Topics in Development and Transition 2006-2007

Handout One

Introductory Materials

- **Historical Context to Today's Reform Agenda**
- **The Challenge of Sequencing Reforms Correctly**
- **Examples of Sequencing Problems from Russia and China – in Session 2**

THE INDIAN CONGRESS CONSENSUS 1945-1970?

- **Industrialisation and New Technologies was Key**
- **“Development” Would Happen Much Faster than in C19th W. Europe**
- **A Socialist State was Essential – Capitalism/Big Business were Suspect**
- **USSR had shown that State Planning was the route to Transformation from Agriculture to Industry**
- **International Trade was also Suspect – Autarky was preferred Route – Vent for Surplus was main mechanism**
- **Agriculture important for Poverty Alleviation but Price Mechanisms de-emphasised**

Result

- A broadly held view in developing countries (1950s through the early 1980s) that widespread state controls of prices, interest rates, trade etc were the appropriate way to encourage “development”

- In today’s “Transition Economies” this state control was implemented (until the early 1990s) by near-universal state-ownership of productive assets

SOME FACTORS ERODING FAITH IN "ICC" (1970-1982?)

- **Schulz's Results (1964) - the Recognition that Agricultural Decisions are Price Sensitive**
- **Increasing Awareness of the great success of a few Export-based economies and the emergence of the "Four Dragons Consensus"**
- **The in-depth Documentation of the Inherent Inefficiencies of the ICC Approach – Little, Scitovsky et al (1970)**
- **The Chronic Failure of the Developing-Country Response to the 1970s Oil Shocks and the Culmination of these in the 1982 Debt Crisis**
- **The Model's Failure to Improve Many Dimensions of Poverty/Deprivation (Inequality, Basic Needs, Employment etc)**

A New (Washington) Consensus 1980-2000 And Beyond (?)

Main Ingredients

- **Fiscal Discipline – Low Inflation**
- **Broader Tax Bases and Lower Marginal Rates**
- **Trade Liberalisation – Lower Tariffs and Fewer Quotas (QRs)**
- **Positive Real but Market Determined Interest Rates**
- **Competitive Exchange Rates**
- **Openness to Foreign Direct Investment (FDI)**
- **Privatisation of State Enterprises**
- **Deregulation – but with key exceptions (Finance, Environment)**

Issues

- **Macro Balance including Low and Stable Inflation is Central to Growth**
- **Financing Industry by Taxing Agriculture worsens Economic Well-Being**
- **Discipline Trade via WTO Rules**
- **Remove State Control of the Business of Banks**
- **Private Sector assisted by FDI is the Driver of Development**

Transition Countries And The Washington Consensus

- **China after 1979 – an apparently successful approach to "Managed" development versus Russia after 1992 – a flawed "Liberal" experiment in "Shock-Therapy"**
- **The Transition Experience to 2000 vividly demonstrated certain issues previously under-emphasised in the policy debates, including:**
- **IMPERFECTIONS can severely undermine the effective working of markets – informational imperfections in particular (Stiglitz)**
- **The LEGAL-INSTITUTIONAL INFRASTRUCTURE required for the effective working of markets is substantial (in its absence markets will fail)**
- **PRIVATE PROPERTY without competitive markets creates perverse and in-egalitarian results**
- **The SOCIAL AND ORGANISATIONAL CAPITAL present in a system can neither be easily destroyed or easily replaced by reformers**
- **The Experience dramatises the practical problems faced by most Developing Economies in reforming away from their previous ICC-type systems**

Other Strands In The Critique Of The ICC

- **Deeper Inquiry about East Asia's Success**
- **Questions the degree of free trade needed for significant success**
- **The Asian and Latin American Financial Crises of the 1990s**
- **Questions the wisdom of early liberalisation of capital flows**
- **Broader awareness of the lessons of New Institutional Economics – based partly on the Transition Country lessons**
  - **Points to numerous institutional and legal pre-requisites to successful liberalisation**
- **The poor record of sustainability of "reform" enforced via conditionality especially in Africa**
- **The cosmetic nature of some "reform" and the perverse hidden consequences (e.g. the "virtual economy" in Russia)**
- **Re-awakening (via the globalisation debate) of some of the neo-radical criticisms regarding power imbalances etc.**

So – "Economic Reform" became standard in Developing and Transition Countries

But even when the NEED for reform is accepted there are still important questions about:

1. The Sequencing of Reforms
2. The Speed of Implementation

    Both questions involve complex interactions as between (a) Structural reforms and (b) Macroeconomic Reform

Macro versus Structural Reform

- There is a very strong argument that you need stable prices (low general inflation) BEFORE you undertake mainstream structural reforms
    - Without this stability, price signals to stimulate the new forms of productive activity will be confused at best and any new investment activity will be discouraged
- Structural reforms will in any case have a much longer time horizon
- BUT some aspects of Macro reform (e.g. tighter fiscal programmes) may work against the incentives that are needed to stimulate the structural change

Speed: Shock Therapy versus Gradualism

Shock Therapy relies on arguments such as :

• the complementarities between policy instruments (i.e. a technical economic argument)

• shock approach prevents anti-reform interest groups from forming (political economy)

• there will often be only a short honeymoon period for a new government

- A particular case of this is where reform follows closely behind a major and disruptive episode of crisis or hyperinflation that creates broad popular support for doing SOMETHING to put matters right.

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Gradualism relies on arguments such as:

- It may help to limit the annualised adjustment costs and so limit the distributional burdens on particular "loser" groups
- Hence it may make reform overall more CREDIBLE
  - this avoids the major problem seen in many failed reforms of an inter-temporal distortion in the prices of tradable goods
- The sheer impossibility of removing some distortions (or building necessary new institutions) quickly enough
  - A weak or limited financial system would be one leading example of such an institutional failure
- Congestion externalities – shock treatment many cause too much transitional unemployment relative to the achievable longer term level

