Macroeconomic policy: going back to origins?

Tatiana PAPIASHVILI[1]

Ilyas ÇİLOĞLU[2], Faruk GURSOY[3]

Abstracts

Decline in public interest to "pure" economic theory is disturbing fact. This paper considers the main macroeconomic hypothesis through their implementation in practice - macroeconomic policies in the USA, in post-soviet countries (Russia and Georgia) and Turkey as well. Stabilization policy of these countries experiences that governments combine keynesian discretionary policy and classical rules. The so-called economic stabilization programs for Russia, Georgia and Turkey sponsored by the IMF have led to absolutely different and not always positive results. In particular, Russia overcame recession and financial crises of 1998 without IMF loan. Georgia now is looking for the new program. The programs were faulted because they did not take into consideration all peculates of post-communist economies. Most successful this program was in Turkey that has achieved macroeconomic stability and high rate of growth.

Keywords: Macroeconomic Policy, IMF Policy, Georgia, Turkey, Russia

Introduction

Talks about economic crisis in Georgia are no longer on the agenda. Theoretical economy has automatically dropped out of our economic reality. Such an ignorance has not brought any benefits to anyone. On the contrary, economic history provides us a lot of examples, when new ideas, new theories have pulled many countries out of the vicious cycle of recession. The most obvious example is Keynesian theory of employment, which enabled the world economy to overcome the Great Depression of 1930s.

Stagflation or the Great Inflation of 70s has brought to life monetarism which continues to be the most widespread theoretical concept up until now. Other concepts such as evolutionary theory, theory of organizations, institutionalism (the theory of rational and adaptive expectations), supply-side hypothesis are being actively developed side by side with the abovementioned concepts. We wouldn't consider the basic postulates of these theories and their "weak" and "strong" sides. Let's emphasis that "apriori" none of them could be applied entirely to our economy under the following circumstances.

Firstly, in contrast to Reagan, who had realized in "Reaganomics" program the ideas of supply-side economics, modern governments in developed countries prefer to pursue more flexible macroeconomic policies based on several theories that at one glass seem to be conflict.

As we know, in the U.S.A new Keynesians are called "Activists" and their opponents are monetarists who present new classical school. In the latter's opinion, the Activist policy should be replaced by certain long-term rules, concerning with regulation of the money supply, national income, price level, and other rules of fiscal and monetary policy.

[1]Assoc. Prof. Dr., Georgian Technical University, Tbilisi, t.papiashvili@mail.ru

[2]Assist. Prof. Dr.,IBSU, Tbilisi, Agmashenebeli Alley 13th km,№2, ilyas_c@hotmail.com

[3]M.A., IBSU, Tbilisi, Agmashenebeli Alley 13th km,№2, fgursoy@hotmail.com

Up until present the Federal Reserve System (FED) of the U.S.A has not implemented any of the suggested rules of economic policy. Moreover, the FED adopted the discretionary monetary policy. But at the same time the FED sets planned targets that limit main parameters of the money supply and the volume of loaning for each year .These targets do not have to be realized compulsorily.

On the other hand, the FED makes prognoses of major economic variables such as nominal and real GDP, deflator GDP, unemployment rate and etc. to predict and control the rate of growth of monetary aggregates. The FED agrees that time lags and mistakes of prognosis make the "precise adjustment" of the economy problematically. At the same time, it doubts that all suggested rules of the economic policy, even if they are flexible, can be equally useful and effective in all circumstances. The FED emphasizes that it is necessary to preserve the mechanisms of backward relations, logic, and weighted discretionary approach toward monetary policy, that aims at the solution of long-term problems.

Secondly, according to the theory of economic policy, developed by Dutch economist Y.Tinbergen, successful macroeconomic policy should include a sequence of steps .First of all, it is necessary to choose the objectives of monetary policy or the goals, then find a set of variables to aim them (intermediate targets). After that, governments have to estimate which political and economic instruments they possess (operating targets). And finally, they must have a model of the economy, that relates targets with the instruments. For example, if the major goal of society is inflation, then orthodox restrictive methods proposed by monetarists are effective. These methods include: stabilization of the exchange rate, balanced budget, strict monetary policy. Such programs have been already widely implemented in many countries including Georgia. If society decides that the growth of real GDP is on the agenda, tools of the keynesian expansionary fiscal policy are more suitable. It is not accidental that at threshold of cyclical decline George Bush administration decided to lower taxes and extended "Star Wars" program. Because innovations would created incentives for the development of new technologies, that were the main sources of economic growth in the United States in recent years.

