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Price liberalization, monetary, and fiscal policies for transition economies: a Post Keynesian perspective

Abstract: *Post Keynesian economic analysis recommended a different reform program for transition economies than the orthodox model in the form of shock therapy implemented and imposed by the Washington consensus. In contrast to the dominant view, Post Keynesians recommended gradual price liberalization, which involved maintaining fixed prices and wages and subsidies, the establishment and maintenance of buffer stocks, government intervention to stimulate investment and incomes, and industry-incomes policies. With regard to monetary policy, Post Keynesians argued that a discretionary monetary policy was essential to reduce unemployment. With respect to fiscal policy, budget deficits were essential to maintain full employment.*

Key words: *monetary and fiscal policies, price liberalization, transition economies.*

The transition from a centrally administered to a market-based economy in the Commonwealth of Independent States (CIS) and Central and Eastern Europe has been characterized by a substantial reduction in output, increased unemployment, hyperinflation, corruption, and illegal activities. These results were due to the implementation of the orthodox policies, mainly in the form of shock therapy. These transition policies were inspired by the Washington consensus, under the principle of "one size fits all" (Cross and Strachan, 2001, p. 187; Kolodko, 1999, pp. 4, 22). The International Monetary Fund (IMF), the World Bank, and mature market economies made sure that shock therapy, the orthodox policies of the Washington consensus, consistent with the dominant worldwide view of free markets and free trade, were introduced by linking "foreign

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aid" with the carrying out of the orthodox policies. Lending by these organizations was renamed "assistance," despite the fact that they were commercial credits with tough accompanying terms, associated with liberalization, deregulation, and privatization. Many transition economies were left with no other choice but to fall into the hospitable but stern arms of the Washington consensus. In contrast, Balcerowicz (1995, p. 310), the architect of the shock therapy program in Poland, claimed that, in negotiations with the IMF, multilateral banks, and the Western governments, there was very little pressure exerted with respect to economic strategy that had to be adopted. This was because the Polish program of shock therapy was basically in line with the goals of these institutions. A reduction of debt depended on Poland's adoption of a comprehensive and radical economic program, which was allegedly "in any case required on domestic grounds" (ibid., p. 319).

This paper aims to offer an alternative policy formula of price liberalization, monetary, and fiscal policies for transition economies based on Post Keynesian economic analysis. The Post Keynesians recommended policies consistent with their ultimate goal of developing a civilized market society by achieving the objective of full employment (Davidson and Davidson, 1996; Marangos, 2000–2001). This would involve a specific set of policies, which are very different from the Washington consensus proposals implemented. It is demonstrated that the orthodox policies of the Washington consensus were not required to overcome transitional recession.

What is the Washington consensus?

In 1990, Williamson invented the term "Washington consensus" to refer to the lowest common denominator of policy advice being addressed by the Washington-based institutions to Latin American countries as of 1989 (Srinivasan, 2000, p. 265; Williamson, 2000, p. 251). It was a consensus achieved in Washington among the United States Treasury, the IMF, and the World Bank, as well as some influential think tanks, a prominent majority of academics, along with assorted editorialists (Kolodko, 1999, pp. 6–7; Naim, 2000, p. 91). The consensus argued that the policies to achieve economic growth in developing countries, as the experience of Latin America was interpreted, were: macroeconomic stability, liberalization, and privatization (Stiglitz, 2000, p. 13). It was assumed that fiscal discipline accompanied by deregulation, trade liberalization, and privatization would be sufficient to eliminate stagnation and launch economic growth in less developed countries and transition economies. The

fashionable opinion held that unfettered free markets, a reduced role for the state, and integration into the international economy provided the best modus operandi for development (Levinson, 2000, p. 11).

What inspired the Washington consensus? As the creator of the term explains , it originated from an attempt to answer a question posed to him by Hans Singer during a seminar at the Institute for Development Studies: "What were these 'sensible' policies that were pursued in Latin America?" (Williamson, 2000, p. 254, emphasis in original). Williamson emphasized that the Washington consensus, as he conceived it, was in principle geographically and historically specific, a lowest common denominator of the reforms that he judged "Washington" could agree were required in Latin America as of 1989. In spite of this, the Washington consensus has been accepted as common wisdom on policies for development and growth. The Washington consensus was applied to structural crisis in other countries including the transition economies of the CIS, Central and Eastern Europe, the newly industrialized economies, and the ailing advanced economies (Cross and Strachan, 2001, p. 182; Kolodko, 1999, pp. 4–5). In Table 1, the Washington consensus, together with the shock therapy policies, are contrasted with the policies recommended by the Post Keynesian framework.

