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## The shock therapy model of transition

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**Abstract:** The aim of this paper is to develop a comprehensive analysis of the shock therapy model of transition. As such the model requires an analysis of what I define as the primary elements: economic analysis, definition of a good society, speed, political structure, ideological structure and initial conditions. Also it is necessary to develop an appropriate mechanism of implementation, what I define as the secondary elements: price liberalisation-stabilisation, privatisation, institutional structure, monetary policy and the financial system, fiscal policy, international trade and foreign aid and social policy. In addition, there was a need for a strategy by which the reform program would be implemented. In the conclusion an assessment of the shock therapy model as a political strategy takes place.

**Keywords:** shock therapy; transition; sequence of reforms.

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### 1 Introduction

The shock therapy transition model was firstly implemented in Poland, on 1 January 1990. The countries that followed with the shock therapy stabilisation and liberalisation program were Czechoslovakia (which started on 1 January 1991), Bulgaria (1 February 1991), Russia (2 February 1992), Albania (July 1992), Estonia (September 1992), and Latvia (5 June 1993). Jeffrey Sachs was an adviser to the Polish government and both he and Anders Aslund advised the Russian government and guided its shock therapy reform process in 1992–1993 (Schlack, 1996, p.617). Aslund was, in fact, an economic adviser to the Russian government from November 1991 to January 1994 (Aslund, 1995, p.xi). Both Sachs and Aslund

“shared the belief that the economy [in Russia] was in such a terrible mess that a radical, comprehensive, liberal program would be needed to introduce any kind of rational order.” (Aslund, 1995, p.16)

The supporters of the shock therapy model argued that the elements of the model would ensure growth at full employment with low inflation and stability. Consequently, as Lipton and Sachs (1992, p.249) argued, “we would rather stress how little evidence there is in favour of the pessimistic view”. In summary, the shock therapy model was a neoclassical model of transition advocating the immediate implementation of the necessary reforms to establish a free market economy.

The implementation of the shock therapy model was short-lived. Despite the substantial initial support for governments initiating the process in transition economies, considerable undesirable outcomes resulted such as unemployment and inflation. This led to unpopularity in the governments. High inflation caused social and political instability, threatened the fragile democratic governments, and risked not only regional but also global security. The risk was substantially increased by the adoption of proportional representation as the basis for parliamentary representation, which resulted in multi-party coalitions that were weak, fragile and easily pressured. As Boycko argued,

“no matter how strong the purely economic case for ‘big bang’ price decontrol is, this measure cannot be recommended to a politically weak government whose primary objective is to stay in power. We, however, tend to favour a different conclusion: the social costs of having a weak government that does not dare to (or does not want to) decontrol prices are tremendous.” (Boycko, 1991, p.44)

These governments suffered head-on confrontations with the powerful political and economic blocks, and populism together with a public disillusioned with the whole reform process. Intrinsicly, these governments did not have the power to pursue the policies required by the shock therapy platform. In a democratic environment, the substantial reduction in output and employment associated with the shock therapy process of transition, resulted in the ultimate downfall of these governments through the electoral process. The threat to the shock therapy process from the electoral process was recognised by Woo (1997, p.311). He indicated,

“a return to the old day of firms pursuing non-economic objectives in return for soft budget constraints is a distinct possibility if a non-market-oriented government were elected.”

The reasons why the shock therapy process of reform did not deliver all the benefits was recognised to some degree by Sachs (1995b). Aslund also conceded,

“the main lesson to be drawn is that transition to capitalism is possible as at least Poland shows, contrary to what many once thought, but so far the number of countries that have succeeded is less than those that have failed.” (Aslund, 1994a, p.24)

For the shock therapy supporters, the reasons for this were not due to the fundamental elements of the reform strategy, but rather the inadequate response by the mature economies and the international financial institutions in assisting the transition economies.

Due to the lack of international financial aid, transition economies were forced to implement orthodox stabilisation policies based only on fiscal and monetary policies (Aslund, 1995, p.188). Among mature market economies and international organisations,

“there was no intellectual understanding of what to do” (Sachs, 1995b, p.61), there was an unwillingness to make any substantial commitment, and there was no political will (Aslund, 1995, pp.215-6). Mature market economies and international organisations neglected to observe that the frail governments who supported and implemented the shock therapy process would be unable to survive without substantial outside financial support. The International Monetary Fund (IMF) particularly failed to provide the necessary financial resources to help offset the budget deficits of reformist governments.

## **2 Primary elements of the shock therapy model**

In order to better understand the shock therapy approach, an analysis is required of the primary elements of the model consisting of economic analysis, definition of a good society, speed, political structure, ideological structure and initial conditions.

### *2.1 Economic analysis*

The shock therapy model is based on neoclassical marginalist economic analysis. Individuals are characterised by rational maximising behaviour and prices are determined in a perfectly competitive market by supply and demand curves, in equilibrium, without market power. Neoclassical economics is based on microeconomic foundations, inquiring into conditions of static equilibrium. The economy can be viewed as being in equilibrium. The macroeconomic variables are the result of adding up microeconomic relationships. Savings determine investment, and equilibrium is achieved at full employment by an adjustment in wages. Consequently, as long as there are no impediments in the operation of the market process, allocative and productive efficiency is always achieved.

### *2.2 Definition of a good society*

The view of a good society expressed is a construction based on the neoclassical values to which most neoclassical economists, and shock therapy economists, subscribe. The model developed is a stylised version of what neoclassical economists suggest is a good society.

For neoclassical economists individual autonomy and sovereignty is of the highest priority for free people. Restrictions on individual behaviour by general interests and/or state interests are detested. It is argued that the intrinsic motivation behind human actions is based on the human need to be self-determining and self-reliant in relation to the external world. Pursuing and accomplishing goals that are optimal from the individual's point of view express this. Free people make decisions as independent decision-makers and have the courage to pursue their own convictions through the exchange mechanism operating in a market-based system. Thus, a free person rejects attempts by others to exercise control or power over their own choice of behaviour. A free person treats other people as equals, thus limiting exchange to only voluntary transactions. The market as an economic institution is the expression of economic freedom. The market, in the absence of any form of discretionary power, is an institutional process in which individuals interact with each other in pursuit of their economic objectives.

Due to their individualism, people have an explicit and complete set of priorities. They express their preferences through the market process, which in turn is a reflection of their values. There is no distinction between individual preferences and society's values. Consequently, economics is neutral in the choice between values. Society's choice is the sum of individual choices. The market outcome is just and acceptable to all market participants. The basic principle under which the market functions is: if a person is entitled to something but wants to exchange it for something which belongs to someone else, and if the exchange is executed without violence, theft or deception, then that person becomes entitled to what the other person was previously entitled to and vice-versa (Chipman, 1981, p.8). Both parties in an economic transaction should benefit, provided the transaction is voluntary and informed. Otherwise, the transaction will not take place.

In this way, through the market process everyone is able to escape coercion by one buyer or seller by going to another. The market prevents one person from interfering with another; no one individual can influence or direct the actions of another, allowing a high degree of autonomy. Hayek regarded

“competition as superior not only because it is in most circumstances the most efficient method known, but even more because it is the only method by which our activities can be adjusted to each other without coercive or arbitrary intervention of authority.” (Hayek, 1986 [1944], p.27)

In addition, society is able to harvest the benefits of the division of labour and specialisation of function. Society is able to cope with complexity in an effective way. Planning and markets are not compatible coordination mechanisms that can be harmoniously combined in any proportions. Indeed, planning can only eventually lead to coercion. However, economic freedom cannot be absolute. The philosophy underlying economic freedom is not the crude self-interested behaviour of getting what is desired by whatever means. Rather, the means must be within defined rules. To facilitate freedom, free societies have developed appropriate laws and institutions, which include defined property rights and procedures guaranteeing the execution of contracts.

A cardinal characteristic of the market mechanism is freedom of enterprise. This implies that individuals should have the right to establish, administer, appropriate any surplus and liquidate their enterprise. The all-important difference between a centrally administered economy and a market economy is whether enterprise managers take directions from the state or from the market in realising income, that is whether they seek subsidies or profits (Aslund, 1995, p.137). In the event of market failure, government action is not automatically required. Priority should be given to private alternatives, with minimal involvement of state property. Examples where this can be achieved include: television transmission which is a public good funded through advertising; a voucher system for education whereby the state provides vouchers to the parents, equal to the amount of external benefit associated with education and redeemable at private schools which effectively compete for vouchers; and private health insurance which is a private good, not a basic right, and the most effective alternative to free health care.

“An economy with a predominantly state ownership is unbalanced by definition and is also inflation prone” (Winieski, 1992, p.274). That is why state enterprises during transition should be guided by strict rules. The reform process distributed ownership more equally through privatisation than its predecessor and also increased efficiency and tax revenues. A general observation is, the more mature an economy, the smaller the role

is of the state in managing productive resources, and the greater the role of private individuals in allocating resources through the market (Targetti, 1992, p.6).

The prices that emerge from voluntary transactions that are motivated by self-interested individual behaviour generate a spontaneous order, a pattern of allocational and distributional outcomes. Prices co-ordinate the activity of people in such a way as to make everyone better off. Individuals whose only aim was their own gain are led by an invisible hand to promote an end that was not part of their intentions (Smith, 1986 [1776], p.477). Economic order is achieved through the market process as an unintended consequence of the actions of self-interested individuals. In the absence of market failure the operation of a competitive market results in efficient scarcity prices, which are indispensable to the operation of the market system. Scarcity prices perform three important functions. Firstly, they transmit information about the different preferences of the economic units. Secondly, they provide an incentive to adopt the least-cost methods of production. Finally, they determine who gets how much of the product (Giersch, 1989, pp.7, 8). Prices can perform these important functions only if the market is able to function freely, that is without any discretionary intervention by the government and/or individuals which results in distorting prices, producing the undesirable results of shortages, queues and low-quality products. Furthermore, and most importantly, the market stimulates technological change, which results in a dynamic transformation of the whole society. This is possible by allowing access to resources to those who are willing to adopt new technologies and rewarding them for their effort.

The market makes individuals take part in a process more complex and extended than they could otherwise comprehend. The market process transforms the complex problem of the allocation and distribution of resources into a simple one. The alternative of rational economic calculation is infeasible, according to the arguments of von Mises and Hayek. Coordination is simple and democratic, in terms of accountability via the market test. Accountability means that people in positions of power are constantly questioned and examined about their actions; by contrast, central administration lacks such accountability. This is because politicians responding to pressure groups with the aim of being re-elected exercise discretionary power. They exploit their power in order to extend their privileged position. In a centrally administered structure, the bureaucrats have been assigned the responsibility of decision-making that influences the whole society.

