THE POLITICAL ECONOMY OF SHOCK THERAPY

John Marangos

University of Ballarat and Monash University

Abstract. The collapse of the centrally administered economies gave rise to a transition process towards economic systems based on market relations. Nevertheless, the transition process is not restricted to the economic field. The political and ideological aspects of the transformation are fundamental. As such an analysis of the shock therapy model requires the exposition of what I define the primary elements of the shock therapy model which are: 1) The body of economic analysis used by the shock therapy model. 2) What structure of society the shock therapy model desires to achieve? 3) The speed of the reforms. 4) The political structure consistent with the model. 5) The consistent ideological structure. After the identification of the primary elements of the shock therapy model the next step is to identify secondary elements, the desired changes with respect to: 1) Price liberalisation-stabilisation. 2) Privatisation. 3) Institutional structure. 4) Monetary policy. 5) Fiscal policy. 6) International trade and Foreign Aid. 7) Social policy. The analytical framework developed makes possible to understand the shock therapy model from a new and more enlightening perspective. We are better able to comprehend the complexities involved and the disagreements about the reform process.

Keywords. Economics of transition; shock therapy; central administration; political economy.

1. Introduction

The shock therapy model derived its name from Poland's stabilisation and liberalisation program, initiated on 1 January 1990, which became known as shock therapy or Big Bang. The countries that followed with the shock therapy approach 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).

An analysis of a transition model, in this case the shock therapy model, requires the exposition of what I define as the primary elements of the shock therapy model:

1. The body of economic analysis used by the shock therapy model.
2. What is the structure of society that the shock therapy model wants to achieve?

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3. The speed by which the reforms must be implemented.
4. The political structure, which is consistent with the shock therapy model.
5. The ideological structure which is consistent with the model.

Based on shock therapy analysis of the political, economic and ideological structure of capitalism, as the tradition of political economy requires, suggested that capitalist societies develop the necessary institutions to achieve a free society. A self-interest ideology under a market system accompanied by political freedom ensures faith in individual actions. Economic freedom is reinforced by political freedom, and both are stimulated by an ideology of self-interest. The economic system which they favour is 'as if' in competitive capitalism, and neoclassical economic theory is used as an instrument to achieve their goal. The supporters of the shock therapy model argued that the elements of the model would ensure growth full employment with low inflation and stability. In summary, the shock therapy model is a neoclassical model of transition advocating the immediate implementation of the necessary reforms to establish a free market process.

The transition to a market economy, required not only the exposition of the above mentioned primary elements, but also a process by which these primary elements will be achieved. Thus what remained was to develop an appropriate mechanism, that is the secondary elements, by which the desirable primary elements would be achieved. It should be remembered that the secondary elements of the shock therapy approach should use only policy instruments consistent with the neoclassical theory. The next step is to identify the secondary elements, that is, the desired changes with respect to:

1. Price liberalisation-stabilisation.
2. Privatisation.
3. Institutional structure.
4. Monetary policy.
5. Fiscal policy.
6. International trade and foreign aid.
7. Social policy.

The analysis of the secondary elements of the shock therapy model of transition revealed that the shock therapy supporters recommended: immediate price liberalisation; minimum state intervention; an institutional structure as a product of market forces; an independent central bank; a neutral tax system and a balanced budget; free international trade and a fully convertible currency and a safety net. The transition process demanded the introduction of a package of measures, containing most of the required reforms, which should been approved by the political process and introduced immediately. Correspondingly, the reform process was not only an economic challenge but also a political challenge (Sachs and Lipton, 1990, p. 62–3). In this way, the reform program would be credible and would win the people's support. The analytical framework developed in this paper makes it possible to understand the transition process, in particular the shock therapy model, from a new and more enlightening perspective. We are better able to comprehend the complexities involved and the disagreements between economists about the appropriate process of reform.

2. Primary elements of the shock therapy model

2.1. *Economic analysis*

The economic analysis used by the shock therapy model is neoclassical marginalist economic analysis. Consequently, as long as there are no impediments in the operation of the market process, allocative and productive efficiency is always achieved.