The implementation of the Washington consensus had disastrous consequences for the transition economies. Independent of the inconsistencies associated with orthodox economics, there was an apparent contradiction between the foundation of the Washington consensus and the heritage of central planning. The Washington consensus was actually aiming at countries that already had a market economy and were not just in a transition to a market capitalist system. In contrast, the experience in transition economies revealed that market institutions and behavior were not already in place. In transition economies, institutions essential to a market economy were either distorted or did not exist, and market behavior was unfamiliar or immature. Market institutions had to be developed from scratch. Srinivasan argued, "it is common knowledge among economists" (2000, p. 266) that the outcome to any policy reform that operates through price incentives depended on non-price factors in the form of institutions.

The Post Keynesian alternative

In contrast to the shock therapy policies recommended by the Washington consensus, Post Keynesians advocated active government intervention in the development of market relations in transition economies. Post Keynesians strongly disagree with the Washington consensus that all

Table 1
Washington consensus, shock therapy, and Post Keynesian policies

Policies	Washington consensus	Shock therapy	Post Keynesianism
Price liberalization	Immediate price liberalization	Immediate price liberalization	Gradual price liberalization
Wage policy	Equilibrium market-determined wages	Tax-based wage policy (incomes policy)	Tax-based wage policy (incomes policy)
Privatization	Immediate privatization of all state enterprises Deregulation (abolish barriers to entry and exit)	Immediate privatization of all state enterprises Deregulation (abolish barriers to entry and exit)	Gradual privatization of state enterprises Maintaining barriers to entry and exit
Monetary policy	Independent central bank Immediate interest rate liberalization	Independent central bank Immediate interest rate liberalization	State-controlled central bank Gradual interest rate liberalization
Financial system	Privately owned banks	Privately owned banks	A combination of state-owned and privately owned banks
Fiscal policy	Balanced budget Neutral tax system	Small budget deficit financed by foreign aid or Treasury Bill market Neutral tax system	Budget deficit Discretionary expenditure policy and discretionary tax system
International trade	Free trade and fully convertible currency	Free trade and fully convertible currency	Clearing union
Initial conditions	One size fits all	One size fits all	Differences in socioeconomic background

governments can do is to produce oscillations from equilibrium positions and are unable to influence the long-run level of economic activity (Cardim de Carvalho, 1995–96, p. 159). Governments have an important role to play in development. They have to become more capable at managing liberalization, providing social protection, understanding and controlling risks, and building social capital (Levinson, 2000, p. 13). The schism between equity and efficiency in the orthodox model does not appear in Post Keynesian analysis. Both equity and efficiency can be achieved as long as there is a redefinition of the concepts of freedom and efficiency. Efficiency does not designate maximization of output at minimum cost, but, rather, the maximization of social welfare. This is due to the extensive nature of the externalities associated with production and consumption. "If it is necessary to give up a bit of market efficiency or a bit of aggregate income, in order to contain democracy-threatening uncertainty, then so be it" (Minsky, 1996, p. 364). Thus, the aim of economic policy should be the development of an open, democratic, civilized society, which should not be sacrificed for narrow efficiency considerations (Minsky and Whalen, 1996–97, p. 162).

What the Washington consensus failed to recognize was that the transition process did not only involve the development of markets but also the development of the state. State intervention ensured full employment, and the achievement of social goals and state property avoided market failure. In contrast to the Washington consensus, which recommended implementation of a tough stabilization package (as presented in Table 1), Post Keynesians proposed gradual liberalization. If the historical experience of the successful postwar reconstruction of Western Europe approximated the economic conditions of transition economies—which is doubtful—the successful policies adopted contradict those implemented in Russia and Eastern Europe. During the period of reconstruction, price ceiling and subsidies were maintained and economic planning was implemented. Monetary and fiscal reforms and policies were adopted and the European Payments Union was established, with the aim of restoring trade among countries. Exchange rates were controlled and capital flows restricted, and the United States provided financial and technical support under the Marshall Plan. Finally, markets were influenced and guided by an active state with the aim of supporting the initiatives of firms. The state was able to implement these policies only under a consensus process, which encouraged cooperation rather than conflict.

Ultimate success in transition economies depended on whether or not sufficient noneconomic conditions prevailed, and this included political,

ideological, and cultural dimensions, as the Post Keynesians argued. Russia and Eastern Europe were characterized by widely different civilizations, history, religion, and different levels of economic and political development. Consequently, the transition process was a path-dependent process that relied on the initial conditions, the policies initiated, and the external environment. Reform strategists in Washington should not, Post Keynesians argued, have ignored these factors. In the following, we concentrate on price liberalization, unemployment, monetary and fiscal policies, and the financial system.

