex-Yugoslav economies (similar institutional arrangements, similar macro-economic indicators concerning inflation, exchange rate etc. as well as similar start of reforms as conducted by the last Yugoslav Government).

Graph 1. Transition progress: sums of 9 EBRD indicators (1990-2007)

Source: EBRD (2008)

with all other ex-Yugoslav economies (see: e.g. Godoy & Stiglitz, 2007; corresponding transition indicators in EBRD, 2008).

Secondly, an astonishing development occurred within the country — the favourable inherited conditions deteriorated over the nineties: the sum of the nine EBRD indicators went down from 15 in 1992 to 10.67 in 1998, which is a striking evidence of the politics and policies conducted in the remaining part of the former Yugoslavia consisting of Serbia and Montenegro. However, and also remarkable, the reforming processes in the country were re-started after 1998, in the year that marked the launching of more independent Montenegrin politics toward its Serbian counterpart. Ever since that year the value of transition indicators has increased consistently, although at a different pace and/or speed. It should be noted that this tendency continues beyond 2007 although the increase of the sum of the EBRD indicators was reduced to less than a point until 2009 (+0.66).

In comparison with the other countries we may state that the speed of reforming processes since 1998 has been sufficient to put Montenegro on the average level of all transition economies reached by 2001 that is, after more than a decade of transition endeavours. However, this is still the level which was reached (on average) by the group of the CEEB countries already around 1993-94 that is, after five years only since transition had begun in the majority of those economies.

Finally, if we draw attention to some significant groups of the EBRD indicators we may remark some other intriguing points. Namely, we may discover that in the period 1999-2007 the Montenegrin economy was assessed with relatively high marks for the results in privatisation and liberalisation. The sum-value of the two indicators

for privatisation of (a) small and (b) big firms increased from 2 in 1998 to 7 in 2005 (although it slightly diminished in 2009 for slow privatisation of bigger companies in the public sector) while the sum-value of indicators for price and trade liberalisation had risen from 3.67 in 1998 to 8 already in 2007 which is a significant move since the maximum value for both categories could be 8.67.

It should be pointed out that fast privatisation and liberalisation characterise almost all transition economies reflecting in that way an illusion of the “big bang” theory of transition based on the idea that fostering private ownership and liberalism could *per se* secure an efficient market economy. On the other hand, privatisation and liberalisation were seen as a tool for increasing of competition but according to the market structure in many transition economies it turned out to be a dubious proposition³ while according to the EBRD assessment indicators for competition policy in the majority of cases were poor and one of the least developed aspects of the whole transition process.

So it was within the Montenegrin economy: until 2007 competition policies were assessed by *one* which is the value that depicts the initial state with no advancement or with an extremely low level of progress. A later shift to the value of 1.67 in 2007 and 2.0 in 2009 still ranks the country poorly compared with more developed transition economies. Yet, this modest move is primarily due to some formal and not very substantial changes (establishing of the competition body, adjustment of competition laws with the EU standards etc. with negligible implementation results). In conclusion it should be said that this is also due to a mistaken hyper-liberal prediction that liberalisation would produce a competitive market structure and for that reason competition policies were rather neglected in the transition reforms agenda.

The third important point concerns the entire environment that was developed under transition. Namely, if privatisation and liberalisation are fast they have to be followed by strong and viable institutions. Otherwise the results will be suboptimal and/or will be introducing a new imbalance within the economy. Among the EBRD indicators one can select at least four indices that provide certain information on institutional development, like those that reveal the state of enterprise reforms, banking and non-banking financial system as well as the reforms in infrastructure. If the reforms were well balanced then the value of these four indicators seen as a ratio to the values of the remaining five, should produce a coefficient equal to 0.8. However, this is not the case with the Montenegrin reforms: in 2007 this ratio was 0.49 and in 2009 it reached 0.52. This is to demonstrate that deeper institutional reforms were

3. Thus for example, in analysing the case of Serbia I have shown that former monopolies have not been dismantled despite free and subsequently real entry of foreign companies through privatisation procedures and in some industries the market structure has even deteriorated (Cerovic, 2009).

