Instability

Fundamentals say that there will be some variation and fluctuations in the prices and exchange rates over time. Speculations, in theory, should smooth out the fluctuations by buying low and selling high – that is, speculators should be stabilizing. But, in fact, they make the swing bigger: The yen was 170 to the dollar in 1991, 78 in 1995, 154 in 1999, 100 in 2000, and 116 today. Speculation doesn’t work like it supposed to because investors don’t have a 2-3 year time horizon. They can’t take losses for 2-3-4 years at a time.

Same sort of concept occurs in inventory control. In theory, the variance in production should be less than the variance in sales. However, the exact opposite has happened – production swings have gotten much bigger than sales variance. This is because businesses don’t have a 2-3 year horizon either. They have a short time horizon. Also, everyone thinks they will sell more than they actually do so the build production in anticipation. So they build up capacity and then investment dries up when sales aren’t borne out. Both of these factors drive instability into the system.

Historical examples of transition to capitalism

At the end of WWII, the western countries told the eastern countries that the transition to capitalism would be easy – that it would happen as a “spontaneous combustion”. However, this system is very hard to start – 75% of capitalistic countries in the world are failing.

Looking at Western Europe and Japan – they were trying to start capitalism at the end of WWII. This was difficult for them because they were at the end of a war and so had no money and their agriculture was completely destroyed. But they still had to somehow buy infrastructure from the U.S. In 1948, the U.S. adopted the Marshall Plan and gave these countries money to get started. But when Eastern Europe and Russia tried and failed in the late 80s, they believed it didn’t work.

With a disruptive technology, you have go down in terms of productivity before you can go up. This is very hard to do politically. Another problem with Russia is that 70% of the products came from one factory that had over 300,000 workers – capitalism can’t work on huge factories. This causes problems when countries breakup and such at the end of communism. At this time, Eastern Europe was similar to post-WWII-Europe: manufactured goods were of low quality and had no market value so they couldn’t sell them.
Why didn’t the U.S. have problems? We didn’t start with communism (we started with feudalism) so there was no transition.

Property Rights

For capitalism to work, a country needs private ownership of property. Establishing this ownership is often messy and bloody (think Native Americans) but in time, all things and practices become respectable. Without property rights (as in Russia), anyone selling anything is by definition a crook because they don’t own the things they are selling.

If you had to hand out property/companies in Russia, how do you do it?
1. Give it to the people working there → What do you give to the public servants (policemen and such)? How do you split it? What about the inequality of the plants? At this time there will be no investments so 85% of the factories in Russia need to be shut down because they won’t work. If only 15% of the factories work, people can’t hedge their risks against the failure of the company. Additionally, workers owning a company is not capitalism, it’s a cooperative.
2. Sell it → No one has any money – all the foreigners would end up buying it.
3. Give everyone a mutual fund to buy the companies they want (à la Czechoslovakia) – this isn’t capitalism either. Plus how do you then get rid of the corruption?

Let’s look at farming/agriculture: if the state previously owns everything, it’s a big commune. People have become specialized in their specific tasks. After a transition, no one knows how to be a real farmer. Additionally, there is no infrastructure for real farmers to sell their goods anyway. It becomes a chicken-egg problem as you need produce to get the infrastructure but no one will produce unless there is some infrastructure. (Marshall Plan tried to alleviate this.)

Communism to capitalism (in Russia)

What attitudes do you need for capitalism?
1. Search and hunt mentality.
2. Willingness to take risk.
3. Make bottom-up decisions (instead of top-down).
4. Have more inequality in incomes.
5. Let speculators get rich first (who stop inefficiencies but look bad doing it).

These are all cultural things that communists didn’t have. And in Russia, they were all communists because you had to be to get ahead. They were used to decisions being made from higher authorities. Some Russian government officials would deliberately sabotage reforms in order to save their own jobs.

In addition, communism had a company social welfare system (not country) in that your employer provided pensions, housing/maintenance, and health care. During transition, all these things collapsed including unemployment insurance (which didn’t exist).
Plant managers in communism were also used to rejecting orders from state because it really didn’t matter. When the companies privatized, they continued with the same attitude so things didn’t work. Managers in communism had a military mentality which doesn’t work in capitalism.

During transition, tax collection also breaks down because there is no method of collecting taxes (the government usually just took the plants’ incomes but that no longer works. Since it is such a huge task to implement a tax system, this results in huge budget deficits which only drives up inflation.

Other things that are needed when starting capitalism:

1. Incentives to start private savings (the government used to do it before).
2. Legal system and institutions to enforce contracts and such.
3. Interest rate system – no role for this in communism so this needs to be developed.

The incentives in communism are that you will succeed if you do a good job and be punished if you don’t. When the system disappears, so do these incentives – no more promotions or punishments. You need the incentives of capitalism to motivate people again. But if you are stuck in between the two, then you have no incentives at all and you’re stuck in a mess. How do you get out of it? It is hard to make people honest but one big thing that can be done is to establish property rights and do it fast (just give it to anyone and argue the fairness about it later). It’s important to do this as quickly as possible and to avoid regulation as this creates opportunities for corruption.

So should you do the transition fast or slow? A fast transition will lead to the right market incentives (these things depend on each other) but will also lead to huge shutdowns and massive unemployment. A slow transition, though, leads to more corruption and economic growth is usually incompatible with corruption.