EC330-3-SP – Lecture 6

Macroeconomic Stabilisation: Theoretical Analysis

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Plan of talk

- **Introduction**
1. The "Washington consensus"
2. Macroeconomic stabilisation: components
3. Structural transformation: components
4. Theoretical models of price liberalisation
- **Wrap-up**

Aim and learning outcomes

- **Aim**: summarise
  - the components of the policy packages implemented in most transition economies at the start of the reform process, under the intellectual guidance of the IMF and the World Bank
  - the principal models suggested in the theoretical literature to analyse the effects of one of the key ingredients of macroeconomic stabilisation policies, the freeing of prices from central plan fixing
- **Learning outcomes**
  - describe the approach to transition reforms that became known as the "Washington consensus" as well as its policy ingredients
  - discuss the results from theoretical models on price liberalisation

The "Washington consensus" packages

- **no relevant theory** to provide guidance was initially available
- political elites of command economies sought **western advice**
  - as transition countries became IMF and World Bank members
  - also seeking financing and credibility for the unpopular reforms
- implemented set of **transition policies**
  - comprised **stabilisation-cum-transformation** *packages* of reforms, with *two major ingredients*
    - (short-term) heterodox *stabilisation* programmes bound to IMF *stand-by arrangements* (SBAs)
    - (longer-term) structural *transformation* measures committed under *structural adjustment loans* (SALs) granted by the World Bank
  - became known as the **"Washington consensus"**

Macroeconomic stabilisation (I)

- implemented in transition economies under **IMF stand-by arrangements** (SBAs) early in the reform process
- consisted of the following **components**
  - Price liberalisation
    - reduction of subsidies to consumer and producer prices, with exceptions for housing, utilities and energy prices that were to be freed several years later
    - deregulation of price fixing, going along with liberalisation of domestic trade
  - Balancing the government budget
    - increases in taxes (including on excess nominal wages)
    - cuts in government spending

Macroeconomic stabilisation (II)

- Restrictive monetary policy
  - an increase in the central bank reference interest rate so as to restore positive real rates of interest
  - direct regulation of bank lending (credit ceilings) in most cases
- Income policies, aiming to stop the inflation spiral
- Foreign trade and exchange rate regime liberalisation
  - abolishing export and import licences and quantitative restrictions
  - permission given to all enterprises to engage in foreign trade on their own, while socialist state foreign trade organisations were dismantled
  - tariffs, meaningless under administered trade during socialism, now became active instruments of trade policy but were lowered to express commitment to trade liberalisation and forthcoming GATT/WTO membership
  - internal current account convertibility of the domestic currency
  - devaluation of the national monetary unit, bringing it to levels close to its (black) market rate, with differences among the countries as to the chosen, and subsequently maintained or modified, exchange rate regime

Structural transformation (I)

- usually undertaken under **structural adjustment loans** (SALs) granted by the World Bank
- comprised the following **measures**
  - Launching privatisation, at the same time
    - dismantling the former state monopolies, and
    - introducing competition rules and free entry (of private and foreign firms)
  - Setting up a market environment, through
    - banking and financial sector reform
    - tax reform

these first two policy packages had to be *immediately* launched or at least announced in order to add credibility to the stabilisation packages

Structural transformation (II)

- Developing a social safety net
  - to replace the former all-embracing protection system “from cradle to grave”
  - to cushion the impact of the austerity measures and of the structural transformation
- Initiating industrial policy
  - to identify winners and losers in the industrial activities to be restructured
  - to devise appropriate policies such as subsidies and tariffs
  - to take care of the environment, at least so as to stop the damages caused during socialism

these second two policy packages were considered initially as *less urgent*, and were therefore implemented much later and to a less decisive extent

Price liberalisation

- is a key **element** in transition because it is a necessary condition for the introduction of the market mechanism in an economy that has been centrally planned
- has *two* important **dimensions**
  - an *efficiency* dimension: reflected in its objective to bring about a dramatic improvement in the *allocation* of resources
  - a *redistributive* dimension, with political economy implications: it will in the short run create *winners and losers*

Lipton and Sachs (1990)

- **assumptions**
  - 1. supply for a given good is *inelastic* at a level *Q*
  - 2. due to shortages, there is an *average cost of queuing*, *s*
  - 3. *price liberalisation* reform is then implemented
- ***pre*-reform** analysis
  - 1. when the price for the good is *below* the market-clearing price
  - 2. the *expected* welfare of the *representative* agent is *Q-s*
- ***post*-reform** analysis
  - 1. the price for the product may now be *higher*
  - 2. but there is *no queuing* anymore (so that *s=0*)
  - 3. although the supply is still at level *Q*
- => **price liberalisation** has raised welfare to level *Q* (from *Q-s*)

Forms of rationing

- rationing by the **price** mechanism
  - favours individuals who have the *highest willingness to pay*
  - in practice, differences in income will favour individuals with *higher income* who have the highest willingness to pay
- rationing by **quantities with queuing** (in Lipton-Sachs, 1990)
  - favours *poor* individuals
  - *those* of them who get served at a lower price may get consumer surpluses despite the *aggregate* inefficiency of queuing
  - *possibly* making this form of rationing preferred by a majority: this is an early theoretical result established by Sah (1987)

Murphy, Shleifer and Vishny (1992)

- **point:** welfare effects of *partial liberalisation* are *ambiguous* and depend on
  - the *initial inefficiency (in rationing)*, and
  - certain *demand elasticities* in the different sectors of the economy
- **aim:** illustrate the *disruptions* caused by *partial reform*
  - explaining in particular the *input diversion* that took place in the state sector in the Soviet Union during the Gorbachev period
  - a *small private sector* was allowed to develop then under the name of "cooperatives"
- <u>Figure 6.1, p. 134</u> and <u>Figure 6.2, p. 135</u> in Roland (2000) "extract" the **key lessons** – we analyse these *graphs* next

Graphical analysis of partial price liberalisation

- Figure 6.1 illustrates the **welfare *loss*** (areas A + E) from *partial* price liberalisation
  - **assuming** input diversion under *efficient* initial rationing (i.e. when both modelled sectors have the *same* willingness to pay for a given good in shortage)
- Figure 6.2 illustrates the **welfare *gain*** (area A - B) from *partial* price liberalisation
  - **assuming** input diversion under *inefficient* initial rationing (i.e. when the two sectors have *different* willingness to pay for the shortage good)
- note that *input diversion* is made possible in Figure 6.2 because the delivery **plan** Q_b **cannot be enforced**
  - **otherwise** allocation *as under central planning*

Lau, Qian and Roland (2000)

- the possibility of enforcing delivery plans allows for an original policy of price liberalisation: the **dual-track system**, as introduced in ***China***
- **result:** *dual-track price liberalisation* is **Pareto-improving**
  - irrespective of supply and of whether rationing is initially efficient or inefficient
  - moreover, **efficiency** can be achieved under exactly the same conditions as *big bang price liberalisation* provided that enforcement of the plan track is
    - in terms of the *rents* it generates
    - rather than in terms of *physical quantities*

Concluding wrap-up

- **What have we learnt?**
  - what the usual IMF heterodox stabilisation package was, as applied to transition economies
  - which the components of structural transformation programmes were, as implemented in transition countries under World Bank guidance and financing
  - what the basic theoretical results on price liberalisation, a key ingredient of transition reforms, are
- **Where we go next**: to macroeconomic stabilisation as evidenced in the *data* for transition economies