

The People's Republic of China Under Chairman Mao Zedong

Historical Background:

- ❑ Longest continuous civilization: at least 4000 years of good history.
- ❑ Empire unified in 221 BC from warring states
- ❑ Dynastic Cycle: stable imperial autocracy divided by periods of chaos. Internal power struggles before Song, foreign invasion: Mongolians, Manchus (Qing Dynasty).
- ❑ China was the world's most advanced economy for much of human history. Also cheap labor, premodern agricultural technologies, gentry-supported backward-looking imperial state, Malthusian tensions.
- ❑ The Opium Wars (1840-42, 1862) coincided with decline of Qing power (Taiping Rebellion).
 - Century of Humiliation: unequal treaties, indemnities.
 - Slicing the Melon: missionaries, foreign concessions.

Revolutionary China

- ❑ Scholar Protests (1898): Kang Youwei, Liang Qichao, the Guangwu emperor, and the Hundred Days (put down by Ci Xi).
- ❑ 1911 Wuhan Uprising (1911), abdication of boy emperor: 2nd, 3rd revolutions; Nationalist Party (Guomindang, or KMT). Sun Yatsen, Chiang Kaishek.
- ❑ May 4th Movement (1919), disillusion with western democracy, CCP founded.
- ❑ Warlord Period: CCP-KMT alliance, 1927 Northern Expedition, CCP-KMT split, Nationalist Nanjing government.
- ❑ CCP: Jiangxi Soviet, Long March, Zunyi summit, Yan'an redoubt; kidnapping of Generalissimo, alliance with KMT.
- ❑ Japanese encroachment: War over Taiwan, Korea (1895), War with Russia (1905), Manchuguo, invasion (1937); Rape of Nanjing, retreat to Chongqing.
- ❑ Civil War (1945-49). KMT better armed, but morale low, corruption and hyperinflation rampant.

The "High Tide of Socialism"

- ❑ October 1, 1949: Chairman Mao announced that "The Chinese people have stood up." PRC founded.
- ❑ Common Program (1949) – very inclusive approach.
- ❑ Land Reform (1950-53) – brutal, political.
- ❑ Mutual Assistance Treaty (1950)
- ❑ Korean War (1950-53) – confidence, status, radicalization
- ❑ First FYP (1952-57):
 - Nationalization, gradual collectivization – big push to complete both in 1955-57.
 - Soviet advisors, loans, turnkey factories, etc.
 - Soviet-style planning, heavy industrialization – difficult, "learning by ruining," still successful. Plan not actually completed until 1955.
 - Hundred Flowers (1957) followed by Anti-Rightist Campaign.
 - Agricultural production reached 1937 levels, economy growing.

Mao Zedong Thought



- Peasants, not workers, the Chinese revolutionary class: landlords, not capitalists, are the exploiters.
- People's War: guerrilla warfare techniques
- Mass Line rather than reliance on Party: Emphasis on Campaigns to educate, arouse the masses; Anti-intellectualism (vs. Chinese traditional respect for the scholar).
- Continual Struggle (not harmony), even after revolution; inherent contradictions.
- Self-Reliance: denies comparative advantage, division of labor, need for central planning.
- Egalitarianism.
- Need to adapt Socialism to Chinese circumstances.

The Great Leap Forward (1958-61)

Following Announcement of 2nd FYP, Mao announced switch to "Da Yue Jin." Turned Marx on his head.

- Plan for "three years of bitter struggle" to overtake UK in steel production, rapid industrialization.
- Agriculture: giant communes, mass production methods, direction from top, communal kitchens consumed surplus.
- Rural industrialization: backyard steel furnaces, push for "appropriate technology."
- Urbanization: rural workers, agricultural surplus taken to cities.
- Politics in Command: little planning, pressure on cadres to overstate success, feedback loop.
- **Break with the Soviet Union** (1960): Khrushchev's denunciation of Stalin, Mao's rejection of Soviet methods.
- **Initial news very good, truth was awful**: 30 million starved in famines (first rural, then urban), estimated 50 million fewer Chinese by 1961.
- Lushan Conference: ouster of Peng Dehuai, Mao admitted some errors. Policies slow to change.

