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# The Transition to Capitalism in Eastern Europe – Some Theoretical Controversies

**Wolfgang Zank**

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## INTRODUCTORY REMARKS

The transition in the countries of the former communist world to a Western type of society and economy has been the subject of a huge political and academic debate. In this paper, I try to give an overview over some central topics of this debate. The emphasis is on the economic aspects of transition, which, however, are closely intertwined with political, social and cultural problems. Priority was given to texts, which explicitly voiced or criticised policy recommendations in a concrete way, and which were based on empirical observations. By contrast, merely formal models without empirical basis are discussed only to a restricted extent. This reflects the author's scepticism as to constructions of the *reine Vernunft* in social sciences, as long as these constructions are not controlled by experience, both as to the premises and to the conclusions. Similarly, the main interest of this paper is theoretical, but some sections are merely descriptive. Seemingly banal empirical facts can have a strong impact on some theoretical positions.

In this paper, of course only a small selection of positions can be reviewed. These are presented first, rather extensively, with frequent direct quotations, in order to convey the positions correctly. As we shall see, many problems arise from the point that positions are reported incorrectly, a mistake the present author has endeavoured to avoid. *Thereafter*, the positions were critically screened.

The author tried to assemble a broad range of views, perhaps thereby also contributing to a dialogue across the barricades. But it must be emphasised that the author did not find all positions equally convincing. They are nevertheless presented here rather extensively. The process of refuting them *carefully* gives the opportunity to discuss many important problems. Seen this way, even untenable positions can have their merits.

The often-debated problem whether the Chinese Way could have been an alternative for Eastern Europe will be discussed in another paper, and only casually be addressed here.

## I. THE ESSENCE OF TRANSITION – KORNAI'S MODEL

János Kornai, originally of Budapest University, later also at Harvard, is presumably the scholar whose work has had the most profound impact upon how economists have interpreted the mechanisms of the former communist systems. Recently he published a relatively simple model, which highlights some key features of the process of transition[1].

Kornai starts with the contention: "Two systems can be said to have dominated the 20th century: the capitalist system and the socialist system." His category "system" is obviously very broad; "capitalism" covers all Western economies, from Sweden to New Zealand, regardless of their differences. They share, however, some common characteristics which justifies it to group them under one system. The same can be said about the "Socialist System" (or synonymously, Communist System). The essential difference between the systems, in Kornai's view, lies in the political sphere: In communist countries, a Marxist-Leninist party is in a position of undivided power. As to the capitalist system, "democracy" is not a necessary condition; capitalism "can operate under dictatorial regimes as well, as long as the political powers are friendly to private property."[2] We might add here that the

1 János Kornai, 'What the Chance of System From Socialism to Capitalism Does and Does Not Mean', *Journal of Economic Perspectives* – Volume 14, Number 1 – Winter 2000 – Pages 27-42.

2 Ibid., p. 29.

"friendliness to private property" implies an important political difference between dictatorships: It means that at least some important legal norms are in place which restrict the power and arbitrariness of the dictatorship. By contrast, Lenin, Stalin and Mao did not respect any legal or moral norms whatsoever. We leave the question aside whether a *highly developed* capitalism is compatible with authoritarian regimes (the present author thinks it is not). Kornai distinguishes between three types of political transition, the establishing of an anti-Communist dictatorship, the "velvet-revolution", and a type 3, where "the communist party is transforming from within, through a change from a sharply, mercilessly anti-capitalist force into one that is covertly, but ever more openly, pro-capitalist."[3] China and possibly Vietnam represent this type. Whether this path leads to a pro-capitalist dictatorship or to democracy, must remain undecided for the time being.

The extent of private property is the second essential feature in Kornai's model. In communist countries, state and quasi-state property is in a dominant position, in capitalist countries it is private property. There is, of course, also state property in capitalist countries, and in some communist countries there was a considerable private sector, e.g. in Polish agriculture. But in all these countries state property was clearly dominant.

Closely related with this point is Kornai's third criterion, the way the various economic activities are co-ordinated. In capitalist countries we find a preponderance of market co-ordination, in communist countries a preponderance of bureaucratic co-ordination. As Kornai explained in an earlier paper, "bureaucratic co-ordination" is to be understood in the tradition of Max Weber, meaning a vertical relationship: "Control is exercised by a multilevel hierarchy. Administrative coercion and legal sanctions compel individuals and organizations to accept orders and prohibitions from above … The transactions are not necessarily monetized, but if they are, the subordinated individual or organization is financially dependent on the superior."[4] By contrast, market co-ordination is a horizontal relationship between buyer and seller, who are equal from a legal point of view. In its pure form, market co-ordination prices are based on mutual agreements, the transactions are monetised.

As soon as the three first features are in place, each system produces a set of economic mechanisms which guide the behaviour of the actors – a field where Kornai has done research for many years. We recapitulate the main results: Within the communist systems, the absence of markets meant that there was no mechanism to establish meaningful prices. Planning and bureaucratic co-ordination issued first and foremost orders as to physical quantities. But given the rather fictive prices, there was no proper measure to evaluate the efficiency of production. Nor did the companies have an interest in developing transparent and realistic accounting procedures. And if accounting showed that a company had produced losses, the losses had hardly any consequences. They were covered by the state; conversely, profits were confiscated. So, even in case of huge losses, the company could more or less go on as before. It worked under a soft budget constraint. Instead of maximising profit, the enterprises maximised production, measured in physical terms (quantity drive). Production was extended, until the company hit against some kind of resource barrier, for instance raw material supply, energy supply, or manpower.

By contrast, capitalist companies work under a hard budget constraint. If expenses are higher than receipts, the firm has to close down. Of course, there have been exceptions; e.g. some companies might receive subsidies. But these are exceptions from a general rule. And given the point that receipts must be earned on the market, the limits of demands also limit

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3 Ibid., p. 33.

4 János Kornai, 'The Hungarian Reform Process: Visions, Hopes, and Reality', *Journal of Economic Literature,* Vol. XXIV (December 1986), pp. 1687-1737, esp. p. 1690.

the production. As Kornai put it 1980: “With the classical capitalist firm it is usually the demand constraint that is binding, while with the traditional socialist firm it is the resource constraint.”[5]

If a Western firm experiences a situation where expenses are higher than receipts, it has to react, it has to find new markets and/or reduce costs, i.e. reorganise production. This implies that a capitalist firm responds rather quickly to price signals: Moving out of markets with falling prices, and reorganising production in respond to changing input prices. The price mechanism thereby plays a crucial role in propelling economic change. By contrast, the state-owned companies in a communist system react slowly to price signals and adapt more slowly. And this implies much slower growth in productivity.

The soft budget constraint and the quantity drive implied that every company constantly had a demand for some kind of input factor. Shortage was a general feature of the system, which created a row of other effects. Often companies were forced to accept input material of a lower quality than ordered for because the materials of the appropriate quality were not available, at least not in the quantity demanded. This means that the quality of the products deteriorate too, “one of the most harmful effects of shortage.”[6] And the company or individual that could deliver a product which was in short supply, were in a dominant position. Customers could not go to other producers, it was a sellers’ market. And the sellers had few incentives to improve the quality of their produce, no competitor could threaten their position. And given the companies’ huge demand, in the face of insufficient or unreliable supply, the companies developed a practice of hoarding. The excessive hoarding in turn exacerbated the problem of shortage.

The absence of reasonable prices and accounting implied also that the commanding authorities had few possibilities to assess the effectiveness of investment decisions. In the planning process, resources could not be channelled into the sectors and branches were they brought the biggest returns on investment because this could hardly be measured. Instead, the decisions were taken after a process of plan bargaining: Managers and high-ranking party officials forwarded claims for more resources for their particular spheres of influence, which the party leadership and the planning authorities had to balance somehow. Given the point that more resources meant more power, everyone was interested in receiving as much as possible.

Quantity drive and soft budget constraint had an effect on the labour market which was beneficial in the short run: The companies had an almost unrestricted demand for labour. As long as an additional worker could contribute to an increase in production at all, he was welcome. And if he could not be productively employed for the time being, it might be good to engage him as labour force reserve. Also workers were hoarded. As a consequence, once the main features of a communist system were installed, open unemployment disappeared rather quickly. In, for instance, East Germany this was the case for males already in summer 1948 (women in 1950)[7]. But the price was widespread unemployment on the job.

Capitalist firms exhibit a systematically different behaviour. People will be employed only if they contribute to the profit of the firm, i.e. if their contribution to production is more worth than their salary. Companies which do not cover their expenses (including a reasonable profit for the shareholders) must dismiss employees, or get closed down. As Kornai put it:

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5 János Kornai, *Economics of Shortage. Volume A*, North-Holland, Amsterdam-New York-Oxford, 1980, p. 27.

6 Ibid., p. 37.

7 Wolfgang Zank, *Wirtschaft und Arbeit in Ostdeutschland. Probleme des Wiederaufbaus in der Sowjetischen Besatzungszone Deutschlands*, München, 1987, pp. 178-181.

"The labor market is demand-constraint because production is demand-constraint."[8] Unemployment has been a chronic feature of any capitalist system. They differ as to the amount of unemployment, or as to the duration of unemployment spells, and as to the generosity of unemployment benefits. But no capitalist system seems to be capable of ever producing full employment.

By contrast, labour shortage, the neglect of costs and financing and the disrespect for customers were general features, to be observed throughout the communist world, from Leipzig to Shanghai, regardless of all differences in culture and tradition among these countries. They were consequences of the system. Schematically, Kornai's model can be summarised as follows:

*Table 1: The essential features of the capitalist and the communist system.*

| COMMUNIST SYSTEM: | CAPITALIST SYSTEM |
|---|---|
| Undivided power of the marxist-leninist party | Political power friendly to private property |
| Dominant position of state and quasi-state ownership | Dominant position of private property |
| Preponderance of bureaucratic co-ordination | Preponderance of market co-ordination |
| Soft budget constraint; weak responsiveness to prices; plan bargaining; quantity drive | Hard budget constraint; strong responsiveness to prices |
| Chronic shortage economy; sellers' market; labor shortage; unemployment on the job | No chronic shortage; buyers' market; chronic unemployment; fluctuations in the business cycle |

*Source: Kornai, 2000, p. 29.*

These two systems are viable ones. A communist system, provided that dictatorship is intact, can work for decades. A capitalist system can also work, (in effect much better). But as Kornai has pointed out previously, a situation in the middle, a kind of blend between the two systems, is an unstable one. Hence hopes that a kind of "market socialism" or other constructions which try to combine the good sides of both systems, and avoiding the bad ones, are unrealistic. This position gains much plausibility against the background of the Eastern European experiences.

Before we discuss this problem more in depth, we should add a few remarks about some terminological problems. Firstly, Kornai's choice of labelling the Western systems as "capitalist" is perhaps slightly unfortunate, given the point that all Western countries are mixed economies with a huge public sector that distributes between one and two third of the Gross Domestic Product (GDP). So, if the aim of transition is a Western type of society, it can never be a transition to pure capitalism. This point might seem banal, but some shrill tones in the debate stem perhaps from this misunderstanding: Namely that some Western advisors, or the IMF, or others, have been working for the installation of "pure capitalism".

Furthermore, Kornai used the terms Communist or Socialist system interchangeably. We use, unless in direct quotations, only the word Communist system. We want to separate this system clearly from the aims and policies of Western socialist parties. The term "communist"

8 Kornai, 1980, p. 244.

seems also historically to be more appropriate, given the point that in 1918 Lenin insisted that the Bolsheviks should call themselves Communists, in order to mark the breach with the Social Democrats. After 1945, some of the ruling parties in the Soviet Orbit called themselves e.g. *Sozialistische Einheitspartei Deutschlands*, but the choice of names of this kind was tactical; Stalin had no intentions of embracing social-democratic principles. The point that the ideologues of these parties called their societies "socialist", reserving the term "communist" for the aim they allegedly were heading for, could be a historical argument for excepting the term "Socialist system", but it weights, in the eyes of the present author, less than the above mentioned ones.

Still as to terminology: We are going to use the term "Eastern Europe" to cover all the countries of the former Council for Mutual Economic Aid (CMEA) plus Yugoslavia. "Eastern Europe" is thus more a political than a geographical term. The same is valid for "Western Europe", which also covers Finland and Greece.

As to the content of Kornai's model, we want to emphasise some implications, as regards the relationship between politics, economics, and culture: In Kornai's view, the political sphere is clearly the dominant one because it determines the economic system. Under the conditions of international rivalry between the systems, there is, however, a "cybernetic loop" between politics and economics, given the point that the Western system has been vastly superior as to economic productivity which in turn became translated into political capabilities. Thus, the choice of an economic system is a political question, but the economic systems are not equally good from a political point of view. This has been an essential problem for the Soviet Union under Gorbachov, and China under Deng Hsiao-Ping. But in case a ruling party gives stability of its dictatorship priority over international capabilities, it can of course maintain a communist system for many decades, although the economic performance is miserable. North Korea is a case in point. But in the long run this strategy is hardly feasible. Firstly, the economic misery undermines the legitimacy of this system in the eyes of the population. Furthermore, communist ideology promises the liberation and self-determination of the working people, but the reality has been repression and bureaucratic regulation. Communist ideologues have justified this as temporary features on the way to the promised social reality. But if allegedly temporary evils turn out to be permanent structural (i.e. non-reformable) features, then the ideological convictions of most believers become systematically eroded. And without believers, no dictatorship can survive in the long run. Seen in this perspective, in the longer run it is the economic characteristics of the system which determine the political sphere.

## II. PROBLEMS AND DISCUSSIONS BEFORE TRANSITION

### 1.The Failure of Immanent Reforms and the Demise of the Soviet-typed Systems

Already during the 1950s it became apparent to many high-ranking officials that the communist systems suffered from severe shortcomings. In 1963, the GDR as the first state of the Soviet Orbit, introduced some reforms which aimed at a more economic use of the resources by strengthening the role of prices and accounting, and by decentralising and giving more competencies to the managers; with the change of the leadership from Walter Ulbricht to Erich Honecker, most of these reforms were revoked. In 1968 also Hungary entered the path of reforms, which were substantially enlarged during the 1980s. Poland joined the reform camp the same decade, and also the Soviet Union under Gorbachev decentralised the economic competencies substantially after 1988. All these reforms failed to produce the intended results. Industrial reconstruction hardly gained momentum, the companies did hardly become more competitive in hard-currency markets. In many respects, the reforms even worsened the situation, by weakening the state authority over the enterprises, thus giving the managers of the state-owned enterprises more autonomy, without corresponding responsibility. Furthermore, the unclear ownership situation made so-called “spontaneous privatisation’s” possible – the theft of the assets of the company by managers and employees[9].

Grzegorz Kolodko, who participated in the Polish reform discussion prior to 1989, summarised the main intentions as follows: “The idea was to change economic and financial mechanisms extensively, but to alter state ownership and property rights only slightly.”[10] If this had succeeded, it would have represented a blend of the two systems. But it did not succeed. Kolodko himself characterised the factual outcome as follows: The system established in the 1980s was a “hybrid combining the relics of old arrangements with elements of the new. In a non-performing way, it still mixed centralized bureaucratic rationing with market allocation methods.”[11] More specifically, he adds that “the weight of structural distortions generated constant pressure for the transfer of resources from efficient enterprises to less profitable ones. To compensate for the unprofitable production there were many grants and subsidies, as well as strong dose of fiscalism, which was expressed in the relatively heavy taxation of enterprises.”[12] In short, the reforms did not transform the soft budget constraint into a hard one.

In the 1970s, many of these countries borrowed heavily in the West, in order to buy modern equipment and to increase productivity, without having to change the system. But within the context of the communist system, the investments did not generate sufficient productivity. It became increasingly difficult to earn the hard currency which was necessary to pay for imports, and to pay back the credits.

In spite of half-hearted reforms and Western credits, the Eastern economies slowed down, or fell into stagnation. The gap to the West widened. International comparisons have always

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9 Thomas A. Wolf, ‘The Lessons of Limited Market-Oriented Reforms’, *Journal of Economic Perspectives*, Volume 5, Number 4, Fall 1991, pp. 45-58, esp. p. 56. This article concentrates on the Polish and Hungarian experiences. As to the daunting results of Gorbachevs economic reforms, see Anders Cslund, *How Russia Became a Market Economy*, Washington, The Brookings Institution, 1995, esp. p. 43.

10 Grzegorz Kolodko, *From Shock to Therapy. The Political Economy of Postsocialist Transformation*, Oxford University Press, 2000, p. 23.

11 Ibid., p. 20.

12 Ibid., p.23.

been difficult. But different methods produce similar results. If GDP per capita, measured in U.S. dollars at 1985 relative prices, is used as an indicator, Spain was lagging slightly behind Hungary in 1950; in 1989, Spain was in the lead by 10,100 to 6,700[13]. Alternatively, a "physical indicator" method places Czechoslovakia at 91 per cent of the level of neighbouring Austria in 1961. In 1980, Czechoslovakia has fallen back to 70[14].

Revealing is perhaps also a comparison between the sectoral distribution of employment. In the developed world, the data have shown some general trends during the second half of the 20th century: Agriculture has been declining, industry rose until about 1960 and has been declining afterwards; and services have been rising. These trends are also observable in East and West Germany. But by 1989, the GDR figures closely resembled those of West Germany at around 1965 [15]. In this perspective, the GDR appears to have reduced the speed of economic change by about a half. The figures of the other Eastern European countries exhibit similar distortions.

During the 1980s, the economic situation of most Eastern European countries became desperate. In summer 1989 the Polish communists, being helpless in front of a massive economic crisis, accepted (almost) free elections. The Solidarity movement formed the first democratic government in an Eastern European country. Some month later, in the GDR, the new SED leadership under Egon Krenz had to confront the following facts: For decades the GDR had consumed more than it had produced; the foreign debt had risen from 2 billion D-Mark (West) in 1970 to 49 billion; the foreign currency income covered only 35 per cent of the expenses. Just in order to prevent a further increase of the debt, living standards had to be reduced by 25-30 per cent[16]. By that time, the Berlin Wall could not prevent mass emigration any more, given the point that the Hungarian government in practice had opened the border to Austria. In short, also the SED leadership was in a hopeless position, and so were soon also the other parties which did *not* try immanent reform. In the Soviet Union production fell in 1991 by about 20 per cent, the budget deficit rose to 20 per cent of the GDP, and international reserves had been exhausted. In December 1991, the USSR defaulted on its foreign debt payments[17].

To sum up, by the end of the 1980s, the countries of the Soviet orbit had entered a persistent economic crisis; in some countries (Poland, Yugoslavia, Bulgaria, USSR) the situation became outright desperate. Production was falling rapidly, budget-deficits exploded, the danger of hyperinflation was imminent and international creditworthiness ruined.

## 2. On the Theoretical Feasibility of an Reformed and Efficient Communist System

Ideas of reforming the system "somehow", going on "somehow", or to introduce some kind of "market socialism" still find their audience. The point that China has not yet performed a complete transition to a Western system, seems to keep hopes alive. For instance, Kolodko writes: " … though these experiments [*with combinations of socialism and market*, *W.Z.*]

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13 Kornai, 2000, p. 39.
14 Ibid.
15 Rainer Geissler, *Die Sozialstruktur Deutschlands. Ein Arbeitsbuch zur Entwicklung im geteilten und vereinten Deutschland*, Opladen, 1992 p. 118.
16 Wolfgang Zank, 'The Power of Legends and the Long-Term Effects of Short-Term Mistakes – The Convulsions of Monetary and Economic Transformation in East Germany 1990-1997', Tadeusz Kowalski, *Financial Reform in Emerging Market Economies. Quantitative and Institutional Issues*, Poznan, 1997, p. 261-284, esp. p. 263.
17 Cslund, 1995, p. 52.

were generally fruitless, this should not be taken as a sign that similar experiments cannot bear fruit elsewhere. Thus, the case of China is important not only because of the significance of this mighty country and its economy, but also because of the new path taken in the introduction of so-called 'market socialism'. "[18] These sentences are difficult to reconcile with a previous passage in the same book: "Considering the logic and the mechanism of market-oriented reform and the transition to a market economy, it seems quite likely that these countries … are at least 'transitioning' … to a full-fledged market economy. However, this in not absolutely certain."[19] We can agree that it is possible that in the future China might stick somewhere on the road of transition. The question is, however, if this outcome would be advisable.

There has been a long debate, also among prominent Western economists, whether such a system is theoretically at all conceivable. Evsey Domar, for instance, constructed a scheme of free price setting, combined with a bonus plane, which would push the firms to set the prices so that they would be equal to their marginal costs. More recent contributions (by, among others, Paul A. Samuelson), under the influence of the debacles of immanent reform in Eastern Europe, concluded that bonus schemes would make hierarchical paralysis only worse[20].

We might ask theoretically: If the soft budget constraint lies at the heart of the economic inefficiency of the communist systems, is then a kind of "market socialism" with a hard budget constraint conceivable? In this case, the state-owned enterprises have to compete against each other, and they have to balance their budgets. If they fail, they are to be closed down. This implies that bankruptcy and unemployment become regular features of the system. It also implies that credits and other form of capital injection must be remunerated with an equal rate of interest; "cheap loans", if not totally excluded, must be an exception. In this case, the state, owning the enterprises, would act as one big capitalist. But such a system will still be systematically inferior to a capitalist system. If no private ownership of the means of production is allowed, and thus no direct private investment possibilities, there would be a strong disincentive on saving, compared to a capitalist system. Furthermore, a portion of the private fortunes will be transferred to capitalist countries, where the returns are higher, unless there are very strict border controls. These border controls would substantially weaken the possibilities for international divisions of labour, and thus produce inefficiency. It would also be impossible to attract private foreign investments, they should even be forbidden, given the fact that private ownership of the means of production are not allowed. What would be the aim of such a construction, which repeats most of the evils of capitalism, without reaching its level of productivity? Of course it is conceivable to allow some private property and retain state-ownership in the most important enterprises. But then we are already far on the capitalist side. Such a system would resemble Italy up to the 1980s, or pre-Thatcherite Britain. In the West, also Socialdemocrat and Socialist parties have opted for privatisation because huge shares of state-ownership in the sphere of production have proven to be counterproductive. They do not produce social benefits, but much inefficiency. No relevant political force in the West campaigns for the nationalisation of enterprises any more. The political strife in the West has been about a public sector which produces public goods, and about the size and extent of the welfare state. In these spheres, a strong public sector has proven to be

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18 Kolodko, 2000, p. 33.