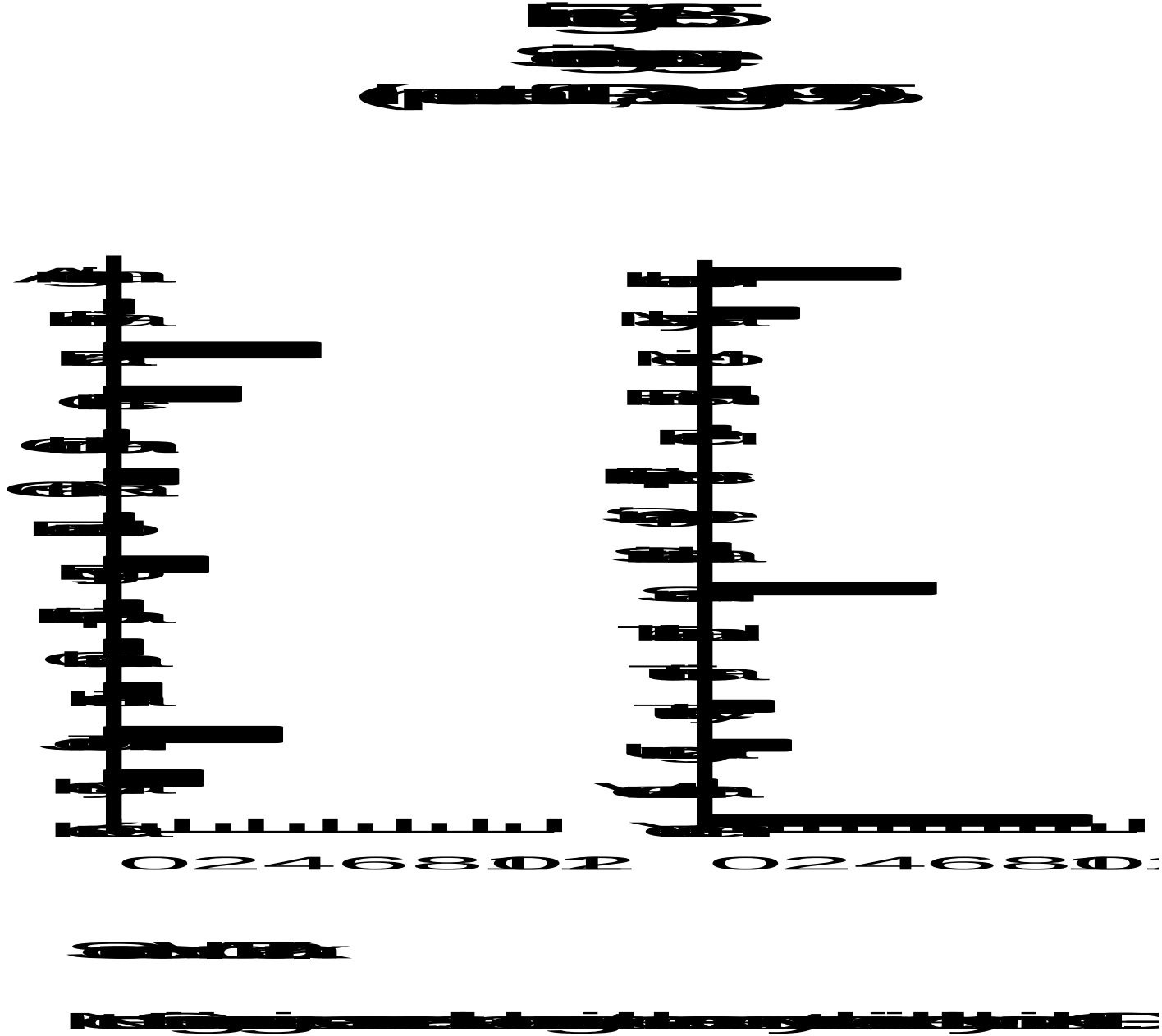
Aspects of the Sequencing Dilemma

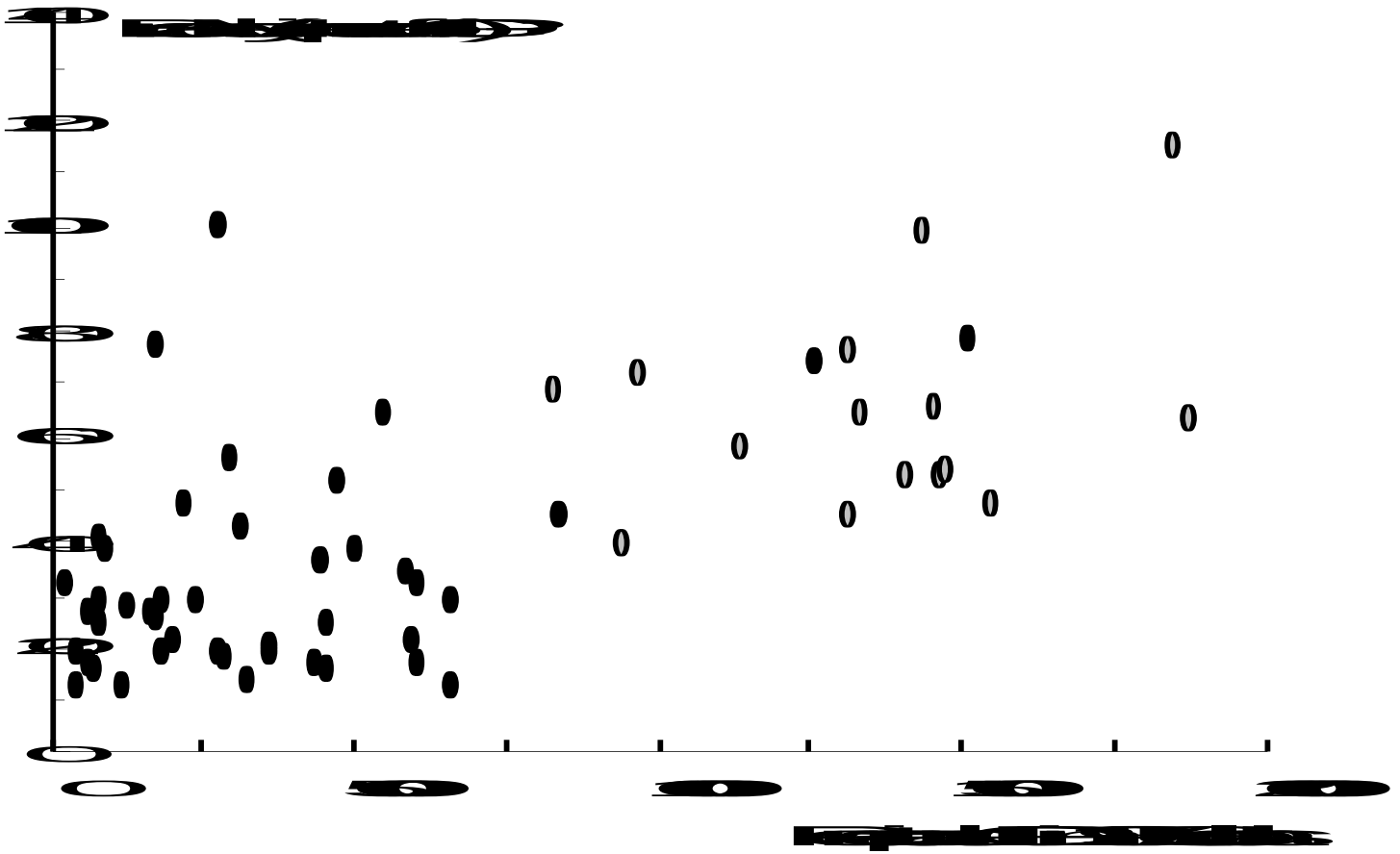
1. Fiscal Deficits and Inflation

2. Domestic Finance Sector

- Aim is Deficit Financeable at Reasonable Inflation Rate. This is needed to ensure stable price signals for the longer structural change. Also it avoids excessive (implicit) taxation of two growth forces namely (i) the Financial Sector and (ii) Exports (note large reliance on seignorage and inflation taxation in developing countries)

- Aim is lower taxation of sector to induce greater Financial Depth. Implies greater market determination of interest rates and Govt borrowing disciplined by these rates. So scarce savings can move to the more productive sectors/uses (Note low depth in developing countries)





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3. International Trade

- Involves removal of excessive import and export controls an taxes to favour (new) production linked better to comparative advantage. Implies near equalisation of RERx and RERm and so the elimination of the high implicit taxation of export

