



# ADDITIONAL TOPICS EMERGING MARKET ECONOMIES

## INTRODUCTION

There is perhaps no greater economic policy challenge and opportunity around the world today than the emergence of market economies. The tearing down of the Berlin Wall, the end of central planning in East Germany and the unification of Germany are stirring symbols of this emergence. So is the end of central planning in Russia, the countries of central and Eastern Europe and countries in the Transcaucasian and central Asian regions, such as Armenia, Georgia and Mongolia. The emergence of market economies is also seen in China and Vietnam. A common feature of these countries is that a major transition is occurring — a transition from a *command economy*, or a centrally planned economy in which the government sets prices and decides *what, how* and *for whom* goods should be produced, to a *market economy* that is based much more on markets and freely determined prices, in which most of these decisions are left to individuals.

Similar attempts to reduce government restrictions on markets are occurring in many other countries in Latin America and Asia. Although these economies were not formerly centrally planned, international and domestic trade was tightly restricted, and major parts of the economies were government owned. In recent years, Argentina, Chile, Mexico and India have either reduced government control of large segments of their economies or encouraged closer ties with market economies around the world, or both. Mexico recently joined a free trade agreement with the United States and Canada, while Chile and other countries of Latin America are anxious to join.

Table 1 provides a list of countries designated by the *Economist* magazine as emerging market economies; clearly the list goes well beyond the former centrally planned economies. Even though the *Economist's* list is not comprehensive (neither Mongolia, Ukraine nor Vietnam are included), it demonstrates that the phenomenon of emerging markets is very widespread.

**command economy:** an economy in which the government determines prices and production; also called a centrally planned economy (chapter 1).

**market economy:** an economy characterised by freely determined prices and the free exchange of goods and services in markets (chapter 1).

POPULATION (MILLIONS)		POPULATION (MILLIONS)		POPULATION (MILLIONS)	
China	1260	Thailand	64	Portugal	11
Hong Kong	6	Argentina	36	South Africa	51
India	1018	Brazil	170	Turkey	70
Indonesia	219	Chile	15	Czech Republic	11
Malaysia	22	Colombia	39	Hungary	10
Philippines	82	Mexico	103	Poland	40
Singapore	3	Venezuela	23	Russia	151
South Korea	48	Greece	11	TOTAL	3491
Taiwan	22	Israel	6		

**TABLE 1**  
*Emerging market economies as defined by the Economist*

Source: Population figures are projections for the year 2000 from the *Statistical Abstract of the United States*, 1995, pp. 845–46.

Although the long-run goals of the emerging market economies are to raise economic growth and improve living standards, the short-run problems of moving

from a centrally planned economy to a market economy are particularly difficult. In fact, economic growth has faltered in some countries that are trying to make a transition from central planning to a market economy, especially in central and Eastern Europe and the former Soviet Union. People of these countries have shown signs of frustration and impatience with the transition.

In this topic we take a special look at those emerging market economies that are making a transition from central planning. To understand what is happening now, we need to look back at what economic life was like under central planning. We first show how central planning grew out of the communist revolutions that were induced by the Marxist criticism of market economies. We then examine the aim of market reforms, alternative approaches to reform and the experience of several economies during the transition.

## CENTRALLY PLANNED ECONOMIES

With few exceptions, such as the North Korean economy, centrally planned economies no longer exist. But there are important economic lessons to be learned from the experience of the many countries that tried central planning during the twentieth century. A well-known expert on the ideas underlying communism, socialism and the market economy, Robert Heilbroner, summarises the lessons this way: ‘The Soviet Union, China and Eastern Europe have given us the clearest possible proof that capitalism organises the material affairs of humankind more satisfactorily than socialism’ (See Robert Heilbroner 1993, ‘The Triumph of Capitalism’, *New Yorker*, January, pp. 98–109).

**socialism:** an economic system in which the government owns and controls all the capital and makes decisions about prices and quantities as part of a central plan.

**capitalism:** an economic system based on a market economy in which capital is individually owned, and production and employment decisions are decentralised.