The Cultural Revolution

- Recovery (1962-65) under Liu Shaoqi, Zhou Enlai, Deng Xiaoping: return to central planning, party control, agricultural decentralization.
- Socialist Education Movement (1965), development of Mao's personality cult (little red book).
- Great Proletarian Cultural Revolution: red guards, attacks on "four olds;" elimination of Mao's competitors; breakdown of education, public order, and planning; near civil war in 1967, order then re-established by PLA.
- Continuation of radical policies until Mao died (1976):
 - "Gang of Four" radicals, extreme uniformity.
 - Conflict with USSR, rapprochement with USA (Shanghai Communiqué, 1972), triangulation.
- After Mao's death, Hua Guofeng new chairman: two whatevers, arrest of Gang of Four, Great Leap Outward.

People's Republic of China After Chairman Mao

- ❑ In 1972, Mao Zedong met with Nixon and relations with the rest of the world began to normalize.
- ❑ Mao Zedong, Zhu De, and Zhou Enlai died in 1976. Hua Guofeng was new Chairman, and arrested "Gang of Four."
- ❑ Deng Xiaoping – a small, intelligent, pragmatic, and popular figure within the CCP – was admitted back into circles of power after being purged twice.
- ❑ In Dec. 1978, Deng Xiaoping emerged as "paramount leader" after his proteges (Hu Yaobang, Zhao Ziyang) were elected to highest formal positions.

Deng Xiaoping



- ❑ End of "Politics in Command" -- managers promoted on the basis of skills, rehabilitation of rightists, end of class labels.
- ❑ Political restructuring to end personality cults: no more CCP Chairman, term limits on highest positions of General Secretary, Premier, et cetera.
- ❑ Party legitimacy still depended on Mao's reputation, so party repudiated most of his policies with repudiating him.
- ❑ Pragmatic "black cat, white cat" approach.

China's Economic Reforms

- ❑ Open Door Policy (by 1980): Joint-Ventures, Special Economic Zones, foreign exchange retention, tourism, et cetera. China granted "MFN Status" by U.S. and other developed countries, but still subject to textile and other quotas along with annual MFN Review.
- ❑ Rural Reform (by 1980): Household Responsibility System, decollectivization, rural and urban markets, new rural enterprises (TVEs), and the eventual release of surplus labor.
- ❑ Industrial Reform (by mid-1980s): Decentralization, SOE autonomy, profit retention, two-tier pricing system, banking reforms, *getihu* system, et cetera. SOEs improved productivity in 1980s but also started to borrow heavily from state banks, and by late 1980s competition, rising productivity from other sectors, and SOE inefficiency was leading to falling profits and falling market shares.

Chinese Policy after 1989

- By late 1980s, inflation was rising and many inside and outside the CCP were becoming dissatisfied.
- Zhao Ziyang pushed for tolerance of private sector and wholly-owned foreign firms, but was blamed by CCP conservatives for reform problems.
- Student protests in 1987 led to ouster of Hu Yaobang, and large Tian'anmen protests after death of Hu led to a crackdown in June 1989, ouster of Zhao, and worsening of international relations. New leadership included Jiang Zemin and Li Peng.
- Retreat from reform in 1989-1991 did not help SOEs but did lead to millions of rural job-seekers coming to the cities.
- Deng Xiaoping pushed for return to reform with his trip to SEZ in Shenzhen.
- In 1992, the CCP announced that China would seek to create a "Socialist Market Economy" (*Shehuizhuyi Shichang Jingji*), effectively renouncing traditional communist objective. Prior attitude was that reform was temporary.

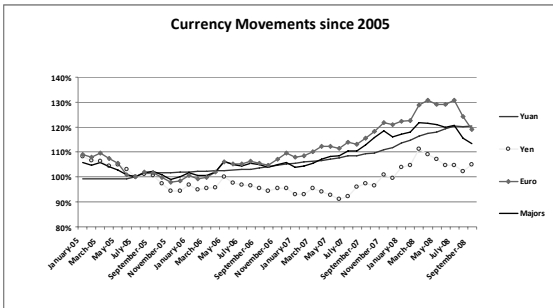
The Socialist Market Economy

- Initial reforms included:
 - Efforts to improve SOE management through limited liability incorporatization and creation of stock markets, but state retained controlling share.
 - Tax and fiscal reform to prevent rising deficits.
 - Simplification of exchange rates and devaluation to black market rate, full convertibility of current account by 1996.
 - Separation of state banks into commercial banks and policy banks.
- SOEs were to be the "cornerstone" of the SME, but their profits, shares, and performance plummeted.
- NPL problem in state-owned banks 25-50% of loans, but state banks continued to lend to SOEs.
- Inflation accelerated in mid-1990s, wiping out real effect of devaluation. Zhu Rongji named vice-premier (later premier) and began to tighten money and credit growth and tried to reduce NPL problems.