4. Labour Market

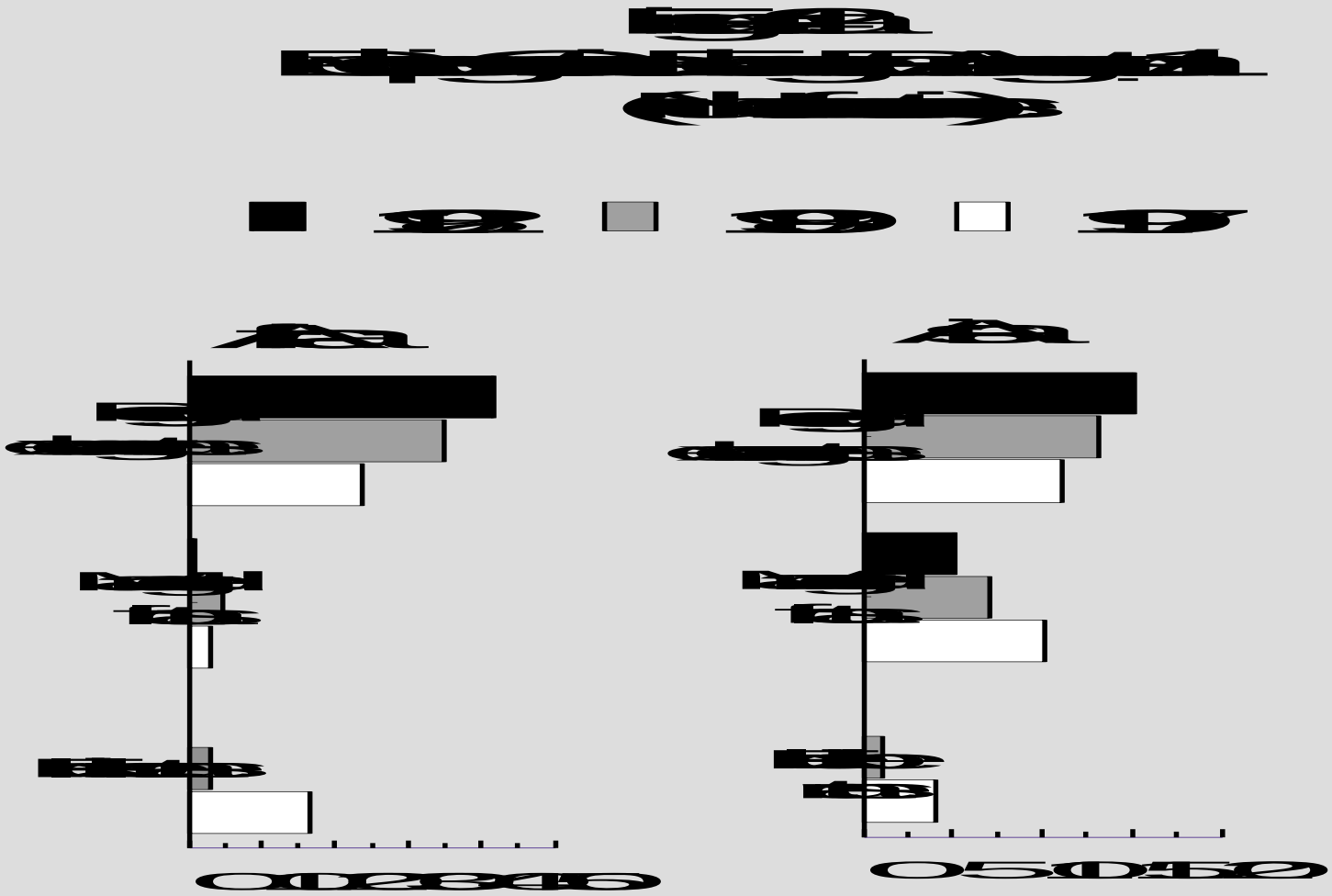
- Improve labour mobility will invariably be needed to facilitate the movement of resources from older to newer activities. So effective trade reform may involve prior labour market reforms. Indexation of wages to past inflation could be a major issue if recent past has seen excessive inflation

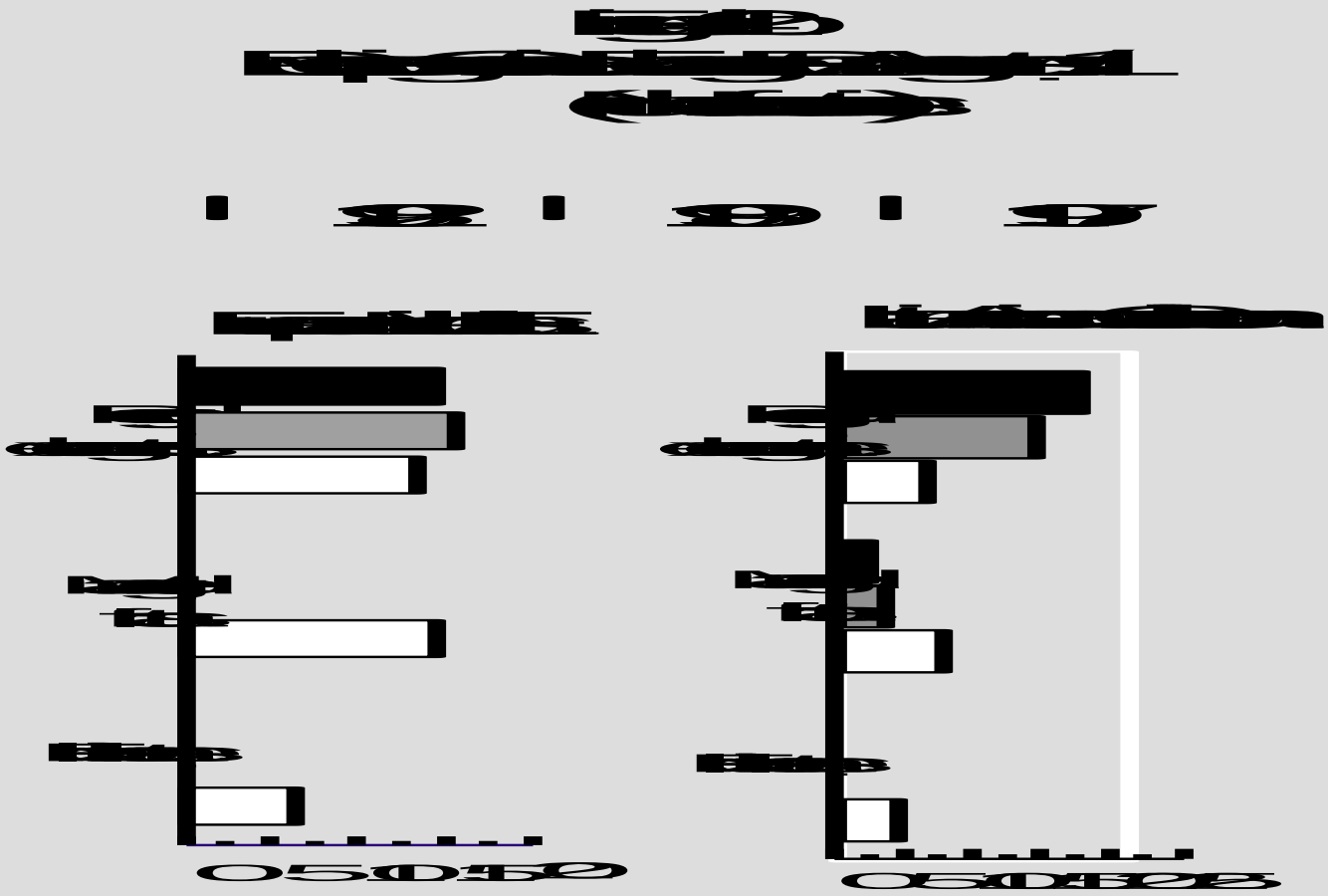
5. Exchange Rate

- Freer rate more responsive to Supply and Demand for FOREX (see predominance of pegging in developing countries)

6. International Capital Flows

- Aim is efficiency and risk management gains from greater access to international finance including better terms and products (for both lenders and borrowers)





