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## Which Dilemmas of Policy Making under Thatcher and Reagan can be Identified in the Transition Economies of 1990s?

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### Abstract:

The macroeconomic aspects of the transition experience in the early 90s were a great challenge. Different policy mixes were introduced, both on a country level and among the transition countries. Some of the programs shared similarities to Thatcher and Reagan packages for economic recovery. There was no clear-cut answer to the question of how to achieve macro stabilization in a transition environment: to implement supply-side or demand-side policies, micro reforms or macro reforms first. Blindly relying on theory or other countries' policies could be damaging. That is why historical experience has to be taken with caution and tailored to the specific environment in the particular country.

**Keywords:** policy dilemmas; Thatcher; Reagan; transition economies.

**JEL Classification:** P21.

### Introduction

The transformation of the transition economies in the 1990s was a major process. The reform agenda was impressive in terms of the challenges and problems of political, social and economic nature that were involved, and especially the magnitude and significance of those challenges. Scholars, however, do not unanimously agree that the transition process had no predecessors in ideological and conceptual terms. Officials at Washington institutions – IMF and World Bank - claim that Thatcher and Reagan, when coming to power in UK and US, respectively, faced a similar set of problems. Thus programs, based on the UK and US experience, were among the ones proposed to the transition countries.

This paper focuses at the dilemmas that Thatcher and Reagan governments faced. The difficult choices they faced are analysed and compared to the ones that policymakers in early 90s in transition countries made. The structure of the paper is the following: Section 1 provides a short overview of the transition economies in end of 80s and the beginning of 90s. Section 2 identifies Thatcher's economic policies and their impact on the UK economy. Section 3 delves into Reagan's plan and the effect it had in on the US performance. Section 4 discusses the applicability of the two approaches in the context of transition countries with their shortcomings and limitations. Last section concludes.

### 1. Short overview of transition countries in the 1980s and early 1990s

In the early 90s, Soviet Union collapsed. That breakdown made obvious the need for reforms in the other centrally planned economies as a whole. All the countries in Eastern Europe and the ones that once belonged to the Soviet Federation operated under administrative planning. Although differing from country to country, those regimes shared many similar characteristics of the economy.

Unsustainable and chronic fiscal deficits prevailed in government books. That financial situation was mostly due to the subsidies given to the loss-making state-owned enterprises, the phenomenon which Janos Kornai (1992) calls soft budget constraints. Moreover, those swelling deficits were monetized through the issuance of credit from the central bank. The ballooning deficits were financed by excessive money creation (so-called "monetization"), which fuelled inflation. Prices of goods were state-controlled and most of the commodities were in shortage and were rationed.

On the supply side, there was over-industrialization. One gigantic, monopolistic enterprise dominated in each sector. On first glance, there was no unemployment, since everyone had a place to work either in a plant or in the rural sector. However, unemployment was hidden because there were many employees who received wages without exercising any effort in the production process. In the last years of central planning only cosmetic attempts of reform were made. In some countries, introductions of semi-market measures in rural areas were implemented. Farmers were allowed to trade the excess production on the market, once they have fulfilled the required quota.

On the labor market, the situation was dismal as well. The skills people have done not match the ones required in a typical market economy. There were too many engineers and too few entrepreneurs with vision and new ideas to start their own businesses. Although possessing a very well-qualified labor force, transition countries did not have an adequate human capital at the beginning of the reforms.

The above-mentioned problems were the most severe ones that had to be addressed. Macroeconomic stabilization and some serious restructuring on a micro level was needed to facilitate the transition from centrally planned system to a market-based one.

## 2. Thatcher's economic policies 1979-87

When she took office in 1979, Margaret Thatcher announced her program of economic stabilization, based on the supply-side view. It featured liberalization and deregulation of monopolies, privatizing of inefficient state enterprises, as well as cuts in public spending to close the gap in the government deficit. Inflation was to be curbed by setting a target on money growth and decreasing the power of trade unions by establishing a better coordination on wage bargaining. Thatcher started with demand-side policies in order to eliminate the high demand. Monetary and fiscal policies should be put under control before supply-side reforms are implemented. The priority in Margaret.

Thatcher's plan was to put a halt on inflation. In economic theory inflation is the most distortionary tax, because it twists relative prices. Moreover, inflation also interferes with the normal economic activities. People shy away from the currency and money cannot exercise its role of the lubricant of the economy. Transaction costs increase, people expect higher levels of inflation yet to follow. The very expectations act as self-fulfilling prophecies and regenerate the inflation spiral.

