

Second Midterm Guide

Prepared by Andrew Jalil, David Agrawal, and Jonathan Rose

Part I.

1. Soft Budget Constraint

This term refers to a situation in socialist economies in which state enterprises are rarely threatened with exit from the market because of the government's financial commitment to their existence. State run enterprises may fail to pay taxes, fail to repay bank debts, and may be bailed out by the government when losing money. This lack of firm exit prevents any natural selection of efficient and profitable enterprises. It distorts decision making at the firm level because of the moral hazard created for workers and management, and it creates fiscal problems for the government. During transition, this creates additional problems as investment is not efficiently distributed when funds are used to perpetuate state-operated enterprises.

2. Optimum Currency Area

Coined by the economist Robert Mundell, the theory of optimum currency areas focuses on three factors in identifying the suitability of a particular region for monetary union. These factors are:

- (1) Asymmetric shocks. (If potential members of the monetary union are more likely to be hit by asymmetric shocks, then one monetary policy for all members may not be entirely appropriate.)
- (2) Labor mobility. (A more mobile labor force can lead to reductions in inter-regional differences in unemployment, reducing the need for independent, country-specific monetary policies)
- (3) Fiscal federalism. (If countries are hit by asymmetric shocks, then fiscal federalism—the ability to make transfers payments from prosperous members to ailing members—may ease economic conditions and promote stability.

Arguably, on this basis, Europe is a weaker candidate for monetary union than the U.S. But could this change over time? Are these conditions fixed? Could they adapt endogenously?

3. Postal Savings System

--an important feature of the Japanese financial system during that country's high-growth era

--a system that channeled funds into favored sectors.

--A key feature of the Japanese financial system at a time when Japanese savings was supremely high by international standards—41% in 1971.

4. Fundamental Disequilibrium

--term from the Articles of Agreement of the International Monetary Fund

--One of the key lessons policymakers gleaned from interwar experience was the need for an adequate adjustment mechanism. Under Bretton Woods, a country was allowed to adjust its parity with the permission of the IMF. According to the IMF Articles of Agreement, such

adjustments were necessary when an economy was in ‘fundamental disequilibrium.’ Because the difficulty countries had in agreeing how frequently and freely they and their partners should be allowed to resort to devaluation, the term was never officially defined. The vagueness inherent in the definition of this term rendered the adjustment mechanism more problematic.

5. Treaty of Rome:

- The founding treaty establishing the European Economic Community in 1957
- The Treaty can be viewed in the context of reconstructing the European economy after World War II. From this perspective, the European Coal and Steel Community was an intermediate step toward the Treaty of Rome
- Although the Treaty embraced the general idea of deeper political unification, the European Community it established was primarily an economic entity
- The main concrete goal enumerated by the signatories was the creation of a customs union (elimination of internal tariffs and agreement on a common external tariff)
- Successful completion of Europe’s customs union within ten years of conclusion of the Treaty helped to encourage economic growth and began the process of political and monetary integration

6. Chaebol

- Main sources: Rodrik; 3/6 Lecture
- Chaebol are commercial and financial conglomerates in South Korea
- By 1970, twenty Chaebol controlled fifty percent of GDP
- Companies that have integrated backward and forward in the production process, such as Hyundai are Chaebol
- Government policies greatly helped these conglomerates
 - Bank lending naturally favored these companies, which results in South Korean growth being driven by old rather than new firms
 - Government used them “as instruments for the government’s industrial diversification strategy” (Rodrick 32)
 - Used to solve coordination problems
- Preferential access to credit by Chaebol may have had some negative consequences on innovation incentives
- However, overcoming coordination problems across industries were resolved and helped stimulate Korean growth

7. Voucher privatization

A method of privatizing state operated enterprises during the transition from a centrally planned economy. Citizens receive vouchers with which they can purchase shares in the enterprises being privatized. This was practiced in many countries, notably including Russia and the Czech Republic. Voucher privatization could be part of a "big bang" reform package, since it is generally a faster method of privatization than selling off state enterprises to private investors, especially in countries with large numbers of enterprises (i.e. Russia). As such, it was advocated partially because of its theoretical complementarities with other rapid reforms, and because it may create an investor constituency supportive of market-oriented reform. But absent an

institutional framework to protect widely dispersed small investors, voucher privatization is vulnerable to insider manipulation and corruption.