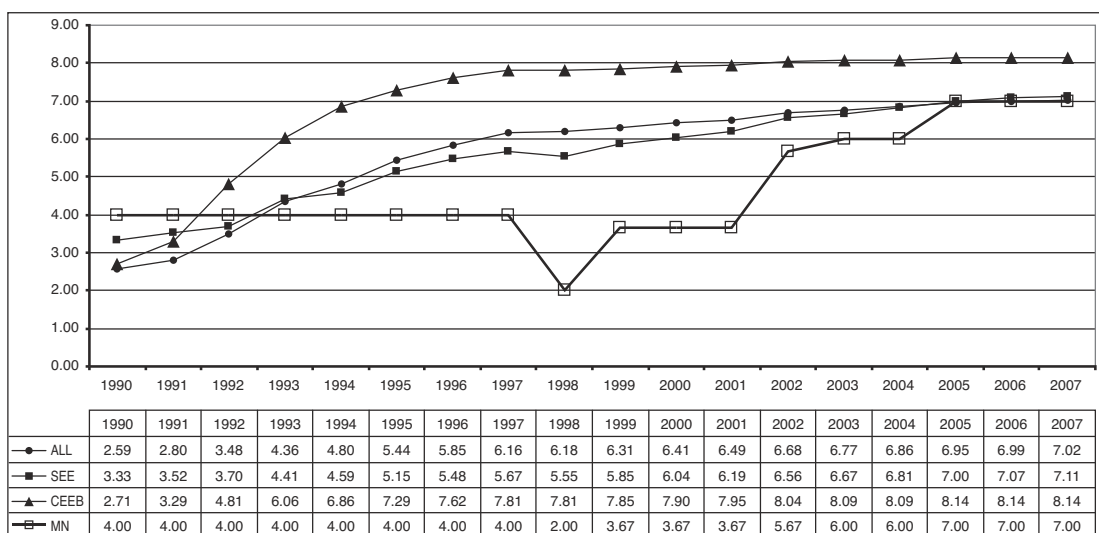
very much lagging behind those that can be understood as “one step” reforms — like privatisation and liberalisation.

Indeed, if we use the ratio of the EBRD assessments for privatisation (small and big) to institutional development as measured by the sum of values of the four indicators mentioned above, we shall again remark an obvious lag between the two sets of reforms. Thus, in the period of 2005-07, when the privatisation indicator was valued at 7 points, this ratio for Montenegro was in the range of from 0.88 to 0.84 and in 2009 it was 0.74 (but with a decrease of the privatisation indicator to 6.67). Comparing these values with other transition economies at the time when their privatisation score was assessed by the EBRD at 7 points (as in Montenegro in 2005-07), we shall meet much lower figures that stay for more balanced reforming process. For example, in Poland this ratio ranges from 0.7 to 0.62 (1994-5), in Estonia it was 0.7 (1994), in Slovenia 0.68 (1996) in Hungary when the privatisation indicator was 6-8 the observed ratio ranged from 0.56 to 0.67 (1994-95). In general, it could be said that Montenegro enters the circle of those transition economies where privatisation was going ahead of the deeper reforms while their reforming aftermath was not very successful or that the Montenegrin approach to reforms lags behind if compared with the most successful “transitioners” from CEEB.

