# Shock "Therapy" the Market Way

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*Twenty years after transition began and the merits of "shock therapy" were argued the most hotly, (former) transition countries are hard hit by global shocks originating in Western market economies. Although discussions now focus on troubles in Western developed countries, countries in Eastern Europe and the CIS were particularly hard hit in 2008/09. This should not come as a surprise given their pre-crisis vulnerabilities. As transition countries opened up to trade and capital flows—like other countries that want to reap the benefits of the global economy—they also became subject to the shocks that hit open economies. The very high current account deficits and/or reliance on commodity exports prior to the crisis exposed many countries in this region to two of the shocks that have been most costly to emerging markets and developing countries in the past, namely sudden stops in capital flows and terms of trade shocks. However, the lesson from the crisis should not be that opening up is bad in general, but that shock absorbers should be put in place to minimize the damage market-based "shock therapy" can do.*

## Shock Therapy and Transition

It is now twenty years since the failed 1991 coupe that led to the break up of the Soviet Union and started the transition from plan to market in (then) communist countries. A few years earlier, in 1989, the Stockholm Institute of East European Economies was set up at the Stockholm School of Economics. Its first director was Anders Åslund who was a strong proponent of shock therapy (see Åslund 1992). The basic idea was that a rapid transition from plan to market through changing institutions, privatizations and other liberal reforms would minimize the cost of transition. There are still different views on the merits of shock therapy as a reform strategy, but this brief will not address this debate.

In the wake of the academic debate of shock therapy, the broader research agenda was put under the heading "transition economics", which became a new field in economics. This also lead Erik Berglöf, new director of the Stockholm Institute of East European Economies, to change the institute's name to the Stockholm Institute of Transition Economics, or SITE for short, the name we still use today. The economics of transition was also the title of the fifth Nobel symposium in Economics (Berglöf and Roland, 2007).

The use of the label "transition economics" may see a revival in the aftermath of the Arab spring. However, the economic issues that now face the (former) transition countries are much the same issues that emerging markets, developing countries and also advanced countries around the world grapple with. This is not least true when we look at what has happened in the current crisis.

Below this brief will argue that the shock therapy ex-communist countries were subject to in the early 90's has been changed to the shock "therapy" open market economies around the world have been facing for a very long time. And just as there were heated debates on what the right therapy was then, the world is now debating what the "therapy" for the current shocks should be.

## Output Drops around the World

Significant drops in output have not only been observed in countries transitioning from plan to market but have occurred with regularity throughout modern history in countries around the world. The figure from Becker and Mauro (2006) shows the frequency of countries that entered into a major output loss event—defined as a cumulative loss of at least 5 percent of initial GDP in an event that last at least two years—during the 20th century. In the after-war period, a relative modest 5 to 10 percent of countries have entered into a period of significant output loss. However, in the great depression, almost half of the countries for which data is available entered into a period of significant loss of output.

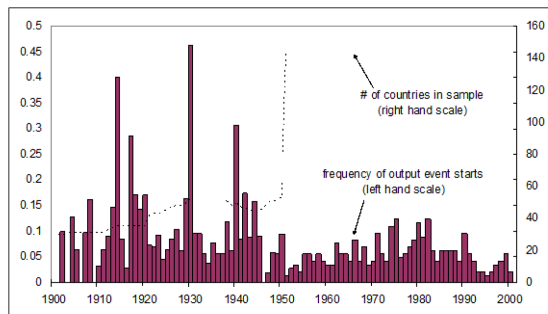


*Figure 1. A century of output collapses*

Since the methodology used in Becker and Mauro follows countries until they return to pre-crisis levels of GDP, it is too early to provide a full account of what the number would be in the current crisis that started in 2008. Nevertheless, it is straightforward to compute how many countries have experienced output losses in 2008/09 (which is the first criteria to satisfy in the Becker and Mauro measure) and this number is close to fifty percent, on par with the great depression. This is not to say that the total output loss will be as high as in the great depression, but it clearly tells the story that this is the worst global crisis we have seen since then in terms of how many countries have been affected.

The share of countries affected at the onset of this crisis varied greatly in different parts of the world and at different levels of development. The most surprising statistic from this crisis is that 90 percent of advanced economies experienced an output drop whereas "only" 40 percent of emerging market countries did. The regional differences between emerging markets are also striking; 85 percent of countries in Central and Eastern Europe (CEE) and more than half of CIS countries saw output decline, far above other regions.

