

PROBLEMS OF THE TRANSITION TO THE MARKET ECONOMY

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Introduction

It is interesting to think about the problem of the transition to the market economy as an analog of the transformation of a caterpillar into a butterfly. That process starts with a caterpillar, which goes into a chrysalis, inside which many changes take place, and from which a butterfly emerges. What happens inside the chrysalis? The caterpillar that went into it has a structure, an anatomy and physiology. It has many legs, a digestive system, eyes, etc. In the transformation the anatomy changes. The eyes may stay about the same, but some structure that existed in the caterpillar gets transformed into wings. Many of the legs simply disappear, that is, they are absorbed.

This is also what happens in the transformation of the administrative-command economy into the market economy. The old system had an anatomy (a structure) and a physiology (rules of operation). The market economy, too, has an anatomy or structure, and rules of operation, but they are different from those of the administrative-command system. In explaining the transformation of the administrative-command system into the market system, we can start with the old anatomy and physiology, and describe how that anatomy needs to be changed to convert it to a market economy.

In the caterpillar, the program by which this process unfolds is controlled genetically and endogenously. There is a program written in the genes that controls how each step of the process takes place. In the case of the transformation of the planned economy to the market economy, the program has to be exogenous. Someone outside the system has to write that program and apply it.

The Anatomy of the Administrative-command Economy

It is useful to think of the administrative command economy as composed of three sectors – the state production establishment or SPE, the household sector, and the foreign sector, shown in the diagram below.

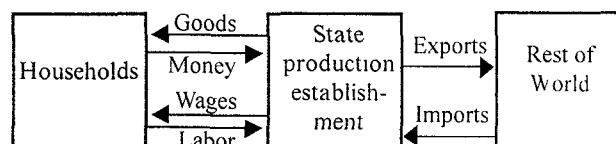


Diagram 1

The state production establishment combines functions of the state with functions of production. The main characteristic of a state is that it has coercive power, and in the USSR the state and the SPE as a whole was the instrument of the totalitarian communist party. The internal structure of the SPE can be thought of in two ways—as a hierarchical administrative structure that coordinates production by all the enterprises in the system, or as flows of resources as described in an input-output table. «Socialist ownership of the means of production» means that the SPE owns all the resources, but it is dependent on households for a supply of labor to operate these means of production.

6supplied. The state kept to use for its own purposes a large share what the economy produced in the form of huge investments, military expenditure, financing free social services and so on. These are important end-use columns in the input-output description of the SPE.

The SPE had a connection to the external world in the form of exports and imports (also an

important end-use column in the input-output description of the SPE). In the old Soviet system, there was no need for exports and imports to balance for an individual republic-there could be a big net inflow of resources-say to build the Toktogul dam-or a big net outflow. An important feature of the Kyrgyz economy within the USSR or as a sovereign nation is that since it is very small, its exports and imports need to be very large in relation to total output.

In this system money was unimportant. Finance was passive, and there was no macroeconomics in the usual sense. Households were badly exploited, and especially rural households.

Transforming the Old Structure to a Market-economy Structure

The first step is to separate the state from production. Enterprises must be privatized and given economic independence to make their own decisions and to take responsibility for their own fate. The SPE is divided into two actors-the state, and a private business sector that is responsible for production, shown in diagram 2.

Administrative co-ordination of relations between enterprises through the command hierarchy is replaced with market co-ordination. Instead of the administrative command hierarchy, new producer goods markets appear. An important task in privatization is to encourage the emergence of enterprising firms-firms that seek to survive by finding markets, creating new products and engaging in price competition. The labor and consumer goods markets need to be freed from administrative interference. Controls on where you live and work are abolished, and prices are set by supply and demand, not admin-

istrative control. This eliminates the producers' monopoly and monopsony power.

There is a role for the state to play, usually described as establishing a level playing field and enforcing the rules of the game. The playing field and the rules of the game have to do with defining and protecting property rights, encouraging competition, controlling monopoly, controlling corruption, etc.

The state also has responsibilities in areas of market failure.» There are some aspects of economic allocation that will not be properly taken care of by competition among private firms, and so the government corrects for this. Most of this has to do with «public goods,» involving externalities, such as protecting the environment.

Foreign trade needs to be liberalized-export and import will just be another decision made by individual firms. But this also means creating a convertible currency, and a foreign exchange market. The economy is now independent, and exports and imports have to balance or an excess of imports can only be financed by capital flows-foreign investment, loans or grants from international organizations.