“Economic control is not merely control of a sector of human life which can be separated from the rest; it is the control of the means for all our ends. And whoever has sole control of the means must also determine which ends are to be served, which values are to be rated higher and which lower, in short, what men should believe and strive for.” (Hayek, 1986 [1944], p.69)

The market, as a means to economic freedom, promotes political freedom because it separates economic power from political power (Friedman, 1980, pp.88–94). If political power and economic power are joined, coercion is inevitable, as for example in Fascist Italy, Nazi Germany and the centrally administered Soviet Union and Eastern Europe. The preservation of freedom requires the elimination of such concentration to the fullest possible extent, so as to reduce coercive power as much as possible. Using the spontaneous forces of society results in using as little coercion as possible. The market is a means by which the organisation of economic activity is removed from the control of the political authority. By enabling people to co-operate with one another without coercion, it reduces the scope of political power. Furthermore, the market serves

as a source of potential opposition to the misuse of political power, a form of accountability. Berle (1954, p.66) argued that absolute power in any form of organisation, in this case the political organisation, was usually accompanied by the emergence of countervailing power elsewhere, commonly in a quite different form, such as market relations in this case.

Hence, the shock therapy supporters, consistent with neoclassical economics, were in favour of an economic system based on private property, free market relations and individual material incentives. As such an approximation to competitive capitalism was feasible and desirable. There would be fewer opportunities for corruption and rent seeking (Aslund, 1994a, p.36).

### 2.3 *Speed*

According to the shock therapy model, restructuring could not take place without an effective price system; an effective price system could not exist without a convertible currency. In turn, a convertible currency was impossible without opening the economy to international competition and international competition could not be effective without restructuring. "The idea that there is choice between doing one radical measure or another is simply wrong. There is no trade-off but, on the contrary, complementarity" (Aslund, 1997b, p.187). Countries, such as the transition economies, experiencing such severe macroeconomic imbalances could not afford to reform slowly. "They need a strong dose of medicine quickly" (Thomas and Wang, 1997, p.223). Both the economic and political situation required a rapid and comprehensive reform (Lipton and Sachs, 1990, p.99): "if a house is on fire, you do not tell the fire brigade to pour water slowly" (Aslund, 1994a, p.37). "Shock therapy, on the other hand, means a person who, while putting in his first leg, cannot wait to put in his second one" (Woo, 1994, p.281). "Bitter medicine is easier to take in one dose than in a prolonged series of doses" (Balcerowicz, 1994, p.87).

A gradual process would have been highly uncertain because reformers would have only known the first step or piece of the whole process. It would be a 'piecemeal approach' (Cao et al., 1997, p.31). However, gradualism was favoured because it was the 'ordinary way of administration', making decisions one after the other without coordination (Aslund, 1992, 1997a, p.16). Consequently, "as long as nobody has indicated a feasible gradual reform, we can do little but discard it as a nonstarter" (Aslund, 1992, p.36). Gradualism had been attempted before, for example in Soviet Union from 1985 to 1991, and it failed (Aslund, 1993, p.95).

Most importantly, a gradual process would have resulted in the wastage of the precious reserve of political capital developed after the collapse of centrally administered socialism. At the time, people were willing to accept radical solutions to the difficult economic problems they faced. A gradual process would have resulted in political competition between parties based on self-interest and thus, disillusionment of the public. Balcerowicz et al. (1997, p.135) argued that according to social psychology, people are more willing to adjust their behaviour in an environment that is going through a radical change than during a gradual one. People conceive that the initial crisis is less significant as long as there is a positive outlook for early benefits in the future (Aslund, 1992, p.32). In contrast, the longer it takes to implement the necessary reforms, the more the public's psychology changes, influenced by the possible social costs (Graham, 1997, p.338). Thus, if people have been properly informed, they will accept a democratically adopted stabilisation program with ease. The Polish and Czechoslovak governments, for example,

devoted a substantial amount of resources to informing the people about the expected difficulties associated with the transition process. People were prepared psychologically, thus accepting the hardships with relative ease (Aslund, 1992, p.176) and people were willing to accept suffering if they were convinced of the radical solution (Aslund, 1992, p.30). Consequently, “under the circumstances prevailing in Russia in late 1991, it would have been lethal to hesitate or move more slowly” (Aslund, 1995, p.11). In reality, the gradualists were not gradualists at all but rather ‘obstructionists’ (Rostowski, 1993, p.101).

Deterioration in short-term output and the rise of unemployment, a common development in all transition economies, was not necessarily a negative sign. They mirrored a systematic and structural change due to the misallocation of resources under the previous centrally administered regime. Unemployment, however, was not linked to the speed of transition, or the resoluteness of stabilisation, but rather to wage inflexibility and the creation of new jobs. In the transition economies the gradualist process allowed the continued power of state enterprises and bureaucracy, ensuring the survival of privileges and protectionist measures. For example, the military-industrial complex in Russia resisted the radical reform program because it would otherwise lose its preferential access to resources (Woo, 1994, p.293). A shock therapy approach to transition was the most effective way to salvage the economy for the people because it did not provide the privileged classes with enough time to extract a large share of the resources (Aslund, 1994a, p.37). The transition economies which lacked the endurance to implement a shock therapy process suffered the higher economic and social costs associated with gradualism, which resulted in unequal redistribution of wealth and astounding rent-seeking (Szuk, 1996, p.53). In Russia, in particular, the ability of the bureaucracy to resist the reforms resulted in a gradual process, which failed (Aslund, 1995, pp.6–16). Meanwhile, the shock therapy approach, which was based on immediate liberalisation, which could be managed by a small team of reformers and as such did not require a powerful bureaucracy (Sachs, 1996, p.129). Furthermore, the slower the process, the lower the revenue generated by the privatisation process, which was not in the interest of any government (Klaus, 1995, p.46).

As such the transition process was mostly a political problem rather than a social or even economic one (Lipton and Sachs, 1992, p.215; Sachs, 1993a, p.xiii). Under these difficult economic conditions there would be broad scope for politicians to pledge an easy road to reform. There was a major danger that politicians would respond to the pressure to increase wages, raise government expenditure and stop the reduction in subsidies. Politicians would attempt, at the cost of the reform program, to build up support from the workers, managers and new owners in inefficient firms, who would pressure the government to avoid the closure of their firms by demanding discretionary policies. The newly formed governments, relatively inexperienced in these circumstances and concerned about re-election, might easily give in to sectoral demands, effectively postponing the achievement of a free market. It was also likely that the newly formed governments would be fragile. They were usually the result of coalition governments, which found it particularly difficult to introduce the radical reforms needed to reduce the budget deficit. Consequently, “the fundamental open question about the success of privatisation and other reforms in Russia is whether the days of these politicians are really over” (Boycko et al., 1993, p.181). It was political weakness that undermined the radical transformation and not the undesirable short-term economic and social outcomes essential for restructuring. Therefore, since the political credit available to the transition

government would last only for a limited time, this called for a shock therapy approach (Dabrowski, 1997 [1993], p.52). As Sachs insisted,

“the risk of panic brings to mind Roosevelt’s aphorism that ‘the only thing we have to fear is fear itself’ and underscores the fact that it is the political management of the economic transformation that is the single greatest challenge facing the region.” (Sachs, 1991a, p.26)

#### *2.4 Political structure*

The neoclassical economists are in favour of a pluralistic political structure based on political freedom. Political freedom means freedom from coercion in terms of arbitrary power; freedom even from coercion exercised by the government. But by no means can this be interpreted to imply that there is no role for the political authorities. An effective competitive market system needs a vigorously designed and frequently adjusted legal environment. The government is a form of voluntary co-operation and as such, it should be restricted to areas where agreement exists. People have chosen to achieve some of their goals through the establishment of the government, because they believe that this to be the most efficient way. The government has a monopoly over the legitimate use of force to restrict behaviour that in turn inhibits freedom.

The government should allow individual freedom of actions, subject to specific circumstances of which only the individual can fully be aware. Consequently, for individuals to plan effectively they need to be aware of the government’s policies. Hence government policies should be based on specific rules that are fixed and announced beforehand so that individuals know what to expect. At the same time government needs to provide a means through which citizens can modify rules, mediate differences among themselves, and most importantly, enforce compliance upon those few who would otherwise disregard the rules of the game (Friedman, 1962, p.25).

The political structure can be viewed as symmetrical to the economic structure when it is regarded as a market. Through a pluralistic political structure based on political freedom the political structure ensures, like the market, the diffusion of influence and power. The outcomes in both the political and economic arena are determined by interactions among people pursuing their individual self-interest. Both are systems of popular control; in the political market people vote with their voices, in the economic market with their dollars. People are treated as equals in both markets. Hence the free disposal of private property within a market system can only be possible within a political process based on political freedom. “Political freedom in this instance clearly came along with the free market and the development of capitalist institutions” (Friedman, 1962, pp.9, 10).

Once the society has chosen its economic process the decision making process is affected, especially in terms of the structure and function of the central authorities. This is because the state has a monopoly over the legitimate use of force to impose restrictions on individual economic behaviour. A free person emphasises the benefits derived from free market relations, which is without any form of discretionary power and enjoys a compatible pluralistic political process based on political freedom. The greatest difference between authoritarian and free societies is the degree to which the central authority replaces the market. Hayek (1986 [1944], p.52) asserts that planning leads to dictatorship; therefore “planning and competition can be combined by planning for competition, but not by planning against competition” (Hayek, 1986 [1944], p.31).



In a historical context, politically free societies and the market have a common origin. Friedman states:

“I know no example in time or place of a society that has been marked by a large measure of political freedom and that has not used something comparable to a free market to organise the bulk of economic activity.”  
(Friedman, 1962, p.9)

The rise of the market was associated with the rise of political freedom and the gradual removal of governmental and religious constraints upon the individual. In the absence of the discretionary power of the state all forms of discretionary power in society are eliminated, resulting in a very close approximation to competitive capitalism. Thus market relations are necessary for pluralistic political relations.

Friedman and Hayek argued that the restriction of markets through planning or discretionary measures could only lead to ‘the road to serfdom’. However, they had a very pessimistic view of the market as a means to stimulate political freedom and weaken the power of authoritarian governments. My objective is to demonstrate that market participants enjoying the benefits of the market process would question and undermine the power of authoritarian governments. Individuals who experience the benefits of freedom through market relations are likely to require the same in the political process. This is because the market and political freedom are internally linked: one generates and sustains the other.

