

## Midterm Exam II: Answer Sheet

1. (30%) *Why is the collapse of output in the early stages of transition a theoretical curiosity?*

The early stages of transition involve liberalization. Removing constraints and other rigidities of central planning should make the economy more efficient. With constraints removed performance should improve, rather than deteriorate.

- (a) *Why might the collapse in measured output overstate the true effect?*

Various reasons. First, statistical systems in transition economies were designed for planned economies, where the number of enterprises was small and fixed. Hence, these systems are best at measuring what happens in the declining sectors of the economy, but are much less effective at measuring the growing sectors and new enterprises. Second, price liberalization makes apparent many distortions that already existed. Prices that were fixed increase which makes measured real output fall, but actual output may not have changed.

- (a) *What are the major theories that explain the collapse of output in transition economies? Distinguish systemic causes from policy-induced factors.*

The most frequently cited policy-induced factor would be decreased aggregate demand that accompanies stabilization. Policy that focuses on cutting budget deficits result in lower demand for the output of the industrial sector. This may also be the source of a credit crunch which affects output, though the major cause of the credit crunch is most likely the underdevelopment of the financial system which is a systemic factor.

Disorganization, which results from the removal of planning mechanisms before effective contracting and other similar institutions are in effect, is one important systemic factor. A necessary feature of the output decline is unemployment of resources, and disorganization can be one explanation of this. Another is the absence of property rights which makes it hard to re-deploy assets that are no longer productive at their current uses.

Another important cause of the output decline is the trade shock that resulted from the demise of the CMEA and the breakup of the Soviet Union. It is hard to say whether this is a systemic or policy-induced effect. To some extent the disruption of trade is systemic; it did, after all, effect all transition economies, and it partly resulted from the elimination of socialist foreign trade institutions. But the trade shock is also to some extent policy-induced: the Soviet Union might have reformed without breaking apart, and even if it had to break apart, a payments union could have been established that might have reduced the effects of the shock.

- (a) *If transition involves an adjustment from an inefficient state sector to a more efficient private sector how can output fall? Explain.*

The key point here is the fact that adjustment is not instantaneous. Some unemployment of resources results from the absence of property rights in assets early in transition. If capital is stuck in place, the new private sector may not expand fast enough to absorb labor released from

the declining state sector. Moreover, capital that is not utilized in the state sector is immobilized because of the inability to sell the assets.

2. (35%) *Transition economies often experience a depreciation in the value of their currencies in the wake of external liberalization. Why does this occur?*

Currencies of transition economies were over-valued prior to liberalization. Moreover, prior to transition people in these economies can only hold domestic currency. Liberalization offers the chance to diversify wealth into other assets, which depresses the value of the domestic currency. Inflation, which accompanies liberalization, is an even more important factor. As people switch to foreign currency the exchange rate must appreciate.

- (a) *How does the depreciation in the value of the currency impact on the relative competitiveness of domestic production in transition economies?*

Depreciation makes imports more expensive and exports more competitive. This enhances the competitiveness of domestic production.

- (a) *Why is the depreciation of the value of the currency a transitory phenomenon? Explain.*

Flight from the domestic currency must eventually end, as will diversification. As inflation declines people become more willing to hold domestic currency. Moreover, as reform begins to improve productivity exports become more competitive. Both factors increase the demand for domestic currency. In addition, as foreign investment comes into a transition economy the demand for its currency also increases. So eventually the currency will begin to appreciate.

- (a) *Why would we expect the value of the currency to appreciate as transition proceeds? What would be the likely impact of this appreciation?*

As residents are more willing to hold domestic currency it begins to appreciate. But with domestic inflation higher than inflation in industrialized countries the currency appreciates in real terms as well. This reduces the competitiveness of domestic production. Imports become cheaper and exports more expensive. The temporary protection afforded by real depreciation is reversed.

3. (35%) *Why is privatization considered to be a key element in transition?*

To create a market economy it is important to create private property. Most productive assets under socialism were state-owned, and most employment and output was produced in the state sector. Because productivity in this sector was low, and because of the subsidies required to keep state-owned enterprises operating became increasingly costly, privatization seemed crucial. In particular, it was thought that this would be the best way to create a focus on the bottom line.

In principle, it would have been possible to create a market economy without privatization. This would involve elimination of central planning and price liberalization along with enforcement of hard-budget constraints: in other words, market socialism. In practice, however, this path has not been chosen by reforming economies. The biggest problem is how to enforce hard-budget constraints on state-owned enterprises.

- (a) *The Coase Theorem would seem to suggest that the method of privatization is irrelevant to the efficiency of the outcome. Explain.*

The Coase Theorem asserts that the initial assignment of property rights is irrelevant to the efficiency of their use. Who owns the assets determines the distribution of wealth, but in the absence of transactions costs assets will be deployed to maximize value. Hence, the theorem seems to suggest that what is crucial is to privatize quickly, with the actual method relevant only to the distribution of wealth. Rapid privatization leads to efficient use of assets, and inequities can be dealt with through taxes and other social policies.

- (a) *What aspects of transition make it hard to accept the relevance of this argument for transition economies? Explain.*

Because institutions critical to the market economy are underdeveloped, transactions costs are high. Contract enforcement is weak, so *who controls* an asset may differ from *who has the right* to control an asset. This is especially important when the directors of privatized enterprises continue to be the bosses who ran them when they were state-owned.

- (a) *Why is an emphasis on the revenue received from asset sales likely to be a poor criteria for the design of a privatization program?*

Normally it is a good policy to sell to the highest bidder. But it may be difficult to sell such assets in transition. This may unnecessarily delay privatization which can be very costly. Stocks of wealth may be low in such economies, and if foreign investment is barred, the prices that can be received will be low. In addition, to obtain high prices governments may have to commit to low taxes and subsidies for investment in the enterprise.

- (a) *Why is corporatization a necessary precursor to privatization? Explain.*

Corporatization involves the consolidation of the enterprise's assets and the creation of a balance sheet for it. Prior to corporatization all assets are owned by the state so it is not clear what are the boundaries of a given enterprise. Hence, corporatization results in demarcating what belongs to the enterprise. This must precede privatization so that potential owners can know what they will own. Notice that corporatization involves the delineation of the control rights to the assets that are part of the enterprise. Privatization involves assignment of the cash-flow rights to the assets. It is important that the control rights be well defined so that it is possible to assign cash-flow rights.