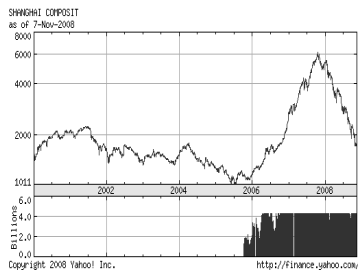
China After 1997

- Deng died in 1997, just before HK was returned to China.
- Asian financial crisis of 1997 did not happen in China because foreign exchange transactions were limited to exports and imports (foreigners were in segmented "B shares" market). But export growth did slow after other Asian economies devalued their currencies, and government has used fiscal policy to keep demand high.
- After Deng died, CCP General Secretary (and President) Jiang Zemin announced new "release the small, retain the large" policy for SOEs, and pushed to allow private entrepreneurs into the CCP.
- In 1990s, China became the largest less-developed recipient of FDI, and this funded China's growing export sector.
 - Many of these exports are in labor-intensive products that used to be produced by other Asian countries, though China is making signs of moving into higher-tech areas.
 - Export sector relied upon to deal with urban unemployment problem.
 - China now accounts for 10% of U.S. imports, and blamed by some in U.S. for loss of manufacturing jobs. The U.S. has lost 2 million manufacturing jobs since 1995, while China has lost 16 million. China runs a large current account surplus with the U.S. but a deficit with the rest of the world.

And then the Yuan appreciated



China's Shanghai Composite Index



The SSE has lost two-thirds of its value since the start of the year.

Socialist Economies: Reform and Transition

An overview of the basic concepts and underlying problems

The Difference between Reform and Transition

Economic reform is usually an effort to make the socialist economy work better.

- ❑ "Perfection of control" involves improvements in planning, changes in planners' preferences, adjustment to state prices, organizational changes, moving the "spotlight."
- ❑ Decentralization means moving the planning process to lower levels of decision-making.
- ❑ Radical reform usually involves a new reliance on markets, reduced role of plan in allocation and distribution, managerial autonomy in SOEs, price reform, and labor reform.

Economic transition is the path taken when the socialist economy is intentionally abandoned.

- ❑ Usually after the fall of the existing government, so it often takes place during democratic liberalization and domestic turmoil.
- ❑ Involves price liberalization, privatization, legal reform, tax reform, social reform, and macroeconomic stabilization.
- ❑ Gradual "evolutionary" approach versus a more rapid transition approach called "big bang" or "shock therapy" policy.

The basic problems of reform

- ❑ The principal-agent problem and the contradiction between state ownership and incentive. Autonomy + state ownership may be worse.
- ❑ Political resistance from cadres, apparatchiks, nomenklatura, urban workers, et cetera.
- ❑ Competition leads to reduced profits for state monopolies, which affects state revenues. Money-losing firms are usually subsidized, not shut down.
- ❑ The information needed to redesign the economy is initially much greater than the information needed for planning to work. Catch-22.
- ❑ Simultaneous existence of plan and market leads to opportunities for increased corruption.
- ❑ Kornai argues that the socialist economic system is an integrated system, so how can plan and market coexist for very long?

The Problems of Transition

Need for major changes in behavior and attitudes:

- ❑ Loss of legitimacy for the old system, its ideology and its adherents.
- ❑ Loss of moral compass – what was wrong is now right?
- ❑ Shortage economy attitudes and behaviors change slowly.
- ❑ Workers and managers may have difficulty adjusting to new expectations.

Privatization:

- ❑ Who gets to own it? auctions versus vouchers, insiders versus outsiders.
- ❑ How do SOE managers behave when they expect privatization?
- ❑ Accumulated "deadwood" from lack of fire, likelihood of conflagration.
- ❑ SOEs served as providers of social safety net, retirement, health care, housing, schools, et cetera. Who will provide it now?