**communism:** an economic system in which all capital is collectively owned.

A socialist economy, also called **socialism**, is an economic system in which the government owns the capital — factories, stores, farms and equipment — and decisions about production and employment are made by those who run the government as part of a central plan for the economy. In contrast, in a market economy, also called **capitalism**, individuals own the capital, and decisions about production and employment are decentralised and made by many individuals buying and selling goods in markets. The term **communism** refers to a theoretical situation where all the people of a country *collectively* own the capital and the land without direct government ownership. Those who advocated communism viewed collective ownership by the people as a long-term goal: a socialist economy would evolve into communism with the government gradually withering away. However, today most economists and historians use the word *communism* to mean the same thing as *socialism*, as defined here.

Not all socialist economies are the same; there are different degrees of government ownership and centralisation. For example, in some socialist economies, farmers could sell a portion of their agricultural output and use the proceeds to buy farm equipment or even consumer goods. Similarly, not all market economies are the same; in most market economies, the government owns the public infrastructure capital and is involved in the production of education, health services and other goods. The degree of government involvement differs from market economy to market economy. For example, a much larger fraction of medical care is produced by the government in the United Kingdom than is produced by the government in the United States and Australia.

However, in reality, the differences between socialist economies as a group and market economies as a group are much larger than the differences between the economies within each group. In other words, there is a ‘night-and-day’ distinction between centrally planned economies with government ownership of firms that do

not have to compete and market economies with private ownership of firms that do have to compete. To understand this distinction, we need to examine how centrally planned economies worked.

## Central planning in the Soviet Union

V. I. Lenin and the Bolshevik party (also known as the Communist party) gained control of the government of Russia in the October Revolution of 1917. At this time, the Russian economy was much less developed than that of most of Western Europe. GDP per capita in Russia was less than one-third that of the United Kingdom or the United States. The economy was mostly agricultural. Although large-scale manufacturing industries were growing, they were still much smaller than those in Germany, the United Kingdom or the United States. For more than 1000 years, before the communists gained control, Russia had been ruled by tsars, who held enormous power and resisted economic and political change.

For those reasons, the Russian people were dissatisfied with both their economy and their political system. Lenin and the Bolsheviks seized the opportunity, forcing through a completely new economic system. Most significantly, Lenin decreed that private firms would be taken over by the government, a process called **nationalisation**. The Bolsheviks immediately nationalised the banking system and, by mid-1918, a massive nationalisation of large- and small-scale industry was under way. Although the alleged reason for the Bolshevik takeover was to give workers control of the economy, Lenin soon rejected worker control. He argued that people like himself were needed to run the economy on behalf of the workers. He began controlling production from the centre, appointing administrators to run each industry from offices in Moscow. In doing so he laid the foundation of a command economy — through which government *diktats*, or commands, rather than prices and decentralised markets, would determine what was produced. In 1921, **Gosplan**, the state planning commission, was established. In 1922 the Communist party established the Soviet Union, incorporating Ukraine and other countries along with Russia into one large command economy.

At the very start, the experiment in central planning was unsuccessful. Production fell and inflation rose dramatically. Much of the blame for the early lack of success could be placed on the civil war between the communists (the Reds) and the anti-communists (the Whites). Moreover, Lenin received little guidance on how to set up a socialist economy. Karl Marx, whose analysis of capitalism provided the intellectual support for the communist revolution, had written virtually nothing about how a socialist economy or central planning would work (see the box on Karl Marx). In any case, the early 1920s saw a retreat from central planning and a partial reinstatement of the market economy under Lenin's New Economic Policy. But with Lenin's death in 1924 and Joseph Stalin becoming leader of the Communist party in 1928, central planning was reinstated with even more force than previously.

## The five-year plans

The goal of catching up with Western Europe and the United States soon began to dominate Stalin's thinking about the economy. Catching up required raising the level of investment in factories and industrial equipment, increasing labour hours, and shifting workers out of agriculture into industry. Stalin wanted to do this rapidly and on a massive scale. To do so he needed to raise investment in heavy industry and reduce consumption. He saw a command economy as the only way to accomplish his goal.

Stalin, therefore, gave Gosplan much more authority to run the economy from the centre. In 1928 Gosplan issued a **five-year plan** stipulating production goals for the entire economy. This five-year plan turned out to be the first of a succession of many more five-year plans, and the methods of central planning that would last for 60 years

**nationalisation:** the taking over of private firms by the government.

**Gosplan:** the planning agency of the former Soviet Union.

**five-year plan:** a document that stated production goals for the entire Soviet economy for the succeeding five years.

**state enterprise:** an organisation, analogous to a firm in a market economy, that is owned and controlled by the government.