2.1 *What is a good society?*

The history of civilised societies is viewed by neoclassical economists as a timeless effort to enhance freedom. This effort is concentrated on structuring all spheres of life and developing institutions, which facilitate the achievement of the freedom of the individual. Freedom must be viewed as a whole, and anything that reduces freedom in one aspect of life is likely to reduce freedom in other parts as well.

Individuals are rational and as such they have an explicit and complete set of preferences, which they order, based on individual priorities. Individuals express their preferences through the market process, which is a reflection of their values. Preferences and values are one and the same thing, since only the individual can express preferences and 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.

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. 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 co-ordination mechanisms, which can be harmoniously combined in any proportions. Indeed planning can only eventually lead to coercion. This is because discretionary power is exercised by politicians responding to pressure groups with the aim of getting re-elected by using their position of power which they exploit with the aim of extending, sustaining and abusing their privileged position.

Private property is the foundation of economic freedom and an essential ingredient for the efficient operation of the market. The state should be reduced as much as possible to a minimum. However, we need to point out 'that even the most market-oriented economies are not strictly laissez faire' (Sachs, 1995b, p. 52). This will involve providing law and order, institutions, providing fiscal and monetary balance, infrastructure to protect the environment, and promote public health and education and the safety net (Aslund, 1997c, p. 20). Moreover, there is a role for state property wherever there is market failure. Nevertheless, the existence of market failure does not automatically require government action, since there is also government failure. Private alternatives should be sought first.

Hence, the shock therapy economists are in favour of an economic system based on private property, free market relations and individual material incentives. As such an approximation to competitive capitalism is feasible and desirable. Consequently we would expect that the recommended transition program would initiate changes in the centrally administered economy, which would aim to achieve an economic system based on the aforementioned elements. Thus the reform program can be assessed on whether or not this ultimate goal was achieved.

2.2. *Speed*

The shock therapy model highlights the interdependence, mutually supportive and interactive character of economic relationships, and as such reforms should be introduced simultaneously. Fragmented changes could not succeed, inasmuch as the individual elements of the reform program were supportive elements of the total reform program. The only possible way to introduce the necessary transition reforms was by introducing them at the same time, simultaneously, in one shot; as one Polish economist, quoted in Sachs (1990, p. 19), had argued 'you don't try to cross a chasm in two jumps'. The program has been described as a 'leap to a market economy' (Sachs and Lipton, 1990, p. 48) and as 'jump to a market economy' (Sachs, 1993a). This was the reason why the reform program is known as 'shock therapy' or 'big bang'.

Based on 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; a convertible currency was impossible without opening the economy to international competition; 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, 1997d, p. 187). Countries experiencing such severe macroeconomic imbalances as the transition economies could not afford to reform slowly. 'They need a strong dose of medicine quickly' (Thomas and Wang, 1997, p. 223). However the implementation of microeconomic liberalisation without macroeconomic stabilisation would had been a shock without therapy (Woo, 1994, p. 278). Thus macroeconomic and microeconomic reforms must go conjointly (Sachs, 1990, p. 21). This was why the reform program needed to be sweeping and expedient. Both the economic and political situation required a rapid and comprehensive reform (Lipton and Sachs, 1990, p. 99). As such, '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).

It was senseless to wait, according to the shock therapy model, until everything was in place, since each element of economic program was equally important and constituted part of the whole reform program. Jeffrey Sachs, stated that 'Poland's goal is to establish the economic, legal and institutional basis for a private-sector market economy in just one year' (Sachs, 1990, p. 19). It was preferable to employ one shock instead a series of shocks over a prolonged time period (Dabrowski, 1997, p. 47). Of course the transition process was to last for years; however, the goal was to implement the necessary foundations of market economy as rapid and consistently as possible (Aslund, 1997c, p. 16). 'A macroeconomic stabilisation is best undertaken as a sudden change, breaking inflationary expectations' (Aslund, 1994a, p. 36).