Thatcher's government implemented a policy of setting explicit targets for monetary growth, which are to be announced to the public. It was expected that people should correct downwards their anticipated level of inflation. Those expectations enter the equation in the form of the wage bargaining. Usually contracts are signed for a couple of years ahead, and somehow indexed to inflation, so that the real purchasing power of money is preserved. The problem with such a policy, however, is how to define money. Economic theory says that money is everything that is generally accepted as payment among people. There are different monetary aggregates that range from currency in circulation (M0) to all assets that are liquid and can be turned relatively easy into cash (M3). In that aspect the government in the face of the Treasury can change the interest rate and control the rate at which new currency was issued but they cannot control the way people use their credit cards. Bank lending turned out to be less responsive to the interest rate, one of the reasons behind that being the financial deregulation. To fight this, a medium-term financial strategy was launched in June 1979. That was an ambitious four-year program, which aim was to bring the rate of growth of sterling M3 within a target range, announced beforehand for each year. As we note from Table 1 below, a reduction was achieved, but the targets were never met.

Table 1. Medium-term strategy of 1979s

1980 – 1981	1981-82	1982-83	1983-84	
Target growth rate M3 (%)	7-11	6-10	5-9	4-8
Actual growth rate (%)	17.9	13.6	11.7	8.2

Source: HMSO as in Smith (1997)

The historical effect of this policy was about to bring a severe recession, maybe the most severe one since 1930s. The reason behind that was not that the monetary targets were set too high, though. The contributing factors turned out to be the wage settlement process that did not come down as quickly as expected and the appreciation of the pound on the international markets. Thatcher increased the wages of the workers in the public sector and the others followed. Together with the raise in the salaries, the interest rate was increased. That pushed the mortgage rates up, as the interest rates are flexible and moving together with the main interest rate. Mortgages are an important component in the retail price index, which is a proxy for the overall price level, and thus measure inflation. Thus, the increase in mortgages rates added to the wage demands on the workers' side. So the trade union officials did not perceive this government policy as credible and continued negotiating

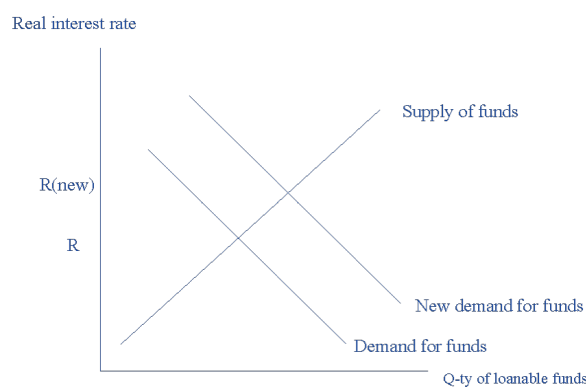
wages in the same way as before. Their expectations were for loose monetary policy in the future. As a result, inflation did not come down as fast as it was initially intended. The targets were not met, but the trend in inflation was going down. Building societies accounts were included in the targeted monetary aggregate, and eventually price level was stabilized. The other reasons for the decrease in inflation were the international trade and exchange rate effects. Since pound was a petrocurrency (because of North Sea oil), an increase in oil prices pushed the value of the sterling higher relative to UK trade partners' currencies. Imported goods became cheaper at home and UK exports more expensive in the world markets, which additionally depressed demand.

After the elimination of the high demand, Thatcher turned to supply-side measures and the micro-foundations that were not working, such as the excessively strong trade unions. The Iron Lady aimed at reducing their negotiating power, since unions aim at facilitating higher payment for members and lower overall level of employment, and make the economy more flexible.

Thatcher pushed legislation in the form of a series of employment acts that made it possible for small enterprises to fire people without going through lengthy procedures. Workers were held accountable for closed shops (enterprises hiring only trade union members) and any industrial action not aimed at the employer and that disrupts economic activity. Thus, the last act of 1990 granted the individuals the right not to be refused employment on the ground of their union (non-) membership. In case that right was infringed on, they could appeal to a higher instance for assistance in taking court actions against trade unions if necessary. The result of the employment acts on the reduction in union power was that it made people unwilling to stay a member of a union.