**collectivised farm:** a farm in a planned economy that is in theory collectively owned by peasants, but controlled by the government.

**production target:** a goal set for the production of goods and services in a planned economy.

were put in place. Gosplan, under command of the Communist party leaders, controlled production not only for Russia but for the entire Soviet Union, which was spread over eleven time zones and covered one-sixth of the world's land area.

Production of most goods took place at **state enterprises** — organisations similar in function to business firms in market economies but owned and controlled by the government. Stalin also virtually abolished private property in agriculture in the Soviet Union. He created **collectivised farms**, through which the government took ownership of most farmland, farm equipment and livestock.

By setting **production targets** for millions of products throughout the Soviet Union, Gosplan tried to control what and how much should be produced at each state enterprise and collectivised farm. Through this method Stalin was successful in raising the level of investment and reducing people's consumption and thereby rapidly expanding the number of machines and factories devoted to manufacturing. In order to make sure that the labour force was sufficient for this rapid industrialisation, the communist government also placed restrictions on workers. For example, new graduates were assigned jobs in different parts of the country, and restrictions on moving to and living in certain areas made it difficult for workers to change jobs if they wanted to.

## Centrally controlled prices

Prices for individual goods were also set at the centre, but Gosplan rarely set these prices at levels that would equate the quantity supplied with the quantity demanded. Shortages were typical. Food prices were set very low, resulting in food shortages. The managers of state enterprises frequently found themselves having to wait for parts or inputs to production. At other times they produced an excess supply that no-one could use. To be sure, when shortages became very severe, markets would develop — enterprise managers in desperate need of materials would offer side payments, or bribes, to other managers or workers to get the materials. These markets operated outside of the normal central planning process and were called *grey* or *black markets*. Some economists feel that these markets enabled central planning to function by reducing crucial shortages.

Prices have three roles: they transmit information, coordinate actions by providing incentives and affect the distribution of income. In a market economy, a change in demand or supply causes a change in the price, which transmits information throughout the economy. Such changes in prices were thwarted by central planning. Central planners simply did not have enough information to know how to change the prices. Thus, the information transmission role of prices did not exist.

The coordination role of prices was de-emphasised, although the central planners recognised that prices affected incentives. The managers of the state enterprises were given rewards for hitting production targets, but the rewards were not designed in a way that encouraged efficient management practices. To poke fun at Gosplan, a famous cartoon showed a picture of a nail factory producing *one* large but useless 510-tonne nail in order to meet the factory's production target for 510 tonnes of nails. There were also few rewards for inventing new products or even for finding more efficient ways to produce the existing products. State enterprises thus became very inefficient. Competition between enterprises was discouraged, and production became highly concentrated in a few firms in each industry.

Gosplan did not ignore the role of prices in affecting the distribution of income. Prices were held low on most staple items and high on the few consumer durable items that were produced. By setting prices this way, Gosplan tried to make the distribution of goods and services more equal. But income distribution was by no means egalitarian under central planning. Communist party officials and enterprise managers were given extra payments in the form of better housing,

transportation and the opportunity to shop in stores that contained consumer goods unavailable to ordinary consumers. Because virtually all prices were set by the government, there was no measured inflation, although with prices set too low for many products the economy was frequently in a condition of shortage. The central bank (Gosbank) was the only bank in the country. It provided loans to state enterprises and collectivised farms in the amounts Gosplan instructed. Gosbank also issued currency (rubles) and accepted deposits from consumers.

Gosplan did not have to worry much about taxes because it could set the price of everything. For example, to finance the production of military goods, the central planners could set the price of inputs to defence production low and the price of defence goods high. They could also simply order increased production of military goods and reduced production of some other goods.

## Trade between the Soviet Union and Eastern Europe

After World War II when communist governments were installed in Poland, Hungary, Czechoslovakia, East Germany, Romania and Bulgaria, Soviet-style central planning was extended to each of the countries of Eastern Europe. How did international trade take place between the Soviet Union and its close neighbours in the Soviet bloc?