The negative consequences associated with the transition program such as the reduced living standards and the rise in unemployment could be minimised as long as the reform program was comprehensive and consistent. The transition countries should bear the necessary recession and endure the radical reform because in the long run the economic growth prospects were guaranteed (Sachs and Lipton, 1990, p. 63). Otherwise, the length of output reduction would be extended unnecessarily (Sachs and Woo, 1994, p. 274). The speed of the transition process would be negatively correlated with the continuance of output decline and positively correlated with the intensity of output recovery (Parker, Tritt and Woo, 1997, p. 14). Official data tend to overstate the decline in output and could not capture the benefits associated with increased quality products and the eradication of queues (Balerowitz, Blaszczyk and Dabrowski, 1997, p. 139). The negative outcomes were not the result of the reform process as such; rather they were due to the inconsistencies inherited by centrally administered socialism. As such, there was no foundation for the critique of the shock therapy process, the criticism was 'politically motivated rather than analytically sound' (Lipton and Sachs, 1992, p. 214). In fact, radical reforms would result in lower fall in output ceteris paribus (Aslund, Boone and Johnson, 1996, p. 236).

A gradual process of transition was undesirable because it ignored the links between reforms, increased transition costs, damaged the credibility of the process, restricted individual behaviour and allowed the formation of special interest groups. 'Slow reform, because it fails to take advantage of these complementarities and positive externalities, has not proved superior to radical reform' (Aslund, Boone and Johnson, 1996, p. 252). It also curtailed economic transformation, since the dynamism of 'creative destruction', that is the replacement of non-viable enterprises with modern and efficient ones, would be subdued.

By maintaining distorted prices and entry barriers, as the gradual process recommends, could only encourage activities such as speculation, diversion of state supplies and corruption. Gradualism would result in an environment of ill-defined property rights, badly operating markets, distorted investment and the growth of an uneven distribution of wealth, all of which seemed inevitable (Aslund, 1995, p. 267). Correspondingly, partially liberalising prices would reduce social welfare (Boycko, 1991, p. 41–2). Fedorov (1992, p. 108), who initially supported a gradual approach, changed his mind by arguing that a gradual reform was politically unacceptable. He became one of the most important spokespeople in Russia in favour of shock therapy.

The transition process is mostly a political problem rather than a social or even economic one (Sachs, 1993a, p. xiii). 'The real question for Russia, in our opinion, is not primarily one of economic strategy, but rather one of political management of economic reform in the next few years' (Lipton and Sachs, 1992, p. 215). 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, increase 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 put pressure on the government to avoid the closure of their firms by demanding discretionary policies. The newly-formed governments, being relative inexperienced in dealing under these circumstances, and being concerned for 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 were fragile; this was 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, Shleifer and Vishny, 1993, p. 181).

While the problems associated with the transition process might be grave 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 had 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, 1997d, p. 186). However, many elements of the transition program did have general application across economies with immensely different initial economic and political environments (Woo, Parker and Sachs, 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).

