5. Explaining the output fall.
Real GDP trends in transition economies after liberalization

- China 1983=100
- Poland 1989=100
- Romania 1989=100
- Latvia 1990=100
- Russia 1991=100
Countries recovering after an initial output fall

- Hungary 1989=100
- Poland 1989=100
- Slovenia 1989=100
- Czech Rep. 1990=100
- Slovakia 1990=100
- Croatia 1991=100
- Estonia 1991=100

GDP index vs. number of years after liberalization.
Countries experiencing an initial output fall and uncertain recovery

- Bulgaria (1990=100)
- Romania (1989=100)
Countries experiencing a very strong output fall and a slow recovery

GDP index

Latvia 1990=100
Lithuania 1990=100

number of years after liberalization

Latvia 1990=100
Lithuania 1990=100
Countries experiencing a continuous output fall

GDP index vs. number of years after liberalization for Russia (1991=100), Ukraine (1992=100), and Belarus (1991=100).
• Output fall after big bang liberalization. Why?
Explanations for output fall.

- Statistical illusion due to underreporting of private sector (Berg and Sachs, 1992) or overreporting under socialism (Winiecki, 1991; Aslund, 1994).
  Problems: more underreporting under communism, in FSU rise of hidden economy came later; in Poland and Hungary, overreporting not issue since mandatory planning had been abolished.

  Problem: Russia had no excess stabilization!
• Contraction faster than expansion (Gomulka, 1992; Kornai, 1993)

Problem: few signs of excess contraction in declining sectors except in East Germany, rather across the board falls in output.

• Credit crunch (Calvo and Coricelli, 1992).
  Yes, but interenterprise arrears and continued soft budget constraints.

• Labor market frictions (Atkeson and Kehoe, 1995).
  Problem: unemployment came after output fall.
Most plausible explanations.

Wei (1995): transformation of single monopoly into multiple Monopolies => higher prices and lower quantities because upstream monopolies do not internalize downstream externalities (higher prices of input downstream lead to higher prices and lower sales compared to single vertically integrated monopoly.)

Assume enterprise has 2 suppliers, pays price of 50 to each and sells at 150 with profit = 150 –50 –50 = 50. Assume indivisible technology (if one supplier leaves, output = 0). Say one supplier has outside option of 100 => ends the contract. Total surplus gain: + 50 –100 = -50.

With efficient bargaining, supplier could be brought back but his outside option may not be verifiable. Under asymmetric information, would have to pay 100 each (infeasible).
Roland and Verdier (2000): liberalization is freedom to change contracts. Firms search for new partners. If investments are specific to the partnership, investment takes place only once new long term partners are found. In the absence of established markets, search can take time.

Dual-track liberalization avoids the disruption while allowing for search for new partners.