

Socialist Economic Transformation: A Critique and Suggestion

by Allan H. Meltzer

Stanley Fischer and Alan Gelb (1991) consider the steps that a socialist command economy should take during the transition to a market economy. They recognize that differences in initial conditions, political considerations and the absence of a validated, dynamic model force economists to fall back on judgment and hunch. Nevertheless, they offer suggestions about a very difficult problem -- how to order the reform process.

Their paper is a welcome start on a complex set of issues. To further the discussion, I will criticize one of their main conclusions and offer a modest proposal to structure analysis of the sequencing of reform that is testable, at least in principle.

Prices, Wages and Exchange Rates

Fischer and Gelb suggest that countries initially should adopt a fixed exchange rate, a fixed money wage and a fixed interest rate. They recognize that exchange rates must be allowed to change if reserves are inadequate, but they prefer a fixed to a fluctuating exchange rate.

With respect to wage rates, they write: "Wage setting cannot be left to the market early in the reform process because socially owned firms are not operating under correct price and management signals...." [I]t will not be possible to leave interest rate determination to the market until far into the restructuring process." (1991, p. 103)

I restrict my comment to the interaction of wages and exchange rates. Fixing the interest rate adds to the problem but does not introduce any additional issues.

Their proposal cannot be an optimal reform program. The problem is that with two (or three) fixed nominal values, the system is inconsistent. One set of nominal values is consistent with the fixed nominal wage rate. Another is consistent with the money stock implied by the fixed exchange rate and decisions in the rest of the world. The real value of money in wage units is fixed, and the system cannot in general reach

a stable equilibrium at full employment. There is inconsistency and, therefore, indeterminacy of equilibrium.

If the fixed wage is above the equilibrium wage consistent with full employment, workers are unemployed and there is an incentive to substitute capital for labor. In the opposite case, wages are below their equilibrium value, so there is an unsatisfied excess demand for labor; workers choose more leisure or part time work than they would choose at the equilibrium wage. The price level and the real wage depend on the money stock, however, and the money stock depends on the exchange rate. Whether prices rise, fall, or remain unchanged depends, to a first approximation, on where the wage rate and exchange rate are set.

Full employment equilibrium can be restored if the exchange rate is devalued or revalued until the exchange rate and all other values are consistent with the real wage. In principle, an adjustment of this kind can be made, although in practice there is a problem of acquiring accurate information on which to base the decision. It is not clear how the policymaker would know where to set the exchange rate for consistency. And, the exchange rate would have to change whenever there are permanent changes in the terms of trade, in factor productivities, or in any other determinant of equilibrium at home and abroad. A fluctuating rate may be worse, but if the principal reason for rejecting a fluctuating rate is informational, the problem is not avoided in a fixed but adjustable rate system.

Adjustment of the exchange rate by devaluing or revaluing solves one problem but introduces another. The system would be made mathematically consistent, but it would be subject to time inconsistency. People would learn that the exchange rate is not permanently fixed but is to be changed periodically. They would anticipate these changes and adjust prices and wages to reflect anticipated exchange rate changes. They would make errors in this process, introducing excess variability. Moreover, as Kydland and Prescott (1977) have shown, this policy would not product the socially most desirable outcome. A better solution would be to allow the exchange rate to fluctuate if the money wage is fixed. With a freely fluctuating exchange rate the economy reaches equilibrium that is consistent and optimal for that policy rule. But, a fluctuating exchange rate may introduce an excess burden of uncertainty during the

transition to a market economy.

The lesson to be drawn is an old one. If there is a fixed exchange rate, money wages should not be controlled. To control wages and/or prices in a fixed exchange rate system, these countries as elsewhere must make the exchange rate commitment credible. The authors reach a different conclusion, however. They do not free labor markets until reform has "proceeded some distance" (p. 98).

Selective Wage Controls

Much of what has been said about general wage controls applies as well to selective wage controls with a fixed exchange rate. Equilibrium at full employment can only be assured if there is consistency between the relative prices of labor and foreign exchange. There is no reason to suppose this will be so.