Individuals in any country dislike authoritarianism. They have high levels of cognitive complexity, autonomy, sociocentricity, attitudes towards self, and identification with moral values. Individuals acquire these qualities through the market process, which results in the questioning and undermining of any restriction on political freedom. It is not by accident that the introduction of market relations in Russia and Eastern Europe has been accompanied by political freedom, since economic and political freedom are linked.

There is a strong link between markets and political freedom. For some, this link does not appear unbreakable. It appears that, while a market system is necessary for political freedom it is not sufficient (Friedman, 1962, p.10). Lane agrees,

“historically, a free market has seemed to be a condition of political freedom, as exemplified in the bill of rights and free elections, but it has not been a sufficient condition.” (Lane, 1979, p.9)

Some countries have developed a form of political process, a hierarchically structured bureaucratic organisation that gives privileges to an elite class. While the market still remains the main process for decision-making, political freedom is restricted to serve the purpose of this minority class. In these instances the political process results in a loss of personal control and encourages dependency. It rewards conformity, obedience and affiliation instead of innovation, enterprise and autonomy. Individuals feel powerless and helpless. Such people perform very poorly in a market system compared with a self-interested competitive oriented individual. In addition, political authorities distort the market by allocating resources through coercion. Although the political authorities control a large part of resources, the influence of their decisions is substantial which effectively results in them controlling, the entire spectrum of economic decisions (Hayek, 1986 [1944], p.45).

I believe this argument was developed due to the political situation in the 1960s and 1970s. In this period the political situation of the world was pessimistic with respect to political freedom. Suppression of political freedom was widespread in the form of authoritarian political structures, especially military dictatorships, where tenure was based on power instead of reason and irresponsible political power was functioning outside the discipline of law. It appeared that the situation would not change, as a feature of authority is that it can persist over time (Kemp, 1988, p.37). Nevertheless the market plays an important role in providing the mechanisms of opposition to the suppression of political freedom. The market serves as a source of potential opposition to the misuse of political power, a form of accountability.

The argument raised by Friedman and Lane that market relations are not sufficient for political freedom is an unfortunate simplification and is no longer realistic. In fact, in the short-term in a market system, political freedom may be restricted but in the long-term, authoritarian political processes cannot survive alongside the markets. The fall of military dictatorships in the end of the 1970s and in the 1980s and the collapse of authoritarian socialism, which stimulated the re-establishment of political freedom, demonstrated this argument.

The market should be evaluated not only as a process of achieving the optimal allocation of resources but also as a process of learning, which facilitates personality development. Through the market, individuals learn to be free, to be independent and to follow their own convictions, and they preserve this set of value judgements throughout their adult life, once they have been developed in their formative years (Inglehart, 1977, p.23). If the market encourages self-help, how can this behaviour be restricted only to the market and not extend itself to the political process in the form of political freedom? Freedom is a skill, which is generated and sustained by the market (Minogue, 1983, p.21).

Despite the differences that exist between markets across time and space, it is possible to formulate a market structure that is representative for our purposes. As such, participation in the market process induces the acquisition of qualities, which are important for personality development. Lane (1981, p.5) identified the qualities necessary for maximising personality development. They are:

- *Cognitive complexity*. This involves the capacity to understand abstractions, to hold preferences, to be able to judge others and oneself, to change concepts, to fit reality rather than fitting reality to fixed conceptions, and finally to hold several ideas to arrive at original solutions. It helps to deal with new ideas and foreign abstracts.
- *Autonomy*. That is, the desire and ability to remain independent, which encourages free initiative and free expression in all areas of life. Through this quality a person is free to conform, or not, to tradition and authority. Sources are treated as information rather than directives.
- *Sociocentricity*. The thoughts and claims of others are understood and given recognition. Sociocentricity capsulates socialisation, experience, understanding and reasoning. Individuals learn in this way the rules of the game and conform to them and justify their actions. It is a guide to social reality and a necessary ingredient in good interpersonal relations.

- *Attitudes towards self.* A combination of self-knowledge, self-acceptance and self-respect are necessary for the establishment of an identity. With this quality people avoid internal conflict and uncertainty about values.
- *Identification with moral values.* Such identification is necessary to secure moral reasoning and moral behaviour without taking refuge in tradition and authority.

Lane's (1981, p.7) analysis aimed to identify the effects of markets and politics on personality development. In my view his analysis was quite simplistic, in that the influence was one-sided; markets and politics influenced personality development without individuals being able to influence the nature of markets and politics. Contrary to Lane's opinion, social processes are reflexive: individuals participating in the market acquire qualities for personality development that will be used in the political process, thus influencing the nature of the political structure. Precisely a market participant will require a specific political process based on pluralism and political freedom.

Participants in the market develop, through a process of trial and error, the necessary skills, qualities and behaviour so as to participate effectively. Participants in the market need to think for themselves. They slowly reject intellectual dependence on others. Market participants reject dependency on the family, village, community, ethnic group or social class. They need to make complex decisions with respect to education and careers. The market environment has also become increasingly complex due to more sophisticated products, numerous brands and aggressive advertising. The market participant needs to search, examine and analyse products. Thus the market participant is faced with difficult and complex choices that require complex cognition.

A sense of autonomy is achieved through the market, since the participants learn that the environment around them is responsive to their actions. Individuals work, get paid, and buy goods through the market process. This allows individuals to control their own destiny. Within the market, individuals can afford to be self-dependent because they have alternatives from which to choose. They are independent and follow their own convictions. The market participant learns that effort will be rewarded and wrong decisions penalised. Rewards are individual instead of collective. Consequently they will need to bear the burden of mistakes, but also enjoy the outcome of correct decisions. The market contributes to the desire, value and belief in one's own competence and in the competence of others to control their own destinies and to develop along unique individual paths.

Economic transactions bring people together providing that any exchanges are voluntary and both parties benefit. Participants need to understand the other's point of view and agreement will only be achieved when the parties involved communicate, bargain and compromise. In this way individuals become sociocentric, since success in the market requires good interpersonal skills. Participation in the market process encourages self-knowledge, self-acceptance, and self-respect because of the direct correlation between effort and reward. It is through successes and failures, as a result of correct and wrong decisions, that participants realise their potential. They learn through their mistakes rather than through tutelage, and they succeed through their own analytical and planning strategies. The market increases the awareness of the participant's potential in solving problems and realising goals. The sense of accomplishing something contributes to one's satisfaction with life. Lastly, the market encourages fair dealing since exchange is voluntary and is executed without violence, theft or deception. The market contributes in this respect to identification with moral values. Thus market participants

are able to develop the qualities necessary to generate a coherent personality. To this we need to add the positive impact of higher levels of education, achieved in a market based system; "... college makes students more liberal, less authoritarian, less dogmatic, less ethnocentric and more interested in political matters" (Inglehart, 1977, p.10).

The qualities gained through the market process can be used in other aspects of life. It would seem inappropriate to split individual behaviour, thus not allowing the qualities developed through the market process to be used in the political process. Individuals must be considered as whole identities; they are able to develop personal qualities from various institutional processes and use them to achieve their goals. What individuals learn by the market can be generalised to non-market aspects. The market provides experiences that demonstrate the efficacy of controlling one's own life. This efficacy is generalised to other situations.

The political structure does not exist in a vacuum. Market participants equipped with the five qualities described by Lane would require a specific political process. They would be interested in participating in the political process because they are sociocentric and identify with moral values. They would be able to participate because they have already acquired the quality of cognitive complexity. With respect to the actual process, market participants would require a process, which encourages self-knowledge, self-respect and autonomy. A market participant becomes integrated into an extensive communications network, being exposed to different sources of information, which expands their horizons and develops their political awareness. This results in treating with suspicion information disseminated by only one source in the political structure. Formal indoctrination is unacceptable to market participants.

Lane's five qualities are a prerequisite for effective participation in politics. It would enable individuals to develop such political skills as being political competent, able to manage political abstractions and co-ordinate political activities, consequently becoming an effective political participant by playing an important role in decision-making rather than entrusting this role to somebody else. Without these qualities one is condemned to endure a life outside the political process of modern society. Thus market participants, developing their personality under market relations, would require methods, institutions and structures that protect their independent personality. They will inevitably require a pluralistic political structure based on political freedom. Market relations accompanied by political freedom facilitate the achievement of an internally consistent personality to guide internally consistent actions.

Thus the market (economic freedom) and a pluralistic political structure based on political freedom are internally linked and one generates and sustains the other. In the long run authoritarian political structures cannot exist with free markets. "Modernisation cannot be achieved without basic freedoms" (Ofer, 1987, p.1768). The growth of markets in transition economies can only foster the development of pluralistic political structure based on political freedom. It was apparent that a successful financial stabilisation and structural adjustment would be inconceivable without a change in the political structure in transition economies (Fedorov, 1997 [1995], p.125).

## *2.5 Ideological structure*

With respect to the ideological structure, neoclassical economists have developed an ideology that emphasises political and economic freedom and encourages self-interest and self-help. It is worth noting the often-quoted passage of Smith,

“it is not from the benevolence of the butcher, the brewer or the baker that we expect our dinner, but from their regard to their own interest. We address ourselves not to their humanity but to their self-love and never talk to them of our necessities but of their advantages.” (Smith, 1986 [1776], p.119)

Neoclassical economists stress that there is no other way of understanding social phenomena than through an understanding of individual actions. Individuals should be allowed, within narrowly defined limits, to follow their own values and convictions rather than somebody else's, and individuals should not be subject to coercion by anyone. The need to strive for a better economic position, to accumulate wealth and competition are inherent in human behaviour and thus cannot be eliminated. They can be suppressed but not eliminated. The people of Russia and Eastern Europe were “troubled, restive, and impatient” (Sachs, 1991a, p.26). Nevertheless, “it seems that the deadening decades of communism did not dull the acquisitive spirit, but rather sharpened it” (Sachs, 1993a, p.xiii). For example, it was argued that the concept of private ownership was unknown to Russians; the Russian language did not even have the word ‘private’ or ‘privatisation’. However, as with most new concepts, the words were added to the national vocabulary. The slogan: “Towards the market at the expense of the state, not the citizens” was very popular in Russia (Kosmarskii, 1992, p.31). Correspondingly, “the cultural barrier had evidently been exaggerated” (Aslund, 1995, p.271).

An ideological foundation for the development of a market system already existed, based on the values of a long tradition of private enterprise and the deeply rooted individualism and rationality of the people. These values could foster an effective market system as long as all impediments to individual behaviour were removed. Correspondingly, there was no substance to the argument that people would not know how to behave in a market economy. For example, small-scale trading can be learned in no time (Aslund, 1992, p.35). Thus the acquisitive spirit was on the rise in Russia and Eastern Europe. “All over Eastern Europe, the entrepreneurial spirit has turned out to be excellent” (Aslund, 1994a, p.35).