Main Tensions in Sequencing

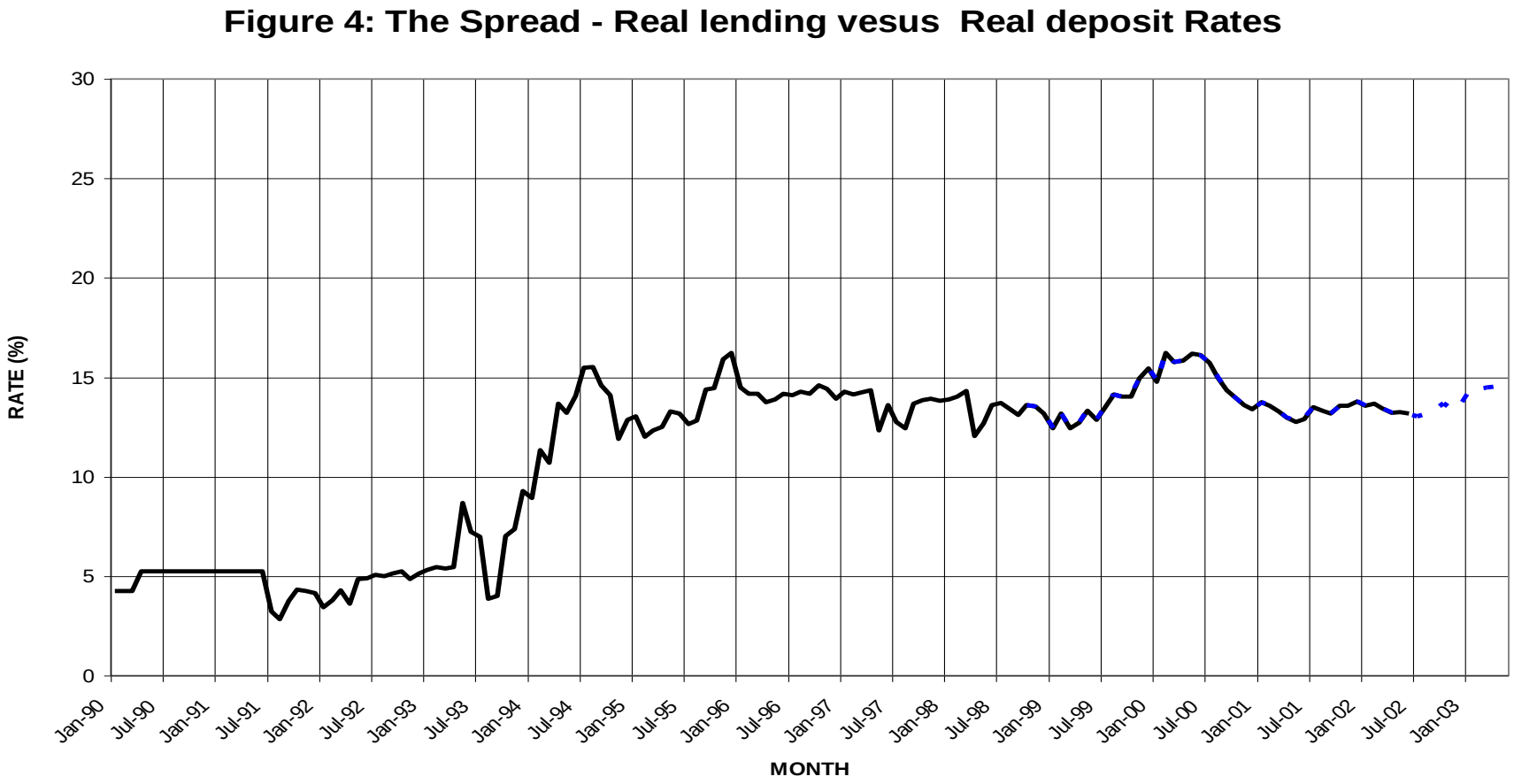
1. Failure of Fiscal v Financial

- Ongoing Inflation implies need for controlled interest rate (fiscal debt dynamics) and taxation of financial sector. “i” IF too low results in capital flight and lower tax (inflation) base OR if “i” relatively high and ER is credibly pegged with an open Capital AC then can result in temporary capital inflows and RER appreciation.

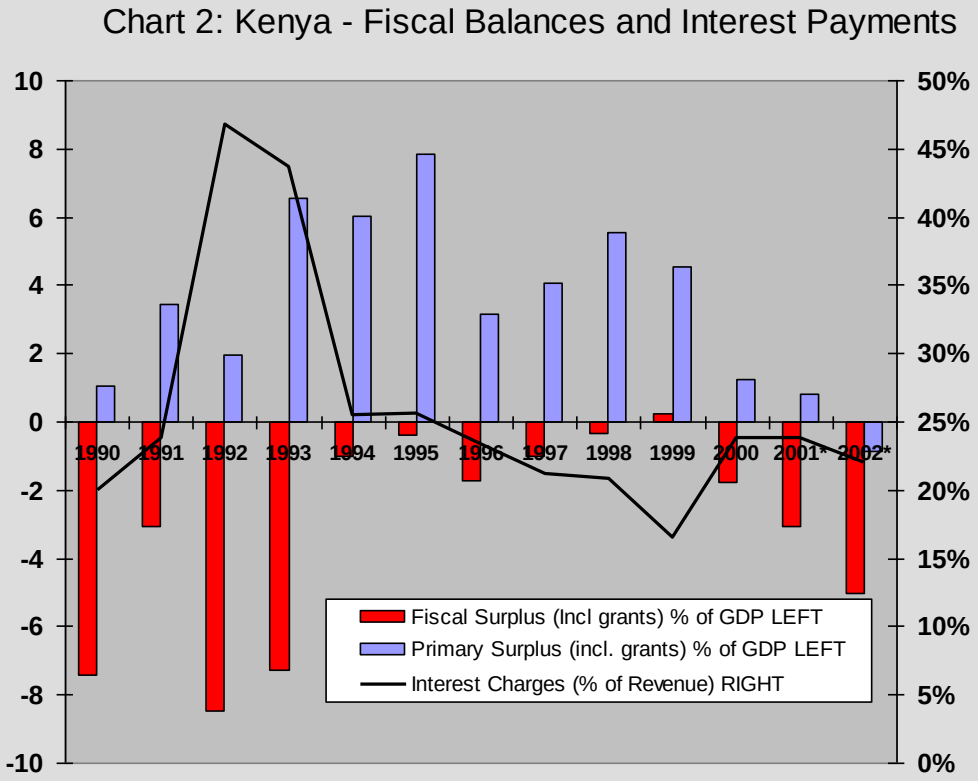
2. Financial Liberalisation before Trade Reform and/or Fiscal Reform

- Allocation of capital now based on the wrong relative prices e.g. too much investment in non-traded goods prices relative to traded goods (Examples Argentina and Chile in early 1980s)

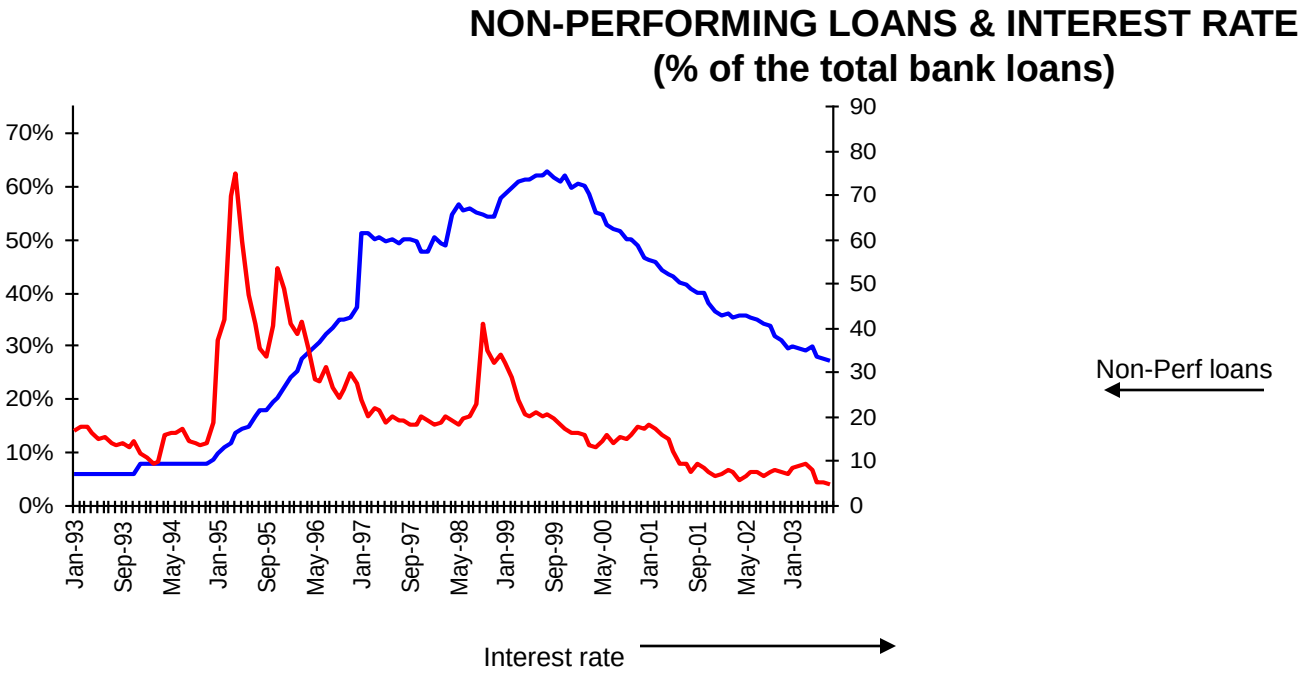
Example: Kenya's Liberalisation in 1991



And Fiscal Balances were also Hit



Example: Mexico Post 1994-Crisis



Source: Inegi

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3. Trade Reform versus ER Liberalisation