Price liberalization and unemployment

The implementation of the orthodox transition models, whether in the form of shock therapy or gradualism, was based on Say's Law: the level of production was the result of the supply-side of the economy. Thus, it was essential to get the prices right from the beginning of the transition process. "Cutting wages and eliminating price distortions are the only means that the mainstream theory has in hand for driving the economy toward high employment" (Taylor, 1994, p. 72). What orthodox economists failed to recognize was that forces of aggregate demand, and not supply, determined the level of output and thus the level of employment (Davidson, 1994, p. 10).

In the labor market, the rigidity of wages was not the cause of unemployment. Wage or price flexibility was neither a necessary nor a sufficient condition for full employment equilibrium. Also, the aggregate supply constraint was neither necessary nor sufficient to explain unemployment (Davidson, 1992, p. 452; 1994, p. 291; Keynes, 1936, ch. 19). Flexible wages increased uncertainty, making planning laborious without having an influence on employment. Decreasing money wages resulted in a reduction of profit expectations (Davidson, 1994, p. 188). Thus, the volume of employment depended on aggregate demand factors, not on wage rates (Applebaum, 1979, pp. 106, 117).

For the orthodox economists, unemployment is always and only the outcome of wage or price fixity. For the Post Keynesians, the explanation of unemployment lies in the money market and not in the labor market (Dillard, 1987, p. 1633). Unemployment is a natural outcome of a money-using laissez-faire economy (Davidson, 1992, p. 452; 1994, p. 295). Orthodox economists, by assuming that Say's Law holds, only solve the unemployment problem by assumption and not by economic analysis. In a nonmonetary economy there is no rational explanation for the existence of unemployment (Davidson, 1994, p. 193; Dillard, 1987,

p. 1638). Meanwhile, in a nonergodic world, it is the existence of non-producible assets, such as money that is held for liquidity purposes for which producible goods are not substitutes, that is the cause of involuntary unemployment (Davidson, 1994, p. 27). "Paraphrasing Keynes one could say that liquidity preference has to do with an urge for inaction, rather than action" (Dequech, 1999, p. 415). Keynes argued that those orthodox economists who relied on rigidities to explain unemployment were "weaker spirits" whose "common sense cannot help breaking in—with injury to their logical consistency" (1936, p. 192).

During the transition process, there should not have been concern over "equilibrium" prices, because transition reforms took place in a state of disequilibrium. Orthodox transition models were based on an obsession with static efficiency, whereas the transition process was a dynamic phenomenon, which made orthodox economics irrelevant. "Nothing stands still, the system moves on, and the future is always different from the past" (Peterson, 1996, p. 157). Consequently, it was questionable whether the immediate freeing of prices would stimulate growth. The restructuring of the economy and the reallocation of resources takes some time. It was better to have enterprises operating, even though they were inefficient, and give them the opportunity to become efficient, rather than close them through immediate price liberalization. Freeing prices encouraged speculation, which did not stimulate increases in output. In addition, it was questionable whether immediate price liberalization would increase efficiency. Thus, in the presence of very rapid inflation, flexible prices would be no better than fixed prices in achieving an efficient resource allocation. Restructuring and reallocation of resources stimulated efficiency due to influential noneconomic factors such as expectations and political stability, as well as free price signals. Actually, the enterprises' response to shock therapy was very different from the orthodox adjustment process. Enterprises reduced output, but did not improve their efficiency and increased prices based on a markup pricing scheme (Kuznetsov, 1992, pp. 475–476). In reality, due to the implementation of the shock therapy model, the mechanism of self-correction for the misallocation of resources has not been created (Yavlinsky and Braguinsky, 1994, p. 97).

In the orthodox transition models, investment decisions were based on smooth production functions that assumed that the economic actors could view the production process as a sequence of infinitely divided factors of production. Perfect knowledge, realized expectations, and perfect competition were equally important. Meanwhile, in fact, investment takes place in an environment of not-so-smooth production functions, imperfect

knowledge, divergence of expectations, collusion, market domination, and government assistance programs. In such an environment, the experience of the transition economies revealed that economic growth was not inevitable. Investment depended on long-term expectations about the future, that is, on expected and actual profitability, expected and actual growth of demand, availability and cost of finance, and capacity utilization (Arestis and Sawyer, 1993, p. 13; Shapiro, 1977, p. 542). All these factors could be summed up as the "animal spirits" of the entrepreneurs. The institutional environment in which firms make decisions determines animal spirits. Subjective and psychological elements also influence animal spirits, which are partially endogenous and partially exogenous (Dequech, 1999, p. 421).

