

3.

The depth and duration of the loss of output during the first half of the 1990's in the CIS countries, the Balkan countries and the CEEC countries can be explained by the different economic and political environments between the three groups. The liberalization efforts in all three groups differed and resulted in different outcomes for each of the economies at hand. Faced with choosing new economic and political policies the differences in the depth and duration of the loss of output were determined by these choices. Three main factors are accredited with having the greatest impact on the ability to transition: the distance for Western Europe, the amount of time spent under Communist rule, and the initial position of economic development of the economy. The initial position of the economy was greatly influenced by months immediately following liberalization because of Gorbachev being committed to socialist ideas, as well as the decades of economic rule of their past. All of the transition countries were plagued by a monetary overhang. The excess supply of money was essentially forced savings. The consumer at the time was worried about decreased purchasing power and at the time of price liberalization spent as much as possible. The level of the monetary overhang determined the jump in the price level; no country was prepared for the dramatic change in the price structure that it would incur. The redirection of the excess savings resulted in

The choice of currency exchange impacted future growth. Estonia is case of success and Russia is a case of failure. Estonia pegged its currency to the DM, while Russia tangled with the ruble and the rubles zone. Being too small to have an individual currency was a major factor in depressing the growth of the CIS economies.

Price liberalization and the swiftness of all liberalization is also documented to be a reason for slower or faster growth. Faster liberalization lead to faster growth. The CIS and Balkans were comparably small economies and suffered from decline in the demand for the few goods that they did produce. CEEC countries benefitted greatly from having their own currencies as well as the Copenhagen Summit.

4.

The process of privatization incorporates an incentive based market structure into the economy. The goal of privatization was to increase the efficiency at which companies were operating. Mass privatization was a process that transition countries were faced with overcoming and was necessary to redirect the management and profits from ownership away from the state and to the individual. The process of privatization includes auctioning and selling of state assets and companies to buyers. Some of these buyers had little or no management skills and were purchasing a firm already operating at levels far below optimum. Inclusion of an investment fund or government held share program would decentralize the risk of the buyer, decrease the price of the purchase, provide an investment opportunity to the poorer individual, and increase the burden of the government to be less corrupt.

Immediate privatization implies that purchases are made at far below their market value because of a lack of access to the real price and liquidity. Both of those issues increase the inefficiency of the

privatization process. The massive amount of monopolistic firms as well as incredibly large vertically integrated firms made swift and complete privatization risky and in some cases impossible. Also, the gradual privatization process left the least efficient and profitable firms in the complete control of the state. Because the entire economy was state run before liberalization and wages were determined by the state, massive amounts of personal cash were not available for private individuals to purchase the large and even small enterprises of the economies. This lack of liquidity would be partially mitigated if potentially profitable management was able to purchase a firm through access to liquidity. The coupon program transferred the credit channel to the individual who had excess savings in the form of monetary overhang and would be benefitted by the payoff from a successful credit program. Russia had very limited payoff for their vouchers compared to the Czech Republic (2<sup>nd</sup> guess is Ukraine).

Including a government linked fractional share system would have provided incentive for the government controlled central bank to provide credit to the newly purchased firms as well as have vested interest in their survival. Complete separation of the firms from government or financial system controls allows the firm to evade taxes. The loss of the firms profit and the taxes is a negative impact on the budget of the state.

5.

a. GDP growth will slow and stability will decrease because the debit obligations for already issued securities will increase. Income will decrease with the decrease in output and the average person will decrease their purchasing power. The risk premium for the country will go up and in foreigners will see investment as less desirable in the foreseeable future. There will be an increase in unemployment because of a decrease in the aggregate supply and decrease in investment ( $S=I$ ).

b. Increasing inflation will lead to an increase wages and then will lead to a wage price spiral. Investors will be happy that monetary policy is effective, but the decrease in the exports will offset the balance for the future. The increased attraction of investment will depend in the flatness of the FE curve. Overall, the current account will suffer further depression as well because exports will increase further depressing internal output and further increasing the current account deficit.

c. The increase in the interest rate will increase the attraction of investment for foreigners. Decreasing government expenditure will decrease the imbalance for the next period and will lower the foreign debt in the future. An increase in the interest rate will increase savings internally and may be able to impact the BoP through the capital account balances. Decreasing government expenditure will increase the interest rate and decrease output further than the central bank policy also.

d. This will look bad to investors and will increase the risk premium to investors. Promising to speed up reforms will look good and if the money is spent well the future will be bright for attracting FDI.