4. Trade, Capital Account and Financial Sector Reform

- Trade reform can be expected to initially worsen the Balance of Payments (Current Account). Ideally this needs a nominal devaluation to help raise import prices to compensate. But no guarantee that free exchange market can deliver this. Nominal appreciation can come from several sources (e.g. donor aid support and from new FDI)
- An open capital account is damaging IF (i) illiberal trade still results in distorted prices > new finance to wrong sectors (ii) illiberal finance still results in repressed financial sector with low interest rates/poor products etc. > substantial domestic borrowing from foreign sources and savings invested abroad>lower base for inflation tax

Other Tensions

- Privatisation – Mass sell off (Russia, Czech Republic) or emphasis on sales to strategic investors (UK, Poland) backed by reformed institutional and regulatory framework –see Stiglitz notes in *Whither Socialism*

- Labour Markets – Improve labour mobility will invariably be needed to facilitate the movement of resources from older to newer activities. So effective trade reform may involve prior labour market reforms. Indexation of wages to past inflation could be a major issue if recent past has seen excessive inflation

see also Agenor Ch 17.

Sequencing – A Case Example

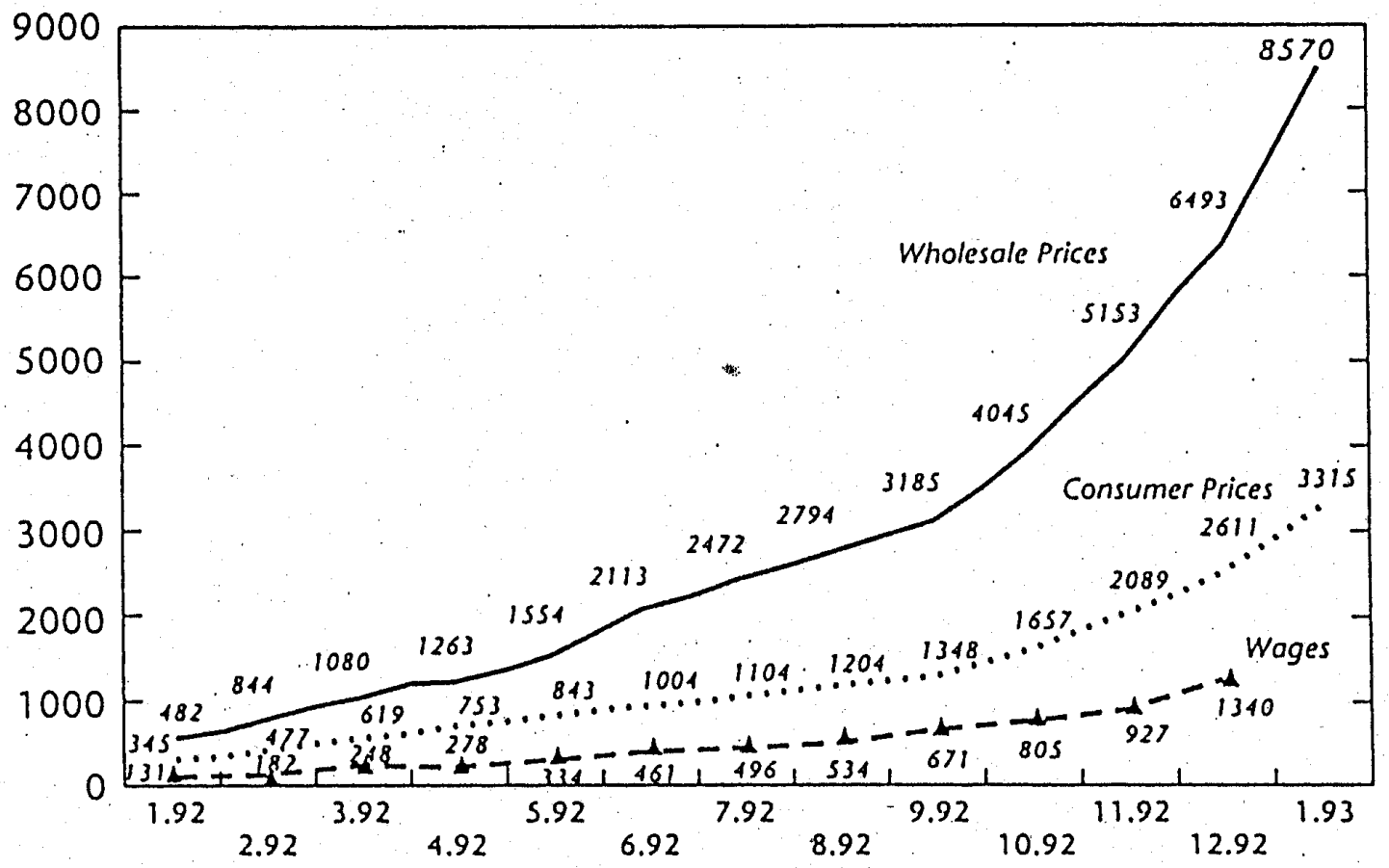
Russia's liberalisation (or prices, trade, finance etc.) from 1992 versus China's liberalisation from 1979

This is the seminar topic for Week 2

Main Reference *is Ronald McKinnon, Financial Growth and Macroeconomic Stability in China, 1978-92: Implications for Russia and Eastern Europe,* in R. Barth, Alan Roe and Chorng-Huey Wong*, Coordinating Stabilization and Structural Reform, IMF , Washington DC 1993*

