Economics of Transition

A new methodology for transforming a socialist economy to a market-led economy and sketches of a workable macroeconomic theory

Hüsnü Kızılyallı

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HUSNU KIZILYALLI
Professor of Economics

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Preface

Judging from economic and political results, the transformation process in Eastern Europe and the former Soviet Union has not been successful in general. Partial, ad hoc or 'big bang' type approaches applied without even roughly estimating the implications of reform measures have yielded unsatisfactory results.

Transformation experiences in general have resulted in big drops in output, high or hyper inflation, high and rising unemployment, large balance of payments (BOP) deficit or extreme foreign exchange shortage, slow pace of enterprise restructuring and privatization, unsatisfactory growth in private sector and foreign direct investment, grand uncertainty about economic and political prospects and pessimistic expectations.

Even under the 'big bang' approach, with open and free trade and exchange regime and with zero or near-zero tariffs, importation of world prices has not materialized, either because of the foreign exchange shortage (overly undervalued domestic currency and inadequate import penetration as a consequence, despite a liberal trade regime on paper) or because of monopolistic market structure, despite and along with an overvalued currency (when external aid inflow was sufficient). Moreover, when the economy is in a state of flux and every market is in disequilibrium, with high-or hyper-inflation and grossly negative real interest rates, it is not possible to claim that the market rate of foreign exchange (either reflecting extreme shortage of foreign exchange or used as a nominal anchor to reduce the rate of inflation) is the true market clearing rate. The market rate of exchange on one hand reflects still distorted domestic relative prices, and on the other it is either clamped down by additional external borrowing (the Polish case) or inflated by the government to raise extra revenue (the Russian case).

The market socialism experiments have not been successful because the process of economic planning was abandoned, while an inadequate market system (partial price reforms affecting commodity markets only, absence of money, and capital markets, and proper taxation systems, *without private*

property rights and entrepreneurship) was instituted. Although this experiment probably helped Hungary perform better in relation to other reforming countries, after the 1990 reforms, while also compared with Poland. In the 1990 reforms, the gradual approach also have possibly yielded better results (examples of Hungary, Czechoslovakia and China) compared with the 'big bang' approach which rather proved to be less successful (example of Poland) or chaotic (Russian example). Contrast between Russian and Chinese experiences is striking; China achieving almost 10% real economic growth and reduction in poverty in the last decade under gradual dual track approach, and Russia ending up in hyperinflation and with impoverishment of large masses and large output/employment losses.

A new method developed herein allows estimating the correct exchange rate based on world prices and under conditions of macroeconomic equilibrium. It also provides a planning methodology for sequencing market reforms, so that macro balances are kept throughout. The method, along with giving the estimate of foreign exchange rate, will provide forecasts of possible outcomes of reform measures, and hence enables planning accordingly. It adopts a comprehensive approach and provides both price and trade reform with immediate effect, but also allows sequencing the reforms in a coordinated manner and in the light of economic, social and political realities. It combines the 'big bang' approach (to price and trade reforms) with gradualist approach to enterprise reform and privatization. Its prerequisites are establishment of a market infrastructure with its basic institutions, banking reform and creation of an effective taxation mechanism with sales and income taxes.

In the second part of the book basic reform issues, such as market socialism experience, the soft budget constraint, enterprise reform and restructuring, privatization, high inflation, dollarization, etc. are reviewed in separate chapters or sections. The reform experiences of the former socialist countries, particularly of Poland, Hungary, East Germany, China and the former Soviet Union are reviewed and evaluated.

