Shock Therapy in Poland: Perspectives of Five Years

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The collapse of communism in Eastern Europe in 1989 and in the Soviet Union in 1991 are watershed events in world history. Naturally, the real import of these monumental events has been especially hard to judge in their immediate aftermath. Each succeeding year, we gain important new perspectives on their meaning. This is certainly true in the economic realm, where debates about the transition from communism to market economy have been especially lively and contentious.

As the economic advisor to the Solidarity movement in Poland in 1989, I urged Poland to undertake a rapid transition to "normal" capitalism, on the model of Western Europe. When the first post-Communist government in Poland came to power in August 1989, the new economic leader, Deputy Prime Minister Leszek Balcerowica, adopted a radical strategy for the rapid transformation of Poland to a market economy. This strategy has subsequently won the somewhat misleading sobriquet of "shock therapy." The strategy has been widely debated since its inception in Poland on January 1, 1990. It has been adopted, in modified form, in much of the rest of Eastern Europe and the former Soviet Union, including Russia after 1991.[1] (For an earlier description of Poland's reforms, see Sachs 1993. For a conceptual overview of "shock therapy," see Sachs 1994c.)

With five years of experience of economic reform in Eastern Europe, the strategy can be more clearly understood and evaluated. The strategy seems to be winning the test of time. Not only have

[1] My own direct role as economic advisor to the post-Communist governments has included Poland, 1989–91; Yugoslavia, 1989–90, before its breakup; Slovenia, since 1991; Russia, 1991–94; Estonia, 1992; Mongolia, since 1991; Kyrgyzstan, 1993. In addition I have led several cross-country studies of the reforms, for the World Institute for Development Economics Research (WIDER) of the United Nations, in Helsinki, 1989–92; the National Bureau of Economic Research, 1992–93; and the Harvard Institute for International Development (HIID), since 1993.

the early “shock therapy” countries — especially Poland and the Czech Republic — outperformed most of the other countries, but the idea of radical, comprehensive transformation to a market economy is increasingly being adopted in countries that earlier shunned the strategy. The newly elected president of Ukraine, Leonid Kuchma, recently declared his intention to lead such a reform effort in his country.

The passage of five years has been particularly important in placing the events in Eastern Europe and the former Soviet Union (hereafter EEFSU) in a clearer international context. In the economic dimension, we can see that the changes in the post-Communist countries of Eastern Europe and EEFSU are part of a powerful and deep trend of *global* economic integration. “Globalization” was of course already apparent in 1989, but the strength of the forces of global integration are even more clear today.

Shock therapy, in the sense of a rapid, comprehensive, and far-reaching program of reforms to implement “normal” capitalism, makes particular sense in view of the global trends. The world economy is undergoing a process of “deep integration,” in which countries are linked not merely by international trade, but also through networks of production, finance, and shared economic institutions. Almost no country in the world dares to stand aloof from these trends.

For countries that have been cut off from the world economy for decades, such as Poland and the other post-Communist countries, it makes special sense to deepen the new links with the global market economy as rapidly as possible. This is for three main reasons. First, the global system provides an invaluable road map for reforms. Second, the global system provides an opportunity to borrow technology, capital, and management techniques, to help catch up economically after decades of falling behind. Third, with many other countries and regions also trying to rejoin the world economy, the post-Communist countries are in international competition for capital, foreign direct investment, and export markets.

Going slowly means ceding necessary investment and markets to other countries and regions.

This paper reviews the basic logic of the "shock therapy" approach, both in general conceptual terms and in specific application in several countries. Why was it adopted ? How has it worked ? What are the real social costs to reform, and how can they be held to a minimum? How can reformers avoid becoming dangerous "social planners," substituting a new unrealistic vision for the old failed Communist vision? And, finally, what are the real economic prospects for the post-Communist countries, and how do those prospects depend on actions of the Western countries as well as the reforming countries themselves ?

THE REVOLUTION OF 1989

The leaders of the Revolution of 1989 in Poland, Czechoslovakia, and other countries in Eastern Europe had an outward-looking agenda from the start. They saw the revolutions in their countries as the opportunity to rejoin the mainstream of Western Europe. The great rallying cry of 1989 was "Return to Europe." When I first made my own economic proposals for Poland in the summer of 1989, they were billed by Polish Solidarity leaders and the media as the chance for Poland to become a "normal" country in Europe in a short period.

This was the main reason why radical, comprehensive economic reform measures could be acceptable in Poland and the other countries of the region. The politicians and the general public understood intuitively that a "shock therapy" approach was not simply another utopian scheme of economic reform, but rather was a quick route to a relatively clear target. In 1989, that clear target was Western Europe. There was already a general, if unexpressed, consensus in the society that whatever would reintegrate these countries fastest with Western Europe should be adopted.

