Introduction to Transition Economics

I. Economics of Transition

- The demise of communism in Central and Eastern Europe ushered in a new phenomenon in economics, transition.
- This is an unprecedented process as no economy has ever moved from a comprehensively controlled economy to a market economy.
- The Economist (March 24-30, 1990: 22) “Hundreds of books have been written on the transition from capitalism to communism but not the other way. There is no known recipe for unmaking an omelet.”
- The key problem is the difficult environment in which the new institutions must take root.
- Transition is not the simple process.
- In transition we are analyzing how one system transforms into another we need to understand what institutions are needed to become market economies.
II. Why Study Transition?

1. Transition and development

   - Transition is very different from development. Development is the process of turning a less complex organism into a more complex one. Transition can be likened to changing the organism from one type to another. Transition thus involves the study of the creation of markets; hence, it should be of interest to all economists.

   - Institutions are precisely what transition economies lack.

2. Politics and Transition

   - developing democracy is thus as important in many countries as the creation of markets

III. The Nature of Transition

Transition is the replacement of one ES with another ES.

1) The Evolutionary View

   - Thus a central feature of transition is to build market-institutions.
2) The Importance of the Historical Legacy

- Industrial structure designed for a command economy; one that is dominated by large industrial enterprises that are destructive of value (i.e., produce negative value added); the absence of property rights, dictatorship.
- Although transition economies share a common legacy, there are important differences.

3) Main explanatory forces in modeling transition are:

- Initial conditions
- Policy measures
- Environmental factors

Initial Conditions:

- Two waves of transition
- Countries differ in the length of socialist period (Former Soviet republics, some 70 years).
• Eastern European countries were generally much smaller and homogeneous in many dimensions, and were located in geographic proximity to Western Europe
• Soviet republics (Estonia, Latvia, Lithuania, Ukraine) vs separate members of Warsaw Pact (e.g. Poland, Hungary)
• Different per capita income
• Differences in economic development-useful index is the percent of the labor force in agriculture versus heavy industry
• Different trade experience (countries had been largely isolated from world competitive forces; Hungary and Poland more open economies)
• Different resource bases
• Degree of distortion in command economy:
  --Deviations from market patterns of resource allocation
  --priority allocation based on ideology
  --Biases in favor of industry
  --Emphasis on investment at the expense of consumption
-- Allocation of labor distorted by rules against dismissal and state budgeting

-- Regional preferences for resource allocation (e.g. Soviet preference for developing Siberia)

-- Foreign trade distorted by state trading organizations

-- Existence of large "shadow" economy

-- Artificially high levels of employment;

-- Countries had been largely isolated from world competitive forces;

distortions growing out of economic isolation were:

- distorted trade patterns
- lack of foreign technological advances
- isolation from democratic ideas
- isolation from Western democratic institutions.
Why the initial conditions matter? As markets are introduced, we expect allocation patterns to revert to more “normal” patterns that resemble long-term market outcomes. The more serious the distortions are, the greater the distance that an economy must travel to reach market dimensions, therefore the more difficult the transition process will be.

Can the effects of initial conditions and thus distortions be measured?

To measure a country’s “initial condition” an “initial condition” index developed by EBRD is used –the index is “derived from factor analysis and represents a weighted average of measures of the level of development, trade dependence on CMEA (Council for Mutual econ Assistance), macroeconomic disequilibria, distance to the EU, natural resource endowments, market memory and state capacity.”

Common Features of transition economies

- dominated by state ownership prior to transition; small private sector share
- foreign trade was controlled by the state
• high level of secondary school enrollment; unlike developing countries, transition econ invested rather highly in education.

• the decline in output--‘J curve’ is the pattern of severe economic collapse followed by recovery;

• The significant increase in inflation accompanied liberalization in transition economies.

4. Transition Policies

a) Speed of transition—should the economy be transformed rapidly, or should there be a more gradual adjustment to the new system.

  – *Big bang (shock therapy)*—strategy that involves moving quickly to eliminate the old order and to replace it with new organizational and policy arrangements, i.e. markets; transition policies could be implemented rapidly.

  • all at once and painful
    – causes immediate, sharp economic collapse
    – get it over with before it can be undone

  • markets would naturally emerge from decentralization
• Poland, other Central European countries
  – \textit{slow and steady (gradual or evolutionary approach)}--
  emphasizes complexity of organizations; process of learning and adaptation required.