I would choose option B assuming that there is availability to effective monetary policy. The increase in the money supply will also lower the burden of prior debts as well as finance the deficit internally. Lower interest rates will encourage investment and should increase output. Further attraction of FDI will be harvested by the increased output and GDP growth making the future for the economy look bright.

6.

Social norms and mentality from the communist era are still plaguing the economic performance of Eastern European market economies today; mainly the preference of production towards heavy industry, the tendency to invest in human and physical capital, the presence of arrears, and distrust of the future. If an economy prefers to produce heavy industry means that the economy will need raw materials and have a harder time competing internationally for trade, also the production of luxury and high priced good for exports will suffer. High investment levels in human and physical capital mean that the infrastructure and level of education will be higher; both of those factors do not guarantee growth. The presence of arrears or lack of payments and an underground non-cash economic system undermines the economic structure for growth by evading taxes and not allowing the banks to impact through the multiplier process. Distrusting the future will make a person less likely to deposit with the bank, invest their money internally at all, and lower the attraction of FDI. Non-payment, or arrears, make a legal framework for business near impossible, beginning with the ability to enforce contracts and bankruptcy issues.

Social trust in an economy is paramount to sustained growth. Being able to trust the economic structure and other members of the economy is necessary to encourage that all transactions that will reap benefit occur. In Russia people do not want to invest because they are worried they will lose their initial investment and also the profits that would be made. This creates inefficiencies because profitable (socially and internally) investment will not occur. Bribes are also a major problem for market economies because the market price can not be known if bribes are accepted by individuals. Bribes within the government are also an issue.

7.

Three causal links are mentioned as explanation variables for GDP growth in Eastern Europe during the 1990's.

First, GDP growth is negatively affected by the GDP per capita at the beginning of the transition. This is explained because some countries like Poland had already began a transition to more efficient production levels and therefore had less catching-up to do. This phenomenon is called conditional convergence and was witnessed in the Eastern European countries. This is explained by the initial decrease in output compared to 1989 levels experienced by the FSU countries was somewhere around 40% and for CEEC countries was 20-something percent. Therefore the GDP growth in FSU countries should be higher and lower in CEEC countries, as was observed. The closer you are to steady-state the closer to zero the growth rate will be.

Second, the distance for Western Europe was deemed significant. This is explained by the results of the Copenhagen Summit in 1993 dictating the CEEC countries would most likely be accepted into the EU, thus lessening their debt burden internally, increasing the attraction of their imports, and giving the countries themselves the motivation socially to accept all of the changes that were happening during the transition. The cost of transportation is also an aspect of this argument because people in Western Europe are more likely to outsource and off-shore to the cheaper land and labor markets of the future EU countries. Western Europe also operated on a higher technological level and the closer the country was to accessing this market the more likely the technology would spill-over. The lower wages of countries further away would be offset by the travelling costs as well as the perceived risk of the money being so far away in a land that Western Europe and the rest of the world had been sequestered from for 70 years.

Third, the state of democracy, meaning higher democracy will lead to higher growth is noted. People were sick of people told what to do all the time and wanted a say in what was happening. An example of countries making sure they did not lose the independence they did have was the attempt to form a single central bank for the CIS. As more and more people began to be on board with a new system such as pricing or legal reforms incentive based structures would become stronger, i.e. the ability to tax and thus stabilize the macro economy. A more democratic society will be able to manage monopolies with greater support of the public, foster legitimate elections for government officials to represent the public opinion, and also increase the personal rights of the individual.

The social security system is better adopted under a democratic government. Whether a pay as you go or a back funded method is used the success of the government is necessary to provide social security at all. People sick of authoritarian regimes were wanting change and as in the Czech Republic and Hungary saw benefits from democratization of their environment.