Thirdly, international practice of stabilization policies experiences that the same program implemented in different countries may cause different results. For instance, in Argentina (Austrakh plan in 1985), Brazil (Crusado plan in 1986), and Peru (Inti plan in 1985) heterodox shock program failed. On the contrary, in Israel and Mexico heterodox methods that included wage and price control were implemented with a great success. Both countries curbed high inflation and achieved quite enduring stabilization.

More familiar to us examples are "Shock therapy" programs in Poland and Russia. This policy promised to provide stabilization in an economy through price liberalization, first of all. In Russia at the beginning of this process prices increased ten and even thousand times, but stabilization did not occur. Another component of the reform was privatization, aimed to rapid increase in economic efficiency of production. However, in Russia in the course of the reform there was a dramatic collapse and decline in economic activities and production efficiency (for example, labor productivity declined almost by 37%). Russian economists talked about the deterioration of productive potential of the country, which did not have rivals in economic history of the country in peaceful time. The next component of the reform - wage control - caused crucial social problems such as mass unemployment, sharp decrease in real wage and enlarge the portion of people with incomes below minimum subsistence level . “Shock therapy” in Russia turned into a shock without therapy and default of Russian economy in 1998.

Fourthly, reasons and nature of recession (in our opinion, it is more correct to talk about depression) in post communist economies were absolutely different from those in Western countries. More specifically, it is a crisis of transition economy. As Y.Kornai predicted in his book “Deficit”, the dismantling of planned economy and it liberalization were insufficient to form market economy.

According to Jeffrey D.Sachs, any stabilization program for post communist economy must take into consideration the following peculiarities that has existed:

- soft budget limitation of public enterprises or, in other words, a lot of privileges to them in form of cheap credit, direct subsidies, tax benefits, etc. Such a financial regime protected public enterprises from market competition and the threat of bankruptcy.
- weak wage control in public enterprises. In socialist economy profit was not an indicator of economic efficiency, managers cared only about accomplishment of plan, because wage and fringes depended on total product.
- large amount of transfer payments .It's a fact that socialism had created a high level of social security. But with ineffective economic system such a policy had inevitably led to substantial budget deficit and high inflation.
- “Monetary Shade” resulting of excessive purchasing power of population. Such a situation occurred because of excessive money supply, on one hand, and a system of controlled prices, on another. Under such conditions inflationary pressure on the economy was very high.

In our opinion, this list of peculiarities of transition economies should be extended to develop a successful stabilization program.

- Transition economy inherits from socialism a high level of monopolization in most industries of economy. In market economy monopoly emerges as a result of decline or restrict in competition while under communism monopoly as usual was a result of government policy.
- The majority of post communist countries suffer from corruption, which infects all spheres of social life, including economy. In corrupted economy market mechanism of distribution of internal resources and received external assistance works in modified way. Corruption increases total costs and price level. Underground economy becomes an inseparable part of this economic system and it accounts half and more of country's GDP. Underground economy and corruption destroy the state budget.
- As we have mentioned above, in most post communist countries strong inflationary expectations of population exist. But it is a component of common

distrust towards government policies. As a result, dollarization of economy appears and banking system operates ineffectively, because most part of the money supply circulates outside the banks.

№It is also necessary to include into consideration the results of globalization process. In epoch of globalization national governments lose some of their functions of macroeconomic regulation of an economy to expense of international organizations which, for instance, finance most of stabilization programs.

The common characteristic of all stabilization programs is their short-term targeting. Short-term targets are slightly connected to the long-term goals. Most of these programs are aimed to conquering the persistent high inflation and the associated macroeconomic instability. However, these measures are not enough to the restoration of the potential of transition economy in post depression period. It is not surprising, that in many countries where such programs have been carried out the consequence was an economy that lurched from crisis to crisis. A familiar example is Turkey.

