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The Changing Mix of Disequilibria During Transition  
- A Romanian Background -

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Abstract

This paper looks at the dynamics of (dis)equilibria during post-command transition. It tries to define an optimal mix between external and internal disequilibrium and to apply this concept to the analysis of the Romanian economy. The forced adjustment of the balance of payments in the 1980s is presented as a prologue to the scrutiny of transformation policy underway; results and dilemmas of macro-stabilization are dealt with in this respect. The paper ends by providing some insights into the problematique of understanding (dis)equilibria in transforming economies.

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### Summary

Romania was a special case under central planning, and the balance of payments adjustment it undertook in the 1980s offers an example of a sui generis shock therapy undertaken in a command system. Direct controls were used to cut domestic absorption to the largest possible extent. This forced adjustment can be seen as an "internalization" of external disequilibria, which created increased domestic imbalances, both open and hidden. If one conceives an optimal degree of internalization, an obvious overtaxation of domestic absorption took place during those years.

The start of transformation consisted, among other things, of the decentralization of decision making, although soft budget constraints continued to operate; a phasing out of direct control devices; an increasing fuzziness concerning property rights, with trade unions becoming key players and "managers/monitors"; and a very liberal trade and foreign exchange regime. Macroeconomic policy was unable to contain the disequilibria because of the modifying domestic institutional and economic arrangements in the country and an unfavorable international environment. This resulted in a reversal: an "externalization" of domestic imbalances, which led to a surge of imports and a dramatic reversal of the current account balance.

The stabilization and transformation policy in Romania further fuels many debatable issues, including the following: How sustainable is stabilization if financial discipline can barely be imposed, and can the latter be imposed without clearly defined property rights? What are the microfoundations of macroeconomic policy during transition? Does industrial policy have a role to play in supporting enterprise reform and stabilization? What is the role of an incomes control policy in an uncompetitive environment and how can an industrial relations policy enhance stabilization under the prevailing circumstances concerning property rights? What is the role of foreign investment in fostering industrial restructuring when domestic investment is inadequate? To what extent does hysteresis occur when resources (labor) have low mobility? And, finally, if wage dynamics will not enhance human capital accumulation, how will long-run growth potential be impaired?



## I. Introduction

Reference to the legacy of the previous decade is a sine qua non starting point for analysis in order to understand better economic developments in Romania after December 1989. The latter was a special case under central planning and the eighties offered an example of a shock therapy - as a balance of payments adjustment - undertaken in a command economy. Direct controls were used to cut domestic absorption to the largest possible extent. This forced adjustment can be seen as an "internalization" of external disequilibria that entailed increased domestic disequilibria, both seen and hidden. If one conceives an optimum degree of internalization (which would indicate the composition of external and internal disequilibria that policy-makers should aim at in order to minimize the cumulated costs of imbalances for the economy) an obvious overtaxation of domestic absorption took place during those years.

After December 1989, the abrupt change of the overall domestic environment consisted, among other things, of: decentralization of decision-making power, whereas soft budget constraints have continued to operate; a fading away of the direct control devices (including fear and hierarchical links); an increasing fuzziness concerning property rights with trade-unions turning into key-players and "managers-monitors"; and a very liberal trade and foreign exchange regime. Macroeconomic policy was unable to contain growing disequilibria because of the modifying domestic institutional and economic setup (including the social and political climate) and an unfavorable international environment (collapsing former CMEA markets, effects of the Gulf war, etc). One can talk of a reversed process: an "externalization" of domestic imbalances, which led to a surge of imports and a dramatic reversal of the current account balance.

The stabilization and transformation policy in Romania gives further fuel to debatable issues suchlike: how sustainable is stabilization if financial discipline can barely be imposed and, further, can the latter be imposed without clearly defined property rights (the micro-foundations of macroeconomic policy during transition)?; does industrial policy have a role to play in supporting enterprise reform and stabilization? the impact of stabilization policies on a "free falling" economy; the effectiveness of incomes-control policy in an uncompetitive environment and the role of industrial relations policy (as part of industrial policy) in enhancing stabilization under the prevailing circumstances related to the structure of property rights; the role of foreign direct investment in fostering industrial restructuring when domestic investment is more than insufficient; hysteresis phenomena linked with unemployment brought about by austerity measures and trade reform (foreign competition) when resources (labor) have low mobility; if wage dynamics will not favor human capital build-up, how will long-run growth potential be impaired?

Part two refers to (dis)equilibria, in general, and is followed by an attempt to define an optimal mix between external and internal disequilibrium, the latter seen in a broad sense. Part four presents the

forced adjustment of the balance of payments in Romania in the 1980s as a prologue to the analysis of transformation policy. Results and dilemmas of stabilization policy during the first three years of transformation in post-communist Romania (till the end of 1992) are presented in section five. The next part talks about (dis)equilibria in transforming economies by providing some insights into this problematic. The paper ends with concluding remarks.

## II. On (Dis)Equilibria

Equilibrium can be seen as "a state of balance among certain forces within the economic system", that is a simple and mechanical meaning; it can be illustrated, for instance, by the equality between market demand and supply, or by monetary equilibrium understood as a balance between money inflows and outflows. Another definition emphasizes "the state of rest of the system, or of its elements". The Keynesian case of unemployment can be given as a mechanical understanding of this definition <sup>1/</sup>, which can be compared with an approach that tries to put under scrutiny the nature of relations among economic agents. In this respect, Fr. Perroux thinks that an economic system is in a state of general equilibrium when the net energy for change, resulting from the interaction among its economic agents, is null (1975, p. 156). And F. Hahn - by taking into account the relationship between information available and the agents' actions - considers that an economy is in a state of equilibrium when the messages circulating inside the system do not induce agents to modify the precepts that guide their actions and the ends pursued (1976, p. 243). Another meaning, which stresses individual behavior and the psychology of economic agents, views equilibrium as "a state of perfect fulfillment of agents' expectations on the essential variables of the economic system". Thus, equilibrium - seen as "informational equilibrium" - "denotes a state in which wage rates and other prices on average are found - over space and over time - to be what they were expected to be" (E. Phelps, 1970, p. 8); when expectations are not fulfilled and agents' plans are not reciprocally compatible the economy would be in disequilibrium. Finally, a meaning offered by J. Kornai in his later works, takes equilibrium as a "normal" state of the system, a state which reproduces itself as "the deviating or even opposing internal forces compensate each other and their resultant is unable to shift the system from its equilibrium path" (1983, p. 150).

The second and third mentioned definitions are quite interesting since they point to the possible latency of a system, -seemingly and temporarily in a state of rest - in conditions when the expectations (desires) of numerous economic agents are far from being fulfilled. Under such

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<sup>1/</sup> The Keynesian case of unemployment may be viewed as reflecting a state of disequilibrium according to the first definition mentioned, especially if one bears in mind the existence of excess supply of labor at operating wages.

circumstances, the pressure for change - towards reestablishing equilibrium - is likely to increase. Consequently, a state of equilibrium (disequilibrium) is to be qualified in relation with the period of time considered. Common sense leads us to see the concept of equilibrium as referring to the outcome of interactions among economic agents, to the state of an economic system. However, the drive for change manifests at microlevels, i.e., at the level of economic agents 1/.

The behavior of economic agents can be judged by taking into account the set of criteria which help to give a meaning to the state of (dis)equilibrium. It can be said that micro-equilibria exist when micro-units (individuals, firms) attain a balance between efforts and rewards (incomes), when their goals are reached and expectations are fulfilled. For the system, equilibrium (disequilibrium) emerges as an aggregate state.

The evaluation of the state of a system requires the selection (identification) of aggregates to characterize it. While aggregate equilibrium does not exclude the existence of "informational noise" and "friction" within the system - caused by information and transaction costs - a state of general equilibrium precludes them. It is obvious that more informational noise and friction entail bigger micro-disequilibria, higher inefficiency, or a lower level of utilization of factors of production.

Stricto sensu, the comparison between aggregate effective supply and aggregate effective demand gives a measure of aggregate (dis)equilibrium. In a normative sense - from the perspective of general equilibrium that maximizes output and welfare in the system, i.e., its performance - the analysis has to take into account a series of factors regarding the actual state of an economy: a) the level of unemployment of resources; b) the degree of allocative inefficiency and "X-inefficiency" (H. Leibenstein, 1966); c) the physical and moral depreciation of resources; d) the intensity of forced substitutions in production and consumption, which harms the quality of output and the welfare of consumers. This broad (normative) sense of aggregate disequilibrium comes very close in meaning to what could be called the aggregate performance deficit of the economy.

