Understanding ‘Shock Therapy’

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SOCIAL MARKET FOUNDATION
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I. Introduction

A substantial number of countries of Eastern Europe and the Former Soviet Union are now engaged in economic 'shock therapy,' meaning a rapid change to private ownership, market institutions, and international economic integration. Poland led the way on January 1, 1990, with the first comprehensive reform program. Czechoslovakia was second, with a comprehensive program that began on January 1, 1991. Exactly one year later, Russia led the former Soviet Union into market reforms. Estonia and Slovenia are other exemplars of shock therapy. While the reforms in Russia and several other countries (e.g. Bulgaria and Romania) have lacked the coherence and speed of shock therapy, the introduction of market institutions in these countries has nevertheless been very rapid, despite intense political opposition. A few countries, notably Belarus and Ukraine, have failed to carry out even rudimentary reforms, and some other countries that sit on the fault lines of the old Soviet empire — Armenia, Georgia, Tadjikistan — are in armed conflict.

The staying power of 'shock therapy' reforms in the midst of deep political conflict is a measure of the depth of forces at play in pushing the economic reforms forward. Radical market reforms have gone much faster and further than most observers felt likely at the start of the process. In just four years, Poland went from being a communists-era basket case of hyperinflation and collapsing production, to becoming the fastest growing country in Europe in 1993, with a market economy now dominated by private ownership, and Poland's successful turnaround is now being emulated in several other countries. Even the electoral successes of political parties that emerged from the old communist parties, as in Poland in September 1993 or Russia in December 1993, have not been followed by reversals of the reforms. Quite the contrary, both the Polish and Russian Governments have recently declared their intention to intensify market reforms, taking as their base the programs of the preceding governments.

While shock therapy continues to be the dominant strategy of economic reform today, it has had a harder time in some quarters of Western public opinion. A important case in point is Dr. John Gray's (1994) widely discussed essay on 'Post-Communist Societies in Transition: A Social Market Perspective.' Dr. Gray pillories the radical market reforms as 'utopian,' 'ill-conceived,' 'history-blind,'
'agonizing,' 'crude and monistic,' a 'recipe for the shipwreck of the project of market reform itself,' in short, a conception condemned to 'incomprehension and impotence.' He criticizes the proponents of these programs as 'purblind and fundamentalist,' and 'betray[ing] an ignorance of [Western] history that is staggering.'

Dr. Gray's assault on the reformers, the reforms, and the economic and political results of these programs, can be dismissed as a straightforward misreading, or more likely non-reading, of the evidence. He seems to hold himself immune from the need to examine and present quantitative evidence in support of his swingeing attacks. Nor does he attempt to show that the reform governments in Eastern Europe and the former Soviet Union have better options available to them. He seriously misjudges the motivations, strategies, and historical underpinnings of the reforms, believing that market reforms are animated by a band of wild-eyed libertarian Anglo-Saxons intent on creating a utopian Eastern Kingdom of Hayek. This is a certainly a remarkable distillation of reform programs such as Poland's, the stated purpose of which is to integrate Poland into the European Union as a normal European country.

Nonetheless, Dr. Gray's essay raises several important questions, and therefore offers a useful occasion to review the theory and practice of shock therapy in the post-communist economies. The essay draws our attention to the important issue of the appropriate 'role models' for reform in the post-communist countries, arguing that it is neither desirable nor feasible to find Western role models for the post-communist countries, for three interrelated reasons. First, the West itself is in flux, so that there is 'no system of stable Western institutions into which the post-communist states might someday be integrated.' Second, the post-communist countries face a unique and adverse inheritance — such as the absence of rule of law — which renders the dominant Western models useless as a starting point for transformation. Third, market institutions 'legitimately and necessarily vary according to the diverse national cultures of the peoples who are their practitioners,' so that there is no 'ideal-typical model' or appropriate existing model for transplantation to the post-communist countries.

This attack on the use of Western models in economic reform is wholly unconvincing in my view. My hunch is that Dr. Gray is confusing the economic strategy of shock therapy with his real target: the triumphalist declarations of the 'End of History' made by Francis
Fukuyama (1991) and others after the collapse of communism. In earlier essays, Dr. Gray (1989) warned against Western euphoria in the aftermath of the fall of communism. He rightly pointed out that liberal democracy is far from assured in the post-communist countries, and that the Western societies themselves have serious internal problems that they must address. But it is one thing to argue that History is not at an end, and quite another to dismiss a strategy of rapid economic transformation and political democratization based on the rapid adoption of Western models. I will argue that the Western liberal democracy remains, by far, the most powerful and appropriate source of inspiration for economic reform throughout the entire world, even if the success of liberal democracy in the reforming countries still hangs in the balance.

I address Dr. Gray's critique of shock therapy in three parts. In Section II, I take up the key question of 'role models,' disagreeing with Dr. Gray on all particulars: there is a Western (or global) system of economics which the transition economies are joining; the dominant models are useful despite the unique adverse legacy of the post-communist countries; and the variety of practical economic choices varies considerably less than the variety of national cultures. In Section III, I attempt to rescue shock therapy from the naive characterizations of the strategy that are common in public discourse. Shock therapy is not a promise of a miracle cure, nor is it a program aimed at a utopian laissez faire. It is a set of pragmatic choices deeply grounded in existing Western economic institutions. I review some of the recent economic and political evidence on the reforms, and show that the practical results of shock therapy have vastly outperformed all other strategies that have been tried. In Section IV, I take up one of the key implications of the current fragile situation in the East: the critical, and so far unfulfilled, role of the West in supporting the transition process to a successful conclusion.
II. Role Models for Economic Transition

At the core of Dr. Gray's critique of shock therapy lies a central issue: do Western capitalist institutions (both economic and political) provide an effective role model for reforming countries? Dr. Gray says no, the West should not and can not provide a role model for the post-communist countries. My own answer is very different. Most governments in the developing and post-communist world are now attempting to introduce a basic set of capitalist institutions, originally introduced in the West, but fast becoming global with their adoption in Asia. This is a highly desirable trend, based on the economic superiority of these institutions over other existing models. The success of 'transplantation' of these institutions is far from assured, but the goal is valid and the chances of success are favorable in most countries.

Is there a Western Model?
Shock therapy presupposes a basic economic model to which the post-communist countries can aspire. Rapid institutional reform is possible because the 'end-point' of reform is clear: a normal 'Western-style' market economy. There are at least two lines of attack against such a vision. First, the Western models are themselves in flux, so that there is no stable target for the post-communist reforms. Second, the so-called West is itself so varied that there is really no obvious target for emulation. Let us consider both of these challenges.

Dr. Gray is emphatic, and in my view wildly extreme, on the first point. According to Dr. Gray, the idea of a stable set of Western institutions is a fiction, since these institutions — such as the GATT, the EU, and NATO — are already 'unraveling.' He writes (pp. 39-40):

The prospect of the orderly integration of the post-communist states into the economic and security arrangements of the Western world is a mirage, not only because of the unprecedentedly formidable difficulties each of them confronts in its domestic development, but because the major Western transnational institutions and organizations are themselves in flux, amounting sometimes to dissolution . . .

The post-communist states, cannot then, hope for admission to a club that no longer exists . . .
The risk is that, as the illusion of 'New World Order' give way to the realities of the chaos of nations, there will be no overarching framework of Western institutions into which integration of the post-communist states might proceed.

At other points, he speaks of the 'melt-down in the post-war world order', and the 'disintegration, or powerlessness and paralysis, of the Western transnational institutions in which the post-war world order was embodied.' He sees, as a result, an enormous backlash ahead as a result of Western advice to the East:

[B]y promising that a few years of agonising economic shock therapy will be followed by [the] speedy integration [of the East] into a stable Western economic order, it is setting up a scenario for devastating disillusionment with the West, particularly in Russia, as it becomes unequivocally clear that the Western countries are in deep disarray and are in no position to honour such promises. (p. 10)

This is all colorful language, but is there any evidence at all for it? It seems to me that all of the events of the past five years point in just the opposite direction. First, the multilateral economic institutions, such as the IMF, the World Bank, the regional development banks, and the GATT, have greatly strengthened their roles and expanded their membership since the end of the cold war. Every one of the post-communist countries has joined the IMF and the World Bank, and most have negotiated assiduously for technical and financial assistance from these institutions. The power and reach of these institutions has been in the ascendant in the past decade, since they have become the pivotal institutions not only for the incorporation of the post-communist countries in the world system, but also for the re-integration of Latin America and parts of Asia into the world economy. Moreover, while these institutions have been discouragingly ineffectual in Africa, they still have the leading role in Western advice and assistance to the African nations.