While "shock therapy" has been attributed to the technocrats, it was Poland's political leaders in Solidarity that insisted on the approach. They understood that the collapse of communism gave an opportunity for decisive steps of reintegration with Western Europe and that these steps should be taken as rapidly as possible. When one of the Solidarity leaders asked me to prepare a draft economic reform plan in July 1989, his instructions were for me to be radical in conception, indeed to formulate a plan to "jump to a market economy." I, of course, had been urging a similarly radical approach in previous months and believed it to be technically feasible.

Shock therapy has been widely attacked by many intellectuals as being yet another "constructivist" system of social engineering, trying to replace one dogma with another. This is mistaken, and practical politicians could already see the difference in 1989. Whereas Lenin had also advocated a kind of "shock therapy" in 1902 in his fateful and disastrous *What Is to Be Done?* his version of "shock therapy" was to create a new world that had never existed. Poland's shock therapy was relentlessly down-to-earth by contrast. The main idea was to create institutions of the kind already in existence, and with proven merit, in Western Europe. Leszek Balcerowicz said it best, when he declared in 1989, "We are too poor to experiment. If the rich countries want to experiment, let them. For us, it is better to take proven models."

While the 1989 revolutions were outward-looking from the start, there is one sense in which the outward vision was too limited. The outward orientation extended to the United States and especially to Western Europe, but not much to other parts of the world. The great challenge, therefore, was seen as a regional one: to reintegrate with Western Europe. Such a priority makes eminent sense, but Eastern Europe cannot afford to stop there. Its main competitors, for example, in attracting foreign direct investment are in Latin American and East Asia, countries with comparable levels of living standards, infrastructure, and labor-market skills. Eastern Europe must therefore best understand how to position itself in the international, not merely the interregional, economy.

THE CONTENTS OF SHOCK THERAPY

The people in Poland and the rest of Eastern Europe had a searingly realistic picture of the failures of Communist economics and the need for fundamental change of the economic system. Nonetheless, large parts of the population misjudged the detailed character of the economic crisis confronting their countries. In an important and troubling way, this led to serious misunderstandings in the dialogue between the East and the West after 1989. On a personal level, it took me some time to understand that my own words about the economic reforms were being interpreted in Poland in some unintended ways.

For some of the Eastern European public, there was a straightforward expectation that the change of the political and economic systems would catapult their countries to Western European lifestyles and living standards. These people rightly understood that they suffered as the result of the economic system in place since 1945, but they wrongly imagined that removing the system would be enough to undo the costs of forty-five years of misguided economics imposed by the Soviet Union.

In retrospect, talk of a "jump" to the market economy and the journalistic label "shock therapy" played into these beliefs. After all, the metaphor of shock therapy suggested that one jolt of economic reform would reinvigorate the "patient" and allow the society to return to normal life. The problem, of course, was rather different. A change of economic system would make possible a gradual recovery of growth and a gradual convergence of living standards over the following decades. But no economic reform, however brilliant, could bridge an economic gap that had grown over decades, and indeed that had already been significant between Eastern and Western Europe before World War II.

To understand the situation of the post-Communist economies it is useful to recognize that there are really three deep economic crises, not just one. The first, and most widely recognized and discussed, is the *systemic* crisis: the need to change from a Communist system to a market system. Even here, of course, there are serious debates and misunderstandings. In Poland today, there are still those who advocate a market system with extensive state ownership (sometimes called "market socialism" or a "mixed economy"). Advocates of market socialism are rather naive in the faith that state enterprises can finally be made efficient and profitable — despite all of the evidence to the contrary from the rest of the world, including Western Europe, Latin America, Africa, China, India, and the rest of Asia.

The second crisis, distinct from the systemic crisis, is the *financial* crisis of the post-Communist state. In almost all of Eastern Europe and the former Soviet Union, governments are bankrupt or nearly bankrupt. Many governments, including Poland, Hungary, Bulgaria, the former Yugoslavia, and Russia, suffer from a heavy burden of foreign debt taken on by the old regime. Almost all governments suffer from huge budget deficits, as tax collections have plummeted and social demands have risen. The result is a life-or-death battle against inflation and default on debts. There are some exceptions, most notably the Czech Republic, which benefited from the fact that the old regime was too conservative and repressive to engage in foreign borrowing, thus leaving the new post-Communist government with a clean slate!