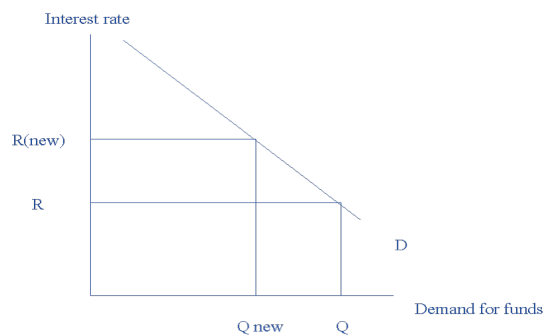
Thatcher also advocated the idea about a smaller welfare state, so she privatized state-run utilities. Even theoretically, the story of privatizing state monopolies is controversial issue. In the UK case, however, the additional hindrance was the very powerful public sector trade unions. Those state-owned enterprises were captured by the trade unions. So it is not just the state ownership issue, but also an additional twist. In this way privatization is a way to get the enterprise out of the control of the trade unions. The vicious symbiosis had to be broken because the trade unions will not allow the company to go bust. State ownership becomes a mechanism for soft budget constraint. Thatcher propagated the idea that it is not the role of the state to do business. Private sector and public sector were presented as competitors for resources. The presence of a big public sector threatens the prospects for growth of the economy because it draws goods and services that would get a higher price if employed in the private sector. Government may borrow from private savings that could have been directed to higher return private investment. The result is a *crowding out* and may lead to higher interest rate if government borrowing is financed domestically. This is what theory dictated through the supply-demand framework (see Figure 1).

Figure 1. Government borrowing and interest rates



What happens in the market for private loanable funds is not obvious? Advocates of the crowding out argument claim that the result is just a distributive one - with a higher interest rate and a greater share of public investment if higher government borrowing induces a decrease in the same amount of private borrowing. That reasoning is summarized in Figure 2 on the next page. Investment, however, is not a function of the current interest rate alone, but also of the expectations of the future economic environment. Consumers could buy durable goods or real estates as a store of value or for speculative purposes. In such occasion, the measure of raising interest rate may not be an effective restraint on such behavior, if it lacks credibility. Thus Thatcher's government decided to reduce the influence of the government on the UK economy and let the markets work, most probably having the government failure idea in mind. The market is the controlling device and exercises pressure on firms to act competitively by operating efficiently. Without competition, there is no spur for development and growth.

Figure 2. Private sector's demand for loanable funds



In the private sector, managers and workers know whether they do the things right. Profit is the indicator for the managers' performance because it shows whether the right goods were produced at the right prices. On the employees' side, wage in real terms is the reward for the effort exercised in the production process – the higher the productivity, the more workers will get. Thus, prices reveal the relative scarcity of goods and services and eliminate waste and bureaucratic slack.

Public sector, however, is not driven by the profit motive but by other objectives. The government may pursue maximizing employment or offering public goods – those that cannot be provided by market (defense, legal system) or ones that have hidden welfare effects (pollution, healthcare). The consumer consumes those goods no matter whether she likes it or not. In the government-owned firm, there is job and firm security. Even if the company performs very poorly, it will not be driven out of business; managers and workers are not rewarded for greater effort exercised because of the fixed by law wages for the state employees.

The above descriptions are not necessarily true in reality. In the world economy, there are some very efficient public companies and some private firms where the profit motive is not the leading one. However, those descriptions were the ones that people were most likely to believe, and Thatcher's government used them.

The state, however, needed to provide the right incentives for the prosperity of the private sector. In theory, private property is one such device because it excludes the possibility of getting subsidies if the factory runs continuous losses. If the enterprise is not able to cover its costs, it leaves the market. Bankruptcy is the market mechanism that facilitates the exit. All the assets are sold to the highest bidder in the presence of a properly working price mechanism and stock market that is reflecting the true value of the company. There are certain critiques, however, to this approach. The policy is based on the fact that it is implemented in an economy with predominant private sector, which sends the right signals to all economic agents - firms, households (workers), *etc.* Smith (1997) points that in mid-1970s the official figures provided by the Treasury showed that public sector formed less than 50 percent of the gross domestic product. That estimate, however, is a great overestimation because the productive capacity of the public sector was less than 10% of the whole economy. Moreover, the companies that are to be transferred into private hands are not supposed by the textbook model to have market power. Otherwise, there would be a need for bailing out. A monopoly, as most of the companies in charge of utilities, is big enough to produce serious crash in the economy if it goes bankrupt. In economic jargon, such a company is too big to fail. The government and especially the UK Treasury in the British case is in charge of keeping the economy stable in such occasions may decide to inject funds into otherwise bankrupt firm, thus bailing the company out.

