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Introduction to Macroeconomics

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Macro Economics Shock Therapy: Chile's Success Story?

In this paper, I will review selected literature discussing economics shock therapy and gradualism, and briefly address the question *did shock therapy work for Chile?* John Marangos explains shock therapy as a means to transform an economy into a "free market economy." He notes that the neoclassical theory of macroeconomics shock therapy entails measures of

[Immediate] price liberalization, ... privatization, ... development of the necessary institutions, ... establishment of an independent central bank, ... privatization of state banks, ... achievement of a balanced budget, the immediate introduction of free trade, and a fully convertible flexible currency.

Marangos mentions Poland's "stabilization and liberalization program" of the 1990s, and comments that several countries of the former soviet block used shock therapy, too. Bolivia's efforts to counter hyperinflation and Germany's "dramatic" elimination of price controls after World War II (Commanding Heights) are additional examples. The contrasting economics theory is "gradualism." The Oxford dictionary explains the term as a "principle or method of gradual as opposed to immediate *change*." When the U.S. Federal Reserve implements measures to stimulate interest rates (Rosenberg), it employs gradualism.

James Cypher observes that the University of Chicago received praise for helping Chile's government shape economic reforms. In the 1970s, they began overhauling the country's economy with shock therapy methods. Cypher contends they "failed spectacularly" and that

"Antitheses" to the shock therapy theories exist. He cites the economist Karl Polanyi, who argues that capitalism is a "historical anomaly" (Karl Polanyi, 1886-1964). Polanyi believes that capitalism changed human relations. Previously, social interaction determined economics actions. This relationship, Polanyi argues, reversed and economics needs now determine social interaction. Cypher, referring to England's industrial revolution, explains:

[Safeguards] and underlying support mechanisms of feudalism were swept away, ... working class and the middle class commenced a long and successful struggle to create institutions under capitalism which would grant a degree of social stability and security to the human participants in the new capitalist society. Thus, through the creation of trade unions and political organizations ... many of the most egregious excesses of early capitalism were curbed.

This means that government policy changes must fail when people establish movements opposing the policies. Movements establish when government action results in consequences contradictory to human needs and behavior. Cypher concludes that Chile's shock therapy measures could only be effective because of a –at the time– distinctive political and social landscape. The dictatorship created an artificial sense of stability through rigid government control over the economy and society. Shock therapy measures had impact as long as the government remained in power and enforced them radically. Their effectiveness changed as the regime came under more pressure. Figure 1 on page 3 visualizes the relationship between shock-therapy-impact and political control. The former loses momentum as the latter increases.

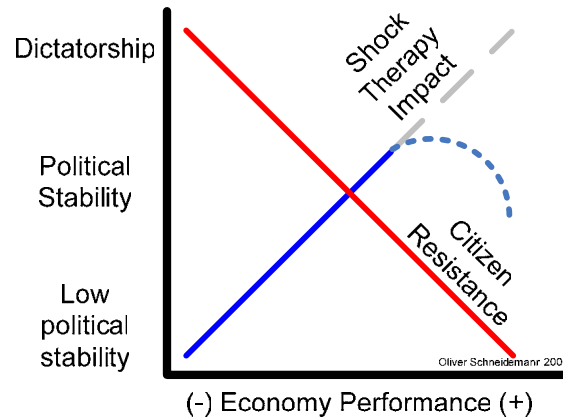


Figure 1: Political Control and Shock Therapy

Cypher writes that the "fictitious Utopia of the free market" was short-lived in Chile.

Marangos reviews economics shock therapy measures in Eastern European countries and comes to an identical conclusion:

The ... shock therapy model was short lived. Despite the substantial initial support for governments initiating the process in transition economies, ... undesirable outcomes resulted, such as unemployment and inflation. This led to the unpopularity of the governments. High inflation and unemployment caused social and political instability and threatened the fragile democratic governments.

To sum up: changes to government economics policies aim at improving a nation's economy. Shock therapy symbolizes initiatives that neutralize time lags affecting the effectiveness of these policy changes. Shock therapy impact increases with political control and stability, before losing momentum. But is there a phenomenon such as *gradual shocks*? For example, was Germany's abolishment of price controls "over a weekend" (Commanding Heights) shock therapy? Or was this merely a *gradual* step in a series of substantial measures implemented in sequence throughout an extended period of time? Marangos closes his paper noting that shock therapy was never implemented. He believes that shock therapy is just a

"gradual process of transition." Vivek Dehejia criticizes the widespread polarized perspective on economics theory. He suggests that economics policies should follow a situational approach. His paper also indirectly points to Polanyi when he discusses "adjustment costs," which influence economics policy success. Dehejia associates these costs with people's agreeableness to change:

[There] exists a critical level of adjustment costs ... If costs are greater than this critical level, [workers] will prefer the status quo to shock therapy; and if costs are less than this critical level, they will prefer shock therapy to the status quo. The intuition is transparent: with large adjustment costs ... the shortrun [sic] losses from reform will dominate the long-run gains, which materialize rather late, and the status quo will be preferable to shock therapy; whereas, with small adjustment costs and rapid adjustment, the long run gains are realized early enough to dominate the short-run losses.

Marangos, Cypher, and Dehejia reason analogously: consent is material to policy. Not the policy facilitates successful long-term change; it is the people that carry it.

Social Consequences

Economies are too complex to use simplistic descriptive policy-labels. Whether a policy is shocking, gradual or a gradual shock is subjected to individual assessment. Judgments vary depending on constituency's perspectives and self-interests. Labels for policies should therefore not be our greatest concern. A better understanding of the social consequences of economics policies and technology innovation is vital. Evolving information technologies augment the society-dissolving effect of capitalism described by Polanyi. Postman, for example, suggests that television programs instigate "a type of discourse that abandons logic, reason, sequence and rules of contradiction" (p. 105). Mobile phones, in addition, bring about a society that "[increases its]

interaction while reducing intimacy" (Eitzen). This signifies that, as we already communicate for the wrong reasons due to economics needs, pervasive information technologies then deflate the substance of the communication. Given their interconnectedness, governments and societies should therefore evaluate economics *and* technology in conjunction with *quality of human life*. Hirschberg, Maasoumi, and Slottje write, "well-being is the central question of macroeconomic policy that requires a better understanding of the dynamic evolution of income as well as other indicators." They provide a framework with 15 measuring-points, shown in Table 1:

"Indicators"	
"[Per] capita Gross Domestic product"	"[Number] of telephones per 1000 people"
"[Inverse] of the Infant Mortality Rate"	"[Number] of households with radio receivers"
"[Life] expectancies for males and females"	"[Inverse] murder rate"
"[Employment] rate"	"[%] of children ages 5 to 17 enrolled in school"
"[Mean] income per household"	"[Circulation] of daily newspapers per capita"
"[Number] of physicians for ... 1 million people"	"[Annual] rate of real GNP growth"
"[Number] of ... highway miles per capita"	"[%] of GNP not for defence [sic] expenditures"

Table 1: Hirschberg, Maasoumi, and Slottje Indicators

Maasoumi et al suggest analyzing data using a "cluster analysis approach." They group comparable attributes used to measure data and establish "distance" metrics introducing a layer of 'weight' between members of a group. Commentary about actual findings is absent in their work, even though they use the United States as a reference. It remains to be seen whether such level of detailed thresholds measuring society-condition will be applied more often. Yet, criteria such as 'number of orphaned children', 'number of single-parent households', and '*change* in number of underage welfare-recipients' should be added. Children are our future. Any measurement of society therefore should consider how *they* do.

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