March 20. The Transition from Plan to Market in the Formerly-Centrally-Planned Economies
• Definition of *economic transition*: moving from a centrally planned economy to a market economy.
iClicker question: which of the following are essential for a smoothly functioning market economy?

• A. A functioning price system
• B. Sound and stable monetary and fiscal policies
• C. Private enterprise
• D. Strong regulatory and legal institutions
• E. The first two
• F. The first three
• G. All four
Thus, transition entailed:

A) liberalizing prices (letting them move so as to balance supply and demand).
B) stabilizing macroeconomically (halting inflation, limiting the volatility of the exchange rate, reducing the budget deficit).
C) privatizing state enterprise.
D) building the legal and institutional infrastructure needed to support the operation of a market economy.
Transition was a huge shock even by the standards of the Great Depression

– On average, real GDP fell by a cumulative 20% in first three years of the process.

– In some countries, measured output fell by as much as 50%.
• Human costs were substantial (rise in mortality rates, fall in life expectancy in Russia, increase in poverty rates across the region).
• Notice how poverty rates rise in EE and CA between 1990 and 1998, while falling everywhere else.
iClicker question: why was the post-1989 drop in output so dramatic?

• A. Stabilization, liberalization and privatization were implemented too slowly.
• B. Stabilization, liberalization and privatization were implemented too rapidly.
• C. Neither A nor B, because the drop in output was a figment of the data.
• D. Neither A nor B, because it was not current policy strategies but preconditions (the historical inheritance) that determined outcomes.
How painful was the adjustment?

• While growth had resumed in 14 of 26 transition economies (TE’s) by 1995, at that point the level of output was some 40% below 1989 levels.

• Although growth had resumed in 20 of 25 countries transition economies by 1998, in only 3 of them (Poland, Slovakia, Slovenia) were 1989 levels of output been regained by the end of the 1990s.
  – Russia, the largest economy in the region, managed to match pre-transition levels of output only in 2001.

• This implied very significant negative impacts on living standards.
But should we believe what we see?

• Shouldn’t we question the 1989 data?
  – Relative prices were distorted. Productivity was therefore overstated. Much previous production was shoddy or of interest only to the military.
  – In the 1990s unofficial – and unrecorded – economic activity grew very quickly as enterprises became tax paying rather than subsidy receiving (reversing their previous incentive to over-report production)
    • The relatively modest decline in electricity consumption (a standard measure of the sum recorded and unrecorded activity) is consistent with this.
    • The Russian statistical agency still adjusts reported output upward by 25 per cent to “adjust for” unreported activity; maybe accurate number for this early period was as high as 40 per cent.

• Share of residents in the region with radios, televisions, refrigerators, washing machines, vacuum cleaners and cars all rose in the course of the 1990s, which is hard to square with falling living standards.
• In any case the preceding discussion is too sweeping, in that it misses large variations within the region.

• In particular, macroeconomic performance was better in Central Europe and the Baltics than in the Commonwealth of Independent States (former USSR minus the Baltics).
• In what follows it will be useful to distinguish three phases of the transition:
  A) the initial collapse of output,
  B) stabilization
  C) the subsequent period of growth
• And to analyze the role of various factors separately in each.

  – Recall how we similarly made progress on understanding the Great Depression by similar dividing and conquering.
Why did the severity of the output collapse vary?

• The obvious candidate explanations are:
  – Initial conditions
  – Timing and success of stabilization
  – Timing and success of liberalization and privatization (more broadly, what we might think of as structural reform)
This brings us to the debate over the merits of gradualism vs. big-bang reform

**Big Bang logic**
- Reforms are complementary
- Stabilizing or privatizing without liberalizing prices prevents rationalization of production & reorientation to the market
- Liberalizing prices without stabilizing leads to hyperinflation, distorting price signals
- Liberalizing and stabilizing without privatizing removes incentive for managerial response

**Gradualism logic**
- Throwing economy open to international competition drives out even viable enterprises.
- Precipitous liberalization starves viable industries of credit. Subsidies enable them to keep producing and prevent loss of productive capital
- Subsidies require budget deficits & inflation until a viable tax system is put in place
- Privatization is politically delicate and time consuming. Quick privatization is infeasible. And if tried, the results will be undesirable
So what does the evidence suggest?