## Shocks 2.0

The Becker and Mauro paper also looks at the correlates of major output drops and focuses on a number of domestic and external macro, financial and political shocks as triggers of output collapses. A large dataset of shocks and output drops is used to compute the frequency of the different shocks; the likelihood that a particular shock leads to an output collapse (as defined above); and the output loss associated with such event. These numbers are then used to calculate how much different types of shocks have cost in terms of lost output for emerging markets and developing countries. The scale in the chart shows how much it would be worth in terms of GDP per annum to avoid a certain shock.

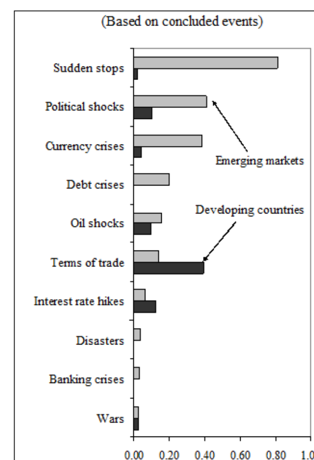


**Figure 2. Shocks that matter**

For emerging market countries, the worst shock has been sudden stops in capital flows that cost almost a percent of GDP per year. Unless countries have high levels of foreign exchange reserves, sudden stops in capital flows means that (often large) current account deficits have to contract and even become surpluses quickly because there is no external financing available for a deficit. This in turn affects domestic production and demand and can have a serious effect on output. Add to this the financial uncertainty that is often associated with sudden stops and it makes it the number one shock to worry about for emerging market countries integrated in the global economy and financial markets.

Less developed countries are in several cases dependent on concentrated commodity exports to generate foreign exchange. This makes this group of countries more vulnerable to terms-of-trade shocks. The estimates of how costly these shocks are range from around half a percent of GDP per year, as is shown in the chart, to around 2.5 percent of GDP if a more extensive sample including very long-lasting output events is used.

Other shocks like currency, political and debt crisis have also been associated with significant losses in output, but tend to occur less frequently, which makes the cost per year smaller.

## The 2008/09 Crisis

As was mentioned previously, not enough time has passed since the start of the crisis in 2008 to use the methodology in Becker and Mauro to compute cumulative output losses since many countries are still below their pre-crisis GDP levels. However, projected losses can be computed by using the IMF's World Economic Outlook forecasts of GDP growth rates. If we then rank the countries according to worst output performance, CEE and CIS countries dominate the "top-ten" list with seven entries. Latvia at the top of the list is projected to lose a cumulative 40 plus percent of pre-crisis GDP during the 11 years it is projected to take the country to return to the GDP level it enjoyed in 2007. The other Baltic countries, Ukraine and Armenia have also been hit particularly hard in this crisis. Russia and Romania are close behind three advanced countries that had to seek IMF and EU assistance to deal with the crisis; Ireland, Iceland and Greece.

The forecasts used for these calculations are constantly being revised and the ranking of countries based on actual outcomes will certainly look different years from now. We can only hope that the current forecasts are too pessimistic although right now many revisions go in the wrong direction.

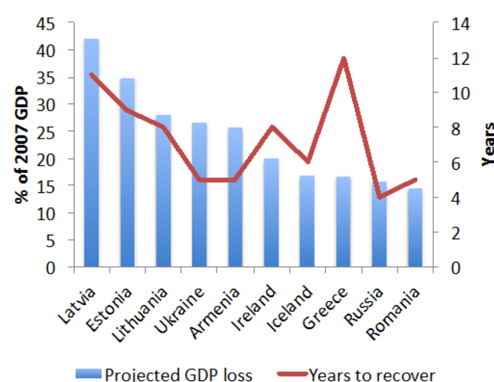


**Figure 3. "Top" ten worst output loss countries**

Could we have predicted what countries were hit in this crisis based on history? Based on the Becker and Mauro (2006) paper: Yes and no. "No" regarding the fact that overall, many advanced countries were hit this time. The paper found that in the past, the frequency of output collapses have decreased with the income level of countries, contrary to what has been the case this time. "Yes" for the fact that CEE and CIS countries where hit significantly more that other emerging markets since they were particularly vulnerable to the sudden stops and terms-of-trade shocks that the paper showed often are associated with severe output losses.

The signs of vulnerability in CEE and CIS countries were easy to see, but warnings ignored; the Baltic countries and Romania had double-digit current account deficits that

where to a large part financed by external debt. For example, current account deficits in Latvia passed 20 percent of GDP in some years, far beyond the 4-5 percent deficits some Asian countries had prior to the Asian crisis in 1997. Ukraine also had large current account deficits and concentrated (metal) exports on top of that, exposing the country to both sudden stops and terms-of-trade shocks.