19 Ibid., p. 3.

20 Joseph Persky, 'Retrospectives. Lange and von Mises, Large-Scale Enterprises, and the Economic Case for Socialism', *Journal of Economic Perspectives* – Volume 5, Number 4 – Fall 1991 – pages 229-236, esp. p. 235.

indispensable, and it has been rising in almost all Western countries, neo-liberal rhetoric non-withstanding. But the political conflicts about public sector and welfare states have been, to return to Kornai's terminology, intra-capitalist debates. To sum up, even the theoretically ideally constructed form of "market socialism" would be systematically less effective, without being able to avoid the most important negative sides of capitalist systems. Given the impact of long-term differences in productivity on peoples' standard of living, and the importance which voters attach to economic performance, such a "market socialism", can not survive under democratic conditions in the long run.

Of course, neither theoretical considerations nor the Eastern European experiences "prove" that "market socialism" is impossible. Perhaps the right solution is not found yet. But at any rate, in the 1980s and 1990s, the adherents of "market socialism" could not contribute with operational advice to the debate about what had to be done. It seems as if "market socialism" had an impact only as an implicit advice to retain as much as possible of the old system.

In Hungary in the 1980s, a group emerged which János Kornai called "radical reformers". These were economists working in different research institutes or in the apparatus of higher authorities. Their common starting point was that the reforms in Hungary had not produced the desired results. The Hungarian reforms were of particular importance, given the point that this country had progressed longest on the road of reform. The radical reformers drew the conclusions that more was needed. As Kornai formulated it in 1986: "Price determination must be left to the market. Derivation from these principles can be allowed only exceptionally. Profit incentives should be strengthened to make them sufficiently responsive to prices."[21] Furthermore, barriers to competition should be eliminated, the growth of small and medium-sized units should be encouraged and monopolies or excessively large units be broken up. "Tough financial discipline, the hardening of the budget constraint, must be assured … bankruptcy must be an ultimate threat."[22] A commercial banking system and a flexible capital market should be developed; realistic exchange rates, import liberalisation and full convertibility were also on the lists of reform aims.

Proper economic change could not be done by merely economic reform: "Political conditions of systemic economic change must be created; the various social and economic group must get appropriate political representation." In short, the Communist Party should give up its power monopoly. "At the same time, the state must continue to play an active role in the economy. Its main obligations are the macromanagement of demand, the regulation of monopolies, the development of the infrastructure, the protection of society against harmful externalities, the redistribution of personal income for the sake of political justice." In other words, the state should perform similar tasks as in the West.

Of considerable importance for future recommendations was also the following point: "The changes listed above and perhaps a few more important measures must be introduced in a consistent manner, as a 'package'. Any one of these changes, implemented separately without the appropriate conditions created by the other necessary changes can be risky and harmful."[23] Here we have an early formulation of the idea that, under the conditions of Eastern Europe, a piecemeal reform process might not be sufficient, or even be counterproductive, given the point that the points on the lists of the radical reformers were interdependent. And it was likewise of great importance for future developments that economists in other Eastern European countries reached similar conclusions. Of these was the

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21 Kornai, 1986, p. 1732.

22 Ibid., p. 1733.

23 Ibid.

group around Leszek Balcerowicz in Warsaw of particular importance. These discussions were not confined to Eastern Europe, but had repercussions in the West. Again Kornai, who in the 1980s also held a chair at Harvard, played an important role as mediator. Harvard is comparatively close to Washington.

Kornai's paper does not address problems of macroeconomic stabilisation, due to the simple point that Hungary's economy was comparably near macroeconomic balance. But by 1989, in some Eastern European countries it was exactly gross macroeconomic imbalances, hyperinflation, soaring budget deficits, and unmanageable foreign debts, which stood at the centre of the agenda.

**3. The Washington Almost-Consensus and the Paradigm of Radical Reform**

At this point in time, leading economists at the IMF, the World Bank, universities such as Harvard or MIT, many Third World countries, and, crucially, some economists in Eastern Europe had built up a consensus that hyperinflation cannot be redressed slowly. As Jeffrey Sachs, of Harvard University, wrote about the discussions in Poland:

> "Balcerowicz and his team saw that almost none of the countries in Latin America had been successful in ending a hyperinflation. While Poland was confronting its hyperinflation, there were similar hyperinflations in Nicaragua, Peru, Argentina, Brazil, and Yugoslavia – an extraordinary array of experiences with which to make comparisons. They noted that up to that point there had been only one successful end to a hyperinflation in 1980s, the case of Bolivia [*where Sachs worked as an advisor, W.Z.*], a country that has moved most dramatically and rapidly against the hyperinflation. President Raúl Alfonsin of Argentina, President Alan Garcia of Peru, and President José Sarnay of Brazil had shared the mistaken notion that a gradual tightening of monetary and fiscal policy would provide a more tranquil and socially stabilizing way to end hyperinflation, but the results of gradualism were decisively negative in all of those countries.[24]

This notion that hyperinflation should be brought down quickly (at a level of somewhere below 40 per cent) merged with the above mentioned concept that, as to Eastern Europe, the transition to a market economy should be done with a consistent reform package. These two points together formed the so-called "Washington Consensus". Journalist quickly baptised this approach "Shock Therapy". Balcerowicz rejected the use of this kind of "emotionally loaded terminology", Shock Therapy being "an expression borrowed from psychiatry".[25] The present author entertains an aversion against the use of medical or biological analogies in social sciences and therefore prefers "radical reform", using Shock Therapy only in quotations.

The above quoted Jeffrey Sachs, 1989 advisor to the Polish Solidarity movement and later to the Russian government, was perhaps the best known representative of this approach. But in spite of his high public profile, Sachs' actual ability to influence events was modest. As John Lloyd, "the well-informed Moscow bureau chief of the Financial Times"[26] in the early 1990s, pointed out: Sachs did not invent Shock Therapy, though he contributed to it. Besides his work in Bolivia and elsewhere in Latin America – where the main initiators of reform

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24 Sachs, *Poland's Jump to the Market Economy*, Cambridge/Mass. and London, 1994, p. 45.
25 Leszek Balcerowicz, 'Common Fallacies in the Debate on the Economic Transition in Central and Eastern Europe', Paul G. Hare and Junior R. Davis (eds.), *Transition to the Market Economy. Critical Perspectives on the world economy,* London and New York, 1997, pp. 116-152, esp. p. 117, [Originally published as European Bank for Reconstruction and Development, October 1993, Working Paper No. 11].
26 Cslund, 1995, p. 341.

where the economists and politicians of these countries – the most important instance in the development of techniques which goes under that name was the puncturing of Israeli inflation in the mid eighties. In this, the key figures were the then chairman of the Israeli central bank Michael Bruno, now [*1996*] chief economist at the World Bank; and, as advisor, Stanley Fischer, then of MIT, and now first deputy manager of the IMF. Both, especially the latter, are much more institutionally powerful than Sachs, and independently held roughly similar views…[27]

In 1991, Fischer, by then chief economist at the World Bank, published a paper together with Alan Gelb, chief of the socialist economies unit at the World Bank. This paper contains the essence of the paradigm of rapid reform.[28]

Fischer and Gelb started by underlining that the countries in question differed as to the extent of their macroeconomic imbalances, and as to the degree of decentralisation. "Countries closer to macroeconomic equilibrium (Czechoslovakia, Hungary) could concentrate on structural reform leading to a market system. Those needing urgent stabilization (Poland, Yugoslavia) faced the difficult task of combining stabilization with structural reforms, in a situation in which conventional indirect fiscal and monetary policy tools were not available."[29] The macro-imbalances stemmed from both budget deficits and soft budget constraints on state enterprises. The imbalances showed itself in open inflation (as in Poland), or in a "monetary overhang" (people possessed money, but could not buy goods in corresponding quantities). In either case, structural reform would not be effective unless aggregate demand and inflation was brought under control.

Some countries (e.g. Czechoslovakia) still had relatively centralised economies, whereas some 70 per cent of the Polish and Hungarian firms were self-managed. But 'Socialism without planning' tended to make budget constraints soft, mainly because governments were committed to preserve the existing jobs, thereby preventing loss-making companies from going out of business. In combination with price controls, chronic shortages were the result. On the other hands, the decentralised economies started with some advantages because many agents were more familiar with market processes. But on the negative side, reformers had to re-establish bottom line discipline over powerful firms.

Stabilisation policy required tightening fiscal and credit policies in order to reduce inflation, but these instruments did not have the same effect as in western countries. For instance, higher interests might reduce household spending, but in the absence of a hard budget constraint, "firms may simply refinance growing interest charges in a giant Ponzi scheme … Until bankruptcy becomes a credible threat, a range of direct controls will therefore be needed …"[30] These could include direct wage controls in the public sector, credit ceilings, or the elimination of subsidies. Thus, macroeconomic measures can help, but "rapid systemic and structural changes are needed to ensure that macroeconomic stabilisation is sustained."[31]

Given the number of commodities (25 million in the Soviet Union), a planned transition to somehow rational prices would have been incredibly complex and protracted. But a feasible way was to combine price liberalisation with the opening of the economy to foreign

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27 John Lloyd, 'Eastern Reformers and Neo-Marxist Reviewers', *new left review*, number 216, march/april 1996, pp. 119-128, esp. p. 123.

28 Stanley Fischer and Alan Gelb, 'The Process of Socialist Economic Transformation', *Journal of Economic Perspectives* – Volume 5, Number 4 – Fall 1991, pp. 91-105.

29 Ibid., p. 92.

30 Ibid., p. 93.

31 Ibid., p. 96.

trade. This way, the country could import a rational price system; prices which were too high in comparison to world market prices, would be depressed through foreign competition; unduly low prices would be raised because producers could earn more by selling them on foreign markets.

Deregulation, demonopolisation and the breaking-up of large conglomerates should accompany price liberalisation. The introduction of an unemployment insurance, employment agencies, and other institutions to encourage labour mobility was also important. But freeing input markets (labour and capital markets) could not be an early priority because e.g. wage regulation could not be abolished until budget constraints have hardened. And financial markets depended on underlying legal and informational systems and skills which hardly existed at that time. Also the problem of old loans must be addressed before a sound banking system and liberalised financial markets could emerge.

"Enterprise reform, which requires the imposition of bottom-line discipline, definition and change of ownership, and reform of management, is the heart of the transformation process. The ownership issue is a political minefield."[32] Given the long time which is necessary for privatisation - studies suggested periods between 3 and 30 years -, the first step of enterprise reform should be corporatisation, i.e. the companies were to be transformed into commercial enterprises, free from ministry control.

Fischer and Gelb shortly reviewed the arguments for and against a speedy privatisation. Slow privatisers argued that a more rational price system and the new rules of economic behaviour must be in place prior to privatisation, otherwise severe economic dislocation might be the consequence. Fast privatisers answered that rapid ownership reform would increase efficiency and prevent that redundant bureaucrats, potentially laid-off workers or other groups which were effected negatively by the reform, could form interest groups. Rapid privatisation schemes typically involved a broad distribution of shares to the population. But huge numbers of small owners could not control the management effectively. Therefore, rapid schemes included the formation of a potent group. One possibility could be the creation of holding companies as dominant shareholders. The main difficulty with this approach was to ensure that the holdings acted as private owners, if they are not. One could also hope for that the trade of shares would eventually lead to the formation of strong groups. But it was not sure that this would happen. Also unacceptable problems of inequity might arise.

According to Fischer and Gelb, a variety of approaches were likely, supposed "that price reform, trade reform and macroeconomic stabilisation have progressed sufficiently to make reasonable viability judgements possible."[33] This is presumably to be understood – the text is not completely clear at this point – that Fischer and Gelb regarded the existence of a somewhat reasonable price system as a condition, to be fulfilled prior to privatisation. Then small strong firms could be privatised rapidly, and small weak firms closed. The state should restructure or close large weak industries, the private sector could not be expected to be capable of this task. "Larger firms with potential are the crux of the privatisation problem."[34] Given the scarcity of domestic owners, holding companies will play an important role. At a later stage, they could be privatised, or converted into pension funds. Foreign ownership and foreign management could play a supplementary and temporary role.

Redefining the role of the state was, according to Fischer and Gelb,

> one of the greatest challenges for reform. Institutions and professions taken for granted in market economies

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32 Ibid., p. 98.
33 Ibid., p. 99f.
34 Ibid., 100.

have to be re-created and reformed to support markets. A secure legal environment has to be created to protect property rights and regulate commercial relations. Accounting and audit systems are needed to organize and monitor information. Complementing the system reforms are needed investments in human capital, in areas such as accounting, credit and market analysis, and bank inspection. Management skills have to be upgraded and modernized, especially in finance and marketing. In some areas, such as financial markets, reform may require a greater state role than before.

Such inevitably lengthy reform processes constrain the inefficiency and speed of reform; for example, in the United States it takes a minimum of five years to train an examiner capable of – perhaps – of dealing with the smallest and simplest bank. These reforms also constitute an area in which foreign assistance may be especially helpful … Given their desire for close ties with and eventual membership in the European Community, it makes sense for the reforming countries to take over or align with Community regulations and codes.[35]

The reforms should be carefully sequenced, but “the initial bundle of reforms is massive, including macroeconomic stabilization, price reform, trade reform, small-scale privatisation, new regulations for private investment, the creation of an unemployment insurance, and the start on work on new tax, legal and regulatory institutions.”[36] For Poland and other countries with severe imbalances, macroeconomic stabilisation had to be the initial priority. In high inflation countries, “it may be necessary to fix the nominal exchange rate to provide a nominal anchor for the price level” (if wages and prices rise too quickly, firms loose ground against foreign producers, so a fixed exchange rate works as a heavy constraint against wage and price increases). Necessary conditions were, however, in Fischer’s and Gelb’s view sufficient currency reserves, and a consistent non-inflationary macroeconomic policy afterwards. Capital account convertibility, i.e. the liberalisation of capital movements across the borders, should come later than current account convertibility (free access to foreign exchange), when expectations of stability had been established.

As already hinted at, the labour market could only be liberalised at a later stage because wage controls were necessary in the beginning. The abolishment of discriminatory regulations against the private sector could start immediately, but the privatisation of larger firms will take many years. As to the banking system, the reform should start with the establishment of accounting and asset valuation standards, banking and bankruptcy laws, and staff training. Next to come were audits of firms and assets and portfolio restructuring. “Only after this process is complete can a market-based banking system emerge and interest rates be liberalized”[37] All in all, many reforms should be started early, the others had to be prepared at an early stage. But implementation might take a decade or even more. Finally, the West could make four important contributions: Giving access to the markets of the industrialised countries, technical assistance, debt relief, and access to capital to finance restructuring.

This programme, with relatively minor variations, united Western institutions such as the IMF and the World Bank, economic advisors to Eastern governments such as Jeffrey Sachs and Anders Cslund, and Eastern European politicians and economists such as Leszek Balcerowicz in Poland, Vaclav Klaus in Czechoslovakia, or Yegor Gajdar in Russia. It can be discussed in many ways. One point to emphasise is the simple fact that this is a transition programme, i.e. a programme which aims at replacing the communist system by a capitalist one. Jeffrey Sachs made this point explicit:

The eastern countries must reject any lingering ideas about a ‘third way’, such as a chimerical ‘market socialism’, based on public ownership or worker self-management, and go straight for a western-style

35 Ibid., p. 100f.
36 Ibid., p. 101.
37 Ibid., p. 103f.

market economy … 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.[38]

But this meant by implication: Someone who was in favour of 'market socialism', chimerical or not, must have been against such a programme, out of principal reasons.

Trade liberalisation belonged to the steps to be done at the start of the process. This did not necessary imply complete free trade - hardly anyone recommended this - but the abolishment of quantitative restrictions and import/export licences, the introduction of currency convertibility with a uniform exchange rate (instead of different exchange rates for different kind of commodities), and the imposition of a uniform tariff on imports; a uniform tariff would not distort prices as much as the multitude of (inconsistent) regulations in the old system did. The opening of the economies meant, by implication, the integration into a broader European market, and the rejection of any ideas of a kind of separate development, or an Eastern European Economic Community. To quote Sachs again:

As Eastern European economies become more integrated with the West, they will tend to become more integrated with each other, as part of an expanding common market. But efforts to promote East European integration make sense only if they accelerate, rather than try to replace, what will occur naturally in a united European market. The East European common market that some suggest as a precursor to integration with the West would simply be a poor man's club. The answers to Eastern Europe's need lie mainly in integration with Western Europe, whose market is perhaps 15 times as large."[39]

It follows by implication that someone who adhered to the idea of a separate development for Eastern Europe, must have been an opponent of this programme. An opposition against integration with Western Europe could be motivated by many considerations: Fear of losing economically in a context of open competition; fear of losing political independence; or fear of losing cultural identity; or a combination of all these. Conversely, if the leadership of an Eastern European country followed a path of "returning to Europe", perhaps even with EU-membership as goal, then the political context was much more favourable to radical reform. At any rate, it is obvious that the paradigm of radical reform was by no means a mere technocratic recipe to improve the allocation of economic resources, but had vast implications for all aspects of culture and society.

Last not least, the question of the *speed* of the reform has provoked many debates. Sometimes it looked as if the controversy between "rapid reform" and "gradualism" was the most important divide in the debate. If there were consensus about the fundamental issues, namely transition to an open capitalist system, the controversy about the speed of the reform would have been a discussion among friends, almost technical in nature. But the often highly polemical tone of the debate could be an indication that this was not the case. Were perhaps some of the vitriolic attacks on "Shock Therapy" not a critique of the speed, but of the *direction* of reform?

To be sure, the idea of rapid change has been unappealing to many representatives of the Western, pro-capitalist main stream of economics, and of Western thinking in general. Karl Popper and others have for decades emphasised that reforms should be incremental; large-

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38 Jeffrey Sachs, ' What is to be done?', *The Economist*, January 13 1990, pp. 19-24., esp. p. 19.

39 Ibid., pp.22-24.

scale changes could have vast and unpredictable consequences, so introducing them is risky, not to say irresponsible. And in mainstream economics many formal models were elaborated that showed that distributing the costs of changes over a longer period was preferable to front-loading the costs. So Stanley Fischer, Alan Gelb and other advocates of rapid reform - undoubtedly otherwise representatives of the main stream of the profession - came as to this point in conflict with many other "main streamers."

The followers of rapid reform pointed at the complementary character of these early reform steps: In order to generate competition and reasonable prices, a half-way price liberalisation would not do; it had to encompass most prices, and must have been accompanied by liberalisation of foreign trade, which in turn presupposed currency convertibility. Reasonable prices also presupposed the control of inflation below 50 per cent, which implied credit restriction and public budgets near balance, so that a deficit could be financed by orderly borrowing, and not through inflationary transfers from the central banks. So, one reform had a proper effect only in connection with the other reforms. Technically speaking, there were positive reform "externalities". Other economists argued that there were "negative externalities". We discuss these problems briefly in section IV, 2. Also the recommendation to put macroeconomic stabilisation at the top of the priority list and bringing inflation down rapidly under 50 per cent has been the subject of much controversy. We return to this problem at several instances in this text.

Another argument for rather rapid reform, not expanded in Fischer/Gelb's article, stems from the theory of rent seeking. Rent is any income which exceeds the costs (including an average profit) which are necessary to produce an item or service. A classical example is the surplus profit which a monopolist realises selling at a higher price, to his benefit and society's detriment. If individuals work for market distortions, or exploits market distortions to realise rents, they are "rent seekers". The theory of rent seeking is of a rather recent origin (end of the 1960s). It has shown that the social costs associated with rent seeking usually are much larger than the traditional theory of market distortions assumed.[40] In Eastern Europe cheap credits to state enterprises which were diverted to private purposes, or buying at low subsidised domestic prices and selling abroad, were frequent examples of rent seeking (see also sections III, 3 and IV, 2). All those activities implied, of course, tremendous and appalling redistributions of income from the poorer sections of the population to few privileged groups. And these rent seeking activities have been possible because of inconsistent reform.

Furthermore, the restriction of credits and the controlling of inflation were but the other side of the coin of imposing hard budget restrictions, given the point that excessive credits to state-owned enterprises were the main point which softened their budget constraint. So, the initial package of price liberalisation, foreign trade liberalisation, currency convertibility, macroecomic stabilisation, restrictive credit policy and building up of a new social policy formed a consistent entity. Diluting it would, according to the adherents of radical reform, only create an unwholesome hybrid.

For the new Solidarity government in summer 1989, heavy political arguments supported the idea of a comprehensive initial package. As Sachs put it,

> Many in the Solidarity leadership feared that Solidarity would simply be pawns of the communist old guard, because Solidarity lacked enough expertise to fill the ministries. They feared that Solidarity would be left to

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40 Gordon Tullock, 'rent seeking', John Eatwell, Murray Milgate, and Peter Newman (eds.), *The New Palgrave. A Dictionary of Economics,* vol. 4, London and Basingstoke, 1987, pp. 146-149, esp. p. 149.

administer painful medicine but without the administrative personnel or policy instruments really necessary to guide the reforms, while the communist guards could continue to frustrate the reforms.

It was here that economic logic and political logic coalesced … The point was simple: if the reformers do not control the ministry of foreign economic relations, all the more reason to let the foreign exchange market allocate foreign exchange! If the reformers do not control the price division of the ministry of finance, all the more to let markets determine prices."[41]

So, for the advocates of rapid reform, economic and political arguments squared nicely as to the initial bundle of reform. This was not necessarily the case as to the later phases, in particular enterprise reform. Its first step, corporatisation, was uncontroversial. But what about privatisation? According to Fischer and Gelb (and many others), privatisation should not be undertaken before inflation was under control, and a reasonable price system had appeared. And they underlined that many institutions had to be in place before markets could work properly. As to the financial sector, they explicitly made privatisation and full liberalisation conditional on that. But as to large-scale industry firms, their text turned ambiguous, where they quoted the arguments of "fast" versus "slow privatisers." This reflects a conflict inside the "Washington consensus" (which as to this point was no consensus). From a strictly economic point of view, within main-stream economics, an abundance of arguments pointed in favour of a slow privatisation; in a context of nonsensical prices, unclear ownership rights and non-transparent institutions, privatisation cannot be expected to have many beneficial effects on the economic efficiency for the first many years. But if privatisation was slow, the managers of the state-owned enterprises and other groups of the old élite retain important power posts, which they could use to block reform and to strip assets. This was a strong argument for quick privatisation.

