TRANSITION TOWARDS THE MARKET ECONOMY: GROWTH AND INEQUALITY

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Transition to a market economy

• Was supposed to bring unprecedented prosperity
  – Moving from central planning to decentralization
  – Providing better incentives
  – Reducing enormous distortions under old system

• Growth in the long run even more
  – As capital stock adjusts
  – As entrepreneurship increases
The outcomes have been—with a few exceptions—a disappointment

- Huge deceases in GDP in Russia, most of the countries of Former Soviet Union
- Smaller decreases in most Eastern European countries
- Small increases in Poland, some of Baltic Republics
- Only real success—China and Vietnam
  - At beginning of 90s, China’s GDP was but a fraction of Russia’s
  - At end of decade, roles had been reversed
Failures even worse than GDP statistics suggest

- Declining social indicators (actual declines in life expectancy in Russia—while rest of world was seeing increases)
- Deteriorating human capital, worsening of educational system
- Increasing role of Mafia
- Huge capital flight
- Huge increases in poverty
- *Were it not for high oil prices, Russia would be in even worse shape*
Inequality

• Expected some increase in inequality
  – Associated with need to provide greater incentives
  – But magnitude should have been limited in resource rich countries, like Russia—use revenues from resources to support public needs

• But magnitude of increase in poverty in Russia, elsewhere (ten fold increase) beyond fears of harshest critics
  – In contrast, China and Vietnam have succeeded enormously in reducing poverty
  – Though inequality has increased
    • Urban rural
    • Regional
• And in Russia, while the government did not have money to pay minimum pensions for aged, it was giving away hundreds of billions of dollars of natural resources
  – Contributing to capital flight
  – Undermining confidence in market economy
  – Creating Oligarchy
Explaining the failures—and the successes

• Major area of controversy
• Most of studies done, e.g. by World Bank and IMF, exclude China, Vietnam
  – Even though these are the true success cases
• Major question: why did China, Vietnam succeed, others fail
  – One answer: China is a developing country, it is easier for developing, largely agriculture countries to make transition
  – But answer is unpersuasive
    • Development hard enough—few successes
    • Why should combining two difficult problems (transition and development) make things easier
    • Among largest failures have been agriculture based economies of the FSU (Moldova), and problems in agriculture sector
Emerging Consensus

• Shock therapy
• Focus on privatization rather than new enterprises
• Focus on price stability, rather than enterprise and employment growth
• Failing to recognize importance of establishing sound legal framework (corporate governance)
• Failing to focus on important role for government
  – Including its need for revenues
  – Important role in social safety net
• Ignored concerns about inequality in name of growth
  – And in the end failed even to get growth
  – And undermined public support for market reforms
• Emphasis on ideology
  – Not understanding what really makes a market economy works
  – Consistent with failure of Washington consensus elsewhere
Pragmatist vs. Ideology

• IMF/Washington consensus ideology predicted that
  – Two-tier price system used by China in transition to get prices right would not work
  – Individual responsibility system would not work, because land was not privatized
  – TVE’s would not work, because they were public (township and village) enterprises
  – China could not get capital without full capital market liberalization
  – China could not grow without instantaneous trade liberalization

• In each case, predictions were wrong
Shock therapy

• Quick transition—before laws and institutions were put in place
  – Thought that legal framework would follow
  – Thought market institutions (banks making credit available) would also follow quickly
  – But neither happened

• One mistake followed another
  – Overnight freeing of prices led to hyperinflation
  – High interest rates to reduce inflation led to depression
    • And capital for investment not available
  – Overnight privatization led to asset stripping
  – Worsened by overnight liberalization, which led to capital flight
• Oligarchs wanted to preserve their economic position, to continue “asset stripping”
  – Legal framework did not follow in Russia
    • Countries joining EU were in advantageous position
  – Most important factor in explaining relative performance among FSU, Eastern European countries
• High interest rates, capital flight meant funds for investment not available
  – Enormous deterioration in manufacturing sector
  – Russia became just a natural resource economy
    • 70% of exports related to natural resources
• Illegitimate privatizations continue to exert dampening effect on economy
  – Insecure property rights undermine investment
  – But legitimizing property rights would entrench oligarchs, perpetuate inequality
  – Continues to undermine support for market reforms
  – And continues to be major source of contention with West
    • Even when matter involves legitimate enforcement of tax laws
Even agriculture failed…

- In contrast to China, where it constituted the important initial success in China’s move to a market economy
- Farmers could not get seed, other inputs
- Farmers could not get tractors or tractor services, or credit to buy inputs
- Farmers had trouble marketing output
  - Especially important in areas like milk
- Predictions that markets would quickly develop to meet these needs were wrong
- In some places, like Mongolia, problems were even worse—
  - Huge problems arose from privatization of herds
    - Environment
    - Vegetarian services
    - Water
Human Capital

• Had been one of Russia’s strength
  – Turned into weakness
  – As it facilitated huge brain drain
  – Not just differences in salaries
  – But research labs
  – And economic opportunity

• Weakening of educational institutions does not bode well for the future
• Problems of migration even worse in some Eastern European countries
  – Migration of 10% or more of population
  – And much larger fraction of young, educated
  – “hollowing out” of countries
Concluding Comments

• Transition to market economy far more complicated than was recognized at the beginning
  – Reflecting the fact that what makes a market economy work is far more complicated that naïve free market ideology suggests
  – Not just a matter of “supply and demand”
• Success in China far greater than anyone had anticipated
  – But failures in Russia and elsewhere far worse than anyone had anticipated
    • Both in terms of growth and inequality
    • And even more so as we look to the future