Trade among these countries and the Soviet Union took place through a trading organisation called the Council for Mutual Economic Assistance. The trade did not take place at world market prices. For example, the Soviet Union, rich in energy resources such as oil and natural gas, would supply energy to the Eastern European countries at prices well below the market prices prevailing throughout the world. The prices were established through political negotiations between the governments, which undoubtedly involved non-economic considerations such as the placement of military troops and weapons. In exchange for the low-priced energy, the Eastern European countries would provide manufactured goods, though those were of a lesser quality than similar goods produced in the West. Prices for trade between the countries of Eastern Europe were similarly negotiated. Thus, neither domestic nor international trade between the centrally planned economies was market based.

## Technological change and the quality of goods

By most accounts Stalin's forced investment and forced labour strategy did increase economic growth in the 1930s in the Soviet Union. In the years after World War II both the Soviet Union and Eastern Europe grew rapidly. However, it eventually became apparent that great inefficiencies associated with central planning were starting to offset the high levels of investment and labour force participation. The growth of technology began to slow down. Investment rates and labour force participation rates had reached their limits, and technology growth was lagging seriously. Environmental pollution was severe in cities such as Warsaw and Bucharest.

State-owned retail shops had few consumer goods, and those they had were of very poor quality. Long lines were evident at stores, especially those selling anything special, such as confectionery or petrol. The availability of goods was also poor.

One of the apparent puzzles about central planning was its success in certain areas. The space exploration achievements of the Soviet Union, for example, were outstanding enough for the United States to get involved in the space race. They were the source of President Kennedy's goal of a manned flight to the moon.

One explanation for this success was that an enormous amount of resources was put into defence production. Just as East German athletes dominated the Olympics because of all the resources that went into their training, a centrally planned economy could excel at certain things. Students with talents useful for defence production — mathematics, science and engineering — were given excellent training

in the Soviet Union. Even inefficiency can be offset by enough resources. Moreover, as mentioned previously, economists found that managers in defence production had ways to go outside the central planning system, essentially using grey markets to obtain parts or equipment in short supply. Such markets were tolerated more frequently in the defence industry than in consumer goods industries.

## From perestroika to the end of the Soviet Union

**perestroika:** the restructuring of the Soviet economy by reforming the central planning process.

Pressures to reform the central planning system began in the 1960s and 1970s and gained momentum in the 1980s. In 1985, Mikhail Gorbachev became the leader of the Communist party. To deal with the problems of inefficiency, poor quality and slow technology growth, he tried to change central planning in a process called **perestroika**, which translates as ‘restructuring’. Perestroika changes were put into the twelfth five-year plan, formulated in 1985. For example, enterprise managers were to be made more accountable for their actions through worker and public criticism. By 1989, however, it was clear that perestroika was doing little to raise economic growth. Economists complained perestroika was piecemeal because it continued to rely on the central planning process to set prices. An alternative plan, called the Shatalin Plan, after one of Gorbachev’s advisers, would have used the market much more. However, it was rejected by Gorbachev because it would have initiated a transition to a market economy, thereby doing away with central planning.

But perestroika started a process that would not easily be stopped. The open criticism of the central planning process made it acceptable to criticise the political authorities. Soon people in Eastern Europe were criticising their own governments and their close ties with the Soviet Union. Gorbachev decided to ‘let go’ of the Eastern European countries in 1989, and by 1990 the republics of the Soviet Union also wanted their freedom. Gradually the Russian Republic began to take over the responsibility for the Soviet Union. After an aborted military coup in 1991, Gorbachev resigned and the Soviet Union ceased to exist. Boris Yeltsin, the president of Russia, disbanded central planning and began to follow a more comprehensive series of reforms aimed at creating a market economy. Yeltsin’s own reforms have also been opposed, and a political struggle will determine how successful Russia is in implementing the reforms.

## Soviet-style central planning in China

The Chinese communists under Mao Zedong gained control of China in 1949. Mao’s goals were similar to those of the Soviet Union — to industrialise rapidly. In fact, Mao originally viewed the Soviet Union as an economic model. He imported Soviet-style central planning to China. Under Mao and the Communist party, most economic production was controlled by the central government, just as in the Soviet Union. In the 1950s, growth was rapid due to heavy investment.

Starting in 1958, Mao began the ‘Great Leap Forward’, which briefly raised economic growth by promoting a warlike work effort throughout the country calling for a massive expansion of production. But the Great Leap Forward could raise economic growth for only a short period. The communist spirit was not enough to make people work hard year after year. The Great Leap Forward ended in a huge decline in production.