Much depended on the specific conditions of the country in question. Where reformers were in a strong position, the scale turned heavily in favour of slow privatisation. It could be prepared carefully, pragmatically, there was no need to hurry. But the matter was different where the reformers were weak. They had a strong motive to privatise quickly, in order to make some basic steps of transition irreversible. In this case, the political arguments outweighed the economic ones. Unfortunately, a country where the reformers were relatively weak, can also be supposed to be a country with very insufficient institutional conditions for a market economy. We return to this problem on several occasions.

To sum up, the concept of radical reform offered to political practitioners a concise list of operational pieces of advice, though not necessarily for the ensuing steps such as privatisation. As to the kind of capitalism to be introduced, whether "Swedish" or "Thatcherite", the concept was open. It *unavoidably* mobilised a wide range of opponents. To those belonged the adherents of "market socialism", or of "separate paths of development". Furthermore, the programme *unavoidably* affected the interests of large segments of the old guard, in particular the managers of the state-owned enterprises. Workers in many industrial enterprises and in large sectors of agriculture were also negatively affected, at least temporarily. The ideological opponents and those, whose interests were negatively affected, could potentially form an anti-reform alliance. From a mere technical point of view, the speed of the reform or the necessity of bringing inflation down have often been debated.

## III. THREE TRANSITION PATHS

41 Jeffrey Sachs, 1994, p. 42f.

The aim of this section is to provide some basic empirical facts about the development in the 1990s, concentrating on three countries. As we shall see, strategies and outcomes varied strongly.

**1. Poland**

This country pioneered the process of political and socio-economic transition in Eastern Europe. Poland differed in many aspects from her neighbours. No other country in the region produced such a stable and strong opposition movement as the Solidarity. In 1980, it reached an estimated membership of 10 million, in a country of 35 million[42]. Originally a trade union, the Solidarity developed quickly into a broader political movement which reflected the "institutionalization of the worker-intellectual alliance"[43]. Furthermore, the Catholic Church constituted a widely-ramificated institution network outside the command of the Communist Party. In the economic sphere there was an unusually large private sector, mainly agricultural smallholders. And finally, the economic performance of the system was exceptionally dismal. In the 1970s, the party leadership under Edward Gierek embarked on a course of heavy borrowing in the West, in order to modernise Polish industry. Initially, the credit-financed investment led to higher growth rates, but this effect soon faded out. Under the unreformed command structure, the investment spree did not produce significant improvements in productivity, and, fatefully, did not generate more exports to hard-currency countries which were necessary to serve the debt. In March 1981 the government defaulted on the foreign debt which had reached a level of 27 billion dollars (about 50 per cent of GDP).[44] The economic crisis led to massive workers' unrest which in August 1980 crystallised in the forming of the Solidarity. The regime resorted to martial law to suppress Solidarity, but this did not solve the grave economic problems.

From 1982 onwards, the government, following a similar path as Hungary, introduced a wave of reforms which aimed at increasing the efficiency and flexibility of the system, essentially by giving more power and independence to the management of the state-owned enterprises, without however altering basic features of the system. But even more so than in Hungary, the reforms produced disappointing results. Productivity did not increase substantially, nor did hard-currency generating exports. In many respects, the reforms even worsened the situation, by loosening the control mechanisms. Budget constraints turned even softer, which became reflected in huge wage increases; managers could overtly or covertly, transfer assets to own private companies ("spontaneous privatisation"). According to Grzegorz W. Kolodko, at that time a Communist Party- economist, by about 1988 "the system had already started to fall apart"[45]. The economy was rapidly heading towards hyperinflation, which by August 1989 became a fact, with an annualised rate of 3,000 per cent; the budget deficit was above 10 per cent of the GDP[46]. Not even ten years after the default and credit restructuring in 1981, Poland was again technically bankrupt.

The regime had come to a dead end and accepted (almost) free elections. In June 1989 the Solidarity won an overwhelming victory, and on August 24, Tadeusz Mazowiecki became the

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42 Andrzej Korbonski, 'Poland', Teresa Rakowska-Harmstone (ed.), *Communism in Eastern Europe*, second edition, Indiana University Press, Bloomington, 1984, pp. 50-85, esp. p. 59.
43 Ibid., p. 65.
44 Harold James, *Rambouillet, 15. November 1975. Die Globalisierung der Wirtschaft*, München, 1997, p. 186.
45 Sachs, 1994, p. 25.
46 Sachs, 1994, p. 40.

first non-communist prime minister in the whole region. Thereby Poland had already at the beginning of the transition, unlike many other East European countries, a government with a strong democratic legitimacy, and which was determined to follow a policy of a transition to a Western type of society, a "Return to Europe." Furthermore, given the point that the possibilities for free discussion and travels abroad have been much greater in Poland than in many neighbouring countries, the new politicians and leading intellectuals did not have to start from scratch when conceptualising transition. Like Kornai and others, Leszek Balcerowicz, professor of economics at Warsaw university, and others had come to the conclusion, not the least under the impact of the dismal record of immanent reforms in Poland, that a decisive break with the old system was necessary. Jeffrey Sachs, who in 1989 worked as advisor for the Solidarity, records:

> I met Balcerowicz soon after he had accepted the position of deputy prime minister, but before his public appointment. His first words were, 'Yes, we will make a radical reform'. Balcerowicz had been preparing for this opportunity for years, and had assembled a team of research economists around him who were prepared to help introduce and implement the reform measures. Balcerowicz held a vision of how Poland should proceed that was similar in concept to the program that Lipton and I had outlined for the Solidarity in July. Balcerowicz invited us to work closely with his team, an opportunity we eagerly accepted.[47]

In the light of later controversies, it is perhaps necessary to underline the simple fact that the deputy prime minister, responsible for economic policy, was Balcerowicz, not Sachs, and that Balcerowicz, together with many others, had worked on these problems for many years. Sachs had the modest role of one advisor among many others, and as such he was accepted because his basic views coincided with those to which the responsible Polish politicians had being adhering to for many years.

Balcerowicz and his team designed a policy which, of all the transition countries, was closest to the recommendations of the "Washington consensus". By January 1, 1990, a comprehensive liberalisation and stabilisation program ("Big Bang") was introduced[48] which immediately liberalised almost all prices; most subsidies to households (mostly food subsidies) and to industry were eliminated, or at least reduced substantially. Overall budget spending was restrained, and monetary policy was tightened. This meant in particular, that cheap credits to the industry were discontinued, and the discount rate was raised. A penal tax on wage increases was introduced, in order to counter the drive to excessive wage increases. Foreign trade was liberalised, at rather low tariffs, and trade licences and quotas were almost entirely abolished. The zloty became freely convertible; the exchange rate was sharply devalued and then kept at a rate of 9,500 zlotys per dollar throughout 1990.

The immediate effect was a price jump, and an accelerated contraction in output (it was already falling throughout 1989). But already in 1992, after the shortest and mildest transition recession in Eastern Europe, the Polish economy returned to growth, and kept thereafter growing throughout the 1990s at a high rate. Unlike many other countries, Poland did not experience a second contraction in the second half of the 1990s, and also the Russian crisis in 1998 hardly effected Poland. The private sector, stagnant in the 1980s, expanded after 1990 rather quickly, and so did exports to hard-currency countries. Inflation fell to underneath the 50-per cent threshold in 1992, and under 40 per cent in 1993, continuing to fall thereafter. Also in 1993, the budget deficit fell under the level of three per cent of the GDP.[49]

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47 Ibid., p. 46.

48 Ibid., p. 48f.

49 Erwin R. Tiongson, ' Poland and IMF conditionality programs: 1990-1995, *East European*

Unemployment, however, has been relatively high, well above ten per cent. Furthermore, Poland experienced high regional disparities, with boom centres such as Poznan, with hardly any unemployment at all, and many backward areas, in particular in the agrarian east. Poland's social problems have, however, been light in comparison to neighbours such as Belarus or Ukraine. Social inequality has hardly risen. According to the World Bank, the Gini-coefficient – 0 indicates total equality, 100 total inequality (one person gets everything) - was at 26 in 1987-89, and at 28 in 1993-97[50]. That means that Poland kept a Scandinavian level of equality.

Polish democracy has proved to be stable. In 1993, the election victory of the post-communist Socialdemocrats meant no return to the past. On the contrary, it was a post-communist government which in April 1994 formally requested EU membership, thereby underlining that they shared the vision of a "Return to Europe". In socialeconomic terms, formal membership application meant of course the unequivocal transition to a Western-typed mixed economy. The Socialdemocrats endeavoured in many ways to show that they were the better "transitionists", claiming that they were able to make the transition more social, but did not intend to stop or reverse transition to democracy and a Western-typed mixed economy. This was a feature which Poland shared with e.g. Hungary, Slovakia and Slovenia[51]. This meant that transition had a rather stable political base. In other countries the communists mutated to nationalist-populist groupings, making the political basis of transition shakier. The rather stable political basis for the transition was perhaps a consequence of the swiftness of the initial reforms. After the "Big Bang", the nostalgiques of the old regime had few possibilities to block further transition, given the point that the heavy bureaucratic bodies became powerless.

Privatisation had been rather slow, a point often criticised be economist such as Sachs. But as the successful stabilisation policy shows, the Polish reformers to high extent have been able to introduce hard budget constraints. And the *political* aim of privatisation, that is neutralising strongholds of the old regime, was not so urgent any more, exactly because democracy and the aim of transition became strongly rooted early on.
OECD experts summarised the Polish development in their Economic Survey 1999-2000 as follows:

> Ten years after having embarked on an ambitious programme of economic transformation, Poland has established itself as one of the most successful transition economies. Efforts to stabilise the economy, put the public finances in good order, conduct a sound monetary order, unleash market forces and implement structural reforms on a broad front have been well rewarded."[52]

We can, of course, not simply conclude from the Polish experience that the paradigm of radical reform has proven to be valid. Firstly, as already the authors of this paradigm underlined, transition is a lengthy process, and Balcerowicz' "Big Bang" in 1990 was only one step which could never have produced lasting positive results if not the other governments later on in the 1990s had delivered substantial contributions. Secondly, Poland's conditions for transition were comparatively favourable, in particular, when regarding the

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*Quarterly, XXXI, No. 1, March, 1997, p. 55-68, esp. p. 61.*

50 Gérard Roland, *Transition and Economics. Politics, Markets, and Firms*, MIT Press, Cambridge/Mass. and London, 2000, p. 21.

51 Kai-Olaf Lang, 'Systemtransformation in Ostmitteleuropa: Eine erste Erfolgsbilanz', *Aus Politik und Zeitgeschichte*, B 15/2001, p. 13-21, esp. p. 16.

52 OECD *Economic Surveys 1990-2000 Poland*, Paris, January 2000, p. 23.

complex question of the institutional framework which every mixed economy requires. As Sachs pointed out:

> The legal structure was not as bad as one might assume, because the previous communist regime had actually undertaken a number of steps to ressurrect Poland's legal codes of the interwar period. There was a 1934 commercial code; there were lawyers who could negotiate and enforce contracts; there was a judicial system, which was rusty, to be sure, but which was assigned the task of enforcing private arrangements. That part of liberalization therefore did not present an impossible task.[53]

In this respect, Poland's initial conditions were much better than, say Russia's. Furthermore, given the point "that the Polish stabilization plan completely matched traditional IMF conditionality lending"[54], it was possible to mobilise Western assistance to a degree that Russia only could dream of. Already in January 1990 the IMF established a fund to stabilise the zloty exchange rate; a month later a standby agreement with the IMF, providing $700 million, and a $360 million World Bank lending was in place. The agreements with the IMF paved the way for a reduction of Poland's foreign debt by 50 per cent.

So, it was certainly not *only* due to the Balcerowicz plan that the Polish transition showed rather positive results. But the Polish experience also seems to suggest that the concepts which Balcerowicz, Fischer or Sachs had developed, were not completely off the mark. At least not in Poland. A different view will be discussed in section V, 3.

**2. Russia**

By the first half of the 1980s, the Soviet Union experienced, in real terms, economic stagnation. This created obvious political problems, not the least as regards the international role of the Soviet Union. Michail S. Gorbachev, in March 1985 elected Secretary General of the Communist Party, was perfectly aware of this point. In a key speech on December 10, 1984, he pointed out: "Only an intensive, highly developed economy can safeguard a reinforcement of [our] country's position on the international stage and allow her to enter the next millennium with dignity as a great and flourishing power."[55] Gorbachev initiated his reforms, not as a programme of transition to another type of society, but as a means to strengthen the Soviet one. He began by rather limited technocratic reforms and neo-Stalinist campaigns, e.g. against alcohol consumption, but progressed soon to more substantial changes. The Law on State Enterprises, in force in January 1988, officially abolished compulsory plan targets (which, however, were retained in watered-down forms). The enterprises could to a high extent freely determine prices and wages; they gained "substantial rights but little responsibility", as Anders Cslund wrote[56], by that time Swedish diplomat in Moscow, and during 1991-1994 advisor to the Russian ministry of finance. In May 1988, a Law on Co-operatives, practically allowed all sorts of private enterprises, supposed they had at least three owners and classified themselves as "co-operatives". This way, hundreds of new commercial banks arose.[57] Other reforms were adopted in a similar vein.

Gradually Gorbachov entered the sphere of political reform. Freedom of speech (*glasnost*) was expanded from 1985 onwards, attempts to democratise the Communist Party were undertaken, and in March 1989 two thirds of the 2,250 deputies of a new Congress of

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53 Sachs (1994), p. 46f.
54 Tiongson, p. 59.
55 Cslund, 1995, pp. 27 and 43,
56 Ibid., p. 29.
57 Ibid., p. 30.

People's Deputies were elected rather freely (political parties still being forbidden); this Congress elected a new Supreme Soviet and, in early 1990, Gorbachev, by only 50 per cent of the votes, as the first and last president of the Soviet Union. Also in the Soviet Republics new democratic bodies (with a higher democratic legitimacy than at Union level) were elected. In 1989, by consenting to the Polish road to democracy and the fall of the Berlin Wall, Gorbachev abolished the outer repression and ended the Cold War.

But the political and economic reforms produced many unintended consequences. Freedom of speech brought many horrors of the past, and many of the inefficiencies of the present, to the surface; Marxism-Lenism died. The Communist Party became practically dissolved, and the republics drifted away (and e.g. stopped paying taxes to the centre). The Soviet Union experienced an institutional breakdown on a large scale. And the economic reforms did not generate more productivity, only confusion. Wages rose dramatically (9 per cent in 1989, 14 per cent in 1990 and 70 in 1991)[58]. In 1991 shortages turned unprecedently grave, queues with people waiting for a week were not uncommon. State finances broke down, the deficit reached more than 20 per cent of the GDP (rather 30 per cent, if properly counted). It could only be financed by enlarging the money supply, or by foreign credits. In 1991, the Soviet Union defaulted.

Confronted with growing disintegration, in principle two ways were conceivable. One possibility was the way back to dictatorship, or at least authoritarian rule. This was what the architects of the coup against Gorbachov in August 1991 offered; still in 1993, Oleg Lobov, Russian minister of the Economy, pushed for a return to central planning.[59] Another alternative was the transition to a Western type of democracy and economic system. Already in October 1989, a State Commission on Economic Reform, headed by academician Leonid Albakin, presented a programme according to which markets should take precedence over the plan. In February 1990, Grigory Yavlinsky, who headed a department in Albakin's commission, and other economists proposed a far more radical programme, originally 400 days, later 500 days of radical reform: "The time for gradual transformation has been missed, and the ineffectiveness of partial reforms has been proved by the experiences of Hungary, Yugoslavia, Poland, and China."[60] Yavlinsky was also a member of a joint American-Russian working group, which met in Cambridge, Massachusetts in summer 1991. Stanley Fischer and Jeffrey Sachs were also present. The group produced a programme called the Grand Bargain. In Cslund's words[61]:

> The great novelty of this program was that it advocated a comprehensive and momentous liberalization coupled with strict macroeconomic stabilization. The Grand Bargain was possibly the first economic program that had drawn serious Soviet participation and that was not gradualist in nature. It also signified a new degree of international cooperation regarding Russian economic reform.

By 1990, however, Gorbachev blocked most initiatives to further reform, among those Yavlinsky's 500-day programme and the Grand Bargain. But the abortive coup against Gorbachev in August 1991 changed everything. The Soviet centre became de facto abolished, and power was transferred to the leaders of the republics. In the case of Russia, this meant to Boris Yeltsin, since June 1991 Russia's first democratically elected president, a champion of far-reaching political and economic reform. In October 1991, Yeltsin made a comprehensive

58 Ibid., p. 48.
59 Ibid., p. 89.
60 Ibid., p. 37.
61 Ibid., p. 40.

speech on economic reform. Shortly afterwards he nominated a new government, with determined reformers (Gennady Burbulis, Yegor Gaidar, Anatoly Chubais) on key posts. Russia seemed to be on the path of radical reform. But as it soon turned out, the Russian reform movement was much weaker than, for instance, the Polish one. There was no mass-movement or civil network behind the Russian reformers which could be compared to the Solidarity. Private business as significant pressure group or independent media hardly existed. The state bureaucracy was firmly in the hands of conservative forces, and the managers of the state-owned enterprises had no interests in comprehensive reforms. Furthermore, the government had to cooperate with a not very representative Congress of People's Deputies and a Supreme Soviet, elected in March 1990. At this time, political parties had not yet been allowed, the voters had unclear alternatives and voted often by negative selection: Known CPSU-members were dismissed, and instead unknown ones became elected. The absence of parties also implied the absence of political structure and discipline in the parliament. In autumn 1991, the parliament endorsed the reform course, but afterwards it turned increasingly negative. The point that Yeltsin did not push for new elections and a new constitution in the aftermath of the abortive coup, thus providing his policy with unquestionable political legitimacy, was presumably his biggest political mistake.[62] Gaidar, the deputy Prime Minister who was responsible for economic reforms, was soon politically hanging in the air. Already in April 1992, the government became de facto a coalition government of reformers and conservatives, and from summer 1992 onwards the parliament blocked almost every further reform step. This impasse lasted until autumn 1993 – after the violent conflict with the parliament. Then, the new elections and, crucially, the new constitution of December 1993, opened the way to orderly politics.

The unclear political situation resulted in contradictory transition policies. On the one hand, by presidential decree, on 2 January 1992, about 80 per cent of the producer prices and 90 per cent of consumer prices were liberalised. But energy prices and transportation were excluded, and regional authorities were allowed to set maximum prices or impose maximum mark-ups on consumer goods. Domestic trade remained largely regulated, which implied heavy breaks on the price mechanism.[63] Foreign trade was liberalised in principle, but various regulations and import subsidies continued for a long time. Export tariffs were introduced for regulated items in order to cover the difference between low internal prices and market prices. In July 1992, the rouble was made convertible in principle, with a uniform exchange rate. All in all, the Russian government introduced a substantial liberalisation package, thus in principle adhering, as to this point, to the Washington Consensus, but much slower and more inconsistent than e.g. the Polish government.

As to macroeconomic stabilisation, however - according to the Washington Consensus a top priority to be addressed at the very onset of reform - Russia chose a completely different path, contrary to the intentions of the Gajdar team. Already in November 1991, the reform government suffered a first political defeat when the parliament retained control over the Central Bank, and in July 1992 Viktor Gerashchenko, a supporter of the coup in August 1991, became chairman of the central bank. Jeffrey Sachs came to call him "the worst central banker in history".[64]

Efforts at stabilisation policy quickly evaporated, Russia experienced an inflation rate (consumer prices, end-period) at 2,318 per cent in 1992.[65] Of course, the liberalisations in the

62 Ibid., p. 61.
63 Ibid., pp. 140f and 313.
64 Cslund, p. 98.
65 Transition Report 1996, p. 203

beginning of 1992 meant a strong price increase, due to the massive monetary overhang (and which thus did not mean a corresponding decline in living standards). But this was basically a one-term event. Thereafter, the main reason for the inflation was cheap credits from the central bank to enterprises. Gerashchenko (and many others at that time), following a kind of pseudo-Keynesian thinking, regarded a monetary expansion of 18 to 20 per cent a month during the first quarter of 1993 as a realistic and pragmatic policy to combat unemployment and to stabilise production.[66] Another inflation source was the continuation of the rouble zone. It was maintained after the dissolution of the Soviet Union in December 1991, due to the interplay of many motives: Some Russian politicians saw the common currency as a political bond which could facilitate the resurgence of the union; actors in the republics were interested in cheap credits; and others (among those, IMF-experts[67]) saw it as a means to facilitate economic co-operation. But there was no consensus about the principle of monetary policies, nor adequate centralised institutions. This meant that the central banks in the republics were free to enlarge the money supply by issuing cheap credits. In July 1993 the rouble zone was finally dissolved. Also the Russian budget deficit, which at that time could not be financed through taxes or orderly loans, contributed heavily to the high inflation.

On 25 September 1993, shortly after Yeltsin had dissolved the parliament, finance minister Boris Fedorov was able to abolish all subsidised credits and to strengthen the budget; keeping the deficit at “only” 9.5 per cent of GDP. Also Gerashchenko changed his policy. For the first time, Russia experienced positive interest rates[68]; inflation came down to 131 per cent by the end of 1995[69], and to 22 per cent in 1996[70].

Russian macroeconomic policy can thus be characterised as, first pseudo-Keynesianism, and then very gradual stabilisation. But as to the third pillar of transition policy - privatisation -, Russia was very fast; faster than Poland, and also faster than e.g. Fischer and Gelb thought to be advisable (see above, section II, 3), given the point that they underlined the importance of successful stabilisation and the existence of a reasonable price system prior to privatisation. But the Russian government initiated a mass privatisation programme under the conditions of high inflation, almost nonsensical accounting evaluations and highly-inadequate legal provisions. The reasons for this haste were twofold. On the one hand, privatisation was popular and politically feasible. On June 11, 1992, the Supreme Soviet adopted the key privatisation programme for 1992, the last major reform decision which this institution endorsed. And furthermore, the weak state, the non-transparent situation and the numerous incidences of asset stripping weighted heavily in favour of quick privatisation. As Cslund put it: “The underlying assumption was that was not privatized would be stolen. Therefore, a somewhat irregular privatization was preferred to a halt in privatization.”[71] And in order to speed up privatisation, the reformers went on compromises and accepted insider privatisation (preferences to the management and the employees) to quite some extent. This created substantial transparency problems and implied many violations of social justice.