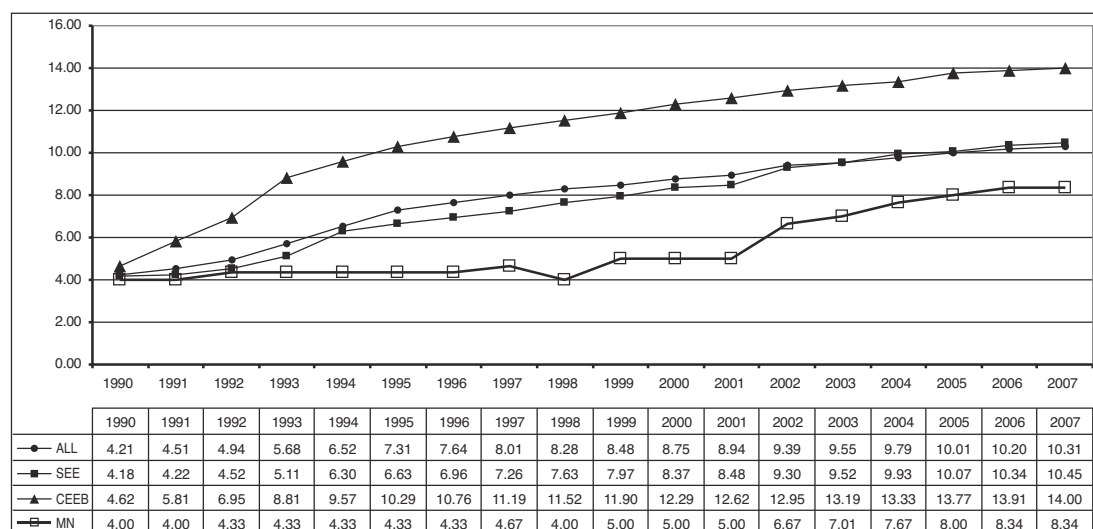
This kind of unbalanced progress in various sets of reforms recommended by transition schemes can be seen in a more transparent way in the following two graphs and tables.

Looking at the data and graphs presented it is easy to conclude that privatisation was advancing at a relatively high speed, particularly after 2001. Some deeper

Graph 2. Privatisation progress: sums of 2 EBRD indicators (1990-2007)



Source: EBRD (2008)

Graph 3. Institutional reforms: sums of 4 EBRD indicators (1990-2007)⁴

Source: EBRD (2008)

and more institutionally oriented reforms have moved on also from 2001 but at a much slower pace. For that reason the Montenegrin economy has achieved the level of privatisation which is equal to an average of all transition economies already in 2007 despite its late start (the Montenegrin score for privatisation equals 99.7% of the one computed for all transition economies and 86% of the one for CEEB). However, Montenegro is still considerably lagging behind the average level when deeper and institutional reforms are observed (80.9% of ALL and only 56.6% of the CEEB group). The questions that are interesting concerning such a progress are whether it appears in consequence of a wrongly chosen policy and whether this could be the only explanation, or whether there were some other forces that slowed down the entire reforming process. In answering these questions we have to detect what are the main forces which govern transition advancement and the speed of reforms.

Initial conditions and the speed of reforms

For a full assessment of transition progress in any country, as indicated at the beginning, one should look at the initial conditions and/or the inherited circumstances. The same could apply to the Montenegrin economy. We have seen that its start was late owing to purely political reasons and despite its faster accomplishment of some reforms like liberalisation and privatisation, the overall result is still relatively weak.

4. The four EBRD indicators being: governance and enterprise restructuring, banking reform and interest rate liberalization, securities markets and non-bank financial institutions, infrastructure.

If we re-count the EBRD indicators to a scale from 0-100% (instead from 9-39 as EBRD indicators suggest) we shall discover that Montenegro still faces a half-completed task. Namely, expressing the EBRD data in the form of percentage points we shall discover that 25.01 points in 2007 mean in fact 53.3% or 25.67 points in 2009 represent 55.6% of the desired goal which should be a developed market economy structure.⁵ Is it enough or were there possibilities for faster advancement of an economy like that of Montenegro?

In answering this question we have to think about initial conditions and to weigh up how initial conditions affect reforms in a transition economy. Actually, we have to analyse transition progress as an endogenous variable rather than to attribute the speed of reforms to the good faith and/or cleverness of policy makers.