However, there was a significant danger associated with the development of the ideological structure, and in particular with nationalism. The role of nationalism, which is part of ideology, should not be underestimated, especially, if “the current drive towards opening the economy fails for one reason or another, a nationalistic revival will follow” (Sutela, 1992, p.86). Shock therapy supporters are totally hostile to the pursuit of policies that promote economic nationalism. As the economies of Russia and Eastern Europe proceeded towards a market economy, nationalism did not encourage the maintenance of cultural diversity, inclusiveness and heterogeneity, but rather favoured social and cultural distinctiveness, exclusivity and purification. This would probably have resulted in justifying discretionary measures in the name of ‘protecting the nation’ and hence effectively withholding the attainment of a free market system. A national policy based on isolationism and xenophobia would have resulted in distortions of economic behaviour. Reformers in the transition economies pursued a large number of policies such as increasing tariffs, economic planning and discouraging foreign investment and multinationals, supposedly to achieve economic and thus political independence. Reformers advocating these policies were out of touch with the interdependent world economy, which ensured their failure. Hence, appeals to nationalism and distinctive national identity and culture could only be used as excuses to stop and reverse the reform. Thus the ideological structure should encourage pluralism consistent with market relations and the political structure.

## 2.6 *Initial conditions*

While the problems associated with the transition process might be serious and complex, they were not unparalleled. The transition process, for the shock therapy supporters, was not peculiar, complicated or enigmatic. "In fact in many ways it is a well-trodden path" (Sachs, 1993a, p.2). These problems needed to be solved by ordinary means and the 'uniqueness' of the situation required unhesitating and determined action. "Everything in this setting pointed to the need for a hard and (of necessity) rough stabilisation policy" (Aslund, 1997b, p.186). Many elements of the transition program did have general application across economies with immensely different initial economic and political environments (Woo et al., 1997, p.xi). Initial social factors do not substantially influence economic growth in transition economies; rather it is openness and investment (Thomas and Wang, 1997, p.230). Thus "in principle the tasks and instruments of macroeconomic stabilisation are the same in Russia as elsewhere" (Aslund, 1995, p.181).

China has been recognised as a successful model of implementing a gradual process of transition. The sectors of the Chinese economy that responded successfully to the new economic conditions were agriculture, exports-oriented firms and services. These industries took advantage of a reform program that was 'gradual' but rapid and radical in these sectors (Woo, 1994, p.279). In other sectors, where in practice a gradual process was introduced, the result was stagnation. It was clear, for the shock therapy supporters, that the gradual process was not based on any economic principles. Rather "gradualism in China is the result of the political deadlock between the Stalinists and the reformers, and not the result of a particular theory of reform" (Woo, 1994, p.279). The Chinese model of gradualism was not relevant as a guide to transition economies. Three-quarters of China's population lived in rural areas at the time of the reforms and the main source of income was agriculture. Economic growth was initiated outside the state sector. In contrast Lipton and Sachs (1992, p.277) argued that in Russia and Eastern Europe a majority of the labour force was employed in urban industry. Thus the main source of growth, in the short run, would come as a result of privatisation of the state sector.

The Chinese gradualist process was a succession from easy to hard, addressing the easy problems first and leaving the difficult ones for later (Cao et al., 1997, p.38). However, once the honeymoon period was over, the Chinese authorities had to deal with the difficult problems. In direct contrast, the shock therapy approach addresses all the problems simultaneously from the start. It would not have been a surprise if China had abandoned gradualism in favour of more rapid economic reforms. The apparent 'success' of the gradual Chinese process of transition could be explained by:

- a the development of the private sector
- b the high savings rate
- c the structural and initial conditions (such as the small state sector)
- d the Chinese diaspora
- e the deliberate mass campaigns against the bureaucracy (Woo, 1994, p.305; Cao et al., 1997, pp.28–31).

Of these factors, (a) and (b) only could be part of the general economic theory of transition. Both were consistent with a shock therapy approach. The remaining factors

were specific to the Chinese economic state of affairs and could not be part of an overall economic model. The different strategies implemented in China and in Russia and Eastern Europe were due mainly to the varying economic problems confronted. The Chinese reform strategy was a traditional development issue (re-allocation of surplus agricultural labour to manufacturing), while Russia and Eastern Europe were faced with the common adjustment problem of reallocating labour from uncompetitive industries to efficient existing or new industries. It was thus much easier to establish family agriculture in China and very difficult in Russia, especially taking into account the bureaucratic obstructions (Aslund, 1993, p.96). "The fact is that economic development is easier than economic adjustment both practically and politically" (Woo, 1994, p.305). It was plausible *a priori* that a gradualist strategy was more likely to succeed in an under-industrialised country like China where there was a vast amount of surplus labour, rather than in Russia and Eastern Europe which were over-industrialised and dominated by state property (Cao et al., 1997, p.28; Rostowski, 1993, p.102). Thus, this does not mean that a gradualist strategy would have succeeded in Russia:

"the recommendation that Russia should take the same path as China amounts to telling apples to be pears. The actual preconditions must be taken into account." (Aslund, 1993, p.99)

Consequently, a successful transition could only take place via the shock therapy approach, and a gradualist one could only fail. The Chinese experience demonstrated that a gradualist approach could only be realised where special initial circumstances existed. There lies a contradiction. The shock therapy process was supposedly based on simple truths and applicable to any transition economy, independent of the initial conditions. "An economic programme can easily be adopted from the Polish experience" (Aslund, 1992, p.178). By arguing that the success of the gradualist Chinese approach was due to the specific characteristics of the economy, the universality of the shock therapy approach was undermined. The experience of China weakened the arguments of shock therapy approach. This anomaly was explained by Parker et al. (1997, p.15) who argued that in "Hungary, Poland and Russia the transition process involved structural adjustment, while in China and Vietnam it involved 'normal economic development'". Nevertheless this argument reinforces the position that initial conditions play an important role in determining the speed of the reform process, which shock therapy ignored. This argument undermines the catholicity of the shock therapy approach.

### **3 Secondary elements of the shock therapy model**

Apart from the exposition of the primary elements, the transition to a market economy also required a process by which they can be achieved. It is necessary to develop an appropriate mechanism, the secondary elements. The secondary elements should use only policy instruments consistent with the economic analysis in question, neoclassical economic theory.

#### *3.1 Price liberalisation and stabilisation*

Immediate price liberalisation and stabilisation were pre-conditions for a successful reform process (Blanchard and Layard, 1993, p.1). Immediate price liberalisation was

also required for the establishment of a hard budget constraint (Aslund, 1993, p.99). Reform of the price mechanism was necessary to allow prices to reach their equilibrium values. Impersonal market forces determined prices and not the government, which was influenced by political considerations. In this way the increased prices reduced real money balances to the appropriate level for monetary equilibrium. Given the lack of a scarcity-based price system it was infeasible to develop an effective stabilisation program. The price system had been so distorted under centrally administered socialism that it was impossible to determine which enterprises should close or continue operation. Furthermore, the valuation of enterprises could not take place without knowing the prices of inputs; this necessitated market competition. Higher prices were in the interests of society because they eliminated shortages and queues; induced greater availability and quality of goods; facilitated lower prices than on the black market; and eliminated corruption. It was better to face a single increase in prices than high and persistent inflation, since there was nothing beneficial associated with high inflation and the accompanying corruption (Aslund, 1995, pp.175, 222). In fact, prices often were lower than on the black market even though official inflation rate had increased.

In a free market environment enterprises would not be protected by the state, but would have to satisfy consumer demand by producing goods based on consumer sovereignty at competitive prices and also to compete with imports. Initially, with little competition and shortages of goods and services, it was easy to set up an enterprise that could be profitable (Aslund, 1994a, p.35). For competition to be effective the inefficient enterprises had to go bankrupt. Permanent 'rehabilitation' of bankrupt companies by the government would make a market economy impossible. The introduction of competition would also result in positive externalities throughout the state sector, since competition encouraged restructuring in the state sector.

An efficiently functioning labour market was a principal prerequisite of a successful transition (Frydman et al., 1997, p.63). The widespread indexation of wages and the large percentage of the labour force employed in state enterprises were obstacles to the achievement of stabilisation (Sachs, 1997a, p.248). State enterprises had a tendency to pay high wages based on political considerations, and restrictions on dismissing workers increased the bargaining power of workers. Thus, wages should also be market-determined, giving rise to unemployment which was part of the remedy. Furthermore, market-determined wages, complementing private ownership of enterprises, would ensure job creation. It should be remembered, as Schumpeter states, that the fundamental aspect of economic development is 'creative destruction'. Consequently, the transition process would necessarily involve some 'destruction'. However, at the beginning of the reform program, to avoid a wage-price spiral due to hyperinflation, Sachs and Lipton (1990, p.56) recommended a tax-based wage policy to encourage wage increases below the increases in inflation. For example, the Polish government initiated penalties on wage increases, the so-called *popiwek* (Balcerowicz et al., 1997, p.138), under which wages were to increase by 30% of the monthly inflation rate in January 1990 and 20% afterwards. Enterprises conceding wage increases above the norm were heavily taxed (Sachs and Lipton, 1990, p.56). Nevertheless, in market economies inflation can only be contained with some unemployment (Layard, 1993, p.15).

The immediate development of market relations in all facets of economic decision-making would result in the majority of the economic problems solving themselves. Market relations would emerge wherever central planning directives were removed. "In short, there is no plausible social argument for so-called soft stabilisation



policies” (Aslund, 1995, p.176). Empirical evidence, it was claimed was conclusive in indicating that only shock therapy was effectual in repressing inflation (Aslund, 1994b, p.70). While price liberalisation was not irreversible, it would ensure that return to the previous state of affairs would be extremely costly (Boycko, 1991, p.43). Essential supplementary policies for stabilisation were a stable exchange rate, an appropriate institutional environment and an independent central bank (Sachs, 1997a), and of course privatisation.

### 3.2 *Privatisation*

The industrial structure under the command system was inefficient, since state enterprises were inefficient and inclined to financial crisis (Sachs and Lipton, 1990, p.62). This was because of internal rent seeking and the imposition of non-economic goals upon state enterprises by governments, which were used as instruments to serve personal goals (Woo, 1997, p.306; Boycko et al., 1993, p.143). Politicians used public enterprises to achieve their political goals instead of satisfying consumer demand. Thus privatisation aimed to reduce political interference in the economy; “whatever else privatisation is supposed to accomplish, it will fail unless it succeeds in this objective” (Frydman et al., 1997, p.85). There was a need for a radical change in the property structure by reducing, restructuring, modernising and privatising state enterprises. Consequently, “until privatisation has been accomplished, the economic crisis is likely to persist” (Aslund, 1992, p.87).

