

EC330-3-SP – Lecture 7

Macroeconomic stabilisation: evidence –
inflation, output decline and recovery

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Plan of talk

- **Introduction**
 1. Evidence on price liberalisation
 1. Degrees of liberalisation
 2. Inflation patterns
 2. Aggregate output patterns
 1. Shock therapy
 2. Gradualism
 3. Reversed reforms
 3. Explanations for the output decline: why recovery
 1. quick in Poland
 2. but not in Russia
- **Wrap-up**

Aim and learning outcomes

- **aim:** discuss the patterns of inflation and output found in the data during macroeconomic stabilisation in transition economies
- **learning outcomes**
 - describe the key stylised facts of transition
 - contrast and compare country cases
 - relate cross-country differences and similarities to transition strategies adopted and/or underlying socio-economic conditions
 - understand – from a theoretical perspective – why recovery was quick in some post-socialist economies but not in others

Price liberalisation during transition

- no matter some *theoretical* arguments in favour of **full (big bang)** freeing of prices
- what was observed *in practice* was a preference for **partial (gradual)** price liberalisation
- the reason was, essentially, of a social nature: **politically sensitive prices** (e.g. housing, energy) kept unchanged for some time, and only liberalised in stages afterwards
- hence, **various degrees** of the *initial* and *subsequent* price liberalisation
 - measured by *share* of administered prices in a general price index (CPI)
 - => Table 6.1 in Roland (2000), p. 133 (from EBRD *Transition Report* 1999)

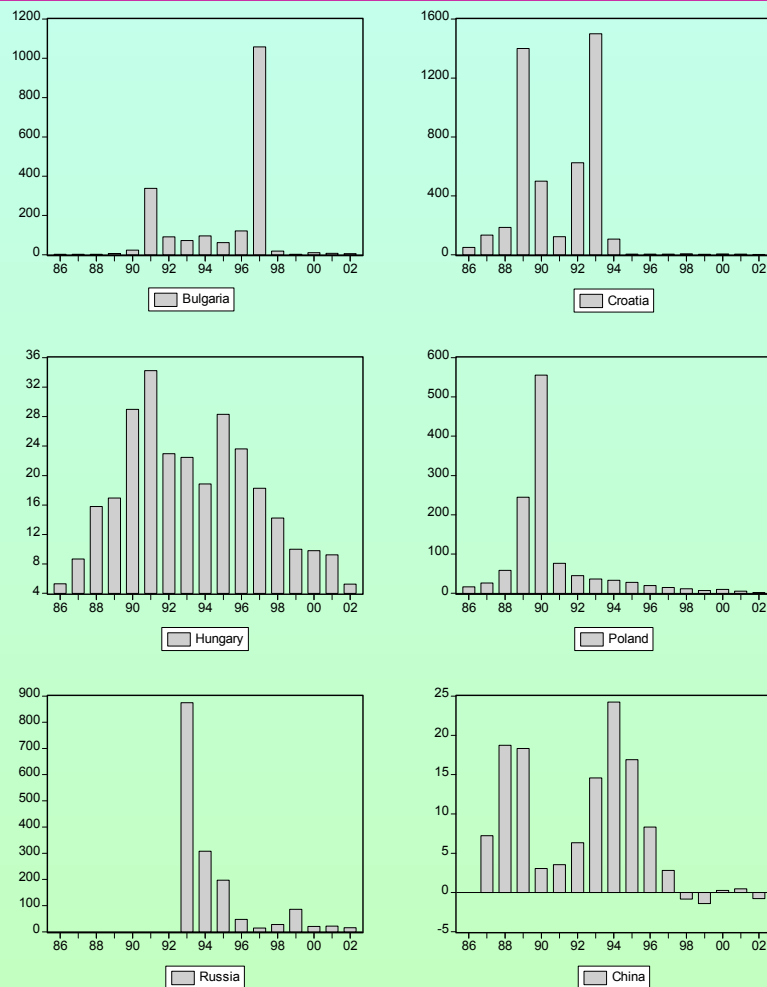
Speed and degree of price liberalisation

- **general pattern:** important though not full liberalisation of prices early in the transition process
- **big bang:** *Poland* kept the share of administered prices roughly to its initial cut at 11%
- **gradual:** *Belarus* applied step-by-step, small reductions each year, which brought the share of administered prices from 90% in 1991 to 27% in 1997
- **reversal:** *Bulgaria, Latvia* and – to a lesser extent *Hungary* – returned to a greater share of administered prices in later stages of the reform process