As pointed out above there is a huge literature on the issue. However, for this analysis I shall try to present the model that I have already used together with a colleague of mine in some of our previous articles.⁶ In the table below (Table 1) I shall use three simple models that consider transition progress (TPROG) as measured by the sum of nine EBRD indicators, to be a dependent on (a) initial GDP per head in 1989, expressed in US\$ (GDP1989) according to purchasing power parity (PPP), (b) experience in market reforms (MREF), which is a dummy that assigns 1 to the countries that have conducted some market reforms during the era of socialist or communist led economy and 0 for the others,⁷ (c) number of years under communist rule (INST1, a variable initially used by de Melo *et al*, 1996) and (d) black market exchange rate margin (INST5) to capture macroeconomic distortions from the pre-transition period (which is also firstly used by de Melo *et al*, 1996). I shall present here the results for 1998 since it corresponds approximately to the transition period of the Montenegrin economy in 2007 because of its late start. By means of the OLS model we get the

5. The calculus is simple: one should extract nine points from the sum of EBRD indicators and relate it to 30 points that can be earned on the transition path. This way of expressing transition progress I have learned from Nuti (2008) and apply in various analyses (see: e.g. Cerovic & Nojkovic, 2008; 2009). The results are not that trivial since according to the EBRD methodology the picture could be brighter as countries were awarded nine points in advance though no reform was taken and implemented. In that way one can realise that by 2007 that is, 18 years after the start of transition reforms, there were only eight countries (28% of the 29 observed) that accomplished reforms by 75% or more, whereas among them only two countries were close to the 90% threshold (Estonia and Hungary) and one of them did just overstep the 75% line (Croatia). Thirteen countries were in the range 55%-75% in accomplishing reforms, ten of which are in the range 55%-65%. There were eight countries below 55%.

6. See the most developed version in: Cerovic & Nojkovic (2009).

7. The more profound market reforms were taken in few countries — in those that emerged from former Yugoslavia and in Hungary and Poland.

following estimates for the three regression equations within a set of 23 transition economies, whose necessary data can be found and are reliable enough:

Table 1. Dependent variable: TPROG (1998)

| TPROG 1998 | | | |
|-------------------------|------------------------|------------------------|------------------------|
| Variable | Equation 1 | Equation 2 | Equation 3 |
| Constant | 19.9226 [2.4328]*** | 34.1089 [3.6194]** | 24.0105 [2.1667]*** |
| GDP1989 | 0.0008 [0.0004]*** | 0.0007 [0.0003]** | 0.0009 [0.0003]*** |
| MREF | 4.1680 [1.9889]*** | | |
| INST1 | | -0.2232 [0.0501]*** | |
| INST5 | | | -0.0287 [0.0094]*** |
| R ² (%) | 32.7 | 58.8 | 43.8 |
| Adj. R ² (%) | 25.9 | 54.7 | 38.1 |
| DW statistics | 1.79 | 2.24 | 1.62 |
| N | 23 | 23 | 23 |

Note: standard errors in parentheses; ***denotes statistically significant at 1% level; **denotes statistically significant at 5% level.

We can see that all the three equations are significant and can explain transition progress to the extent that cannot be ignored in analyses (adjusted R²-s range from 26-55%) while all their variables are also highly significant (mostly at 1% level). It should be underlined that these results are not at all surprising. In another paper (Cerovic & Nojkovic, 2008) it was demonstrated that the proposed model holds for a sequence of years (2001, 2004, 2007) confirming that initial conditions do affect transition progress significantly and in the long run (moreover, their impact does not diminish necessarily over time, at least not beyond 2004). Hence, we can state that each model confirms the endogenous character of the variable TPROG or that this variable is indeed affected by initial conditions like development level, market experience and/or macroeconomic distortions.