8. Moral Hazard

- Main Sources: Radelet and Sachs; 4/3 Lecture
- Moral hazard arises when protecting against risk induces an entity to take on additional risk.
- Moral hazard appears twice in the course: in the lectures on currency crises and on the IMF
- In Southeast Asia, the financial systems were based on the banks, which were essential to development finance and economic growth
 - The government could not let the banks fail and thus guaranteed their protection
 - This induced the banks to take on added risk
 - Further, capital account liberalization “allowed banks to lever up their bets” (Eichengreen 4/3)
- “IMF bailout packages in Mexico, Argentina, and East Asia have arguably contributed to significant new moral hazards” (Radelet and Sachs 40)
 - Investors are less fearful of default because the IMF will bailout the country
 - IMF lets Russia default and interest rates rise, which indicates the moral hazard problem did exist

Part 2

1. “The Bretton Woods international monetary system reflected the lessons drawn by individuals like Harry Dexter White and John Maynard Keynes from experience with the interwar gold standard. What were these lessons?”

“Perceived lessons of the interwar years

- Capital (“hot money”) flows could be destabilizing
- Competitive devaluations should be avoided
- The operation of the international monetary system had been hampered by the absence of an adequate adjustment mechanism
- Inadequate international liquidity could disrupt trade and threaten deflation.
- Hence a need for international oversight of liquidity and adjustment problems”

---(Source: Eichengreen lecture 3/8/2007 Slide 5)

“How did the lessons in question inform the debate over the Bretton Woods System?”

These lessons shaped the debate, with the two leading visions being championed by Harry Dexter White and John Maynard Keynes. Both visions sought to address policymakers’ concerns over the destabilizing nature of capital flows, the destructive effects of insufficient international liquidity, and the need for an adequate adjustment mechanism for countries. But the two plans, the White Plan and the Keynes Plan, differed significantly in terms of their recommendations for the structure of the international monetary system. Ultimately, the Bretton Woods system became a compromise between them.

White Plan

- Emphasized need for exchange rate stability to rebuild trade (reconstruction of trade being the priority of the exported-oriented United States)
- Envisaged a world much like gold standard world before WWII
- This reflected US economic strength and knowledge that the country would emerge from the war as world's leading trader and holder of gold
- Also desired restoration of capital mobility, since US firms had attractive investment opportunities abroad
- No power for the IMF to issue international reserves
- Made very limited provision for concessionary financing, since the US anticipated having to foot the bill (maximum \$2 billion US obligation to other countries)

Keynes Plan

- Emphasized need for exchange flexibility so that policy could be used to address unemployment (which UK anticipated as a widespread problem, and whose solution was the government's priority)
- Foresaw need for the indefinite maintenance of controls on capital flows, so that policy instruments could be directed toward the pursuit of domestic goals
- Pushed for much larger concessionary financing (\$23 billion maximum US obligation)
- Sought to give IMF power to issue international reserves ("bancor")

The result was a compromise

- Exchange rates were pegged but adjustable
- Controls could be retained on payments on capital account but not on payments on current account
- Concessionary financing up to maximum US obligation of \$2.5 billion (a compromise perhaps, but obviously much closer to the US position)
- No IMF capacity to issue 'bancor' "

----(Source: Eichengreen lecture 3/8/2007 Slides 6-9)

“Does subsequent research lead us to re-think those lessons and question certain aspects of Keynes’ and White’s institutional design?”

Re-thinking those lessons...

We might be especially suspicious of the claim that competitive devaluations were a problem during the depression. Eichengreen and Sachs (1985) argue that devaluation was crucial to sustain recovery during the depression.

Questions:

- Question: do these lessons conform to our analysis of what really went wrong with the interwar gold standard?
- Were devaluations part of the problem or part of the solution to the Great Depression? Was there a problem of competitive, beggar-thy-neighbor devaluation?

- ❑ Whichever view you prefer, it still follows that more extensive cooperation/policy coordination would have been better and that there was a need to address the global liquidity problem (liquidation of foreign exchange reserves).”

---(Source: Eichengreen lecture 3/8/2007 Slide)

Questioning certain aspects of the system's institutional design...

Ultimately, the Bretton Woods system dissolved, leading some economists to be critical of some of its key institutional features. First, as financial market participants became more savvy, capital controls became more porous, undermining the compatibility of pegged exchange rates with monetary policy autonomy. Second, economist Robert Triffin foresaw a major limitation of the Bretton Woods system—a growing worldwide demand for US dollars and a mounting problem with insufficient worldwide liquidity ultimately challenged the survival of the Bretton Woods international monetary system.

Note: The student may also go a few steps further and cite material in *Globalizing Capital*.

2. “Rapid economic growth in Europe and Japan in the third quarter of the 20th century (what is referred to as “Europe’s golden age” and “Japan’s economic miracle”) had important features in common. What were these features?”