Marketisation without privatisation was not considered a viable alternative. The experience of Russia, Eastern Europe and China revealed that marketisation without privatisation increased the potentiality of corruption, destabilised the economy, increased inflation and did not really increase efficiency (Woo, 1997, p.320). The undesirable functioning of state enterprises was due not only to soft budget constraints but also to the principal-agent problem.

“Privatisation in a post-communist world is not a process within which the property changes hands. Rather, it is a process within which the ‘non-owner’ or ‘quasi-owner’, the government, transfers the ‘non-assets’ to its first (initial) masters, and by doing it ‘creates’ the ‘assets’.” (Klaus, 1995, p.46)

Only through privatisation could an effective depoliticisation of the firms take place and instead of satisfying the desires of the politicians, the desires of the consumers were met (Boycko et al., 1993, p.140). Consequently, “privatisation was the means of undermining the power of the bureaucracy and achieving a disperse ownership pattern” (Aslund, 1994a, p.37).

Privatisation was a major challenge for transition economies. This was because privatisation was driven by conflicting objectives (fairness, compensation, restitution, enterprise efficiency, budgetary revenues, and employment), based on previously unknown methods (vouchers, management acquisitions, and workers buyouts), fraught with administrative complexity (thousands of small, medium and large enterprises), and within incomplete markets, within a legal vacuum, and with the possibility of corruption (Sachs, 1996, p.129).

Not all firms needed to be liquidated provided there was appropriate restructuring. Such restructuring was subject to privatisation, supporting the development of new enterprises and opening the economy to international competition (Woo, 1997).

The proposal to prepare state enterprises for privatisation through corporatisation, under the direction of the government, a popular 'transition measure' in mature capitalist economies, was not acceptable to shock therapy supporters. It was considered to be undesirable and an unnecessarily time-consuming process that would result in an extremely slow process of privatisation. The government needed to focus on establishing a framework for privatisation and not be actively involved in the restructuring of state enterprises. The government did not have the knowledge or the ability to restructure enterprises. That was the responsibility of the private owners: "winners and losers cannot be selected, *a priori* from among Poland's 7,800 industrial enterprises in the state sector" (Sachs and Lipton, 1990, p.53). Enterprises had to be privatised first and then restructured under private ownership. The private owners had a lot more information, and also the self-interest to be able to restructure the enterprise in an efficient manner. Through overseeing and changing management the creditors could ensure that management followed their directions. Consequently, the role of the government would be minimised by eliminating the distortions associated with the provision of subsidies and tariffs. Moreover, the proposition of developing necessary measures to ensure that 'perfect owners' appropriate the enterprise was senseless. The market alone could select the 'perfect owners' by using the objective yardstick of efficiency; there was no need to use any discretion. "Only a sufficiently pluralistic market can generate sound owners" (Aslund, 1992, p.75).

Labour-managed firms were out of the question. "It is a method to be avoided ... [and] threatens to discredit the very idea of privatisation among the population" (Chubais and Vishnevskaya, 1997 [1993], p.69). This was based on the traditional efficiency objections to labour-managed firms. For example, labour managed firms would find it very difficult to borrow or raise equity, since there is a natural tendency of these firms to increase wages instead of repaying the loans or dividends (Sachs, 1993a, pp.82, 83). Workers in self-managed firms could not be competent owners, since, like state enterprises, they had preserved the characteristics of hired workers without personifying any real proprietary skills and interests. In addition, the transfer of state enterprises to the workers violated equity considerations because they were only a small percentage of the whole population – some workers were lucky enough to be employed by a profitable enterprise while others were in inefficient and bankrupt enterprises. Also, from a portfolio strategy point of view, it was not in the interest of the workers to accumulate their wealth in only one enterprise (Aslund, 1992, p.87).

It was even less proper to transfer ownership to the management, which constituted an even smaller percentage of the workforce in the enterprise (Sachs, 1993a, pp.82, 83). It appeared that spontaneous privatisation was faster and less time consuming. However, the problems associated with spontaneous privatisation were not only economic but also political. The appropriation of state enterprises by managers, through spontaneous privatisation, resulted in social unrest in some cases and the political legitimacy of the government was questioned. Spontaneous privatisation would have created the unnecessarily time-consuming process of re-nationalising and re-privatising the enterprises confiscated by managers (Woo, 1997, p.313). Consequently, management should not be allowed to appropriate state property. The purchase of enterprises by either workers or management would not increase employment or managerial skills, which were necessary to improve productivity and competitiveness. Also, operating the enterprise with the same workforce or management would make it very difficult to gain capital investment and/or credit (Rondinelli and Yurkiewicz, 1996, p.150). Hence there was a

need to develop a suitable legal framework, especially 'conflict of interest' laws to prohibit spontaneous privatisation and discourage labour-managed firms. In addition, the transitional measure of transforming state enterprises into state holding companies was not desirable, as it was likely to become permanent and state enterprises would thus not be privatised (Aslund, 1992, pp.84, 85).

"Without question the Achilles Heel of the economic reform program in Eastern Europe is the state industrial sector" (Sachs, 1991a, p.28). This was due to the employment in state enterprises of a large percentage of the labour force in Russia and Eastern Europe and the emergence of an all-powerful pressure group. The workers, state managers and government bureaucrats could push for wage increases, subsidies and protection, effectively suspending the transition. To avoid discontent, the workers needed to be compensated for their loss by way of a modest amount of shares, free or at a low price, and/or seats on the board. The aim of giving a share of ownership to workers and managers was not based on ideology or justice, but rather on the need to facilitate rapid privatisation. In this way, both workers and managers were transformed into supporters of privatisation (Aslund, 1995, p.230). Therefore the challenge for privatisation was to accommodate the various claims upon state enterprises (Blanchard and Layard, 1993, p.5).

The privatisation process needed to be initiated concurrently for all enterprises, using 'across-the-board mechanisms'.

"The great conundrum is how to privatise such an array, in a manner that is equitable, swift, politically viable and likely to create an effective structure of corporate control." (Sachs, 1990, p.22)

Thus, privatisation should take place through a combination of different methods (sales, free distribution or other means); but, preferably, privatisation of industry should be through free distribution (Sachs, 1991b, p.67). Boycko et al. (1993, p.148) argued that the voucher auctions in Russia were a notable success in initiating enterprises into the private sector. By April 1995 three quarters of Russian industry was privately owned (Boone and Federov, 1997, p.180). The government should not allow unreasonable claims to frustrate the process and the process should be rapid and transparent. To achieve a fast privatisation process, the authorities needed to avoid the lengthy, laborious and costly task of case-by-case privatisation. For example, retail shops could have been privatised immediately by auctioning them under the supervision of municipal governments (Sachs, 1992, p.47). The privatisation of land was relatively painless, and high economic advantages were associated with family farms (Aslund, 1992, p.77). Such actions would have helped facilitate the establishment of a market economy, reduce shortages, improve the quality of goods and provide privatisation with a positive image (Chubais and Veshnevskaya, 1997 [1993], pp.70, 71). Aslund (1995, p.232) recommended that prices of property should reflect market value, which was possible only through an auction process in which the independent participants could bid in an open and transparent manner.

While it was not easy for the transition governments to face the political repercussions of closing down state enterprises, maintaining them (as the gradual approach suggested) would have had a negative impact on the private sector. State firms unfairly competed with private firms for limited resources, which were over-employed in the state sector, increasing the cost of production. While the closure of inefficient state firms reduced output in the short-term, it freed up resources for private firms, decreasing

the cost of production and increasing profitability. New firms were also better placed to enter the market. In the long run it was expected that output would increase in response to a reduction in the state sector (Hussain, 1994, p.270).

In this context we should not underestimate the development of new firms as a means of stimulating growth. Since the efficiency gains of privatised firms would take some time to materialise, any improvement in economic conditions in the short run would come from the establishment of new firms (Woo, 1997, p.323). The birth of a private ownership market economy would be the result of two mechanisms: 'bottom-up privatisation' in which new firms are formed, and 'top-down' privatisation in which state enterprises are privatised (Sachs, 1992, p.44). The main effect of introducing market relations was the origination of new firms, which can be used as a measure of success (Frydman et al., 1997, p.79). The increase of competition due to new firms had a major influence in depoliticising firms (Boycko et al., 1993, p.140). It also forced state enterprises to become more responsive to market conditions, increasing economic welfare. However, economic welfare could only be maximised if state enterprises were privatised (Balcerowicz et al., 1997, p.159). The development of new private firms was not a substitute for restructuring and/or privatising state enterprises (Blanchard and Layard, 1993, p.12). This is because the private sector does not develop in a vacuum; the restructuring of the state sector was crucial for the genesis of the private sector (Blanchard and Dabrowski, 1993, p.134).

The experience in mature market economies of a slow privatisation process was not relevant for the transition economies (Blanchard and Layard, 1993, p.5). The mature market economies had been served by a fully functioning capital market and a large private sector, which could assimilate the state enterprises. Mature market economies could 'afford' to be gradual in their privatisation process, which ensured 'ideal' private owners. If the Thatcherite rate of privatisation in the UK had been extended to Poland, privatisation would have taken several hundred years (Sachs, 1991a, p.29). In addition, there was a public demand for a rapid privatisation program due to the perception that whatever was not privatised would be appropriated by the old guard (Aslund, 1995, p.228).

In addition,

"if state ownership is not reduced fast enough, both political and economic failure may be the result: popular discontent with privatisation will grow and the creation of a market economy will be stalled." (Aslund, 1992, p.83)

The privatisation of state enterprises was directly connected with the other elements of the transition process: with the financial structure, the development of stock and capital markets and especially the institutional structure, so as to facilitate the restructuring of enterprises (Woo, 1997, p.308). In sum,

"in just two years, privatisation has gone from being an abstract idea of a few radical reformers to an operational fact for tens of thousands of enterprises and millions of workers – and this after seventy years of the brutal repression of private property." (Sachs, 1993b, pp.184, 185)

Consequently, privatisation and stabilisation policies were complementary (Boycko et al., 1993, p.176).

### 3.3 *Institutional structure*

The institutional structure was one of the most challenging aspects of the transition modelling process. The aim of the transition process was not only to eliminate the unreasonable distortions of the central allocation of resources, but also to establish the appropriate institutions in organising the new market mechanism for allocating resources. Participation in the market process, as the shock therapy supporters argued, was not based on the crude self-interested behaviour of getting what you want with whatever means; rather, the means you use to get what you want must be within defined rules. Thus, the transition economies required the development of an independent judiciary and an executive subject to the rule of law (Lipton and Sachs, 1992, p.259). This was in sharp contrast to the traditions of autocratic rule by the Tsarist regime and by centrally administered socialism. The process towards a market economy required the destruction of the legal and political processes of the past (Boone and Federov, 1997, p.184).