Accordingly, in a normative sense, aggregate disequilibrium - which is made equivalent to a deficit of utility (performance) - means the distance to the level of output resulting from a full utilization of resources in the system when there is consumers' sovereignty.

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1/ An economy where domestic absorption exceeds domestic output can be viewed as being in a stable state as long as the disequilibria of the external balance are tolerated by the outer world. When adjustments can no longer be put off, they will take place at the level of individuals and economic organizations. For an application of the concept of equilibrium at the level of individuals (economic agents) see, for instance, F.M. Fisher (1985, particularly p. 160).

In a formal manner it can be illustrated by the relation:

$$dU = U^* - U = U(Q(L^*)) - U(Q(L;e),0)$$

where (U) is the utility function;  $U^*$  refers to the maximum level of utility attainable when there is full employment of resources; (Q) is the production function that depends on the level of employment of resources (labor, L) and the degree of inefficiency (e) 1/; 0 denotes the intensity of forced substitutions.

### III. External vs. Internal Disequilibrium - Is there an Optimal Mix?

In a perfect world there would be no external and internal disequilibria; economies would operate at full employment and there would be no performance deficits. Real world is imperfect and since imbalances arise on a recurrent basis, one can imagine an assumed optimal composition of disequilibria. In this regard, the trade-offs encountered by policy-makers in working out economic policies are a telling proof. The misery index (the inflation rate + the unemployment rate) is a well-known, very simple, but suggestive, way of trying to depict a macroeconomic situation; it does conceal a fundamental relationship which has much relevance for governments, at least in the short-run.

Another fundamental relationship (trade-off) exists between aggregate external disequilibrium and aggregate internal disequilibrium, the latter understood in a broad sense. The trade-off does not necessarily arise when internal disequilibrium is seen in a narrow sense: as the equality between aggregate demand and aggregate supply; a proper utilization of macroeconomic policy tools would reduce both the external imbalance and the internal imbalance. For example in an economy confronted with large unsustainable current account (trade) deficits and high inflation, tight monetary and fiscal policies can be used to squeeze domestic absorption and would, hopefully, deal with both problems simultaneously.

When accommodating capital inflows are triggered by rises in real interest rates and foreign capital markets can be resorted to (by sales of bonds) authorities can have substantial room for influencing the required trade balance adjustments. This line of reasoning leads us to think of a composition of disequilibria which would, presumably, be most advantageous for the economy; costs, viewed as foregone welfare, compared to the performance potential of the economy would be minimized over time. This potential can be judged for the short-run and the long-run; in the short-

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1/ The degree of inefficiency, (e), practically reduces labor productivity. In order to simplify analysis, only labor is considered in the production function.

run, it depends on structural constraints (that reduce supply-responsiveness), whereas, in the long-run, these constraints can be removed and the performance potential can be related to the endowment with factors of production. The costs (foregone welfare) can be thought of in absolute terms, or in relative terms - as a percentage of the flows of potential output. Figure 1 is an attempt to illustrate the optimal mix between external disequilibrium, ED (the current account deficit - corrected by autonomous longterm capital inflows - as percent of GDP) and internal disequilibrium, ID (measured as the rate of unemployment). Point A denotes the optimal mix and is given by the least-cost line that touches tangentially the transformation curve between external and internal disequilibrium. Clearly, the marginal cost and the marginal benefit of internalizing one unit of the current account deficit are equal at A. Outside point A the marginal cost of internalization (or externalization of the internal imbalance) increases steadily. Should A be available to the policy-makers as an option, B and C indicate an underreaction and an overreaction, respectively, on their part 1/. Over time, point A shifts according to the dynamics of the economy, one powerful reason being that an economy faces a hard-budget constraint in the long run; a nation can not accumulate IOUs ad infinitum. Consequently, the optimal-mix of disequilibria has to be seen both statically and dynamically. In the latter case, dynamic optimization can be used in order to identify a least-cost function when various constraints apply.

The further comments rely on the case of command economies as a theoretical prelude to the following section. Internalization of the external debt was the major feature of economic policy in Romania in the past decade and its legacy has much explanatory power for current events.

First, distinction should be made between repayment of debt and internalization of an external imbalance. Obviously, not any repayment of external debt is, concurrently, an internalization of external imbalances. One need only think of how these external debts emerge. Two major situations appear in this respect: 1) the importation of foreign resources in order to increase domestic productive investment and, consequently, the growth rate of the economy; 2) the foreign financing of imports aimed at alleviating internal imbalances (the externalization of these imbalances).

Let us look at the first situation. When efficient use is made of the imported capital - which implies a satisfactory rate of return for the newly obtained externally tradeable output -, the repayment of the debt is made out of the surplus of utility (output). The smaller is the efficiency (external earning power) of the utilization of the imported capital, the smaller becomes the net surplus of utility (which remains after disbursement). The internalization process sets in when the cumulated (over time) net effect turns negative, i.e., when net utility turns into net

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1/ Policy-makers over(under)react according to their preference function, which does not fit a Paretian welfare function.

disutility 1/. If the productivity of imported capital put at work is very low, then the case arises as if the country imported resources for consumption on credit. By assuming an economically insignificant productivity of the imported capital the second situation is reached 2/. This situation regards the externalization of internal imbalances which, sooner, or later, brings about the unavoidable internalization process when net borrowing comes to a halt because of its prohibitive cost. The process of externalization can only postpone bringing the aggregate effective demand towards a new motion path, according to the actual dynamics of internal supply. When it is not accompanied by positive changes in the functional structure of the economy and when the external environment does not produce "windfall gains" (such as a dramatic and resilient improvement of the terms of trade), the externalization of internal imbalances complicates the delayed forced adjustments.

As pointed out internalization can be subject to optimization. By assuming a minimum cost (disutility) of disequilibria for the economy - which is given by their composition between internal and external imbalances - it can be inferred that internalization should not exceed a certain degree. This degree is related to an optimum period of repayment of the external debt; a period that minimizes the adjustment costs, ceteris paribus, by presuming no change of the quality of functioning of the economy. The minimization of costs and the optimum degree of internalization are thus seen in an inter-temporal perspective.

The costs of internalization are temporary and durable. The temporary, immediate, costs, refer to the curtailment of absorption (consumption), while the durable costs are reflected by a fall of the growth rate of domestic absorption (consumption) following the reduction of investment (as a result of the forced cut of imports, including capital goods 3/. The analysis deals with net costs since the process of internalization (as

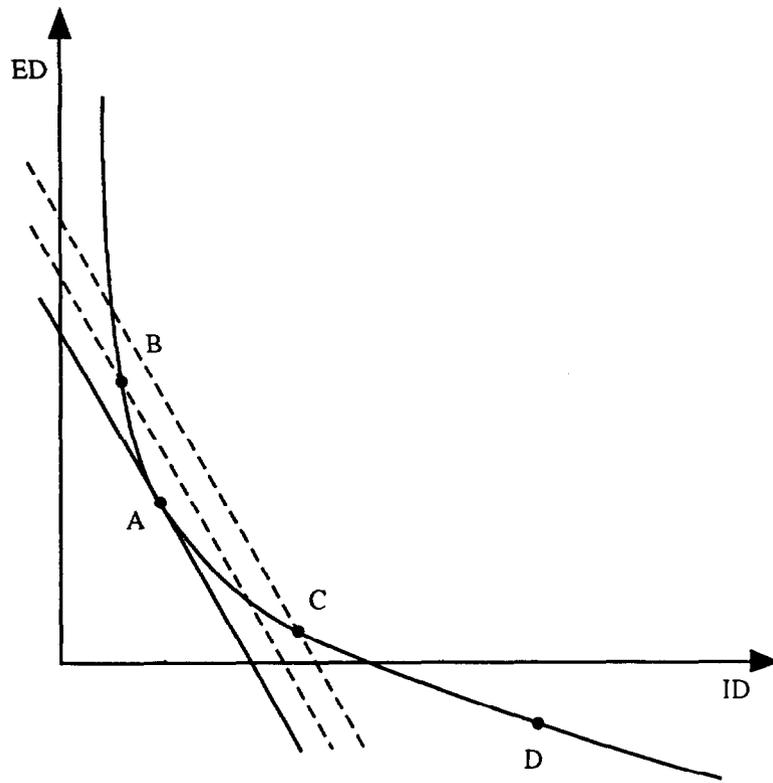
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1/ Internalization is more intensive the smaller is the efficiency of the utilization of the imported capital.