Turkey began a series of reforms in the 1980s designed to shift the economy from an insulated system to a more private-sector, market based model. The reform spurred solid growth that has been punctuated by sharp recession and financial crises in 1994, 1999, and 2001. From 1999 to 2002 government restarted structural reforms in line with ongoing economic programs developed with the IMF. The programs included passage of social reform, public finance reform, state banks reform, banking sector reform, increasing transparency in public sector, and also introduction of related legislation to liberalize telecom and energy markets. Under the IMF program, the government also sought to use exchange rate policies to curb inflation.

In 2000 a growing current account deficit, the weak banking system, and growing concerns over the failure to implement needed structural reforms resulted in a liquidity crisis that led to a revised IMF program. In February 2001 there was a dramatic increase in interest rates and as a result rapid inflation, a severe banking crises, a massive rise in domestic public debt, and a deep economic downturn (GNP fell by 9,5% in2001).The government was forced to float the lira and adopt a more ambitious economic reform program, including tight fiscal policy, enhanced structural reforms, and unprecedented levels of IMF lending. These reforms enabled Turkey to stabilize interest rates and the currency and to meet its debt obligations. In 2002 and 2003, the reforms began to show results. Inflation and interest rate have fallen significantly, the currency has stabilized, and confidence has begun to return.

In recent years Turkey demonstrated strong economic performance and progress has been striking. The numbers speak for themselves. Average real GNP growth over the last three years has been closed to 8% and last year it was just short of 10% (compare with average growth of 2,3% between 1995-2001). Even more remarkable, that acceleration in growth has been achieved in the context of sharply declining inflation and fiscal consolidation. The inflation rate has fallen from 70% three years ago, to close 8% now its lowest level for 35 years. The primary surplus was almost 7% of GNP last year- above the 6,5% target. The public debt ratio has fallen by 30% of GNP since the peak in 2001. Thus, the most impressive result of the Turkish reform is sharp decline in inflation that has been achieved in the context of rapid growth. Both IMF and Turkish government explain this recovery as a result of "successful crisis management".

Macroeconomic stability and high growth rate have already made possible raise in real income and help to reduce poverty. The last has a special meaning in Turkey. Because unmentioned reality behind the growth and deflation was that the unprecedented appreciation of the new Turkish lira resulted in sharp reductions in real wages and a dramatic increase of the surplus value extracted from the working class .Between March 2001 and June 2003 a nominal wage increased of 82,6% and the consumer price index jumped by 121,2%. In January 2003 the Turkish trade unions accepted another deal that eroded real wage for 2003-2004. According to this agreement, the lump-sum increase for the first half of 2003 meant 6-7% average increase in wages. In the same period, the consumer price index rose another 12%.

A report recently prepared by the Turkish government reveals that one out of every four Turkish citizens is living below the poverty line, while 82% of them are not covered by security system. The report also reveals that only 48% of the country's total workforce is covered by social security network.

The recent transformation of the Turkish economy has been remarkable. There is every reason to expect further rapid growth, sustainable over a long period. That will raise real incomes, deliver rising living standards and further reduce poverty.

On May 12 2005, Turkey signed a new arrangement with the IMF that is intended to support a three year economic program that aims to sustain growth, deliver price stability, and more towards convergence with the EU economies. The prospect of EU membership has certainty focused thinking on the further progress needed. On another hand, prospective EU membership adds additional bonus to economic progress.

Stabilization programs of the IMF have been realized in Turkey since 1961, the last of which was carried out in 1999 when the country received $4 billion and recommendations of the Fund concerning planned devaluation of Turkish Lira by means of moving to a new system of the Exchange rate the system of "Crawling " tying. This resulted in a bank crisis on December 2000. A new provision of $7.5 billion and an advice to speed up privatization followed. By the beginning of 2001 country faced with the currency crisis. The IMF applied a new remedy the system of floating exchange rates. Turkish Lira totally lost its value. GNP decreased by 8.5% and inflation boosted. More than a million of Turks have lost their jobs. In May 2001 IMF provided $8 billion more. In autumn of 2001 a new crisis occurred in Turkey and the Fund promised to provide extra $12 billion in case if the tax reform aimed at the expansion of the tax basis by means of increasing taxes proved to be successful. More and more economists attribute temporary "rests" in Turkish crisis not to unstable movement of the economy towards the recovery, but to the waiting of a successive assistance of the IMF. Such an euphony has also taken place in Argentina which has recently become sadly famous for its endless changes of the presidents. One of the reasons is that the efforts of the economists and politicians are being directed not at the implementation of real reforms but at begging of financial assistance. The debt of Argentina exceeds established by the Fund quota by 529% and that of Turkey by 1500%.