However, the development of market relations did not need to be postponed until an appropriate institutional structure was in place, since the emergence of markets did not require a sophisticated institutional structure. A simple economy did not need an advanced judicially enforced system of property rights. "Little economic or legislative sophistication is required" (Aslund, 1992, p.11). Some simple rules would be adequate; as the markets evolved, the legal system and enforcement mechanisms would evolve at the same time. In this context, since people were rational and they made efficient choices using market relations, the market outcome was always an efficient outcome. Capitalist institutions, the result of the market process, could only be efficient institutions. Government supervisory bodies are inherently inefficient in providing an effective overseeing mechanism.

Institutional change was a derivative. The most important goal was the spontaneous development of market relations through the removal of most restrictions on individual activity. While the new market relations served to aid the development of the institutional structure, the institutional structure served to strengthen the new market relations. "Indeed, the legal responses are often only effective against a background of self-enforcing market mechanisms" (Rapaczynski, 1996, p.102). Aslund (1995, p.274) declared that Russia, for example, featured a high level of economic and political pluralism that resulted in the evolution of the necessary market institutions.

The experience of the historical development of capitalist institutions was not that successful economic institutions replaced unsuccessful ones, but rather that failed institutions remained, causing unnecessary misery (Sachs, 1995b, p.56). Thus, there was a choice between creating the necessary market institutions by the government or by spontaneous market institutions. The shock therapy supporters favoured the latter, since it did not involve any coercion. As Woo (1994, p.283) argued, the experience in China "shows that a laggard legal system is compatible with a sustained growth rate of more than 8%". As well, empirical evidence by Svejnar (1996, pp.124, 125) revealed that the legal form of the enterprise (form of organisation, registration and commercialisation) was not correlated with the level of employment and wages in the Czech Republic, Slovakia and Poland.

The shock therapy process utilised market incentives to internalise the developmental process of institutions, instead of relying on the government, an external actor to the whole process. For example, with respect to environmental policy, harnessing market incentives would be the most efficient method for producers and consumers to be

encouraged to internalise any externality (Esty, 1997, p.364). Consequently, a radical reform process would not inhibit the development of the institutional structure. In contrast, the mere fact of the existence of private enterprises and market relations created the need for an appropriate institutional environment. "The evidence suggests that institutional development is stimulated by early and radical reform" (Aslund et al., 1996, p.249).

All the transition economies experienced the negative phenomenon of corruption and with it a rise in crime. This compromised the economic reform program and led to inflation, inequalities and disillusionment with the transition goals in the eyes of the people. This was because civil society was weak and disorganised (Sachs, 1995a, p.22). Of course corruption was not something new. The members of the party under the previous state of affairs used their political power for their own betterment by exploiting the country's resources, which "were nominally owned by the state and thus by nobody" (Sachs, 1995a, p.22). However, with the establishment of political pluralism corruption could not be hidden under the party shield of protection. The origins of corruption remained the same: the old guard, using the positions of power it had inherited, was able to build wealth illegally. Nevertheless, corruption was the result of implementing a gradual process instead of a shock therapy approach. For example, there was no doubt that the gradual and ill-defined process of reform in Russia induced and was often motivated by corruption (Boone and Federov, 1997, p.186). The ill-defined laws and legal procedures, the piecemeal removal of price controls, the subsidies provided by the government, the maintenance of trade barriers and the inconsistent regulations, were all the result of a gradual approach which led to the growth of corruption at every level of government. In reality, there was no reliable legal system (Aslund, 1997c, p.199).

"Such blatant increases in wealth, as well as their often dubious sources, add intense feelings of injustice to the hardships of the middle and lower classes. Indeed, that sense of injustice may well be more corrosive of confidence in democratic institutions and market solutions than the hardship itself, which many people (particularly members of the middle classes) are prepared to view as temporary." (Nelson, 1994, p.59)

The only way to avoid becoming a Mafia economy and to cure corruption and crime was, and still is, radical liberalisation (Aslund, 1995, p.170, 1992, p.174).

The governments of mature market economies and international organisations were responsible, to a large degree, for the escalation of corruption in the pluralistic transition economies. This was because of the inadequate financial support provided to the transition governments, which, due to the poor economic conditions, had to compromise with the corrupt old guard (Sachs, 1995a, p.22). Only the supply of ample financial resources by mature market economies and international organisations would have resulted in guaranteeing the success of the reform program and thereby the elimination of any corruption.

Hence, the shock therapy advocates, while prescribing an immediate transition to a market economy, argued that the market could only deliver operative institutions. Effectively and paradoxically, the shock therapy approach recommended a gradual development of market institutions. The imperative of not using government intervention in the market resulted in a contradiction in the shock therapy model. Shock therapists required the immediate destruction of the institutions of central administration that implied the establishment of market institutions by the government, thus minimising the time necessary to create institutions. In reality, the shock therapy economists were willing

to sacrifice speed in the context of institutional development, so as to not use government intervention, which they regarded as totally undesirable.

### *3.4 Monetary policy and the financial system*

Financial stabilisation was extremely important and urgent because it “is a prerequisite for social stability and for many other reforms” (Sachs, 1996, p.131). As a consequence, monetary policy was central in achieving stabilisation and liberalisation (Dabrowski, 1997 [1993], p.53). The role of the central bank had to be redefined. It must become an effective monetary authority; it could not be the provider of a soft budget constraint. Most importantly, there must be only one central bank with the effective instruments of monetary policy. Consequently, “there should be one currency, one central bank, and one monetary policy in one currency area” (Aslund, 1992, p.61).

The government and the monetary authorities had been put under intense strain due to the substantial reduction in production, living standards and the increase in unemployment. This resulted in concessions to pressure groups and increased money supply, a reduction in the exchange rate and increased inflation. “The first obstacle to stabilisation is the lack of central bank independence” (Lipton and Sachs, 1992, p.231). The money supply had increased unnecessarily due to budget deficits, extra-budgetary non-economically sound expenditure, and loans from the state banking system (Sachs, 1997a, p.244). Consequently, a restrictive monetary policy was essential, as was the establishment of a positive real interest rate. Indeed inflation was more dangerous than unemployment, as Mau (1992, p.269) pointed out.

“In sum, the reasons for easing upon monetary policy are unconvincing. Given the grave dangers of hyperinflation that remain, the government should spend less time worrying about artificially propping up the enterprises in heavy industry and the military-industrial complex. The overall social, political, and economic risks are simply too large.” (Lipton and Sachs, 1992, p.246)

The establishment of a currency board, rather than an independent central bank, would not have been a viable alternative according to Sachs (1997a, p.252). The only responsibility of the currency board is to maintain a permanent fixed exchange rate in relation to an international currency. The currency board buys and sells domestic currency for foreign currency with the aim of maintaining the fixed exchange rate. The currency board can not make any loans to the government or banking system. Currency boards were the main instruments of monetary control in the British Empire. Since 1970 currency boards have been adopted by Argentina, Hong Kong, Panama, Lithuania and Estonia. The French African Franc Zone operated as a currency board (Sachs, 1997b [1995], p.152). Currency boards experience severe problems, except in a small open economy like Hong Kong. There is a tendency for the real exchange rate to become overvalued, and the banking system becomes vulnerable to panics since the central bank cannot play the role of ‘lender of last resort’. Central bank independence, combined with a creditworthy budgetary policy, could achieve stabilisation without the strict rules associated with a currency board (Sachs, 1997a, p.252). Meanwhile, Aslund (1995, p.186) also stated that a currency reform was not considered as an alternative to establishing control of the money supply.

With regard to the large amount of bad debts accumulated by commercial banks in Russia and Eastern Europe, it was socially undesirable for the banks to default. Thus the

government had to take action in this respect. Otherwise, as long as the bad loans existed, the banking system would have been unstable (Blanchard and Dabrowski, 1993, p.145). The government needed to initiate bankruptcy procedures in which the commercial banks transformed their loans into equity. Thus the banks would take over and manage the enterprise or sell it, producing an efficient and rapid privatisation process. The alternative of writing-off bad debts would immediately make banks insolvent, losing any interest in their balance sheet and continuing to give credit to inefficient enterprises (Frydman et al., 1997, p.75). "A tight credit program was the key to ending the shortage economy, getting goods back on the shelves, and ending the extreme weakness of the ruble" (Lipton and Sachs, 1992, p.235).

A characteristic of the transition process was the large increase in inter-enterprise arrears: inter-enterprise debt increased substantially during the transition period. This was due to the fall in demand accompanied by the shortage of cash, while enterprises continued to produce at the same level (Sachs and Lipton, 1997 [1993], p.93). The development of inter-enterprise arrears was an indication of the emergence of a market economy. However, the problem was not that inter-enterprise arrears existed but rather that they were excessive (Aslund, 1995, p.209). This situation created a new 'soft budget constraint', which made it more difficult to determine the financial position of the enterprise and its creditors. In this context, there was a belief that the central bank would finance the inter-enterprise arrears; these encouraged more inter-enterprise debt. Ignoring the problem had resulted in delaying enterprise restructuring and a decline in production (Aslund, 1995, p.214). Sachs and Lipton (1997 [1993], p.93) recommended that a strategy was required to postpone repayments of arrears, stopping the accumulation of new arrears and providing a settlement of past arrears. The debts had to be converted into loans at the central bank discount rate and repaid in one year. The non-repayment of the debt should have resulted in bankruptcy, as the normal operation of the market process required. Thus, the market could solve "problem of inter-enterprise arrears" as long as the state did not intervene and distort the whole process.

The maintenance of the soft budget constraint allowed increases in wages and the employment of surplus labour in the state sector without corresponding increases in productivity, thus not facilitating the reallocation of resources to the efficient private sector. Wage data from countries of Eastern Europe revealed that there were no major differences between wage levels in the private and state sectors (Frydman et al., 1997, p.65). Implying that the wages in the state sector were not linked with productivity, since the state sector was inefficient. Another important source of finance for the enterprises was the stock market. The experience of mature market economies revealed that the stock market was an important source of finance for, and monitoring of, enterprises. The speedy establishment of a stock market was thus a very important goal, for the shock therapy advocates.