The third crisis, and the longest-term, is the crisis of *structural adjustment.* Even if there were no problem of the economic system, and even if the government were financially solvent, there would still be a deep crisis of living standards as a result of the structural characteristics of the Communist economies. Central planning under communism was not merely inefficient. It was inefficient in particular ways. The central planners, under Soviet dictates, were oriented to building up heavy industry, and especially military industry, at the expense of consumer industry and services. Thus, the EEFSU economies have vast capacity in steel, chemicals, coal, and other heavy industries, but were virtually starved for services (banks, real estate, restaurants, even shops) in 1989.

The structural crisis cannot be resolved immediately by legislative or political changes. Even after a market economy is in place, Poland will still suffer from having too much heavy industry. Workers in defunct heavy industrial enterprises will lose their jobs; regions will see sharp drops in living standards and employment; and living standards will remain low for years as a result of the lopsided economic structure. This is the main sense in which "shock therapy" is a misleading metaphor. There is no way to shock the patient to economic prosperity. There is only the chance to give the patient a fresh opportunity to start rebuilding, acknowledging that restructuring and new economic development will take years, even decades, to bring to full fruition.

The idea of radical economic reform is to address all three crises, recognizing that each poses a problem with a different time horizon for solution. The financial crisis is surely the most acute, but also the one susceptible to the fastest successful resolution. In 1989, at the time of the Communist collapse, Poland suffered intense inflation, soon to burst out into full hyperinflation by October 1989. (Economists define hyperinflation as inflation of more than 50 percent per month. Inflation reached 54 percent per month in October 1989.)[2] Moreover, the combination of large budget deficits, extensive printing of worthless paper currency, and Communist-era price controls meant that hyperinflation was combined with intense shortages in the shops and the burgeoning of black markets. Farmers hoarded food, since the official food prices were far below the black market prices and far below the farmers' expectations of what the government would eventually have to pay to procure the harvest. Fears of hunger in the main cities of Poland were widespread and realistic.

The solution to hyperinflation and shortages is well known from twentieth-century economic history and from the recent experiences in Latin America in battling high inflation. A decisive

[2] Note that 50 percent per month compounded over 12 months is more than 12,900 percent per annum!

break with high inflation and shortages requires a series of actions: cutting the budget deficit; stabilizing the foreign exchange value of the currency; raising market interest rates and tightening central bank credits to the government and to the banks; and, most important for ending shortages, removing artificial price controls that prevent the equilibrium of supply and demand at market-determined prices. This combination of measures was introduced in Poland on January 1, 1990, as part of a single package.

The systemic crisis can also be addressed rapidly, but not on the same time horizon as the financial crisis. While the financial crisis can be brought under control within months, the systemic crisis requires years to address, even under the most favorable political conditions with the government and the public united behind the reform actions. The conversion from central planning to markets requires two sets of actions. The first, and administratively the easiest, is the elimination of central planning. Bureaucratic interventions in the economy should be ended, and markets allowed to function freely. This involves, among other things, the elimination of price controls, licenses for international and internal trade, freedom of entry of new private firms into virtually all sectors of the economy, and the end of bureaucratic interventions inside particular enterprises.

The second set of measures involves the building up of new institutions of modern capitalism, including modern commercial law; an independent judicial system to enforce the new commercial law; and a private, corporate ownership structure to supplant the state ownership of enterprises. While the dismantling of central planning can be done literally in days or months, the building up of new institutions requires years. Even the fastest mass privatization of state enterprises, as undertaken in the Czech Republic and Russia, is a project of several years.

If financial stabilization can be accomplished in the first year of radical reforms, and systemic transformation in the first five years, the structural change in the economy is a task of one to two decades. Policy can ease the transition by implementing crucial measures of social protection for the vulnerable groups in the society or for those who lose their livelihoods as the economic structure changes. Policy cannot, however, cause a sudden one-time jump in living standards when the underlying economic structure will remain lopsided and inefficient for years to come. The real growth in living standards will require the birth and development of millions of new businesses, as well as tens of billions of dollars of new investments that must be made over the course of years.

THE RESULTS OF SHOCK THERAPY AFTER FIVE YEARS

Early observers of shock therapy divided along extremes. Some people seemed to feel that a few months of bracing reforms would boost Eastern Europe back to Western Europe; these were inevitably deeply disappointed. Other people felt sure that shock therapy was sure to lead to disaster: starvation, social unrest, instability, a society divided deeply between haves and have-nots. These critics of the reform were fortunately proved wrong. If we can make any conclusions after five years, it is that the most radical reforming countries have indeed gone the furthest in restoring stability and laying the foundations for rising living standards. (For a recent comparative review of the Eastern European record, see Balcerowicz and Gelb 1994.)

