Stabilization loves political breakthroughs

If you want to stabilize, take advantage of a political breakthrough. If you’re not lucky enough to have such a breakthrough, get your stabilization plans ready for one when it comes along.

After the historic collapse of party-state domination of their societies and their economies, countries in Eastern Europe and the former Soviet Union face two daunting challenges: to move toward competitive market economies—and to maintain and strengthen newly gained democracies. The economic transition has three elements: (1) macroeconomic stabilization, (2) the liberalization of prices, markets, and entry, and (3) deep institutional change. The problem of achieving macroeconomic stability and sustaining macro balance through the transition is the focus here.

Transitional economies have to implement stabilization policies in the midst of deep changes in systemic frameworks and in political institutions. With such large changes, systemic and political developments can strongly influence outcomes usually attributed to macro policies. Conversely, macro policies can have a large impact on outcomes traditionally attributed to structural or institutional policies.

To disentangle what affects what, Leszek Balcerowicz and Alan Gelb emphasized the pattern of interaction between macro policies, systemic changes, and political developments, rather than the details of individual programs and outcomes, which are subject to unusually large measurement problems. The core countries in their analysis are those in Eastern Europe with longer post-1989 reform experience—Bulgaria, Czechoslovakia and its successors, Hungary, Poland, and Romania.

Transitional countries now fall into two groups. Czechoslovakia, Hungary, and Poland—together with Albania, two of the Baltics, and Slovenia—have had some initial success in containing inflation following price liberalization. They now must consolidate macroeconomic stability while recovering and deepening institutional reforms. Most of the others—many with new currencies—have not yet held inflation at even moderate levels. The experience of the more advanced reformers in Eastern Europe offers lessons for both groups.

It is important to recognize the role of initial conditions, political developments, and external factors—as well as of economic policy—in determining outcomes. On balance, the core countries that faced the most serious macroeconomic problems may also have inherited the most difficult structural conditions, the most foreign debt, and the strongest trade unions. The political evolution of the countries has differed greatly. Contrary to popular opinion, political instability does not appear to be related to the type of economic program. Consider the Czech Republic and Hungary (both stable but with different political transitions and very different economic programs) and Poland versus Romania (both unstable, but one sustaining a radical program and the other not).

One common factor stands out. The countries in Eastern Europe and the former Soviet Union that have managed to contain inflation have all experienced major political breakthroughs combining democratization and renewed national independence. The record suggests that when there is high initial macroeconomic imbalance and such a major political breakthrough, forcible stabilization and rapid liberalization are almost surely the least risky option.

Initial stabilization has been most successful when radical programs have been launched during an early period of “extraordinary politics” following the breakthrough. The reversion to “normal politics” after an initial hiatus complicates further stabilization by raising inflationary expectations, slowing implementation of structural and institutional reforms, and reducing the propensity of state enterprises to adjust. Bulgaria is an example.

To succeed, stabilization requires fundamental behavioral and institutional changes. One function of
the radical reforms is to signal the need for such change by a discrete regime shift. When stabilization is not achieved, chronic financial indiscipline and mounting arrears can rapidly erode a program and destroy the credibility of a financially disciplined equilibrium. All policies carry high risk, but it seems better to err on the tight side rather than to try to fine-tune policies in the early stages to take advantage of the temporary respite on the balance of payments that appears as inflation is brought under control. The reason: a failure to stabilize initially will require further attempts—but from weaker economic and political bases and with less credibility.

In theory, stabilization could be achieved while retaining extensive state control of the economy. In practice, there has been a close relation between stabilization and liberalization, except on the wage front. Policymakers who valued stabilization also valued liberalization. Cutting fiscal subsidies and avoiding large central bank losses due to subsidized credits have been important elements of macroeconomic adjustment.

All the countries relied on wage controls—and some pegged the exchange rate to provide another nominal anchor. Wage controls are important because of the inevitable institutional lag of privatization behind stabilization and liberalization policy. Restraint is needed to preserve retained earnings to finance restructuring of the enterprise sector, which is likely to have to effect a net resource transfer to the banking system as stabilization is consolidated.

Some countries, such as Romania and Russia, have temporarily sustained positive transfers to their enterprises—unsustainable, as financial balances erode. The experiences of Bulgaria, Latvia, and Slovenia suggest that the importance of fixing the exchange rate is a more open question. It may hinge on whether deeply embedded inflationary expectations concern price increases (as in Latin America) or mostly shortages.

There apparently are no adverse medium-run tradeoffs between stabilization and either output or the speed of transition to a private economy. The failure to stabilize needed to show where adjustments will be less painful. But while large adjustments are needed, it is difficult to cut spending abruptly (especially after the end of “extraordinary politics”) when trying to preserve a democratic consensus in favor of reform.

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wastes valuable time and delays recovery. Private sector development measures, including privatization of small assets and access to commercial real estate, should be included as an essential component of a stabilization package because of the importance for the supply response.

The main fiscal reforms must involve spending. Even after the elimination of subsidies, ratios of spending to GDP are far above those usual in middle-income countries, largely because of social transfers. Severe resource constraints prevent the economies from growing out of these ratios rapidly, particularly if the budget is also to bear the costs of previously hidden inefficiencies.

In-depth analyses of spending—including detailed studies of the incidence of social benefits—are needed to show where adjustments will be less painful. But while large adjustments are needed, it is difficult to cut spending abruptly (especially after the end of “extraordinary politics”) when trying to preserve a democratic consensus in favor of reform.