### *3.5 Fiscal policy*

The reduction of large budget deficits was required in order to eliminate hyperinflation. As the budget deficit was the main source of money creation, and hence inflationary, the reduction of the budget deficit was at the top of the agenda of any economic reform plan (Fedorov, 1992, p.105). Contracting military expenditure, extinguishing subsidies, eliminating enterprise investment financed by government expenditure and reducing state administration could easily reduce the budget deficit. In addition, the aim was to reduce



the power of the bureaucracy to sabotage the reform, with no reductions in social expenditure being necessary (Aslund, 1995, p.181). However, the reduction in the budget deficit would result in a number of inefficient firms closing down as the sources of their survival (government subsidies and inexpensive credit) were eliminated. A balanced budget – even better, a surplus (Aslund, 1992, p.66) – and fiscal responsibility were essential guarantees to new firms and foreign investors that the transition government was serious in putting its house in order. The budget deficit was directly linked to the inflation rate. The higher the budget as a percentage of GDP, *ceteris paribus*, the higher the inflation rate. “In this sense, the most important step towards monetary stabilisation is, in most cases, not really monetary policy, but fiscal policy” (Sachs, 1997a, p.249). That was why the IMF and other international organisations recommended that the transition economies substantially reduce the budget deficit. Meanwhile the reduction in the budget deficit would result in a substantial reduction in the resources available to alleviate the short-term negative consequences of the transition program, such as unemployment and the reduction in living standards. Sachs (1994, p.6) argued that while reducing the budget deficit could reduce inflation, altering the way in which the deficit was financed could also decrease it. Inasmuch as the budget deficit was financed by foreign financial resources (such as foreign borrowing, grants, aid) it would not have resulted in inflation.

With respect to the tax structure, there was a need for the introduction of new taxes consistent with the market process such as value added and income tax, instead of taxes on the profits of state enterprises under the old regime. Boone and Fedorov (1997 [1995], p.179) recommended that a tax reform in a transition economy should incorporate: specifying the concepts of income, costs and profits; introducing income taxes and reducing taxes on state enterprise profits; ending double taxation and lowering value-added taxes; increasing property taxes; removing export duties and many import tariffs; and introducing accelerated depreciation. Consistent with this was the elimination of subsidies to state enterprises and the reduction of public investment spending (Sachs, 1997a, p.246). The central government needed to decentralise its responsibilities, shifting them to the local governments. There was a strong trend to increase the power of local governments (Sachs, 1997a, p.255). In this context, it was reasonable to recommend that local governments administered local taxes, which financed their expenditure programs.

### *3.6 International trade and foreign aid*

The mature market economies had an opportunity to consolidate market capitalism as a global economic system, creating a law-bound and affluent international system by integrating the transition economies into the global market system. On the other hand, after a long period of self-imposed isolation, the transition economies had the opportunity to be part of a highly integrated and interdependent global economy (Wang, 1996, p.21). The breakdown of COMECON was expected to result in a substantial decline or even a total collapse of trade. However it also forced the enterprises to restructure. From the shock therapy perspective on transition, “the collapse of the old intra-FSU trade flows was both inevitable and desirable” (Aslund, 1995, p.112). The establishment of national currencies and free trade with free prices were essential to achieve stabilisation (Granville, 1997 [1995], p.114). With the introduction of market relations the artificial

nature of the old trade pattern was revealed. There was no incentive for the firms to pursue trade, which was not profitable.

“There is hardly any reason to maintain such irrational trade, and the endeavours of governments should be oriented toward facilitating this momentous change rather than trying to force artificial life into moribund trade.” (Aslund, 1994a, p.35)

Nevertheless, the rapid removal of trade barriers, and implementing policies, which encouraged direct integration of the transition economies with the international economy, would bring large and immediate benefits and unleashed previously oppressed entrepreneurial activities. International trade was considered a means for encouraging efficiency, introducing competition into domestic markets, and increasing the availability of goods (de Menil, 1997, p.257). In fact, the transition process was a combination of marketisation and internationalisation of economic affairs (Smith, 1996, p.135).

The liberalisation of international trade and the establishment of a convertible exchange rate were among the most important prerequisites for successful capitalism (Aslund, 1995, p.174). Essentially, “convertibility and external liberalisation are natural bedfellows” (Sutela, 1992, p.89). Both would provide the immediate benefits associated with competition, that is, increasing efficiency via increased specialisation and providing an effective instrument to combat monopolistic behaviour through the establishment of scarcity prices. Limitations on international trade, such as tariffs, trade licences and quotas, should be eliminated. The exchange rate should be liberalised at the same time as domestic prices, reaffirming both the complementary nature of economic policies and the need for a shock therapy approach. The traditional arguments that devaluation would not stimulate exports and only increase the price of imports, that trade liberalisation resulted in unemployment, and that protectionism should remain, have no empirical basis. “These arguments were false for Latin America, and they are false for Eastern Europe” (Sachs, 1991b, p.67). Sachs (1997a, p.249), Aslund (1995, p.183) and Sutela (1992, p.92) were in favour of a pegged exchange rate at the start of the stabilisation programs, and then a more flexible rate after one or two years.

In the case of Russia and Eastern Europe, there was no urgency to show concern about the highly monopolistic internal market structure because domestic firms were small participants in the international arena. Prices were extremely distorted. If monopolistic structures were to remain, resource allocation and social welfare needed to be improved due to the introduction of a rational price system (Boycko, 1991, p.40). Consequently, the monopoly industrial structure could not be used as an argument against privatisation (Shleifer and Boycko, 1993, p.77). International competition would have facilitated the establishment of market relations before the elements of the transition process existed. The liberalisation of trade also would have enabled access to technology and facilitated integration with the mature capitalist economies. Foreign direct investment would be encouraged as long as the traditional conditions existed: political stability, free markets, an appropriate legal environment and stable and a convertible currency (Aslund, 1992, p.58). These conditions could only be achieved by using the market mechanism. As already argued, the development of an institutional structure based on self-enforcing mechanisms would be able to entice foreign investment.

The role of the mature market economies was to provide direction, influence and vision for the transition economies, as well as plentiful financial assistance. "A broader framework of co-operation would be needed during the process of reintegrating Russia in the world system" (Lipton and Sachs, 1992, p.264). Transition economies had much to gain from joining international economic institutions, such as the IMF, World Bank and the World Trade Organisation (WTO). Such organisations promoted among their ranks free trade, free trade and capital flow, harmonisation of law and commercial practices, joint ventures, institutions and policies consistent with free market relations and political pluralism which all contributed to political stability. WTO membership particularly would have facilitated integration into the world economy for the transition economies. More specifically, the WTO would have been able to provide some form of protection from trade barriers by other countries, maintained free trade under the pressure of sectoral interests, and strengthened international market entry. Meeting the membership requirements also would have increased economic efficiency by removing non-tariff barriers, reducing distortions to trade, eliminating state trading and reducing tariffs (Wang, 1996, p.23).

The restoration of trade between transition countries through the so-called 'free trade arrangements' was not desirable. This was because limited administrative resources could have been allocated away from the main goal of integration into the international economy. Wang (1996, p.23) argued that the creation of a regional trading block would be a fruitless exercise, since estimates showed that most of the international trade generated for transition economies would take place with mature market economies and not between transition economies. There were very few analogies between the former Soviet Union and post-war Western Europe to justify the establishment of a payments union. Post-war Western Europe would have been in a better economic situation if convertibility had taken place a lot earlier (Aslund, 1992, p.27). Consequently, the only sensible alternative was the establishment of independent convertible national currencies. This had distinct advantages over a payments union because it created the preconditions for stabilisation and there would be a monetary authority responsible for monetary policy. The financing and liquidity problems for interstate transactions would be solved easily. Mistrust would be removed since enterprises would be dealing directly and make payments straight to each other. "Convertibility would naturally render trade and payments multilateral and was by no means unattainable" (Aslund, 1995, p.113).

The role of the World Bank was to assist the restructuring process by financing projects associated with military conversion, financial services, communications and transport. Loans were provided conditionally, to individual enterprises, that were either private or in the process of privatisation (Lipton and Sachs, 1992, p.263). The role of the European Union and the Association Agreements was extremely important. "In the case of the Central European countries, the European Community is a natural counterpart in the medium term for problems of structural reform" (Lipton and Sachs, 1992, p.264). These agreements secured free trade with the European partners and thus initiated free trade policies. Becoming a member of the European Union was a process that would have guaranteed improved living standards for transition economies, as long as market forces led the reform program. For the transition economies, rapid accession to the European Union would have expanded regional integration, provided a tight framework for the continuing reform of the institutional structure and public sector management, and stabilised investor expectations regarding the long-term growth prospects.

Foreign aid should be selective and provided only to countries pursuing radical market and democratic reforms (Sachs, 1995b, p.62). The international organisations and the G-7 should be willing to finance the budget deficits of transition economies, as long they were committed to producing real financial stabilisation. Foreign aid should be limited in time to avoid it being used as a substitute for necessary economic reform (Sachs, 1993a, pp.27, 28). In addition, foreign aid should not be a substitute for private capital inflow. Hence foreign aid must be provided very carefully so as both to facilitate the reform process simultaneously to reduce the need for it. "Indeed, ill-conceived or premature lending can create large external debts that complicate subsequent reforms" (Wang, 1996, p.21). Foreign assistance required a large mobilisation of resources by mature market economies and international financial institutions, through a joint effort.

According to the Economic Commission of Europe (ECE) in its Economic Survey of Europe for 1993–1994 (1994), the reasons for 'slow disbursement' of financial assistance to transition economies varied from case to case. IMF and World Bank funds were only released to countries that demonstrated their commitment to economic programs for standby credit or showed progress towards Systemic Transformation Facilities (STF). According to the Commission, most countries either failed to adopt an economic program approved by the IMF, were unable to meet periodic performance criteria for the release of scheduled tranches, or could not satisfy development bank conditions. For example, the World Bank's funding to Eastern Europe declined in 1993 (ECE, 1994, p.133). The Commission attested it was not certain whether the inability of these countries to access these funds contributed to their inadequate economic performance and thus, their failure to meet the conditions set by the financial institutions. However, I believe it is obvious the IMF's stringent conditions could not be met and foreign assistance would not be forthcoming, leaving the shock therapy governments to flounder along their own paths of political demise.

Lipton and Sachs (1992, pp.263, 264) stressed that domestic savings and foreign aid would be inadequate to finance economic development. It was foreign direct investment, which would be the major source of transfer of resources, technology, managerial skills and connections with foreign enterprises. Capital inflow was linked to privatisation, since countries without rapid and vigorous privatisation programs were likely to have a very small capital inflow.