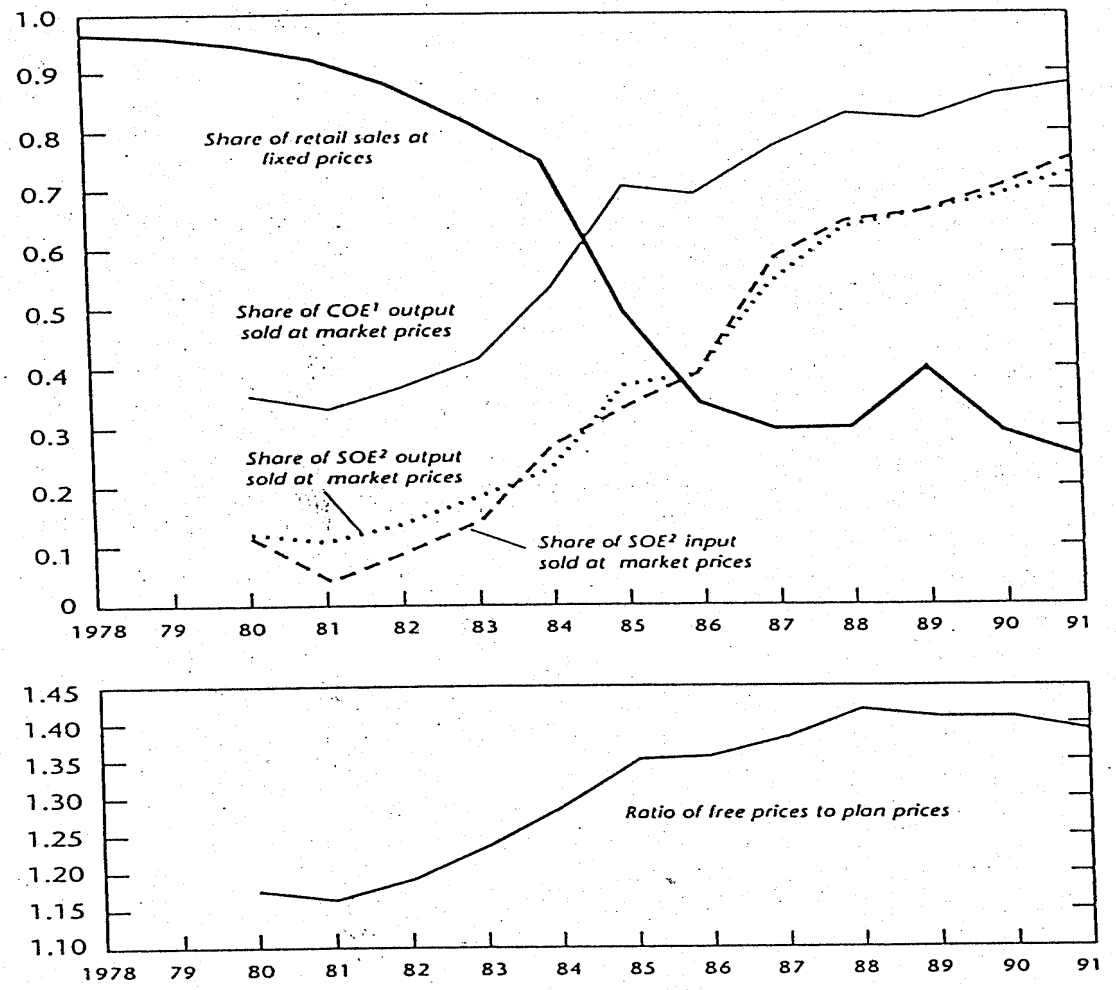
Chart 2. Russia: Wage and Wholesale and Consumer Price Indexes, January 1992–January 1993

(December 1991=100)



Sources: State Commitee on Statistics; Ministry of Labor; and Institute of Economic Policy. Data collected by Mikhail Bernstam, Hoover Institution, Stanford University.

Chart 1. China: Price and Market Reform



Sources: (*Top*) Share of COEs and SOEs at market prices are estimated by Zou (1992) from a sample of 253 enterprises. Share of retail sales at fixed prices from Schmidt-Hebbel (1992). (*Bottom*) Ratio of free prices to plan prices estimated by Zou (1992) from a sample of 253 enterprises; also Gelb, Jefferson, and Singh (1993).

¹Collectively owned enterprises.

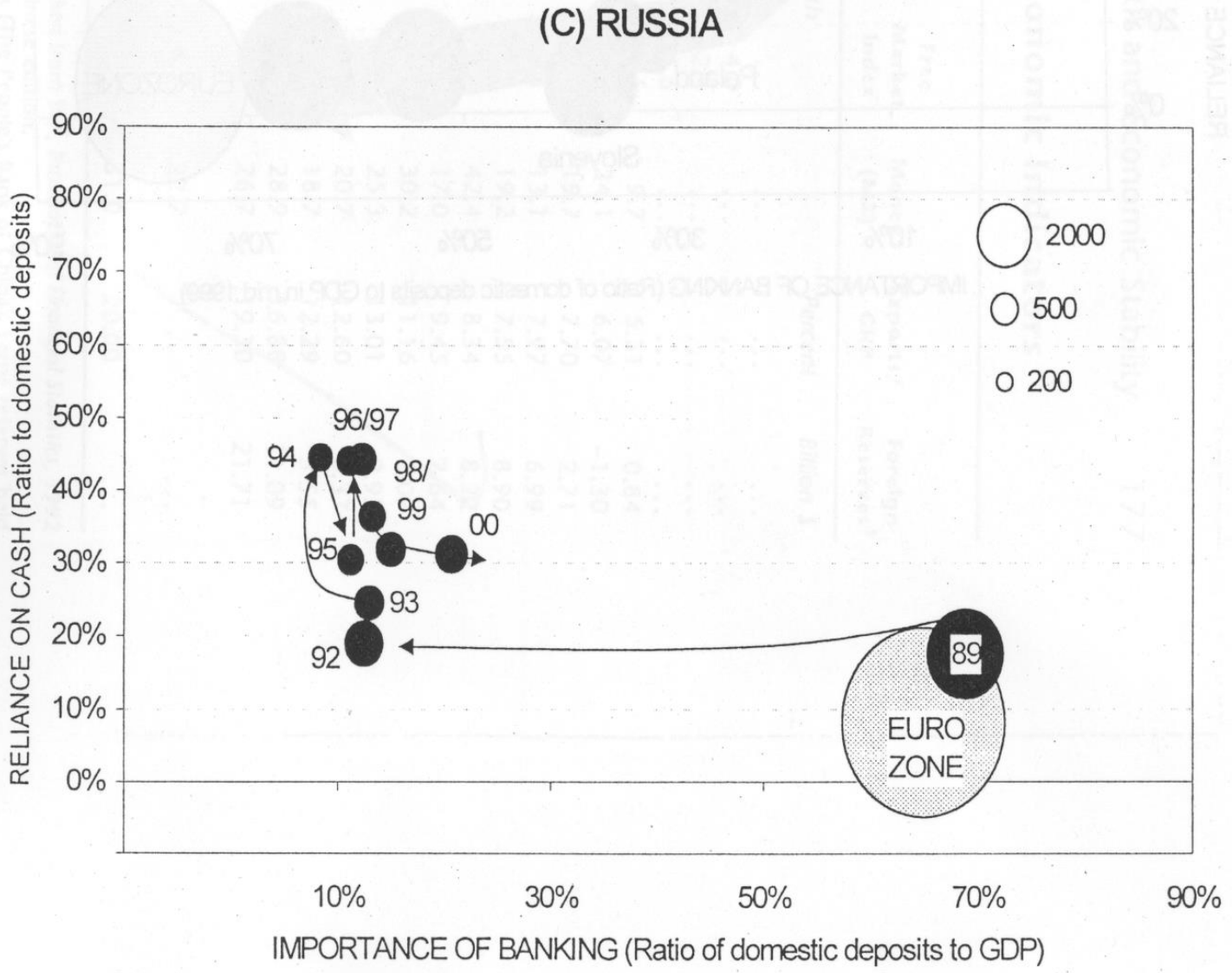
²State-owned enterprises.

Table 1. China's Main Economic Indicators

	Real National Income	Real GNP	General Retail Price Index	Urban Cost of Living Index	Free Market Index	Money (M2)	Exports/ GNP	Foreign Reserves[1]
	Percentage rate of growth						*Percent*	*Billion $*
1975	8.3	...	0.2	0.4	...	...	...	...
1976	–0.3	...	0.3	0.3	4.0	...	...	...
1977	7.8	...	2.0	2.7	–2.4	...	...	...
1978	12.3	...	0.7	0.7	–6.6	...	...	...
1979	7.0	7.6	2.0	1.9	–4.5	9.7	5.31	0.84
1980	6.4	7.9	6.0	7.5	1.9	24.1	6.07	–1.30
1981	4.9	4.4	2.4	2.5	5.8	19.7	7.70	2.71
1982	8.3	8.7	1.9	2.0	3.3	13.1	7.97	6.99
1983	9.8	10.3	1.5	2.0	4.2	19.2	7.55	8.90
1984	13.4	14.6	2.8	2.7	–0.4	42.4	8.34	8.22
1985	13.1	12.7	8.8	11.9	17.2	17.0	9.45	2.64
1986	7.9	8.3	6.0	7.0	8.1	30.2	11.16	2.07
1987	10.2	11.0	7.3	8.8	16.3	25.3	13.01	2.92
1988	11.1	11.0	18.5	20.7	30.3	20.7	12.60	3.37
1989	3.7	4.4	17.8	16.3	10.8	18.7	12.29	5.55
1990	5.1	5.6	2.1	1.3	–5.7	28.9	16.88	11.09
1991	7.9	7.3	2.9	5.1	–0.9	26.7	19.30	21.71
Average 1979–91	8.4	8.8	6.2	6.9	6.5	22.7	...	...
Preliminary 1992	...	12.8	5.4	8.6	...	31.0	20.00	...