Price liberalization:

- ❑ monetary overhang from forced savings likely to cause inflation.
- ❑ all prices are interdependent and relative.

Need for a supporting web of banks, insurance, stock markets, suppliers, retailers, et cetera.

- ❑ These capitalist market institutions evolved over a long period of time.

But also...

- **Macroeconomic stabilization:** the connection between government deficits and monetary growth.
 - Money-losing firms must be shut down (no buyers, and no coordinating system), but this threatens rising unemployment and a downward spiral in demand.
 - Falling government revenues, combined with rising subsidies and social costs.
 - Bank deposits and the moral hazard problem.
- **Reform of foreign trade and investment:**
 - Convertible currency, single exchange rate, increased transparency, and a level playing field.
- **Conditions for growth of new firms:**
 - contract enforcement, restraint of SOEs, legal reforms.

Russia: Everyone in the wrong place and doing the wrong thing

The Gorbachev era left:

- Repressed inflation
- Large fiscal deficit
- Central-regional conflict
- Administrative collapse
- Competition for ownership
- Capital flight



Russia under Boris Yeltsin (1991-99)



Gaidar Reforms – Shock Therapy



- Ruble convertibility
 - Market liberalization
 - Privatization
 - Social Safety Net
 - Political Troubles:
 - Conflict with Congress of People's Deputies
 - Shelling of White House, Oct. 3, 1993
 - Yeltsin Constitution
 - New elections led to ascent of nationalists (under Zhirinovsky) and communists (under Zyuganov)
- “Too much shock, not enough therapy” – Strobe Talbott

Transition Process

- Privatization:
 - State Property Committee (Chubais), 1992.
 - Voucher Privatization – by 1993, 26% of workforce under private management, by 1994 33%, but half of all income through private sources.
 - Land Ownership Decree
 - “Shares for Loans” in 1995
 - Growth of New Private firms accounted for most growth.
- Price Liberalization:
 - Gradual reduction of price regulations
 - By 1997, most prices set by market forces, with exception to key sectors (e.g., oil & gas).
- Competition and the Private Sector:
 - 1995 Anti-monopoly law established Federal Anti-Monopoly Commission, restricted power of gov't to limit competition.
 - Oligopolies continued to dominate many markets.

Taxes

- Tax Reform and Deficit Spending:
 - Taxes continued to be based on profit and VAT taxes, plus special taxes on exports, transportation, et cetera.
 - Poor record-keeping made personal taxes hard to collect.
 - High marginal tax rates, but low rates of collection.
 - Government revenue 44% of GDP in 1992, 29% in 1996
 - Government spending 66% in 1992, 37% in 1996
 - New Tax Code met delay after delay.

Inflation



- Central Bank Policy and Inflation:
 - CBR created in 1990, replaced Gosbank in 1991 – chief monetary authority, regulated private commercial banking.
 - Gerashchenko headed the CBR – Sachs called him “the world’s worst central banker”
 - Inflation rate was 2600% in 1992, 730% in 1993
 - Federal Law of the CBR in 1995 made it responsible for Ruble Stability – inflation fell to 20% by 1996, but Ruble’s value had fallen 0.02 cents (5600 per dollar).
 - New GKO’s provided government bonds for foreign investors.

Performance

- Official estimate is that Russian GDP declined by more than half in early 1990s, though this may be overstated – heavy industry hit hardest.
- Best estimate is a 30% decline in GDP between 1990 and 1995.
- Corruption, organized crime, breakdown in law and order.
- Kleptocracy, oligarchy, and “making money the Russian way.”
- Asset stripping, capital flight.