Poland — the basket case of Eastern Europe in 1989 — has been the most dramatic illustration of the success of radical economic reforms. Poland achieved the earliest return to positive overall economic growth in the whole region, in 1992, leading all of Europe in economic growth in 1993 and perhaps 1994. Other radical reformers, such as the Czech Republic, Slovenia, and Estonia, are pulling far ahead of the pack as well. The gradualists, starting with Hungary, but including Slovakia, Bulgaria, Romania, and most of the countries of the former Soviet Union, are disappointments in economic performance. Several of these countries have started to intensify their economic reforms as a result.

If we look at the economic outturn in Poland in terms of the three crises — systemic, financial, and structural — we can learn a lot about the possibilities of economic change in the post-Communist countries. The financial crisis in Poland was quickly brought under overall control. Within the first months of 1990, the shortages had been eliminated and the inflation had been reduced decisively, from more than 50 percent per month in late 1989 to around 4 percent per month in mid-1990. Poland has continued to battle with inflation rates that are high by Western European standards, but with inflation of around 30 percent per year as of late 1994, we can say that the deep crisis of hyperinflation has definitively ended.

The bigger surprise, perhaps, has been in the progress of systemic transformation. Poland took to a market economy like the proverbial fish to water. Poland's commercial traditions of the prewar blossomed under the new economic freedoms. Hundreds of thousands of new businesses sprang up, especially in the long-suppressed service sectors. By 1994, approximately two-thirds of the work force was in the private sector, which now counted around 2 million private businesses, most very small family firms.

The legal infrastructure also developed rapidly, partly as a result of restoring Poland's interwar commercial laws to the books and partly through the importation of new commercial laws from abroad. This importation came in three ways. Most importantly, there has been a concerted and deliberate attempt to harmonize Poland's commercial laws with those of the European Union (EU), in order to facilitate Poland's eventual membership in the EU. Second, the commercial law has evolved as the result of a slew of economic treaties with the United States and other non-EU countries, in areas of foreign investment, taxation, and trade. Third, there has been a huge influx of foreign law firms, mainly to help service multinational firms opening operations in Poland. Economic law grows in the course of specific deal-making, with the foreign law firms introducing commercial concepts into Poland's evolving legal framework.

The structural adjustments in the economy have of course led to the greatest stresses and controversy. Employment in the old state heavy industry declined markedly, often by 25–50 percent in particular enterprises. Many older workers chose early retirement, and others entered the unemployment queue. Young workers without skills have also had a difficult time finding jobs and have joined the ranks of the unemployed. Overall, measured unemployment rose to around 15 percent of the labor force before peaking, and seemingly has started to decline in 1994. Most Polish economists believe, however, that the unemployment is vastly overstated, since many people who collect unemployment benefits actually have work in the gray (informal) economy. Household surveys in recent years have suggested that actual unemployment rates are closer to 10 than 15 percent. This is still high, especially for a society not used to unemployment, but it is more in line with Western European averages (in mid-1994, the average EU unemployment rate was over 11 percent of the labor force).

There have also been remarkable and positive structural adjustments. The service sector has boomed as the old heavy industry has declined. Private residential construction has picked up sharply in 1993 and 1994. Consumer goods industries are also developing rapidly, to take up the slack of declining heavy industry. Very importantly, Poland and most of the rest of Eastern Europe have demonstrated the capacity to compete in Western European markets. The two-way trade between Eastern and Western Europe has burgeoned since the start of reforms and is thereby laying the basis of Eastern Europe's accession to EU membership.

Much of the controversy over shock therapy, especially in the early years, revolved around the impact on living standards. Changes in living standards from the central planning period are inherently difficult to measure. Official data do not adequately take into account the huge social costs of shortages, queuing, and the lack of choice in consumer goods that characterized life in Eastern Europe before 1989. Large amounts of income earned in the new private sector go unreported. Ironically, measured living standards, according to the old style of data definition, seemed to show a marked decline of living standards at the start of radical reforms. After a few years of evidence, however, almost nobody believes that there has been a sharp decline in living standards. (For an early study showing the limitations of the official data, see Berg and Sachs 1992.) On the contrary, all of the evidence points to a veritable *boom* in ownership of consumer durables (cars, TVs, VCRs, washing machines, refrigerators, personal computers, and the like) once the availability of Western brands increased after 1989. Household surveys also point to a rise in consumption of fruits and vegetables, meats, fish, and other high-protein items, and this rise seems to be widespread among socioeconomic groups.