Since the above analysis has shown that accomplishment of the entire set of transition reforms depends on initial conditions it would be challenging to explore whether the same could apply to those more complicated and more demanding reforms that we have called earlier the institutional ones. It could be reasonable to predict that this kind of change is even more influenced by initial conditions since they typically

determine many elements that could appear important in implementing new institutions like general level of knowledge of the inner meaning of reforms, general social attitudes towards social changes, and factual understanding of the consequences provoked by certain reforming activities. Moreover, Hoff and Stiglitz (2004, 2005) have shown that institutional changes are indeed endogenous that is, dependent on the overall circumstances of an economy in question.

For all these reasons we shall try to use the same models as above but shall change the dependent variable using now only those EBRD indicators that are predominantly institutional in character that is, the four previously defined indices on enterprise restructuring, financial system development and infrastructural reforms and name this variable as INPROG. In the following table (Table 2) the results of that analysis for 1998 and for the same set of transition economies are presented:

Table 2. Dependent variable: INPROG (1998)

| INPROG 1998 | | | |
|-------------------------|-----------------------|------------------------|------------------------|
| Variable | Equation 1 | Equation 2 | Equation 3 |
| Constant | 5.6701 [1.0496]*** | 12.2418 [1.6209]*** | 7.4526 [1.1797]*** |
| GDP1989 | 0.0005 [0.0002]*** | 0.0004 [0.0001]*** | 0.0005 [0.0002]*** |
| MREF | 2.2766 [0.8581]** | | |
| INST1 | | -0.1028 [0.022]*** | |
| INST5 | | | -0.0121 [0.0044]*** |
| R ² (%) | 46.8 | 64.9 | 47.7 |
| Adj. R ² (%) | 41.4 | 61.4 | 42.4 |
| DW statistics | 2.02 | 1.56 | 1.66 |
| N | 23 | 23 | 23 |

Note: standard errors in parentheses; ***denotes statistically significant at 1% level; **denotes statistically significant at 5% level.

It is immediately evident that the models perform even better when institutional changes are explored. The explanatory power of the equations is remarkably higher (from 41.4-61.4%) and the significance of all the variables has increased (except for MREF, but nonetheless it remains highly significant). As already remarked this is a not unexpected result since the level of development, market experience and macro-

economic stability do affect numerous additional factors that are essential in conducting reforms, particularly if they are more demanding in terms of expertise.

Here we can introduce another measure for institutional progress in order to avoid possible misinterpretation if we persist with the EBRD assessments and indices only. This new measure will be borrowed from Transparency International and is known as the Corruption Perception Index (CPI). Despite some subjectivity that may occur, since the index is based on individual estimations and perception that could be biased because of accustomed and/or learned behaviour which could prevent responders from judging the corruption level fairly, it is by no means a very frequently used indicator for the rule of law and its enforcement. It seems that it is of particular importance for transition economies since they have all been repeatedly warned about this kind of misbehaviour.⁸ For all these reasons we shall make use of our equations one more time and try to discover what would be the results when CPI becomes the dependent variable. The set of countries will remain the same but the only change will be the year of observation (1999) since this was the earliest year with available data on the Transparency International site. The results of this experiment are presented in Table 3 below.

Table 3. Dependent variable: Corruption perception index (1999)

| CPI 1999 | | | |
|----------|------------------------|------------------------|------------------------|
| Variable | Equation 1 | Equation 2 | Equation 3 |
| Constant | 0.9889 [0.4960]** | 4.0833 [0.6286]*** | 1.9626 [0.5237]*** |
| GDP1989 | 0.00035 [0.0001]*** | 0.00033 [0.0001]*** | 0.00036 [0.0001]*** |
| MREF | 1.1133 [0.4055]** | | |
| INST1 | | -0.0480 [0.0085]*** | |
| INST5 | | | -0.0067 [0.0020]*** |

