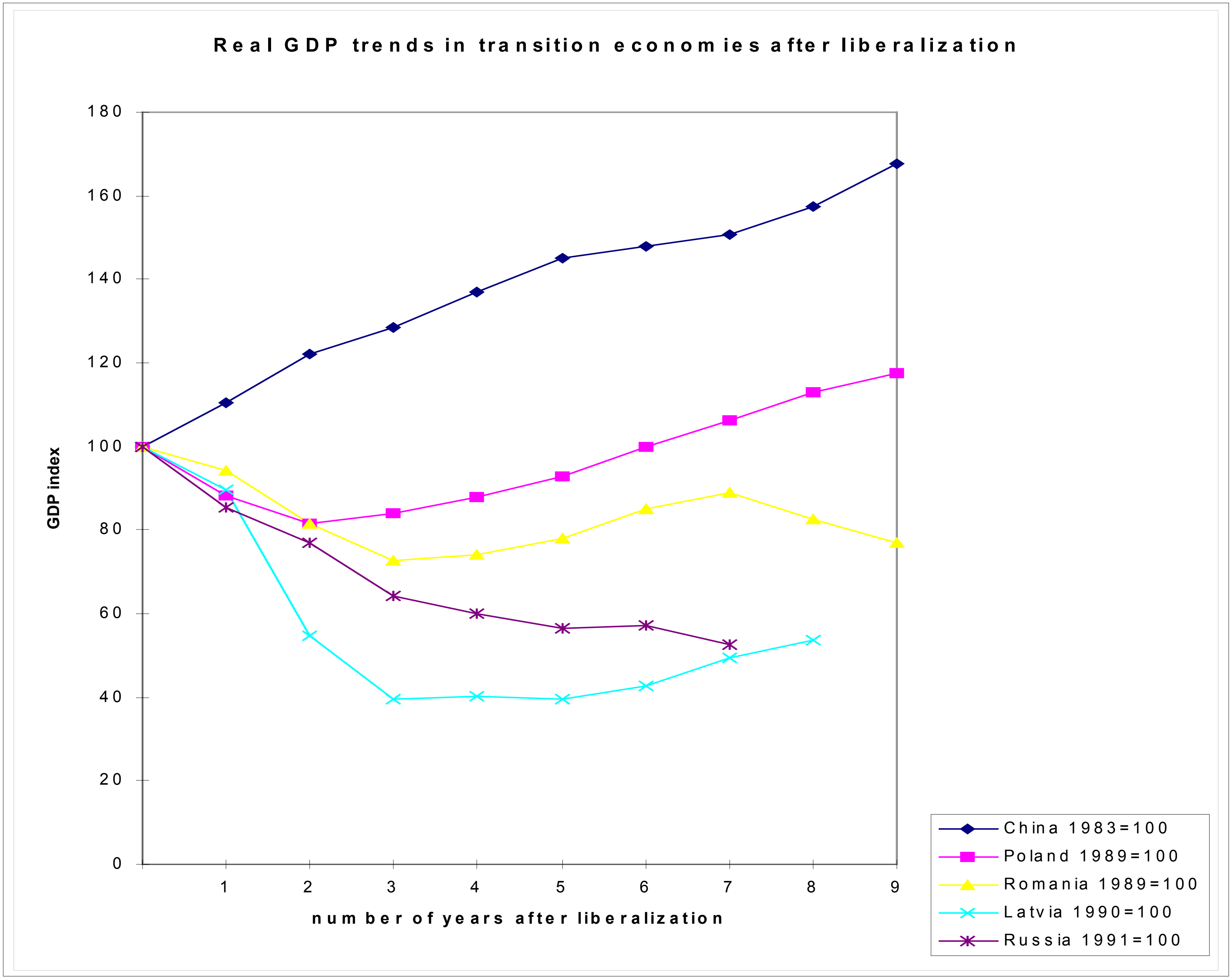
