

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 decreases 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 than 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