Continuing Political-Economic Controversies

If shock therapy is so successful, why has politics proven to be so turbulent in Poland and many other reforming countries? This is a difficult and important question. I can speculate on this issue, but without definitive conclusions. There is still the need to do more research on political attitudes using survey research data.

The first point is surely that not all "shock therapy" countries have faced political turmoil. The Czech economic reforms, led by Prime Minister Václav Klaus, have enjoyed considerable public backing, at least after the division of Czechoslovakia into the Czech Republic and Slovakia. The Czech economic team has been nearly stable since 1990 and was returned to office in 1992 elections with a large majority. This case demonstrates that radical reforms and political stability can be combined.

In Poland, there has been considerable political turmoil, but this should not be confused with great swings in actual economic policy. The Balcerowicz Plan was controversial from the start, and each election has been in some measure a referendum on economic reform. Nonetheless, while each succeeding government has come to office partly on the claim that it will "soften" the impact of economic reforms, the actual economic reform policies have been fairly consistent for five years. All governments have hewed to tight monetary and fiscal policies, market liberalization, and economic integration with Europe. There have been significant debates about privatization, which has been slowed down as a result, but almost all other areas of economic reform have continued to progress at a rapid rate, and without any significant reversals.

Nonetheless, it is important to ask why the public is not more enthusiastic about the reforms. After all, the shops are full for the first time in fifty years, and real consumption of consumer durables has boomed. I think that there are three main answers to this tricky question. First, as has already been mentioned, expectations ran ahead of real possibilities. While foreign advisors such as myself claimed that Poland could "return to Europe" within five years, we meant that the economic system could be reformed, not that Poland could quickly become rich. In Poland, the common belief instead was that change of system would be enough to provoke an enormous jump in living standards.

Second, the reforms have surely created a rise in anxiety levels, even if they have not resulted in a fall in actual living standards. In a quite tough sense, economic reform in the early years is a bit like a society-wide game of musical chairs. Once market forces are introduced, a significant proportion of the population must search for new forms of economic livelihood. The result of that search, to be sure, will be highly positive in the longer term for most of the workers, but the process of change can be deeply upsetting during the transition, and some workers will also end up as economic losers from the changes. This gives rise to what economists have come to call a "status quo bias," in which the population might support a political program of the status quo, even in cases where a majority of the population is likely to benefit under continued reforms. (The original theoretical presentation may be found in Fernandez and Rodrik 1991.)

A simple numerical illustration might be useful at this point. Suppose, for purposes of illustration only, that the society is divided between 40 percent skilled workers and 60 percent unskilled workers. Suppose that *all* of the skilled workers will benefit from economic reforms, and they know it. Suppose that 55 percent of the unskilled workers will lose from the reforms and that 45 percent of the unskilled workers will benefit. Overall, 67 percent of the work force will benefit from the reforms: the 40 percent skilled workers and 45 percent of the 60 percent unskilled workers (27 percent of the labor force). Overall, 33 percent of the work force will lose from the reforms: 55 percent of the 60 percent unskilled workers. Suppose also that before the start of reforms the individual unskilled workers can't be sure whether they will be among the "winners" or the "losers." Before the fact, therefore, unskilled workers will *expect* that they will be losers (55 percent losers versus 45 percent winners), and they will tend to oppose the reforms.

Now, suppose that the reforms are put to a vote. All skilled workers will vote in favor of the reforms. All unskilled workers, however, will vote against the reforms, since they all fear that they are likely to be among the losers after the reforms are implemented. Therefore, the reforms will lose by a vote of 60 percent to 40 percent, even though 67 percent of the voters stand to benefit from the reforms! This is a reflection of the uncertainty of reforms. All unskilled workers vote against the reforms even though almost half of the unskilled workers would actually benefit if the reforms were carried out.

To finish this example, suppose that a decisive government carries out the reforms at the start of the post-Communist revolution. Once the uncertainty is over, the skilled workers and 45 percent of the unskilled workers will be better off, and they will know it; 55 percent of the unskilled workers will be worse off, and they too will know who they are. Overall, 67 percent of the workers will know that they have benefited from the reforms. If the reforms are put to the test *after* they have been in place for a while, they will receive landslide support, even though they would be rejected by the same electorate before the start of the reforms! This paradox of the status quo bias helps to explain why reforms are very controversial at the start, but why they are maintained once they are set in place.