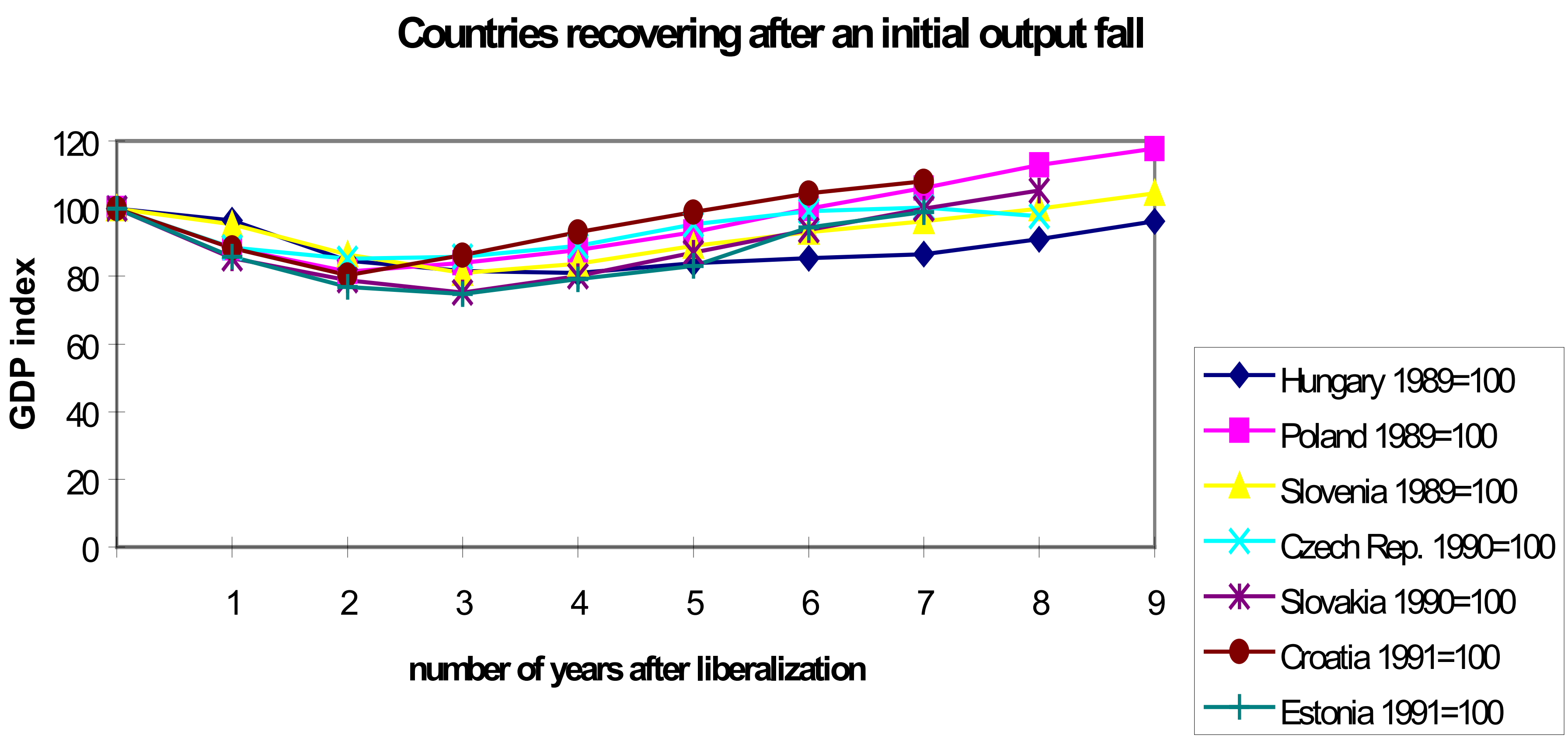
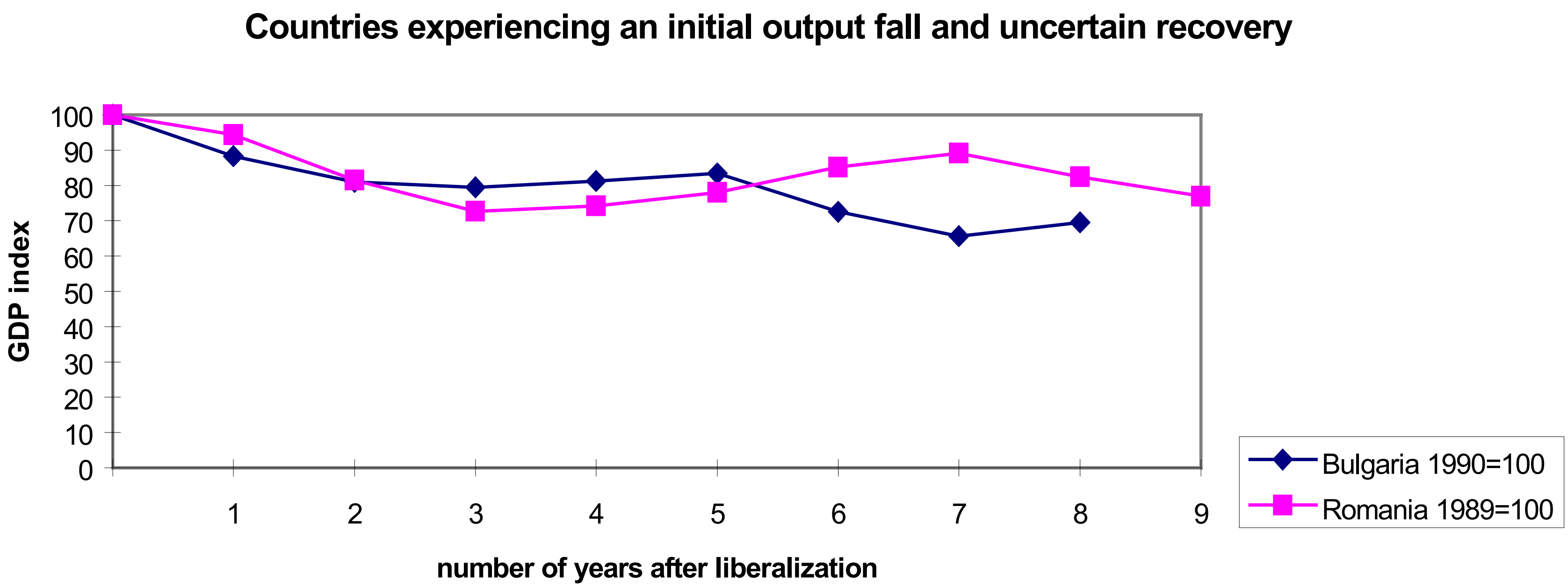