In the third part of the book, in the context of the theoretical foundations of the reform programs, developments in the macroeconomic theory in the last 2-3 decades are reviewed, from the viewpoint of reforming and developing countries, particularly in addressing their inflation, unemployment and growth problems. In particular, the neoclassical and new Keynesian theories, the Phillips curve hypothesis and crowding-out effect of government budget deficits are looked into, both as a theory (their economic logic, causal relationships, validity of their assumptions in the real world, etc.) and in practice, i.e., outcomes of policies shaped under these theories, and empirical findings in macro-and micro-economic studies, related to their economic rationale or assumptions. It is concluded that both neoclassical and new Keynesian theories fail to provide an economically meaningful framework for

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analysis of current economic and unemployment problems, nor for their cure. These theories and their assumptions are not confirmed and validated by empirical findings or outcomes of policies prescribed under them. On the contrary, there is ample empirical evidence to reject these hypotheses and/or their basic assumptions. Despite these facts and failure of these theories in the analysis and explanation of modern economies and their problems, all policy recommendations, particularly those recommended to the reforming or developing countries are still based on these unproven theories or hypotheses, such as the Phillips curve trade-off, supply-side economics, laissez-faire policies of monetarism or neoclassical theory, etc.

It is shown that the Phillips curve does not exist both in theory and practice. The empirical evidence suggests that the Phillips curve not only does not exist, but is positive in the long run, i.e. wage/price inflation reduces output and employment in the long run. Paradoxically, the trade-off may emerge, when strict price stability record is attained, but even then expansionary policy leads to more output increase than employment increment and which might well be explained by the aggregate demand increase under the standard Keynesian analysis, without recourse to the Phillips curve hypothesis. It is empirically observed that the real wages do not change over the business cycle, wage increases do not lag behind price increases and that the aggregate demand increase when leading to the inception of night shift operations rather affects output than employment. All these facts refute the basic premises of the Phillips curve trade-off.

It is also observed that the crowding-out effects of sizeable and systematic budgetary deficits (particularly on current account) on output, saving and investment are negative and significant. It turns out that the budgetary deficits do not promote but retard economic growth.

For developing and the reforming socialist countries (even tentatively for the industrialized countries), it is concluded that the best policy in addressing unemployment and growth issues, is to observe strict price stability, balanced budgets and reducing consumption, if necessary by additional tax effort. A new Marshall plan both to assist in the transformation of reforming former socialist countries and help with the unemployment problem of the industrialized countries would achieve this aim if financed by sound means, i.e. mainly by additional taxation, since capital is and will be in short-supply worldwide in foreseeable future despite a virtually stagnating world economy in the last decade.

The potential output is an illusory concept, based on the unemployment rate rather than on the actual capacity of existing production facilities. The latter reflects the correct potential output (because part of output decline in a recession or stagflation could be explained by a drop in the competitive productive capacity due to declining industries, competing imports and de-

industrialization), variation of output around the former or change in the number of shifts worked in the manufacturing industry is construed as physical evidence of output fluctuations and business cycles. While with rising costs, etc., overutilization of capacity cannot continue indefinitely, its ending may coincide with disinflation policy and then it will be interpreted as the stagflation costs of disinflation; whereas it means returning to the normal level of output.

Moreover in overutilization of capacity and night-shift operations, it is empirically verified that output increase far outweighs employment increase and it is not the wage inflation or any wage-cost advantage inherent in it (in fact overtime and night premiums paid to labor rather constitute a wage-cost disadvantage) that induces firms to operate late shifts, but rather considerations of utilizing the existing production facilities better and thus possibly reaping economies of scale, that entice firms to overutilization of capacity.

The flexible exchanges rates have increased instability and uncertainty worldwide. Volatile movements of exchange rates have increased risks of capacity creation in exporting sectors. Increase in domestic interest rates, to curb inflationary tendencies by leading to capital inflow, have caused appreciation of the currency, which in turn leading to lower exports and higher imports, eventually have resulted in a lower output than originally planned. Hence output might decline even below the potential level, as a result of disinflation policy, because of flexible exchange rates; and this would not have been possible under pegged or stable exchange rates.