A third reason for political controversy is that selected groups of the public are particularly well organized and politically mobilized to seek special privileges from the government. Thus, throughout Eastern Europe, pensioners account for a remarkably large part of the adult population, and, as in the United States, the pensioners are a very active and powerful political force.[3] Similarly, the farmers are also well organized politically and highly mobilized to seek financial advantages from the state. The result is the electoral success of pensioners and farmers throughout the region, most strikingly in Poland. The electoral successes are magnified by the proportional representation system in the Eastern European parliamentary democracies, since relatively small and tightly organized political factions have decisive influence on coalition building. This coalition of farmers and pensioners is particularly susceptible to fiscal excesses, in response to constituent demands for higher pensions and greater agricultural subsidies.

THE DIFFICULT CASE OF RUSSIAN REFORMS

In almost every dimension, the Russian economic reforms, begun in earnest in January 1992, are more challenging and difficult than in Eastern Europe (for an earlier overview, see Lipton and Sachs 1992). The scale of the country is nearly unimaginable: eleven time zones, perhaps 200 distinct ethnic-linguistic groups. The scale of political challenge is similarly profound: to move

[3] Roughly 32 percent of all Polish adults are on retirement pension or disability pension, in comparison with 18 percent in the United States.

from 1,000 years of authoritarian rule to democracy; from 75 years of home-grown communism to constitutionalism; from empire to nation state; and from centralized power to federalism. On the economic front, the three challenges of reform — financial, systemic, and structural —are all present in Russia, and in acute form. The Russian state inherited a financially bankrupt treasury from the Soviet Union, with $70 billion of foreign debt and almost no foreign assets. The systemic challenge is even deeper than in Eastern Europe, since Russia has little market tradition of its own to draw upon. And the structural challenge is certainly the greatest of all, since so many of Russia's vast resources were squandered in the military-industrial complex, and so much of Russia's natural environment was despoiled by the ruthless Communist system.

Russia also faced special short-run challenges of particular acuteness. On the monetary side, the breakup of the Soviet Union led to the establishment of no less than fifteen new central banks — one in each of the new successor states — all issuing credit in the same currency! This was obviously a recipe for disaster, and in fact the shared ruble currency among the successor states was one of the main reasons for high inflation in 1992 and 1993. Only after each of the states introduced its own national currency was it really possible to make lasting progress on stabilization.

On the political side, the great problem was that Russia did not have a decisive constitutional breakthrough until December 1993, two years after the start of radical economic reform. The result was that Russia lurched from one confrontation to the next between President Boris Yeltsin, intent on leading radical economic reform, and the Supreme Soviet, a legislative body held over from the Communist era and intent on slowing or reversing progress on radical reforms whenever possible. Thus, many crucial steps in reform had to wait until 1994 to come to fruition. It is therefore far too early to draw conclusions from Russia's reform experience.

Russia has made important progress on all three areas of the economic crisis, but in almost no case has the progress been as straightforward and clearcut as in Eastern Europe. Russia has been able to avoid hyperinflation, but it has not yet been able to tame the inflation; as of late 1994, inflation is still running at around 10 percent per month. The budget deficit remains very large, at around 10 percent of GDP, and confidence in the Russian currency remains low.

Russia has made greater progress in systemic transformation. Indeed, the most remarkable progress is in the area of privatization, where Russia successfully implemented an extremely radical and decisive strategy of mass privatization, based on the use of vouchers and free distribution of shares to workers and management. Around 80,000 small enterprises and 20,000 medium and large enterprises were successfully privatized in a two-year privatization campaign led by the remarkable politician Anatoly Chubais. This first phase of privatization is already leading to the growth of stock exchanges throughout the country and more generally to the development of capital markets.

The problems of structural adjustment remain acute and are likely to pose grave problems for the society for years to come. In certain areas, there has been little progress in structural change. The disastrously inefficient state farms are a case in point. In other areas, such as the restructuring or closing of highly inefficient factories in the far north or the coal mines in the great coal-producing regions, there are no easy choices, and there has been little progress to date.

The gravest risk to the Russian reformers has been the weakness of the Russian state itself. This may seem paradoxical, since it was the "strong" Russian state that proved to be such a disaster for Russia and the world throughout this century. Nonetheless, since the demise of communism, the Russian central government has lacked the financial and political authority to enforce laws, pay the bills, stabilize the currency, combat crime, or sustain a basic level of public services (e.g., in health care). The situation reached its nadir in the fall of 1993, when the combination of intrinsic economic problems and political conflict between the president and Supreme Soviet combined to make collapse an imminent possibility. After the violent confrontation between the president and Supreme Soviet, however, the situation drastically improved, with the adoption of a new constitution by referendum in December 1993. Since then, the Russian government has been able to achieve a minimally acceptable level of authority and stability, and thereby to reestablish progress on crucial areas of reform.