Another aspect of firm size is that privatization is not supposed to be a result, but a means to achieve a certain end. Making a firm private is supposed to increase the efficiency in management and production process. The price of the product is to reflect the unit cost in perfect competition and subsequently maximize consumers' welfare. That textbook idea holds in an artificial economy with numerous small producers and homogeneous products, but is a big departure from real life. Not only people have different tastes, but also there are some specific products that are provided in the most efficient way by a monopoly. Certain scale of production is needed in order for the firm to cover the huge setup costs (so-called natural monopoly), and/or there may be a common platform for producing certain products jointly. The result of privatizing the monopolies turned out to be just a transfer into private hands of monopoly power. Smith (1997) notes the most criticized case in the UK - the privatized British Telecom that started abusing its position of a price-maker after it was transferred into private hands. There are also counter examples because some economists prefer properly regulated private monopolies than public monopolies. Indeed, some of the privatized monopolies started restructuring. Shareholders and the regulatory agencies, namely Ofcom for British Telecom and Ofgas for British Gas had to enforce efficiency.

Fiscal policy as a whole had to be put in order as well. The evidence from expansionary Keynesian policies was that although beneficial in the short-run, they had no real effect on the economy in the long run when all agents have adjusted their behavior and expectations accordingly. Mrs. Thatcher attempted to cut government expenditure. Since her government came to power in the middle of the year (May 1979), the slashes in spending had to wait until the beginning of the next year. The 1980 White Paper stated the government determination not to stop the growth in public spending but to reduce it progressively over the course of the following years. The economic plan was to increase money allocated to defense and legal system, and start reducing funds for health care and social security. To achieve a negative overall effect, the policy featured ambitious cuts in industry subsidies in line with the free market philosophy. The result after the four-year mandate was an increase, rather than a decrease, though. The areas of law and defense required more resources than initially planned. In addition, increase unemployment put a greater than expected pressure on demand for health care services and social benefits.

Finally, yet importantly, there was the political unfeasibility of the ambitious plans for cuts in the other sectors: funds were provided to the nationalized industries to alleviate the risk of the downturn of the economy. Ironically, the only real cuts in the economy were the ones under the line capital spending. Public investment on infrastructure went into oblivion - roads, schools, among other structures, were gradually falling into despair. That was a mistake, since when policy aims at fiscal adjustment, cut on current consumption are to made instead of reducing expenditure on investment projects, which could increase growth in the future.

In order to put government books in balance the government wanted to increase tax revenues by cutting the marginal tax rates. Following the Laffer curve logic, Thatcher's economic advisors believed the rates are to the right of the optimum and if decreased, the revenues can increase. That is why the government announced cuts in marginal income rates at the expense of the indirect taxation in the form of VAT, which served as a broadening of the tax base. That was a very clever move since you cannot escape paying it. In addition, it is a flat tax, which is less progressive than the income taxes. The policy was to be revenue neutral so the only effect was not a real one but a redistributive one. The tax burden was shifted from the rich to the poor. Besides political considerations, the cut in income taxes was intended to give incentives to work harder and to move their preferences towards entering the work force, working more hours, and exiting the shadow economy. The decreases in corporate tax were intended to make businesses flourish as well and generate more revenue for the budget, but did not exercise the boost that was initially anticipated.

Despite all the unexpected negative consequences of Thatcher policies, however, her reforms represented the first major return to market economy. That is why Thatcher's government two mandates in the office would stay as an important episode in the economic history of stabilization.

### **3. Reagan package**

President Reagan's comprehensive program issued on February 18, 1981 had the aim to take the economy out of the slack by reducing the high inflation, cutting taxes and deregulate the economy. A new commitment to a stable monetary policy was made. The personal and corporate tax rates were to be reduced. This expansionary fiscal policy had to trigger subsequent spending cuts to close the gap of the budget deficit. Thus, the role of the government in the economy would diminish, when coupled with acts for government non-intervention and deregulation in the economy. Reagan announced his intention to reduce interest rates for credit purchases and borrowing of money by reducing government borrowing. Real incomes were to increase by spurring capital investment and enhancing productivity.

This arrangement was possible because of the specific institutional framework in the US. It is the Congress that passes the expenditures, and the president can veto its decision. President Reagan passed tax cut bills having the Laffer curve theory in mind. Even in case tax revenues did not increase, Reagan hoped that the Democratic government would take into account that there were fewer available funds for the state, and cut on spending. That is the first measure that distinguishes Reagan's regime from Thatcher's austerity plan. Moreover, such a political bet would be impossible in the UK because it is equivalent to betting with yourself.