The reach and influence of the IMF and the World Bank in the post-communist reforms should not be doubted. The IMF is surely the linchpin for the financial integration of the post-communist world into the global financial system. Debt relief, international borrowing, even humanitarian aid flows, generally depend on a 'green light' from the IMF. Similarly, the World Bank is a key source of financing for reforms. China has borrowed approximately $20 billion from the World Bank, making it the single largest debtor of the Bank, and making the Bank the single largest creditor of China. Russia will similarly borrow heavily from the World Bank in the next few years.
Regional development banks are lesser known, but extremely important, institutions supporting global integration. The Interamerican Development Bank, the Asian Development Bank, and the African Development Bank, have long complemented the role of the World Bank in providing long-term finance in return for market-based reforms. If anything, these regional banks have gained in prominence and influence in recent years. Their role was highlighted by the speed with which the Western countries established a similar institution, the European Bank for Reconstruction and Development (EBRD), to help finance long-term investment in Eastern Europe and the Former Soviet Union after the collapse of communism.

Dr. Gray’s disparaging remarks about the GATT — that together with NATO, it has not ‘been followed by a successor organization which embodies the internationalist projects of its founders’ — is also wide of the mark. The Uruguay Round of the GATT and the agreement on a new World Trade Organization (WTO) represent milestones in creating a law-based global trading system. The Uruguay Round is vastly more than an agreement over agriculture, or steel, or videos. It is the most ambitious undertaking in history to create a law-based system that can support international economic linkages not only in merchandise trade, but also in services, foreign investment, multinational production, and the creation and transmission of ideas. For this reason, China and Russia have made quick accession to the WTO among their highest economic policy goals.

Nor do the European Union and NATO warrant the obituaries prepared by Dr. Gray. While I have my own deep concerns about economic trends within the EU, there is no doubt that the EU remains the compelling economic and political magnet for the post-communist countries. Virtually all of the countries of Eastern Europe have declared their desire to join the EU as rapidly as possible. Boris Yeltsin was not wrong to hail the recent signing of the EU-Russian Agreement as one of the cornerstones of the post-Cold War era. The likely membership of Austria, Finland, Norway, and Sweden in the EU underscores the compelling nature of the economic integration that underpins West European prosperity. Similarly, NATO remains a beacon for national security of the post-communist countries, with all of Eastern Europe and even Russia accepting the half-way house of ‘Partnership for Peace,’ and with most of the countries clamoring for full membership in NATO.
In addition to these front-line institutions, there is a widening net of secondary institutions: the Organization of Economic Cooperation and Development (OECD), the Bank for International Settlements (BIS), the International Labor Organization (ILO), the Conference on Security and Cooperation in Europe (CSCE). All of these institutions are finding increased rather than decreased country membership and responsibilities in recent years.

This, then, is hardly the picture of collapsing Western institutions, but rather of powerful and unrelenting forces pushing nations towards economic desires for political integration. Dr. Gray would better appreciate the choices facing the post-communist countries if he put their projects of economic reform in a worldwide context. The key Western institutions are not just at the center of post-communist reform, but are at the center of a remarkable global transformation to market institutions, of which the post-communist transitions are only a part. The intensity of this global transformation is accelerating and embracing an ever-widening collection of countries.

At the same time, we should not confuse this picture of accelerating global integration and harmonization with the End of History. Dr. Gray is surely right to emphasize three points. The Western institutions are themselves subject to change. Institutional innovation continues, and there is absolutely no reason to believe that mankind has yet discovered the optimal mix of economic and political institutions. The West also faces serious economic shortcomings. The social welfare state of Western Europe is seriously over-extended. The mix of extreme social welfarism and increased trade competition from low-wage countries is contributing to a serious rise of unemployment and a deepening fiscal crisis in many countries of Western Europe. This brew could still boil over into highly destructive protectionism, that could yet undermine the emerging global system. And finally, in each of the reforming countries, political and social pressures could derail the project of market reform and international integration. I return to these points in Section IV of the paper.

Global Transformation
Probably seventy-five to one hundred governments in the world would describe themselves today as undertaking 'market reforms' to integrate their nation's economies in the world economic system, and most are deeply involved with the international institutions to effectuate these changes. This wave of reform would include almost all of Latin America, South Asia (Bangladesh, India, Pakistan, and
Sri Lanka), East Asia (including China, Indonesia, Laos, Thailand, Vietnam), Eastern Europe and most of the former Soviet Union, and parts of Africa. These countries would include at least 3.5 billion people of the 4.5 billion in the developing and post-communist countries. Even this enumeration probably understates the extent of global, market-oriented institutional change.

This avalanche of change reflects several deep forces at play. Most compelling is the collapse of the model of state-led industrialization, whether in its moderate forms in populist Latin America, or its paranoic forms of the Stalinist Soviet Union and its empire. The God That Failed was not just communism, but the belief that the state could run the productive sphere of the economy. State-led industrialization embraced several doctrines: state ownership of industry; autarkic development behind protective barriers; and comprehensive planning of industrial change. All of these doctrines are in ruins. It is important to understand that the collapse of faith was not the result of a blinding theoretical insight, but rather the slow and tragic unfolding of the failures of the statist model. Throughout the world, state-led industrialization produced state bankruptcy (as in the Latin American, Eastern European, and Soviet Union international debt defaults) and accompanying hyperinflation, economic stagnation or collapse, and massive decapitalization of the societies in the form of capital flight, brain drain, and environmental degradation. (See Sachs, 1994c, on a more thorough discussion of the rise and fall of the strategy of state-led industrialization).

The second force at play is technology: the ongoing information and transportation revolution. Breathtaking improvements in transport and communications technology are rapidly reshaping the global division of labor, and making a mockery of any remaining attempts at autarkic economic development. Falling transport and communications costs, combined with progressive trade liberalization (especially in the context of successive GATT negotiating rounds, together with the emergence of free trade in Western Europe) have meant that international trade has grown faster than global income in almost every year of the past half century. This process has now dramatically accelerated in the past decade. Most of the developing world has unilaterally reduced or eliminated its trade barriers, to end the self-imposed exile from the world system that was at the center of the state-led industrialization strategy (see GATT, 1992, for details on the worldwide trend in unilateral liberalizations). Moreover, technological changes are leading to economic integration not only in trade, but much more deeply in investment and production (see

The third factor in global integration, is the growing importance of legal and regulatory harmonization for its own sake. The international legal order, and hence the institutions of the nations, are adapting to the growing needs of international commerce. There is a need for shared institutions, in trade, property rights, investment, taxation, public health and safety standards, and other areas where international economic integration causes the national legal and administrative systems to come into contact. Harmonization is not the result of one system being superior to another, but rather of the need to lower the need for transaction costs across international borders. Thus, the new GATT agreement prescribes important common international standards in several areas, including intellectual property rights, trade in services, rules of origin, and foreign direct investment. Similar harmonization of principles is underway in banking regulation (e.g. the Cooke Committee of the BIS), tax treatment of foreign investment, financial reporting, environmental standards, labor standards, and many other areas.

Virtually every government in the world now expresses its desire to join the world system, in the triple sense of openness to world trade and finance, participation in multilateral institutions, and harmonization in basic structures of property rights and taxation. Of course there are exceptions — North Korea being the most famous recent case — though even former revolutionary states such as Cuba are now appealing widely for foreign investment. There is a palpable and nearly universal fear that he who shuns the world system will be left behind. On the positive side, there is the feeling in most governments that world markets, if properly tapped, offer a ticket to rapid growth. The extent of cross-border financial flows to the developing world, especially equity funds flows into ‘emerging markets’, has soared in recent years. Overall capital flows into the developing world have risen from roughly $126 billion per year during 1982-88 to an estimated $218 billion in 1992 (IMF, 1993, Table 15, p. 77). In particular, foreign direct investment has soared from $13.3 billion per year during 1982-88 to $39 billion in 1992, while portfolio investment (e.g., U.S. pension fund investments in developing country stock markets) has risen from close to zero during 1982-88 to $13 billion in 1992.