A misguided attempt to revive the spirit of the communist revolution took place during the Cultural Revolution in the late 1960s. But the Cultural Revolution ended up severely hurting the Chinese economy. Productive managers and technicians were forced to leave their jobs and do manual labour. Universities were closed. By the late 1970s it was also clear that economic reform was necessary in China, a subject we will return to later in the chapter.



## HISTORICAL PERSPECTIVE

### Karl Marx, 1818–83

- Born:** Trier, Germany, 1818
- Education:** University of Bonn, 1835  
University of Berlin, 1836–41  
University of Jena, doctorate in philosophy, 1841
- Jobs:** Editor, freelance journalist, Cologne, Paris, Brussels, 1842–48  
Independent study, freelance journalist, London 1849–83
- Major publications:**  
*Communist Manifesto* (with Friedrich Engels), 1848; *Das Kapital*, 1867 (Vol. I); Russian translation, 1868; English translation, 1886

What led to the rejection of markets and the acceptance of socialism in Russia, China and Eastern Europe in the twentieth century? Although personal ambition, war and political repression were factors, the economic writings of Karl Marx in the nineteenth century played a key role.

Karl Marx was an economist and social philosopher, but he was also an eloquent journalist and polemicist. Most of his work as an economist was spent analysing capitalism. His most famous prediction was that capitalism would eventually die of its own internal contradictions.

Marx originally went to college to study law, but he soon was drawn to the writings of the philosopher Hegel, who characterised history as a struggle between conflicting forces; each idea (thesis) generated its opposite (antithesis), which it then had to contend with until a new thesis (synthesis) was created. This Hegelian view provided Marx with a framework to study the historical development of capitalism.

Marx soon became an outspoken critic of the existing economic and political system in Europe. He spent much of his adult life in London, studying and writing in the archives of the British Museum. Marx eked out a modest living — his wife and children struggling at the brink of poverty — through his journalistic writings and through financial assistance from his long-time friend and collaborator, Friedrich Engels.

Marx's polemical writings were influential. The widely read and often-quoted *Communist Manifesto* was a short pamphlet written in 1848 by Marx and Engels. It was nothing less than a stirring call for a revolution:

*A spectre is haunting Europe — the spectre of communism . . . Let the ruling classes tremble at a Communist revolution. The proletarians have nothing to lose but their chains. They have a world to win. Working men of all countries, unite!*

Surprisingly, perhaps, Marx and Engels found much to admire in capitalism. They wrote that the *bourgeoisie*, the class that owned or ran the business firms

*. . . has accomplished wonders far surpassing the Egyptian pyramids, Roman aqueducts and Gothic cathedrals . . . [D]uring its rule of scarcely one hundred years, [it] has created more massive and more colossal productive forces than have all preceding generations together.*

It is in Marx's economic writings — longer and more ponderous — that his detailed criticism of capitalism is found. In particular, his treatise *Das Kapital* aimed to show why Adam Smith and David Ricardo were wrong in their praise of the market economy. For example, referring to Smith's idea that workers would benefit from increased labour productivity due to the division of labour or to more machinery, Marx wrote in *Das Kapital*:

*Adam Smith, by a fundamentally perverted analysis, arrives at [this] absurd conclusion . . . In truth, Adam Smith breaks his investigation off, just where its difficulties begin.*

Marx argued instead that increases in labour productivity would not benefit workers; capitalists, trying to maintain their profits, would keep workers' wages from rising. But history shows that wages increased by huge amounts in the 150 years since Marx wrote.

Although socialism may have originally seemed like an attractive alternative to the market system, socialism's own severe problems eventually became obvious. Surprisingly, however, Marx wrote almost nothing about how a socialist economy would work. His writings focused entirely on capitalism.

*Sources of quotes:* Marx, K. and Engels, F. 1848, *Communist Manifesto*, in ed. A. P. Mendel in 1961, *Essential Works of Marxism*, Bantam Books, New York, pp. 1, 44 and 16–17; Marx, K. 1906, *Capital: A Critique of Political Economy*, Modern Library, New York, p. 647.

## REVIEW

- Central control of the economy began in Russia soon after the Bolsheviks rose to power. Central planning grew and dominated the Soviet economy under Stalin in the 1920s and 1930s and spread to Eastern Europe and China after World War II.
- Although the high investment and high labour-force participation led to strong growth initially, central planning eventually broke down. Inefficiency, poor-quality goods and slow growth of technology were the most obvious problems.