The problem with Laffer curve is that there is no time dimension in it. The exact shape depends on the time period governments have at their disposal. If it is a short one, it might be the case that very high tax rates are needed to decrease the deficit. But if the Laffer curve is a long-term one, lower tax rates will lead to higher revenue because of the higher elasticity of GDP. Economic theory claims that the effect of such a tax cut has long-lasting effects on the real economy. Government can only change the form and distribution of the burden, but not the intertemporal budget constraint. First, tax financing is distortionary. But if the government outlays decrease, that means future taxation would be lower. However, if this tax cut does not induce dwindling government size and



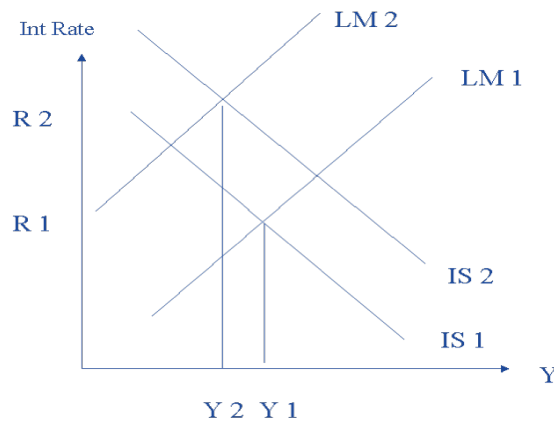
deficits balloon, higher taxes have to be raised in order to balance the books. At the time this policy was implemented, it was not obvious how long would it take for the government to achieve the required spending cuts.

Although not directly connected to the Reagan policies, debt financing is worth mentioning as an alternative to tax financing. Debt financing is less distortionary because technically speaking; it is not in the households' optimization problem. The country borrows, the economy is growing and future tax revenue is higher. This means that financing the debt is possible without raising taxes in the future. That instrument, however, was not in the agenda because of the already high deficit that the US was running.

Once elected, Reagan administration continued the dis-inflation activity that was in place under Carter's regime. Blanchard (1987) notes that Reagan's role was to establish more credibility. People were to adjust downwards their inflationary expectations. Tight money would squeeze the economy on the one hand. On the other, expansionary fiscal policy was to decrease private savings and make private sector cut back on investment. Those two factors would reinforce the recession, but once the government makes government savings less negative, the crowding out effect would be alleviated and investment will spur. A sustained expansion was to follow.

In the IS-LM framework, the initial effects of Reagan policies are described by a shift to the right of the IS curve and shift to the left of the LM curve, so that the overall result is a higher interest rate and lower output, see Figure 3.

Figure 3. The effect of tight fiscal and monetary policies on the US economy under Reagan



The interesting thing about this disinflation episode was that Fed Chairman Volker achieved credibility without strict control on the growth rates of the money aggregates. The targeted variable was the interest rate, which remained high during the period of swelling deficits at the cost of more fluctuations in growth rates of M1, M2 and M3 money aggregates. The increase in the interest rate was not met fully by foreign central banks and that led to appreciation of the US dollar, which was an external factor that helped bring inflation down. The credibility of the anti-inflationary commitment was not undermined by either the failure of the Federal Reserve to achieve the monetary targets, or the decline in interest rates, as the economy slowed down in 1986.

The second part of the government action was, as mentioned before, fiscal policy. The deficits increased first because of expenditure effect - more funds were directed for defense and transfers to poor, veterans, unemployed and pensioners. Moreover, as the interest rate was set high to cool down the economy, that increased the interest payments on the public debt and the current account deficit. The tax cuts also reinforced the rise in the deficit. Personal tax rates were cut, and there were tax breaks on savings and deductions for contributions to individual retirement accounts (IRA). That increases both disposable income and private savings. Moreover, when inflation was decreased, people went into lower tax brackets and their effective tax rates decreased as well. The coupling of the two effects was expected to lead to more funds available for households, lower inequality and better incentives on labor supply.

On the investment side, there was a cut in incomes in the top tax bracket, that is the taxes businesses pay. Depreciation for tax purposes was accelerated. That meant that a company writes-off the price of newly purchased machinery faster than the machinery depreciates. The effect of the depreciation allowances and deductions was offset by the tight credit conditions imposed by high interest rates in the economy. Simple calculations by Blanchard (1987) point even to a negative overall effect for investment. Moreover, the deficit as a percentage of GDP increased and Reagan administration had to step in with a more detailed tax reform and faster reduction in spending. Later in his mandate, however, Reagan government eliminated investment tax credit. Write-off periods were lengthened, thus counterfeiting the beneficial effect on investment exercised by the cut in the corporate taxes.