The transition process was a nonergodic process because neither the result nor the relevant probability distributions could have been deduced from the past. In addition to the uncertainty associated with the normal functioning of the market, the transition process gave rise to "transition uncertainty," due to institutional and systematic transformation, the behavioral inheritance of the past, and political and social changes (Lah and Susjan, 1999, p. 591). The traditional notion of rationality (optimal positions are always calculable) was irrelevant. The procedural notion of rationality (the limited ability to process information) was relevant for transition economies due to the inability of individuals to process information accurately under transition uncertainty. In addition, the Washington consensus policies in the form of shock therapy increased rather than reduced uncertainty (Yavlinsky and Braguinsky, 1994, p. 93). The uncontrolled and "rushed" approach created an environment that was not conducive to structural, institutional, and financial reform. The instability created in conjunction with immediate price liberalization, reduced rather than increased investment. The best solution under the circumstances for economic actors was to wait. Whereas the private cost of waiting was low, the social cost was very high in terms of employment and economic growth. Such economic conditions required government intervention, as there was obviously market failure in the provision of information. Price signals were not able to reduce uncertainty.

Due to uncertainty, investment was reduced, exaggerating the reduction in aggregate demand, which in turn reduced output and increased inflation and unemployment. There was a "capital strike" (Crotty, 1980, p. 25; Taylor, 1994, p. 65). In such circumstances, it was the role of the government to intervene and stimulate the economy with public investment (Kuznetsov, 1992, p. 475). Public investment would also crowd in private investment by reducing production costs and creating a favor-

able investment climate. As a result, wage income would grow, stimulating noninflationary growth in consumption.

In the Kaleckian and Keynesian traditions, savings adjust to investment, rather than the reverse, which is assumed in orthodox theory. Thus, credit has to be created to finance investment ahead of the generation of the corresponding saving. Due to the endogenous nature of money, credit is created by the banking system. A high proportion of profits are saved, and such profits form a substantial part of total savings. Hence, there is a close link between profits, savings, and investment (Arestis and Sawyer, 1993, p. 12). "The investment market can become congested through a shortage of cash. It can never become congested through a shortage of savings" (Davidson, 1994, p. 132). There is empirical support for the proposition that savings do not stimulate investment. Almost all corporate investment is financed out of retained corporate profits, whereas net household savings is close to zero and, in addition, households mainly lend to each other in aggregate (Asimakopulos, 1979, p. 64; Palley, 1998, p. 100). In transition economies, the banking system was not familiar with the new economic conditions and was unable to create the necessary credit to ensure the endogeneity of money. Profits were not adequate to provide savings due to the substantial reduction in output as a result of free prices, or were spent on imports or deposited in foreign banks. Savings were not available from the previous generation because there had been no savings incentives under the previous economic structure. As a result, the government had to appropriate and direct savings into productive investment. Such mobilization of savings could only take place via state-run development functions of the transition government (Kuznetsov, 1992, p. 490). In addition, Post Keynesians believed it was the responsibility of the government to use discretionary measures to ensure the viability of the enterprises before and after privatization. The government should assist and equip enterprises with the essential internal structure necessary to survive the competitive market process (Davidson and Davidson, 1996, p. 215). As Bucknall proposed, "the Russian experience suggests that privatisation first is not the best way to proceed" (1997, p. 12).

The transition process, based on price liberalization, resulted in faster increases in prices than in wages due to the monopoly power of firms. Labor was not able to respond by using trade unions because either they did not exist or they were inexperienced at negotiating due to their purely administrative function under the previous regime. Consequently, immediate price liberalization resulted in inflationary processes as economic actors attempted to use whatever market power they possessed to raise

their prices in self-protection (Taylor, 1994, p. 67). As a result, there was a redistribution of income from labor and pensioners to the new capitalist class. Under the assumption of a low marginal propensity to consume out of profits, there was a reduction in aggregate demand, with all the negative consequences. Aggregate demand reduction through wage cuts and increasing prices was an essential part of the shock therapy model.

