

EC330-3-SP – Lecture 5

Transition Strategies: Big Bang vs Gradualism

Alexander Mihailov

University of Essex

Plan of talk

- **Introduction**
 1. Initial conditions before transition started
 2. Transition: definition, objectives, constraints, strategies
 3. Stylised facts about key country experiences
 4. Gradualism vs big bang: a model on the trade-offs
- **Wrap-up**

Aim and learning outcomes

- **aim:** understand
 - how transition can be defined and analysed
 - what the trade-offs are in opting for a transition strategy (big bang vs gradualism)
- **learning outcomes**
 - discuss the legacy of central planning in the light of differing or similar initial conditions of transition paths
 - describe the objectives and constraints of transition and the debates and policies that have been implemented
 - analyse and compare the outcomes of these debates and policies, as they were reflected in the reforms launched in, and the data gathered for, the transition economies
 - provide a theoretical perspective on the stylised facts of transition

Initial conditions of the (classical) socialist economy: a general summary

- **no markets:** the price system (completely) absent
- **plan** instead: allocation of goods by the planning administration
- **no autonomous enterprises:** told what to produce, from whom to buy and to whom to sell
- hence, **distorted structure(s)**
 - bias to (heavy) industry (overdeveloped) vs services (“unproductive”, Marx) – Roland, T.1.1, p. 6
 - bias to large vs small firms – Roland, T.1.2, p. 7
 - bias in output mix and quality originating in an incentive structure that maximises plan indicators (and, hence, costs...)
 - inefficiency in *real* behaviour: Nove (1958), glass planned in tons (too thick and heavy), then in square metres (too thin and fragile)
 - inefficiency in *financial* behaviour: Kornai (1980), soft budget constraints

Initial conditions in real-world socialist economies: (certain) diversity

- **Central Europe**
 - GDR: a “success story” of orthodoxy
 - Hungary: 1956, gradual changes since 1968
 - Poland: 1979-1980 crisis (martial law), 1989 shock therapy
 - Czechoslovakia: 1968, “normalisation”, velvet revolution
- **Eastern Europe**
 - Yugoslavia: “market socialism” since 1965
 - Albania, Bulgaria, Romania: essentially, no much reform
 - Estonia, Latvia, Lithuania: 1939 in USSR, 1991 out of USSR
- **USSR**
- **non-European** (formerly) socialist economies
 - Ex-Comecon members: Cuba, Mongolia, Vietnam
 - Recipients of assistance from USSR: North Korea, Laos
 - China: the dual-track system since 1979

No guidance from theory (nor from previous experience)

- **unpreparedness** of the economics profession
 - early literature was largely verbal, aimed at giving *advice*
 - but Western advisers were only equipped with theories of *macroeconomic* stabilisation and with some experience with reforms in *developing* countries
- whereas *transition* should be understood as a multi-dimensional process of a **large-scale institutional change** of “marketising” *centrally planned* economies
 - a major challenge was that complementary reforms had to take place without creating too much economic disturbances, as the economy must continue to function: as if “changing the engines of a plane while it keeps flying” (Roland, 2000)

An economic system

- is characterised by **5 building blocks** (Kornai, 1992, 1998)
 - political system
 - dominant ownership structure
 - dominant mode of economic coordination
 - incentives
 - market situations
- therefore its **sustainability** as well as **transformation** *cannot* be separated from the political sphere:
 - “economic interests as shaped by incentive structures and allocative mechanisms translate, through the political system, into political coalitions that sustain existing arrangements or lead to their transformation” (Roland, 2000)

The strategic vision: from plan to market (– but how?...)

- **what was expected**
 - *stabilisation* programmes would restore external and internal macroeconomic balance
 - at the same time bringing about a mild recession of a short duration, i.e. 1-2 years = *transformational recession* (Kornai)
 - to be followed by *bottoming out*
- **what generally happened** did not meet the above expectations
 - *output* fell more than anticipated and the *supply response* was greatly delayed, even in the most favourable cases
 - *structural changes* lagged everywhere
 - many *other “surprises”* could be further enumerated
- our **understanding** of transition remains limited and happens mostly **“after the fact”**...

The choices involved

- on the **speed** of transition: shock therapy vs gradualism
 - *shock therapy* = *big bang* = *cold turkey* = a simultaneous and quick implementation of all (transition) reforms
 - *gradualism* = sequencing of (transition) reforms in a given (hopefully “optimal”) order
 - in the case of gradualism, also on the particular **sequencing** of reforms = the order in which measures in stabilisation (-cum-transformation) packages should be implemented
- **comparative overview** by country and reform: Roland (2000), Table 1.3, p.15

Transition as a large-scale institutional change: objectives

- **improving allocative efficiency** by correcting the distortions of socialism through
 - introduction of flexible prices
 - and creation of competitive market environment
- **stabilising the macroeconomy**, which is necessary for a correct functioning of the price system
- **providing better incentives** and corporate governance arrangements to make firms respond to market signals
 - privatisation at a large scale
 - encouragement of entry of new private firms and creation of an entrepreneurial class
- **creating government institutions “adequate” to markets**
 - need for political and institutional stability
 - need to protect private property rights from encroachment (by the government but also by the mafia)

Transition as a large-scale institutional change: constraints

- **uncertainty of outcomes**, at both *aggregate* and *individual* levels
 - because the *model of capitalism* toward which transition economies should converge is not necessarily clear (*role of government* in the economy)
 - because even if the goal of transition is clear, there is *no accepted theory of how to get there* (*experimentation and learning* during transition)
- **complementarities and interactions between reforms**
e.g. *privatisation* and *price liberalisation*
- **political constraints**
 - crucial, especially in Eastern Europe (vs China) where *political* reform – the move to democracy – preceded *economic* reform – the move to the market
 - transition is an economy-wide process involving *winners* and *losers*, even if *aggregate welfare* is (expected to be) ultimately enhanced

Did the USSR/CPSU (in)voluntarily left the socialist system to break up?