If one can draw any clear conclusions from Russia since 1991, it is that economic reform can work effectively, if politics gives the reforms time to take hold. Markets can flourish in Russia when they are allowed. The essential problem remains one of politics rather than economics *per se.* This, at least, is positive news and puts to rest some of the doubts expressed about the compatibility of Russian culture and the market economy. Russia will manage well with markets, if market reforms are given the chance.

Does China Provide a Counterexample to Shock Therapy?

While Eastern Europe and the former Soviet Union have been struggling to achieve financial stability and systemic change, China has been charging ahead in economic growth.[4] Since the start of Deng Xiaoping's market reforms in 1978, China has been the fastest-growing country in the world, averaging around 10 percent per year GDP growth. China's reforms, seemingly, have been more gradual than in Eastern Europe. The state remains Communist; there has been little privatization of industry. Does this suggest that China has landed on a reform strategy clearly superior to the "shock therapy" and other approaches in EEFSU?

The answer is no. China differs so drastically from EEFSU that one cannot read China's successes as pointing a better way for Eastern Europe and the former Soviet Union. Consider the three crises I have discussed at length. First, China did not face financial

[4] This section is based heavily on Sachs and Woo 1994.

insolvency at the start of its reforms. Therefore, it was able to launch economic reforms without the need to make drastic cuts in the budget or drastic restrictions on monetary policy. As for the economic system, China was always less centralized than the Soviet Union, with much greater independence and initiative at the local and provincial levels. The most important difference, by far, lies in the third area: structural adjustment.

The key distinction between China and EEFSU is that China was in 1978, and still is today, an overwhelmingly peasant agricultural economy. In 1978, more than 70 percent of the total labor force was in peasant agriculture! Only 8 percent of the workers were in state industrial enterprises, and only 18 percent of the workers were in state enterprises of all kinds (industrial and nonindustrial). By contrast, only around 12 percent of the Russian labor force was in agriculture at the start of President Yeltsin's economic reforms in 1992, and fully 90 percent of the work force was in some kind of state enterprise.

These structural characteristics make a profound difference for the nature of economic reform and development in China and EEFSU. In China, there is no overwhelming need to close down old industries or to privatize the economy. Such steps would be very helpful, but they are not of decisive importance. Rather, for China, the decisive step is to free up the nonstate economy, so that rural workers can leave low-productivity agriculture and join nonstate firms in industry. Thus, the main problem is to spur the flow of workers from agriculture to industry. Since peasant workers toil at subsistence wages, and without social protections, they are eager to leave this back-breaking work and to migrate to rural industry or to urban industries in the booming coastal provinces.

In EEFSU, by contrast, there is no vast rural hinterland from which to recruit the employees of the new nonstate sector. Also, there is no way to leave the state sector intact, since it is highly inefficient and financially destabilizing. Thus, in Eastern Europe and Russia, it is necessary — even if politically difficult — to make a frontal assault on the problems of the state sector, including retrenchment, factory closings, and privatization. China's "two-track approach" of permitting a nonstate sector while continuing to subsidize and protect the state sector simply cannot work in EEFSU, where the state sector traditionally employed almost all workers, not the 18 percent employed in the state sector in China.

If China had made great progress in reforming the state sector, then it could provide important lessons for EEFSU. Alas, China has little to teach in this area. Despite the overall boom in the Chinese economies, the Chinese state enterprises are overwhelmingly loss-making and therefore present a tremendous financial burden to the rest of the society. It is estimated that, in 1994, roughly two-thirds of all state enterprises in China are in the red. These losses are contributing to inflation rates of around 25 percent per annum in China, which is very high by Chinese standards. For these reasons, lessons on restructuring and privatization of state enterprises are likely to flow from EEFSU to China, rather than the other way around.

Post-Communist Reforms in Global Perspective

Five years after the start of Eastern Europe's reforms, it is now more clear than ever that EEFSU's return to the world economy is part of a deep global trend. The Communist countries were the most extreme forms of a more general phenomenon of economic policy in the developing world after World War II. Most of the developing countries, with the significant exceptions of a few East Asian countries, adopted a model of autarkic development, in which industrialization was to be fostered by cutting the home economy off from world markets, thereby protecting the domestic industry from international competition. Such a strategy could be seen throughout Latin America, Eastern Europe and the former Soviet Union, Africa, India, China until 1978, and some other parts of Asia.