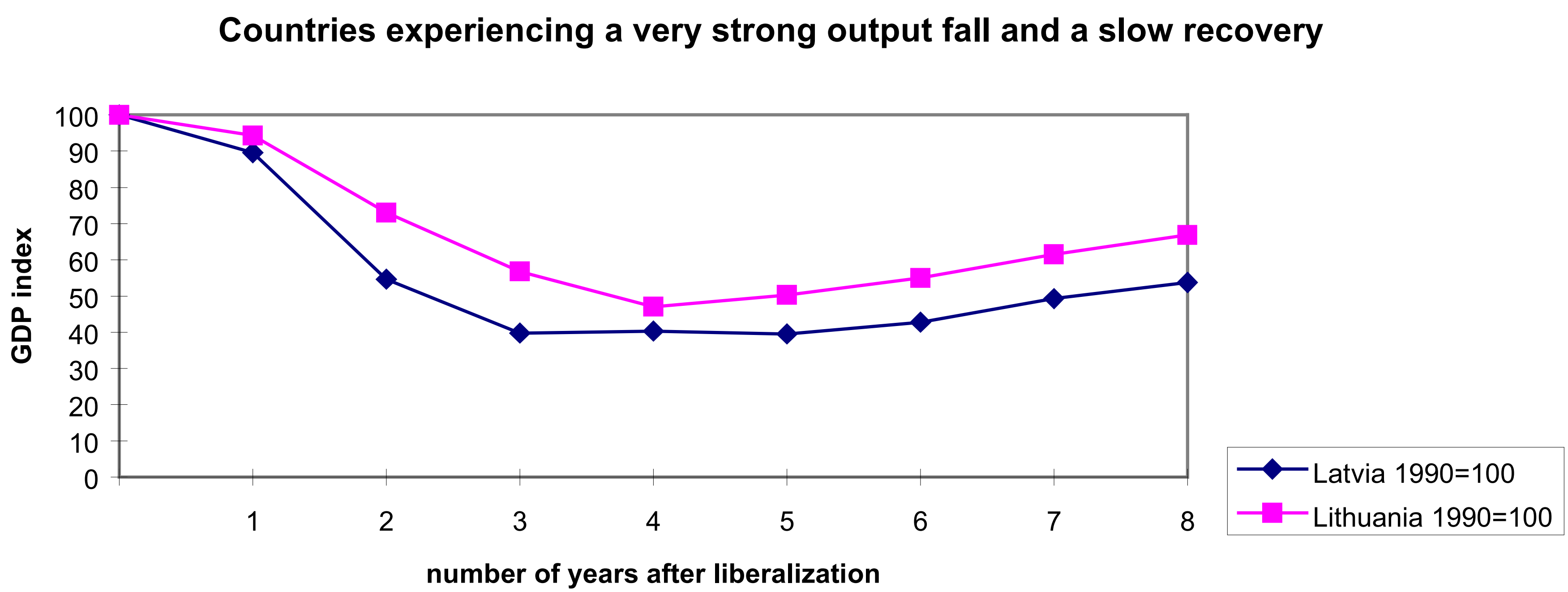