2/ The general criterion for measuring internalization in the first situation (the second situation speaks for itself) sounds like this: the extent to which repayment of the external debt creates a cumulated (over time) net disutility for the economy which translates itself into lower consumption and smaller economic growth rates.

3/ The costs are felt on the supply-side of the economy in another way as well: a prolonged containment of internal consumption with the inherent lack of new material incentives to producers and individuals would hardly stimulate innovative efforts. In a worst scenario the consumption effect and the production effect would reinforce each other on a downward-going spiral. The point was made forcefully by L. Antal (1983) as well.

Figure 1: The Optimal Mix of Disequilibria





gradual repayment of the debt) entails also benefits for the economy under the form of a reduced debt service 1/.

An overreaction signifies a larger and a faster speed of internalization as compared to the size and pace indicated by the optimum process. In the case of overreaction policy-makers put a higher value on the reduction of the external debt than on the need to cushion against growing internal imbalances. Their perception of economic difficulties is biased towards the presumably (on their part) more visible and pressuring side of overall disequilibria. An underreaction, i.e., a too slow and too small internalization, increases also the costs of forced adjustment in comparison with the optimum situation. When policy-makers underreact there is an underestimation of the later costs of forced adjustment. The cases of overreaction and underreaction throw light on major interrelated problems of internalization: its dimension, speed and structure.

The dimension and speed of internalization, on which the repayment period 2/ depends, determines the extent to which domestic absorption is curtailed. The structure of internalization refers to how the two basic components of domestic absorption are hit by its programmed reduction. Thus, deeper cuts in consumption can protect its future levels by maintaining investment above a reasonable level. And vice versa, a drastic and persistent reduction of investment, though it facilitates the task for policy-makers of not leaving untouched the consumption of population, affects negatively the development of the productive apparatus of the economy. Furthermore, the future growth rates of consumption are affected since the latter is a function of the capital stock. The longer is the period of disbursement the easier to make is the choice concerning the structure of internalization. Another factor that intervenes in the optimization analysis is the level of the interest rate, the more so when it fluctuates and causes upward-going variations of the debt-service, which can hardly be borne by the economy; an exceedingly high real interest rate favors a reduction of the repayment period, but its "pressure" is to be judged in conjunction with the actions of all the other factors. Some restrictions for the process of internalization must be paid attention as well: the curtailment of consumption can not go below a critical inferior level and the investment can not be cut more than what is absolutely

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1/ Benefits could accrue to the economy should a significant change occur in the attitude of the trading partners, following an improved financial standing of the debtor country.

2/ In spite of the known term structure of the external debt its period of repayment becomes variable in the optimization analysis; the debt can be repaid faster than the period suggested by its original maturity schedule, or it can be restructured and paid back over a longer period. In general, it is hard to think that the time variation of internalization can enable a one-time process to take place since the critical floor levels of consumption and investment (obviously different for each national economy) act as restrictions.

necessary for the economy to continue running; the inferior limit for investment gives the critical level of intermediate imports.

The hypothesis regarding the invariability of the mode of functioning of the economy can be dropped. In this case, the optimum period of internalization has to be correlated with the period of adjustment of the mode of functioning of the economy and of its industrial structure (in order to bring about the required changes in the material structures of production).

#### IV. The Pre-Transition Shock-Therapy

Initial conditions in the transforming economies are frequently paid insufficient attention. This is quite puzzling since differences in the contents and results of the currently undertaken stabilization policies can be significantly related to dissimilar initial conditions. The countries in the region have different histories under command planning (communism) when judged in terms of relaxation of direct controls (partial reforms) and economic policy choices. 1/ The different histories explain why market ingredients, institutions vary among the national environments and, also, why macro- and micro-disequilibria differed among them on the eve of the "Big-Bang" of 1989.

Thus Hungary is the classical example for reforms evolving within the system and the former Czechoslovakia is conspicuous for the ability of central planners to keep macro-disequilibria under relative control (though, for the latter country, dynamic losses measured as against the pre-communist legacy and the investment rates during command planning are much higher). Unsurprisingly both countries have fared better than the rest in their stabilization programs.

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1/ The relative ease in subduing open inflation in the former Czechoslovakia would vindicate, partially, R. Portes (1977) and others who pointed out that central planners can be quite effective in keeping macro-imbances under control. Relatedly, I would say: a) traditionally, Czechoslovakia showed better results vis-à-vis her communist neighbors in this respect; b) after the invasion of 1968, the new communist leaders struck a sort of tacit social contract with the population - more consumer goods through an altered investment policy; c) though command economies generate shortages steadily and macro excess demand is a structural feature of the system, central planners can react and alleviate both micro and macro imbalances. However, when the assessment is made in terms of foregone performance, the country finds itself at a terrible loss after more than four decades of communist rule. One should recall that the former Czechoslovakia was a leading industrial power in Europe before the second world war.

Romania, under communism, stands out for its unflinching adherence to Stalinist precepts of economic policy, its isolationism, its industrial policy choices which ignored blatantly comparative advantages, its trade policy choices that ran counter to the very logic of functioning of the domestic economy and a sui generis "shock-therapy" in the eighties. At the end of that decade the Romanian economy was one of the most tightly controlled and centralized in Eastern Europe. The Ceauçescu regime deprived the country of the experience of any significant economic reform, leaving the administration tied to a Stalinist model that had by that time been abandoned by almost all other countries in the region. In addition, the economic policies of the regime further distorted the economic system" (D.G. Demekas and M.S. Khan, 1991, p. 8).

Romania provides an interesting and instructive case of "immiserising-growth" caused by the logic of motion of the system, in the main, the rush to speed up industrial growth, and to increase ties with market economies on a very weak functional basis. In the literature, this phenomenon is explained by the existence of various price distortions which harm resource allocation, worsen the terms of trade, and lower welfare. 1/ But one can think of the very mode of functioning of the economy (including the genesis of wrong industrial choices) as the distortion that leads to immiserising growth. It can be shown that the inner dynamics of the system - incapacity to cope with increasing complexity and inability to assimilate and generate technological progress - lead to a "softening" of output, characterized as its expansion with a large bias toward industrial soft goods, which entails a steady deterioration of the terms of trade. This is what happened in Romania where forced industrialization gave precedence to steel, chemicals and machine-building industries, and agriculture was terribly squeezed. The unhealthy nature of such growth can be briefly explained as follows: The biased expansion of the production of soft goods - which belies the comparative advantages of the economy - requires a quantity of hard inputs which would either be provided only by disrupting domestic production, or not be achieved for many export-destined goods are unsalable. Actual exports of soft-goods are hence smaller than the level programmed and the remaining necessary inputs are obtained through an international exchange of hard goods. This means that the country has to forgo consuming certain kinds of hard goods (consumer goods which are in high demand from ordinary citizens) in favor of acquiring other types of hard goods, such as energy, raw materials and spare parts; the welfare loss for the population is tremendous and it, in turn, triggers a supply-multiplier effect on the part of consumers (seen as labor suppliers), that further affects negatively output.

The start of the eighties highlighted the grand economic debacle; the external shocks - such as the brutal rise in the oil prices, or the sharp increase of world interest rates - whose effects were mitigated by external financing for a while only, accelerated the decline of the economy.

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1/ See especially J. Bhagwati (1958) and H. Johnson (1967), especially.

External debts rose at over 10 billion dollars. Ceaușescu rejected any suggestion of market inspired reform that could have improved the performance of the economy and its export capacity. Clearly, this attitude made it very difficult any attempt to reschedule external debts. Getting rid of the whole external debt became the paramount goal of his economic policy. Moreover, it was decided that no effort be spared in order to reach this goal as soon as possible. How haunting the goal became is proved by the size of prepayments in the latter half of the decade: \$0.5 billion in 1987, \$2.9 billion in 1988, \$1.2 billion in 1989. This is a clear case of overreaction in internalizing the external debt, with deleterious effects on the whole economy.

This extraordinary "shock-therapy" - unprecedented in the world - was enforced through a considerable squeeze on domestic absorption, on both consumption and investment.