- the socialist economic system rested upon the **monopoly of the communist party** => a **breach** in this monopoly triggered its collapse under *Gorbachev*
 - the legitimacy of CPSU was allowed to be questioned in USSR
 - CPSU renounced support of that legitimacy in the “brother countries”
- in **early 1989**, CPSU
 - did not condemn the “round table” negotiations in Poland
 - did not block the progress toward multipartism in Hungary
- in the **autumn of 1989** “the winds of change” swept through Eastern Europe and the Berlin Wall was down in a night
- **1991**, collapse of CMEA (Comecon) => trade at world prices (but arrears in TRs initially created settlement problems)

GDR: a unique experience of an immediate monetary union

- **key dates**
 - 9 November 1989: breach of the Berlin Wall
 - 1 July 1990: economic and currency union
 - 3 October 1990: political union – GDR became the five new provinces (*Neue Länder*) of reunified Germany
 - 1989-1994: privatisation tackled by the *Treuhandanstalt*
- **lessons** from GDR's unique “merger”: even with favourable conditions, the pain from transition was largely underestimated
 - *financial burden* was huge: the Western part of the country devoted many more funds (and effort) to this task than the assistance made available to the remaining countries in transition
 - *material losses* were huge: a large share of the productive capacities were dismantled as obsolete or harmful to the environment
 - *human costs* were huge as well: GDR population had one of the highest
 - participation rates (80% in 1989) under socialism
 - unemployment rates (10% in 1991) among the ex-socialist countries

Poland and Russia: diverse big bang experiences

- **Poland:** shock therapy
 - July 1989: G-7 Summit empowers the Commission of the European Communities with the coordination of assistance to Poland and Hungary => PHARE (in 1990, Czechoslovakia, Bulgaria, Yugoslavia and, later, Romania added to PHARE)
 - catastrophic situation, default on foreign debt
 - January 1990: Leszek Balcerowicz (advised by Jeffrey Sachs) launched what became known as “shock therapy”
 - 1991-1995: mass privatisation blocked politically => privatisation proceeded de facto in a gradual way
- **Russia:** “a shock without the therapy” (Ellman, 1992)
 - various successive programmes announced and partly launched in 1992-1993 were based on a shock therapy concept (if only to please IMF)
 - but were altered due to political conflicts of all sorts and not implemented

China: gradualism under the dual track approach

- a **plan track**: production and prices are *frozen* at a defined pre-existing level, usually last period's output
- a parallel **market track**: liberalisation is carried out *at the margin* so that market transactions can take place outside the plan track
 - since 1979 in *agriculture: contract responsibility system*
 - the commune was assigned the responsibility to sell a fixed quantity of output to the state procurement agency and to pay a fixed amount of taxes
 - it had the right to receive a fixed quantity of inputs, e.g. chemical fertilisers
 - the commune was otherwise free to do whatever it wished
 - it reassigned the collective responsibilities to the individual farm households and made them directly responsible for the fulfilment of their shares
 - since 1984 in *industry*
 - *within-quota* output according to the plan
 - parallel free markets for the *above-quota* output of enterprises
- designed to be **Pareto-improving** (Roland, 2000): the Chinese dual-track system both
 - provides the efficiency gains from price liberalisation
 - and protects individual agents from welfare losses

Dewatripont and Roland (1995, AER): model assumptions

- **uncertainty is aggregate**, in the sense that
 - the outcome of transition, *as a whole*, is not clear
 - agents involved are *ignorant* of the underlying process: as if “without a map”, Shleifer and Treisman (2000) book title
- **two reforms**
 - if implemented *simultaneously* = big bang
 - if implemented *sequentially*, after uncertainty resolution on the first reform = gradualism
 - *complementarities* between the two reforms

Dewatripont and Roland (1995, AER): model **conclusions**

- **the type of uncertainty and learning** during the reform process **matter** in the comparison of the two strategies
 - gradualism has an option that a big bang does not have, namely the *option of early reversal at a lower cost*
 - because gradualism has this additional option of early reversal *after partial uncertainty resolution*, it may take reforms easier to start
- **for gradualism to be optimal**
 - the first reform has to be *informative* (i.e. learning is *possible* from experience with its implementation)
 - furthermore, learning needs to be *fast* enough
- **otherwise, big bang cannot be dominated**

Concluding wrap-up

- **what have we learnt?**
 - what transition is
 - how initial conditions were related to strategies chosen
 - in what aspects the actual transition strategies differed
 - which the trade-offs b/n gradualism and shock therapy are
- **where we go next:** to the theoretical analysis of macroeconomic stabilisation