On the spending side there was a bill legislating automatic cuts in both defense and non-defense sector. Some programs were exempt (Social Security) and some protected by imposing limitation for cuts (health care and retirement programs). Nevertheless, due to the credibility effect as well as the appreciation of the dollar on the international markets, dis-inflation was less costly in terms of forgone output. The recovery, not especially strong, was partly credited to the expansionary fiscal policy. William Branson from Princeton University (qt. in Blanchard 1987) makes the point that Reagan plan was based on the Laffer curve theory: that cutting tax rates increases tax revenue. As evidence, he brings forth the budget outlook as of 1981, which turned out to be a rather rosy scenario:

Table 2. 1981 Budget outlook

	1981	1982	1983	1984	1985	1986
Proposed Outlay Ceilings	654.7	695.5	733.1	771.6	844.0	912.1
Receipts with tax plan	600.2	650.5	710.2	772.1	850.9	942.1
Target Deficit(-) or Surplus	-54.5	-45	-22.9	+0.5	+6.9	+29.9

Source: A Program for economic recovery (in Hailstones (1982))

Branson continues that the story with the political bet was used only after the recovery in 1983, which did not translate into decreasing of the deficit. Reagan administration could not attribute the deficit to the recession or blame the Fed, but had to recognize that a structural deficit had emerged. Branson continues that the recovery was actually self-bred from the recession the government put the economy into. Increasing in the interest rates and announcing the anticipated budget change made financial markets react to the news and depress demand beforehand. Once the expansionary fiscal policy was implemented, it had rather a Keynesian stimulating effect on the economy. In general, he believes that the performance of the US economy under Reagan led to deterioration of all macroeconomic factors (except inflation).

Even though Reagan regime is marked with ambivalent feelings, it bears an important piece of important advice for policy makers. In addition to the smaller welfare state idea, it argues that fiscal adjustment through increased tax revenues by cutting marginal tax rates may be a cause worth fighting for.

#### 4. Transition countries case

While Thatcher came to power with first thing in mind to drastically reduce inflation, the problem of transition countries were their fiscal balances. In the majority of the cases, institutional framework is underdeveloped and monetary policy out of control. That made fiscal domination in transition countries rule and necessitated the conducting of pro-cyclical fiscal policy because of low credibility. Low inflation requires tight budget. The latter can be achieved through working tax system. Budget cannot be balanced in the midst of inflation, however. Moreover, market prices of capital and labor cannot emerge in high inflation environment. Because institutions in transition economies are underdeveloped, fiscal and monetary decisions will not be translated to the micro-foundations. By decreasing the deficit, the government would make a commitment of low future inflation. The government is implicitly saying that it will borrow less and less both domestically and internationally, and the inflationary pressures will be weaker. That is what Poland did under Balcerowicz and was remembered as one of the successes in the transition world. It is a consensus among economists that a well-functioning market economy needs stable price levels. Prices are important signals to what goods and services are in demand, and their relative valuation. Under central planning, there were price controls imposed and that is how inflation was held on check. So some economists (Sachs, Lipton and others) proposed that price liberalization be executed immediately, so that the economic agents perceive the relative prices in the right and not in a distorted way. Eliminating all price caps was easier and was quickly implemented. The effect of this policy was that prices skyrocketed.

According to some group of economists, the explanation for that phenomenon was the excessive demand for certain commodities: people were ready to pay a higher price once rationing was abolished. The forced, involuntary money savings they were holding in state banks had almost no purchasing power. Those were savings that caused a monetary overhang. The problem with that argument is that even if people had some forced savings, they could buy goods on the second-hand market. Another option was to buy foreign currency on the black market. The value of domestic currency is different from zero, and the value of foreign currency is not infinite in terms of units of domestic currency.

It is true, indeed, that the goods in state shops were under-priced. When prices are liberalized, however, commodity prices jump up. If there is enough competition among state shop providers and you allow private shops to enter the market you have a very quick supply response. The example is Poland, where the number of shops tripled in a very short time.



However, if people have rational expectations, it is wise to instigate once-for-all increase in prices because gradual increase will feed into consumers' expectations for another increase and they would try to outguess the government by increasing their demand for goods one period ahead. In transition economies, inflationary expectations were highly volatile because of the great uncertainty surrounding everyday economic choices.

Similarly, if people have adaptive expectations, it is better to increase prices little by little, until agents adjust their behavior accordingly. A rapid increase in the price level will provide too slow a response and would deepen the problem through the wage bargaining channel. Higher wages meant higher costs for SOEs: those went through the so-called "cost inflation" channel (Herr *et al.* 1994). Indeed, increases in the administered prices and budgetary cuts followed. Ironically, it was exactly those cuts that fuelled inflation.