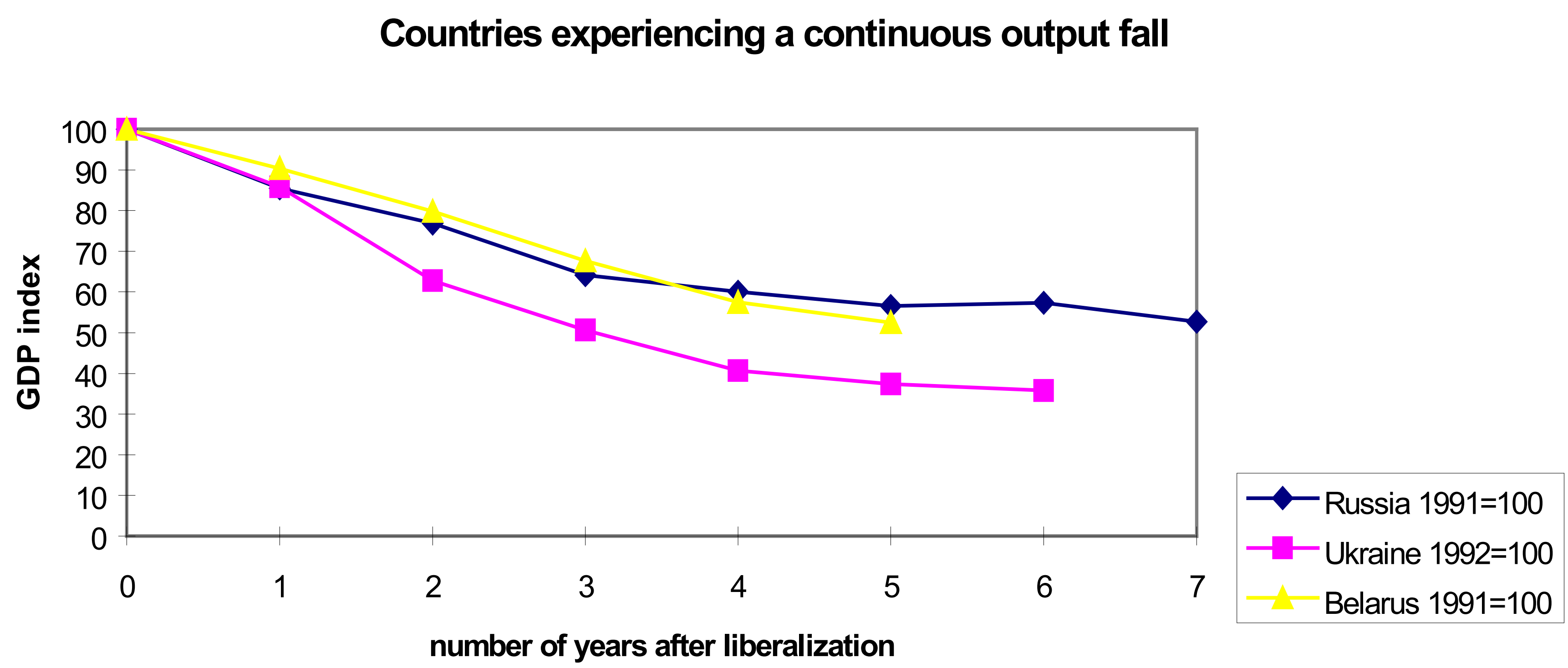
5. Explaining the output fall.