The flexible exchange rates have become a major source of instability, by allowing countries with inflationary tendencies and policies, to abandon fiscal and monetary discipline and rely on exchange rate to redress BOP problems by successive devaluations (i.e. through floating the rate). In case of high inflation economies, this policy has accelerated the inflationary process through continuous supply shocks (cost-push effects) generated. The other extreme opted for is to maintain the rate stable for long periods, irrespective of the domestic price developments, to control and check the cost-push effects and thus reduce the inflation rate. This alternative is more destabilizing, because it leads to accumulation of sizeable short-term external debt and generates expectations of devaluation at a higher rate in the future. Along with developing countries, the reforming countries as well are now employing either policy. Both of these policies are just palliatives, since they don't address the real causes of domestic inflation by means of fiscal and monetary discipline.

The aim of this book is to study the economic problem (transition, inflation, unemployment, growth and development particularly), without any preconceived idea or prejudice and recommend solutions accordingly. The author subscribes to no general school of thought, new Keynesian, neo-classical or Austrian, but believes that under certain conditions (in certain periods of certain countries) one of them may hold true.

Moreover the book attempts to look into the current economic problems combining both the short-run (stability) and the long-run (growth and development) aspects. Although 'in the long run we are all dead', the seeds of future are sown today. In reality, it is not possible to separate and isolate the long run from the short run. This obvious fact, however, deliberately or by ignorance is overlooked by governments in general and they try to solve the current apparent problem by sacrificing the long run (at a huge future cost). However the long-run and the short-run are interwoven and interdependent; and ignoring the long run implications of short-term economic decisions has, in fact, become the main cause of the current economic problems.

Except for a general war or a major technological breakthrough like the discovery of a cheap source of energy, it is possible roughly to predict economic prospects of developing and industrialized countries, in the next 5-10 years, under the present policies (except for major, drastic policy changes). On the basis of current policies and prevailing stagnating or declining trends, one can safely claim that, except for Far East, (which would be better off), these countries would not be better off in general and some would be worse off; and the unemployment problem will definitely get worse. Although all this is quite obvious, and shows that today shapes the future and there is no other future than the one which is the result (function) of current trends and policies, policy-makers and economists alike still distinguish between the short run and the long run. An economic policy prescription or package should not divorce the long run from the short run; preoccupation with the short run, however, seems to be the standard practice during the last 2-3 decades and nowadays.

As a matter of fact, in government decisions, the long-run considerations are either not weighed properly or completely ignored. A way out of this dilemma might be setting up an independent or autonomous economic administration mechanism, although financial system (taxation and budgets) would still be shaped and decided upon by the executive and legislative branches of the government. In practice, such a mechanism could be put in place by an independent central bank and a charter for financial/economic affairs and a semi-autonomous economic planning (indicative) machinery (in countries where politically it is admissible); this mechanism will see to it that the long-run considerations also count in current economic decisions.

Since the subject matter of this book is applied economics, consistent unequivocal positions have to be taken on specific issues, even risking error, provided that the real economic world is firmly identified, validity of assumptions are verified and acceptability/admissibility of basic hypothesis are firmly established; because in policy-making and economic planning ambiguity and vagueness complicate issues, lead to inconsistencies and frequent policy reversals, and cause uncertainty or even chaos. Nevertheless, policies and

measures that turned out to be harmful or useless, should be corrected in good time and in a consistent manner.

The correct approach in economic policy making requires proper diagnosis of the economic problem to be dealt with, and identification and verification of actual conditions surrounding it. Whereas in most instances, particularly in developing and even in certain reforming countries, policy package derived from the standard or novel theory is readily applied, without making sure that the hypothetical conditions assumed are valid for the case to be treated. In this sense, it is still not understood that there is no unique solution to even the most common current macroeconomic problems. E.g., nowadays in high inflation countries it is fashionable to use privatization proceeds in financing the budgetary deficits on current account with a view to checking inflationary growth and a lower inflation rate thus achieved (which is a short-term phenomenon anyway) is treated as a big success, while the real remedy, the genuine tax reform is being only paid lip service.

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