The case with the interest rate was very much the same. High nominal interest rate was put in place to limit credit expansion and suppress the high demand. High interest rates are important in curbing inflationary expectation as well, but they might be a reason for time-inconsistency problems as discussed in Blanchard *et al.* (1991). High interest rates may hint about disbelief on the central bank's side of a decreasing inflation in the future. They will not be cut unless inflation starts falling. But staying high, inflation expectations are revised upwards and a vicious circle comes into motion.

The question policymakers were trying to answer was how to set the right interest rate. In theory, that constitutes a very big problem because there is no real interest rate that is objectively high, only nominal ones. Ex-ante real interest rate is a good candidate, as that is the interest rate on the assets you are holding, given the prices you expect to get. That interest rate is a function of expectation of future inflation. This issue comes to illustrate the vital role credibility is playing. It all boils down to the basics: what is inflation going to be and what are people's expectations about it. In Poland after the price liberalization and tight monetary policy was implemented, the monthly inflation rate was 45%. It seems big in nominal terms, but in comparison, the actual price increase in the first month was 80%. The interest rate proved to be sufficiently high. From the next moment on, inflation started coming down.

Fixing the ER temporarily is another option: if everyone believed the peg is going to hold, there would be capital inflows, attracted by the higher than abroad interest rates. Foreigners turn their currency into zloty and make money in foreign currency terms when they exchange once again. So we note how delicate, even knife-edge the choices a government has to make are. Expectations are very important and sometimes success is due to luck.

The Philips curve is intertwined with the issue of stabilization, and this relation is worth delving into. Before privatization, the economies are situated at the origin – no inflation, no unemployment. Thus freeing prices will not lead to a stable situation. There will be pressure to go towards the curve. If there has to be zero unemployment with free prices, that would correspond to infinitely high inflation. Thus, the story of fighting inflation is the story of allowing too much unemployment. Labor reform is usually a trade-off between current vs. potential (future) employees. Since all those are sensitive issues, there is little discussion on them in the literature.

Moreover, unemployment is not only inefficiency. Labor allocation can be improved, but there is no need for new allocation because the initial one was not completely irrational. Once there is capital (because the country does not build the enterprises anew from scratch) and the exchange rate is sufficiently devalued, employment can be maintained. (Actually, a lot of pressures for printing more money were aiming to use credits to employ more people and to keep them on work, since more workers in a factory meant higher prestige for the managers). We take Poland as an example with its booming exports of low-quality steel. Even if it was rotten, that was the only commodity that was produced competitively. The result was that Western countries steel industries forego high-quality production in favor of the lousy steel. Therefore, this example comes to show that all sorts of scenarios are possible at competitive prices.

On the question of financing stabilization in transition countries in the 1990s, it should be said that the best to finance by issuing debt because the expectation was that those countries would become much richer once capitalist. However, markets were unwilling to lend. It was true that most of the transition countries had high debt/GDP ratios, but even Ukraine, which seceded from the Soviet Union with no debt obligations, could not borrow (see table 3 on the next page). Thus, transition countries had to turn to tax financing, which made the problem even worse because there was no working tax administration. Tax evasion flourished. Workers find it in their own interest not to pay taxes. The government faces serious hardships in raising the necessary revenue through income taxes. It decides to focus on indirect taxation such as the value-added tax (VAT). Even nowadays, the revenue from this tax comprises more than a third of the tax receipts in transition countries.

The dilemma between micro-reform and macro-reform first was present in transition countries as well. It was very hard to sort the micro-fundamentals unless we fix macro-fundamentals before that. Micro changes to increase competitiveness on the supply side are practically impossible in a situation of high demand. Take for example trade

unions in Poland, which were very strong. In case of a strike, they could block the whole supply. This is a classic hold-up problem, a bottleneck, which everyone suffers from. In an economy of high demand, if the company where a worker is employed goes bust, the worker could get another job relatively easy. So trade unions organize strikes in order for the members to maintain their privileges. In transition countries, the role of the trade unions was taken by management. At first, that comparison may seem awkward, but there are many important similarities. Managers oppose restructuring because they perceive it as a loss. Some of them might think of employees as political influence. The higher the employment, the more powerful they are. As a result, inter-enterprise arrears accumulated to postpone restructuring.