Since "immiserising growth" limited the potential to raise exports, the targeted trade surpluses were achieved through very heavy cuts in hard currency imports (see Table 1). Apart from the reduced level of investment, the growth possibilities were impaired also by an unusual curtailment of imports of machinery and equipment from the western countries 1/. By using a Laffer-curve-analogy it can be said that a heavy overtaxation of domestic absorption took place during those years which showed up, subsequently, in lower growth rates of production, lower welfare (consumption), bigger domestic disequilibria (both seen and hidden); shortages were on the rise in both production and consumption.

Official figures do not convey the extent of the harm done by this overtaxation. Table 2, for instance, shows the dynamic in GDP growth rates. But these figures do not capture the effects of the decline on the quality of resources used - partially, as a result of import substitution and import switching (from CMEA countries). The actual loss of output was obscured considerably by rising costs of production that transferred into higher nominal values of goods and, thereby, inflated artificially nominal GDP 2/. It is quite possible and probable that a growth of nominal national income represented a drop of real national income, when valued in international terms. This effect was compounded by the labor-supply multiplier: workers who adjusted their real work efforts to their real incomes.

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1/ At the end of the 1980s, these imports were 0.1 percent of the level at the start of the decade (0.1 billions in 1989, as compared to 1.1 billions in 1990).

2/ In two main instances import substitution entailed soaring costs of production that showed up in higher nominal values of output. First, it is the case of promoting very costly domestic production of technology and equipment. Secondly, rising costs accompanied inexorably the efforts deployed to increase the degree of procurement of energy and raw materials out of domestic sources.

Table 1. Current Account Balance (in \$ million)

	1980	1983	1985	1987	1988	1989	1990	1991	1992
Convertible Currencies (in U.S. \$)									
Trade account	-1.534	1.688	1.558	2.436	3.608	2.559	-1.743	-1.357	
Exports, fob	6.503	6.246	6.156	5.864	6.511	5.965	3.364	3.533	
Imports, fob	8.037	4.558	4.598	3.428	2.903	3.406	+5.107	+4.890	
Services balance	-865	-766	-450	-211	17	305	87	-12	
Current account	-2.399	922	1.118	2.225	3.625	2.864	-1.656	-1.369	-1.200
Source: National Statistics									

Table 2. GDP (Percent change per annum)

1978 - 1981	1982 - 1985	1985	1986	1987	1988	1989	1990	1991	1992
4.5	4.0	-0.1	2.3	0.8	-0.5	-5.8	-7.4	-13	-15.4
Source: National Statistics									

The welfare effects of the shock-therapy, too, can hardly be captured by statistics since they express several interlinked phenomena: reduced available consumer goods because of net exports (the net foreign balance was 7 percent of the GDP, on average, during 1985-1987 and attained 9.5 percent in 1988, the peak level for the decade), the loss of utility caused by the "softening" of certain goods (of output, in general), forced substitutions and forced delays in consumption, the change in the utility perceptions (preferences) of the consumers, due to demonstration effects and changes in availabilities of goods. The impact of the shock-therapy on the average citizen is indicated by his consumption pattern in 1989: food expenditure, 50 percent; clothing and shoes, 13 percent; energy, 7 percent etc. Essentials of life held a disproportionately high share in comparison with countries of similar income per capita levels; this can not be attributed to spillovers caused by distortions in relative prices 1/ since real incomes (not "measured" real incomes) went down and shortages of the mentioned items intensified over the period.

The eighties brought about a substantial increase of the monetary overhang. Estimates that use the income velocity of broad money held by households as a proxy for the degree of forced savings of the population suggest that up to 1/3 of money balances were held involuntarily (E.R. Borensztein, D.G. Demekas, J.D. Ostry, 1992, p. 27). Relatedly, another phenomenon is worth mentioning: the existence of a "suppressed excess demand" under the guise of forced substitutions in consumption 2/. When "demonstration effects" in consumption are strong, the supply-constraint is not absolute, and the structure of consumers' preference is quite stable (the "discouraged consumer effect" is much less significant than what might be presumed in conditions of intensified shortage over long periods of time), the elasticities of substitution in consumption are sufficiently low 3/ for consumers' welfare losses to be considerable. The monetary overhang and the hidden excess demand formed a disequilibrium on the side of household demand (the pent-up demand). This repressed demand

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1/ In the case of Poland, L. Podkamminer (1982) stresses the spillover effects in consumption due to distortions in relative prices.

2/ There is another aspect about forced substitution in consumption that needs to be pointed out. Consumers are forced to purchase products of very low salability, which in conditions of a buyers' market would go almost instantly out of production. The consumer's utility bought by a certain amount of money is reduced through forced substitution. Moreover, an illusion of a possible value equality between the aggregate demand for and the aggregate supply of goods is created, through an administrative fixing of the prices (values) of the inferior goods. Here, one deals with additional distortions in prices, which can create a false value equality between aggregate demand and aggregate supply.

3/ "It is important to recognize that household behavior, including the supply of labor and effort, is clearly determined by shortages faced in markets for individual goods, but unaffected by the existence of unsold inventories of other, overpriced goods" (J. Brada, A. King, 1986, p. 174).

put a tremendous pressure on the balance of payments after December 1989, when consumers were able to switch their preferences in favor of tradeables 1/. If the excess demand is combined with the unaccepted (by the population) drop in consumption, during the 1980s, one gets a feeling for the magnitude of the urge to return to "normal" paths and patterns of consumption, which took concrete shape once the command system began to crumble.

The ten years of debt internalization accentuated the decline of competitiveness of the economy and disequilibria among sectors, shortages increased, the people's plight went beyond imagination; and the country imploded. Romania was a laggard among her neighbors as to the institutional prerequisites for helping post-communist transition, the psychological readiness of the population for abrupt change, and the social base for market reforms. Moreover, the "shock-therapy" of the eighties created among people very high expectations for an immediate and substantial improvement of material conditions after a change of the rules (or of the regime), which signalled a high degree of intolerance for new austerity measures.

#### V. Stabilization Policy and Disequilibria in Romania

Internalization of external disequilibrium and the extreme overreaction of decision-makers were indicated as the major feature of economic policy in Romania in the 1980s. Almost symmetrically, the most salient feature of economic life after December 1989 is a major reversal of the abovementioned phenomenon: an externalization of domestic imbalances. What happened in Romania in a relatively short while (1 year) is also unique among her neighbors: from a current account surplus in hard currency of \$2.864 billion in 1989 the country moved to a deficit of \$1.656 billion a year later (Table 1). The turnaround is absolutely astonishing if the size of foreign trade is taken into account - in 1989 exports and imports in hard currency totalled slightly under \$10 billion. Thus, the reversal meant almost 45 percent of the foreign trade turnover in 1989.

The roots of this situation, which go into the previous decade, were already underlined; there was a tremendous pressure from below 2/ to consume tradeables, to reduce exports and boost imports of both consumer and intermediate goods. The switch in favor of tradeables was almost instant and hardly stoppable; it was strengthened by a "shunning of domestic goods" syndrome (foreign goods, apart from quality attraction, still mean for many prestige, status). Having been starved for years, consumers and producers reacted immediately to the new environment and their reaction forms one side of the story.

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1/ The switch was reinforced by a shunning of domestic goods in favor of imported goods (a phenomenon acutely felt in the former East Germany)

2/ What my colleague E. Ghizarie named **decompression**.

However, there is another side of the story that needs to be highlighted. The policy-makers complicated the state of the economy by commission and omission. By commission since they practiced a brand of populist macroeconomics, faltering in the face of pressures from below, but lured also by the elections held in May, 1990. This resulted in high laxity in conceding wage rises 1/, and introduction of the five days workweek, though output was plummeting, maintenance of wideranging price controls and of a much overvalued exchange rate, and mismanagement of the foreign exchange reserves. At the end of 1989 foreign exchange reserves stood at more than \$1.7 billion; these went down to under \$400 million at the end of 1990. By omission for one can about real attempts to stabilize the economy before November 1990. Trying to sum up one can say that both aggregate external disequilibrium and aggregate internal disequilibrium increased 2/, with micro-disequilibria partially alleviated by substantially increased imports. Policy-makers should have been concerned by the fact that production was reestablishing an import-dependency unsustainable in the long run. And this became obvious soon.