Russia's dependency on energy and mineral exports was also well known, with 80 percent of export revenues coming from this source. However, the pre-crisis boom in oil and mineral prices had made Russian policy makers think this was a strength and not a vulnerability. On top of that, the strong external position of the government and central bank obscured the external financial vulnerabilities that had built up in the private sector. With the sharp decline in oil prices in the crisis, Russia was hit both by a terms-of-trade shock and a sudden stop in capital flows to the private sector.

There were of course individual countries in other regions that were showing vulnerabilities and were hit in the crisis, but the countries in the CEE and CIS region stood out as particularly vulnerable to the shocks that hit emerging market and developing countries in the past. The IMF's Global Financial Stability Report from October 2008 summarizes these vulnerabilities in its Table 1.5 on macro and financial indicators for emerging markets very well. The shaded boxes that indicate potential problems in the table completely dominated the picture for CEE and CIS countries whereas other regions looked significantly less vulnerable. In short, history told us what shocks matter and the vulnerability indicators clearly showed where the shocks would do most damage.

## Therapy 2.0

What are the policy lessons from this? Countries will always be subject to different types of shocks, and the question is how these shocks can best be absorbed to minimize the economic costs. In other words, what is the "therapy" needed to deal with these shocks? A key challenge is to find the policies and tools that strike the right balance between crisis prevention and high sustainable growth. Isolation to protect against external shocks is certainly not the answer.

Early warning systems (EWS) that identify vulnerabilities ahead of time and give policy makers time to reduce these vulnerabilities and thus avoid crisis is of course what everyone dreams of. The IMF and others have worked on various EWS models since the Mexican and Asian crises with mixed success (see Berg, Borensztein and Pattillo, 2005). With this crisis, the G20 and other groups of policy makers have made new calls for developing EWS, at times seemingly unaware of past efforts and the limited success in this area.

However, at the IMF the more formalized or mechanical EWS models are complemented with both bi-lateral and multilateral surveillance with the bulk of the findings made publicly available and communicated to relevant policy makers. These surveillance efforts contain much more information than more limited EWS models and also come with policy recommendation on how to deal with potential vulnerabilities.

There are of course limitations also with the surveillance by the IMF and other international and domestic organizations. First of all, they have to get it right and at the right time. This is far from trivial, not least because of our limited understanding of the links between the financial sector and the real economy. And even when the analysis gets it "right" in the sense of identifying vulnerabilities, it may take a long time before vulnerabilities translate into real problems and during this time, the analysis and recommended policies may seem misguided.

This is linked to the second major issue; to make relevant policy makers (politicians) listen to and take action on the advice. There is

a reason Reinhart and Rogoff called their book "This time is different" since this is often the response to warnings from the IMF and others that suggest a party has been going on for too long and the punch bowl needs to be taken away.

Given the limitations of early warnings and surveillance more generally, there remains a strong need to reduce vulnerabilities in a systematic manner and develop tools to deal with the crises that were not prevented. This will require both domestic measures and a strong commitment to international cooperation. The latter part is of course extremely important right now in order to find appropriate solutions (read debt resolutions) to the problems cross-border banking and capital flows have created. It will also be key in setting up the rules for the future: what capital requirements should banks have; (how) should financial transactions or institutions be taxed; how can cross-border supervision be made more efficient; what type of crisis resolution mechanisms should be put in place both at the international and regional levels; etc, etc. Unless there is broad international agreement on these issues they will do little to address the weaknesses that were at the heart of this crisis.

On the domestic side, the usual IMF recommendation of creating a stable macroeconomic environment—with fiscal room to maneuver and a monetary policy that leads to stable prices—is always going to be part of a countries ability to absorb shocks. For countries that are integrated in international financial markets, exchange rate flexibility and a reasonable level of international reserves seem to be advisable. Jeanne and Rancière (2008) analyze optimal foreign exchange reserves for countries that are subject to sudden stops. Becker (1999) instead looked at accumulation of government assets as part of an optimal public debt and asset management strategy in a world with bailouts of the private sector which seems particularly relevant today.

The macro side should of course be combined with strong domestic supervision of the financial sector; structural policies that lead to sustainable growth in a competitive global environment; and strategies in commodity exporters to reduce the vulnerabilities associated with a narrow export base.

Although advanced countries get most of the attention in the international financial press today, emerging market and developing countries should not think that this is a new world were the shocks of the past do not matter to them. They do, so better get ready for "shock therapy" the market way while there still is time.

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