The Russian transition produced many disappointments. Output did not recover for many years; in 1997, the official statistics showed modest growth (1 per cent)[72] for the first time. After a new setback, Russia entered a period of recovery in 1999 - some eight years after the

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66 Cslund, p. 77.

67 Ibid., p. 120.

68 Ibid., p. 199.

69 Transition Report 1996, p. 203.

70 OECD *Economic Surveys, Russian Federation*, March 2000, Paris 2000, p. 34.

71 Cslund, 1995, p. 247.

72 OECD*, Russian Federation*, p. 34.

beginning of the transition. Furthermore, the transition implied severe social problems and massively growing inequality. The World Bank calculated an increase of the Gini-coefficient from the end of 1980s to the mid-1990s from 22 to 52[73]. This was presumably an exaggeration; the Russian authorities (Goskomstat) calculated 37.5 before the crisis of 1998, and 39.7 after it[74]. At any rate, social polarisation has increased much more than e.g. in Poland, presumably mainly due to the high inflation. It worked as a kind of highly-digressive tax. Some groups, e.g. pensioners, were extraordinarily hard hidden, given the point that their pensions were adjusted only every third month. The high inflation allowed also for a high "downward flexibility" of the real wages (which perhaps had positive short-time employment effects). On the other side of the social spectrum, the high inflation-cum-privatisation allowed for gigantic gains; people with the right connections, usually managers of the state enterprises and *nomenklatura* members, could get huge credits, use them to buy assets, and then "pay them back" when the inflation had reduced their value to the equivalent of some stamps.

The high inflation and the wave of subsidised credits at the beginning of the transition implied that most enterprises still worked under soft budget constraints. As to this point, privatisation meant a substantial change. But the highly subsided transportation and energy prices (less than half the level of the world prices) imply that budgets were still in 2001 soft to some extent. Subsidised cheap energy and transport have also meant waste and ecological damage. The same can be said about the fact that electricity companies often could not cut off non-paying enterprises; to a high extent they accepted payments in commodities, or other forms of non-cash payments. And so did local and regional authorities - the insufficient deregulations and the particularities of the fiscal relations between the centre and the regions have created a set of incentives which worked in this direction[75].

In spring 1995, aided by an arrangement with the IMF, the Russian government followed a stricter stabilisation line. On 6 July 1995, the rouble exchange rate was fixed to a corridor between 4300 and 4900 rouble per dollar, originally for four months, but prolonged to the end of the year; thereafter the corridor was lowered and "tightened" to 4550 to 5150 per dollar.[76] This was in accordance with the theory that a fixed exchange rate could work as an anchor for stabilisation policy. But in 1998, after Russia finally seemed to have recovered, the country became victimised by a disastrous financial crisis which mercilessly revealed severe structural problems. Prior to the crisis, the Russian government had opened the country to short-term capital influx, in the beginning with good results – the interest rates on government bonds fell dramatically, from over 150 per cent in mid-1996 to under 20 per cent one year later.[77] The share prices of Russian companies soared. But there was little foreign long-term or direct investment. Most Russian companies were not very attractive because they were dominated by insiders in non-transparent ways. Interestingly enough, a substantial part of the political spectrum did not want stable foreign investment (fearing for alien domination); only short-time portfolio investments were welcome. But when Russian export earnings declined and the crisis in East and Southeast Asia began, Russia experienced massive capital flights. The rouble course was not credible, the central bank was powerless against the speculation against the rouble. In August 1998, Russia temporarily defaulted on its debt, the rouble

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73 Roland, 2000, p. 21.

74 OECD, *Russian Federation*, p. 153n48.

75 These problems were investigated in-depth by the OECD team, see ibid., pp. 83-112.

76 Deutsches Institut für Wirtschaftsforschung, Berlin, 'Die wirtschaftliche Lage Russlands. Kurswechsel in der Stabilisierungspolitik', *DIW-Wochenbericht*, 51-52/1995, pp. 876-897, esp. pp. 890 and 892.

77 Ibid., p. 35.

plummeted to a fourth of its previous value, inflation rose to 38 per cent per month in September 1998.[78] But in contrast to 1992, the Central Bank, again under the leadership of Viktor Gerashchenko, acted decidedly and averted the threat of hyperinflation – but at a high social price. Thereafter, the cheaper rouble and rising oil prices stimulated Russian exports, the Russian economy grew again, in 2000 even by 9 per cent. For the first time, the state budget showed a surplus.

Western and Russian observers agree that there are still many moments of instability in the Russian development. Much of the growth in 1999 and 2000 was due to high oil prices, and there have been only few foreign investments. Opaque business structures, a very burdensome bureaucracy and a slow and highly inadequate judicial systems are problems which are often mentioned in the Western and Russian press. The incentive structures are still distorted. President Vladimir V. Putin denounced in his "state of the nation"-message in April 2001 the "rental character" of the Russian economy: "The income which can be realised by the redistribution of wealth is higher than the profits which can be generated by its production". And as to the administrative apparatus: "The system defends its right to receive a so-called status rent – or directly speaking: Bribe and compensations."[79]

Judging from Putin's message, the government and Duma majority seem to be determined to proceed on the way to an open capitalist economy. Putin declared: "The course towards integration with Europe is one of the key directions of Russia's foreign policy."[80] He mentioned "partnership with the European Union" as being of growing importance. Pseudo-Keynesianism or "Third Way" ideas seem to be dead. The only deviation from this strategy seems to be Putin's retreat from the project of introducing unequivocal property rights on land – a concession to the Communist fraction in the Duma – but of minor importance in the overall picture.[81]

Currently (2001) it is, however, still an open question for many observers whether Putin's economic "Westernising" course is accompanied by an equally firm determination to consolidate democracy.

### 3. Ukraine

On 24 August 1991, after the abortive coup against Gorbachev, the Ukrainian Supreme Soviet, by a majority of 346 to 1, declared the republic to be independent, subject to a referendum to be held on 1 December. The referendum resulted in a majority of 90.3 per cent in favour of independence. Leonid Kravchuk, previously responsible for ideology in the leadership of the Communist Party of Ukraine, became the first president. And although the passage to independence was accompanied by much national-romantic rhetoric, the attitude of the population was rather utilitarian. In a poll, 79 per cent gave "escape from economic crisis" top priority. Only 21 per cent were mainly concerned with the "cultural rebirth of Ukraine", and only 18 per cent with "securing the political sovereignty of the republic."[82]

By 1991, a comparatively diversified political spectrum had developed, counting, among others, nationalist groups, and an "All-Ukrainian Union of Workers' Solidarity"(VOST), which styled itself as the equivalent of the Polish Solidarity. But the dominant political

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78 Ibid., p. 44.

79 Lyubov' Kizilova, 'Konets renty', Izvestiya, 4.4.2001, p. 4.

80 'Shto skazal glava gosudartsva o situazii v strane', *Izvestiya*, 4.4.01., p. 4.

81 Ibid.

82 Taras Kuzio, *Ukraine: Perestroika to Independence*, Houndmills, Basingstoke and London, second edition, 2000, p. 199.

grouping and major force behind the drive to independence was a national communist alliance, which united a huge section of the former Communist Party with some other groupings. The motives behind the national communist drive to independence were mainly fed by three utilitarian motives: Technocratic elites seeked to free themselves from political interference from above. Furthermore, against the background of the Soviet economy and bureaucracy falling apart in 1990-91, Ukrainian elites seeked to escape from the all-Union system as part of an elementary crisis management. And in the context of the shrinking economy, local elites tried to expand their control over local institutions, in a zero-sum struggle over diminishing resources. These elites were represented in the Ukrainian Supreme Soviet by 67 members of the industrial apparat (mainly enterprise managers), 44 members of the agricultural apparat, most of them Kolchos chairmen, and 16 members of the institutional apparat, representing scientific or cultural institutions. Through spring 1991, these groups increasingly demanded state-building measures.[83]

Kravchuk's alliance could keep oppositional and truly reformatory groups in a minor position, by campaigning along nationalist slogans, and because of its widely-ramificated power network and control over most mass media. Thereby the political situation differed substantially from Russia; the difference to Poland was outright abysmal. And so was the strategy of economic reform: "… Kravchuk, needing the backing of the directors of Ukraine's factories and collective farms, pledged he would preserve as much of the economic status quo as possible."[84]

Throughout the early 1990s, a basically unreformed Ukrainian economy continued disintegrating, with production falling and budget deficits rising. In June 1992, the state covered the net interenterprise arrears by credits and thus doubled the money supply. Ukraine moved towards hyperinflation.[85] Privatisation progressed very slowly, the main reason being the opposition from agro-industrial groups in parliament. Not even small-scale privatisation made substantial progress; by the end of 1994, only 8,000 out of 45,000 enterprises with less than 200 employees were privatised. Most of the formal economy remained highly concentrated and horizontally integrated. "Enterprise budget constraints have remained soft because of budgetary subsidies, continued cheap directed credits, especially to depressed industrial regions, and tolerance of non-payment for utilities."[86] Modest gains in stabilisation (Kravchuk could reduce the budget deficit from 44 to 20 per cent of GDP)

> were wiped out by a single vote in parliament. In May [1993] the directors of the large state enterprises and collective farms who make up the majority in the legislature refused to renew [P*rime Minister*] Kuchma's special powers. As they had habitually done before, they ordered the National Bank to increase the already large money supply so that the state could raise wages and offer cheap credits to state farms…[87]

Inflation reached a staggering 4,700 per cent in 1993. Since October 1994, however, Ukraine made progress in stabilisation. Inflation fell to 10 per cent in 1997, and the worthless money was replaced by the relatively stable and convertible hryvnia.[88] There was progress in the

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83 Ibid., p. 171f.

84 Chrystina Lapychak, 'Ukraine's Troubled Rebirth', *Current History*, October 1993, pp. 337-341, esp. p. 337.

85 Cslund, 1995, p. 212.

86 European Bank of Reconstruction and Development, 1996, p. 181.

87 Lapychak, p. 340.

88 James Dean, 'Ukraine: Europe's Forgotten Economy', *Challenge/*November-December

field of price and trade liberalisation and privatisation, small-scale privatisation proceeded even quickly. In June 1996, the new constitution solved some of the basic problems of the divisions of power between parliament and president and guaranteed private property rights. Nevertheless, even by the end of the 1990s, large sectors of the economy remained unreformed. Of particular importance has been the energy sector. As in Russia, the remaining bureaucratic regulations and intransparent structures enabled people with connections to make fortunes by rent seeking. There have mainly been four forms of rent: (1) Buying at domestically controlled prices and selling abroad at higher world market prices, (2) Importing Russian gas and oil at subsidised exchange rates, in cases even without paying by free-riding on government's credit guarantees, (3) Borrowing from the state at absurdly low interest rates, say 20 per cent when inflation rate was 2,000 per cent; and (4) by private capture of state subsidies to loss-making firms. In 1992, these rents were of the magnitude of 70 per cent of GDP.[89] The rents were captured mainly by a handful of oligarchs, which in turn had a strong interest in slowing down further reform. The high inflation, which also in Ukraine worked as a heavy tax, on particular on the poorer segments of the population, in combination with the huge opportunities for rent-seeking for comparatively few, can explain to high extent the extremely unsocial character of the Ukrainian transformation. From the end of the 1980s to the mid-1990s the Gini-coefficient rose from 23 to 47.[90] Rent seeking and asset stripping still continue by 2001, and the related interests are an essential factor in the political crisis which Ukraine experiences this year (tape recordings seem to give evidence that President Kutchma ordered the murder of a journalist, and several more criminal acts).[91] According to Yulia Timoshenko, herself previously an energy oligarch, who as energy minister tried to reform this sector, until her dismissal by Kutchma in January 2001 (and subsequent arrest on fraud charges), asset stripping continues: "Currently the coal enterprises get robbed to an extent that did not even happen to the oil and gas companies. The system of pumping money out of them has reached serious proportions. The sector is at the brink of annihilation, although Ukraine's independence is dependent on coal."[92]

Ukrainian and Western experts, from the IMF, the World Bank, Harvard University, George Soros, a German Advisory Group, TACIS, and many more, produced numerous reform proposals. "Proposal after proposal is rejected. Consultants fly home in frustration, only to be replaced by more of their kind. In short, reform is stalled."[93] Meanwhile, production continued falling. "Average annual GDP growth rates, 1994-98, were about 0 per cent in both Uzbekistan and Belarus, about –4 per cent in both Russia and Kazachstan, and about –10 per cent in Ukraine. In other words, Ukraine was very much at the bottom of a dismal league."[94]

The dismal performance during the 1990s can certainly be interpreted in many ways. But those who judge that slow reform, as opposed to radical reform, is the more appropriate transition strategy, cannot find much support in the Ukrainian experiences.

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2000, pp. 93-108, esp. p. 101.

89 Ibid., p. 104f.

90 Roland, 2000, p. 21.

91 For longer transcripts, see e.g. 'Watergate in Kiew', *Der Spiegel*, 12/2001, pp. 230-234.

92 Yanina Sokolovskaya, ' Yuliya Timoshenko: U nas – klanovaya strana', *Izvestiya*, 27.01.01, pp. 1 and 7, esp. p. 7.

93 Dean, p. 101.

94 Ibid., p. 99.

## IV. Evaluations "in Washington"

By the mid-1990s, a large literature had appeared about the experiences of transition. Anders Cslund, Peter Boone and Simon Johnson grouped it in three parts, policy prescription, formal models, and individual country studies. "The policy prescription work, by both academics and international organizations, has been overwhelmingly in favour of complete stabilization and carrying out all other reforms with as much intensity as possible. In contrast, the formal models have almost unanimously argued that radical reform is too costly and a slower approach is preferable. Taking an intermediate position, individual country studies have found that radical policy has important advantages, but that slower reform can also have positive results."[95] There where, however, few comparative studies, and even fewer in which a larger sample of countries was inspected. To those belonged a paper of an IMF-team, headed by Stanley Fischer, since 1994 its First Deputy Managing Director. Another study was presented to the Brookings Institution by Anders Cslund, Peter Boone and Simon Johnson, all three former advisors to transition countries. Thus both papers were written by sympathisers of the "Washington Consensus". Three Critical perspectives on the paradigm of rapid reform will be presented in the following sections.

### 1. An IMF-perspective: Fischer, Sahay, and Végh

The IMF-team (Stanley Fischer, Ratna Sahay, and Carlos A. Végh) focused on stabilisation and growth and analysed the available data of 26 transition countries in Eastern Europe, the former Soviet Union and Mongolia for the period 1989-1994. "When the average performance for this group is profiled, a rather bleak picture emerges: real GDP has fallen uninterruptedly since reforms began, while inflation has been high and rising, fuelled by deficits averaging more than 6 percent of GDP."[96] At different point in times, according to the judgement of IMF-experts, 25 of the 26 countries began to implement a systematic stabilisation package. In most cases this coincided with an arrangement with the IMF. According to their list, Poland was the first (in January 1990), Hungary soon followed, but e.g. Belarus or Ukraine waited until November 1994, and Russia even until April 1995. "Inflation has been extremely high in the transition economies. Of the 26 countries …, 22 experienced at least triple-digit annual inflation in the 12 month preceding the month the stabilization program was implemented. The remaining four countries – the Czech Republic, the Slovak Republic, Hungary and Tajikistan – had double-digit inflation."[97]

Fischer, Sahay and Végh rearranged the data for each country from calendar time to a scale where the date of the stabilisation package is the point of reference, and this procedure "changes the picture dramatically"[98]. The average GDP was "falling until the year of stabilization, but then recovering, with growth on average becoming positive in year T+2", that is two years after the stabilisation programme. "Inflation peaks in the year before stabilization, comes down very sharply when the stabilization plan is implemented and

95 Anders Cslund, Peter Boone, and Simon Johnson, 'How to Stabilize: Lessons from Post-communist Countries', *Brookings Papers on Economic Activity, 1: 1996, pp. 217-313, esp. p. 218.*

96 Stanley Fischer, Ratna Sahay, and Carlos A. Végh, 'Stabilization and Growth in Transition Economies: The Early Experience', *Journal of Economic Perspectives – Volume 10, Number 2 – Spring 1996- pp. 54-66, esp. p. 47.*

97 Ibid., p. 51.

98 Ibid., p. 55.

remains low thereafter." Before stabilisation there were large fiscal deficits, in the order of 8 to 10 per cent of GDP, "followed by a significant improvement in the year of stabilization and, with a brief interruption, continued improvement."[99] In a footnote the authors explain: "The temporary deterioration in the fiscal balance a year after stabilisation appears to be associated with the initial large expenditures needed for structural reforms (for example, creating social safety nets and cleaning up bad loans in the banking system)."[100]

The former Soviet republics began stabilisation rather late, so there were not yet data available for the years after stabilisation. But a division of the sample in former Soviet Republics and Eastern Europe plus Baltic states essentially confirmed the picture. The text can, however, be supplemented with the observation that, according to their own graphs, the "brief interruption" in the process of fiscal consolidation became quite pronounced – in fact, the fiscal balance of the Eastern European and Baltic countries was on average even in "T+3" *worse* than in the year preceding stabilisation (albeit improving). This means that on average those countries managed to bring down inflation rather quickly through monetary policy, but smoothened the restrictive macroeconomic impact by expansive fiscal policies, with deficits at around 4 per cent of GDP. To the present author this looks like a very reasonable policy; Fischer and his colleagues seem to have preferred a quicker fiscal consolidation, but they do not discuss this point explicitly.

The authors investigated the connection between growth and inflation more in detail. A regression analysis showed a significant negative correlation (R-square: 0.63) - the higher the growth rate, the lower the inflation. Screening the countries individually, of the 26 countries in their sample, 14 economies were by 1994 growing again. In ten countries (Albania, Croatia, Czech Republic Estonia, Hungary, Latvia, Lithuania, Poland, Slovak Republic, and Slovenia), inflation was below 50 per cent in the year when growth began, or earlier. Mongolia and Armenia were not far away from this threshold. Bulgaria and Romania, however, had returned to growth one or even two years prior to the reduction of inflation to below 50 per cent. In the first half of 1995, also the Kyrgyz Republic had joined the growth group, after it had reduced inflation sharply. "In each of these economies, annualized inflation was around 50 percent or less in the first month of 1995. These figures tend to support the view that low inflation – below 50 percent in annual terms – is a necessary condition for growth to begin."[101] At this point the text exhibits a slight inconsistency: A few pages before the authors referred to "particularly convincing" research by Michael Bruno and William Easterly who argued "that *40 percent* per annum inflation is a red line beyond which growth will not be sustained"[102] As a matter of fact, they offer even a third "red line" when arguing at the end of the article that an "inflation rate of below 4 percent per month is a necessary condition for sustainable growth." [103] This would be *60 percent* per year. Perhaps they meant 3.85 per cent per month (50 per cent annually).

Thereafter Fischer, Sahay and Végh turned the question round and asked whether low inflation actually goes together with growth. In 1994, 11 countries had reduced annual inflation below 50 per cent. In ten of them growth revived either the same year when inflation fell below the threshold, or with a lag of one or two years. The only exception was Tajikistan which in 1994 experienced low inflation and negative growth. But the low inflation was

99 Ibid., p. 56.

100 Ibid., p. 56n13.

101 Ibid., p. 58.

102 Ibid., p. 46, emphasis added, W.Z.

103 Ibid., p. 64.

presumably due to an outright shortage of bank notes, not stabilisation policy (which according to the IMF-list did not begin before February 1995). In the first half of 1995, also Georgia and Macedonia have brought inflation below the 50-per cent threshold, without yet growing. But Georgia in fact returned to growth in 1995 and Macedonia in 1996, i.e. outside the range of the article by Fischer, Sahay and Végh, and Tajikistan in 1997[104]. So, they fit into the pattern - allowing for a lag of one or two years. All in all, "stabilization appears close to being both a necessary and sufficient condition for growth."[105]

In a next step, the authors ran a series of regression analyses. Growth and inflation were the dependent variables and macroeconomic policies, structural change and initial conditions the explanatory variables. The macroeconomic policies were specified by the fiscal balance, as per cent of the GDP, and by the exchange rate regime. The authors used a dummy variable which was zero if the exchange rate was floating, and one when the countries had a fixed or pegged exchange rate.

In order to measure the structural change they used an "liberalisation index" , computed by a team of World Bank economists (Martha de Melo, Cevdet Denizer and Alan Gelb), for the period 1989-1994. This index is based on information in the 1994 and 1995 *Transition Reports* by the European Bank for Reconstruction and Development. In this index, a zero represents an unreformed planned economy, and one a fully reformed economy. The index is the weighted average of three indices, namely price liberalisation and competition (weight 0.3), trade and foreign exchange regime (also 0.3), and privatisation and banking reform (weight 0.4). This index can be used to measure the level of liberalisation at a particular point in time, or to catch the impact of liberalisation over a certain period, cumulating the index over the years. We reproduce the levels of liberalisation and the change in the year of most intensive reform in the next subsection.

Finally, the initial conditions were measured by two indicators: The initial level of GDP per capita, and the dependence on trade with the former CMEA area, i.e. the Council of Mutual Economic Aid, the economic organisation of the former Soviet orbit. The last indicator can clarify the impact of the collapse of the CMEA trade and the breaking-up of the Soviet Union. Alternatively, a dummy variable for the year 1992 was used to catch these effects. This gives all in all five explanatory variables: Fixed exchange rate-dummy, fiscal balance, the cumulative liberalisation index, the trade with the CMEA area as share of GDP (alternatively a 1992-dummy), and finally the level of GDP per capita. The data from 25 countries in three years (1992-1994) entered the analysis.