"Having noted this, however, we must be realistic about the timetable for significant foreign capital flows, which will only come about on a large scale after a few years of successful reform ...." (Lipton and Sachs, 1992, p.264)

However, foreign investors should not receive any special treatment, because a discretionary measure like this would only result in distorting the market outcome. This was in contrast to the practice of the shock therapy process in Poland, where foreign investors were provided with compensation guarantees for nationalisation, preferential income tax rates and tax holidays (Rondinelli and Yurkiewicz, 1996, 151).

### *3.7 Social policy*

It was important to realise that the specialised human capital of middle-aged and older workers, who were not in demand in the new economic conditions, plus their small potential for retraining, meant that they should receive financial assistance. Younger

workers would be expected to bear the burden of this transfer. However, a retirement scheme had to be developed in which retirement income was directly dependent on the worker's contribution to the retirement fund, to avoid the long-term consequences of fiscal deficits. Nevertheless, income inequality did not increase substantially, as the critics of shock therapy argued. In Russia in April 1993, income inequality was no greater than in the UK, and a lot less than the USA (Illarionov et al., 1997 [1994], p.142). Shock therapy economists were not surprised by the link between the speed of the reform process and the reduction in life expectancy. While changes in life expectancy varied between transition countries, they were inversely related to the speed and depth of reforms (Sachs, 1996, p.131). In the Czech Republic, Poland and Slovakia, which introduced a shock therapy approach, life expectancy rates continued to increase during the transition period. However it was a different scenario in countries, which introduced a gradual approach such as Hungary where life expectancy was reduced and the Ukraine where it plunged (Sachs, 1996, p.131). The inflation caused and maintained by the gradual approach, increased stress, making life unpredictable, and more people were confronted with difficulties, which they could not manage (Aslund, 1995, p.288).

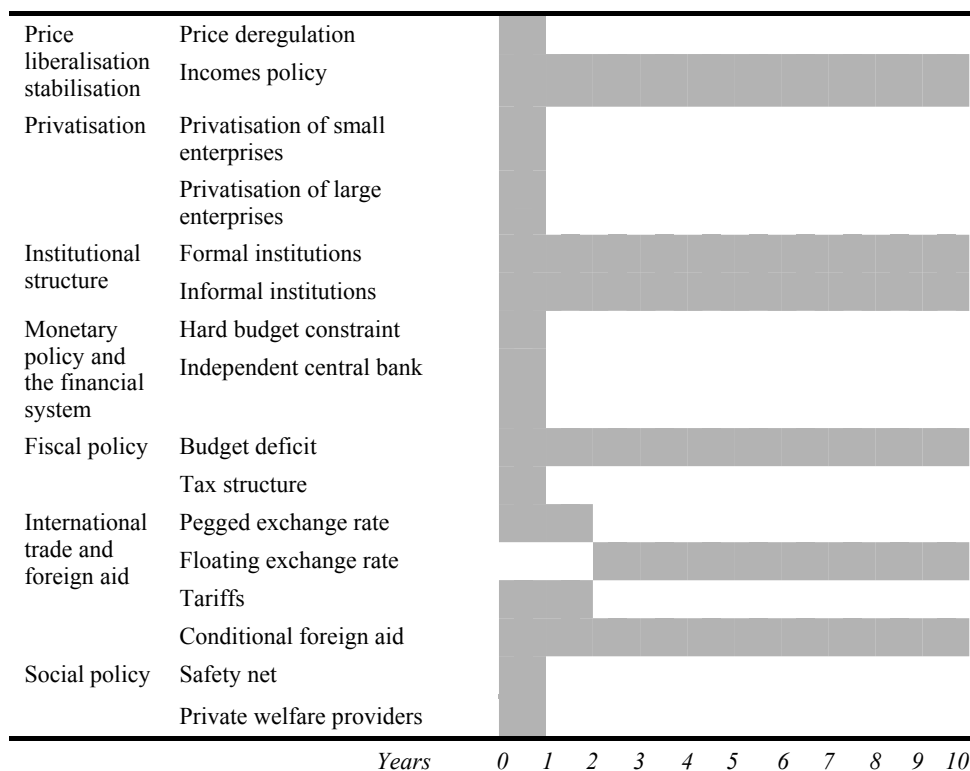
The provision of government assistance was directly linked to the culture and the perceptions of the people about the role of the state in society. For example, in the Czech Republic unemployment was often viewed as the fault of the individual rather than society. This resulted in a substantial reduction in demands for financial assistance. The Czech Republic has one of the least-generous safety nets in Eastern Europe (Frydman et al., 1997, p.67).

Before the transition process started it was predicted that a social disaster would take place due to the extremely high social cost involved. But this did not come about (Illarionov et al., 1997 [1994], p.156). The transition economies had the means to overcome a social disaster. However they did not have the means to maintain the shock therapy process.

#### **4 The process of transition**

Even though the shock therapy process implied an immediate liberalisation of markets, as we can see from Table 1, there were some elements of the transition program that had to be introduced gradually. As such, the necessary institutional structures, both formal and informal, could only have been developed gradually. In addition, a balanced budget could only have been achieved after the maintenance of budget deficits funded by foreign aid. A fully convertible exchange rate could only have been implemented after maintaining the pegged exchange rate and tariffs for a short period of time. An incomes policy had to be maintained throughout the transition process.

**Table 1** The shock therapy process of transition



## 5 Conclusion

The aim of the shock therapy model was to remove social obstacles driven by anti-social self-interest. The result would have been a free market, free enterprise economy, which, as the supporters of the model argued, in the long run guaranteed full employment, stability and growth. With regard to the associated costs of the reform process, “these costs are exaggerated; for that reason, a generalised social explosion is unlikely to derail the reforms” (Lipton and Sachs, 1992, p.216). In addition Woo (1994, p.290) argued that “recently available data suggest that the initial estimates of the economic costs of the shock therapy have been overstated”. Consequently,

“the more radical a reform has been in these terms, the smaller the fall in total output, the earlier the rise in output, the smaller the decline in standard of living, and the more even the income distribution. Only the rent-seekers benefit from slow reform, while there are definitely no socially beneficial effects arising.” (Aslund, 1997b, p.186)

The shock therapy model assumed large debt cancellations and large financial assistance in the form of grants and long-term loans. Instead, foreign aid was substantially below the necessary amounts, and in the form of export credits. Meanwhile financial support by mature market economies was modest, if not totally inadequate. It was estimated that the Soviet Union would have required about \$30 billion annually in the first two years of

the reform process and then \$20 to \$25 billion in each of the third and fourth years (Sachs, 1992b, p.215). In 1995, Russia received roughly \$380 million in aid from the USA, that is, one-sixth of the aid to Egypt (Sachs, 1995b, p.57). Sachs (1991a, p.31) was adamant with regard to the need of financial aid provided externally:

“Passing through the valley of tears requires first and foremost, political leadership, and second, enough social consensus to sustain a stable set of policies. But even Moses and the Israelites would not have made it through the wilderness without some manna from heaven. External assistance can be vital in the perilous first years of change. And Moses did not face re-election for forty years (though he certainly faced a leadership challenge at the base of Mt. Sinai).”

The shift to gradualism took place in Poland on the 19 September 1993, in Russia on the 12 December 1993, in Bulgaria on 18 December 1994, in Estonia on 5 March 1995, in Czech Republic on the 1 June 1996 and in Latvia on the 25 July 1997. In all cases, this occurred after unfavourable election results for the shock therapy governments. Below is a summary of how the shock therapists fared in Eastern Europe and Russia:

- *Poland.* The Mazowiescki government and to a lesser extent the Suchocka government, with the support of the President of Poland, L. Walesa, implemented the shock therapy approach. The growing dissatisfaction over the reforms, which failed to attract adequate foreign financial aid, resulted in the both governments losing early elections to gradualist coalition governments. Walesa also lost the presidential elections; he was a victim of the implementation of the shock therapy approach in a democratic environment without substantial foreign financial support.
- *Czech Republic.* The implementation of shock therapy by the Klaus government, without any substantial foreign assistance, resulted in the loss of its majority in the parliament after only one term in office. Klaus managed to remain in power but the minority government had to substantially alter the shock therapy program in order to retain its position. Ultimately Klaus was forced to resign, signalling the end of the shock therapy process.
- *Bulgaria.* The democratic process in Bulgaria did not facilitate the implementation of the shock therapy approach. It has been stressed that the shock therapy process required a strong government to be able to implement the necessary reforms. This was not the case in Bulgaria. The lack of foreign financial assistance made it impossible to enforce immediate reforms.
- *Russia.* Shock therapy was short-lived in Russia. The Gaidar-inspired government lost the support of the public and Yeltsin because of the social impact of the reforms. The foreign financial aid was not adequate enough to encourage public support for the Gaidar program. The disappointing election result forced Gaidar and his fellow reformists in the government to resign, putting an end to the shock therapy process.
- *Albania.* Due to inadequate financial support, the shock therapy approach was introduced together with authoritarianism. With the violent overthrow of Berisha, and hence the shock therapy approach which was directly linked with authoritarianism, the reform process was discredited. Gradualism was the natural course of the new government.

- *Estonia*. The sharp decline in living standards to an unacceptable level prompted the Estonians to oust the Mart Laar government, which had pursued a shock therapy model of transition with limited foreign financial assistance. An alliance of impoverished peasants and unskilled workers, the prime victims of the free market and liberal foreign trade regime defeated the Mart Laar government.
- *Latvia*. Latvia was the only notable exception. It was able to sustain the shock therapy process and the government managed to remain in power after the elections. The Latvian case highlighted the crucial role of foreign aid, as well as authoritarian rule. Latvia benefited from a total of 131.9 million SDRs from the IMF while Estonia received 65 million SDRs and Albania, 62.4 million SDRs. In other words, Latvia received more financial assistance than Estonia and Albania combined, despite being similar to Estonia in terms of population, size and level of industrialisation. The IMF justified the large amount of aid because it considered Latvia was a country displaying “a remarkable degree of stability” (ECE, 1993, p.233). This implied that both the Birkavs and Skele governments implemented a reform process consistent with IMF guidelines. As a result, Latvia was able to sustain the burden of the reforms because of the level of foreign assistance under authoritarian rule. Foreign aid was able to maintain the authoritarian rule for some time. However, authoritarian rule does not last for long and in Latvia, the Skele government only lasted five months before it was forced to resign under serious accusations of corruption. This also highlighted the problem associated with the provision of ample financial assistance under authoritarianism to facilitate transition; it encouraged corruption. Thus, as of August 1997, when Skele’s government resigned and Krasts’s government took power, the economic reforms slowed dramatically. The social costs of sustaining the reforms made it very difficult to balance the budget and to privatise state enterprises, thus allowing the government to create a budget deficit.

Hence, as a political strategy, shock therapy turned out to be suicidal for the governments that launched it.

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