Thus, the Post Keynesians argued that it was not desirable to remove price controls and subsidies immediately. What the orthodox transition models did not recognize was that, due to the highly monopolistic structure of the market, prices were determined by a markup pricing scheme. Enterprises in mature market economies implement pricing procedures based on normal cost and target rate of return (Lee, 1996, p. 91). Likewise, enterprises under central administration applied markup pricing. There was no reason for enterprises to change their pricing policy with the introduction of market relations. Kuznetsov (1992, p. 481) argued that, as the market sectors with markup pricing were dominant, this would cause the Soviet economy, for example, to stagnate. Flexibility in prices is achieved by flexibility in markups. Whenever firms are required to increase investment and lack the internal funds, they increase prices by raising markups (Kregel, 1979, p. 56). Profit maximization is not the ultimate goal; rather, firms aim to generate enough internal funds to finance planned investment, subject to some minimum profit constraints (Kenyon, 1979, pp. 37–38). Prices are not linked with current demand but with future demand, which helps determine investment expenditure sufficient to satisfy such forecasts.

Hence, Post Keynesians maintained that prices had to be controlled for basic goods such as consumer and producer necessities, wages, energy, credit, and foreign exchange. Any removal of controls should coincide with the elimination of imbalances. Price controls would have created the necessary environment for restructuring. However, such a difficult task would have required the establishment of social consensus based on broad social cooperation. In this way the state, the political parties, and representative organizations would have gained political legitimacy, authority, and support. However, this would have necessitated discretion and intervention, which the shock therapy supporters opposed.

State-administered prices would have restricted abuse of power by monopolies. It would have been necessary to provide assistance to new firms unable to compete effectively with existing firms, which enjoyed monopoly power. Assistance had to be in the form of infrastructure and institutional support, and lowering costs of inputs. According to Peterson, "an infrastructure investment program is good economics" (1996, p. 166).

It was the responsibility of the government to identify industries requiring assistance and regions suffering from severe social problems, and they should have been given the best opportunities to attract investment (Sutela, 1992, p. 87). These policies could be part of an industry policy designed to stimulate demand and encourage access to capital, skill, and infrastructure enhancement. Funding for such an investment infrastructure program could be provided by foreign aid, a Treasury bill market, or through the maintenance of state-owned enterprises that generated tax revenue on their profits and would no longer be "subsidy-guzzling dinosaurs" (Taylor, 1994, p. 77).

Inflation was an immediate problem faced by transition economies as a result of introducing market relations. The negative consequences of inflation, and especially hyperinflation, were that it disorganized and destabilized the economy, encouraged speculation, and discouraged investment. The shock therapy approach favored liberalizing prices immediately, under conditions of macroeconomic disequilibrium, while still having effectively soft budget constraints and a monopolistic structure. The Post Keynesians argued that these policies could only breed inflation. What orthodox economists did not realize was that inflation was not necessarily the result of "excess demand," but rather arose from a fundamental conflict over the distribution of income. Conventional instruments of fiscal and monetary policy per se could not control inflation. "The control of inflation requires something more than control of the stock of money (even assuming that such control were possible)" (Arestis et al., 1999, p. 541). The shock therapy supporters recommended severe fiscal and monetary policies with the aim of reducing inflation. Nevertheless, there was a great social cost in the form of high and persistent unemployment, reduced capacity utilization, and low economic growth (Davidson, 1994, p. 154). In such circumstances, it was irrational to initiate immediate price liberalization (Ellman, 1994, p. 12). Meanwhile, the Post Keynesians favored an incomes policy together with price controls, increased imports, and a buffer stock policy for important resources and agricultural products to ensure adequate supply and price stability in the long term.

The reduction in inflation in transition economies was not the result of the severe fiscal and monetary policies adopted, but rather the outcome of incomes policies. Surprisingly, Sachs and Lipton (1990, p. 56) recommended, in line with the Post Keynesian propositions and in contrast to the Washington consensus, that at the beginning of the reform program the government should introduce a tax-based wage policy. A tax-based wage policy would encourage wage rises below the increase in

inflation to avoid a wage–price spiral due to hyperinflation. For example, the Polish government, which implemented shock therapy, imposed penalties on wage increases, the so-called *popiwek* under which wages were to increase by 30 percent of the monthly inflation rate in January 1990 and 20 percent thereafter. Enterprises conceding wage increases above the norm were heavily taxed (Balcerowicz et al., 1997, p. 138). Fischer and Sahay (2000, p. 5) argued that the performance of transition economies in reducing inflation has been impressive across the board. Nevertheless, they did not mention or recognize the contribution that income policies had in successfully combating inflation across transition economies, as the Post Keynesians recommended.