As the authors themselves pointed out, country specific effects turned out to be highly significant, in other words, important differences were not captured by their explanatory variables. With this caveat in mind, the calculations showed that the CMEA collapse and the break-up of the Soviet Union had "a major negative impact" on output, and that countries with lower initial GDP per capita had lower output declines. Thus, initial conditions were important. As to the policy variables, the fiscal balance, if regressed together with the exchange rate on GDP, was important, but became insignificant when other variables were also included. But the exchange rate dummy had a stable significant impact, so the authors found their view confirmed that a fixed exchange rate was advisable. Last not least: "The state of market-oriented reforms, as reflected in the liberalization index CLI, appears to have been critical in spurring growth … This is an important result from the policy viewpoint."[106]

104 Kolodko, pp. 378, 390 and 404.
105 Fischer, Sahay, and Végh, p. 59.
106 Ibid., p. 61.

As to inflation, the pegged exchange rate dummy and the fiscal balance turned out to be highly significant. Together they formally explain 70 per cent of the variations in inflation. Also the liberalisation index, “somewhat surprisingly”, exerts a downward effect on inflation. The inclusion of this variable raises the fit to 75 per cent. Initial conditions mattered also in this context: Countries with a higher share of trade with the CMEA, and those with higher income levels, experienced higher inflations. “The results strongly suggest that, in addition to addressing the fundamental fiscal disequilibria, a pegged exchange rate has been a key component of successful inflation stabilization packages.”[107]

As the authors concede, regression results can be interpreted in different ways. For instance, it cannot be excluded that stabilisation only succeeds if growth follows, so that stabilisation cannot be seen as a necessary and sufficient condition for growth. But they found it “striking” that there were only two economies which began to grow again without that inflation had fallen below 50 per cent (and in those countries it did soon afterwards). Furthermore, there was perhaps no *inherent* link between stabilisation and growth. Perhaps access to external financing was much more important for growth, and in this respect the IMF-programmes were essential. IMF-arrangements only came in place when the governments began stabilisation policy. In this perspective, the statistically observed stabilisation-growth link basically reflects IMF programme designs. But the authors state that their results closely resemble those of Bruno and Easterly who studied other countries, and this leads them “to doubt that the results in this paper merely reflect IMF program design.”[108] The reader is, however, left alone in his doubts whether their doubts actually are a valid argument in this case.

The authors also dismissed the idea that their results were only applicable to Eastern European countries, not for poorer Soviet Republics. They point out that the Baltic countries had been heavily depended on the Soviet trade, but nevertheless practised a successful stabilisation policy. Also the very poor Albania did so. In conclusion, they find that their policy conclusions were generally applicable. Finally they ventured the prediction that “the countries of the former Soviet Union and Mongolia will follow the pattern … In other words, growth in these countries will on average increase in 1995 and will turn positive in most of these countries by 1996 or 1997.”[109]

To provide the reader with a clear and testable prognosis – this comes close to the optimum in social sciences. And at first glance, their prediction was fairly accurate. Azerbajan returned to growth in 1996, Belarus 1996, Kazachstan 1996, Moldova 1997, Russia 1997, Tajikistan 1997,Turkmenistan 1998, Ukraine 1998, and Uzbekistan 1996.[110] But the greatest republic, Russia, and others, experienced a horrible set-back in 1998. So, with the knowledge of hindsight, it is easy, not to say cheap, to point out that their analysis, for all its merits, had some weaknesses.

To begin with, as the authors themselves wrote, there were enormous data problems. The GDP figures almost certainly overstated the output decline (see below, section 9), and also inflation figures must be taken with a huge error margin. This, of course, reduces the accurateness of their calculations; remarks about statistical significance have a restricted meaning. Furthermore, only three years entered their regressions. This period is very short when the aim is to say something about growth. And they tried to capture the development by

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107 Ibid., p. 62f.

108 Ibid., p. 64.

109 Ibid., p. 64.

110 Kolodko, statistical appendix, p. 364-410.

five variables only. Many other factors which Stanley Fischer himself declared to be vital (e.g. functioning financial institutions or legal systems) do not enter the picture at all. One can, of course hope for that they are to some extent correlated to their variables. It is e.g. plausible to assume that hyperinflation and the functioning of financial or legal institutions are negatively correlated. In this case the model would retain much of its statistical validity, but this is a matter of hope. And finally, as often in multivariate analysis, seemingly significant correlations are not robust, if other variables become included. We discuss a case in point in the next subsection.

Of course, a criticism of this kind can be directed against *all kind* of multivariate statistical analysis, and is in itself cheap, unless the critic is able to present a better analysis (which the present author is not). But these considerations might induce one to interpret the statistical results more cautiously. Fischer and his colleagues can claim that, unless someone presents better figures, the data *do not contradict* their policy recommendations. But do they "strongly" support them?

Furthermore, an analysis which runs a set of variables against many countries and establishes significant relationships, might induce the consumer of these calculations to overlook specific conditions in the countries. "Significant" relationships are, after all, reliable only for the aggregate, they might be completely misleading for individual countries. A case in point is the fixed exchange rate. The fixed exchange rate was perhaps a good decision for Estonia. But for Russia it was a disastrous mistake . The same can be said about the early liberalisation of capital movements – both part of the IMF-recommendations, and both at the core of the crisis of 1998 when the rouble exchange rate had lost all credibility and triggered off massive capital flight.

After the East Asian and Russian crises, the IMF had a hard time in the media. In a *Financial Times* article, Stanley Fischer pointed out that the IMF (or others) could not reform Russia more than Russia's government and people do.[111] Paul Welfens, president of the European Institute for International Economic Relations at Potsdam University, was not impressed: "The IMF protests its innocence too loudly."[112] He criticised in particular that the IMF "turned the blind eye" to the fact that the Russian government achieved disinflation and budget savings by piling up arrears on its wage bill, thereby permanently breaching its labour contracts and undermining the rule of law (one of the factors which did not enter the regressions of Fischer, Sahay and Végh).

> The IMF's second big mistake was to sanction a fixed exchange rate for the rouble. Most economists prescribe fixed exchange rates only for countries with a diversified export basket. For Russia, which earns half its hard currency from oil, gas and other energy exports, this prescription was irresponsible. The price volatility of oil almost guaranteed Russia would be vulnerable to speculative attacks on its currency …
> It is also unclear why the IMF and some other actors in Washington supported early liberalisation of Russia's capital account when economic textbooks suggest such a move was premature. Wall Street investment banks may have a legitimate interest in liberal capital markets worldwide, but the IMF's role should have been to ensure the careful sequencing of liberalisation[113].

It is somewhat ironic that in 1991 Stanley Fischer and Alan Gelb wrote something very similar: "Capital account convertibility should come later than current account convertibility,

111 Stanley Fischer, ' What went wrong in Russia', *Financial Times*, 27.9.99, p. 16.
112 Paul Welfens, 'What went wrong at the IMF?', *Financial Times*, 5.10.99, p. 17.
113 Ibid.

when expectations of stability have been established."[114] The problem was perhaps that in 1995 the IMF grossly overrated the "expectations of stability". The statistical analysis by Fischer, Sahay and Végh contributed presumably to this overoptimism. This is not to say that none of its conclusions are valid. It seems highly plausible that a reduction of inflation under a threshold of about 50 per cent is a necessary condition for growth (and for elementary social justice, and for rule of law). Their rearranging of the data according to "stabilisation time", and their country comparisons produce good arguments to support this. But the narrow focusing on a very restricted set of variables and a somewhat uncritical attitude as to the shortcomings of regression analysis might have contributed to the fateful error that a fixed exchange rate was a good idea in all cases.

A friendly critique might emphasise that the IMF changed its policy after 1998. After the crisis it has been recommending flexible exchange rates, unless countries buttress stable rates by very systematic policies (as e.g. the EU member states have done).

### 2. Cslund, Boone, and Johnson – The Politics and Economics of Reform

Symbolically in Washington, at the 61st conference of the Brookings Institution (March 1996), Anders Cslund, who after his time in Moscow went to the Carnegie Endowment for International Peace, Peter Boone (London School of Economics), and Simon Johnson (Duke University) presented a lengthy paper, which, supported by a wide range of material, addressed both political and economic problems. 26 countries entered their samples. Their main questions were whether radical reform proved more costly than slower reform; which considerations have determined the choice of the strategy; to which extent reform policy prevailed in elections; and which reform tactics have proved effective.

Their definition of radical reform focused on two criteria: how rapidly inflation was brought under control, and the change in the level of the liberalisation index. In all the countries with radical reform, inflation peaked in the year of price liberalisation and then fell. Gradual reformers have a peak in inflation usually one year after liberalisation, while in most of the remaining countries inflation continued to accelerate. In their view, a "striking correlation exists between political regime and economic politics."[115] Some countries opted for democracy; the new governments decided for rapid reform and sustained it. These were, with the beginning of rapid reform in brackets, Poland (1990), Czechoslovakia (1991), Estonia (1992), Latvia (1992), and Albania (1992). Inflation peaked in the year of reform and was rapidly brought to under 50 per cent; the liberalisation index jumped by at least 0.3 in one year (Latvia only 0.22). Reform continued, and in 1994 the index was within the range of 0.8 to 0.9 (Albania lower, due to poor conditions for private sector entry).

Other democratic countries choose or ended up with slower reform: Hungary, Lithuania, Bulgaria, Russia, and the Kyrgyz Republic. "With the exception of Hungary, all these countries had higher inflation after two years of reform than the countries that pursued radical reform early, and none had inflation of less than 50 percent by 1994. These countries either had a small jump in their liberalization index (Hungary, Lithuania), or a very slow subsequent increase (Bulgaria)."[116]

In other countries, the communist rulers stayed in power, and reforms were initially delayed. This was the case both in countries were there was some democratisation (Romania, Moldova, Belarus and Ukraine), and also where there was little (Kazakhstan, Uzbekistan, and

114 Fischer and Gelb, 1991, p. 102n9.
115 Ibid., p. 223.
116 Ibid., p. 224.

Turkmenistan). Inflation was brought down in Romania and Moldova, but remained above 100 per cent in 1994, and in the others the level was even in 1995 high above 100.

We reproduce parts of their tables 1 and 2, which are mainly based on the data in a World Bank study (de Melo, Denizer, Gelb):

*Table 2: Inflation and Liberalisation in Post-communist countries:*

| | Inflation | | | Liberalisation | | | |
|---|---|---|---|---|---|---|---|
| Country | Year of peak | Level in year of peak | Level 2 years later | Year of most intense reform | Prior level | Change in year of most intense reform | Level in 1994 |
| *Rad. reform* | | | | | | | |
| Poland | 1990 | 586 | 43 | 1990 | 0.24 | 0.44 | 0.86 |
| Czech Repub. | 1991 | 57 | 21 | 1991 | 0.16 | 0.63 | 0.90 |
| Slovakia | 1991 | 61 | 23 | 1991 | 0.16 | 0.63 | 0.86 |
| Albania | 1992 | 226 | 28 | 1992 | 0.24 | 0.42 | 0.70 |
| Estonia | 1992 | 1,069 | 48 | 1992 | 0.32 | 0.32 | 0.89 |
| Latvia | 1992 | 951 | 36 | 1992 | 0.29 | 0.22 | 0.78 |
| | | | | | | | |
| *Grad. reform* | | | | | | | |
| Hungary | 1991 | 34 | 23 | 1990 | 0.34 | 0.23 | 0.86 |
| Bulgaria | 1991 | 336 | 73 | 1991 | 0.19 | 0.43 | 0.70 |
| Lithuania | 1992 | 1,020 | 72 | 1991 | 0.33 | 0.22 | 0.82 |
| Russia | 1992 | 1,353 | 220 | 1992 | 0.10 | 0.39 | 0.66 |
| Kyrgyz Rep. | 1993 | 1,209 | 49 | 1992 | 0.04 | 0.29 | 0.76 |
| | | | | | | | |
| *Excommunist w. democratis* | | | | | | | |
| Romania | 1993 | 256 | 33 | 1990 | 0.00 | 0.22 | 0.71 |
| Moldava | 1992 | 1,276 | 327 | 1992 | 0.10 | 0.28 | 0.55 |
| Belarus | 1994 | 2,200 | …. | 1993 | 0.20 | 0.13 | 0.36 |
| Ukraine | 1993 | 4,735 | 842 | 1994 | 0.13 | 0.13 | 0.26 |
| *Without dem.* | | | | | | | |
| Kazakhstan | 1994 | 1,980 | … | 1992 | 0.14 | 0.21 | 0.39 |
| Uzbekistan | 1994 | 746 | … | 1992 | 0.04 | 0.22 | 0.43 |
| Turkmenistan | 1993 | 3,102 | 2,500 | 1994 | 0.16 | 0.06 | 0.22 |

As we see, their classification is not without ambiguities. Latvia, grouped under “radical”, liberalised slower than “gradual” Bulgaria or Russia. And as to the *level* of liberalisation, “gradual” Hungary and Lithuania were more advanced in 1994 than “radical” Albania and Latvia. And Slovenia, bringing annual inflation down from 201 to under 50 per cent within one year, and which ranked high on the liberalisation index, was placed under “others”. Obviously, the decisive criterion for the authors was whether inflation actually peaked in the year of most intensive reform, an indication that the policy aimed at stabilisation and liberalisation simultaneously.

The authors ran a series of regressions, in some aspects similar to Fischer, Sahay and Végh, but with some important modifications. As it turned out, while “price liberalisation is only one component of reform, in post-communist countries it has been highly correlated with liberalization.”[117] They can show a strong negative correlation between the level of inflation (in the years 1991 to 1995) and the Cumulative Liberalisation Index (over the years 1989 to 1995). Cslund and his colleagues also tried to catch the different institutional setting and therefore, by introducing a dummy variable, distinguished between former Soviet republics and other transition countries. Also war-torn countries were marked by a dummy variable. As it turned out, the negative correlation between cumulative liberalisation and inflation remained strong. Fischer, Sahay and Végh established the same result. We have here one of the pleasant cases where two research groups, using related but different methods, come to the same conclusion.

This is, however, not always the case. Fischer and his colleagues established a positive and significant correlation between output change and the cumulative liberalisation index , and so had de Melo, Denizer and Gelb before them. The inference was clear, the more reform, the smaller the output decline. But in the model which Cslund, Boone and Johnson used, with their Soviet Union and war-torn dummies, the picture turns unclear. The Soviet Union had a much more burdensome legacy, due to a much larger military sector, due to more distortions caused by planning, weaker legal systems, and the like. If this legacy is incorporated by a dummy for Soviet Union, the otherwise significant relationship between cumulative liberalisation (1989-1994) and output change (1989-1994) turns insignificant. The same happened with the connection between inflation and output. The relation remains significant when the Soviet Union (“rouble zone dummy”) is included, but it disappears with the inclusion of the dummy for being affected by war. In other words, countries such as Georgia and Tajikistan had very high inflation and low output, but both can in part be explained by the fact they suffered from war. If this factor enters the picture, the otherwise “clear” relation between inflation and output is not clear anymore. Stanley Fischer commented on the Brookings conference: “This is a surprising result, and it appears to be inconsistent with related regressions by Sahay, Végh, and myself.”[118] Did he accept this surprising result? Or is it invalid because it is inconsistent with his own calculations? But perhaps the result is not so surprising after all. The theory to which Fischer (and Cslund) referred said that inflation should be brought under a level of 40-50 per cent. But it seems to be quite irrelevant whether inflation is at 200 or at 500 per cent. This implies that when a “rouble zone dummy” becomes introduced, then the correlation becomes insignificant because all those countries were far above the 40-50 per cent threshold, where the differences did not matter much, for a long time. The “war-torn” dummy has a similar effect, most war-torn countries were on inflation levels where the actual differences did not matter much. It seems far more reasonable to compare the countries which were underneath the 40-50 threshold, with those which were

117 Cslund, Boone, and Johnson, p. 219.
118 Ibid., p. 293.

above for a longer time (as Fischer, Sahay and Végh have done), and then the picture becomes again quite clear (see previous section).

Given the point that the initial conditions “rouble zone” and “war-torn” are so important, it makes more sense, according to Cslund, Boone and Johnson, to compare countries under similar conditions. Therefore they formed three groups, Eastern Europe, the Baltic countries, and the former Soviet Union, in order to study the consequences of reform strategy.

Cslund, Boone and Johnson referred to a row of formal models which were critical to the paradigm of radical reform because it, allegedly, caused high and unnecessary social and economic costs. For instance, Olivier Blanchard and Philippe Aghion argued that rapid reform and the cutting of subsidies produced high unemployment because of “search externalities”. Finding new employment takes time; the optimal policy would be to slow down reform, in order to keep unemployment low. Another “negative externality” of rapid reform is the increase in taxes which is caused by unemployment, which in turn slows down private sector development. Other models assumed the presence of sector-specific capital, for instance information capital, which cannot be used alternatively, and which gets destroyed by rapid reform. Wei Li and Blanchard argued that rapid reform destroys interfirm relationships; slower reform would allow the new sector to grow faster relative to the decline of the old one, so output losses were lower. Guillermo Calvo and Fabrizio Coricelli focused on imperfections in the credit market; state firms get starved of credit due to the tight monetary policy, and output could be boosted by more private credit. Other authors emphasised wage and price rigidities, which also meant that a tough stabilisation policy would provoke a fall in output that was unnecessarily large.

But the empirical evidence does not support these pictures. As Cslund, Boone and Johnson pointed out, delaying reform could be very costly. In the time span between 1989 and 1992, when their most intensive reform began, Russia lost 16 per cent of GDP, Ukraine 31, Estonia 19 [119]– gigantic costs which did not enter these models. And as to output, the radical reformer Poland had the best cumulative performance by 1995 among the Central and Southeast European countries; among the Baltic states, by 1995 radical Estonia’s GDP had fallen to 64 percent, but in gradual Lithuania it was down to 39. And by 1995 Russian output had declined less than Ukrainian. “These direct comparisons suggests that there is no evidence supporting the argument that radical reform leads to a greater fall in output. Even if viewed in the least favourable light, they are highly suggestive that more radical reform results in a lower output decline, other things being equal.”[120] Furthermore, although there is no robust significant relation between cumulative liberalisation and output change *between 1989 and 1995*, the relationship is indeed significant as to the growth *in 1995* – those who liberalised most, grew fastest in 1995. And focusing on 1995, there is also a significant relationship between low inflation and high growth.[121]

As to unemployment, the authors did not find any consistent relationship between output and unemployment. Using again their dummies for “rouble zone” and “war-torn”, there was no correlation between unemployment, the level of inflation, or the cumulative liberalisation index. Throughout the former Soviet Union, unemployment had remained rather low, in Russia and Ukraine labour markets have been enormously flexible. No less than one fifth of the Russian workers found new jobs in 1993. But when using the method of direct comparison of countries with similar conditions, there is “some evidence that radical reform is

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119 Ibid., p. 231.

120 Ibid., p. 236.

121 Ibid.

more costly.” Thus, by 1994 the Estonian unemployment was at 8.1 per cent, in Lithuania it was 3.8. Poland’s level was at 16 per cent, in slower reforming Hungary and Bulgaria it was at 11 and 13 per cent. However, “the case against radical reform is weakened substantially by the experience of the Czech Republic, which had intense reform (measured by the liberalisation index) but experienced rather low unemployment. 3.3 percentage point increase in the year that reform began, and a 0.6 fall over the next two years.”[122]

The picture is clearer as to the development of the private sector. The growth of the private sector 1989-1995, and the share of the private sector in 1995 were usually considerably higher in the fast reformers than in the slower ones. In statistical terms, the correlation between private sector indicators and cumulative reform index, or between private sector and inflation, has been strong and significant, also when the rouble zone or war-torn dummies entered the equation. “Aghion and Blanchard’s externality has not proved empirically important.”[123]

Peter Murrell and others have argued that rapid reform slows down the development of new institutions, whereas gradualism gives the time to build up new institutions. Measuring institution building is certainly very difficult. The EBRD had actually created an index which measures institution building in two areas, laws and legal practices, and banking and financial markets. And the IMF had established a ranking of institutional reform in the former Soviet Union. When these data are used for regressions, it turns out that the cumulative liberalisation index is in both cases positive and significant; inflation is significantly and negatively correlated to the IMF’s ranking list; as to the EBRD index, it remains negative, but misses being significant by the narrowest possible margin. So contrary to Murrell’s model, rapid reformer are more successful at institution building.

> The key problems in institutional development, such as weak banks and bad debts in the banking system or lack of enforcement of property rights, can usually be attributed to the postponement of radical reform….
> There is a good deal of logic behind a positive correlation between radical reform and the evolution of promarket economic institutions. A government that embraces radical macroeconomic stabilization and rapid liberalization is also likely to speed up the introduction of accompanying legal changes; these are complementary policies. At the same time, the existence of private enterprise and market relations creates demands for institutions that will defend property rights, enforce contracts, and so forth; this is an example of positive externalities at work.[124]

Cslund, Boone and Johnson then discuss the problem why so many nations choose to introduce reform gradually. In their view, the political weight of the old elite was a decisive factor: “The relative power of interest groups at the start of the postcommunist reform gave a clear advantage to the former elites. Both politically and economically, the state enterprise managers entered the transition period as the strongest organized group. This was most pronounced in the former Soviet Union, where they became dominant.”[125] They had an interest in delaying reform because their possibilities for rent-seeking were best under the conditions of inconsistent reform. The most straightforward form were subsidies from the state budget, or subsidised credits. Also tax exemptions or exploiting import and export regulations were also important. These rent incomes were substantially larger than the scope for benevolent social programs.

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122 Ibid., p. 241f.
123 Ibid., p. 247f.
124 Ibid., p. 249.
125 Ibid., p. 253.