## ALTERNATIVE PATHS TO A MARKET ECONOMY

How does a country change from central planning to a market economy? Recall that the first action of the Communists in Russia was to abolish private property rights and nationalise industry. One of the most difficult parts of reform has been to reverse this step, restoring private ownership and privatising state enterprises.

### The goals of reform

Defining the goals of reform is simple; getting there is what is difficult. The goals are simply the essential ingredients of a market economy. To summarise, these are:

- *freely determined prices* evolving out of decentralised markets rather than prices controlled by government
- *property rights and incentives*, which the Hungarian economist Janos Kornai argues in his book *The Road to a Free Economy* are the most important and frequently underemphasised parts of a market economy. Decentralising decisions without prices providing incentives through property rights will not create efficiency.
- *competitive markets* so that the price system leads to an efficient allocation of goods, labour and capital
- *freedom to trade at home and abroad*, which is needed in order to achieve the efficiencies associated with comparative advantage and economies of scale
- *a role for government* in establishing a policy that keeps inflation in check and that efficiently collects taxes to pay for public goods and provides a social safety net
- *a role for non-government organisations*, because in a market economy many transactions occur within organisations — as, for example, when an entrepreneur sets up a new firm to market a new product.

There is general agreement that any successful transition from central planning to a market economy must achieve these features of a market economy. A legal system specifying property rights and enforcing contracts must be set up. A banking system must be established. A system of tax collection must be put in place. As is true of many areas of economics, however, there is disagreement about the speed of the transition.

### Shock therapy or gradualism?

A major question about the transition to a market economy is how fast it should be. The two basic alternatives are **shock therapy** and **gradualism**. Under shock therapy, or the *big bang* approach, all the elements of the market economy are put in place at once. Under gradualism, the reforms are phased in slowly.

**shock therapy:** the abrupt introduction of free markets in a formerly centrally planned economy.

**gradualism:** the slow phasing-in of free market reforms.

One of the most remarkable aspects of the transition from central planning in the countries of Eastern Europe was the strong commitment to move to market economies on the part of government policy makers and the general public at the start of the reforms in 1989 and 1990. Most officials went out of their way to emphasise that they were not looking for a third way and to recognise the need to move to a Western-style market-based economic system in order to raise living standards.

Such positive attitudes about reform were part of the motivation behind shock therapy. Those in favour of a shock-therapy approach argue that such positive attitudes are probably temporary, creating a brief window of opportunity for reform. The enthusiasm for reform may diminish if, as is likely, the reforms do not bring noticeable improvements quickly. Thus, rather than see the reform movement aborted in midstream, it is better to sweep through the reforms quickly. This was one of the arguments for the shock-therapy approach that was used in Poland.

Another argument in favour of shock therapy is that all the elements of reform are interrelated. Making state enterprises private without competition, for example, could make things worse. And freeing up the price of energy products will reduce the government subsidy needed to finance the energy-producing enterprises. This will reduce the government budget deficit. Also, removing trade barriers and establishing a sound currency will be a guide to what the process should be as the free price system gropes for a new set of relative prices.

The arguments against shock therapy are that people require time to adjust to new circumstances. Enterprises producing medical supplies in Moscow might be used to getting cotton from central Asia, but if free trade makes it more attractive for central Asia to sell cotton in Japan, then production in Moscow will be disrupted.

Even though the production of low-quality black-and-white television sets in Warsaw is inefficient compared with imports from Malaysia, it might be better to move gradually to free trade. This would give the firms time to move into some other business and the workers time to find other jobs. The arguments against shock therapy are similar to the arguments against a fast disinflation strategy or against an immediate reduction in tariff barriers.

## REVIEW

- The goals of a transition to a market economy are much easier to state than to achieve; the goals can be defined in terms of the key ingredients of a market economy.
- Shock therapy and gradualism are two different paths to a market-based economy.

## ECONOMIC REFORM IN PRACTICE

What has been the experience of those countries trying to make a transition from central planning to a market-based economy? The transition has been difficult. Although the formerly centrally planned economies of central and Eastern Europe and the former Soviet Union had slow economic growth under communism, the period of transition has seen deep recession. In some countries the decline in real GDP has been nearly as large as the decline in real GDP during the Great Depression in the United States. There are significant signs of improvement in the countries of central and Eastern Europe, except for Ukraine. But Russia and many of the central Asian countries continue to suffer transition problems.