According to Post Keynesians, the Washington consensus adjustment process in the form of shock therapy led to substantial price increases, and output reductions caused a lengthy stagnation, effectively postponing any form of restructuring of the economy (Yavlinsky and Braguinsky, 1994, p. 104). In contrast, the Post Keynesians recommended the gradual liberalization of prices, the establishment and maintenance of buffer stocks, government intervention to stimulate investment and incomes, and industry and incomes policies to maintain noninflationary full employment.

Monetary policy and the financial system

The new economic conditions required the development of a two-tiered banking system comprising the central bank, which prints money and controls the stock of money, and the private banking sector, which accepts deposits and provides credit. For the orthodox economists, the central bank had to establish credit targets to hold overall money growth to levels consistent with the rapid elimination of inflation. This is because, for them, inflation is a monetary phenomenon. The quantity theory of money states that the monthly rate of inflation is equal to the rate of growth of the money supply minus the rate of growth in output. Therefore, monetary policy should have followed a specific rule: that is, increase the money supply in line with the increase in real output. Åslund stated, “the evidence is clear: the quantity theory of money is applicable in Russia, too” (1995, p. 220). In this way, for the orthodox economists, the danger of inflation would have been reduced. This was possible only by establishing an independent central bank with the aforementioned rule stated in the constitution.

In contrast to the orthodox economists who consider money to be neutral, the Post Keynesians view money as “a dominant—if not the single

most important—institution in systems of market capitalism" (Peterson, 1996, p. 157). Money is not just a medium of exchange and a measure of value but also a store of value, which, in a monetary economy, individuals value more than income itself; it is a means of limiting losses in a profit-and-loss economy (Dillard, 1987, p. 1645). Most important, in contrast to Friedman's point of view, money as a nonproducible asset, which people hold for liquidity purposes, cannot be substituted for producible goods or assets. Money, consistent with Keynes, has two special characteristics: a zero elasticity of production and near-zero elasticity of substitution (Davidson, 1972; Keynes, 1936). These two characteristics, together with Keynesian uncertainty, ensure money cannot be neutral. When the future looks bleak, people want more liquidity and demand for money increases. The increase in the demand for money does not stimulate an increase in the production of money, and, since there are no close substitutes, the increase in demand for liquidity cannot be met.

The Post Keynesians believe that nonneutrality of money and endogenous money supply are crucial in inducing changes in the real sector (Davidson, 1994, p. 128). Nonneutrality of money exists under both flexible and sticky wages and prices (Davidson, 1992, p. 455). "This is absolutely unthinkable under the monetarist paradigm but quite natural in other frameworks of economic analysis" (Yavlinsky and Braguinsky, 1994, p. 100). This is because orthodox economics does not have a theory of money and so is not applicable to the real world (Wray, 1996, p. 141). Orthodox economists, by assuming that money is neutral, at least in the long run, divide the economy between real and money sectors. For the Post Keynesians, by rejecting the neutrality of money, it is impossible to split the market economy between the real and monetary sector (Minsky, 1996, p. 361). Monetary policy is extremely important since it has implications for income distribution (Arestis and Howells, 1992, p. 137). Post Keynesians propose that monetary policy, money, and finance were integral in understanding the economy (Arestis and Sawyer, 1993, p. 18; Cardim de Carvalho, 1995–96, p. 173).

For an entrepreneurial economy, production is always monetary production under uncertainty, and money can never be neutral in an economy that operates in historical time. Consequently, Post Keynesians require an active domestic and international monetary policy (Wray, 1996, p. 129). In the Keynes–Kalecki–Kaldor tradition, investment is an exogenous factor. It cannot be represented as a stable, downward-sloping function of the interest rate (Crotty, 1980, p. 22). The autonomy of investment is possible because of the credit system from which firms can borrow. Investment determines how much credit firms seek from outside sources.

Credit often comes from the banking system, which leads to the creation of money. Bank credit is accepted under the usual law of contracts—contracts are the essence of any entrepreneurial economy—as the means of contractual settlement that is money. Furthermore, a supplier of investment goods may grant credit, for example, to the purchaser; however, trade credit is not considered part of the money supply. Thus, the level of credit taken on by the firm is determined by, rather than being the determinant of, the level of investment. Essentially, the stock of money, in contrast to the monetarist view, is endogenous; as long as banks are willing and able to supply additional credit to all borrowers at the current interest rate. It is determined by the level of investment, which also implies that investment takes place independently from the level of current savings (Moore, 1979, p. 128). However, banks and financial institutions may be short of liquidity as a result of monetary tightening initiated by the central bank, or by banks unwilling to lend due to excessive risk. Firms may also be constrained by a low level of corporate cash flow (Palley, 1998, p. 100). The endogeneity of money as a result of credit provided by financial institutions is central to the Post Keynesian view of the economic world (Howells and Hussein, 1999, p. 441). Money responds to the needs of production through the credit provided by the banks. The central bank determines the rediscount rate, and the banks provide loans to creditworthy customers at the rediscount rate, plus a risk-related markup. New loans create new deposits.