> The potential rents from subsidised credits, import subsidies, and export controls added up to a staggering 55 to 75 percent of GNP in Russia in 1992….
> The Russian Sports Foundation, run by President Yeltsin's tennis trainer, was the main importer of alcohol into Russia in 1994 and 1995, as it was exempt from import tariffs and excise taxes. For 1995, the Russian Ministry of Finance valued the tax exemption of the Sports Foundation at no less than $6 billion, or 2 percent of Russia's GDP … [126]

Some authors (e.g. Mathias Dewatripont and Gérard Roland) had argued that gradual reform is politically optimal because it allows the government to buy compliance from groups which are negatively affected; the government should buy off each group in a piecemeal fashion. If it does not, the opposition will prevent or reverse reforms. Others, e.g. Balcerowicz had pointed out that reformers had only a brief grace period which they should use as much as possible to ensure that reforms are irreversible. From a theoretical point of view, it is, however, unclear whether radical reform would produce a political backlash, there are arguments both ways. To test these, Cslund, Boone and Johnson studied the electoral successes of reformers. They were much better than often assumed. Of the six radical reform governments, four were reelected. The Polish and the Estonian ones lost in 1993 and 1995, respectively, but the Polish one was the result of the fragmentation of the Solidarity, not of huge voters movements; one third of the votes were "lost" because many parties did not pass the 5-per cent threshold. And the post-communists continued reform. Besides, governments that delayed reform also ran into electoral troubles. "The empirical record shows that as a strategy for political survival, radical reform may actually raise the chances of winning subsequent elections. Further, apart from Estonia, there is no clear sign of a popular backlash against radical reform, and in all cases when a reforming government has lost an election, its reforms have not been reversed … The observer is left with the impression that people in the formerly communist-controlled countries have taken all the economic suffering ftlinesurprisingly well, and that once reforms are implemented, they are irreversible."[127]

Opinion polls (the Central and Eastern Eurobarometers) showed the predominance of pessimistic outlooks among the population, but gradual reform reforms appeared to breed greater pessimism. And throughout the region, most people found that reforms were *too slow*, or absent. And as to attitudes towards market economy, the market economy is generally unpopular where the reforms remain far from complete. "Thus our conclusions from the elections results are reinforced by the opinion polls: rapid reform does not meet with a groundswell of political opposition that would threaten to reverse it … Experience so far indicates than once a far-reaching reform has been launched, generally even subsequent ex-communist governments support its continuation."[128]

All in all, neither political not economic experiences support the view that gradualist reforms would produce better results. The authors base their conclusions on an impressingly broad range of methods and huge amounts of empirical material. They document a thorough and detailed knowledge of the politics and economics of the region; their wording is careful. It is also pleasant to notice that they produced results which were perhaps not politically welcome to them (e.g. the vanishing statistical significance of the relation between inflation and output). But all this does, of course, not mean that there are no possibilities for criticism. There is, as always, the problem that the data are not very accurate; hence statistical significance is a problematic term. But at least, the authors formulate their conclusions carefully, and they endeavour to throw light on the subject from different angles and try to

126 Ibid., p. 258 and 258n50.
127 Ibid., p. 269f.
128 Ibid., p. 273.

cross-check results.

But again, with the knowledge of hindsight, some parts appear weaker. For instance, also these authors recommend fixed exchange rates. And they wrote: " … the Czech Republic stands out as the country that has done everything right."[129] Some years later the Czech economy ran into substantial problems, many of them structural, so this sentence was perhaps over-optimistic. As highly problematic appears also their treatment of the tactics of the Estonian Central Bank, which fixed the exchange rate and then sold vast amounts of future contracts, about 4 per cent of GDP, up to eight years ahead, promising to sell foreign exchange at 8 croon to the DM. Every government and central bank which in the future put stabilisation at risk and devaluates, will face gigantic losses. The authors seem to approve of it. They seem to overlook that "poison-pill" tactics of this kind imply heavy risks: if a devaluation should become unavoidable, the Estonian people have to foot the bill. Stanley Fischer, in the discussion, found the tactics of the Estonian Central Bank "more bothersome than impressive".[130]

More substantially, Cslund and his colleagues seem to infer that all reforms should be implemented as soon as possible, without considering sequencing. In this respect, they referred to a paper by Michael Mussa, of the IMF, who could show that under a set of certain conditions (e.g. rational expectations) market distortions such as a protectionist tariff should be removed as quickly as possible; a stepwise abolishment would produce greater costs. But as Stanley Fischer pointed out, this results holds only if there is only one distortion. If there are multiple imperfections, some of which can not be removed quickly, then the Mussa result did not imply the highest speed possible. A case in point was the imperfect financial system which could not be brought in good shape immediately. "The analytical argument could, therefore, be turned around to argue that other reforms should not be implemented until a decent financial system, that would enable firms that ought to survive to borrow for that purpose, is put in place. Equivalently, it is not optimal to put everybody to the test of market prices before the financing to meet that test efficiently is available."[131] This can perhaps be read as a critique of the speedy Russian privatisation. So at this point the divergence "inside Washington" as to the speed of privatisation (see section II,3) came to the surface again.

Barry W. Ickes pointed out that Cslund and his colleagues underrated the importance of the initial conditions for the choice of the reform strategy. In their model it is basically the political strength of the old communist elite which determines it. But in some countries, radical reform (which Ickes in principle advocates) can also be much more costly than in others. The weaker the financial system at the start of the transition, and the more loss-making enterprises there are in the industry, the more costly stabilisation will be, and the less likely political leaders will be to embark on radical reform.[132] This argument could actually go together with Cslund's: Politicians, being aware of the high costs at the beginning of transition, shy away from rapid reform, unless experience has shown that a slow procedure does not help.

James Duesenberry suggested that the authors drew the distinction between the old elite and the population too sharply. In their account, only the old elite takes advantage of rent-seeking. But when e.g. loss-making enterprises receive subsidised credits which are financed through an inflation tax, then the employees of these enterprises gain from it too, at least temporarily. Duesenberry conjectured that some forms of rent-seeking helped avoiding

129 Ibid., p. 291.
130 Ibid., p. 297.
131 Ibid., p. 295.
132 Ibid., p. 304.

extremely costly short-run outcomes for parts of the population. Not only the old elite had an interest in delaying reform.[133]

All in all, the paper by Cslund, Boone and Johnson did not answer all questions, and not all of what they wrote is equally convincing. But it remains a fact, that in the vast literature about transition, there have been few contributions where the conclusions rests on such a solid empirical basis.

## V. VERY CRITICAL PERSPECTIVES

### 1. Peter Gowan: Transition as Imperialism

The "Washington Consensus" and the policies which were inspired by it, became often subject to severe criticism. A particularly strong one can be found in a lengthy article by Peter Gowan, one of the editors of the *new left review*, in the issue of September/October 1995. Some months later, answering to critical remarks by the former *Financial Times* correspondent John Lloyd, Gowan published a rejoinder which contains some important clarifications and expansions.[134]

In Gowan's presentation, the people of Eastern Europe became the victims of a Western policy which visited upon them poverty, malnutrition, and criminality. For instance, between 1989 and 1993 excess mortality in Russia, Ukraine, Bulgaria, Hungary and Poland – in Gowan's account a side effect of Western policy – was 800,000. This came about because the Western powers imposed upon Eastern Europe an economic regime which suited Western hegemonic interests, but which was contrary to the basic needs of the people in the "target countries". All this did "not so much suggest a new era on the globe as something rather old-fashioned which, in the days of communism, used to be called imperialism."[135] And: "The word imperialism is out of fashion. But fashion is not everything … And imperialism has been a perfectly normal part of our world for a long time. It refers to the political domination by the members of one state over populations outside that state."[136]

Shock Therapy was "above all, a US government policy backed by the UK, and in large part by the German government. The French government resisted it but was defeated and the Japanese, who would undoubtedly have rejected the economic rationale for it, kept as far out of
the whole business as it could."[137] In order to understand transition, we have to accept concepts such as Susan Strange's "structural power", or Joseph Nye's "soft co-optive power". "This is about creating rules and institutions within and around target states that have the effect of getting the leaders of these states, in Nye's words, to 'want what you want'."[138]

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133 Ibid., p. 304.

134 Peter Gowan, 'Neo-Liberal Theory and Practice for Eastern Europe', *new left review*, number 213, September/October 1995., pp. 3-60; John Lloyd, 'Eastern Reformers and Neo-Marxist Reviewers', *new left review*, number 216, March/April 1996, pp. 119-128; Peter Gowan, 'Eastern Europe, Western Power and Neo-Liberalism', *new left review*, number 216, March/April 1996, pp. 129-140.

135 Gowan, 1995, p. 60.

136 Gowan, 1996, p. 135f.

137 Ibid., p. 130n6.

138 Ibid., p. 136. The quotations refer to Nye's *Bound to Lead: The Changing Nature of American Power*, New York 1990.

> The problem which the US faced in Eastern Europe was to implant institutional structures and rules within the states of the region that would, once in place, make the leaders of these states 'want what the US wants'. These include foreign investment regimes, trade regimes, state-market relations, appropriate freedoms for TNCs [*Transnational Corporations, W.Z.*] appropriate tax regimes, minimalist welfare states, deregulated financial markets, fully convertible currencies, the absence of foreign-exchange controls, privatized utilities, appropriate regimes for mass communications, appropriately organized stock markets, the right kinds of definitions of intellectual property rights and the appropriate forms of corporate property and governance, appropriate forms of domestic ideology and politics, and so forth … I referred to these goals as the regime goals of the USA. Nye does not mention the fact that these institutional structures must ultimately be underpinned by distinctive social structures such that the dominant social class will experience huge gains, as they have, paradigmatically, in Mexico. These were the goals of Shock Therapy. These are the bottom line. They are about ensuring that US power is strengthened in its dominance into the next century. It is what we might call, if you will pardon the pun, neo-classical imperialism[139].

Lloyd criticised that Gowan treated the Eastern European governments as passive and ignorant "pawns manipulated from Washington, London – and Harvard"[140]. Answering to this criticism, Gowan highlighted three mechanisms by which the Western powers were able to steer the Eastern European development: *Markets, linkage and leverage*.If target states failed in international *markets*, they were particularly vulnerable to external pressure. This was a severe problem for East Central Europe states "once their regional economic network collapsed, given the Cold War barriers to their entry to Western markets and their debt problems."[141] Not so much for Russia, because of her export capacities.

*Linkage* referred to domestic groups which came to identify with the interests of the Western actors. The first group were "intellectuals captivated by the beauty and elegance of neo-classical and Hayekan economics … Some of these intellectuals were true believers in what Lloyd has called the new gospel and what the NLR [*new left review, W.Z.*] called the cargo cult [*a cult of some natives in Micronesia who came to worship as a deity an American cargo plan containing goods, W.Z.*]. The honest and ascetic Leszek Balcerowicz is surely archetypical here."[142] Other linkage intellectuals were more cynical, for instance ambitious young people, or former communist intellectuals seeking for new credentials. More important was, however, another group, namely "that large minority in the region who could hope to become the new propertied class", and who came to see "Western powers and institutions as their champions and hoped-for future protectors"; the role of Western and Western-owned media, "with their word-smiths of Economic Reform, have helped to give shape to such groups."[143]

Thirdly, *leverage* "involves the direct use of negative and positive incentives by Western actors on target governments."[144] In his first text, Gowan explained (referring to Sachs who repeatedly underlined the West's responsibility and possibilities to influence events): "The capacity to open or close their markets to East European products; to decide on debt, on grant aid, on loans, and on the terms for loans for political as well as economic purposes, on technology transfers, on currency support and so on; to decide on entry or exclusion from international institutions; to allow Eastern workers to flow westwards. All these give Western

139 Ibid., p. 137.
140 Lloyd, p. 122.
141 Ibid., p. 138.
142 Ibid.
143 Ibid.
144 Ibid.

governments tremendous bargaining power."[145]

In his first article, Gowan attributed a key role to Western advisors. In particular Jeffrey Sachs' "inverted Leninism" played a central role; Sachs was modelled as a kind of Grand Strategist of the West whom "all Western authorities [*such as the IMF, World Bank, OECD, EBRD, W.Z.*] have joined".[146] After Lloyd's criticism to this point, Gowan accepted that e.g. Michael Bruno or Stanley Fischer were more important,[147] but this concession seems to be limited to names, not to the substance.

According to Gowan, as to the practical execution of the Western strategy, institutions such as the IMF played an essential role: "The IMF has strenuously pressurized governments to take the … course", of "massively cut back on spending". Furthermore, "The IMF was using the slump as an instrument for rapid social engineering at micro level to create the desired goal of a state open to FDI [*Foreign Direct Investment, W.Z.*]."[148] IMF, the World Bank and the European Bank of Reconstruction and Development also opened the way for Western corporations, using a variety of means. For instance, the World Bank has "blocked governments from restructuring state-owned enterprises before privatizing them … The World Bank has similarly sought to emasculate national development banks."[149] IMF and the World Bank acted this way, in order to secure that private capital steered enterprise restructuring. Given the scarcity of private capital in these countries, Western capital had to enter the scene, thereby gaining control over these enterprises. The "struggle was precisely about this control going largely to Western actors."[150]

> If you plunge the region into the most severe peacetime depression known anywhere since the Second World War, if you simultaneously bring enterprises into technical bankruptcy through the collapsed domestic markets and a fierce credit squeeze, and if you ban governments from restructuring companies before selling them off, then you ensure that Western purchasers can buy them for next to nothing.[151]

There were alternatives to Shock Therapy. One was formulated by the French government in 1989/1990. In Gowan's summary:

> 1). Encouraging the former Council for Mutual Economic Assistance (CMEA) region, including the USSR, to remain linked together economically.
> 2). Leaving the evolution of socio-economic forces in each country to the interplay of forces within the country concerned, without using Western pressure to impose a particular system.
> 3). Making the emphasis of Western policy that of economic revival in the region as a whole, using, for example, a regional development bank for that purpose.
> 4).Rejecting the perspective of bringing some ex-communist countries into the EC in the short or medium term. Instead, offering a pan-European confederation embracing both the EC and the East, including the USSR.[152]

Sachs (and many others) opposed this proposal, arguing that a reconstructed CMEA just would be a "poor mens' club". As we saw, Sachs advocated instead the liberalisation of foreign trade, accompanied by currency convertibility, i.e. integration with Western Europe and the world market. According to Gowan, Sachs' concept prevailed over the French

145 Gowan, 1995, p. 12.
146 Ibid., p. 6, p. 6n6, and p. 11.
147 Gowan, 1996, p. 135.
148 Gowan, 1995, p. 29f.
149 Ibid., p. 32f.
150 Ibid., p. 34.
151 Ibid., p. 45.
152 Ibid., p.6

proposal because it "dovetailed nicely with the politico-economic policy objectives of the Bush administration … The French government was unable to carry the day against Washington because the Bush administration's policy offered adequate scope for German interests. In particular, the anchoring of the Visegrad countries *[Poland, Czech Republic, Slovakia, Hungary, W.Z.*] to the German economy was a prime goal of Bonn and once the arrangements with Moscow for German unification were consolidated, the German government ceased to pursue its earlier interest in new pan-European frameworks."[153]

The American and German policy had devastating consequences for the people of the region: "The most damaging cost and, at the same time, the most fundamental feature of ST [*Shock Therapy, W.Z.*) was the decision to encourage the fragmentation of the CMEA region and to replace with a hub-and spoke interaction between isolated, shattered economies and gigantically powerful Western forces. From this, all else followed."[154]
Gowan summarised the main damages which were caused by this policy as follows:

> 1. A severe slump caused by the shattering of the region's economic links, a shattering actively encouraged by the IMF and justified by Sachs as beneficial.
> 2. Severe domestic slumps deliberately engineered by the IMF [*because of its insistence of restrictive monetary and fiscal policy, W.Z.*].
> 3. These slumps were engineered in conditions where developed financial markets did not exist, and thus enterprises … would have to turn to privatization into foreign hands for survival.
> 4. An attempt to revive these economies by export-led growth directed towards the EC when the US government knew perfectly well that the EC would seek to resist such an export surge.
> 5. Continued domestic deflationary measures imposed on target governments thereafter by the IMF at a time when the revival of these economies could only be achieved through domestic, demand-led growth.
> 6. Successful pressure at the start of ST to dismantle the trade-protection regimes of target countries with very damaging effects on domestic producers facing strongly subsidized export drives by West European companies.
> 7. Attempts by the World Bank to block effective micro-economic strategies in target countries …
> 8. A system of negative and positive incentives to force maximum privatization into the hands of foreign companies…
> 9. A refusal to engage in serious debt reduction, except in the case of Poland, and a general approach of using debt problems as an instrument of leverage for domestic institutional engineering.
> 10. A severe weakening of R&D [*Research and Development, W.Z.*] and educational infrastructures and efforts to remorselessly attack social protection systems.
> 11. A form of FDI [*Foreign Direct Investment, W.Z.*] which was geared more towards market control in the target countries than to technical upgrading and production expansion …
> 12. Very severe consequences for the health and well-being of the population of the region.
> 13. A very grave shattering of the social tissue of these societies and enormous strains on their political systems as result of a deliberate choice of strategies to defeat social and political opposition to the goals of institutional engineering.[155]

The combined effects have been so disastrous that "even for a country growing like Poland for the foreseeable future, the population will have to wait for the best part of twenty years simply to return to their living standards under a communist system that had long been in crisis."[156] This policy was only possible by undemocratic means, the "most brutal and direct" example being Yeltsin's violation of the Russian constitution in 1993.[157] And finally: "The earlier 1990s in Eastern Europe was not just a missed opportunity for Europe. It was an ugly

153 Ibid., p. 59.
154 Ibid., p. 54.
155 Gowan, 1996, p.131.
156 Gowan, 1995, p. 56.
157 Ibid., p. 50f.

business. There was a sudden power vacuum in the region and in the West, imperial impulses swept all others aside. Great damage was needlessly done."[158]

A truly dismal picture. Gowan is certainly right on many aspects. The demise of Communism and the transition to a Western society has surely been in the interest of the United States (and, not the least, Germany). The Soviet Union constituted an existential security risk for the US (and Germany), Soviet policies threatened US political and economic interests all around the globe. The transition largely removed that threat; Russia even became a potential ally, with many interests being similar to the American ones. In a more limited economic sense, the transition in Eastern Europe opened new possibilities for Western corporations to make profits. Gowan is also certainly right that the Western powers have had capabilities to influence events. And no doubt, out of intellectual convictions or out of material interests, groups in these countries worked for the "Westernisation" of their societies, and thereby by implication, for Western interests. Undeniably also, the transition has been a painful process; open unemployment was unknown before, inequality and poverty has been rising. The collapse of the trade relations within the CMEA and the import restrictions of the EU aggravated things. The "shattering of the social tissue of these societies" meant also severe mental burdens. Mortality has risen, particularly in the former Soviet Union (though not at all in the Czech Republic and Slovakia), the main reason presumably being stress.[159] And certainly, Yeltsin's procedure in 1993 was very problematic from a constitutional point of view. And finally, Gowan's text is, as John Lloyd put it, in "full agreement … with the basic tenets of the case made … by the Communist Party of the Russian Federation (CPRF), Zhirinovsky's Liberal Democratic Party of Russia, the recently formed Congress of Russian Communities (Lebed) and many other Marxist-Leninist and nationalist groupings in Russian, in the former Soviet Union, and a few rather smaller and less influential Marxist and far-rightist groups in Central and Eastern Europe."[160] Gowan's text has therefore also the merit of giving large sections of the Eastern European societies a voice in Western Europe.

But all this does not make his general picture right. Firstly, Gowan seems to suppose that if a transition is good for the USA, it must be negative for the people in the "target region". But this is not necessarily the case. Germany and Japan after 1945 are cases in point. Certainly the "transition" of these countries were in the interest of the US. And, unlike Eastern Europe, in both cases the US directly supervised the "transitions". The US gained important allies and could profit economically. But the German and Japanese populations profited also from these changes – in fact tremendously so, politically and economically.

Gowan, quoting Joseph Nye, emphasised the importance of "regime goals" for the US policy. But on his own he compiled a long list of alleged "regime goals" which by far exceed Nye's meaning of this term. Without any explanation or empirical evidence, he put e.g. "minimalist welfare states" on the list. This is a fiction. Countries with "maximalist" welfare states such as Denmark or Sweden have for decades been open economies within the Western Hemisphere, and there has never been any US pressure on them to reduce their welfare states. And in the middle of the 1990s, they were more "maximalist" then ever before, with public expenses, as share of the GDP, being at 60 and 63 per cent respectively.[161]

The Japanese and German "transitions" were successes from the US point of view because they resulted in stable and prosperous democracies. This is the reason why they

158 Gowan, 1996, p. 140.

159 Cslund, 1995, p. 287.

160 Lloyd, p. 119f.

161 OECD, 2000, appendix, basic statistics. The Danish figure is from 1995, the Swedish one from 1996.

became stable allies for the US after 1945 (as, albeit to varying degree, all democratic states are). If West Germany or Japan had been socially and politically unstable, as in the 1920s, they would have been unreliable, perhaps even again becoming enemies. After 1989, many transition countries have shown severe signs of instability. Unstable transition states menace the interests of the US (and, not the least, Germany). They might follow a risky foreign policy, make common cause with "rogue states", or they might turn into breeding places of organised criminality, drugs trafficking, and mass emigration. If this instability was the direct result of US and German imperialism, then this was amateurish imperialism. Which, of course, cannot be excluded beforehand.

But instability in the "target countries" was not mainly the result of US imperialism because Gowan grossly overrated the capabilities of Western powers to steer events. It is already untenable to picture the IMF and the World Bank as mere instruments of the US. Certainly, the US treasury is a very influential player in this context, and the US can veto strategic decisions. But the IMF is an organisation formed by 182 member countries, and all IMF programmes must be endorsed by the 24 persons of the directorate who represent all member states. Usually the decisions are taken by consensus.[162] But far more important in our context: The IMF hardly played any role in the transitions countries during the first years of the transition. In 1990, Poland received an IMF-loan in order to stabilise the currency, but in e.g. Russia, IMF-financing did not begin before 1995, and other forms of Western aid were minuscule. In 1990 Sachs and others had repeatedly *demanded* generous Western help, and in 1994 he massively attacked the Western governments and the IMF *because of their passivity*.

On the one hand, Gowan depicted Sachs as the enormously influential strategist of the West. As to the building blocks of Shock Therapy, "all Western authorities have joined"[163] him. But if Sachs had such a tremendous influence as to those points, it is then somehow enigmatic why the Western governments and the IMF did not listen at all to him when it came to the question of Western financing, a point of great importance in Sachs' eyes. Nor did the Russian government listen much to him, although he was advisor to the finance ministry. There was simply no Master Plan which co-ordinated all Western governments and institutions such as the World Bank and the IMF. And when the IMF did not give loans before 1994/5, as in Ukraine or Russia, it could not "engineer" anything, nor could it be held responsible for the rising mortality between 1989 and 1993.

The largely fictive character of his account also becomes obvious when he blames Shock Therapy for the social evils of transition. Gowan's presentation is based on the sequence, first there was Shock Therapy, all over in the region, and then there was misery. Gowan has not been the only author to depict events this way. This is marvellous: The elementary fact that countries such as Russia and particularly Ukraine *did not practice "Shock Therapy"* went unnoticed. A comparatively minor point lies in the fact that he – fortunately – grossly overrated the social costs of transition, and the time necessary to re-establish living standards to the pre-transition level. We discuss some statistical problems in section V,3.

Gowan's article contains numerous and interesting empirical facts, for instance many details of the EU-financed PHARE-programmes. But the very building blocks of his narrative are without empirical basis. He writes that US strategy and German policy lay at the heart of the misery: "... Bush administration's policy offered adequate scope for German interests. In particular, the anchoring of the Visegrad countries to the German economy was a prime goal

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162 "Gleiche Rechte für alle" [*Interview with the new Managing Director Horst Köhler*], *Die Zeit*, 30. 3. 00, p. 25.