Net private flows now far exceed official flows into the developing countries, and are likely to do so in the post-communist countries as
well in the coming years. Reforming governments therefore attempt to cater to private investors as much as to official institutions. A recent notable case was the role of major private-sector investors in Mexico, who pushed policy advice on the Mexican Government in the wake of the assassination of Presidential-candidate Donaldo Colosio, as a condition for keeping private-sector funds flowing to Mexico. Similarly, Argentina, Turkey, Venezuela, and other governments have similarly courted private investors in recent weeks with promises of conformity with strict, market-oriented reforms.

At the base of all of this transformation and courting of international markets is the powerful notion that convergence of living standards is a likely consequence of economic integration. The idea is that poorer countries, whether in the developing world or the post-communist world, have the potential to grow more rapidly than the developing world, and thereby to narrow the gap in living standards, if they harmonize their economic institutions and join their economies to the global economic system. But convergence is conditional, not guaranteed. Many poor countries fall farther and farther behind the rich countries. To spur convergence, it is crucial to be part of the shared economic system with the richer countries, and to create a national economic environment that is attractive for saving and investment. Under such conditions, capital, technology, ideas, and management skills, will flow from the richer to the poorer countries, and domestic entrepreneurs will have the incentive to undertake additional investments, thereby providing the extra margin of growth that leads to the narrowing of income differences.

Western Europe, and the OECD countries more generally, provide a powerful demonstration of convergence in the post-war period. As the poorer regions of Europe (first Italy, and then Ireland, Greece, Portugal, and Spain) integrated with the richer countries in the region (especially Benelux, France, Germany, and the UK), they successfully narrowed the income gap with the richer nations. Italy even overtook the laggard UK by the late 1980s, according to some measures of per capita income. The overwhelming evidence that European integration was an engine of growth of the poorer West European periphery was one of the most powerful inducements to the Revolutions of 1989 in Eastern Europe.

Which Model of the West?
Since the Western economies differ markedly among themselves, is it even meaningful to talk about a 'model' for economic change in the East? According to Dr. Gray, the answer is no; each of the possible
role models for market development — Anglo-Saxon, Swedish, German, Chilean (authoritarian capitalism), Japanese, and Chinese — achieved its current institutional patterns as a result of historical contingency, unique political compromises, and distinctive cultural patterns. For example, the distinctive British emphasis on individualism can be traced back to the Middle Ages; Japanese elite leadership has depended on a cultural homogeneity unmatched in the post-communist countries; China's predisposition to markets is rooted in indigenous, Confucian-based tradition. In short, every model is unique, and 'legitimately and necessarily vary[es] according to the diverse national cultures of the peoples who are their practitioners.' To believe otherwise, asserts Dr. Gray, is to fall prey to the 'history-blind perspective of neo-liberal theory'.

In my opinion, it is the culturalist perspective, rather than 'neo-liberal theory' that is historically misconceived. For two hundred years, one culturalist explanation after the next has tried to explain why one national group has succeeded economically while others have failed, trying to locate the causes in allegedly deep-rooted factors of national culture or character. These predictions have been notorious failures. It is well to recall the culturalist interpretations of Western observers in Japan at the start of Japan's capitalist revolution in the 1870s, when Japan was embarking on a systematic program of institutional borrowing from the West. As Rosovsky (1966, p. 132) has reminded, the Western observers were 'extremely pessimistic' about Japan's prospects:

With considerable complacency they wrote: 'Wealthy we do not think it will ever become: the advantages conferred by Nature, with the exception of the climate and love of indolence and pleasure of the people themselves forbid it...'. [Or]

'The national banking system of Japan is but another example of the futility of trying to transfer Western growth to the Oriental habitat. In this part of the world principles, established and recognized in the West, appear to lose whatever virtue and vitality they originally possessed and to tend fatally towards weediness and corruption.'

Forty years ago, other Confucian-based societies were felt to possess deep-seated obstacles to economic growth: strict hierarchical relations, tending to authoritarianism on the one side and obsequiousness on the other, without the traits of individualism and self-reliance necessary for entrepreneurial development. Korea and China were viewed as hopeless cases among development specialists, not future paragons of economic performance. Forty years later,
alleged Confucian traditions are now widely described as the source of Korean and Chinese vitality.

The emphasis on the 'cultural matrix' of economic life as a barrier to 'shock therapy' fails for three reasons. First, it misconstrues the real content of an economic 'role model'. Second, it puts far too much emphasis on culture as a barrier to the rapid adoption of these common economic institutions, a point suggested by considerable historical experience, some of which is related by Dr. Gray himself. Third, Dr. Gray needlessly lumps Eastern Europe together with the former Soviet Union in his cataloguing of the difficulties of reform. Many of his doubts on the prospects for reform are relevant for Russia, but not at all for Czechoslovakia, Hungary, Poland, or Slovenia. Let us consider these three points in greater detail.

In the actual practice of 'shock therapy' in many countries around the world, the first aim of reform is not to adopt a particular country as a model, but rather to establish the core institutions of modern capitalism. In the case of Russia, for example, it simply makes little sense at the start to argue whether Russia should aim for Anglo-Saxon liberalism, the German social market economy, Austrian corporatism, or any other single model. No doubt, Russian capitalism will be distinctive in many ways. But Russia (and the other post-communist economies) can actively aim for the key institutions that are common to all of these models. Here I would list six core institutions:

1. A monetary system based on a stable, convertible national currency;

2. Freedom of international trade and foreign investment;

3. Private property rights, as codified in a commercial code and company law, protecting the freedom of contract, establishment of enterprises, entry into new economic activities, and so forth;

4. Private ownership of a high proportion of national assets;

5. Corporate control of large enterprises (joint-stock company, limited liability, market trading of voting shares, capital markets for exchange of ownership, and corporate governance by owners over managers via supervisory boards);

6. A social safety net (unemployment and welfare payments) for the most vulnerable groups in the society.
These key institutions are common to all advanced market economies (e.g. the OECD economies), even though the particular forms of these institutions vary in important ways. For example, every advanced market economy organizes the ownership of large industrial enterprises according to the corporate form, while the specific form of corporate organization varies (e.g., a two-tier board structure in Germany, versus a one-tier board structure in the U.S.), and the form of corporate ownership also varies (interlocking corporate ownership in Japan; institutional investors in U.S.; bank governance in Germany). Similarly, the countries differ markedly in the forms, coverage, and generosity of the social payments, but all countries maintain a basic system of unemployment compensation, welfare payments to poor families, and pensions for retired and disabled individuals.

'Shock therapy' does not presume to dictate the specific ways to implement private property rights, corporate ownership, and the social safety net. These areas are, of course, the inevitable battleground of democratic politics for the indefinite future. The gist of shock therapy, however, is the view that the basic legal, economic, and administrative infrastructure of these six institutions can be put in place rapidly, without having to determine their detailed forms.' Even after Russia adopts a company law and a commercial code, and even after Russia succeeds in privatizing the ownership of industry, the actual forms of ownership and property rights will evolve for decades, in unpredictable ways. Of course, as Dr. Gray rightly stresses, such evolution is also underway in the Western countries.

To a crucial extent, the precise institutional forms will be determined by the country's position in the regional and international economy. The first institution — a stable, convertible national currency — is enshrined in Article VIII of the IMF Articles of Agreement, and thus is a core international obligation for membership in the world economic system." The second institution — free international trade and finance — is embedded in the terms of GATT agreements, and now will form the conditions for participation in the new World Trade Organization. The OECD also establishes common guidelines for foreign direct investment, which will become operational for Eastern Europe as Poland, Hungary, the Czech Republic, and possibly other countries, join the OECD in the next few years.

The specific contents of property rights and corporate governance are generally a matter of national provenance, except for constraints imposed by regional groupings. Since most of Eastern Europe is now
aiming actively for membership in the European Union, many aspects of property rights (e.g. competition policy, the role of works councils, the treatment of foreign-owned companies) will be determined by directives from Brussels, rather than national law. Similarly, the North American Free Trade Area binds Mexican law in important areas of property rights. The last core area of institutional design — social safety spending — is perhaps the most contentious and the least bound by international conditions. It is, of course, at the center of political controversy in most of the developed and transition economies.

These core institutions do not exhaust the range of economic policymaking or debate. They leave open the critical question of industrial policy, for example, another flashpoint of controversy in economic reforms. Should Eastern Europe and the former Soviet Union engage in active industrial policy? What are the real lessons in this domain from the successful developing countries in East Asia? There is no consensus on these important issues, though in practice the real range of choices is much more limited than the public debate would suggest."