Real GDP trends in transition economies after liberalization
180
160
140
120
100
80
60
40
20
0
GDP index
1
2
3
4
5
6
7
8
9
number of years after liberalization
China 1983=100
Poland 1989=100
Romania 1989=100
Latvia 1990=100
Russia 1991=100

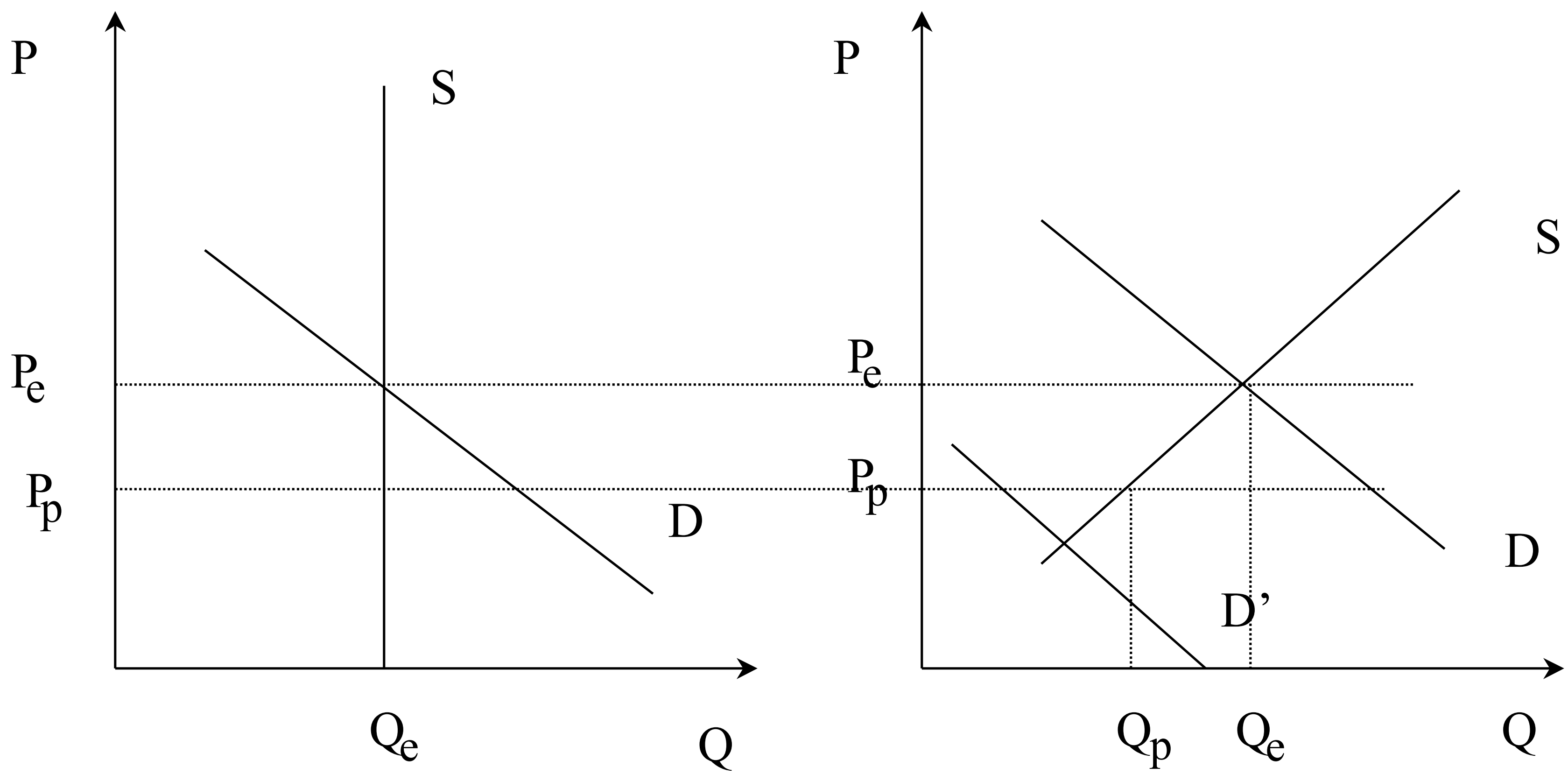

Countries recovering after an initial output fall
GDP index
0
20
40
60
80
100
120
1
2
3
4
5
6
7
8
9
number of years after liberalization
Hungary 1989=100
Poland 1989=100
Slovenia 1989=100
Czech Rep. 1990=100
Slovakia 1990=100
Croatia 1991=100
Estonia 1991=100


Countries experiencing an initial output fall and uncertain recovery
GDP index
100
90
80
70
60
50
40
30
20
10
0
1
2
3
4
5
6
7
8
9
number of years after liberalization
Bulgaria 1990=100
Romania 1989=100


Countries experiencing a very strong output fall and a slow recovery
GDP index
100
90
80
70
60
50
40
30
20
10
0
1
2
3
4
5
6
7
8
number of years after liberalization
Latvia 1990=100
Lithuania 1990=100


Countries experiencing a continuous output fall
GDP index
100
90
80
70
60
50
40
30
20
10
0
0
1
2
3
4
5
6
7
number of years after liberalization
Russia 1991=100
Ukraine 1992=100
Belarus 1991=100

• Output fall after big bang liberalization. Why?



Explanations for output fall.

• Statistical illusion due to underreporting of private sector (Berg and Sachs, 1992) or overreporting under socialism (Winiecki, 1991; Aslund, 1994).
Problems: more underreporting under communism, in FSU rise of hidden economy came later); in Poland and Hungary, overreporting not issue since mandatory planning had been abolished.

• Aggregate demand shock because of excess stabilization.
Bruno (1992), Bhaduri et al (1993), Berg and Blanchard (1994), Rosati (1994)).