- Alas, it doesn’t speak unambiguously...
Timing and success of stabilization doesn’t matter clearly, although some might read this as saying early stabilization is better

- True, we see a bigger drop in output in early stabilizers (where the monetary and fiscal tap was closed), but we also see an earlier recovery.
  - It is as if “You can pay me now or you can pay me later.”
- Not obviously possible to reduce the costs of stabilization by delay (though you can certainly affect the timing of those costs).
  - So timing (rapid vs. slow stabilization matters for the incidence of the costs – short, sharp pain vs. dull, drawn-out ache) but not for the overall amount of pain.
Timing and success of structural adjustment seems to have clearer implications

- But where the timing of stabilization has an ambiguous impact on total costs, the implications of early/rapid structural adjustment seem pretty clear.
- Early structural adjustment seems to be associated not just with a relatively early drop in output and early recovery (which is what we saw for stabilization), but it is pretty clear that it minimizes the transitional output losses.
- This inclines me weakly toward the big-bang school (that the problem was that reformers didn’t move faster).
But timing is not all that mattered. Initial conditions also mattered

- The more distorted an economy was at the outset of the transition, the larger the initial output fall.
  - Here initial distortions are measured by a complicated index.
  - But you can obtain the same thing by just looking “years under communism” or “distance from Frankfurt.”
• So what we have seen is that whether countries proceeded rapidly or gradually, they all ended up at more or less the same place once the process was complete.
• What was important was completing the process – following through with comprehensive reform.
• So perhaps what really mattered was the implications of the two strategies for political support and reform sustainability.
Maintaining political momentum for reform: both camps argued that their approach was better for achieving this

**Big Bang**

- Proponents of the big bang approach could argue that their approach was best for maintaining political support, since it promised an early return to sustained growth (although, more problematically, it also augured a more serious initial recession).
- They also argued that reformers needed to capitalize on the brief period of “extraordinary politics”
- They further argued that speed can prevent special interests from mobilizing to block reform

**Gradualism**

- Proponents of gradualism argued, in contrast, that going slow minimized the initial output drop.
- It also allowed the public to learn about the benefits of reform over time (although, more problematically, slow reform in this case meant an extended recession).
What does the evidence say about maintenance of political support?

• There were indeed many cases of ambitious reformers who lost elections and were thrown out of office (Lithuania, Poland, Hungary, Bulgaria, Estonia, Latvia)
• But there are also many cases of nonreformist governments that got thrown out of office
• Somewhat disappointingly for the preceding debate, empirical work finds that there was essentially no correlation between the speed and ambition of reform and probability of winning reelection.

– Steve Fish in our political science dept. has done interesting work on this...
More than the pace of change, the nature of the political system matters for reform

- Broad-based (encompassing) coalition governments appear to have been better at sustaining reform
- In addition, greater political competition (measured a frequency of government change) is positively associated with reform.

- The next two figures show these two points in turn...
And what countries quickly acquired competitive, encompassing political systems?