Many critics of shock therapy have asserted that the national characteristics of the post-communist countries preclude the rapid adoption of these core institutions. At various points, Dr. Gray asserts that the legal heritage in the East is insufficient to support a system of modern property rights:

Further, the post-communist countries, unlike the Western exemplars with which they are conventionally compared, lack almost entirely the legal and institutional infrastructure of the market on which economic take-off was based, and which policies of economic liberalisation in Western countries presupposed as necessary conditions of their chances of success.

This pessimism is unfounded, but for reasons that Dr. Gray himself makes clear! According to Dr. Gray, in a sentiment with which I wholeheartedly subscribe, the social market theorists:

reject the view that markets are, or should be, the unplanned outcomes of cultural or historical evolution. For these thinkers, market institutions are not forms of spontaneous order, which we receive as gifts from history, but instead human artefacts, created — in all their varieties beyond the most rudimentary — by legal artifice and political intervention.

In other words, the legal-historical legacy is not determinative. 'Legal artifice' and 'political intervention' can overcome the adverse legacy.
This is not merely a theoretical view. Though some observers (e.g., Murrell, 1990) have mistakenly assumed that Great Britain's centuries-long legal evolution is the norm for social change, worldwide history reveals many more cases in which legal innovation and transplantation radically altered the inherited legal order in a short period of time. Once again, Dr. Gray hits this point precisely, while minimizing its significance for reforms in the East today when he attacks 'shock therapy.' It is worthwhile to quote at length:

The Scots adopted a wholly novel, Romano-Dutch legal code, in less than a generation, around the start of the eighteenth century, at the initiative of a handful of lawyers inspired by a single man, James Dalrymple, the first Viscount of Stair; modern Turkey was founded when a foreign legal code was imposed on it by fiat by Kemal Ataturk; Meiji Japan adopted important elements of German legal practice; and so on. In these and similar cases, the legal framework of market institutions, and of a civil society, is not a spontaneous emergence from a long period of incremental and evolutionary change, but the result of swift and radical initiatives, undertaken in favorable circumstances. Most of the post-Soviet states have no option but to follow this latter course, with all its uncertainties; the English path, with its leisurely pace and fortunate historical context, is not an option for them.

This, of course, is precisely the credo of shock therapy.

A related point has recently been made by Rose (1994):

The majority of European states have constitutions that have had to be written quickly in order to replace a regime that has collapsed or been discredited. Germany, Austria, and Italy have drafted constitutions in the wake of military defeat and under the eye of occupation armies. Three Mediterranean states have had to write new constitutions following the collapse of their old regime.

Even a nation's constitution, then, is not generally the result of the gradual evolution of political norms, but rather the response to urgent international or domestic contingencies.

If there is any lesson from these recitals of the historical experience, it is that economic-legal institutions are not as deeply constrained by the 'cultural matrix' as Dr. Gray supposes at many points in his essay. It is indeed the evidence that Japan could successfully adopt German commercial law after the Meiji Restoration; or that Turkey could adopt the Swiss Civil Code under Ataturk, that belies the view that the post-communist countries are trapped by their culture or adverse legal legacy.
It is indeed one of the great questions for social science to explain events such as the Meiji Restoration. A country isolated for more than two centuries, when challenged by superior military power, was able to absorb Western institutions in core spheres of the economy and society in a matter of a few years, and thereby initiate a century of phenomenal economic growth. The 'social market perspective' indeed gives one hint to the answer: economic institutions are human artifices that promote efficiency. Basic ideas like fiat money, central banking, corporate law (with limited liability and transferable shares), patent law and other intellectual property law, are highly successful human innovations that can be imitated and emulated by all countries. It took more than two hundred years in Britain to develop modern company law, but now that corpus of law is available for rapid adoption by other countries.

Another part of the answer lies in the limited domain of law. Even when a nearly identical legal code is implemented in two countries (e.g. commercial law in Germany, subsequently copied in Japan; or civil law in Switzerland, subsequently adopted in Turkey), the actual results surely depend on local culture and history. In a brilliant book, Upham (1987) describes the interplay of Western-based law and Japanese ideology, culture, and power relations in forming the operational characteristics of the Japanese legal system. Upham explains that while 'the fundamental norms of Japan's legal system were either written by foreigners, like the Constitution of 1947, or derived from Western legal models, like the Civil Code of 1896' (p. 11), the actual practice of law reflects the power of the bureaucracy to step in 'to recapture control of the social agenda'. Rather than law being viewed as rule-based or judge-made, Japanese law is interpreted to give wide latitude and discretion to the bureaucratic leadership, reflecting deep and long-standing patterns of power in the society, even pre dating the Meiji Restoration.

This two-sided character of law — that it may be quickly adopted, but then applied in conformity with local culture, tradition, and power relations — is reassuring to the project of 'shock therapy.' The goals of radical reform are not to brush aside the unique features of Russian culture. Rather, they are to put the most up-to-date and efficient economic institutions at the service of the Russian people, while also recognizing Russia's unique cultural heritage. In this sense, one can eat one's cake and have it too in the domain of legal reform: quick adaptation of law combined with a culturally conditioned gradual evolution of legal practice.
Economic freedom and economic reform
Dr. Gray strenuously and oddly rejects any view of market institutions as reflecting 'fundamental rights' to economic freedom. Economic institutions, according to Dr. Gray, are purely instrumental ('justified by the contribution to individual and collective well-being') and are not grounded in more fundamental human rights. I find this view unsatisfactory, and perhaps one of the reasons that Dr. Gray underestimates the vitality of market reforms in the post-communist countries. I would rather argue that market institutions are successful in part because they conform deeply with human aspirations towards freedom.

Dr. Gray attributes to U.S. social theorists and 'Lockeans' the alleged linkage between market and freedom. Of course, Milton Friedman's classic Capitalism and Freedom and Robert Nozick's Anarchy, State and Utopia are paradigmatic of this line of thought. But Dr. Gray is wrong to dismiss this as U.S. libertarian thinking. In the recent Papal encyclical Centesimus Annus (1991), for example, the Pope draws a similar linkage between freedom and economic performance. In interpreting the events of 1989, the encyclical declares that one factor in the collapse of communism was:

certainly the inefficiency of the economic system, which is not to be considered simply as a technical problem, but rather a consequence of the violation of the human rights to private initiative, to ownership of property and to freedom in the economic sector.

The encyclical continues later on in a similar vein:

The modern business economy has positive aspects. Its basis is human freedom exercised in the economic field, just as it is exercised in many other fields. Economic activity is indeed but one sector in a great variety of human activities, and like every other sector, it includes the right to freedom, as well as the duty of making responsible use of freedom.

I would strongly concur that one powerful motive force in the market reforms is the restoration of freedom in economic life.

Differentiating among the post-communist nations
One of the weaknesses in Dr. Gray's broad-brushed critique of 'shock therapy' is the repeated lumping together of the former Soviet Union with the post-communist countries of Central and Eastern Europe. Russia presents an altogether more complex and risky situation than does Poland, the Czech Republic, Hungary, Slovenia, or the Baltic States. There is not the slightest reason to believe that the cultural heritage of the Czech Republic is inimical to market capitalism, or
that the Czech Republic 'lack[s] almost entirely the legal and institutional infrastructure of the market . . .' (p. 39), in view of the fact that in the inter-war period, Czechoslovakia was one of the most dynamic capitalist economies of Europe. Those traditions and even legal norms, are being recreated at a rapid rate.

The Central and Eastern European countries do not face Russia's internal divisions with respect to social and economic goals. These societies are almost united in the aim to 'Return to Europe' in the general sense of adopting Western European models, and in the specific sense of joining the political and economic institutions of Western Europe, especially the European Union. Moreover, many of these countries are able to re-activate their own legal traditions towards this end. For example, Poland reactivated its 1934 Commercial Code (which in turn had borrowed heavily from German commercial law) in 1989, as the foundation for the re-emergence of the private sector. More generally, rather than groping for a culturally specific framework of economic law, Poland is making a straight line for the EU. As Poland's leading official in charge of European Integration stated in 1990:

The most important thing will be to harmonize economic policy and legislation. Poland will try to take an enormous step forward in coordinating its economic and monetary policy with that of the EEC, followed by policies on industry, customs duties, commerce, company law, conditions for residence, and the pursuit of economic activity - taxation, social matters, regional issues, environmental protection, agriculture, energy, scientific research, the protection of intellectual property. And that is still not everything. We know that joining the EEC means adopting about 7,000 legal regulations. At the present time we are at the process of translating the EEC code of preferential product listings. We also have asked the Community to produce a list of norms that we would introduce right away, because they are of exception importance. (cited in Sachs, 1993, p. 5)

The same sentiments would be repeated in almost all of the countries of Eastern Europe.