Russian Financial Crisis and Recovery

- August, 1998 default on ruble-denominated government debt
- Commercial banks insolvent
- Four-fold devaluation
 - Per capita income fell 25%
 - Import-substituting enterprises expanded
- Increased prices of energy and metals since 2000
- Increased tax and improved tax compliance provided a large budget surplus

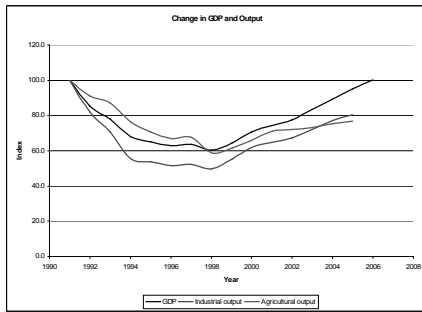


After Yeltsin

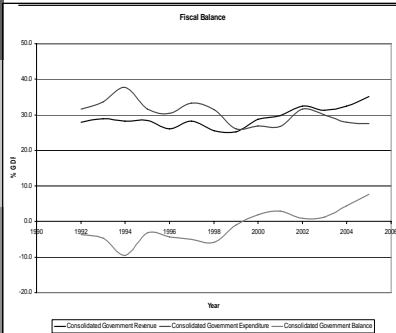
- ❑ Boris Yeltsin resigned as President in 1999, replaced by his new Prime Minister Vladimir Putin, a former KGB official, who was elected to his own term as President in 2000, and overwhelmingly re-elected in 2004.
- ❑ Military action in Chechnya, crackdown on oligarchs and political dissent, attacks on free press.
- ❑ High approval ratings, economic recovery and growth, more assertive internationally.
- ❑ Putin replaced in 2008 as President by Dmitry Medvedev. Putin elected to Duma, began second term as Prime Minister.
- ❑ Currently proposes allowing third term for president, but says it is not intended for himself.



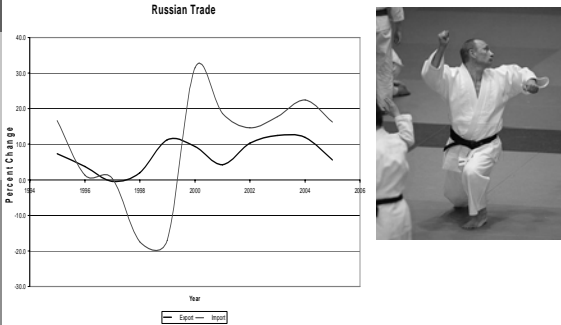
Russia: Recovery in Output



Russia: Fiscal Balance



Vlad the Lucky: Exchange Rates and the Price of Oil – Before it hit \$95/barrel



Reform and Transition in Central and Eastern Europe

- ❑ East Germany and future members of the EU: Poland, Czech Republic, Slovakia, Hungary, Slovenia, Lithuania, Latvia, and Estonia.
- ❑ Former Socialist Countries not likely to enter the EU soon: Bulgaria, Romania, Albania, other republics of the former Yugoslavia (e.g., Croatia and Serbia/Montenegro) and other European republics of the former Soviet Union (e.g., Belarus and Ukraine).

2004 Entrants to the EU

Country	Pop	Per-capita GDP	By PPP Method	Growth 1980-1990	Growth 1990-2001	Growth 2001	2001 FDI/GDP	Trade Ratio
Czech Republic	10.3	\$5270	\$14,550	2.0%	1.1%	3.6%	8.8%	123%
Hungary	10.2	\$4800	\$12,570	1.5%	2.1%	4.0%	5.8%	124%
Poland	38.7	\$4240	\$9,280	-	4.1%	1.2%	4.5%	49%
Slovakia	5.4	\$3700	\$11,610	1.6%	1.9%	3.2%	11.8%	134%
Slovenia	2.0	\$9780	\$18,160	-	2.7%	2.9%	3.8%	103%
Estonia	1.4	\$3810	\$10,020	-	-0.2%	5.3%	-	-
Latvia	2.3	\$3260	\$7,870	-	-2.6%	9.0%	-	-
Lithuania	3.5	\$3270	\$7,610	-	-2.3%	4.3%	-	-

2007 Entrants and Others Less Likely to Enter Soon

Country	Pop.	Per-capita GDP	PPP	Growth 1990-2001	Growth 2001
Romania (2007)	22.4	\$1710	\$6980	-0.4%	5.5%
Bulgaria (2007)	8.1	\$1560	\$5950	-1.0%	5.1%
Russia	144.8	\$1750	\$8660	-3.9%	5.5%
Ukraine	49.1	\$720	\$4150	-8.0%	10.0%
Belarus	10.0	\$1190	\$8030	-1.0%	4.4%
Serbia/Montenegro	10.6	-	-	0.3%	4.9%
Croatia	4.4	\$4550	\$8440	1.3%	4.1%
Albania	3.4	\$1230	\$3880	2.9%	5.6%