• spread out and less painful
  – avoids collapse, in principle
  – takes longer

• Institutional change is path-dependent. Organizations are viewed as complex hierarchies within which participants pursue objectives while guided by incentives but subject to bounded rationality. “Bounded rationality” refers to the limits of information; the limits faced by decision makers and personal limitations (inadequate education).

• The hierarchical structure of an organization implies the principal-agent problem.

• Organizational change is sequential, path-dependent and evolutionary through a process of organizational learning and adaptation.
b) Sequencing of specific reforms—the order in which reforms should be introduced.
   
   – where to begin
   
   • in what sectors?
   
   • where to privatize
   
   • liberalization of prices (when?, some or all?)
   
   • safety net
   
   • Importance of sequencing and complementarities, e.g. financial markets must be developed as firms are privatized and required to raise capital.

The notion of gradual reform implies that there is a proper sequence in which reforms must be implemented. Some reforms must be first, whereas the notion of big bang is that all, or at least several, components, must be implemented at once.

c) Transition stages:

• To decide on a particular transition strategy

• The legislative base of transition began to evolve early 1990’s.
• Implementing of new policies toward market institutions, arrangements and outcomes.

5. The framework of transition

a) Microeconomics of transition

– creation of markets and associated price signals
  • product markets
  • factor markets
– privatization
– property rights

The process of privatization and development of factor and product markets—Involves changing the nature of property rights.

• A major difficulty in the privatization of enterprises in the transition economies has been:

- the existence of large state subsidies in many instances
- the problem of valuing enterprise assets
- the absence of well-developed capital markets
• Restructuring is frequently defined as changes which take place in an enterprise after formal privatization has been completed.

b) The development of the macro economy (both institutions and policies).

• creation of monetary-financial system
  ▪ financial markets (regulatory agencies)
  ▪ central bank/monetary authority (monetary policy)

• state budgetary process
  ▪ revenues and expenditures
  ▪ tax structure
  ▪ budgetary process
  ▪ stabilization is important, especially during the initial stages (fiscal policy)

• Normalization refers to the development of financial markets for financial intermediaries and the budgetary process and the banking system.

c) International trade and finance
  • elimination of state trade monopoly
• convertibility of currency and the implementation of an exchange regime capable of sustaining a reasonable foreign & domestic balance.

d) Safety-net issues—the concept of a safety net refers to changes in pensions, medical benefits, benefits for the elderly, unemployed etc.

6. Legal System

a) Property law—set of rights

• rights to income from the use of property

• rights of transferability (sell, rent)

• rights of control (exercise of decision making)

b) Contract law—framework within which parties can legally enter into contractual relationships

• protection of vulnerable parties (consumers, tenants)

c) Bankruptcy law—controls how businesses can close down and distribute their assets and pay their liabilities

d) Anti-monopoly laws—prevent anti-competitive practices

e) Securities law—regulates sale of stocks and bonds to public
• regulatory body to prevent fraud and ensure full disclosure

f) Intellectual property law—patents, trademarks, copyrights

g) Labor laws—defines rights and obligations of employers and employees

7. Assessing transition patterns—growth index models

a) Simple model of transition economy

• Let’s assume that the performance of transition economies is determined by just one variable: liberalization (Lib)

\[ Gr_i = f(Lib_i) \]

\( Gr_i \)—an index of growth, 1989-1999, 1989=100

\( Lib_i \)—an index of liberalization

• Scatter diagram

b) More complex model of transition economy

\[ Gr_i = f(IC_i, Lib_i, Env_i) \]

\( IC_i \)—an index measuring initial conditions

\( Env_i \)—a measure of environmental factors
c) Transition experiences differ according to:

- the level of economic development
- environmental factors
- distortions left behind

8. Problems of specification and estimation

- specification
- endogenity
- time lags
- selecting the dependent variables

9. Empirical evidence

- debate about what dependent variable or measure of the outcome of performance is appropriate (growth, unemployment rate, inflation)
- attempt to capture the impacts of systematic change—the typical index to capture systematic change has been liberalization
- serious econometric issues
- data in transition—measurement problems