Problem: Russia had no excess stabilization!

• Contraction faster than expansion (Gomulka, 1992; Kornai, 1993)

Problem: few signs of excess contraction in declining sectors
except in Eat Germany, rather across the board falls in output.

• Credit crunch (Calvo and Coricelli, 1992).
Yes, but interenterprise arrears and continued soft budget constraints.

• Labor market frictions (Atkeson and Kehoe, 1995).
Problem: unemployment came after output fall.

Most plausible explanations.

Wei (1995): transformation of single monopoly into multiple Monopolies => higher prices and lower quantities because upstream monopolies do not internalize downstream externalities (higher prices of input downstream lead to higher prices and lower sales compared to single vertically integrated monopoly.

Blanchard and Kremer (1997): inefficient bargaining in imperfect legal environment.

Assume enterprise has 2 suppliers, pays price of 50 to each and sells at 150 with profit = 150 –50 –50=50.
Assume indivisible technology (if one supplier leaves, output =0).
Say one supplier has outside option of 100 => ends the contract.
Total surplus gain: + 50 –100 = -50.

With efficient bargaining, supplier could be brought back but his outside option may not be verifiable. Under asymmetric information, would have to pay 100 each (infeasible).

Roland and Verdier (2000): liberalization is freedom to change contracts. Fims search for new partners. If investments are specific to the partnership, investment takes place only once new long term partners are found. In the absence of established markets, search can take time.

Dual-track liberalization avoids the disruption while allowing for search for new partners.