Sources: Wong, Heady, and Woo 1993; Qian 1993. M2 data taken from IMF, *International Financial Statistics*, 1992 yearbook; other data from *Statistical Yearbook of China*, 1992, Chinese edition.

[1] Foreign exchange reserves are those held by the central bank (The People's Bank of China). Large reserves held by the foreign trade bank (The Bank of China) are excluded.


(C) RUSSIA
RELIANCE ON CASH (Ratio to domestic deposits)
90%
80%
70%
60%
50%
40%
30%
20%
10%
0%
2000
500
200
96/97
94
98/
99
00
95
93
92
89
EURO
ZONE
10%
30%
50%
70%
90%
IMPORTANCE OF BANKING (Ratio of domestic deposits to GDP)

Note some simple Monetary Propositions

$$Seignorage = \mu m_t \ldots\ldots\ldots\ldots\ldots\ldots\ldots [A]$$

$$where \ldots\ldots \mu_t = M_t - M_{t-1} / \ M_{t-1}$$

$$and \ldots\ldots m_t = M_t / P_t$$

$$Inflation\ Tax \ldots\ldots = \pi m_t \ldots\ldots\ldots\ldots [B]$$

$$where \ldots\ldots \pi = P_t - P_{t-1} / P_{t-1} = \dot{P}_t / P_{t-1}$$

In the Long Run Steady State where the rate of money growth is equal to the rate of inflation, we will have

Seignorage = Inflation Tax

Since Mt/Pt = constant

A lower *m (Russia after 1992)* requires a high π in order to get the same inflation tax revenue as a high "m" country (China)

Figure 1: Comparisons of Financial Depth

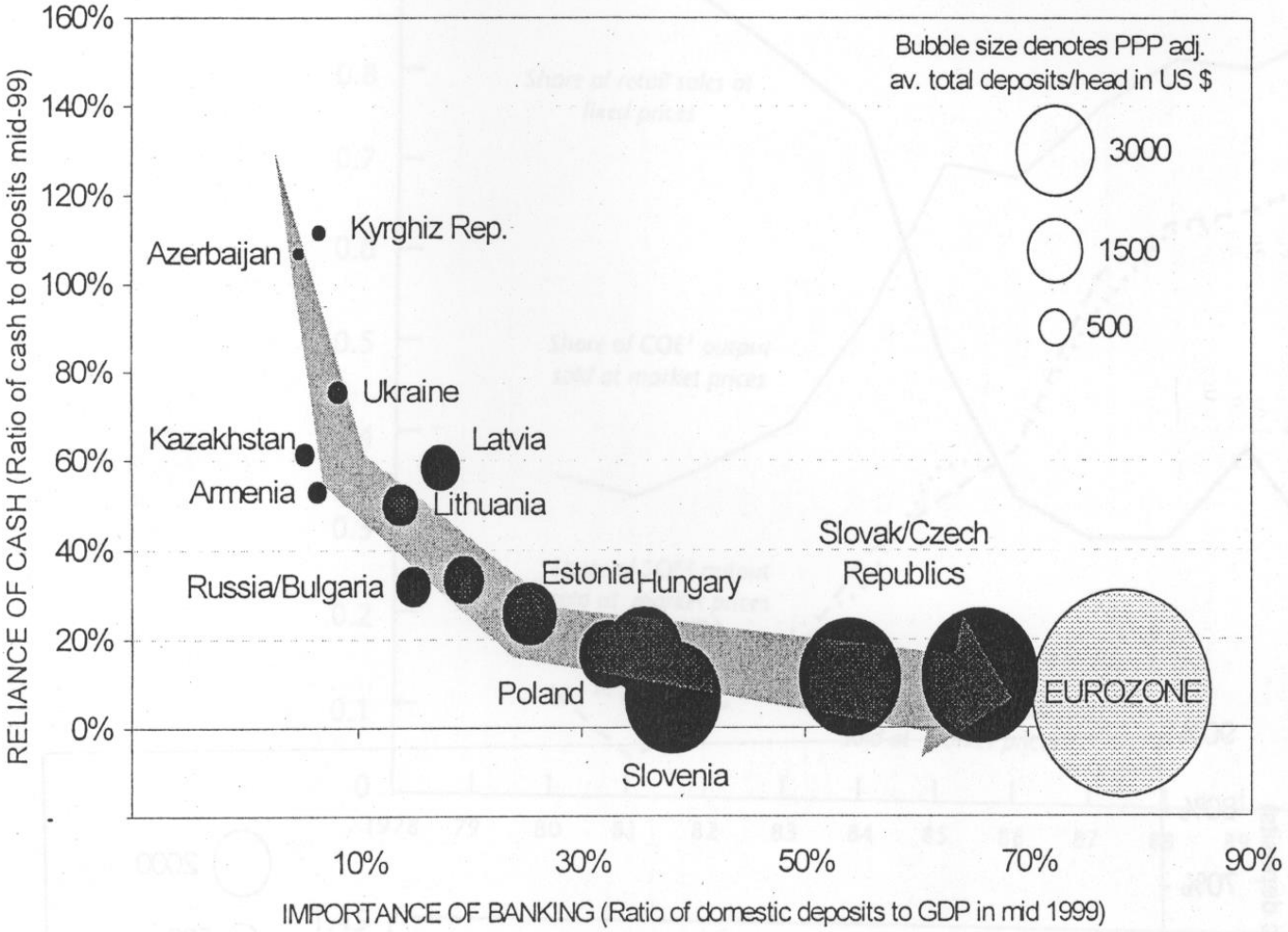


Table 7. China: Monetary Aggregates as Share of GNP

(In percent)

	Household Savings Deposits/GNP	Currency/GNP	M1/GNP[1]	M2/GNP[2]
1978	5.87	5.9	...	28.0[3]
1979	7.05	...	...	...
1980	8.94	...	...	...
1981	10.97	...	...	...
1982	13.01	...	...	...
1983	15.36	...	...	...
1984	17.45	...	...	...
1985	18.96	11.5	39.0	60.8
1986	23.08	12.6	43.6	69.3
1987	27.19	12.9	43.8	73.7
1988	27.12	15.2	42.5	71.8
1989	32.34	14.7	39.9	74.7
1990	39.77	14.9	43.0	86.4
1991	45.88	16.0	47.5	97.0

Source: *Almanac of China's Finance and Banking*, 1990.

[1] M1 = currency + enterprise and institution demand deposits.

[2] M2 = M1 + household savings deposits (demand and time) + enterprise and institution time deposits. In China, household demand deposits are not checkable, but enterprise and institution demand deposits are.

[3] Preliminary estimate.