Nor is there any evidence that 'deep-seated norms of equity and fairness' (p. 31), which Dr. Gray stresses are necessary to underpin the popular acceptance of economic institutions, pose insurmountable obstacles to rapid market reforms in Central and Eastern Europe. Opinion surveys in recent years have shown that attitudes towards income equality, entrepreneurship, and the role of the government in providing social guarantees, are roughly the same in Eastern Europe and Western Europe.
The situation in Russia is altogether more complex. There is no doubt that the social and ideological divisions in Russia are sharper; the historical heritage is less favorable (simply, there is little interwar or pre-revolutionary legacy of market capitalist institutions); and the role of the European Union as a political and institutional anchor to the reform process is much weaker than in the case of Central and Eastern Europe. Despite these infirmities, Russia's capitalist revolution is still in train.
III. The Theory and Practice of Shock Therapy

While shock therapy has won many battles 'on the ground,' it has definitely lost in the arena of public relations. The term itself is a mistaken analogy to medical treatment, but one that has stuck as the result of widespread use in the public debate. On the one hand, it conjures an image of a brief period of excruciating pain, as the economy is jolted with a high-voltage blast of reforms. On the other hand, it seems to promise a speedy recovery if the pain is endured: one jolt of market competition and the economy jumps back to life.

Both sides of the analogy are flawed. The measures that constitute shock therapy do not by themselves create 'agonizing pain' (in the words of Dr. Gray) in the body politic. The image of plummeting living standards as a result of rapid economic reforms is completely wrongheaded, and betrays a deep misunderstanding of the actual economic dynamics in the region. On the other hand, rapid institutional reforms cannot, by themselves, guarantee a speedy economic recovery. Dr. Gray is correct: the adverse legacy of communism is deep, pervasive, and indeed tragic. There is no magic solution to the waste, pain, and dislocation caused by decades of communist misrule. The case for shock therapy is not that it offers a miraculous cure, but rather that it constitutes the best hope for a recovery of human freedom and a democratically based rise in living standards.

The triple adverse legacy of communism
The economic crisis in the post-communist countries is often portrayed as having one dimension: the creation of a market economy. In fact, there are three distinct economic crises confronting the region, and three crises confronting at least some of the countries. The practice, and results, of shock therapy must be understood in the context of these interlocking problems.

The first and most urgent crisis is state bankruptcy. Communism did not just leave collapsed and demoralized societies, but also financially bankrupt governments. Authoritarian regimes have a penchant for clinging to power to the last moment, using whatever resources and short-term sleight of hand to prolong their tenure. Thus, the Latin American military governments in the 1970s borrowed heavily on international markets to try to eke out further years of (lucrative) rule. They constantly rejected the economic imperative of budget
cuts for fear that their fragile legitimacy would thereby be undermined."

The communist governments were no different, and perhaps even more cynical in their short-run manipulations of the economy. Some East European governments were precocious foreign borrowers: Poland borrowed heavily in the 1970s in order to jump-start a failed economy, and Hungary did the same in the 1980s. Mikhail Gorbachev turned to foreign creditors heavily in the second part of the 1980s, running up the foreign debt by around $40 billion during 1986-89, before the Western creditors got cold feet. When the credits stopped flowing in, and started to flow out, the Soviet Government spent its gold reserves, hoarded its diamond stockpiles, and even lied about its remaining gold in order to secure 'collateralized' loans in 1990 and 1991. Remarkable, even Bulgarian despot Todor Zhivkov was able to find international commercial banks willing to lend several billion dollars in the 1980s.

All of these efforts, of course, could not bail out the socialist catastrophe. Poland went bankrupt as early as 1976 (when it first defaulted on its foreign debts), and the default remains in place today, pending completion of a recent agreement between Poland and its commercial creditors to cancel nearly half its foreign bank debts. Bulgaria defaulted in 1989 and is completing a similar agreement on debt reduction. The Soviet Union effectively defaulted at the end of 1991, and Russia has taken over the renegotiation of roughly $70 billion of foreign debt.

The result of this heavy borrowing and the communist loss of control over the economy in the wake of political collapse was a nearly generalized fiscal catastrophe in the region: huge budget deficits, the loss of international creditworthiness, the flight from the national currency as opportunities for capital flight became available, money printing to support government spending no longer covered by tax collections. Most of the region fell into hyperinflation or near hyperinflation. All, with the notable exception of Czechoslovakia, suffered an acute and generalized financial crisis, with the state unable to cover even urgent bills without the recourse to inflationary finance, defaults of existing loans, and emergency international lending.

The second crisis is the obvious one: systemic collapse and transformation. The communist system did not merely end, it imploded. The 'command economy' was based, fundamentally,
on the Government's ability to have its orders implemented. The government's authority, in turn, depended fundamentally on fear rather than economic incentives. The planners' orders were followed because the consequence of disobeying orders could be catastrophic. Gorbachev's greatest contribution was to eliminate the pervasive fear that choked the communist societies. This unleashed freedom, but it also unleashed disorder in an economy not governed by normal incentives. As I have detailed elsewhere (Lipton-Sachs, 1992), industrial wages exploded, 'spontaneous privatization' by the nomenklatura burgeoned, and even rudimentary investments (such as repairs of broken gas and oil pipelines) were put aside, often with disastrous consequences.

The breakdown of the old system and the merciful breakdown of terror set the clock running on transformation to a market system. There could be no thought of leisurely transformation: the post-communist leaders inherited complex, urban, industrialized societies that had already stopped working. Industrial production was in free-fall before the onset of 'shock therapy.' The looting of state assets added to the dramatic need for rapid systemic change.

The third crisis is that of structural transformation. The Soviet system (including the economic regime imposed on Eastern Europe) was not designed to pursue socialist ideals, but rather to realize Stalin's goal of creating a military superpower. Planners were planning for a purpose: to develop, expand, and then sustain, the Soviet military-industrial complex. The economic desolation after communism is not simply the result of unconscionable waste and corruption of the old regime. It is the systematic legacy of having pushed the country's best resources — scientists, foreign exchange, raw materials — relentlessly into heavy industry and military production for more than fifty years. Thus, we find the deep and tragic consequence that literally millions of people are in the 'wrong jobs,' dedicated to building armaments, and factories to build armaments, and machine tools to build those factories. The counterpart of the hypertrophied heavy industry was the nearly complete starvation of the 'service sector' of the economy, such as retailers, wholesalers, restaurants, personal services, finance, communications, and related sectors.

Some data help to make the point vividly (see Sachs, 1992 and 1993 for further details). In 1988, according to a IMF study, the Soviet Union had just 20 retail outlets per 10,000 population. At the same time, the U.S. had 60 outlets per 10,000 population, while Italy, champions of la dolce vita, had no less than 175 retail outlets per
10,000 population. The flip side was that the Soviet Union in that year produced 160 million metric tons of steel, while the U.S., with an economy perhaps 10 times larger in real purchasing power terms, produced just 90 million metric tons of steel. Put differently, per dollar of GDP, the Soviet economy produced 17 times more steel than the U.S. economy!

Few observers appreciate the triple crisis — state bankruptcy, systemic transformation, and structural adjustment — confronting the post-communist economies. It is common to hear that radical economic reforms 'create high inflation,' because of the end price controls, even though black-market inflation was already soaring in Russia, Poland, and elsewhere before the start of 'shock therapy'. It is common to hear that radical economic reform leads to industrial collapse, even though the collapse in production began before the start of reforms, and is the result of vast overproduction in heavy industry, which cannot find market outlets now that the state's support of military-industrial production has declined. It is common to hear that radical economic reforms lead to a collapse of living standards, even when the production that is falling is heavy industrial output (e.g. basic steel, or tanks) without effects on household consumption levels.

The three-way classification of the post-communist crisis helps to account for the varying performance of some of the key reforming countries. For example, consider the difference in performance of Russia and China. Russian industrial production has collapsed while China's has boomed. Oddly, Dr. Gray argues that it is 'partly its resistance to Western advice, and to Western exemplars, that accounts for the Chinese economic achievements of recent years.' (p. 26) There is a much more direct and satisfactory explanation (see Sachs and Woo, 1993, for extensive discussion and documentation of the following points). China began its market reforms in 1978 as an overwhelmingly agrarian economy: 72 percent of the labor force was in peasant agriculture; just 18 percent were in state enterprises; and just 8 percent were in state industry. In Russia in 1991, by contrast, Yeltsin inherited an economy with just 13 percent of the workforce in agriculture; more than 90 percent in state enterprises; and approximately 40 percent in state industry.