Historical Background

- Before 1919, most CEE countries were not independent sovereign states. Post-WWI treaties (treaties of the Paris suburbs) created the borders.
- In 1944-45, Soviet Red Army occupied all of CEE except Yugoslavia and Albania. Churchill's "iron curtain" came down, and Soviets established new policies.
- Joint Allied Occupation in Germany and Austria: East German Soviet Zone became DDR, Berlin Blockade and Airlift, building of Berlin Wall.
- U.S. Policy of Containment, Cold War, Marshall Plan, and NATO.
- Soviet established Warsaw Pact and CMEA (Comecon).

Pre-1989 Hungary

- Matyas Rakosi's "salami tactics," fraudulent elections in 1947, Stalinist First FYP.
- Imre Nagy's **New Course**, 1953-1955, ended forced collectivization and focused more on consumer goods.
- **Hungarian Revolt** in 1956 followed conflict between Nagy and Rakosi. Attempt to leave Warsaw Pact led to Soviet Invasion under Khrushchev. West distracted by Suez crisis. New leader Janos Kadar walked a tightrope.
- **New Economic Mechanism**, 1968-73: indicative planning, limited market, profit motive, foreign trade, no decentralization, labor management, or political reform. Not very successful.
- **Reform of Reform**, 1979-88: Dismantling of monopolies, bankruptcy, some new firm types.

Pre-1989 Czechoslovakia

- ❑ Successful and growing industrial democracy from 1919-1938.
- ❑ Free elections in 1946, but communists seized government in 1948.
- ❑ 1963 Reforms were resisted by Nomenklatura.
- ❑ 1968 **Prague Spring** led by Dubcek. Takeback of unions, workers councils, free speech and press, foreign trade, and invasion by Brezhnev and Warsaw Pact. Set **Brezhnev Doctrine**.
- ❑ Under Gustav Husak, Czechoslovakia became one of the most conservative CEE economies.
- ❑ **Charter 77** on Human Rights, playwright Vaclav Havel would spend years in prison.

Pre-1988 Poland

- ❑ Old Empire until 1600s, weak government due to Sejm veto power. Dissolved into Russian, Prussian, and Austrian empires. Reemerged from 1919-1939. New borders after 1945.
- ❑ Worker Uprising in 1956 – collectivization abandoned, planning decentralized.
- ❑ Worker Uprising in 1970 – Geirek increased wages, imports, borrowing from West.
- ❑ 1970s debt crisis led to austerity policies.
- ❑ 1980 uprising at Lenin Steelyard in Gdansk (Danzig) led to creation of **Solidarity**, Lech Walesa. Government recognition, negotiation, and concessions.
- ❑ Soviet Military Exercises in 1981 led General Jaruzelski to declare martial law and outlaw Solidarity.
- ❑ New austerity policies, popular resistance, and economic stagnation. Inflation was 25% in 1987, high for a socialist economy.

Events of 1988-1990

- ❑ Gorbachev signaled end of **Brezhnev Doctrine**, encouraged CEE countries to try reforms – both economic and political – to resurrect their slowing economies.
- ❑ Poland, 1988: Roundtable Talks led to recreation of Sejm, partially free elections, return of Catholic Church's nationalized property. Solidarity took all seats in 1989 elections, Walesa would win presidency in 1990.
- ❑ Hungary, 1988: Kadar ousted by HSWP, followed by Grosz, Pozgay. In 1990 elections, HDSP got 8% of vote.
- ❑ June 1989, China's Tiananmen demonstrations, crackdown.
- ❑ East German emigration through Czechoslovakia. Rumors led to a massive crowd that tore down the Berlin Wall, government falls.
- ❑ Czechoslovakian "Velvet Revolution" in 1989.
- ❑ In Bulgaria, Zhivkov's government overthrown. Romanian Demonstrations in December 1989 led to bloody crackdown in Timisoara. Ceausescu and his wife overthrown and shot. Albanian government falls apart in 1990-91.