In 2002-2004 an analogical economic program was accepted. According to the authors, its realization will make it possible to prevent future crises by preserving the basis for fixed and long-term economic growth. The program includes three key elements:

- Preservation of the floating exchange rate to limit the possibility of potential speculators attacks, stabilize percentage level.
- Continuation of the reforms of financial system and strengthening of the trust towards internal national financial assets.
- Reforms concerning taxes and expenditures which will help to settle fiscal debt at a certain time.

Besides this, the structural reforms already initiated in three regions will be carried on:

- In banking sphere, to direct investment sources toward the real sector od the economy.
- In governmental sector, to increase the transparency of the government activity and to reorganize enterprises.
- In private sector, to speed up privatization and to stimulate the inflow of foreign direct investments.

Conclusion

The first half of 2002 will be crucial, for it will illustrate the “Authenticity” of stabilization achieved within a country: whether so-called “critical point” in reforms has been passed. However many Turkish economists doubt in the success of this program being afraid of debt crisis or crisis of credibility. In this relation economic reforms in Russia are attracting greater interest. Russia has refused the assistance of the IMF and, moreover, has decreased taxes (In Russia per-capita tax of 13% was used, which was the lowest in Europe). The Ruble has been stabilized. The country implements policy supporting export and, furthermore, it has applied for entering WTO under beneficial for itself conditions with a perspective to become a world market supplier of weapons, color metals, steel, chemical products, etc., everything what the West did not permit it to sell because of “Undemocracy”. A favorable investment climate emerges in Russia where real and not “Mafia” investments are directed.

A quick glance at Russian reforms convinces that a precisely thought over combination of simulative fiscal and mildly strict credit-monetary policies is effective under conditions of Transitional economy as they create real grounds for progressing to the next stage of the reforms the stage of economic growth.

References

1. Sachs D. Jeffrey, Larrain B. Felipe (1993). Macroeconomics in the global economy. Prentice-Hall, Englewood, New Jersey.
2. Krugman R. Paul. (1994). International Economics: Theory and Policy. HarpetCollinsCollegePublishers.
3. Chacholiades Miltiades. (1990). International Economics. McGraw-Hill Publishing Company.
4. Begg David, Fisher Stanley, Dornbusch Rudiger (1994). Economics. McGraw-Hill Book Company
5. Parkin Michael.(1993). Economics. Addison-Wesley Publishing Company.
6. Kornai J. (1990).Deficit. Moscow, Nauka.
7. Долан Э., Линдсей Д. (1994). Макроэкономика (пер. с англ.) М., СПб.
8. Агапова Т.А. (1998). Бюджетно-налоговое регулирование в переходной экономике: макроэкономический аспект.
9. Агапова Т.А., Серегина С.Ф. (2005). Макроэкономика. М., «Дело и Сервис».
10. Албегова И.М., Немцов Р.Г., Холопов А.В. (1998). Государственная экономическая политика. М.,СПб.
11. Линдвуд. (2005). Макроэкономическая теория и переходная экономика. «Инфра-М».
12. Мартынов В.А.(2005). Переходная экономика: аспекты, российские проблемы, мировой опыт.М., Экономика.
13. http://www.turkishweekly.net (accessed 01.12.2005)
14. Ikinci, Sinan., (2005), "Turkey: IMF plan demands new attacks on working people", World Socialist Web Site, May issue, http://www.wsws.org/articles/2005/may2005/turk-m30_prn.shtml, (accessed 25.11.2005)
15. Evrensel, Ayse Y., 2004, ``IMF Programs and Financial Liberalization in Turkey``, Emerging Markets Finance and Trade, Vol. 40 Issue 4