2.3. *Political structure*

It was apparent that a successful financial stabilisation and structural adjustment would be inconceivable without a change in the political structure (Fedorov, 1997, p. 125). In line with neoclassical economists the shock therapy economists are in favour of political pluralism, which is consistent with market relations, that is, economic pluralism (Marangos, 1997, 1999). Pluralism is an agreement to tolerate different views and aspirations and simultaneously to set limits to them through the constitution, institutions and the market process. Pluralism recognises the non-identical views of all citizens. For the shock therapy supporters, an important element of the transition process was the establishment of a democratic process of decision-making; this was achieved, for example in Russia since now it is a democratic society (Aslund, 1995, p. 273). However the question arises as to whether democracy is consistent with the shock therapy approach. Shock therapy supporters argued that 'for transition economies democratisation seems to be a necessary condition for a successful change towards a market based economic system' (Aslund, 1994b, p. 63 and 1997c, p. 14); 'the market revolution has gone hand in hand with a democratic revolution' (Sachs, 1995b, p. 50). The justification was that democratisation was essential for the transition process, since it immobilised the transitional rent-seeking of the old elite by establishing new institutions to eliminate the power of the old elite and at the same time yielding the new policies credible (Aslund, 1994a, p. 31). Otherwise, without democratisation civil society would be weak and the power of the old elite substantial, compromising the reform process and transferring power to the antidemocratic establishment (Aslund, 1995, p. 11). Therefore, 'the transition process is dependent on how well developed civil society is, because the better developed it is, the sooner other, more representative forces will defeat the state managers (Aslund, 1992a, p. 63). Aslund (1992a, p. 169) summarises the need for democracy based on the achievement of credibility and legitimacy, to fight vested interests so that 'economics must gain superiority over politics'. Thus 'democratisation can be strongly complementary to economic reform' (Aslund, Boone and Johnson, 1996, p. 227). Correspondingly, the goal of the transition economies should be to establish a democratic society as rapidly as possible (Aslund, 1994b, p. 64).

In my view, a democratic political process was inconsistent with the shock therapy process of transition. This is because democracy requires the continuous responsiveness of the government to the preferences of the members of society. Policy-making reflects the variety of preferences and interests of the members of the society. The common will is not laid down in an authoritarian or totalitarian manner by the state but is determined through a plethora of different opinions which are freely discussed. Provided they find majority support they can be put into effect (Bracher, 1989, p. 231–44). The shock therapy model of transition to a market economy can only be consistent with a 'light' government (Walters, 1992, p. 101), not a democratic one. 'Democracy is neither necessary nor sufficient for good economic performance' (Intriligator, 1998, p. 241).

The government in transition economies could not rely on requests for faith, patience and calm. Radical economic reform had to go ahead, based on some simple and specific principles, and as such did not require input by the members of society. The electoral process also posed the most severe threat to the reform process, since voters could be easily hijacked by politicians with illusory promises. Within the democratic process, the ultimate aim of any government is to survive in political competition with alternative political parties. This would certainly result in the newly-formed governments in transition economies succumbing to the pressure of political opinion to reduce the necessary negative outcomes of the reform program.

Hence, the shock therapy supporters argued, there should be no political interference, and the reform process should be implemented independently of the political process. The program must be implemented consistently in spite of criticism and without favouring anyone; everybody must follow the basic rules. This could only take place by stripping the government of its discretionary power and assigning it the responsibility of maintaining the rules written in the constitution in the tradition of Friedman (1962, 1980). Consequently, the shock therapy model is consistent only with a non-elected government, which does not exercise discretionary power instead of one, which is democratic but intervenes in the market, distorting and thus withholding the attainment of a free market. Shock therapy supporters were implicitly in agreement with Walters (1992, p. 101) when he stated, referring to the transition economies, that 'we should not claim democracy as either sufficient or even necessary for a liberal society with a market economy'.

I agree with Woo (1994, p. 289) that 'we think that it is wrong, or at least premature, to claim that political liberalisation undermines economic reforms'. Political pluralism did not undermine the shock therapy program; democracy did, as experience demonstrated. Shock therapy supporters are not willing to admit that a democratic process undermined the shock therapy transition model. The implicit 'assumption is that correct economic theory must subordinate democracy' (Glasman, 1994, p. 79). Correspondingly, 'the processes of liberalisation and democratisation in the society will survive only if they are completed by a strong executive power that exerts control over the entire Russian Federation. I believe that this power is not only desirable, but inevitable' (Mau, 1992, p. 273). Strangely enough Woo (1994, p. 306) concluded his paper with the statement that, 'the effective one-party rule in Japan, Korea, Singapore, Malaysia, Indonesia, and Taiwan are testimonies to the compatibility of a market economy with many political forms'. This implies Woo preferred one-party rule, which is consistent with the shock therapy approach.