Events during that year showed a fundamental flaw of the system in transformation: the high degree of decision-making power of enterprises when these do not face hard-budget constraints and enjoy free access to hard currency. They also made clear the damage caused by an economic policy whose dimension of "benign neglect" was very high profile. November signalled the beginning of intentions of stabilization policy by a partial liberalization of prices and a devaluation of the domestic currency (from Lei 20/\$1 to Lei 35/\$1). These measures, followed by another package in January 1991, proved to be too little and too late.

Confronted with a free-falling economy 3/ and unable to contain growing disequilibria (unsustainable trade deficits 4/, rising prices, vanishing investment) an IMF supported stabilization plan was introduced at

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1/ Some would link it with the elections of May 1990. Measured real wages rose by 11 percent over the period December 1989 - October 1990, while output was on the decline; price decontrol was initiated in November of that year.

2/ The rising nominal wages against the background of declining output and price controls led to increased monetary holdings.

3/ Real GDP fell by 7.4 percent in 1990 and by 13.0 percent in 1991. For 1992 the drop is 15.4 percent.

4/ The external trade deficit in hard currency was \$1.743 billion in 1990 and \$ 1.357 billion in 1991 (Table 1).

the start of 1991 1/. The government could hardly have done otherwise since the looming trade deficits became more than threatening. With the benefit of hindsight it can be said that, in view of the large external disequilibrium, policy-makers have been constantly under-reacting to the dynamics of the economy.

Why did they under-react. The state of the economy in December 1989 and the high expectations of the population after the "shock-therapy" of the 1980s, obviously, blunted the resoluteness of the decision-makers to move swiftly with a comprehensive austerity program and comprehensive freeing of prices. Another possible explanation is that the government underestimated the seriousness of the situation for quite a while. And finally, the lack of foreign financing, paradoxically, instead of stimulating boldness, increased the degree of cautiousness.

A conceptually middle of the road (gradualistic) stabilization program took shape which entailed essentially: tightening of the fiscal and monetary policy 2/ (although real interest rates remained highly negative), a tax-based incomes control policy, a new devaluation 3/ and introduction of two-tier exchange rate system (through the initiation of an interbank foreign exchange auctions system, in February 1991).

The program was ineffective in stopping inflation (see Table 3). Moreover, the real credit squeeze, caused by the high jump in prices (after liberalization) followed by their steadily rising level (the price index reached 352, 2 percent in October 1991 as compared to the pre-liberalization moment in October 1990), did not help in moderating output decline. The volume of gross inter-enterprise arrears increased exponentially, reaching a figure approximating 50 percent of the GDP (measured at the December 1991 prices) at the end of the year. At the same time, the spread between the two exchange rates persisted, exports continued to be sluggish, whereas the CMEA trade virtually collapsed.

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1/ In January 1992, P. Murrell asked me: "why did Romania resorted to an IMF supported plan in view of her excellent external account position at the start of the transition. I replied that: a) more important than the stock of external debt are the sustainable flows of imports; and b), under the prevailing social and political circumstances rejecting conditional support from the IMF would have forced authorities to try to reimpose direct controls, a path-policy scarcely desirable and, practically, unfeasible at the time. People too often tend to forget that the Chinese solution means "change controlled from above". In Romania the social explosion triggered processes beyond any control.

2/ Credit ceilings of 22 percent were imposed for the year and interest rates (although they remained negative in real terms) were liberalized in April of 1991.

3/ From Lei 35/41 to Lei 60/41 (Table 4).

Table 3. Inflation Rate

	Inflation (CPI Index)	
	October 1990 = 100 percent	Monthly Index
<b>1991</b>		
January	158.1	
February	169.2	
March	180.4	
April	228.2	
May	239.8	
June	244.5	
July	267.7	
August	297.6	
September	319.4	
October	352.6	
November	391.0	
December	444.5	
<b>1992</b>		
January	531.2	119.5
February	624.4	112.5
March	657.3	110.0
April	688.0	104.7
May	771.3	112.1
June	804.1	104.3
July	829.6	103.2
August	857.6	103.4
September	944.5	110.1
October	1035.2	109.6
November	1174.9	113.5
Source: National Statistics		

The end of the year brought about a "global compensation" as a means to reduce inter-enterprise arrears. Though the additional credit was mostly sterilized by March 1992, the initiative brought to the fore the moral hazard issue. The only achievement of the program was doing away with the monetary overhang.

At the end of 1991 growing tensions were building into the system: an overvalued official exchange rate and an excessively liberal trade regime, too low prices for energy and raw materials which favored their overconsumption, insufficient inflows of capital to compensate the low levels of saving and the feebleness of investment. The strategic move of November 1991, the unification of the exchange rate 1/ and the introduction of internal convertibility, became irrelevant in a short while, basically, because of the lack of supporting foreign financing and, very likely, because of the choice of an overvalued rate. For several months the exchange rate remained unchanged at the Lei 198/\$1, a level that meant a growing imbalance between the supply of and the demand for foreign exchange 2/. Moreover, an overhang of hard currency claims was stockpiling 3/. Many exporters and importers found a way out by practicing barter deals, which introduced an implicit exchange rate into the functioning of the economy; this rate mitigated the pernicious effects of overvaluation. However, capital flight and insufficient exports were becoming of major concern; the whole policy was in need of a major overhaul which, among other goals, should restore actual internal convertibility.

What came out of the decision-making process in the spring of 1992 provides, in my opinion, a good case-study for understanding critical choices faced by macroeconomic policy during transition. Basically, policy-makers had to decide on an optimal mix of short-run disequilibria, that should reduce the performance deficit (as defined earlier) and deal with the major constraints. The line of reasoning was that recessionary effects of the fight against inflation - that involved austerity measures - could be counteracted by the pulling (multiplier) effect of a policy that would succeed in boosting exports and attracting capital inflows. Increasing exports and restoring internal convertibility appeared as a must since the economy was menaced by suffocation on the side of the external balance. The idea of creating an export drive was reinforced by the long-run requirements of reform policy: achieving an equilibrium exchange rate, setting positive real interest rates (which should encourage savings and relieve the pressure on the exchange rate), adopting special export promotion measures, and working out an industrial (restructuring) policy that should enable the imposition of financial discipline (the fight against arrears) by distinguishing between "bad guys" and "good guys". Interest rates were raised considerably (the refinance rate of the National Bank reached

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1/ At the level of Lei 184/\$1 (Table 4).

2/ Caused by the increasing overvaluation of the domestic currency due to inflation differentials.

3/ Because, officially, internal convertibility was enforced.

80 percent), the exchange rate was devalued substantially (see Table 4) 1/ and exporters were granted full retention rights in order to cope with their distrust of policy-makers and encourage capital return. The full retention measure was thought necessary since enterprises had, still, very vivid in their memory what they considered as partial "confiscation" of their hard-currency holdings at the end of 1991 2/. At the same time, Law 76, aiming at enforcing financial discipline and triggering restructuring, was passed by Parliament.

Two major debates revolved around the new package of measures introduced in May of 1992. One controversy related to interest rate policy. Some would argue that in a depressed (declining) economy and in which the disinclination to save is on the rise because of the shrinking household budgets - it is counterproductive to raise interest rates in real terms. On the other hand, in Romania's case, the foreign exchange constraint has become so threatening and the capacity for expanding exports is not so insignificant, that the choice favored the attempt to achieve positive real interest rates. And an additional argument was at hand: domestic investment has been so feeble (after 20 percent in 1990, it reached 12.3 percent of GDP in 1991, the lowest level since 1945) that bringing in foreign capital is also a must in order to enhance restructuring of industry and growth resumption.

The other controversy is a Romanian version of the much celebrated confrontation between elasticity "optimists" and "pessimists". The latter point out the structural rigidity and heavy import dependency of the economy and fear that devaluation would only fuel inflation, without provoking a quick and significant improvement of the trade balance. On the other hand, they ignore an essential truth hovering over the functioning of the Romanian economy: the much overvalued exchange rate which has been discouraging exports and has been subsidizing imports. That devaluation was the right move is proved by the dynamics of foreign trade which scored a succession of surpluses after June 1992. Additionally, temporary real unification of the exchange rate and the disappearance of the black market for foreign exchange - as a fundamental structural achievement in the mode of functioning of the economy - was obtained during the second half of 1992.

Unfortunately, political reasons connected with the elections of September 1992, stymied the determination of the government to pursue a consistent exchange rate policy. Once more the official exchange rate was kept fixed - at Lei 430/\$1 - trade imbalances soon reappeared in October, 1992, and the spread between the official rate and the black market rate

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1/ From Lei 206/\$1 in April, it moved to Lei 226/\$1 in May, Lei 304/\$1 in June, Lei 365/\$1 in July, Lei 383/\$1 in August and Lei 430/\$1 in September (Figures are end of month).