8. The appearance of corruption is not that strange under transition. Under substantial social and economic changes that characterise the transition process and which very often are not supported by correctly designed institutional surroundings, the emergence of corruption can be anticipated. Unfortunately, this is to be analysed rather from the standpoint of insufficiently designed transition policies, schemes and recommendations in particular (speeding up privatisation and some other reforms without proper benchmarks) than from the standpoint of incorrect policies and/or misbehaviour on the local grounds of a transition economy, although this cannot be ignored either.

| | | | |
|-------------------------|------|------|------|
| R ² (%) | 59.4 | 71.9 | 64.8 |
| Adj. R ² (%) | 55.3 | 69.1 | 61.2 |
| DW statistics | 2.64 | 2.37 | 2.38 |
| N | 23 | 23 | 23 |

Note: standard errors in parentheses; ***denotes statistically significant at 1% level; **denotes statistically significant at 5% level.

Not surprisingly, the results did not change remarkably, although the explanatory power of the models as presented by the adjusted R squared is further strengthened (55.3-69.1%) and the significance of variables remains constantly high (all at 1% level except for MREF). In other words, the level of corruption is also mainly determined by inherited conditions including GDP level, market experience and/or macroeconomic difficulties, which should not be a great surprise. This result also speaks in favour of the idea that social changes cannot be enforced at one's will nor they can be brought about through social "engineering" but have to be patiently built and improved over time.⁹

After obtaining these results we may now apply them to the case of the Montenegrin economy and try to define what is its real position concerning transition progress and whether it differs (and how much) from an expected and achievable level in conducting reforms.

Initial conditions and transition in Montenegro

In analysing the economy of Montenegro one can explore observed delays in transition from two parallel standpoints. As said before and firstly, the Montenegrin economy is suffering from a delay that originated in the nineties and that appeared in consequence of the prevailing politics of that time, which were in essence hostile towards transition reforms. The other standpoint concerns the developments emerging from 1998 onwards, when analytical interest should be directed to the reforms taken during the past decade and to assessing whether they were fast and comprehensive enough.

9. Ironically enough, all these and similar arguments that uphold contemporary criticism of the "big bang" approach and over-accelerated reforms, including the idea of the impact of initial conditions on transition progress, have much in common with the well known, though easily neglected (both by the present-day reformers and the revolutionaries of yesterday) Marxian thesis on the relationship between "productive forces" and "relations of production". The point is that we could not change social relations and social order at our will unless the development level was high enough to provoke these changes, sustain and maintain them.

In discussing the delay from the nineties we may use our regression models in estimating the extent of the lag. Using equations 1-3 presented in table 1 we may easily calculate what would be an expected level of transition progress expressed by means of the sum of nine EBRD indicators (TPROG). For want of fully reliable data we shall approximately estimate the 1989 level of GDP per head in terms of PPP at US\$ 4000. As explained above the variable MREF should take the value of 1 while the values of the other two variables (INST1 and INST5) will be calculated from already mentioned original source (de Melo *et al.* 1997). According to the equations 1-3 we obtain the following values for TPROG: 27.3; 26.9 and 27.5 respectively. This is to demonstrate that the Montenegrin economy should have been able to achieve the level of transition progress that equals around 27 EBRD points already in 1998 if only it had had an opportunity to conduct reforms at an average pace (compared with other transition economies) and in line with its initial conditions. However, we have remarked that an opposite process took place and that it had moved back the country to the level of 10.67 or some 16-17 points below its estimated and potential grade.¹⁰

When Montenegro took a more decisive approach regarding its reforming policies, that is since 1998, it was shown that it had a persistent advancement in implementing the reforms which led the country to a level of 25 EBRD points in 2007. Presuming that this was a real or *de facto* initiation of necessary transition policies we may use the same models from above to estimate whether these achievements could be seen as satisfactory, having in mind the initial conditions as they were in 1998. This can be done since the models are based on the same length and the same phase of transition process (initial decade) but estimated for the countries that were earlier in their reforming activities (1989-98). For that reason we have to correct our data for initial conditions i.e. to re-estimate GDP per head in terms of PPP for 1998. We let this variable take the estimated approximate value of US\$ 2600¹¹ and have done a little correction in INST5 but the latter adjustment appeared to have a negligible impact on the overall result.

