Is There a J-Curve for the Economic Transition from Socialism to Capitalism?

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Much economic thinking about current developments in Eastern Europe, where the transition from plan to market and from socialism to capitalism is underway, seems to show, once again, that economics is, indeed, the dismal science. Specifically, both western observers and policymakers in these countries appear to believe that there is some sort of large and negative supply-side shock that this transition imparts to the reforming economies. For lack of a more pejorative term, we will call this J-curve pessimism. Such J-curve pessimism does not appear to dominate other aspects of life. People who undertake diets or begin to exercise, for example, can correctly expect that this course of action will lead them to lose weight or become fitter in a way that is directly related to the rigor of their diet or exercise regime. It is only the dismal science of economics that would have them believe that their efforts would first lead to gains in weight or worsened fitness, and only in the distant future to an improved state of health.

Perhaps the most graphic example of this economic pessimism is the so-called theory of the J-curve effect of the devaluation of a country’s currency. Countries in deficit are generally advised to devalue their currency so as to improve the trade balance by making their exports cheaper and imports dearer. Dismally, the short term effect of the devaluation is to worsen the trade balance since, with quantities unable to respond to prices in the short run, the main consequence of devaluation is that foreigners need to spend less of their currency for the
country's exports. Only in the long run, when quantities adjust, will the trade balance improve. Traced out over time, the balance of trade post-devaluation thus describes a J, first worsening and then gradually improving.

Similarly it is argued that the introduction of economic reforms associated with the transition must reduce the productive capacity of the economy. Gomulka (1991) argues that changes in prices, combined with rigidities in resource allocation, will "reduce the (maximum) potential output" (p. 77) of the economy. This inward shift of the production possibilities frontier, or worsening of the economic situation, will later be compensated by the fact that such a decline "represents Schumpeterian creative destruction, designed to release resources locked in unproductive or insufficiently productive uses, for their future use elsewhere" (p. 72). Clearly, the worse the misallocation of resources, the greater the destruction that will be wrought and the more pronounced the J-curve effect.

Murrell (1990, 1991a), on the other hand, allows for the mobility of resources but, following some rather misleading and wrongheaded analysis of statistical evidence conducted by Whitesell (1990), concludes that planned economies are so efficient at allocation that marketizing reforms can do little to improve the existing allocation of resources. Indeed, reforms, by destroying existing economic institutions and mechanisms, must cause a temporary inward shift of the production possibilities, and new sources of information will evolve to replace the old mechanism only very slowly. In the interim, lack of coordination and thus a fall in the potential, and actual, output of the economy is inevitable.

On virtually all counts, the introduction of economic reforms in Eastern Europe has, indeed, coincided with a worsening of economic performance. As Table 1 shows, production has fallen sharply; unemployment, previously unheard of in these countries, has risen to levels that may soon surpass what is tolerable in market economies: inflation is reaching levels where the prefix hyper is no longer merely political hyperbole; and the trade balance appears to be worsening for many of the countries of the region. Moreover, this deterioration of economic performance is not perceived as a short-term phenomenon. Polish architects of the "big bang" had hoped that by the end of 1990 industrial production would be recovering from the shock-induced decline of the first half of the year, but this rebound has not materialized as yet.

In Hungary, the imposition of tight monetary policy by the Antal government was supposed to weed out the inefficient and uncompetitive firms, leaving the field to the strong and able, who would then lead