2/ After "exchange-rate reunification", their claims for foreign exchange were not satisfied adequately by banks and a hard-currency overhang started to build up.

Table 4. Exchange Rate (Lei/U.S. Dollar)

Period	End of Period		
	Official	Interbank rate	Referene rate (National Bank)
1991			
January	34.74		-
February	34.66	203.00	-
March	36.97	200.00	-
April	60.67	200.00	-
May	60.35	190.00	-
June	62.05	190.00	-
July	60.77	270.00	-
August	61.38	250.00	-
September	59.77	230.00	-
October	60.36	260.00	-
November	-		184.00
December	-		189.00
1992			
January	-	-	198
February	-	-	198
March	-	-	198
April	-	-	206
May	-	-	226
June	-	-	304
July	-	-	365
August	-	-	366
September	-	-	430
October	-	-	430
November	-	-	430
December	-	-	430

Source: National Statistics

resurfaced alarmingly at the end of 1992 (Lei 430/\$1 vs. over Lei 600/\$1 for the black market rate). In this case, one can see how easily politics can alter economic policy and nullify a structural achievement acquired with a lot of difficulty. As far as interest rate policy is concerned, it had limited success since inter-enterprise arrears, as a form of temporary quasi-inside money, - though they came down to cca 25 percent of GDP at the end of 1992, which is a clear improvement over the previous year - provided enterprises with very cheap credit and enabled them to continue putting pressure on the foreign exchange market and prices. As a matter of fact, inter-enterprise arrears - which can be viewed as a defense reaction of a system under much strain - endogenized money supply in a perverse way and emasculated, to a large extent, monetary policy; in essence, they mirror structural and sectoral disequilibria within the economy and make up a structural trap for stabilization policy 1/.

#### VI. Interpreting Dis(Equilibria) in Transforming Economies

New phenomena such as open inflation, open unemployment connote new forms of operating disequilibria in the emerging market economies. They still coexist with substantial hidden unemployment and price controls, making up complex and intricate combinations of internal imbalances. We can think also of other types of disequilibria, which do not necessarily fall within the strict realm of conventional economics, and which could help us understand better the functioning of economies (societies) in transition. These include, in particular, "organizational disequilibrium", meaning the shortage of market-required organizational capital; the gap between people's expectations and what governments can deliver in the short run - "expectational disequilibrium", or excess expectations; and under close scrutiny should also be the micro-foundations of macro-disequilibria - the extent to which Say's principle operates and hard budget constraints are imposed.

Recently, there has been a flurry of research activity about the reasons for the unprecedented falling of economic activity in the region. Why so large and why so persistent is "aggregate disequilibrium" in the broad sense, to use the terminology of this paper? To answer this question, one needs first to define the potential performance under the circumstances.

R. Portes asked once rhetorically: "why have we overestimated so much the actual and potential performances of the former centrally planned economies" 2/. If we admit this "performance illusion" - similar to Fr. Holzman's "salability illusion" - then part of the fall in output can be seen as a normal depreciation, at world market values, of production. "The

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1/ For more elaboration on inter-enterprise arrears as a symptom of a system under strain see D. Daianu (1993).

2/ At a conference in Luxembourg, in February, 1991.

Midas-touch effect" in reverse 1/ can explain the damage caused to the economy in a dynamic sense, to its performance potential. Otherwise said, institutional rearrangements (turning the system into a market based economy) would not lead to that increase of performance which might be suggested by the past flows of inputs (accumulated capital and human stock) and macrostructural changes 2/. Another way of looking at this issue is by exploring missing factors in an extended (multifactor) production function. And here the finger could be put on "organizational capital" (P. Murrel, 1991) 3/ and on critical institutions 4/, which can not be built overnight. And let us not forget that imports are not a solution since the aforementioned factors can not be, essentially, but home-grown. From this perspective a proper set of property rights - that can not be decreed and enforced by authorities at will - appears as a structural constraint affecting potential performance.

What about the rest, or the corrected - after depreciation - J-curve (or L-curve) effect mirroring aggregate disequilibrium in this broad sense. Taken as outcome, performance deficit can be related to structure, policy and environment (Th. Koopmans, J.M. Montias, 1971).

Structure is not meaningless in explaining performance deficit when its major flaws can be dealt with in a timely fashion, i.e., by not inviting criticism that the required changes are developmental in nature - that they take time (and Natura non facit saltum) and should rather be put under the already used roof of performance depreciation.

The reform of property rights shows that drawing the conceptual dividing line is not an easy task. Where private property rights can be quickly enacted and enforced and they actually drive individuals' actions and enhance efficiency (land reform and active privatization are examples) structure is very much alive as a target for transformation policy. But when the texture of property rights is harder to define and the governance issue clouds the sky, one, easily, trespasses into the territory of developmental matters. Nonetheless, it is clear that when fuzziness about property rights is policy-related, action is urgently required. Romania's experience is quite instructive in this regard. Thus Law 15 of August 1990, on "Restructuring of State Economic Units" devolves and dilutes power by

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1/ Expression concocted by J. Winiecki several years ago. Winiecki referred to King Midas of Antic Greece who was cursed to turn into gold everything he put his hands on, including his own food.

2/ J. Rostowski (1991, p. 191) is very much in my line of thought with his remark that in centrally administered economies the problem is not just that resources are allocated inefficiently, but the process of allocating them is inefficient.

3/ And all other who espouse an evolutionary approach. The leading fountain of ideas can be found in R. Nelson and S. Winter (1982).

4/ Rules enjoying wide social acceptability are also to be included (D. North, 1982).

creating confusion as to who are the real owners of enterprise assets. In this way collusion phenomena are encouraged, management contracts (to monitor the performance of managers) are easily avoided by managers and, ultimately, the attributes of the state (as the owner of the still unprivatized property) are devoid of substance.

Admittedly, the fuzziness created by this law has been embedded in a climate of "citizens' rebellion" against any kind of authority, but the fact remains and gives much concern to policy-makers. Together with "citizens' rebellion", fuzziness about property rights can explain the rise in X-inefficiency and the non-profit centered objective function of enterprises, which strive to boost wages and preserve jobs. The contention here is that as long as property rights will not be well defined and enforced, budget constraints will continue to be as soft as to undermine any efforts to stabilize the economy; in other words, it turns out that the softness of budget constraints represents the Achille's heel of stabilization policy.

Underlining the weak micro-foundations of macroeconomic policy in transforming economies does not mean that the remedy is around the corner. Clamoring in favor of privatization 1/ does not help much when the real process is slow and cumbersome. Notwithstanding, all available means must be used in order to impose a modicum of financial discipline, and the latter can be pursued by improving the governance (on commercial terms) of state owned enterprises.

Structure can help us in understanding why it is so hard to impose financial discipline - apart from the general climate in the economy and inadequate property rights - by focusing on the given distribution of resources (assets) in the society. Transformation sets in with an initial endowment of resources that spans the whole spectrum of enterprises: negative value added, non-profitable, but still positive value-added and profitable units. "The power of the weak" (the loss-market enterprises) is the power of structure over those which can make ends meet financially, but are trapped into the network. Inter-enterprise arrears are, perhaps, the most telling embodiment of this emprise de la structure (Fr. Perroux, 1969); the higher are the discrepancies in real performances and the larger is the share in total output held by giant loss-making units, the more overwhelming is this power. The events in Romania ("the global compensation" of December 1991), in Russia, and in other transforming economies fit such a description. A way out of these serious difficulties would be to devise a form of industrial policy that would buttress stabilization policy through an effective incomes-control policy, forceful enterprise reform and restructuring.

The initial endowment with resources, as legacy of communist industrialization, can bring fortune to some, and misery to others; it lies

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1/ J. Sachs and D. Lipton (1991) voiced most strongly the need to privatize fast in order to avoid undermining stabilization.

at the roots of what can be construed as a distributional struggle within society between potential haves and have-nots. In economies that are so heavily monopolized and monopsonized it is almost impossible to stop inflation and a vicious circle can be at work: due to external and internal shocks the social pie shrinks, pressure groups ask for and get higher wages to keep pace with rising prices, and as a result the wage-price spiral is given a further twist, monetary and fiscal policy get tighter, output shrinks further and the vicious circle goes on (see Figure 2). This scenario is more plausible, the less mobile resources and the less competitive markets are, and when weak governments are likely to give in to such pressures 1/.