To understand the problems of transition, we must look more carefully at the countries undertaking the transitions. Consider two countries — Poland and China — that have been undergoing a transition for several years and that have achieved positive economic growth.

## Reforms in Poland

Poland was the first country in Eastern Europe to start a transition to a market economy. The Polish program has typified the shock-therapy approach.

Four months after the reform program was put in place in Poland, there were many visible signs of its effects, including a decline in inflation and a reduction of shortages. Inflation, which averaged 420 per cent in 1989 and 1990, had fallen to 25 per cent by 1992, but the adjustment costs, as evidenced by large declines in production and employment, were painful. Real GDP declined by 12 per cent in 1990 and another 7 per cent in 1991. However, by 1992 real GDP had stopped falling and showed a small increase. By 1994 economic growth was 5.2 per cent, rising to 6.9 per cent in 1997.

The Polish stabilisation program made use of several policy initiatives. Government expenditures and the budget deficit were reduced sharply, largely through a reduction in government subsidies to state enterprises and a halting of public infrastructure investment. Most prices were deregulated at once and were left to be determined by state enterprises or private firms. Coal prices increased significantly, but internal transportation prices and rents remained low. Wage growth was controlled by government guidelines.

The result of these policies was a substantial decline in demand. There was also a reduction in shortages — the lines of people waiting to be served in butcher shops disappeared, for example. This reduction was brought on partly by the decline in demand, but also because free prices began to bring the quantity supplied into equality with the quantity demanded. Goods started appearing on the shelves, and firms could get intermediate inputs without long delays. Imported consumer goods, most noticeably fruit and vegetables, were more available. The trade account went into surplus in 1990 with exports increasing rapidly and imports declining rapidly.

At the start of the reform program, employment declined surprisingly little despite the large declines in production. The unemployment rate increased only to about 2 per cent of the work force in the first few months of the program, but then unemployment increased sharply. Many workers were laid off because the state enterprises needed to reduce wage costs in order to avoid losses as the demand for their products dropped.

In order for a market economy to take root, it is necessary that existing state enterprises be privatised, a process called **privatisation**, and that new private firms be able to start up. Moreover, private investment from abroad provides technological know-how. Privatisation helps provide managers with the incentive to allocate resources efficiently and increase productivity.

The Polish Government submitted a privatisation bill to the Parliament after the economic reforms began in 1990, but it moved slowly because of extensive debates. The main controversial issue was over who owned the state enterprises that were being sold. Hence, privatisation was one part of the Polish reform program that was gradual.

## Reforms in China

Market-based reforms began in China earlier than in the former Soviet Union. The first reforms were in the agriculture sector. By the late 1970s, the Chinese

**privatisation:** the process of converting a government enterprise into a privately owned enterprise.

Government was leasing land back to individual farmers in order to give them more incentive to produce. The reform resulted in a huge increase in the growth rate of farm output. Agriculture production grew by 3 per cent per year from 1952 to 1978; from 1978 (when the reforms began) to 1981, the growth rate was about 6 per cent per year. Moreover, the increased efficiency in agriculture increased the supply of labour in the industrial sector.

By the mid-1980s, about the same time as perestroika was starting in the Soviet Union, economic reforms were already spreading beyond the farm sector. Individual state enterprises were first given more discretion to experiment with new products and to use the profits generated from those products. As in the case of agriculture, industrial enterprises were leased to the managers, who could then keep part of the profits. As a result of these reforms, real GDP growth increased rapidly. Economic growth averaged a remarkably rapid 9.6 per cent per year from 1987 to 1994. During the 1990s real GDP was falling in Russia.

China also reduced restrictions on foreign trade. In fact, much of China's growth has come from producing goods for foreign trade. Exports grew even more rapidly than real GDP. However, reform of exchange rates and monetary policy came much later in China. Free exchange of the local currency in terms of foreign currency was fully established only in 1993. And by the early 1990s, inflation was starting to become a problem in China. The inflation rate reached 22 per cent in 1994.

To summarise, the overall reform in China has been much more gradual than in Poland. But economists continue to debate whether the gradual reform is better or worse than shock therapy.