The foreign exchange market is only one element of a whole financial sector, which did not exist before and must be created. It includes banks, securities market, foreign exchange market, a money market in general. The function of the financial sector is to gather the savings of the society, channel them to investment and other non-consumption uses, such as government borrowing. It provides the tools for rational allocation of capital, for disciplining both the government and enterprise management, and for

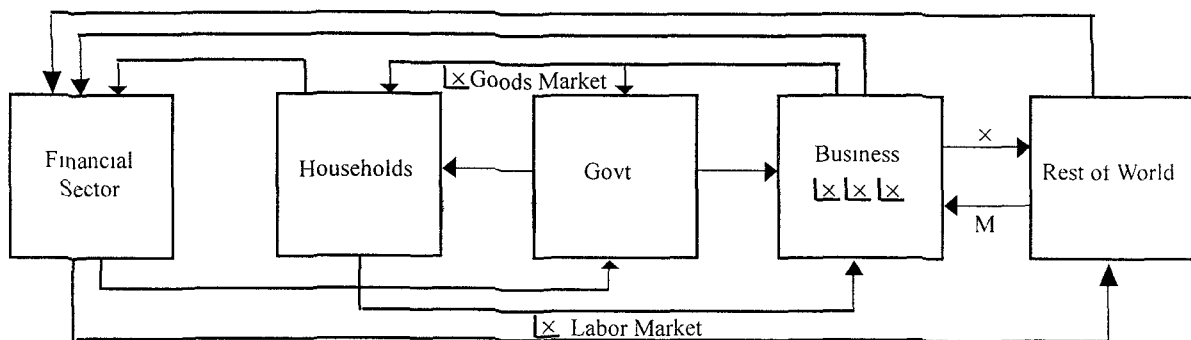


Diagram 2

attracting foreign investment. When all these steps are completed you will have the anatomy, that is, the institutions and structures, of a market economy.

This transition is inevitably a painful process. Even if it done right, there will be a collapse of production and a fall in incomes. The structure of output produced by the old system did not meet the needs of the new market-it is not competitive. Much of the production capacity is economically valueless. Like in the caterpillar, a lot of the old structure is irrelevant to the new way of living. Many of those legs are unneeded by the butterfly, and so in the transformation were lost or absorbed. The same thing happens in the transformation of the economic system.

So what can be done to minimize the pain, and to speed up the process? Figuring out the details and sequence of the various steps is the most difficult task, on which there is little agreement. Remember that in the case of the caterpillar, this program already exists in the genes. It has worked more or less flawlessly for millions of years. Only when there is some mutation will the program fail, leading to death or malformation. But in the case of the economic reform «program» nobody ever did it before. And for each element of the program there exist numerous choices and ideas. If the program is defective, the system that emerges will be a crippled one that can't «fly.» I will not try to discuss here how to write this program, but remind you that we know that it is possible to design a program that works, since Poland, Hungary, Czechoslovakia, Slovenia, and others have done it.

Standard Problems

Still, it is useful to emphasize what can go wrong in general and to note some problems specific to Kyrgyzstan. Typically, there is an effort to keep all those old legs by giving budget subsidies, cheap bank credit, exercising arbitrary tax treatment. There is excessive pressure on many firms in the form of high taxes, but even those high taxes can't

cover the big expenditures and transfers, so the government and the banking system try to cover it by printing too much money. The result is inflationary pressure. The high tax pressure drives economic activity underground, or kills it. One of the major requirements for success is a sound tax system. Agriculture accounts for a large share of Kyrgyz GDP. Agriculture is a low-income, poor, sector, and is a difficult sector to transform to a market basis.

Kyrgyzstan was highly integrated with the rest of the old SSSR-a large share of Kyrgyz production that was sold to firms in other republics is no longer salable. The customers in the rest of the old SSSR have failed, or found better suppliers. Nor is the output salable on the general world market.

Since Kyrgyzstan is so small, it can't be autonomous. It must trade on a large scale, and with a few exceptions those exports are unlikely to be finished goods or products of extractive sectors. They need to be intermediates, semifinished goods, etc. How to find those niches is a big problem. But finding them is a task best done by private business entrepreneurs, either domestic or foreign.

Indiana University, USA or a small, poor, country, rules that encourage capital inflow are essential. Kyrgyzstan is also landlocked, transport costs are high, one would think that a lot of its exports ought to go to other countries in the region. Kyrgyz recovery depends importantly on free trade within the Central Asian region. Unfortunately the other Central Asian governments tend to be rather protectionist.

To deal with these special problems of Kyrgyzstan, there needs to be some kind of development strategy. The most important step in overcoming them is to finish the job of creating a market economy. But as mentioned earlier, there are many choices to be made in designing the new institutions, and they need to be designed in the light of some strategic idea of the optimal direction of Kyrgyzstan's economic development. But that is a topic for later discussion