The policy impact on aggregate disequilibrium (performance deficit) directs attention towards the efforts deployed to combat inflation, towards stabilization policy and its effects on aggregate supply and aggregate demand.

What would be the theoretical underpinnings of the macroeconomics of transition? To answer this question one can link stylized theoretical explanations with the two competing visions within the paradigm provided by neoclassical analytics (equilibrium economics). One of them, which is best represented by the New classical macroeconomics school, rejects any state intervention in the economy, since agents, as rational beings, - it is argued - optimize using all available information 2/. This type of optimization would secure full price flexibility and, thereby, sufficiently fast allocation of resources. According to this vision any rate of unemployment is natural since it expresses agents' preferences. The other vision starts from the assumption that prices are so rigid that they induce adjustments through quantities as well, so that aggregate demand equilibrates aggregate supply below full employment; there is talk then of a non-walrasian equilibrium, which would invalidate Walras' Law.

The two visions look at the functioning of a market economy. If the transforming system is viewed as a pathological form of market economy, wherein structural disfunctionalities and rigidities are extreme, a hypothesis can be submitted: implementation of shock treatments would lead to significant drops in production, at least in a first phase. In this stage of transformation, the entrenched structures are being broken and changed, which means that the quantity of friction inside the system rises considerably and important energies (resources) are consumed in order to accommodate, adjust, change. In other words, the process amounts to a change of the organizational behavior of economic actors, to the build-up of new organizational capital - aside from the need for reconstruction, in general. In this phase of transition there exists a territory over which

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1/ I owe to L. Csaba the observation that weak governments raise the probability for such a vicious circle to occur.

2/ This may be contrasted, for example, with the view that agents operate under "bounded rationality" (H. Simon 1958).

both commands and markets - as regulatory mechanisms - do not function according to their respective logic, and the net inefficiency caused by friction compounds the congenital inefficiency of the old system. Over this "no man's" territory "market coordination failures" combine with the "abandoned child" feeling of many enterprises, which are no longer able to rely on central allocation of both suppliers and customers. For these enterprises information and transaction costs skyrocket. This perspective can get interesting insights from "structuralist macroeconomics" (L. Taylor, 1983, 1991) that can help highlight perverse effects of "orthodox" policies undertaken during transition 1/.

Nevertheless it should be stressed that none of the two visions can tackle adequately the weak microfoundations of macroeconomic policy in a transforming system, wherein budget constraints are still soft and short-term economic rationality of many units and individuals clashes with the need to reallocate resources. Monetary and fiscal policies can hardly be effective when market discipline is weak. The temporary quasi-inside money represented by inter-enterprise arrears, as a symptom of weak market discipline, shows the relative limits to the effectiveness of tight monetary policy under the circumstances.

An issue that has not been put under sufficient scrutiny is "the implementation of stabilization policies in free-falling economies". It is clear that much of the decline in output is due to what was named depreciation of potential performance, to structure and external shocks (like the collapse of CMEA and foreign competition). The crux of the matter here is not apportioning the blame for the drop of output 2/, but realizing the impact of stabilization on rapidly falling aggregates.

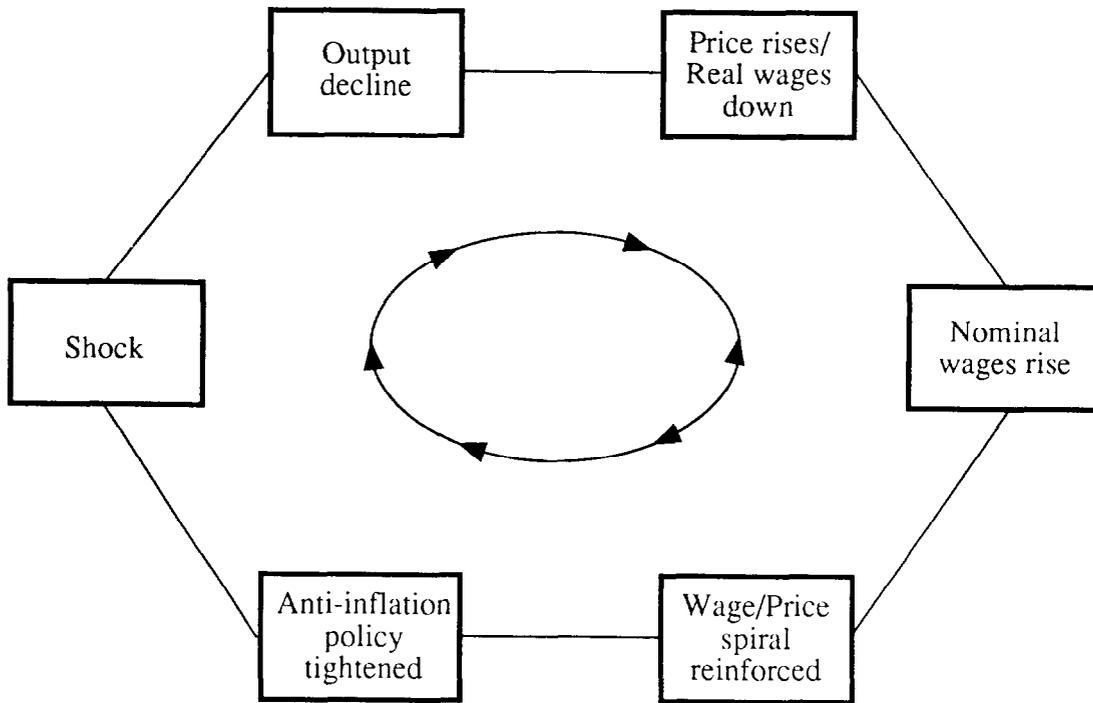
Another way of looking at the impact of policy on the dynamics of output is to consider the process of market destruction and construction. In this respect we could use the term network deconstruction, which connotes delinkages produced in the system because of its functional opening. A command system - seen as a dynamical complex system - relies on chain links, whereas a market system is based on parallel connections. The opening of the economy perturbs entrenched relationships and it triggers a process of delinking that, eventually, results in a growing number of domestic players being forced to drop out of the game. This process can be viewed as a short-run market coordination failure that leads to falls in aggregate effective supply and aggregate effective demand. For the delinked parties, information and transaction costs are exceedingly high. It can thus be argued that delinking puts pressure on inefficient units and speeds up

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1/ Analyzing stagflationary effects of stabilization policies in reforming economies G. A. Calvo and F. Coricelli (1992) emphasize the similarities between the "enterprise-side view" and the neo-structuralist approach.

2/ Some of the drop - as pertinently underlined by J. Winiecki (1991) - is benefactory since it means doing away with useless production.

Figure 2: The Vicious Circle due to Distributional Struggle





restructuring, without, however, necessarily compensating for the undesirable effects on aggregate domestic supply. Within such a framework hysteresis phenomena can and should be dealt with; rising unemployment and the effects of an overly open (too unprotected) economy, in a world with imperfect markets and fierce competition, need to be addressed in this respect.

The discussion can be broadened and undertaken in terms of a "dual economy", with a healthy and dynamic sector and a retrenching, declining sector. As long as the declining sector has the upperhand economic aggregates would follow downward-shaped curves. The recovery sets in when the growth sector "goes over" a threshold as to the share of output held in GDP. Four key variables can be thought of as influencing the dynamic of aggregate supply: the shares held initially by the two sectors, the speed of growth and that of decline, and the metamorphosis speed. The latter indicates the restructuring of parts of the declining sector (resource reallocation), which join the healthy sector. The metamorphosis speed affects both other speeds, but cannot be identified with either of them. Different situations can be imagined by manipulating the key variables. A situation can entail rapid and brutal downturn, quick recovery and intense metamorphosis, hopefully brought about by substantial inflows of foreign investments. A J-curve like situation means less brutal decline than in the first case, but still impressive, whereas the upturn is not in immediate sight; metamorphosis is less strong. A L-curve like situation denotes strong imbalance between market destruction and market construction with the upturn remote. The intensity of metamorphosis (of resource reallocation) determines the scope of hysteresis phenomena and, broadly speaking, the dynamics of social equilibrium; the fewer are the losers, the smoother transformation will unfold.