## REVIEW

- Poland took the lead in major economic reform in Eastern Europe. Its reform program is the prototype of shock therapy.
- The transition has been hard on the Polish economy. However, real GDP growth started increasing in 1992 and reached 6 per cent in 1994. Institutions have been put in place that will help foster the market economy in the future.
- China started its market-based reforms in the late 1970s by selling off a large amount of land to the farmers. Controls on state enterprises have been lifted more gradually.

## ECONOMIC FREEDOM AND POLITICAL FREEDOM

Free markets and political freedom are not the same thing. Free markets, or economic freedom, allow people to engage freely in trade without restriction. Political freedom allows people to engage in free speech or to vote for their political representatives without restriction.

In principle a society can have political freedom without economic freedom — people could vote for central planning and price controls. Or a society could have economic freedom without political freedom: a dictator could allow people to trade without restrictions. Economists and political scientists have long debated whether there is a tendency for political freedom and economic freedom to exist together.

In abolishing private property and establishing central planning it is clear that Lenin and Stalin placed severe restrictions on people's political freedom. Indeed, millions who refused to go along with Stalin's program were imprisoned or executed. Thus, as practised, socialism stifled both economic and political freedom. By abolishing private property it eliminated one of the key ingredients of a free

market economy. But by abolishing democracy where it existed, or preventing its establishment through totalitarian dictatorship, it also restricted political freedom.

Central planning as practised in the Soviet Union, China and Eastern Europe resulted in a great loss of economic freedom along with a great loss of political freedom. Central planning was run by dictatorships. In order to carry out the collectivisation of agriculture and forced investment and labour strategy of the 1930s the Soviet government had to imprison or execute many people. And the effort to restore a market economy and end central planning in Russia and Eastern Europe has been associated with an increase in democracy and political freedom.

However, the association of political and economic restrictions under communism does not prove that economic freedom and political freedom are necessarily connected. Throughout history there are examples where economic freedom has increased while political freedom has been repressed and vice versa. Many refer to China in the late 1980s as an example: a highly publicised and televised confrontation between dissident students and the government in Beijing indicated that the move towards free markets was not necessarily a move to political freedom.

## REVIEW

- The relationship between political freedom and economic freedom has long been of interest to economists and political scientists.
- History has shown that there is no causal relationship between democracy and free

markets. There is, however, a close relationship between economic progress and political freedom. Most countries today with high real GDP per capita are also democracies with few restrictions on political freedom.

## CONCLUSION

It was the economic failure of central planning and strict state control that led to socialism's demise. The failure of the centrally planned economy in East Germany in comparison with the success of the market economy in West Germany was as close as the real world ever gets to a controlled experiment. But if the emerging market economies do not deliver economic success for the people of these regions — a success that will be as obvious as was the failure of socialism — it is likely that there will be more changes, perhaps for the worse. And the success or failure of the market reforms in one country strongly influences what goes on elsewhere. Policy makers in Latin American countries say that the spirit of economic and political reform in those countries was stimulated by the 'revolution of 1989' in Eastern Europe.

As we have seen, the countries that are attempting a transition to a market economy have a difficult task before them. There have been setbacks, and there are likely to be more. The people of the United States, Japan and Europe have a historic opportunity to participate and support the emerging market economies through developing links, investing, and providing technical cooperation, assistance and advice. They have much to gain if the transition is successful.

## KEY POINTS

- 1 The term *emerging market economies* usually refers to both former centrally planned economies making the transition to market economies and to developing economies that have recently increased privatisation and reduced restrictions on trade.
- 2 Central planning and state control grew out of the communist revolutions under Lenin in Russia in 1917 and under Mao in China in 1949. Central planning was extended to central and Eastern Europe after World War II. At communism's height, over one-third of the world's population lived in centrally planned economies.
- 3 By mounting an intellectual criticism of the classical economists' model, Marx spearheaded the communist revolutions that eventually led to central planning.
- 4 Most centrally planned economies grew rapidly in their early stages due to heavy investment, but eventually productivity growth slowed down sharply and even declined.
- 5 The transition from central planning to a free market economy is much more difficult than the reverse transition. The road from socialism to free markets will be long, with the gains perhaps not noticeable for many years.
- 6 There are two different approaches to transition: shock therapy and gradualism.