As a result, Russia faced a catastrophic problem of structural adjustment: how to transform a militarized, industrialized, and urbanized economy into a civilian-based, service-oriented economy. The task was inherently conflictual, since there would be losers in
the old heavy industry together with the winners in the new industry. Moreover, many of the old industrial structures simply needed to be closed or drastically scaled back. In China, the task is less conflictual, as it involves creating investment conditions for peasant farmers, living near subsistence, to take up new jobs in the industrial sector (mainly in rural enterprises and coastal, export-oriented enterprises). There was no need to close down old production to make room for the new society, since China could simply draw upon the hundreds of millions of underemployed peasants in the hinterland.

Shock Therapy in Practice

The aim of shock therapy is to address the three crises of post-communism via the rapid introduction of the six core institutions of capitalism described in Section II. As has often been stated, the reform is viewed as a 'seamless web,' in which each of the six key institutions is critical for the successful operation of the others. Nonetheless, there are several short-run tactical judgments that underlie shock therapy in practice (see Sachs, 1993, for further details). These tactical judgements may be described as follows:

1. Currency stabilization, price decontrol, and international convertibility take precedence, and are to be achieved at the very start of reforms. This is for economic reasons (even a rudimentary division of labor in market economy requires a working currency and prices set by supply and demand), and for political reasons (high inflation is so demoralizing that it puts the rest of social stability in question);

2. A rapid opening to international trade should also be achieved at the start, so that international markets impose competitive discipline on domestic markets, which otherwise would be dominated by inefficient, monopolistic state-owned enterprises;

3. New private businesses should be encouraged at the start of reform, through legal protection, ease of incorporation, elimination of licensing requirements, and, if possible, the initiation of lending facilities to support small, privately owned enterprises;

4. Privatization of state enterprises should be as rapid as possible, based on transparent programs involving the free distribution of equity shares to the population, in programs now known as 'mass privatization programs.'

5. Stabilization can and must precede privatization. Even before privatization takes hold, it is possible to end high inflation and
commodity shortages; to impose 'hard budget constraints' on state-owned enterprises; to spur industrial restructuring in state-owned enterprises; and to spur the establishment and growth of the new private sector.

6. A social safety net for the initial adjustment — including unemployment compensation, the adjustment of pensions in response to price liberalization and subsidy cuts, and emergency income transfers to the poorest households — can and should be put in place at these start of radical reforms. It is important, however, to keep social spending in line with realistic economic and budgetary possibilities. Foreign financing may therefore be desirable to help cover the emergency social burdens.

Shock therapy puts primacy on currency stabilization, very much for the reasons enunciated by Lord Keynes in The Economic Consequences of the Peace (1920), the Tract on Monetary Reform (1923), and other essays on Central European inflation in the early 1920s. As Keynes wrote compellingly in Economic Consequences (1920, p. 236),

There is no subtler, no surer means of overturning the existing basis of society than to debase the currency. The process engages all the hidden forces of economic law on the side of destruction, and does it in a manner which not one man in a million is able to diagnose.

Keynes explained with unsurpassed sociological insight the damage wrought by a sustained period of high inflation (1920, pp. 235-236):

By a continuing process of inflation, governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens. By this method they not only confiscate, but they confiscate arbitrarily; and while the process impoverishes many, it actually enriches some. The sight of this arbitrary rearrangement of riches strikes not only at security, but at confidence in the equity of the existing distribution of wealth. Those to whom the system brings windfalls, beyond their deserts and even beyond their expectations or desires, become 'profeeters,' who are the object of the hatred of the bourgeoisie, whom the inflationism has impoverished, not less than of the proletariat. As the inflation proceeds and the real value of the currency fluctuates wildly from month to month, all permanent relations between debtors and creditors, which form the ultimate foundation of capitalism, become so utterly disorder as to be almost meaningless; and the process of wealth-getting degenerates into a gamble and a lottery.

Together with currency stabilization, shock therapy advocates the rapid adoption of currency convertibility (for all current account transactions) as a mécanism for establishing market-based
international trade from the very start of reform. Convertibility is typically achieved by a large currency devaluation to unify the official exchange rate with the black-market exchange rate, thereby setting a price for foreign exchange that can be defended by the central bank. The goal of immediate convertibility was controversial at the start of post-communist reforms, but is now generally supported by economists. A popular argument was that it took Western Europe more than a decade (until 1958) to achieve currency convertibility after World War II, so that a comparable period of time would be needed in the East.

We now see that the analogy fails for two reasons. First, Eastern Europe desperately needs the rapid opening of trade to the West, since only international trade can quickly instill competition on domestic markets in the post-communist countries. Second, the Western European countries enjoyed substantial convertibility well before 1958, through the operation of the European Payments Union. A payments union among the Eastern countries, however, would now constitute a 'poor-man's trading club,' which would simply reinforce the backwardness of the region, and could not serve as a way out of misery.

One of the most controversial parts of the shock therapy reforms has been the idea that stabilization and liberalization could be carried out in advance of privatization, which will necessarily take many years to complete. Before 1989, a common view among reformers in the East was that market stabilization and liberalization in advance of privatization would prove futile: the state-owned enterprises would not adjust to market forces, and would find ways to reassert 'soft-budget constraints,' thereby undermining stabilization. This fear, in fact, has not materialized. In economies undertaking shock therapy, state-owned enterprises begin to restructure and adjust in the presence of currency stabilization and open trade, well before privatization takes place (see Pinto and Van Wijnbergen, 1994, for recent evidence to this effect in Poland).

Shock therapy presupposes that rapid privatization will be initiated at the time of stabilization and liberalization, so that after a few years, the economy will be not only market-oriented, but predominantly privately owned. Privatization proceeds from two directions: 'top-down privatization' signifies the transfer of ownership of state assets to private owners, while 'bottom-up privatization' signifies the formation of new enterprises by private entrepreneurs. Bottom-up privatization can proceed with remarkable speed especially in
services, transport, and construction. Top-down privatization requires novel methods in order to ensure speed and comprehensiveness, since there are typically thousands or tens of thousands of state-owned industrial enterprises in a post-communist country. Mass-privatization programs, based on the free distribution of shares, has passed from theory to practice in a growing number of countries, as diverse as the Czech Republic, Mongolia, and Russia.

**Results of Shock Therapy after Five Years**

From the time of Poland’s initiation of economic reform at the start of 1990, shock therapy has been subjected to a deluge of criticism, misunderstanding, and theoretical attack. Fortunately, the actual experience with reform is clarifying and diminishing the controversy. The staying power, and indeed spread, of shock therapy in the region is due to its proven success.

Dr. Gray repeats the most common misunderstandings about shock therapy despite the fact that the empirical record in Eastern Europe is now extensive and contrary to his assertions. Consider his four main claims:

1. A policy of deregulation is meaningless when the economy is dominated by elephantine state enterprises that have never been subject to market forces and in which the parallel economy, though large, is secondary in that it flourishes in the interstices of the command economy. The result of shock therapy as applied to the post-communist economies will only be slump. (emphasis added)

2. While such therapy is supposedly taking effect, large state enterprises will be able to protect themselves against its effects to a degree by constraining banks and suppliers to keep credit lines open to them. This in turn chokes off credit to the nascent private sector. Rather than assisting in the growth of the private sector in post-communist countries, shock therapy is far more likely to strangle it at birth. (emphasis added)

3. In Russia attempts at shock therapy have so far resulted in wild, 'spontaneous' or 'Hayekian' privatization that is in fact only the latest episode in nomenklaturist expropriation and rent-seeking.

4. The elections of December 1993 [in Russia] are proof, if proof were needed, that the political result of neo-liberal economic policy in Russia is massive instability. This is not a recipe for foreign investment, or for the political legitimacy of market reform.