“Aspects of Japan’s postwar growth common to other regions

- High investment (as in Europe)
- Rapid export growth (as in Europe)
- Accommodating labor markets (as in Europe).
 - ❑ In Japan, wage moderation and acceptance of new technologies was extended by labor in return for lifetime employment (in the large enterprise sector, anyway)

Parallels with European reconstruction

- Japan too received extensive US aid in the immediate postwar years.
- Chronic government budget deficits, subsidies, inflation, and hence price controls and shortages.
- Solution came in 1949, when intensification of Cold War led US to turn its attention from punishing the aggressors to restarting the Japanese economy. (Observe the parallel with Germany.)
- William M. Dodge, the President of the Bank of Detroit, was dispatched to Tokyo by the Truman Administration. Dodge insisted on an end to subsidies and on fiscal consolidation, exchange rate unification, and restoration of market-based international trade as preconditions for continuation of US aid.
 - ❑ His insistence on drawing a line in the sand against budget deficits came to be known as the “Dodge Line.”
- The Dodge Line and associated reforms, it is argued, inaugurated the Japanese economic miracle.”

---(Source: Eichengreen lecture 2/27/07, Slides 7-8)

“But there were also differences. What were they?”

“Accounting for Japan’s growth

- Aggregate production function:
- $Y = f(K, L, T)$, where T is technology, K&L are capital and labor inputs.
- In Europe, T accounts for 2/3, K&L inputs 1/3 in postwar Golden Age, as we have seen
- In Japan, the pattern was a bit different. T accounted for ½ of output growth, while K&L inputs also accounted for ½. (Note that output grew by nearly 10 per cent per annum over the period.)”

---(Source: Eichengreen lecture 2/27/07, Slide 21)

“Distinctive Aspects of Japan’s Growth Miracle

- Savings Promotion
- Industrial Policy
- Modalities of Technology Transfer
- Financial System”

---(Source: Eichengreen lecture 2/27/07, Slide 9)

---(Japan’s savings and industrial policies, and the structure of its financial system all had distinctive features. However, depending on interpretation, the student may also find some similarities, particularly with respect to industrial policy. Details of these ‘distinctive aspects’ are located in Eichengreen lecture 2/27/07 Slides 10-12).

“In both cases, growth slowed in the final quarter of the 20th century. Do the common features explain this slowing or do the differences?”

“Obvious Explanations

- Scope for catch-up exhausted
- Labor market grew less accommodating (demands for higher living standards)
- Diversification of social goals (spending on housing and pollution abatement -- the latter exceeds that in virtually any other country)
- Savings rate declined as the population began to age
- Higher energy costs disproportionately impacted Japan
- Collapse of Bretton Woods System hurt this heavily export-dependent economy.”

---(Source: Eichengreen lecture 2/27/07, Slide 27)

The first two explanations—scope for catch-up being exhausted and less accommodating labor markets—can be applied to both the Japanese and European growth slowdown. “Institutions developed for a world of extensive growth hinder continued growth when they become locked in” (Eichengreen lecture 2/27/07, Slide 28).

Several of the other explanations may be distinctive features of the Japanese experience, but ultimately, grading should be fluid, depending on the clarity and depth of the student’s reasoning.

3. Economists sometimes find that technical progress accounts for a smaller share of economic growth in late industrializing economies than in earlier industrializing economies. They sometimes estimate that the Asian “tigers” (South Korea, Taiwan,

Singapore, Hong Kong) actually experienced zero TFP growth from the mid-1960s through the mid-1990s. Are these conclusions reliable? What explains them? What are the implications for even later industrializing countries like China?