- The answer, to a first approximation, is: those countries that had them before.
  - Countries basically put back in place their pre-WWI, pre-Communist political systems.
  - Where these had been open, encompassing (proportional representation) systems, better policy outcomes (sustained support for reform) results.
    - Another example of how history casts a long shadow...
Privatization as a strategy for locking in reform

- This was Russia’s (post-1992) strategy. Sought to create reformist constituency. Privatized 70% of the economy by the end of 1994.
- Prior to 1995 election (which the Communist leader, Gennady Zyuganov, was expected to win), Yeltsin secured additional resources for the government (and for his campaign) by the now notorious loans-for-shares scheme, where natural-resource based enterprises were turned over to industrial groups in exchange for loans to the government.
- Then these same parties acquired additional property through insider dealing, by exploiting liquidity constraints, etc.
- For all these reasons, property was acquired by the former Nomenklatura.
- Fears that privatization would be temporary and inability to quickly create political and legal checks and balances led to asset stripping by new owner/managers.
- Precipitous, unequitable privatization, it can be argued, ended up undermining support for reform.
- It also encouraged consolidation across sectors (as large enterprises have used windfall profits from high oil prices to buy undervalued manufacturing assets – in the automotive sector for example – creating opaque ownership structures).
Factors undermining legitimacy and efficiency of Russian privatization

• Russia rushed to capitalize on period of exceptional politics. Shortcuts were taken, favoring insiders (In Russia, ownership of 15,000 enterprises was transferred in 1992-4, mainly to insiders.)
• Insufficient time to create needed regulatory and legal structures
• Outsiders have therefore been reluctant to purchase shares on the secondary market
• Shareholder rights were weak
• Budget constraints were soft
• Valuation of state enterprises was intrinsically difficult
Successful privatizations

• Unlike Russia (where insiders profited) and Czech Republic (where precipitous privatization allowed incestuous relations to develop between banks and corporates/specifically, under state pressure banks have continued to extend credit to poorly performing firms, and investment funds have been reluctant to pull the plug on friendly mangers), other countries have successfully privatized
  – Examples include Poland, Hungary, Slovenia, and the three Baltic countries

• They relied on a series of transparent one-off auctions after taking sufficient preparation time.
Further lessons of transition experience

• Growing recognition that liberalization, stabilization and privatization are not enough.
• Growing appreciation, in other words, of the need for reliable institutions of contract enforcement.
• Growing awareness of the need to control corruption, cultivate respect for the rule of law, strengthen shareholder rights.
Who Made the Most Progress in the 1990s at this Kind of Institution Building?

- Answer: Central European countries with:
  - the most experience with market capitalism
  - the fewest years under Communism
  - the earliest liberalizations
  - the most success at small-scale privatization
  - the greatest reliance on trade
  - and the closest connections to the European Union.
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So what does this tell us about how to encourage Institutional Development?

– History matters (prior experience with the market is important).
– Where a competitive market economy is created, firms will press for adequate regulation, competition policy, auditing and accounting standards.
– Extensive small scale privatization therefore encourages institution building.
– Also important should be exposure of domestic producers to relevant institutions (i.e. via foreign trade).
– External incentives (lure of EU membership) has been important in Eastern Europe.

  • Next 3 slides illustrate some of these points...
Chart 2.12

Institutional reforms and exports to the West

Sources: EBRD and IMF Direction of Trade Statistics.

1 Supporting institutions are defined as the average of the transition indicators for the following categories in 1999: competition policy; enterprise reform and corporate governance; banking sector reform; securities markets; overall legal extensiveness and effectiveness; infrastructure (average of telecommunications, railways and electric power).

Bottom Line

- Speed of transition is secondary; consistency (sustaining reform, following through) is what matters.
- Political openness and contestibility make it more likely that the government will sustain reform and follow through.
- Institution building is important, although this is the aspect of economic development and reform that we know least about.

Nicholas Crafts and Christof Ruehl, in an article written for the EBRD, compare institutional quality (as measured by the International Country Risk Guide) in the TEs with that in Western Europe, Japan and East Asia when the latter began their post-WWII growth spurts. As these authors measure them, the CEEC-4 appear to have equally high quality institutions, whereas other TEs (such as Russia) do not.*

- This suggests that the CEEC-4 should be able to close the gap vis-à-vis Western Europe by growing at 4-5 per cent per year (although several decades will still be required). Other TEs, including Russia, will require additional institutional reform before this is feasible.