With respect to the financial structure, the orthodox transition models examined the problem of transition in the context of a hard budget constraint. The budget constraint is the sum of financial resources available to the decision-maker, which places a constraint on spending. However, firms under central administration encounter a soft budget constraint, instead of the hard budget constraint. Whenever a socialist firm was in the red, the central authority would bail it out with financial assistance in the form of subsidies, reduced taxation, provision of credit, or increased administered prices (Kornai, 1992, pp. 140–145). For the orthodox economists, a soft budget constraint would violate the concept of relative scarcity, a fundamental aspect of the market process. The recommended hard budget constraint was based on the assumption that savings determine investment and also that Say's Law applied (Szego, 1991, p. 330). Experience, however, showed that the introduction of a hard liquidity constraint, especially for state-owned enterprises, did not establish a hard budget constraint. Interfirm credit and bank credit increased substantially during transition. In Poland, interfirm credit in early 1990 was more than double the volume of bank credit for working capital (Calvo

and Frenkel, 1991, p. 140). The increase in bank credit was the result of the absence of a banking regulatory framework. The establishment of "independent" central banks did not alleviate the problem since they were only independent on paper. The central bank simply provided credit to the transition government, while the transition government provided credit to enterprises.

For the Post Keynesians, the central bank should not be independent, as the orthodox transition models perceived, because this would require the central bank to formulate monetary policy independent of civic values, which requires full employment. "The tendency toward independent central banking (both at national and international levels) can be seen as a rejection of the spirit of Keynes since it has become associated with the idea that the control of inflation must dominate other macroeconomic policy objectives" (Arestis and Bain, 1995, p. 161). An independent central bank model did not allow governments to use the money supply to fund budget deficits (ibid., p. 163). Thus, the only option available to transition economies was to reduce the budget deficit by reducing government expenditure in an environment of preexisting high social transition costs. The theoretical and empirical suggestion of the link between independence of the central bank and price stability is the result of very restrictive assumptions, based on very strong and narrow views of how the economy operates (Cardim de Carvalho, 1995–96, pp. 170, 173; Grabel, 2000, p. 6). In addition, banking innovations have undermined monetary targeting. Hence, the Post Keynesians recommended government intervention to establish a healthy financial system, which facilitated restructuring. This required some banks to be state-owned.

Fiscal policy

The Washington consensus stipulated that the reduction of large budget deficits was required in order to eliminate hyperinflation. For the Washington consensus, the budget deficit was the main source of money creation and hence inflation. The reduction of the budget deficit and the achievement of a balanced budget were at the top of the agenda for the economic reform program. Sachs (1994, p. 6) argued that while reducing the budget deficit could reduce inflation, altering the way in which the deficit was financed could also decrease it. Inasmuch as the budget deficit was financed by foreign resources (such as foreign borrowings, grants aid) or by domestic borrowing (by the creation of a Treasury bill market), it would not have resulted in inflation. The advantage of the Treasury bill market would have allowed flexibility in

fiscal and anti-inflationary policy by permitting the government to borrow from domestic investors rather than printing money. Consequently, Sachs argued, in contrast to the Washington consensus, that it was possible to have low inflation and a small budget deficit, which could have financed the necessary social programs.

The insistence of the IMF on budget cuts rather than deficit-financing did not allow aid to be used to finance budget deficits (Martinez-Vazquez et al., 2001, p. 503; Sachs, 1994, p. 8). In fact, IMF aid was conditional on reducing budget deficits. For example, whereas the Russian government revealed that it would like to sell bonds to finance the budget deficit, the IMF showed no interest in this proposal or in providing the necessary resources for the establishment of a functioning capital market (Sachs, 1994, p. 9). An internal capital market would have reduced the heavy reliance of transition economies on the IMF. Due to the refusal of the IMF, the idea was abandoned. In summary, it is extremely difficult to finance budget deficits without a functioning domestic and international capital market.

