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Summary of
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"The Path of Output from Plan to Market" by Thorvaldur Gylfason

This paper is intended to clarify the contribution of macroeconomic stabilization and structural adjustment to the transformation from plan to market in Central and Eastern Europe and elsewhere. At first, the restructuring of the economy is accompanied by a collapse of output, increased unemployment, and high inflation. High inflation drives a wedge between the marginal products of real and financial capital, and thus distorts production. To maximize efficiency and output, the inflation distortion must be eliminated. The static output gain from stabilizing prices and consequently improving the allocation and utilization of capital at full employment is captured in a simple formula in which the gain is approximately proportional to the square of the original inflation distortion. This formula is analytically equivalent to Harberger's triangular measure of the deadweight welfare loss from inefficient taxation. Substitution of plausible parameter estimates into the formula indicates that the static output gains from stabilization can be quite large. For example, the eradication of inflation of 250 percent per year can increase total output by about 4 percent permanently according to the model, when the elasticity of substitution of financial for real capital is between one half and one.

Moreover, successful stabilization increases the rate of growth of output per head, and not only its level, in the presence of constant returns to capital in a broad sense. The efficiency boost that is obtained through an improved allocation and utilization of capital is likely to increase economic growth, either permanently, according to the new theory of endogenous growth, or at least over an extended period, according to the neoclassical growth model. The stimulating effect of stabilization on growth through increased efficiency is complicated, however, by its interaction with the depreciation of financial capital through inflation and the endogenous determination of optimal saving.

The main conclusion of the paper is that sound monetary, fiscal, and financial policies can, by bringing inflation down, play an important role in encouraging the reallocation of resources and the reorganization of production that are necessary, in Central and Eastern Europe and elsewhere, to foster a favorable development of output and employment after the initial slump. In particular, macroeconomic stabilization not only helps raise the level of output, but also its rate of growth over time.