As I mentioned at the outset, these claims are offered without any empirical support whatsoever. Nonetheless, they are interesting to consider, since they represent the massive confusion that surrounds the reform programs.
First, as regards to economic growth, there is now no doubt that the
shock therapy countries are precisely the ones to escape from 'slump'
the earliest and the most vigorously. The collapse of industrial
production in the entire region is the result of the huge structural
dislocations facing the post-communist economies as they escape
from the militarism and heavy industrialization of the Stalinist
model. All of the post-communist economies therefore suffered a
terrible jolt to industrial production after 1989, whether the economy
was in shock therapy, gradual reform, or no reform. It is the 'shock
therapy' cases however that recovered most quickly, by encouraging
the rise of new sectors to replace the inevitable declines in the old
heavy industries. By 1992, Poland resumed aggregate economic
growth. By 1993, Poland was the fastest growing country in all of
Europe, at 4 percent per annum growth, an achievement which
might well be repeated in 1994. Other shock therapy countries, such
as the Czech Republic, Estonia, and Slovenia, are also outperforming
their 'gradualist' counterparts in industrial recovery and overall GDP
growth, and they are expected to lead the region in growth in 1994.

Even odder is the charge that 'shock therapy' somehow strangles the
private sector or keeps alive the state enterprises at the expense of
private firms." If there is a single most dramatic result of the Polish
reforms it is the burgeoning of the private sector. The number of
individual proprietorships in Poland has risen from 0.8 million at the
end of 1989, with 1.5 million workers, to 1.8 million enterprises at
the end of November 1993, employing 3.2 million workers. The
increase in the workforce in individual proprietorships, of around 1.7
million workers, constitutes more than 15 percent of the non-
agricultural labor force! Moreover, another 1.6 million workers are
employed in larger private firms, and another 3 million workers or so
are in private agriculture. By the end of 1993, approximately 60
percent of the labor force was in the private sector, compared with
just 25 percent (overwhelmingly in agriculture) at the start of shock
therapy. The proportion continues to rise rapidly in 1994.

The charge that shock therapy leads to nomenklatura privatization
also puts the actual results on their head. One of the central lessons
of the reform period is that 'state ownership' in the post-communist
countries is a serious misnomer. Once the authority of the communist
party collapses, there is no real ownership of the enterprises, only a
grab for assets by various stakeholders. 'Wild' or 'nomenklatura'
privatization characterizes the period before a system of law-bound
mass privatization is implemented. Managers with access to the
enterprise assets are often able to capture them on their own account.
Mass privatization is the best hope to arrest this spontaneous process, by establishing a transparent, rule-bound system to divide the assets among the various stakeholders, including the management, the workers, and the general public. The terms of this division have differed in the various countries, usually as a reflection of the relative power of the competing groups. In Russia, the workers and management got the most (roughly 50 percent for the workers, 10 percent for the management), while in the Czech Republic, the insiders got the least, with most of the shares being 'sold' to the public for vouchers rather than to the workers and management. Through this method of legal, transparent, rule-based privatization, Russia has succeeded in privatizing roughly two-thirds of industry during a two-year privatization campaign.

The fourth claim is that 'shock therapy' has produced political instability. Once again, the opposite is the case. Countries that have pursued shock therapy, such as the Czech Republic, Poland, and Slovenia are the first countries in the region to reach a national consensus on the broad terms of economic management. Thus, even when elections led to the replacement of governments in Poland and Slovenia, the successor governments continued to pursue the basic reform policies of their predecessors. Countries that have failed to achieve even rudimentary monetary stabilization, such as Belarus and Ukraine, continue to experience the greatest instability, to the point of breaking the national consensus on sovereignty. Leading Belarus politicians have argued in favor of abandoning monetary sovereignty and returning monetary policy to Russian control as the (desperate) price for achieving some measure of economic order. Meanwhile, in the Ukraine, Crimeans recently voted for a reassertion of Russian sovereignty, partly in response to the dismal failure of the Ukrainian Government to bring an end to explosive inflation.

The political instability in Russia can hardly be viewed as a result of 'shock therapy,' since political turmoil in Russia during 1992 and 1993 prevented decisive actions on stabilization that are at the heart of the shock therapy. Rather, Russia is still experiencing the revolutionary consequences of the collapse of Soviet communism. The political struggles during 1992 and 1993 between the President and the Supreme Soviet reflected the absence of any consensus on the locus of legitimate power. This constitutional struggle, in turn, blocked vital initiatives necessary for economic stabilization.

The breakthrough to new elections in the Fall of 1993, and the adoption of the new constitution with the elections of December
1993, may actually have gone some way to establish a stable political regime in Russia. While it is still to early to be sure, the new Russian Government has made effective use of the new constitutional order to implement tougher measures of monetary stabilization. As a result of intensified measures of economic stabilization, inflation has declined to around 6 percent per month by mid-1994. This cooling of high inflation seems to have reduced Russian political and social tensions more generally.

Even though shock therapy offers the best chances for stable, democratic transformation in the post-communist countries, the best chances are far from certain. The transition period inevitably involves enormous dislocations to the general public, and these dislocations provoke anxiety, political reaction, and the space for demagoguery, populism, and social unrest. Political support for the economic reforms remains tenuous in many countries, and will continue to do so until the economic performance palpably improves. The provision of emergency social support to vulnerable groups can play an important political as well as economic role in the early phase of adjustment.

One effect so far of the high social anxiety is the widespread electoral success of political parties with roots in the old regime. Parties of the 'democratic left,' based on the earlier communist parties, have had strong electoral showings throughout the region, including in Hungary, Lithuania, Poland, Slovenia, Russia, Ukraine and most recently in the German Lander of the former GDR. These successes have come in countries with a broad range of reform programs, varying from Poland's shock therapy to Hungary's moderate pace of reforms to Ukraine's extreme gradualism bordering on inaction. It is useful to reflect a moment on the possible meaning of these electoral successes.

It appears that the major constituency of the leftist parties are the pensioners and older workers in the state factories, who are turning to the left parties for income protection from the gales of change in the society. One of the remarkable features of the post-communist landscape is the remarkably high proportion of pensioners in the population, reflecting several interconnected factors: (1) the very early age of retirement in the communist countries (generally 55 for women, 60 for men); (2) the widespread use, and abuse, of the pension system as a device to avoid open unemployment of older workers after the start of reforms in 1990; and (3) the subsequent politicization of the pension system to attract electoral support. As a
result, the proportion of the adult population on pension vastly outstrips the proportions found in the OECD economies.” In recent elections, these pensioners have voted heavily for the left-of-center parties, and appear to have given them the margin of victory in several countries.

So far, the victories of the communist-successor parties have not altered the basic path of reforms. Left-of-center parties in Lithuania, Poland, Russia, and Slovenia have supported a continuation and even intensification of stabilization and privatization. The political risks have therefore been the usual ones, familiar in the West, of a bidding war over social entitlements, in societies where the budget is already stretched to the limit. In other words, the post-communist democracies are rapidly, and insidiously, falling into the fiscal politics familiar in the social welfare states of Western Europe. The danger in Eastern Europe does not seem to be a return to communist ideology or practice, but rather the undermining of a fragile and hard-won fiscal balance achieved in the early years of reform.
IV. Still No End to History

Even though there are compelling economic reasons for the post-communist economies to adopt radical market-oriented reforms, the ability of governments to implement those reforms is far from certain. In each of the dozens of countries now engaged in economic transformation, the reform process is a great drama, facing great political challenges as societies struggle with the hugely adverse legacies of state bankruptcies, defunct economic systems, and structural imbalances. It is one thing for a theorist or an economic reformer to assure that things can work out well in due course, and quite another for political leaders to manage the turmoil during the early years of reform.

Elsewhere (Sachs, 1994a, 1994b) I have endeavored to describe some of the risks inherent in situations of extreme economic crisis. There are two main sorts of risks. First, bankrupt governments have grave difficulties maintaining an adequate level of public services, thereby putting social stability at risk. The weakness of the government leads to a breakdown of normal economic and political processes; this breakdown in turn further weakens the state. The result is a spiraling loss of economic stability and a progressive weakening of the government. The vicious circle of state bankruptcy and social instability may be manifested in several ways: rising inflation, a flight from the national currency, increasing tax evasion and general lawlessness, and even the breakdown of relations between the central government and regional governments, as occurred in China after the 1912 Revolution, or in Yugoslavia after 1989. Russia has been at risk of this kind of spiraling loss of control since the collapse of communism in 1991. The adoption of the new Russian Constitution in December 1993 is probably the single most important institutional safeguard so far against the risk of rising lawlessness and further weakening of state functions.