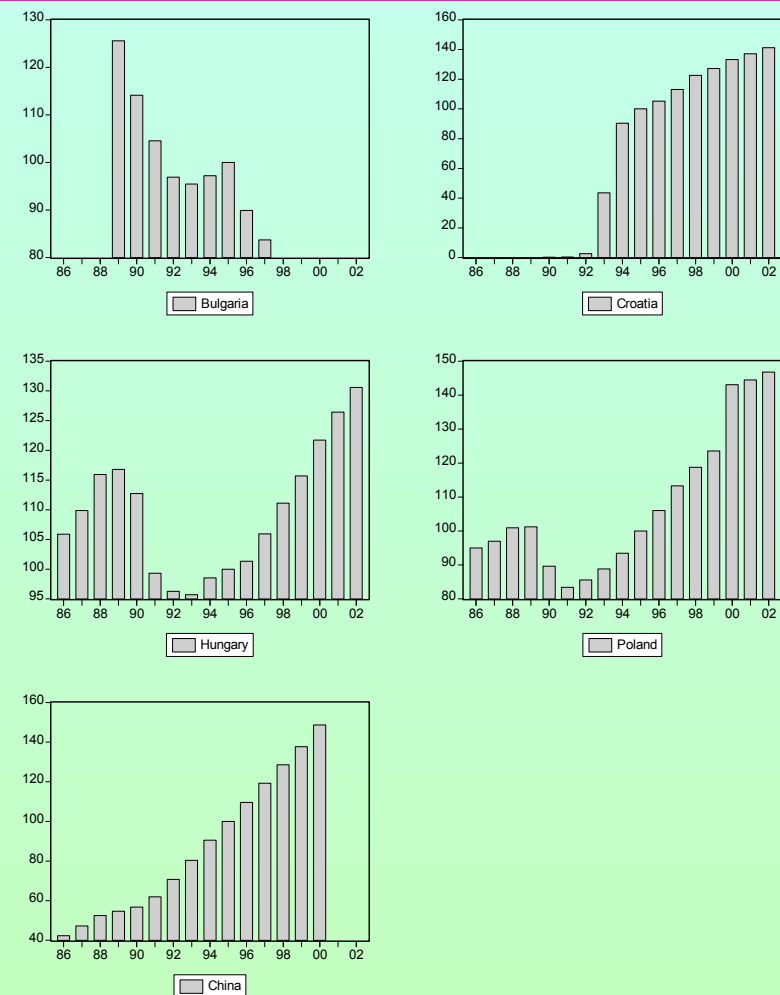
such reversals illustrate the presence of political constraints induced by the *redistributive* (vs *efficiency*) dimension of price liberalisation

Inflation and output: transition patterns

Transition Evidence: CPI Inflation, % pa (Source: IFS ESDS)



Transition Evidence: GDP Volume, 1995=100 (Source: IFS ESDS)



Inflation dynamics: stylised facts

- initial price jump in all countries which liberalised prices in a **big bang** manner (Poland and Russia in the figure)
- this price jump was higher than expected
- by contrast, a true initial price jump is not evident in data for **gradualist** reformers (Hungary and China)
- yet in countries which implemented **consistent reform** policies (Poland in the figure), the price jump was followed by a gradual, although not very quick, return to one-digit annual inflation
- by contrast, in countries with **policy reversals** (Bulgaria) or **war** (Croatia) the initial peak in inflation was followed by a second, stronger one => harder to bring down inflationary expectations

Output dynamics: stylised facts

- biggest output fall in most **shock-therapy countries** generally *coincides* with timing of price liberalisation
- this initial output decline tends to *persist*, in a **less and less severe** manner
- in **gradualist countries** output fall, if observed at all (which is not the case of China – see figure), *cannot* be attributed to price liberalisation
=> often explained instead with *external shock* of CMEA breakdown in 1991 (case of Hungary – see figure)
- indecisive transition with **reform reversals** (due to stronger political constraints) has manifested itself in a *second* major output fall after the economy has once bottomed-out (Bulgaria, 1991 and 1997)
- another interesting fact (not seen in our figures) is that for the **years prior to liberalisation** a substantial output fall was already reported in some ex-USSR countries (Russia and Ukraine)

“Standard” explanations for the output fall: Nutti (1993) - Lavigne (1999)