163 Gowan, p. 11.

of Bonn …"[164] Is this to be understood in the sense that Bush offered to Kohl the "anchoring" of the Visegrad countries, so Germany and the US made a deal? In this case we would like to know who negotiated this deal, and when it was ratified. And how Gowan came to know about it. Or did Germany support Shock Therapy because Bonn realised that it offered opportunities to fulfil its own imperialist designs? Unfortunately (fortunately) Gowan dwells in the realm of fiction when he writes that the "anchoring" of the Visegrad countries to the German economy was a "prime goal" of Bonn: We have to state the elementary fact that Germany has been a member of the European Community for long. It is true, *in the 1930s* Germany tried to gain political influence in Eastern and South Eastern Europe by using her economic strength, e.g. offering preferential tariffs and market access to countries such as Hungary or Yugoslavia,[165] this way "anchoring" these states to her own economy. But Germany's policy goals and means have changed between 1935 and 1990. And perhaps even more important: As EC/EU member Germany had simply no possibility to practice a policy as in the 1930s. Tariffs have been regulated by the EC/EU, and free access to the German market meant free access to all EU markets. It was precisely this *anchoring of Germany* within the EU that made fears of "German-imperialism-using-economic-means" unfounded. This was presumably an essential political condition for the transition. The Polish and Czech governments could decide to open their economies without having to fear to come under German dominance.

Gowan's account is also without empirical basis as to the formulation of the reform programmes in the "target states". He seems to think that when he compiles a list of "mechanisms of transmission of external influence", then it is not necessary to study the political processes in the Eastern European countries. But depicting the outcome of the political processes as a linear function of Western designs is as fictive as blaming the IMF for economic outcomes in countries where it has not been involved.

In Gowan's eyes, the decision not to continue the CMEA was a prime disaster; it "fragmented" the region and exposed small "shattered, isolated" economies in "hub-and-spoke-relations" to overmighty Western forces. But the opening of their economies did not "fragment" the region. On the contrary, the traditional CMEA was a very cumbersome organisation, the degree of division of labour between its member countries was small, compared to the Western world. The trade liberalisation enabled these countries to overcome their traditional fragmentation and to integrate with the outer world. The relations to the West after 1990 were not "hub-and-spoke-patterns." No one impeded them also to trade among each other and *also to integrate more among themselves*.

A continuation of the CMEA would have left the Eastern European countries in a situation which they could only see as a cage. They would have remained *anchored* to the Soviet Union. It was not Sachs or the IMF, it was the democratic governments of the transition countries, Russia included, which buried the CMEA. Besides, the history of the Third World is littered with "Third Ways", "Separate Developments", "Import Substitution Programmes", and the like. The experiences were bad, without exception. This is the reason, why these countries, from Latin America over India to China, have been moving towards greater integration into the world market. Only North Korea did not do so.

In Gowan's account, EU protectionism destroyed the possibilities that exports towards Western Europe could substantially contribute to economic recovery. His method consisted

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164 Gowan, p. 59.

165 Peter Krüger, *Versailles. Deutsche Aussenpolitik zwischen Revisionismus und Friedenssicherung,* München, 1986, esp. p. 167.

in compiling a list of “sectors of export strength” of the transition countries (e.g. food/agriculture, or textiles/clothing),[166] then stating that these were the sectors where these countries ran into barriers of EU protectionism, and then to conclude that there were no real possibilities. Had he studied the EU policies and the trade statistics more carefully, a different picture had emerged: From 1989 onwards, the EC signed agreements with the transition countries which aimed at the elimination of quotas and the application of the Most Favoured Nations rules. Already in December 1990 negotiations to conclude Europe Agreements began. Preliminary agreements were quickly put in place, and by 1996 formal Europe Agreements were signed with ten transition countries. They aimed at creating a free-trade area within ten years, with a shorter timetable of liberalisation on the EU side. However, in “sensitive sectors” (coal, steel, textiles) the timetable on the EU side was slower. In spite of these restrictions, to quote Loukas Tsoukalis, “trade liberalization moved at a rapid pace, an early enough the bulk of trade in industrial goods became free of restrictions. The result was a *spectacular growth of trade*. In 1989, the Visegrad Four, plus Bulgaria and Romania, had accounted for 2.8 per cent of extra-EC exports and 2.7 per cent of extra-EC imports. By 1995, their share had risen to 6.5 and 5.8 respectively… The opening of the economies of the CEECs *[Central and Eastern European Countries, W.Z.]*” was accompanied by a major geographical shift in both exports and imports towards the EU and an increase in trade surplus of the latter.”[167] The fact that these countries, with the exception of Hungary, became net importers of agricultural products, has indeed been one of the many scandals which the EU agricultural policy has created. But Gowan blew problems of this kind out of any reasonable proportions.

Besides the “impossibility” to increase exports to Western Europe, the “severe domestic slumps deliberately engineered by the IMF” and “the continued domestic deflationary measures” were the other main reason, in Gowan’s view, why “Shock Therapy” has produced so disastrous results. But Gowan’s wording (as many others in this context) contain a seemingly slight, but substantial inaccuracy: The IMF (or Sachs, or Balcerowicz) never recommended a “deflationary” policy, but a “disinflationary” one. A *deflation* is a period with falling prices. There is consensus among Western economists that a deflation causes severe problems because the actors can realise substantial profits by simply holding financial assets liquid; their real value increases because the prices are falling. This would imply substantial problems on the demand side because the assets are not spent. So, a deflation must be avoided, and it has never been a problem in the transition countries, except Croatia. But many Eastern European countries had severe inflation problems, at times even hyperinflation. Hyperinflation destroys the money and thus severely burdens the exchange of products, and it causes appalling social effects. Therefore inflation should be brought under the level of 40 per cent. And as to the effects we can just state that Poland, following this line, experienced the mildest and shortest transition recession, whereas the Russian Federation or Ukraine who did not combat inflation during the first years, suffered from a declining GDP until the end of the 1990s.

In Gowan’s account, the paradigm of rapid reform was but an ideological cloak for Western capitalism. As to this point, his text echoes the very early Friedrich Engels and Karl Marx of 1848: “The ruling ideas of each age have ever been the ideas of the ruling class.”[168]

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166 Gowan, 1995, p. 26.

167 Loukas Tsoukalis, *The New European Economy Revisited,* Oxford University Press, 1997, pp.248-250, quotation p. 250, emphasis added.

168 “Die herrschenden Ideen einer Zeit waren stets nur die Ideen der herrschenden Klasse.” Karl Marx/Friedrich Engels, ‘Manifest der Kommunistischen Partei’, *Marx Engels Werke*

Later Engels and Marx modified this position, by granting a certain autonomy to intellectual productions (thus discarding the sentence above as oversimplification). More specifically, Gowan seems to reject that the *experiences* of the unsuccessful Eastern European reforms prior to 1990, or the experiences from hyperinflation in other parts of the world, or the fiascos of "import substitution policies", were of importance for the production of economic ideas in Eastern Europe. This is perhaps due to the fact that he was simply ignorant of the Eastern European discussions before 1989. The very opening of his first article reads: "Eastern Europe's market for policy ideas, suddenly opened in 1989, was swiftly captured by an Anglo-American product with a liberal brand name. This policy equivalent of fast food erected barriers to other new entrants and established a virtual monopoly on advice in most target states in the region."[169] Apart from the problem, how Jeffrey Sachs ever should have been able to erect entry barriers to other ideas; and apart from the empirical fact that in e.g. Russia *other* ideas prevailed for many years: The market for ideas did not "suddenly open in 1989". There were many discussions going on long before.

To sum up: Gowan is right as to some points, and his text raises many interesting questions. But his answers, as to his *main* points, do not survive closer scrutiny.

## 2. Joseph Stiglitz: The Problems of Corporate Governance

After the Asian crisis, a broad chorus of critics voiced acrimonious judgements against the IMF and other institutions under Western influence. They got extraordinary and unexpected support when a highly reputed "Washington insider", Joseph Stiglitz, Fischer's successor as the chief economist of the World Bank, joined the critics with a row of furious public statements. As Rudi Dornbusch, of MIT, observed: "The debate continued recently at the World Economic Forum conference in Singapore, where the last rounds of the battle left the Stiglitz side, aided by Malaysia's Prime Minister Mahathir Mohamad, with an apparently resounding victory and a standing ovation from the crowd of top Asian corporate leaders."[170]

Also the Western policy towards the transition countries became the subject of Stiglitz' criticism, for instance, at the annual World Bank conference on development economics in Europe, in Paris in June 1999.[171] In his account, a combination of overhasty privatisation in the context of highly imperfect markets and overharsh disinflation policies propelled the Eastern European countries downwards. Insofar, Stiglitz' position exhibits parallels to Gowan, but his way of reasoning was different.

Stiglitz pointed at the many ambiguities in the statistical material and concluded that some central tenets of main stream theory should be treated with a high degree of scepticism, among those the idea that low inflation is conducive to growth. He acknowledges that inflation can be a problem because it interferes with the working of the price system.

> But when attempts to suppress inflation are associated with a movement out of market system and towards a heavy reliance on barter, the price system works even more imperfectly. Theories of downward wage and price rigidity have contended that pushing inflation below a critical threshold actually interferes with the dynamic adjustment of the economy…
> Price stability (low inflation) is not an end in its own, but a means to more fundamental goals, such as faster economic growth. And when pushed too far – below a critical level – not only may the costs of

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*(MEW)*, Band 4, (Ost-) Berlin, 1974, pp. 459-493, esp. 480.

169 Ibid., p. 3.

170 Rudi Dornbusch, 'The IMF Didn't Fail', *Far Eastern Economic Review*, 2.12.99, p. 28.

171 Joseph Stiglitz, 'Quis Custodiet Ipsos Custodes?', *Challenge*, vol. 42, no. 6, november – december 1999, pp. 26-67.

pushing inflation lower not be worth the benefits, but the benefits may actually be negative. Macrostability does not, in itself, imply microrestructuring...

At one level, the facts speak for themselves. The transition to the market economy has not delivered what its more ardent advocates promised … The quandary of failure of so many experiments is particularly vexing when the economic theory was so clear in its predictions. Distorted prices, central planning, and attenuated incentives arising from the absence of clear property rights meant that resources were not efficiently allocated. Reducing those distortions, decentralizing decision-making, and privatizing – even if not done perfectly –should have moved the countries closer to their production possibilities curve. Output should have soared – instead it plummeted.[172]

And: "… the observed problems are precisely those anticipated by information economics, with its emphasis on corporate governance."[173] In this context, the problems of strong legal protections of ownership became very important. As World Bank studies have shown, only countries with very strong legal protections could support diverse ownership. From this perspective, the voucher privatisation, which was practised in Eastern Europe, could only produce the disastrous combination of weak legal protection with dispersed ownership. Theoretically, the banks could control the firms, but the Eastern European banks were no real banks. Their lending became the source of new soft budget-constraints, or instruments to divert wealth to political cronies. Also the voucher investment funds became vehicles for high-powered abuse. These structural problems created "enormous opportunities for theft."[174] Furthermore, there were enormous returns associated with getting loans. "The consequences were predictable, one might say almost inevitable: Loans were not necessarily allocated to those who were the most likely to use the assets of the firm most efficiently, but to those with political connections …"[175] Liberalising capital movements just allowed "these robber barons to take their cash flows out of the country … capital account convertibility was thus an essential ingredient in the failure."[176]

The Chinese experience shows that a perfect legal structure was not strictly necessary to attract foreign capital or to induce domestic investment. The key was competition. It was the absence of competition that created rents that so often get diverted to inefficient uses.[177] Also bankruptcy procedures could not work properly. Under the weak legal systems, the potential for corruption was obvious, and the many possibilities to delay procedures created new incentives to use the time for asset stripping. The architects of the Russian privatisation predicted that the appropriate institutions would follow private property, not the other way round. "There is, to my knowledge, no theory – and scarce historical evidence – underlying these optimistic assessment of institutional evolution."[178]

And finally, "In many countries, a strict interpretation of the rules of a market economy would lead quickly to government takeover of large proportions of existing assets that have been privatized in the past decade."[179]

All in all, it was ill-conceived transitions strategies which followed the recipes of the Washington consensus which produced the misery. But in contrast to Gowan, the core problem was not so much imperialist impulses, but rather poor intellectual concepts such as

172 Ibid., p. 31f and 34f.
173 Ibid., p.31.
174 Ibid., p. 41
175 Ibid., p. 41.
176 Ibid., p. 42f.
177 Ibid., p. 45f.
178 Ibid., p. 55.
179 Ibid., p. 61

inadequate and outdated theories of the firm.

Stiglitz focuses on many important and real problems. Corporate governance has been highly problematic in many transition countries, not the least due to weak legal systems. Quick privatisation under these conditions, as in Russia, had certainly many drawbacks. And free capital movements were problematic. And certainly, a disinflationary policy can, if pushed too far, produce negative results.

But unfortunately, from Stiglitz' text we can not learn too much what to do about all these problems. To begin with, his text is of extraordinary vagueness. Certainly can an anti-inflation policy be pushed too far. But was this actually the case in ‚say, Russia? Was it wrong to bring inflation down from the level of 2,300 per cent, where it was at the end of 1992? In 1998 Russia was again at the brink of hyperinflation, and this time the Russian Central Bank, aided by the IMF, acted swiftly to avert this danger. Should they better have tolerated the return of hyperinflation? Does Stiglitz object to the aim of bringing inflation to fewer than 50 per cent?

Stiglitz said that recent economic literature had stressed the importance of social capital and concluded: "Perhaps an alternative transitional strategy, paying more attention to the preservation of what social capital currently existed, might have led to fewer abuses. We know little about how to preserve and create social capital."[180] So, what can we do? Or is this an implicit hint that the reformers better should have reformed as little as possible, in order not to risk the destruction of social capital?

He is certainly right that macroeconomic stabilisation in itself does not guarantee restructuring at the micro level. No one ever said that. But many said that macroeconomic stabilisation was a necessary condition for it. Stiglitz rightly points at the possibilities which cheap loans gave to people with connections to strip assets; this also meant new soft budget constraints. The conclusion is that it is advisable to stop cheap and subsidised credits. Which is the same as to say that a rather strict monetary policy was a necessary condition for hard budget constraints, and thereby for the restructuring at the micro level. But Stiglitz seems simultaneously to point at cheap loans as a source of evil, and at the same to advocate a policy of cheap loans. The same inconsistency becomes apparent when he discusses the problem of capital flight. The strongest force which in 1998 drove private assets out of Russia was the expectation of a devaluation of the rouble. In other words, a sufficiently strong stabilisation policy which lays the foundation for a rather stable exchange rate is a necessary condition for keeping the capital in the country. If this condition is not in place, even barriers to capital movements will not help much, in particular in a weak state such as Russia. Capital controls were in the 1980s even in Western European states inefficient; that was one of the reasons why they were abolished. Given the high level of corruption in Russia, capital controls would presumably have helped even less. China, although also temporarily affected by inflation problems, was much better at macroeconomic stabilisation than Russia in the 1990s, and this was one reason why China was a more attractive investment place.

The present author agrees that the liberalisation of the capital account in Russia came prematurely. But the problem appears more to have been the *inward* influx which first pushed asset prices up; thereafter the exodus of this short-term capital contributed heavily to the destabilisation of the situation.

Stiglitz mentioned that the Chinese economy produced high growth rates in spite of institutional problems. "China demonstrated that one did not have to have a perfect legal structure, with property rights perfectly clarified, in order either to attract foreign capital or to

180 Ibid., p. 53.

induce domestic investment."[181] He seems to be unaware of that this sentence invalidates most of his reasoning, where he pointed at the weak legal institutions as the *main* reason for bad corporate governance, and consequently of bad economic performance. Instead he introduced another variable, competition. Again very vaguely, he formulated that "the contrasting experiences of China and Russia suggest that, if one has to make a choice, competition may be more important than private property, especially the form of ersatz privatizations which occurred."[182] May be. Stiglitz does not offer any evidence that competition on the Chinese market should be systematically stronger than in Eastern Europe or Russia. At least as to Poland or the Czech Republic, this is highly unlikely. But supposed that Stiglitz is right as to this point, what would be the political conclusion? Exactly because they regarded promoting competition as a key element of successful transition, experts like Sachs or Cslund recommend a consistent deregulation of prices and export/import restrictions, in order to expose the previously closed economies also to external competition; many former Soviet republics did not do so. The logic of Stiglitz' arguments points in favour of consistent liberalisation, but instead, again in rather weak terms, he writes that the connection between liberalisation and growth is doubtful.

Stiglitz seems to have preferred a much slower privatisation, and in 1999, a re-statalisation of the assets. But he does not address the point that under the conditions of a weak state, as in Russia, state property is not safe. The stripping of assets began before transition, and one motive for the quick Russian privatisation was exactly the wish to prevent asset stripping. Ukraine privatised much slower than Russia, and it fared much worse. These experiences do not support the view that slowing down privatisation in Russia would have produced better results, on the contrary.

As a related problem, Stiglitz does not discuss the point that delaying reform can be very costly, as discussed above. And as equally discussed above, many experts, Western and Eastern ones, after studying the experiences of the immanent gradual reform, concluded that incomplete reforms can make things even worse. Moving just a few small steps towards market mechanisms does *not* improve the system, it even can make things worse, for instance, because important actors such as directors of state firms get freed from control. So, Stiglitz' initial statement that economic theory predicted that *any* move towards capitalism should produce higher output, is simply wrong. He does not seem to be familiar with these theoretical discussions.

He is certainly very familiar with modern theories about the firm, a subject to which he had delivered many important contributions. But to a large extent he refers to *American* discussions and experiences, many of his references are to his own articles within this context. Other sections of his text are formal model deductions without empirical basis. In between, he offers some patchy pieces of empirical evidence, collected from different East European countries, but with hardly any consideration of different conditions and policies. Instead, his article is based on the implicit assumption that all European transition countries followed the same policy, made basically the same mistakes, and that it was Western economic recipes which caused the problems. He does not discuss concrete alternatives, or the costs of not reforming, or the differences in the Eastern European experiences.

From the very onset of transition there was consensus among reformers and economists that privatisation could not be expected to create optimal corporate governance immediately. There was, however, the problem that corporate governance was not optimal under the old system either, to put it mildly. It was a part of the "Washington consensus" that the first step

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181 Ibid., p. 45.

182 Ibid., p. 45f.

should be corporatisation, but there was no consensus about the following steps. There were many contributions about the problem of how to design a privatisation strategy which could strengthen corporate governance, as e.g. the article by Fischer and Gelb documents (above, section II,3). Also the pro and cons of slow versus quick privatisation have been discussed for long, there were strong theoretical arguments for both cases. And a different matter was then the political outcome in the transition countries, where, of course, political factors often produced results which diverged from those which were optimal from an economic point of view. For instance, the Russian reformers had very good political reasons to speed up privatisation, although the institutional conditions were far from optimal. The present author has not the impression that Stiglitz had followed this debate, nor that those who had followed, could learn much from reading the article reviewed here. It is perhaps difficult to participate both in the debate about East Asia and about transition in Eastern Europe at the same time.

Besides, the East Asian countries recovered after the crisis in 1997-98 rather quickly; as did Russia, or Brazil. "How come?" asked Rudi Dornbusch. "Simple. Asia, Mexico and Brazil adopted IMF-strategies. And the IMF's policies worked … But why give the IMF all the credit? Because every country that is recovering followed much the same strategy – even Malaysia, rhetoric notwithstanding… So, in the end, three cheers for the IMF."[183]

A similar conclusion, albeit formulated in a more restrained way, can also be found in a book which otherwise is written from a very critical perspective as regards the "Washington Consensus".

### 3. Grzegorz W. Kolodko: "From Shock to Therapy"

Above we quoted already sometimes Grzegorz W. Kolodko, professor of economics at Warsaw university and minister of finance between 1994 and 1997, i. e under the post-communist Socialdemocrat government. After his term in office he wrote a 400-page study under the title *From Shock to Therapy* for the World Institute for Development Economics Research at the United Nations University (UNU/WIDER), which was published by Oxford University Press in 2000. So, all in all a book by a prominent author published by a prominent editing house.

In contrast to Peter Gowan, Kolodko is clearly in favour of a transition to an open capitalist system. As he wrote already in the introduction: "Liberalization, stabilization, and privatization are indispensable, and sound fundamentals [*such as balanced budgets and low inflation, W.Z.*] are required …."[184] And about institutions such as the IMF or the World Bank he writes: " … but for once it ought also to be admitted that the contribution of these international organizations has been significant and positive."[185] All this seems to place him rather firmly in the camp of the "Washington Consensus". But he certainly does not approve of the policy which was closest to the recommendations of this consensus, namely that of his predecessor Balcerowicz. This was "shock without therapy",[186] a term already used by the post-Communists in 1990.[187] But fortunately, by the mid-1990s the Polish government, practising "interactive policy" was able to turn "the Polish economy around".[188] This moment

183 Dornbusch, 1999.
184 Kolodko, p. 6.
185 Kolodko, p. 277.
186 Ibid., p.39.
187 Sachs, 1994, p. 58.
188 Ibid., p. 112.

coincides with the time when he was finance minister.

Kolodko touches a wide range of issues and presents many data. To discuss everything would require a book on its own. We concentrate upon the sections where he criticises the "Washington consensus", the Polish policy in the early 1990s, and the main lessons. We learn:

> It is therefore necessary first to liberalize prices and later stabilize them. This is the only time when it makes sense to consider radicalism versus gradualism. Whereas privatization and institutional arrangements must last for years, liberalization and stabilization policy can be imposed for a short time if the political situation permits. The response to the policy choice between radicalism and gradualism is a function of the magnitude of financial instability and should be based on the government's capacity to carry out socially unpopular initiatives. The bigger the instability, the more justified are 'radical' stabilization measures, but the more radical the stabilization policy, the more severe is the following contraction. Furthermore, in such a case the radical stabilization policy is not only more justified, but also, for psychological and political reasons, more suitable…
>
> The core tactic of macroeconomic stabilization is the containment of excessive aggregate demand. If the stabilization policy is executed in a radical manner, then demand is to contract in real terms … But the only way to control wage growth over the longer run is to impose hard budget constraints on both private sector and state sector enterprises… For the state sector enterprises direct income policy instruments must be used, but also intermediate fiscal and monetary instruments.
>
> Thus, putting a cap on aggregate demand during a period of liberalization calls for restrictive fiscal and monetary policies. Heavy taxation is used to remove excess liquidity from companies and households.[189]

All this sounds like a late, but exact echo of Stanley Fischer, Alan Gelb or Jeffrey Sachs. The point that privatisation and institution building required patience was already underlined by those authors, but it was also already them to say that liberalisation and stabilisation policy should be executed in a rather short span of time. Consensus can also be presumed on the point that the bigger instability was at the start of transition, the more urgent was the necessity of radical stabilisation. No one doubts that a substantial reduction in aggregate demand causes a contraction, but given the point that Kolodko qualifies this policy as "justified", we conclude that he regards a contraction in this context as unavoidable.