After modifications have been made we may estimate the new results. In compliance with the equations 1-3 in Table 1 we conclude that, according to initial conditions from 1998, the expected level of transition progress in Montenegro in 2007

10. I have demonstrated in the project mentioned in footnote 1 that this delay may be responsible for a substantially lower level of GDP per head in the Montenegrin economy in 1998. If seen as a dependent variable of initial GDP (GDP1989), TPROG, MREF, average inflation and some other variables it appears that it could be from 2.7 to 3.0 times higher than real GDP per head in 1998 in current US\$ (or around US\$ 3400-3500).

11. In calculating this value of the GDP *per capita* in PPP terms we use the estimated level for 1989 (US\$4000) and adjust it by means of the estimated GDP *per capita* index for 1998, which is 65 (EBRD, 2008).

(expressed by the sum of nine EBRD indicators) could be: 26.3; 25.4 and 26.3 respectively, which is somewhat above the real achievement (25.01) or approximately around 2-5% higher.¹²

However, this result, which does not differ much from the progress actually attained, requires a certain amount of additional care. Despite the fact that the level of GDP had considerably diminished during the nineties it cannot be assumed that this deterioration has changed all connected factors that could affect reforms and for which the GDP variable stands. Namely, the GDP level is to represent a series of corresponding variables like knowledge, understanding of reforms and so on, which are not that changeable in such a short period of time.

For that reason, in re-thinking our calculations it would be wise to stay with the GDP per head level that was achieved shortly before, i.e. in 1989 and estimate the potential level of reforms according to that figure. In that case the result should change and we shall have the same result as for the first but lost decade of the nineties or we may state that an achievable transition progress in Montenegro in 2007 should be at the score of 27-27.5 in terms of EBRD points or around 11% higher than the attained one. Consequently, we may state that the reforms in Montenegro could have been somewhat faster and/or deeper than they actually were.

A similar procedure can be used in assessing institutional developments. Applying equations 1-3 from Table 2, we shall obtain the following values for institutional progress: 9.27; 8.45 and 8.80 respectively –if calculated with the GDP level from 1998 or 9.99; 9.22 and 9.54– provided the GDP level from 1989 is used. However, in both cases the values obtained are higher than the achieved progress assessed by the EBRD at 8.34, confirming our previous conclusion that institutional reforms are lagging behind other transition economies with similar initial conditions. Since I have already stated why the latter version should be more realistic and more reliable it transpires that the delay in institutional reforms can be roughly considered to be in a range of from 9.5-14.4% that is, for this margin below attainable progress.

Finally, the same method of reasoning can be employed in estimating the alternative measure for institutional development used in this paper — the CPI. Using equations 1-3 from Table 3 we realise that the values of the CPI for Montenegro could be expected to be: 3.5; 3.1 and 3.4 respectively (based on the GDP level from 1989). Since the real value of CPI for Montenegro in 2007 was 3.3 and in 2008 was 3.4 (note that the model covers eleven years from the transition starting point) we may

12. It is worth noting that the *Economic Reform Network*, a non-government organisation in Podgorica, gathering experts from various fields and using allegedly the same EBRD methodology, has attributed to Montenegro 24 points as the sum of nine EBRD indicators already in 2003, obviously expressing rather its enthusiasm for reforms than neutral expert observation and analysis (ERN, 2003).

conclude that although it is low, still it is approximately at the level predetermined by the inherited conditions or is somewhat lagging but for a tiny margin.¹³

However, all data and all estimation done in this section show that despite an already long period of 10-11 years of broader transition attempts and reforming activities, the economy of Montenegro is still somewhat below the level that could be expected. Moreover, this is to confirm that there are certain possibilities and chances for further improvement, particularly in the field of institution building and institutional adjustments.