This inward-looking model failed not only in the Communist countries, but in the rest of the developing world as well. By the 1970s, many Asian economies had already begun the switch to an outward-oriented industrialization strategy, based on the export of labor-intensive goods in the world markets. It took the Latin American debt crisis in the early 1980s to reverse the policy course in most of Latin America. Similarly, it took a balance-of-payments crisis in India in 1991 to put an end to India's decades-long closed-economic strategy. EEFSU's reforms must be put in the context of the worldwide switch to global integration and free trade. It is not enough, for example, for Poland to seek to join Western Europe. It must also recognize that it is competing with middle-income countries in East Asia and Latin America for foreign investment inflows and for export markets.

The worldwide character of the economic reforms is both heartening and disquieting for Eastern Europe. On the one hand, the fact that Latin America, India, China, and dozens of other countries are also following the strategy of market reform, trade liberalization, and privatization helps to confirm that the reforming countries of EEFSU are on the right track. On the other hand, the competition in world markets for international investment flows is fierce, and it is important that Eastern Europe not continue to lag far behind East Asia in attracting foreign investment.

The early results of Eastern Europe's competition for foreign investment are mixed. Foreign investment has risen sharply since 1989, but it remains far below the levels of foreign investment in East Asia. Poland has been attracting roughly $1 billion per year in foreign direct investment flows, as well as several hundred million dollars per year in portfolio capital flows. By contrast, Singapore has been attracting roughly $5 billion per year in foreign direct investment alone, and Malaysia has been attracting like amounts. One of the problems for Eastern Europe is that its geopolitical "place in the world" is still unsettled, as I explain in the next section.

THE ROLE OF THE WEST

After five years, we can see considerable progress in economic reforms in EEFSU. And we can see considerable evidence that the faster the reform measures are implemented, the better the outcome. And yet, important risks remain, in both Eastern Europe and the former Soviet Union. To an important extent, the remaining risks reflect the shortcomings of actions on the side of the leading developed economies of Europe, the United States, and Japan, rather than failures in the reform efforts in the post-Communist countries.

The risks are different in Eastern Europe and the former Soviet Union. In Eastern Europe, the prospects for sustaining democracy seem solid, and economic reforms have reached the point of irreversibility in most of the countries. Now the problem is not the risk of utter collapse, as it was in the early years, but rather the quality of economic performance. Will Eastern Europe now charge ahead economically, with high growth rates sufficient to begin closing the gap in living standards with Western Europe? Or will Eastern Europe instead remain an economic backwater, lagging far behind in living standards and failing to attract the foreign investment that could push the economies into faster growth?

A lot will depend on the West, and on Western Europe in particular. Eastern Europe based its revolution on the "return to Europe." This return is vital to the political, social, and cultural health of Eastern Europe, but it is also crucial for its economic health. And yet, Western Europe has so far remained vague and noncommittal on the central question of Eastern Europe's "return": the timing and modalities of Eastern Europe's membership in the European Union. While the countries of Eastern Europe have received general rhetorical commitments that they will eventually be welcomed as EU members, they have not received any clear signals as to when that might occur.

The costs of this delay have been high. The experience of Portugal and Spain in the 1970s and 1980s demonstrates clearly that EU membership was vital in enabling these two countries to attract large flows of foreign direct investment, which in turn were needed to raise living standards and to modernize industry. In addition, membership in the EU was very important in sustaining the political momentum of economic reforms in Portugal and Spain. Therefore, Western Europe's delay in embracing Eastern Europe's membership in the EU is highly risky. It continues to deflect needed foreign investments to East Asia, and it risks undermining the vital social consensus in favor of economic reform that has so far sustained the tricky and difficult process of change.

The risks are different, and even more grave, with respect to the former Soviet Union. In the case of Russia and most of the other states (the Baltic States being the exception), democracy itself is not yet consolidated, and the economic reforms could still collapse in an outburst of hyperinflation, tax evasion, and criminality. Therefore, it is still crucial to consolidate the basic directions of reform.

As I have stressed on many occasions, the West bears a major responsibility in this most crucial phase of democratization and market reform (see Sachs 1994a, 1994b, 1994). Throughout the history of this century, fragile democracies facing deep financial crises have required international assistance to help pull them through the crisis. Foreign assistance cannot create growth or even sharply higher living standards. It can, however, bolster weak governments long enough for more basic economic reforms to take hold. That is the lesson of the Marshall Plan and of similar aid to Israel, Mexico, Poland, Turkey, and other countries in the past fifteen years. It is vital that the West apply this lesson to Russia and the other countries of the former Soviet Union before financial disaster takes away this historic opportunity for democratization and fundamental economic reform.

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