Table 6. China: Household Bank Savings Deposits, 1978–91
(In billions of yuan)

	Total Household Deposits	Increase Over Previous Year *(Percent)*	Urban Household Deposits[1]	Increase Over Previous Year *(Percent)*	Rural Household Deposits[2]	Increase Over Previous Year *(Percent)*	Total Household Deposits/ GNP *(Percent)*
1978	21.06	—	15.49	—	5.57	—	5.87
1979	28.10	33.43	20.26	30.79	7.84	40.75	7.05
1980	39.95	42.17	28.25	39.44	11.70	49.23	8.94
1981	52.37	31.09	35.41	25.35	16.96	44.96	10.97
1982	67.54	28.97	44.73	26.32	22.81	34.49	13.01
1983	89.25	32.14	57.26	28.01	31.99	40.25	15.36
1984	121.47	36.10	77.66	35.62	43.81	36.95	17.45
1985	162.26	33.56	105.78	36.21	56.48	28.92	18.96
1986	223.76	37.90	147.15	39.11	76.61	35.64	23.08
1987	307.33	37.35	206.76	40.51	100.57	31.28	27.19
1988	380.15	23.69	265.92	28.61	114.23	13.58	27.12
1989	514.69	35.39	373.48	40.45	141.21	23.62	32.34
1990	703.42	36.67	519.26	39.03	184.16	30.42	39.66
1991	911.03	29.51	679.09	30.78	231.94	25.94	45.88

Sources: *Statistical Yearbook of China*, 1992; Qian 1993.
[1] Deposits held by households in the state banking system.
[2] Deposits held by households in rural credit cooperatives only.

Table 10. China: Selected Interest Rates, 1980–91[1]

	National Retail Price Index	Nominal Interest Rates: Household 1-year Time Deposit	Nominal Interest Rates: Household 3-year Time Deposit	Nominal Interest Rates: Loan to Industry[2]	Nominal Interest Rates: Loan to Township-Village Enterprises[3]	Real Interest Rates: Household 1-year Time Deposit	Real Interest Rates: Household 3-year Time Deposit
	Percent per year			*In percent per year*			
1980	6.0	5.40	6.12	2.52	2.16	−0.60	0.12
1981	2.4	5.40	6.12	2.52	2.16	3.00	3.72
1982	1.9	5.76	6.84	3.60	4.32	3.86	4.94
1983	1.5	5.76	6.84	7.20	4.32	4.26	5.34
1984	2.8	5.76	6.84	7.20	7.92	2.96	4.04
1985	8.8	7.20	8.28	7.92	10.08	−1.60	−0.52
1986	6.0	7.70	8.28	7.92	10.08	1.70	2.28
1987	7.3	7.20	8.28	7.92	10.08	−0.10	−0.98
1988	18.5	8.64	9.72[4]	9.00	10.08	−9.86	−8.78[4]
1989	17.8	11.34	13.14[4]	11.34	11.34	−6.46	−4.66[4]
1990	2.1	8.64	10.08	9.36	9.36	6.54	7.98
1991	2.9	7.56	8.28	8.64	8.46	4.66	5.38

Sources: *Statistical Yearbook of China, 1992*; *Almanac of China's Finance and Banking*, 1990, 1992; Qian, 1993.

[1] Year-end figures.

[2] For circulation capital (one year).

[3] For equipment.

[4] Cost-of-living adjustment allowance not included. See Table 11.

Table 8. China: Rural Credit Cooperative Activities
(In billions of yuan)

	Total Deposits	Loans to Households	Loans to TVEs[1]	Loans to Collective Agriculture	Total Loans/ Total Deposits *(Percent)*
1979	21.59	1.09	1.42	2.24	22.0
1980	27.23	1.60	3.11	3.45	30.0
1981	31.96	2.52	3.55	3.57	30.2
1982	38.99	4.41	4.23	3.48	31.1
1983	48.74	7.54	6.01	2.82	33.6
1984	62.49	18.11	13.5	3.84	56.7
1985	72.49	19.42	16.44	4.14	55.2
1986	96.23	25.80	26.59	4.46	59.1
1987	122.52	34.76	35.93	6.45	63.0
1988	139.98	37.24	45.61	8.01	64.9
1989	166.95	41.57	57.19	10.73	65.6
1990	214.49	51.82	76.07	13.41	65.9
1991	270.93	63.14	100.73	16.99	66.8

Source: Qian 1993. Data taken from Statistical Yearbook of China, 1992.
[1] Township and village enterprises.

Table 9. China: Bank Lending to the Nonstate Sector as a Proportion of Total Bank Loans Outstanding

(In percent)

	Urban Collectives	Urban Individuals	TVEs[1]	Agriculture	Total Nonstate Loans
1985	4.95	0.17	5.63	6.85	17.60
1986	5.11	0.13	6.82	6.68	18.94
1987	5.47	0.16	7.25	7.28	20.16
1988	5.58	0.17	7.59	7.19	20.53
1989	5.15	0.11	7.39	7.12	19.97
1990	4.93	0.09	7.42	7.17	19.61
1991	4.74	0.08	7.63	7.39	19.84

Sources: *Almanac of China's Finance and Banking*, 1990; Qian 1993.
[1] Township and village enterprises.

Table 4. China's Fiscal Situation in the Reform Period

(Percentage of GNP)

	Revenue		Expenditure		Budget Deficit		
	Chinese Definition	"Standard" Definition	Chinese Definition	"Standard"[1] Definition	Chinese Definition	Government Borrowing Requirement Definition[2]	Stock Definition[3]
1978	31.24	34.77	30.96	34.49	−0.28	−0.28	−0.28
1979	27.66	31.69	31.94	36.86	4.28	5.16	5.16
1980	24.28	29.10	27.13	32.91	2.85	3.82	3.28
1981	22.83	27.28	23.36	29.35	0.53	2.06	1.17
1982	21.64	27.14	22.21	29.32	0.56	2.18	1.41
1983	21.50	27.66	22.25	29.78	0.75	2.11	1.64
1984	21.57	26.47	22.21	28.22	0.64	1.75	1.51
1985	21.81	26.84	21.56	27.64	0.25	0.80	0.50
1986	23.31	25.23	24.04	27.39	0.73	2.15	1.85
1987	20.96	22.79	21.67	25.00	0.70	2.20	1.75
1988	18.68	19.93	19.24	22.41	0.56	2.48	2.16
1989	18.43	20.41	19.01	22.75	0.58	2.35	2.09
1990	18.50	19.63	19.28	22.51	0.78	2.88	2.15
1991	18.13	18.52	19.30	21.88	1.17	3.36	...

Source: Wong, Heady, and Woo (1993).

[1] The "standard" definition of revenue subtracts the borrowing included in the Chinese definition and adds the subsidies that were counted as negative revenue. The "standard" definition of expenditure adds to the Chinese definition subsidies that were considered negative subsidies.

[2] The government borrowing requirement definition of the deficit is "standard" expenditure minus "standard" revenue.

[3] The "stock" definition of deficit is the government borrowing requirement definition minus principal repayments.

Table 5. Consolidated Deficit of Chinese Government and State-Owned Enterprises, 1988–91

(Percentage of GNP)

	Open Deficit[1]	Hidden Deficit[2]	Consolidated Deficit (1) + (2)	A Conservative Reestimate[3]
	(1)	(2)	(3)	(4)
1988	2.48	5.14	7.62	6.08
1989	2.35	5.22	7.57	6.01
1990	2.88	7.55	10.43	8.17
1991	3.36	6.76	10.12	8.09

Source: Wong, Heady, and Woo (1993).
[1] Government borrowing requirement as in Table 4.
[2] Central bank financing for the deficits of state-owned enterprises.
[3] Assuming that the hidden deficit is 70 percent of the estimate in column (2).

Main Conclusions

1. Russia's shock therapy reforms in 1992 led to massive and rapid changes in key macro aggregates that:
   - Made it far more expensive in inflationary terms to finance any given fiscal deficit
   - Made it less likely that the financial system would be much use in support the major resource reallocation that Russia badly needed
2. The parallel rapid mass privatisation radically changed the distribution of income and wealth away from the mass of Russians and towards a small number of wealthy "oligarchs" able to protect their assets from the effects of hyper inflation
3. The more gradualist approach in China resulted in a very impressive rise in monetisation that enable the authorities both to finance significant fiscal deficits at a low inflation cost and to also absorb the losses from dinosaur state-owned enterprises
4. The parallel liberalisation of the economy for FDI and the development of new industries enabled a fundamental resource shift in the economy that also favoured very rapid real growth.