Selective wage controls and a fixed exchange rate has been recommended to Eastern European economies by some of the principal international organizations (and other advisors) and adopted in Poland (and perhaps elsewhere). Firms in the Polish state sector must pay a tax on wage increases above a fixed level. Since Polish prices are rising, real wages in the state sector fall. Other things equal, the fall in real wages induces a shift out of this sector. If the sector starts with excess labor relative to the equilibrium level that would prevail in a competitive market economy, the reallocation would be desirable. Whether the reallocation occurs depends also on the exchange rate which is fixed independently of the money wage. At the given exchange rate, some of the state industries may be induced to expand even if they do not earn competitive returns on capital, continue to receive subsidies, or do not pay taxes. Since the system with two fixed prices does not have a unique equilibrium, it is difficult to know how the system will evolve. Polish experience is not encouraging.

Once again, achieving full employment equilibrium may require a change in the fixed money wage or in the exchange rate to remove the inconsistency. Until the change occurs, unemployment may be higher and the costs of transition larger than in a system without wage controls.

One of the arguments for selective wage control is that there is no competition, particularly for large state sector enterprises. These enterprises lack incentives to

maximize profits, so workers or their representatives may demand and receive wage increases in excess of productivity. To avoid unemployment government will be called upon to maintain subsidies to cover the losses. The additional spending would increase the budget deficit and raise money growth. This would increase inflation, induce devaluation and possibly stagnation.

Must constraints be placed on wages until state firms are sold? Arguably, there is no obvious reason why wage controls, or taxes on wage increases, should be a more effective discipline or a more efficient method of reducing excess employment in the state sector than a credible commitment to a fixed exchange rate, budget balance and imports of competing goods. If the Eastern European countries were to permanently fix the exchange rate by closing the central bank and establishing a currency board, there is no mechanism for financing budget deficits by inflation.¹ The commitment to a fixed exchange rate and monetary stability would be as credible as can reasonably be expected. Inflation could not be used to rescue workers even temporarily from the unemployment caused by their wage demands. Once workers learn this, the exchange rate will serve as an anchor. Competition from abroad would limit pricing decisions. There would be no inconsistency between wages and any other fixed nominal value with resulting unemployment or excess demand for labor.

Suggestions for Studying Transitions

Obviously, all reforms cannot be made at once if only because the time of responsible officials is a scarce resource. Fischer and Gelb have many useful suggestions about the sequencing of reforms. I would like to suggest principles that may be useful.

The principles are simultaneity and recursivity. All changes that are interdependent should be made at one time. For example, money, exchange rates, prices, wages, interest rates are all interdependent. Money cannot be controlled without closing the budget deficit, so fiscal reform must be part of the package of

¹A proposal of this kind has been made by several authors (including me) but most frequently by Hanke and Schuler (1991).

reforms. If some of these changes are made, while others are not, results are nonoptimal. Changes must be made. This is costly to the credibility of the reform program. My earlier discussion of wages and exchange rates illustrates this point.

Some reforms can precede the freeing of prices and the effort to reduce the budget deficit. There is a recursive relation between rules for contract, procedures for enforcing contracts, financial structure, accounting and valuation rules, or property rights and the type of market economy that results. The institutions of the market system are not much affected by the sets of prices that emerge, but the converse is not true. Rules and institutions influence the extent of competition, or the price elasticity of supply.

These rules do not imply that all state firms be sold before the market is allowed to function freely. Rules for valuation, contracts and rules for sale and distribution must precede the selling of state assets, but state firms cannot be valued without prices and interest rates. The plan for eliminating subsidies and selling state assets, once announced, will affect the prices of goods and services and therefore anticipations and valuations. The actual sale or realization, given the anticipation, is likely to have a smaller affect.

These principles lead to a different ordering than proposed by Fischer and Gelb. They appear to differ also from the sequences that have been adopted in Eastern Europe. At least in principle, we can test for simultaneity and recursivity by studying other economies. I do not think these principles alone provide a framework. At most, they are a step toward development of such a framework to replace intelligent judgment and guess.

References

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