Poland

- ❑ **Balcerowicz Plan** under new Solidarity-run government beginning in 1990 – market liberalization and *shock therapy* most rapid in CEE economies.
- ❑ Privatization: public sales, then “mass privatization.” Rapid growth of new firms, rising FDI.
- ❑ Collapse of Soviet trade slowly replaced by growth in trade with Germany & EU.
- ❑ Macroeconomic stabilization helped: Inflation was 553% in 1990, 33% in 1994, 16% in 1997.
- ❑ First CEE economy to recover: growth began in 1992, highest in Europe by late 1990s.
- ❑ High unemployment: 16% in 1994, 13% in 1999.
- ❑ Political stalemate after 1991, return of renamed communists in 1995 elections led to no retreat on reform.

Hungary

- ❑ **1988 Economic Stabilization and Structural Reform Program:** a radical, but *gradual*, move towards the market. Western laws, economic integration, tax and banking reforms, ending of state firm subsidies, privatization, political reform, et cetera.
- ❑ 1990 Elections gave power to Hungarian Democratic Forum under Antall: gradual economic reforms continued. Deficits (10%), slow privatization, GDP fell by 18%, rising unemployment (12%), foreign debt (250%).
- ❑ 1994 Elections to Socialists under Horn: aggressive privatization (80% by 1998), export promotion, austerity, crawling exchange rate peg, falling inflation, rising FDI (1/3 of total, 1/3 from U.S.), rising trade and faster growth (4.4% in 1998, rising to 6%).

Czech Republic

- ❑ Husak resigned, free elections, Vaclav Havel new President and Civic Forum in power. Vaclav Klaus new finance minister.
- ❑ Jan. 1, 1991 – central planning abandoned, most subsidies ended, koruna becomes convertible, liberalization of most prices, foreign trade and tourism.
- ❑ Government surpluses helped cut inflation from 45% to 0% by end of 1991. Inflation relatively low through 1990s.
- ❑ Privatization through small firm auctions and *Kuponova Metoda*, FDI and new firm growth, while remaining large SOEs and state banks slid towards bankruptcy.
- ❑ Political stalemate by mid-1990s.

East Germany

- Most advanced of CEE Soviet-bloc economies. Yet when the wall came down in 1989, West Germans discovered a weak economy with inefficient factories, unproductive workers, and terrible environmental damage. Trabants on the Autobahn.
- 1990 – Reunification: monetary, economic, social union, followed by a political union.
 - Extension of West German legal system, labor and other regulations, social insurance, codetermination, et cetera.

Currency Conversion

- 1:1 parity conversion for prices, wages, small savings, pensions; 2:1 conversion for other savings
- 4:1 the official rate, 12:1 the black market rate.
- Political decision with terrible consequences.
- East German goods and labor overpriced given relatively low labor productivity and quality.
- Normally, free trade with Europe would be an advantage for such an economy, since exchange rate would fall and make exports cheaper.

Market Restructuring

- Treuhandanstalt (THA) – privatization agency:
 - East German industry organized into 221 Kombinate, large inefficient monopolies that made privatization difficult.
 - No new investment before privatization, reliance on market restructuring.
 - Difficulty of determining property ownership.
 - Environmental damage made many factories too risky to purchase under German environmental rules.
 - In defiance of expectations, THA eventually completed its mission and shut down.

What happened?

- ❑ Fiscal cost of reunification led to deficits, offset by Bundesbank policy. High interest rates led to savings inflows from the rest of Europe, and caused European financial crisis in 1992, and European recession.
- ❑ Contrary to expectations, the eastern Länder did not catch up. Unemployment much higher than in west, productivity much lower, growth rate slower so gap is widening. The cost of reunification also helped to slow growth in the west.
- ❑ Ossie vs. Wessie social conflict, Neo-nazi problems, blaming Gästarbeiter for unemployment.

Lessons

- ❑ Big Bang vs. gradualism.
- ❑ Privatization of SOEs vs. new growth.
- ❑ Macroeconomic Stabilization is key; it depends on getting government budget under control.
- ❑ Creation of an honest government and a safe investment climate (Olson).
- ❑ Importance of trade relations, foreign investment.
- ❑ Social Safety Net and long transition period.
- ❑ Democratic political shifts may not alter economic reality, and policy is not ideological.
- ❑ Lots of things can go wrong.