The transition economies have suffered from chronic fiscal problems. Private enterprises have excelled at avoiding tax, especially under the current inadequate institutional structure. Depression has accompanied privatization, inhibiting any increase in tax revenue. Hence, Post Keynesians argued that to achieve a successful transformation, transition economies had to take into account the revenue factors when considering such policy areas as privatization and foreign trade. A system where "only the stupid pay taxes," the contracts are not executed as agreed, or the payments are not made on time can hardly be called a market economy. For Kolodko "it is rather chaos stemming from institutional disintegration" (1999, p. 16). For example, the Russian government is weak and unable to collect due taxes not because of the legacy from the centrally administered socialism but owing to an ill-advised Washington consensus of deregulation and privatization. At present it is very difficult for the sovereign new state to have some meaningful control of economic affairs because of mismanaged liberalization and the manner the institutional redesign occurred (Kolodko, 1999, p. 17).

Aggregate demand is the key policy instrument in influencing the economic activity in a market economy (Peterson, 1996, p. 163). Post Keynesians argue that the level of aggregate demand determined by individual actions is insufficient to create full employment at the going real wage. It is the responsibility of the government to adjust aggregate demand to the level of full employment since in a decentralized market there are no automatic mechanisms to ensure an appropriate level of

aggregate demand (Arestis et al., 1999, p. 541; Davidson, 1992, p. 456; 1994, p. 82). Thus, budget deficits during recessions, as in the transition case, were essential to maintain full employment. However, these budget deficits should be the result of productive government expenditure on private–public infrastructure development in order to stimulate employment and thus promote a civilized society. The deficits should not be due to reductions in taxes such as the Reagan supply-side deficits. Increasing investment is much more effective than increasing consumption; this is because investment directly influences aggregate supply and consumption indirectly (Hudson, 1999, p. 676). Davidson (1994, p. 79) and Davidson and Davidson (1996, p. 503) characterize government fiscal policy as the "balancing wheel." This recommendation was in contrast to the orthodox-dominated international institutions' proposal, which imposed the shock therapy approach. The IMF and the World Bank's conditioned loans were based on reducing government expenditure and substantially reducing the budget deficit.

For the Post Keynesians, the development of a tax system should be based not only on revenue considerations but also on the social and cultural background of the society. There is a definite link between tax compliance and civic values (ibid., pp. 91–92). In a civilized society, there is a conscious payment of taxes by members of the society, and noncompliance is not considered an alternative. Noncompliance is the result of the diminishing role of civic values in a society. In these circumstances, the discussion of whether or not to pay taxes comes under scrutiny as a result of "rational" computation associated with the benefits and costs of deceiving. In addition, enforcement mechanisms for noncompliance will be ineffective as long as there is an imbalance between self-interest and civic values. Simplicity of the tax system encourages compliance. The development of a civilized society in the transition economies would have encouraged taxpaying norms consistent with civic values whereby individuals would have to pay their taxes as part of their moral duty. "In a civilised society where civic values and self-interest flourish, the citizens must be willing not only to die for their country but also to pay for it" (ibid., p. 217). This perception of taxpaying norms was in contrast to the orthodox transition model, in which individuals were not motivated by moral duty but rather by self-interest and according to which it would have been impossible to increase tax compliance. Taxpaying norms appropriate for a civilized market economy required a radical transformation of behavior by individuals previously under a centrally administered structure. This was in line with the goal of developing a society based on civic values.

Conclusion

Post Keynesian economic analysis recommended a different reform program for transition economies than the orthodox program implemented and imposed by the IMF, the World Bank, and mature market economies in the form of shock therapy as recommended by the Washington consensus. In contrast to the dominant view, Post Keynesians recommended a gradual price liberalization, which involved maintaining fixed prices and wages and subsidies, the establishment and maintenance of buffer stocks, government intervention to stimulate investment and incomes, and industry-incomes policies. With regard to monetary policy, Post Keynesians argued that a discretionary monetary policy was essential to reduce unemployment. This can only be possible by establishing a state-controlled central bank and maintaining government-owned banks competing with private banks. Government intervention was crucial to establish a healthy financial system, which facilitated restructuring. With respect to fiscal policy, budget deficits were essential to maintain full employment. Taxpaying norms appropriate for a market economy required a radical transformation of behavior by individuals; this can only be achieved by state-developed incentives. The policy recommendations of Post Keynesians with regard to price liberalization and monetary and fiscal policies did not require an immediate and radical change. Hence, transition costs would have been reduced and corruption and illegal activities minimized by developing a civilized society, which is the ultimate goal of Post Keynesians for both mature market and transition economies. Alfred Marshall once said that short words are usually bad economics (Naim, 2000, p. 90). This is all the more true for the "Washington consensus."

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