Table 3. External debt, 1991-1999, percentage of GDP

	1991	1992	1993	1994	1995	1996	1997	1998	1999
<i>Central Europe</i>									
Poland	61.5	56.4	54.9	47.1	38	35.2	36	36.2	38.3
Czech Rep.	26.4	23.8	24.3	26	31.8	36	40.6	43.1	42.3
Slovakia	n.a.	24.1	26.6	32	30.9	38.8	48.5	55.9	53.1
Hungary	67.8	58.1	63.7	68.7	70.4	61.1	51.9	56.9	59.9
<i>South-East Europe</i>									
Romania	7.4	16.5	16.1	18.3	24.1	29.5	30.1	24	27.1
Bulgaria	157.4	160.4	127.7	116.8	77.4	97.7	95.8	83.7	80.5
<i>Baltic countries</i>									
Estonia	n.a.	n.a.	18.2	23.4	22.1	31.8	55.3	55.6	56
Latvia	n.a.	n.a.	n.a.	n.a.	31.8	39.4	48.4	50.3	60.7
Lithuania	n.a.	3.1	12.2	12.4	22.8	26.4	32.8	33.3	40.8
<i>CIS</i>									
Russia	161.2	128.2	66.9	43.7	36.6	32.3	29.8	58.6	87.1
Belarus	n.a.	10.7	27.7	45.2	25.8	15.5	17.2	18.3	31.1
Ukraine	n.a.	2	11.2	19.1	22	20.6	23.5	28	37.3
Moldova	n.a.	1.3	20.4	53.1	46.3	48.1	54.3	59.7	105.7
Armenia	n.a.	n.a.	n.a.	30.9	29.2	38.4	48	42.9	46.3
Azerbaijan	n.a.	n.a.	4	18.3	17.6	14.7	10.2	12.1	24.1
Georgia	n.a.	12.8	67.8	80	63.7	44.9	44.6	47.2	63
Kazakhstan	n.a.	24.5	33.4	28	21	21.3	28.6	37.3	50.1
Kyrgyzstan	n.a.	n.a.	33	37.3	51.2	63.2	76.8	89.5	138.7
Tajikistan	n.a.	n.a.	73.3	93.8	158	83.8	98.5	90	94.9
Turkmenistan	n.a.	n.a.	3.6	207.8	36.6	34.3	65.3	75.6	112.2
Uzbekistan	n.a.	n.a.	n.a.	20	20.2	30.6	56.5	72.7	109.5

Source: EBRD (Aslund 2002)

Another question with no clear-cut answer in transition countries was what to pursue first: stabilization or privatization? A reason pro privatization first is that SOEs would not react properly to the effects of stabilization policies: cannot anticipate old managers to initiate restructuring. On the other hand, stabilization would lead to weaker labor unions and more responsive labor market, which would ease the difficulty of privatization and restructuring. Thus, it is more appropriate to stabilize before.

Macroeconomic stabilization is not just to reduce the inflation rate, because inflation is just one of the symptoms of high demand. However, that excess demand makes micro reforms difficult. Countries that have some small level of micro flexibility, like Russia, attempted to introduce macro stabilization first. In countries, where there was no flexibility, steps were taken to introduce some. What is the minimum of supply-side flexibility is hard to say? In that aspect, Poland had an advantage, as it had high flexibility. There were small private enterprises that were competing among themselves. Corporate governance was good since worker representatives elected managers. As a result, those enterprises responded quite strongly to stabilization. The product mix was also very important. Of course, in other countries the situation was not the same. Every country took a different road. The dilemmas, however, were the same: Do you make micro reforms first or macro ones? Do you implement supply-side reforms or demand-side ones? Still, there is no one-size-fits-all answer.

## Conclusion

The transition experience of former socialist economies in the 1990s in Eastern Europe posed a great challenge for economists trained in modern market economics. Western advisors, who came to help the formerly centrally-planned systems, proposed different sets of policies for different countries. Those advisors only had knowledge of reform measures implemented in developed economies, thus most of the stabilization programs shared similarities

to Thatcher and Reagan packages for reform in the UK and the US, respectively. In the early 1990s, there was no clear-cut answer to the challenge of achieving a successful aggregate stabilization in a transition country; there was no consensus whether supply-side or demand-side policies were a priority, whether macro reforms should be introduced first, and then focus on microeconomic issues, or vice versa – whether distortions at microeconomic level were detrimental for macroeconomic stability. Advisors who implemented a “one size fits all” package, in ignored specifics, were detrimental and created huge damages. Historical experience had to be taken into consideration as a primary factor, and then reform measures needed to be tailored to the specific environment in each transition country.

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