Mentioning social equilibrium allows to say a few words about the expectational shock the transforming economies have got. People expect governments to deliver the goods that they were denied during the decades of communism and in the Romanian case, after a terrible shock-therapy in the 1980s. Expectations are high whereas output - even it corrected for the increase of variety, quality and availability of goods, and what can not be captured by statistics - has been falling dramatically. A growing expectational gap can easily perturb the fragile social and political equilibria and undermine stabilization policy.

Expectations should be related also to moral goods seen as public goods. What makes also the post-communist transition difficult is a legacy of pervasive moral crisis. It is hard to build new institutions when truth-telling, trust, loyalty are very scarce commodities. As K. Arrow said: "They are goods ... they have real, practical, economic value; they increase the efficiency of the system, enable you to produce more goods or more of whatever value you hold in high esteem" (1974, p. 23). Two ideas can be put forward in this respect. First, production of intangible goods - understood as moral reconstruction of society - is a must for helping a recovery of the output of material goods and services; the former "crowds in" the latter.

Secondly, trust, truth-telling and loyalty can substitute tangible goods to a degree which is particularly important when depression does not have an easy and quick cure.

### VII. Concluding Remarks

How to stabilize the economy (achieve aggregate equilibrium in a narrow sense), how to stop the fall of output and, eventually, resume growth is a daunting task for policy makers in the transforming systems. When policy overshoots 1/ and takes the economy outside a zone covering an assumed optimal state (mix) of disequilibria, what is at fault is not necessarily the decision-maker but the policy instruments that are at his disposal. Policy-makers always overshoot, or undershoot, as markets do - which means that they can exceed what can be visualized as the natural rate of adjustment 2/ of society, or underestimate the potential for change of the social body. Since policy over(under)-shooting is practically unavoidable, the problem lies with reducing as much as possible the likely deviations. Another interesting question to answer is on which side policy erring is to be preferred by assuming that the goal of keeping the deviation at a minimum is kept in sight. Here one deals with both objective and subjective elements for making a judgement.

In the transforming economies the policy-mix of stabilization should not use the classical tools only; fiscal and monetary policy, exchange rate policy, incomes-control policy 3/, need to be complemented by an industrial policy that should help tackle the crucial issue of enterprise reform (S. van Wijnbergen, 1992) and impose market discipline. Industrial policy (that means more than enterprise reform) has been given too low a profile, or simply neglected, crippling economic policy, in general, and stabilization in particular. Industrial policy can reduce the costs of stabilization, help policy-makers handle the three major constraints (the foreign exchange gap, the budget deficit and the low level of savings) in making choices about the trade-off between external disequilibrium and internal disequilibrium. Industrial policy can also help dealing with the "Big Trade-Off" (A. Okun, 1975) which has come into the open in post-

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1/ This is, for instance, what Gr. Kolodko (1991) and M. D. Nuti (1992) claim has happened in Poland, where too much emphasis was put on reducing external imbalance by "a too large devaluation of the zloty and too tight monetary and fiscal policy".

2/ The natural rate of adjustment (of accommodating change) of society can be defined as an imagined optimal speed of change that maximizes society's welfare function intertemporally; it, itself, is adjustable because of the learning capacity of society. L. Csaba talks about a natural rate of ownership change (1992, p.22).

3/ "Controls are more likely to be useful, the larger is the desired reduction in inflation, and the more serious is the credibility problem" (P. Persson, S. van Wijnbergen, 1993, p. 81).

communist societies: efficiency vs. equality. It is noteworthy that even the experience of frontrunner transforming economies suggests the need for such a policy (G. Szapary, 1992). There are strong reasons to have reservations about industrial policy seen as a means to "pick winners and losers", especially in an environment with so much uncertainty and lack of transparency; however, under such circumstances, industrial policy should rather be viewed as a damage-control device, aimed at allowing a breathing space needed to cope with the high degree of uncertainty and fuzziness about property rights, and to mitigate the costs of restructuring and resource reallocation. A complete "hands-off" reform policy on the part of the governments is unjustified not only by the lack of institutional requisites for market forces to operate effectively, but also by the simple fact that these forces, alone, would impose unbearable costs on the social body.

In Central and Eastern Europe we deal with markets in their infancy, which need to be nurtured in a world of imperfect information and competition. There is a need and, at the same time, scope for industrial policy, which should aim at helping restructuring as it is suggested by market signals, as well as at protecting the main asset of these societies which is made up of segments of highly skilled labor and a large pool of scientific and technical intelligentsia. A paradox of these societies is that striking ignorance coexists with tremendous intellectual and labor capabilities; this combination obscures potentialities for progress by a possible across the board over-depreciation of the factors of production. Capital and technology inflows, as well as the functional opening of the economies, could counteract this over-depreciation for certain segments of the economy, but could also impose undue hardships on it and stalemate reforms.

Industrial policy is critical for bridging the gap between the effectiveness of controlling demand and that of stimulating supply. Supply responsiveness is so low that stabilization seems to be hardly sustainable. In this context industrial policy refers to a combination that correlates incomes-control measures with industrial restructuring (including privatization) initiated by public authorities who process information

provided by markets 1/. It refers, also, to the introduction of a proper set of incentives for managers of state-owned enterprises, which should induce them to run these units efficiently; slow privatization makes it urgent and vital to improve drastically and foremost the management of state-owned enterprises. The goals would be to put a lid on high inflation, alleviate unemployment (to cope with the hysteresis phenomena) and promote exports. Such a policy is more urgently needed when the social pie is considerably smaller, redistribution effects impact negatively on many people and social safety nets are not adequate.

Transformation is a process with pronounced social and cultural dimensions, which involves overcoming inertia, changing mentalities and psychologies (the creation of a social ethos that fits a market economy), and a fierce struggle among "coalitions of interests" (M. Olson, 1982). The clash of various interests in society, against the background of an evolving structure of ownership, increases the degree of autonomy of the process in the sense of reducing the room of maneuver for decision-makers 2/. Since as a real process change can only be evolutionary, policy would have to be shaped and adapted appropriately.

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1/ A possible scheme would be to link incomes with the dynamics of saleable output, in the vein of what M. Weitzman proposed in a well known book(1984). Negative value-added enterprises should be closed without delay: it is less costly to pay workers unemployment benefits and retrain them than to keep these units running. Profitable enterprises do not pose any problem since they are in good business. The zone of concern for policy-makers is represented by unprofitable units, which, under normal conditions (with sufficient flexibility of resources) would have to be done away with. The idea is to resort to a phased in elimination according to a timetable that pursues reducing the costs of adjustment, and also allows a breathing space for figuring out which are the potentially viable enterprises. This gradual phasing out would attenuate unemployment and distribute its costs over time. At the same time, public authorities would have an easier time in securing resources for social-safety nets and for facilitating labor reallocation through training programs. The problem lies in convincing workers about the benefits of this scheme for the economy as a whole and for each and every one of the targeted enterprises. This objective could be achieved as part of a social compact within the framework of an industrial relations agreement that sees workers as an active voice in the management of transformation. It can be argued that such a scheme slows down restructuring, which is a valid statement if social and political constraints are dismissed. Nonetheless, to ensure that transformation is sustainable as a real process, there are many reasons for advocating the paramount importance of an adequate industrial policy.

2/ In order to undergo a, relatively, smooth progress the process needs to be backed by a strong coalition of interests (a social base), a "reform constituency" which, unfortunately, can be built overnight since privatization is slow.

Stabilization itself would have to be understood as a process most likely to show a stop and go dynamic (including setbacks). I submit that the control of disequilibria will feature a stabilization policy path moving in tandem with the pace at which the economy will acquire more of the basic ingredients of an advanced market environment. In this vein, stabilization policy, itself, could undergo a "stabilization process".

The bottom line is: how quickly can overall growth be resumed? There is no easy answer. A pessimist would point out the success story in Latin America - Chile, where over 15 years were needed before the economy could effectively embark on a sustainable growth path (S. Edwards, 1991) - and would doubt that people in Eastern Europe and the CIS would be patient enough to attain that stage. Moreover, the international environment, with worrying trends ("beggar your neighbors'" policies, world economic recession, etc.) are likely to be a major impediment. An optimist would, perhaps, stress the major comparative advantage of these economies - an abundance of highly-trained labor and considerable R&D capabilities - which, from a "neo-growth theory" perspective might trigger a miracle in the not too distant future.

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