- Main sources: Krugman, Rodrik, Lecture: 3/6
- The rate of TFP growth in Asia is disputed. Rodrik (4) cites two studies: one indicating that TFP growth rates were low, but were consistent with Latin America and a second study indicating that TFP growth was practically zero
- The Krugman article discussed in class compares the Asian Tigers with the Soviet economy – claiming that TFP rates were basically zero by the 1990s. (Note: This reading was discussed in class but was not assigned. Thus, the quotes below are meant as a summary of the economic logic of low TFP that should be explained.)
 - Krugman writes, “Sustained growth in a nation's per capita income can only occur if there is a rise in output per unit of input. Mere increases in inputs, without an increase in the efficiency with which those inputs are used--investing in more machinery and infrastructure--must run into diminishing returns; input-driven growth is inevitably limited.”
 - He continues, “Once one accounts for the role of rapidly growing inputs in these countries' growth, one finds little left to explain. Asian growth, like that of the Soviet Union in its high-growth era, seems to be driven by extraordinary growth in inputs like labor and capital rather than by gains in efficiency.”
 - Rodrik verifies that the Asian Tigers were characterized by high savings and investment in capital
- However, these claims of zero TFP growth are likely exaggerated
 - If TFP growth were zero, then the diminishing returns to investment implies that the return on investment should fall to zero
 - However, return on investment fell to about 15% in most Asian economies, which is not comparable to the Soviet fall to near 0%.
 - This claim may not hold because the Aggregate Production Function has some unrealistic assumptions, data is not 100% reliable, and rapid structural change in an economy creates indexing and measurement problems (Lecture Slide 16).
 - New data indicates that TFP growth was positive and significant, but still only accounted for one quarter of total growth
 - Many Asian economies were capital scarce and thus could realize benefits to investment. Rodrik (42) argues the Asian economies cannot be compared with the Soviet Union because decisions in Asia were made on profitability – not just by a planned bureaucratic decision.
 - South Korea has smaller TFP growth than Taiwan. Recall that government planning was stronger in Korea and that government planning is likely much less likely to encourage intensive growth.
 - Thus, Krugman was exaggerated, but his argument still holds merit in part because TFP growth was relatively small – and even more so in countries with high amounts of institutional intervention.
- The implications for China and others:
 - If Krugman were entirely right, the U.S. would likely remain the economic center because Chinese growth will slow when innovation becomes necessary

- If TFP growth is not zero under government intervention and the Chinese can make their decisions based in part on profitability, it is likely that the return on investment will not converge to zero
- Therefore, late developing countries should develop institutions or reform existing institutions to be more like Taiwan than South Korea – such that the scope for intensive growth is more likely

4. More than two dozen countries of the Soviet bloc moved from central planning to some form of market economy in the 1990s. The experience of the German Democratic Republic (East Germany) was unusual in many respects. How exactly did it differ? What light is shed by this case on the experience of other so-called transition economies?

- Main sources: Sinn, 3/20 and 3/22 Lecture
- German transition was different in that economic and legal institutions were imported from West Germany. This sheds light on the role of institutions. Examples of institutions imported and resulting differences:
 - Established political and legal institutions familiar with market based systems existed in the Germany to assist in the transition
 - Transfer payments from the West helped. (According to Sinn, one in three deutschmark spent in the East came from the West)
 - Subsidies from the West created a negative cost of capital resulting in large investment in building infrastructure
 - Inheritance of West German Labor Unions was unique to the GDR because the West feared that low cost East German labor would compete wages down
 - Continuation of West German social assistance in the East
 - Access to western goods was not restricted, where other transition economies could restrict access to “foreign” goods
 - Result was the “largest output collapse ever seen in a modern industrial economy” (Eichengreen 3/22). Yet, such a collapse is consistent with “Big Bang Theories”
- Unique social and political constraints
 - For example, property rights were even more uncertain in the GDR. Nazis property was returned, but Soviet property was not. However, confusion arose over Nazis and Soviet seized property.
 - Environmental liabilities existed that created additional uncertainty over whether firms should claim property rights in the West
- Rapid political and economic integration occurred because of the inherited institutions, however, integration was not perfect and problems of privatization existed. Many other transition economies followed approaches that were more gradual.
- The case of the GDR sheds some light on the other transition economies
 - According to Sinn, a major factor slowing convergence is the excessively high wages in the East. As such, although having institutions to help are important, flexibility is also essential.
 - Flexibility on wages
 - Nation-wide wages may not be best if certain regions have a propensity for lower wages

- Importing legal systems and rules may not be ideal if they prevent labor and management from making agreements supported by both parties
- Transfer payments in the GDR case are possible because the East has a much smaller population than the West. If the reverse were true, transfers would be unlikely.
- At the same time, subsidies and transfers may not stimulate investment in the correct forms of capital. Despite the negative cost of capital from subsidies, investment was excessively in buildings rather than machinery capital.
- The speed of transition in the GDR resulted in a short, but very deep initial recession.
 - We know that political support for a transition from a planned to market economy is essential.
 - In other countries, a deep recession may destabilize political support for transition. Thus leaders must weigh the deepness of the recession with the duration of the recession in order to decide whether to adopt a transition that is gradualist or “Big Bang”
- Property rights are important to determining if businesses will make long term investments on that property
 - Political factors and the complexity of remedying property right disputes may create uncertainties that delay fixed investment.
- Institutions experienced with market economies are helpful in creating conditions where insiders from the planned economy do not benefit
- Stronger institutions encourage respect for private property, exports, and support for markets
- Since sustaining reform is important, experienced political democratic institutions are helpful for convergence
 - CEEC-4 had these high quality institutions but other TEs did not (Eichengreen 3/20)
 - This implies that many of the transition economies needed additional institution building