At the end of the 1980s, Poland suffered, according to Kolodko, "both severe shortages and high and accelerating price inflation"; the economic disequilibrium was "serious".[190] This is almost an euphemism, given the point that in August 1989 inflation had reached a monthly rate of 34 per cent, i.e. an annual rate of more than 3,000 per cent,[191] at a time when output was falling. In 1989/1990 Poland therefore fulfilled both the necessary and the sufficient conditions for radical reform. The first Solidarity government came exactly to this conclusion and constructed the 'Big Bang'-package of January 1, 1990, by which prices and foreign trade were liberalised and the currency made convertible. The following stabilisation policy reduced inflation, according Kolodko' figures, from 586 per cent in 1990 to 35 per cent in 1993.[192] All this looks like a policy as if designed using Kolodko's passages quoted above as a recipe. But he does not applaud.

It is, however, not easy to see which parts of the 'Big Bang'-programme he does not approve of. In fact, he *does not even mention* it. Only in a footnote does he make one single remark which, by implication, is connected to the "Big Bang"-package; he acknowledges that the governments decision in 1991 to replace the fixed exchange rate by a crawling peg (a

189 Ibid., p. 86.

190 Ibid., p. 62.

191 Sachs, 1994, p. 40.

192 Kolodko, p. 394.

beforehand-announced slow gliding devaluation) had a positive impact.[193] This means by implication that he approves of the (much more fundamental) decision of January 1, 1990, to make the zloty convertible.

Kolodko does, however, explicitly criticise the stabilisation policy after the 'Big Bang': "In the stabilisation programme of 1990 in Poland … aggregate demand was reduced too much, and fiscal and monetary policies were too restrictive."[194] Basically the reader has, however, to be content with statements. There is, however, one argument: "The strongest argument in support of this thesis [*that stabilisation policy overshot the mark*, *W.Z.*] is the inflation itself. In every country it was higher than expected and lasted for a longer time than expected."[195] How is that to be understood? If inflation was *too high*, or at least higher than expected, then this is clear sign that the mix of fiscal and monetary policy was *too loose*. He also critici excessive … Trade liberalization accompanied by the foreign exchange undervaluation … had serious inflationary implications and led to worsening terms of trades."[196] Also at this point, the reader has to be content with statements. Furthermore, this critique is inherently self-contradicting. On the one hand, he said that the zloty exchange rate policy was *too soft* .This would have been a serious policy mistake because it implied that imports, calculated in zlotys, were too highly priced; domestic producers were unduly protected. This indeed could have fuelled inflation. Kolodko must have this mechanism in mind when he wrote about the "serious inflationary implications." But didn't he write just a few paragraphs above that stabilisation policy was to *too restrictive*?

Within the same passage he writes that exchange rate and foreign trade policy was *too rigid* because domestic production was unduly replaced by imports; foreign competitors could sell their products too cheaply on the Polish market. If this was the case, the trade and exchange rate policy delivered a strong contribution to the *fight against inflation*. We must conclude that Kolodko holds the view that the trade and exchange rate policy simultaneously fuelled inflation and suppressed it overharshly, and that it simultaneously protected domestic producers too much and too little.

Kolodko repeatedly underlined how severe the recession was, much more severe than the Polish government anticipated in 1990.[197] But the point that economic forecasts were wrong is not an argument that the measures taken were wrong. Nor is the fact that there was a recession, a valid argument against these policies. Kolodko insinuates this, but he himself wrote that a recession was unavoidable, in particular in the case of severe imbalances (as in Poland). Besides, in the Polish case the recession was the shortest among the European transition countries, already in 1992 Poland returned to growth. The Polish recession was also the mildest, in particular, if measured by the revised figures. National accounting systems have always been problematic, but the Eastern European ones prior to 1990 were particularly so, given the point that prices often were nonsensical, material output was overvalued, and services and small enterprises were largely disregarded. As Z. Rejewski, the former head of the Polish statistical agency wrote in 1993: "The rise of the second economy, carefully estimated, has reached the level of 20 percent of GDP in 1992. Therefore, if the second economy is taken into account, the 1989-1992 fall in GDP was of the 5 to 10 percent magnitude [as opposed to the official data of 18 percent]"[198]. Kolodko does not seem to agree,

193 Ibid., p. 77n6.

194 Ibid., p. 88.

195 Ibid., p. 87.

196 Ibid., p. 90f.

197 E.g. ibid., p. 106f.

198 Rajewski, Z. (1993), 'National Income', in L. Ziekowski (ed.), R*esults of the Polish*

but instead of presenting arguments, he insinuates political manipulation: "… Sometimes the data are changed significantly ex post for political reasons … So, the outcomes of the disastrous year of 1990 – the year of the 'shock without therapy' – are being leviated from the record as if by magic."[199] In contrast to Kolodko, the statisticians who revised the official data presented arguments; to the present author, who on several occasions had to work with highly problematic pre-transition data (of the GDR),[200] their arguments seem perfectly plausible. Why does Kolodko reject them? Has he an interest in presenting the development in 1990 as bleak as possible?

A similar problem appears as to the measuring of the living standards. Taken at face value, the official Polish data show a dramatic fall of minus 37 per cent (!) in real wages (i.e. nominal wages corrected for inflation) from June 1989 to 1990. But as Jeffrey Sachs and A. Berg have argued early on, 1989 is a nonsensical basis year. This becomes apparent when the years before are taken into consideration:

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*Economic Transformation*, Warsaw: GUS/Polish Academy of Science, as quoted in: Jeffrey Sachs and Wing Thye Woo, ' Reform in China and Russia', Economic Policy , April 1994, pp. 101-145, esp. p. 125.

199 Kolodko, p. 105.

200 E.g. Zank (1987), passim.

*Table 3: Polish real wages, deflated by the consumer price index*

| Date | Real Wages |
|---|---|
| June 1987 | 917 |
| June 1988 | 969 |
| June 1989 | 1,304 |
| June 1990 | 822 |
| June 1991 | 945 |

*Source: GUS monthly statistical bulletin, as quoted in A.Berg and J. Sachs, 'Structural Adjustment and International Trade in Eastern Europe: The Case of Poland', reprinted in Paul G. Hare and Junior R.Davis, pp. 267-315, esp. p. 287. (Originally: Economic Policy, April 1992, 14 )*

The statistics reveal a gigantic real wage boost from 1988 to 1989. Poland experienced a strong wage pressure, due to a combination of strong unions and soft budget constraints. There was, of course, no corresponding increase in consumption because the commodities were not there. Instead, shortages, queuing, and a huge monetary overhang were the result. After the liberalisation on 1 January 1990, prices jumped upwards, on paper massively reducing the real wages, but in practice mostly removing the monetary overhang and ending queuing. Seen in this light, it makes much more sense to use 1987 as basis year. In this case, the fall in real wages in 1990 is still substantial (10 per cent), but much less than before. And taken the end of shortages and queuing into consideration, the fall in real *consumption* was even less. And already in 1991, the real wages were *higher* than before the transition. Kolodko pointed out that unemployment was rapidly rising. This was certainly a substantial social cost of transition, but it has nothing to do with a calculation of real wages and real consumption. And as to *this* problem, the reader has again to be content with statements such as the following: "Another exercise (Berg and Sachs 1992) tries to argue that real consumption in Poland in 1990 fell only by about 4 per cent, despite the tremendous decrease in real wages of approximately 25 per cent." [201] Again no argument. And why 25 per cent? The uncorrected 1989-1990 data say 37 per cent.

To sum up, the search for arguments that the policy 1990-1993 was a failure, did not produce convincing results. Unfortunately, the results are not more promising when we turn to the second pillar of his position, namely that the policy was substantially altered in a positive way by about 1995. Kolodko's book does not contain a description of the "new policy", instead we have to compile various remarks which are distributed throughout the book, such as: "Later, under the 'Strategy for Poland' programme, the policies of liberalization and macroeconomic stabilization were shifted towards gradualism (Kolodko 1996). These were successful. They brought inflation down by more than two-thirds in 1994-1997 and simultaneously boosted GDP by over 28 per cent."[202] And: In Poland there was "an output collapse of about 20 per cent at the beginning of the 1990s [*was it?, W.Z.*] and a remarkable GDP expansion of over 28 per cent in 1994-1997 … [The] contraction was mainly due to earlier policy mistakes, while the later success stemmed from quite different, even opposed policies."[203] Further, "by the mid-1990s, 'interactive' economic policies aiming at gradual structural change and the involvement of society in the

201 Kolodko, p. 106.
202 Kolodko, p. 42.
203 Ibid., p. 76.

transition process were turning the Polish economy around (Hausner 1997)."[204] According to Kolodko, there was an alternative to "shock without therapy", but: "Unfortunately, this approach, which consisted in gradual, yet comprehensive and determined reforms, new institutional arrangements, and a redefined role of the state and which was later executed as the 'Polish alternative' was either not accepted initially, or applied only partially."[205]

The present author did not understand from these remarks what this policy shift might have consisted of. It is regrettable that a former finance minister, who himself administered such a substantial change to the better, did not find the space of, say five pages, in a book of more than 400 pages, to explain such an important "turn-around". Also, other observers must have missed the importance of the shift. For instance, the European Bank for Reconstruction and Development, summarised the Polish development in its Transition Report 1996 as follows:

> With the election of a left-centre coalition government in September 1993, the space of structural change, particularly that of privatisation, slowed. While implementation of the long-delayed National Investment Funds programme began in July 1995, other forms of privatisation remain stalled. New proposals link privatisation with pension reform, but both issues are complex and politically sensitive.[206]

In the report, the various fields of transition policy are reviewed more in detail; in none a substantial change of policy is discernible. Nor did the OECD experts who wrote the Economic Surveys on Poland – see the quotation above in section III,1 – notice a profound change from "shock failure" to "therapy".

In Kolodko's view, the policy of the mid-1990s, although highly original, is nevertheless to be seen in a longer continuity. But also as to this point, we have to be content with statements, scattered over various places, such as: (1) "…from a bird's eye view, the continuity between the early reforms [in the 1980s] and the recent stages of transition seems significant in certain countries … It must be obvious that the more continuity there is, the better the country has performed during the transformation."[207] Or: (2) " … a radical thrust towards toward additional liberalisation [*in 1989-1992*, *W.Z.*] only accelerated the progress of reforms which had already been launched. This was followed, first, by a rather chaotic situation, in which developments occurred by chance and only later, especially in 1993-7, by a planned approach implemented in an organized way."[208] Similarly: (3) "Of course, these changes [*in the1990s*] should also be seen as a significant acceleration of the changes introduced during the reforms of the 1980s. Thus, the transition process, after some turbulence and mismanagement in the early 1990s, became quite healthy after 1993 in terms of the advances in market institutional arrangements and the achievement of the highest medium-term rate of growth not only among transition economies, but also in the whole of Europe." [209] And finally:

> (4) "In Poland, the transitional contraction lasted 'only' three years , from mid-1989, when the Solidarity-led government took over, until mid-1992. If not for the previous reforms, this contraction would have lasted longer, as indeed occurred in a number of other countries, which had not been keen to undertake systematic reform. By the same token, the decrease in output [in the early 1990s] would have continued longer if not for

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204 Ibid., p. 112. His reference (Hausner) is an unpublished paper, presented at a conference at UNU/WIDER.

205 Ibid., p. 152.

206 European Bank of Reconstruction and Development, Transition Report 1996, London 1996, p. 165.

207 Kolodko, p. 58f.

208 Ibid., p. 38.

209 Ibid., p. 42.

the fundamental policy shift executed after 1993 vis-B-vis both development and systematic change."[210]

In particular the last sentence is enigmatic: Poland returned to growth in 1992, so, how can the policies after 1993 be credited for this turn-around? Anyway, it is obvious that Kolodko sees a continuity of positive reforms from the early 1980s to the mid-1990s, interrupted by "some turbulence" 1989-1992. In this perspective, the good periods coincide with the years where he and his political fellows-in-arms were in power. And the reforms in the 1980s must be credited for the point that the Polish recession was the shortest. Quotation (2) can perhaps even be interpreted this way that the transition began in the early 1980s.

There seems to be consensus – see Stanley Fischer and Alan Gelb - that the partial reforms in the 1980s had some positive effects; e.g. many managers became used to market signals. And Sachs (see section III,1) underlined the positive importance of the legal reforms in the 1980s.

But nevertheless, Kolodko's continuity perspective is not without problems. Firstly, as Kolodko himself wrote, the reforms in the 1980s produced lamentable results. In his owns words, "… owing to policy mistakes and the incapability between command and market instruments, imbalances reappeared, and inflationary pressure began to rise."[211] When Solidarity took over, it inherited a rapidly falling production, hyperinflation, and an astronomic foreign debt. It introduced a reform-package which removed exactly this "incompatibility between command and market instruments" and brought the serious financial and monetary imbalances under control. And as we saw, Kolodko explicitly supports such a policy, when discussing transition problems in general. And if it was a remarkable success in 1994-1997 (which it certainly was) that Polish inflation fell from 32 to 15 per cent, then it was perhaps also a success that inflation fell from 3,000 per cent in August 1989 to 35 per cent in 1993. In 1990 Polish exports into hard-currency countries rose quickly, thereby for the first time after the war generating the necessary foreign cash. In 1992 also aggregate production began to rise. When Kolodko became finance minister, growth rates were already high. Presumably, most observers would interpret such a development as a mounting crisis in the 1980s, and a turn-around in the early 1990s.

We can discuss this also using the liberalisation index of the World Bank. On this index (ranging between zero and one) Poland was prior to the "Big Bang" at a level of 0.24. In 1990, the index jumped upwards by 0.44, up to 0.68. In 1993 it was on 0.82 and in 1994, when Kolodko took over, at 0.86,[212] In other words, in 1989, Poland was still a predominantly *unreformed* economy which in the period between 1990 and 1993 became predominantly a market economy.

Kolodko attributes the long recession of the 1990s in many countries, particularly Ukraine, to a "systemic vacuum: neither plan nor market".[213] To this diagnosis, most observers would agree. It was exactly the dreadful consequences of a non-performing system mix which brought observers like Balcerowicz or Fischer to the conclusion that a coherent reform package should be adopted quickly, to shorten the period of system mix as much as possible. But according to Kolodko the systemic vacuum was due to – Shock Therapy: "The vacuum was an outcome of the radical, ideologically and political driven overthrow … of old institutions without the establishment of new arrangements to replace them."[214] Or: "Whether in its abbreviated form in Poland, or in the long, drawn-out version in Russia, 'shock therapy' has failed especially because of the systemic vacuum which followed the radical dismantling of the old institutional set-up and

210 Ibid., p. 76f.
211 Ibid., p. 60. Emphasis added, W.Z.
212 Cslund, Boone and Johnson, p. 221.
213 Ibid., 111.
214 Ibid., p. 112.

because of the huge recession."[215] Leave alone the point that the drop in production in Poland and the Soviet Union began under the old regime, and that Kolodko himself declared a transitional recession for unavoidable: What is a "drawn-out shock therapy"? Was this paradigm not about a reform package within a short span of time? And to attribute the problems of Ukraine to "Shock Therapy" is simply absurd. Also Kolodko belongs to the group of authors who declare "Shock Therapy" to be the culprit, even in cases were nothing like that was practised.

Repeatedly he imputes on followers of "Shock Therapy" the desire to reduce the role of the state as much as possible, as quickly as possible, at any cost, in any fields. But e.g. Fischer and Gelb never talked of smashing the state, but "redefining the previously all-encompassing role of the state … In some areas, such as financial markets, reform may require a greater state role than before."[216] About the "Washington consensus" Kolodko writes: "According to the consensus a tough financial policy, accompanied by deregulation and trade liberalization *would be enough* to eliminate stagnation and launch economic expansion … The Washington consensus has partially failed with respect to the transition economies because it has neglected the significance of institution-building when the other fundamentals are by and large in order. This oversight explains why so many Western scholars did not at first properly understand the true nature of the challenge."[217] With these Western Scholars he cannot mean Stanley Fischer or Jeffrey Sachs. Fischer and Gelb wrote: "Institutions and professions taken for granted in market economies have to be re-created and reformed to support markets. A secure legal environment has to be created …"[218] In this article they explain these points in detail. Also Jeffrey Sachs frequently discussed institutional problems, see for instance his above-quoted position as to the legal structure in Poland on the onset of radical reform. Anders Cslund wrote: "The whole economic strategy must be based on the recognition of the state's limited capacity. A judicious application of new institutional economics and economic history is required."[219] His book *How Russia Became a Market Economy* contains detailed discussions of institutional problems in every chapter. And his discussion is much more specified than Kolodko's usually general remarks. And as we saw, Cslund, Boone and Johnson could produce significant evidence that rapid reform was more conducive to institution building than gradualism. Kolodko is obviously not aware of that he exposes banalities when he repeatedly insists of the importance of institutions. The problem has not been that Fischer or Cslund were not aware of the importance of institutions, the problem is that Kolodko is not informed about the positions he attacks.

A similar picture emerges when looking at another of Kolodko's "lessons", namely the importance of a correct sequencing of the reforms: "Several mistakes have been linked to the poor sequencing of policy measures…First*, state companies should be formed into corporations at the onset of transition, that is, before privatisation* … Second, *the regulation of capital markets should precede the liberalisation of capital flows* …"[220] The emphasis is his. But all this we could read already in 1991, and much more specified, in the article by Stanley Fischer and Alan Gelb (see section II,3).

Also smaller details exhibit that he did not spend much time at reading the authors he criticises: "The claim that the initial great slump was caused by the delay in privatization (Sachs, 1993) … is incorrect."[221] But Sachs wrote: "Privatisation is another key that remains on the

215 Ibid., p. 149,

216 Fischer and Geld, p. 100, emphasis added, W.Z.

217 Ibid., pp. 119 and 123, emphasis added.

218 Fischer and Gelb, p. 100.

219 Cslund, 1995, p. 7f. Emphasis added, W.Z.

220 Kolodko, p. 99.

221 Ibid, p. 100.

policy agenda."[222] He did not at all attribute the initial contraction to a delay in privatisation. More substantially, Kolodko writes about a new "post-Washington consensus" which allegedly has been evolving from a criticism of the Washington Consensus; but his "post-Washington consensus" is basically the old one, to which he himself had converted.

Kolodko began his career as a supporter of the old regime. As such he opposed Solidarity and Balcerowicz in 1990. But by 2000 he stood at positions near to those of Stanley Fischer. And it fits into this development that he worked as an advisor for the IMF this year. But being, as a matter of fact, on IMF-near positions, Kolodko tried at the same time to show that the Communist system was not so bad after all, and that Balcerowicz' IMF-near policy in 1990 was all but disastrous. This dilemma, perhaps together with a great desire to polish his own reputation, led Kolodko into almost uncountable self-contradictions.

## VI. CONCLUSIONS

The process of transition has been very complex, and in many aspects disappointing. With the knowledge of hindsight, it is also easy to detect mistakes, in practical politics and in theoretical positions. Someone who wants to criticise the IMF, finds material e.g. in the IMF's position as to the continuation of the rouble zone in 1991-93. Or, perhaps more substantially, as to its endorsement of a fixed exchange rate for the rouble, and the liberalisation of capital movements already in 1995.

If it comes to the policies of the reform governments, Yeltsin committed presumably a serious mistake by not heading for new elections and a new constitution immediately after the abortive coup in 1991. And the speedy Russian privatisation appears at least doubtful, although, under the given political conditions, there were presumably few alternatives.

But it appears, however, that the correction of these errors can be incorporated in a modified Washington consensus. As a matter of fact, the IMF already changed its policy as to fixed exchange rates. But as to the basics of the Washington strategy, it appears that the recommendation of speedy reform in principle was a sound one. And consequently, it appears that those governments which delayed reform, are, at least with the knowledge of hindsight, to be criticised much harder than radical reformers or Western advisors. As to the vast literature which, on the basis of formal models, concluded that gradual reform was preferable, we conclude that it is always very problematic to derive policy conclusions from exclusively formal models.

We were also on a journey into the realm of the literature which voices a very strong criticism of "Shock Therapy". This tour gave ample possibilities to discuss interesting problems, but otherwise has unearthed surprisingly little substance. The amount of gross self-contradictions, statements which were at odds with basic facts, and wild conjectures has been high. The present author can explain this finding to himself only by supposing that these authors were too much steered by ideological convictions.

If we have a look on this part of economic theory which today exerts political influence on Western governments or institutions such as the World Bank, the IMF, the OECD, or the European Central Bank, then we find that the range of divergent opinions has narrowed considerably within the last 25 years. Some observers speak of "epistemic communities", or of "monomics". This can, of course, be seen as a gigantic capitalist conspiracy, or alternatively, as the production of ideology in the sense of the very early Marx. But it appears to the present author that it also has very much to do with empirical evidence. Communist systems have proven

222 Sachs,, 1994, p. 111. We quote the paper-back edition (1994), Kolodko mentions the first edition (1993) of the same book.

to be inferior (and inhumane), and there is no such thing as "market socialism". There is only one performing system, and this is the Western one, which, however, in itself allows for a wide range of variations. If this lesson is accepted, then many implications, and thus policy recommendations, follow. The same is true as to experimenting with high inflation rates. If there is consensus that it produces more damage than good to tolerate high inflation, not to speak about hyperinflation, then a long row of conclusions also follows. If those few things are accepted, then one is already halfway in "Washington". As to the mere speed of reform (as opposed to going on experimenting with "non-capitalist ways of development"), there were good theoretical arguments both for and against rapid reform. But it was remarkable how, early on, those Western experts who were engaged with practical transition policies, were united by a consensus in favour of rapid reform, as opposed to the majority of their colleagues who only dwell in academia. As it turned out, the practitioners were the better theorists.

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