Conclusions

Montenegro has travelled along a very specific transition path. Its initial position was favourable for conducting reforms and was in front of all observed groups of countries including the most successful countries from CEEB. However, this encouraging position had deteriorated over the nineties and transition had to be restarted by the end of the decade. The reasons for this decline could be found in political factors, including the Montenegrin position in the union with Serbia, which is the only country that has displayed similar developments.

Since 1998-99 Montenegro has demonstrated more decisive policies in reform implementation. For that reason it has reached the average level of transition progress of the entire set of transition economies in a comparable period of time and in some activities is found in front of them. When observed from this standpoint the Montenegrin transition reforms could be assessed as successful so far. On the other hand, as in many other transition economies, reforms concerning privatisation and liberalisation were much faster and appeared easier than the ones connected with institution building and institutional improvements.

However, transition progress is an endogenous phenomenon and depends on the inherited conditions of a country. Analysed from that standpoint it could be claimed that despite its late start the Montenegrin economy has preserved some initial advantages but did not succeed in exploiting all of these potentials. According to the analyses conducted in this paper we may conclude that it is still lagging behind its estimated level of reform advancement when inherited conditions are taken into consideration. Since the present lag is not particularly remarkable the results obtained could be a useful guideline for the policies that should be taken in future.

The basic problem and the primary task in further reforms could be summarised as the need for deeper restructuring and faster institution building. Since institutional advancement should also be treated as endogenous in character we have identified

13. It should be noted that in 2009 the value of CPI for Montenegro came forward to the level of 3.9, ranging from 3.5 to 4.4 (Transparency International, 2009).

the biggest delay in this set of reforms when it was analysed according to the inherited conditions. The importance of this finding is in the fact that institutional delays and lags could prevent exploitation of benefits from privatisation and liberalisation achieved so far. For that reason the most important future policies should be laid in the field of institutions and their improvements and the main efforts of local policy makers should be directed to achieving the accessible level of institution building.

Appendix

In order to help the reader to follow the basic lines of argument I shall briefly present the principal ideas of the EBRD transition indicators that are widely used in the paper. The set of eight indicators has been established and regularly published in the EBRD annual issue –*Transition Report*– since 1994 in order to present the assessments and judgements made by the EBRD’s Office of the Chief Economist. The indicator values range from 1-4+ while the refined scale that includes plus and minus signs indicating assessments that are on the borderline of four standard categories was introduced in 1997. Later on the entire series from 1989 onwards have been reconstructed and are available through the EBRD web site. For quantitative analyses the EBRD transforms this scale so that pluses and minuses value one third of a point (rounded at +/-0.33). The set of eight indicators (also called indices) include assessments for the following reforms grouped in three classes:

Class I: *Enterprises* that includes (1) Large-scale privatisation, (2) Small-scale privatisation, (3) Governance and enterprise restructuring

Class II: *Markets and trade* that includes: (4) Price liberalisation, (5) Trade and foreign exchange system, (6) Competition policy

Class III: *Financial institutions*: (7) Banking reform and interest rate liberalisation, (8) Securities markets and non-bank financial institutions.

Later on (from 2002) the fourth class or ninth indicator is in use: (9) Infrastructure or infrastructure reform that is a compound assessment for the reforms in the following industries: electric power, railways, roads, telecommunications, water and wastewater.

All the indicators are in frequent use in transition analyses (to my knowledge first used extensively in Sachs, 1996) and represent the most comprehensive set of information regarding transition progress. On the other hand the methodology is also frequently criticised since the basic ideas behind the indicators are mainly relying on neo-liberal doctrines. Recently their consistency was also questioned (Babetskii & Campos, 2007). The other critique concerns the scale for assessing transition progress that starts from 1 for no or zero change, as discussed in the paper. The basic methodological issues could be found through the EBRD web site.

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