- **“incredulity”** approach: the fall is mostly an illusion, due to imprecise measurement
- **“complacency”** attitude: output had to fall, if not that deeply, due to
 - *external shocks*: policy-makers’ scapegoat
 - *systemic disorganisation*: disruption of former links among centrally planned unities which were not immediately replaced by functioning market mechanisms
- **gradualist** alternative: better follow China’s example instead of prescriptions by the Washington consensus

“Standard” explanations for the output fall: Roland (2000) (I)

- purely **macroeconomic** explanations: AD/AS analysis
 - excess fall in aggregate *demand* due to restrictive stabilisation policies
 - simply postulating a fall in aggregate *supply*
- **microfounded** explanations
 - *informal* stories: output fall is related to price liberalisation, in particular to speed of closure in shrinking sectors (due to changed relative prices) which has been excessive
 - *formal* models
 - **credit crunch** hypothesis, Calvo and Coricelli (1992): high interest rates + hard budget constraints => enterprises strongly reduced their demand for credit... but:
 - interenterprise arrears
 - recent evidence of a weaker “credit squeeze”

“Standard” explanations for the output fall: Roland (2000) (II)

- models with **labour market frictions** that result from *sectoral shifts*, such as Atkeson and Kehoe (1996),... but:
 - sectoral shifts in other economies do not generally lead to such big output losses
 - evidence that sectoral shifts have not been too strong in transition countries
- models with **monopoly behaviour** of enterprises after liberalisation, e.g. Blanchard (1997) and Li (1999): a “double marginalisation” argument
 - central planners behaved like a *single* vertically integrated monopoly
 - liberalisation led to *multiple* monopolies charging monopoly prices to *downstream* monopolies
 - ... but
 - in an *open* economy after trade liberalisation import competition should eliminate the monopoly effects
 - moreover, empirical evidence for *low* concentration levels in Russia (yet it may be compatible with *regional* monopolies and may miss to account for the inherited strong *specialisation* bias of enterprises)

“Innovative” explanations for the output fall: Roland (2000)

- all “standard” explanations above are *valid only partially*
 - a crucial flaw in all of them is that they assume **markets as functioning**
 - and thus apply standard D/S analysis (at a *macro* or *micro* level)
 - which was, of course, *not* the case in real-world transition economies
- two recent, “innovative” models attempt to go *deeper*
 - “at a more **inframarginal level** than the level of markets, looking at the decision problems of individual producers” (Roland, 2000)
 - both propose **disorganisation** effects of liberalisation on existing production links as the principal reason for transition output decline
 - differ in what is considered the more profound *cause* of disorganisation

Disorganisation: Blanchard-Kremer (1997) and Roland-Verdier (1999)

- Blanchard-Kremer (1997): cause of disorganisation is **inefficient bargaining** when legal contracting institutions are absent
- Roland-Verdier (1999): derives disorganisation from search frictions and investment specificities
 - the absence of pre-existing markets makes **search** more costly
 - as a result of **investment specificity**, agents will only invest once they have found long-term business partners
- a second important difference b/n these models is that
 - Blanchard-Kremer (1997) is not a dynamic model, so the output fall can be
 - either understood as a comparative static exercise
 - or interpreted dynamically as leading to a *permanent* output fall => Russia
 - Roland-Verdier (1999) features, in turn, only an *initial* output fall followed by a higher level of output than under socialism => Poland

Why quick recovery in Poland, but not in Russia?

- other models, e.g. Johnson, Kaufmann and Shleifer (1998) and Roland and Verdier (1999: WDIWP), stress **political constraints**
 - Russia and transition economies with similar output paths have essentially become the victim of *government collapse*
 - so that *law enforcement* has turned out *impossible* in the face of the spontaneous emergence of criminal activity preying on private producers
 - *markets* did not come into being so quickly when the state withdrew from administering economic activity in such countries as did *mafia-like structures*, taking profit of the institutional vacuum (and social chaos)
 - lack of rule of law in Russia, and similar cases of transition, led to an increase in *predatory behaviour* that affected adversely productive activity
- => a considerable *slowdown* in the emergence of the new private sector and, consequently, of an output recovery

Concluding wrap-up

- **What have we learnt?**
 - what the stylised facts in the data about transition are
 - how similar or different transition paths have been
 - which are the most likely explanations of the output fall
 - why quick recovery was observed in some of the post-socialist economies but not in others
- **Where we go next:** to examining exchange rate management as part of transition reforms