The second great risk is the paralysis or reversal of economic reforms in mid-course, caused by a loss of nerve among the public and the political leadership, and the anti-reform tactics of vested interests that would be hurt by the successful implementation of reforms. There is no more opposite piece of political wisdom than Franklin Roosevelt’s judgement in the depths of the U.S. Depression that ‘the only thing we have to fear is fear itself’. As one astute commentator has recently put it:
[FDR] understood the importance of psychology — that people have to have the courage to keep seeking a cure, no matter what the cure is. America had lost its will to recover, and Roosevelt was certain that regaining it was the first order of business. (cited in Sachs, 1994b, p. 18)

One of the most striking and common phenomena of countries in deep economic crisis, particularly in inflationary crises, is the remarkable — almost extravagant — levels of pessimism found among the public and the politicians. It was commonplace in Germany in 1947, Poland in 1989, and Russia in 1992, to suppose that the economic crisis would necessarily end in widespread starvation or even civil war.

All of this is important for explaining the key role that the international community can play in fostering the success of the fragile reforms now underway in the post-communist countries. As explained at much greater length in Sachs (1994a, 1994b), international assistance — whether in the form of financial aid as in the Marshall Plan, or in the form of institutional support such as Russia's recent Partnership Agreement with the European Union — serves most importantly to help bolster the reform process, so that the reforms have time to work and thereby to win the broad support of a confused and anxious population. Financial aid, even of the scale of the Marshall Plan cannot make much a difference in average living standards of the population, and surely not for more than a few years. The real contribution of aid is to buy time for the more fundamental process of economic restructuring to take hold.

At key points in recent years, the Western assistance has been pivotal in pushing the reforms forward. The $1 billion Polish Stabilization Fund established by the Western Governments at the start of 1990 was a crucial spur to Poland's first reform government. Similarly, the two-stage cancellation of half of Poland's foreign debt inherited from the communist regime, was vital in keeping the reforms on track in the difficult early years. The debt relief served at least three critical purposes. First, and most directly, it eased the acute pressures on the Polish budget, giving an opportunity to help cover social needs in a non-inflationary way. Second, the two-stage nature of the debt reduction over a three-year period gave the Polish Government and public a clear set of incentives for maintaining the reforms during the first critical years. Third, it gave the clear sense of a 'fresh start,' both the public and to potential international to investors, who now saw the prospects for Poland's economic recovery. The Association Agreements between several Eastern
European nations and the European Union are also important institutional anchors to the reform process.

Nonetheless, the Western effort has lacked the boldness and vision commensurate with the enormous challenges faced by the post-communist nations, and with the enormous stakes of the entire world in the successful democratic and peaceful transformation of these nations. A bold and forward-looking European Union would make good on its own long-term interests by establishing a clear timetable for accession of the post-communist nations of Eastern Europe. Similarly, the Western world would recognize the enormous benefits of providing Russia with some $10-15 billion per year of budgetary support to help Russia's fragile democratic government wind its way through the minefield of state bankruptcy and economic reform.

Such a package of budgetary support would enable the Russian Government to cover around 4 percent of GDP in critically needed social spending without the resort to inflationary financing of the budget via the central bank. Such budgetary finance, combined with a ruble stabilization fund and strict conditionality, would underpin a concerted effort aimed at a rapid drop of inflation and a credible stabilization of the value of the rouble. Both the drop in inflation and the stabilization of the exchange rate would provide an enormous economic and political boost to Russia's reform efforts at a critical early stage. In addition to the direct budgetary support, the West should also provide financial assistance to Russian enterprises to help spur privatization and structural adjustment, as it is now doing, though in relatively small amounts. Such enterprise support can be provided through the European Bank for Reconstruction and Development (EBRD), the World Bank group, and programs of individual governments (such as the U.S.-Russian Enterprise Fund). Assuming that stabilization and privatization are successful, Russia could expect that large private inflows of capital would replace official assistance within a few years. See Sachs, 1994b for further details on a Western aid program to support Russia's reforms.

The West cannot guarantee that liberal democracy will triumph in the vast number of countries now attempting political and economic transformation. But neither can the West afford to view these transformations as an exciting, if risky, spectator sport. While we can't hope to end History, we can surely hope to help shape it according to our ideals.
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1. For a detailed account of Poland's strategy of shock-therapy transformation, see Sachs (1993).

2. In the case of Poland, see the Government's economic strategy statement, 'Poland's Economic Strategy, 1994-1997' June 1994. In the case of Russia, see the remarkable article by Prime Minister Viktor Chernomyrdin in the Financial Times, May 1994, in which the Prime Minister stresses that the new Cabinet after the December 1993 elections is simply carrying out the Government's economic policies established in August 1993, a program which was largely the handiwork of radical economic reformers led by then Finance Minister Boris Feodorov.

3. Despite Dr. Gray's harsh attack on me (pp. 32-33), there is absolutely no evidence that he has actually read any of my work, nor does he provide a single reference to my work. His attack on me is supported by reference to a magazine article that in turn made a reference to another (unspecified) study that allegedly criticized my work.

4. See this year's Nobel laureate, Douglass North (1994), for the basic statement of the view that the West's economic preeminence, beginning with the industrial revolution, is the result of superior economic institutions, rather than the result of differences in scientific or technological accomplishment extrinsic to the economic system. As an explanation of the fact that for 200 of the past 250 years, economic growth was 'largely restricted to western Europe and the overseas extensions of Britain', North argues that most societies (outside of Western Europe) 'got stuck' in an institutional matrix that did not evolve into the impersonal exchange essential to capturing the productivity gains that came from the specialization and division of labor that have produced the Wealth of Nations.

5. Economists are increasingly taking note of 'network externalities,' in which the benefit to a consumer of using a particular system depends on the number of other people also using the system. For example, the advantage of having a fax machine depends on how many others have a fax machine. The advantage of VHS video equipment versus Betamax depends on the relative uses of these two systems. Legal arrangements are surely a type of network externality. There are intrinsic and significant gains in harmonizing legal codes in order to lower transactions costs.

6. See the interesting article, 'Some Mutual Funds Wield Clout In Developing Countries,' by Craig Torres and Thomas T. Vogel, Jr., Wall Street Journal, p. 1, June 14.
7. The topic of convergence -- how to measure it, and when it will occur -- has become a major theme of recent economic research. See, for example, Barro and Sala-i-Martin (1992).


9. I tried to make this point from the very start of Eastern Europe's reforms, in Sachs (1990, p. 21): 'The main debate in economic reform should therefore be about the means of transition, not the ends. Eastern Europe will still argue over the ends: for example, whether to aim for Swedish-style social democracy or Thatcherite liberalism. But that can wait. Sweden and Britain alike have nearly complete private ownership, private financial markets and active labour markets. Eastern Europe today has none of these institutions; for it, the alternative models of Western Europe are almost identical.'

10. Specifically, Article VIII declares that members shall not 'impose restrictions on the making of payments and transfers for current international transactions', except with the approval of the Fund. Thus, the requirement of convertibility is limited to current account transactions. In practice, many developing countries receive waivers on their obligation under Article VIII, though IMF conditionality is typically aimed at the establishment of Article VIII conditionality.

11. This is for several reasons. First, all countries engage in industrial policy in the sense of coordinating infrastructure investment (roads, ports, telecommunications, rails) with industrial and regional development. Second, all countries engage in some form of industrial policy in mitigating the social effects of industrial decline. Third, many forms of active industrial policy (e.g. export subsidies, trade barriers) are proscribed, or at least heavily circumscribed, by GATT rules or by rules in the Association Agreements with the European Union. Fourth, most of the post-communist governments simply lack the financial and administrative wherewithal to engage in widespread industrial promotion. Most governments that have tried to do so have quickly backed down in the face of this constraint.

12. A classic case in point is the Brazilian regime in 1979, which rejected the obvious need to stabilize the economy in favor of two more years of reckless foreign borrowing, which ushered in Brazil's deep debt crisis in the 1980s. (For details, see the Introduction in Sachs, 1989).

13. See Sachs and Woo (1994) for a detailed elaboration, both theoretical and empirical, of the arguments in the text.

14. In fact, I have seen this view expressed precisely one time, in the magazine article by Alan Walters cited by Dr Gray. There too, the assertion was made without evidence.
15. Consider the following striking examples. In the United States, there are 34 million pensioners (retirees plus disabled), compared with a labor force of 120 million workers. Thus, the number of pensioners equals 28 percent of the workforce. In Poland, there are 8.6 million pensioners, compared with a labor force of 18 million, so that the number of pensioners equals 48 percent of the labor force. In Slovenia, where the retirement system has been most lax, there are a remarkable 450,000 pensioners, compared with a labor force of some 700,000. Pensioners therefore number 64 percent of the labor force!