2.4. *Ideological structure*

With respect to the ideological structure, neoclassical economists have developed an ideology, which emphasises political and economic freedom and encourages self-interest and self-help. Market power is the consequence of use by the state of its discretionary power. If this discretionary power does not exist, individuals will behave 'as if' they are in competitive capitalism. Hence the state should play a minimal role; it should be a 'minimal state' and the constitution should allow it to act only where there is market failure. It should also provide a 'safety net'. However, justice does not mean equality of income distribution; rather justice means equal treatment by the state, that is, everyone's entitlement to basic human rights and equality before the law, rejection of all privileges based on class, colour, religion or gender. Thus the ideological structure should encourage pluralism consistent with market relations and the political structure.

Shiller, Boycko and Korotov (1992) argued that empirical evidence strongly revealed that there were no notable differences between Americans and Russians with respect to economic risk and incentives. The argument that Russians would not be able to respond immediately to market opportunities due to the suppression of the entrepreneurial spirit did not have any substance. ‘Predictions that people had forgotten how to set up and run a private enterprise have turned out to be completely wrong’ (Aslund, 1994a, p. 35). The economic behaviour and choices are influenced by situational differences, that is incentives and institutional structure, instead of attitudinal differences. Russian consumers reacted positively to the market reforms, and their behaviour was consistent with and predicted by classical economic theory (Parker, Tritt and Woo, 1997, p. 8; Boone and Federov, 1997, p. 187). Interviews with Polish consumers revealed that the new capability of planning shopping was one of the most fascinating features of the new economic conditions (Berg, 1994, p. 397). Private enterprises increased dramatically as enterpreneurship was oppressed but still alive (Aslund, 1997e, p. 192). Consequently, self interest and self-help was replacing paternalism and statism (Mau, 1992, p. 266).

3. Secondary elements of the shock therapy model

3.1. *Price liberalisation and stabilisation*

The shock therapy economists were in favour of an adjustment approach based on prices, which involved an immediate jump in the price level. This was necessary so that investment decisions were not distorted by transitional prices. It also required the abolition of subsidies, which would result in higher prices. However, it would make available resources in the budget to finance social programs. Subsidies were highly destabilising, since they grew with inflation, increasing the budget deficit, which could not be financed (Aslund, 1994a, p. 26). Any restrictions on prices were undesirable because they disrupt the market process. Higher prices would encourage the development of new enterprises and competition, because under these conditions it would be profitable to operate. This involved freeing prices, declaring exchange convertibility, and encouraging devaluation. In this way the monetary overhang, that is, forced savings due to the inadequate supply of goods and services under the previous regime, would be eliminated. The experience of the Polish economy with full economic recovery and annual GDP growth rates of 4% ‘is testimony to the power of macroeconomic policy to induce structural adjustment’ (Berg, 1994, p. 377).

Naturally, output would be reduced, as the experience of the transition economies divulged. It was an inevitable ‘cost’ of the development of market relations (Layard, 1993, p. 16). ‘The collapse [of output] was a natural and inevitable result of systemic change and cannot be considered exogenous’ (Aslund, 1993, p. 97). It was pointed out that the goal of the transition process was 'economic transformation, and not instant growth' (Aslund, 1994a, p. 32). However, the statistical evidence is quite unreliable since it did not capture the real transformation in output. As such, improvement in quality, the elimination of queues and forced substitution cannot be revealed in a set of statistical numbers. Taking into account these qualitative transformations, it is argued, living standards have not been substantially reduced.

Inflation was totally undesirable and the most serious problem of transition (Aslund, 1994a, p. 24). It distorted the economic functions of prices and all other economic institutions thus having a negative impact on economic growth. As long as high inflation had prevailed and the more hesitant the reform, the larger the total fall in output (Aslund, 1994a, p. 33). The fight against inflation had to take place immediately. Postponing any action with the excuse that other elements of the economic system have to be in place, it 'would be like abandoning a fire to try and rebuild a house while it was still burning. Similarly, attempting to eliminate galloping inflation gradually would be like trying to put out the fire slowly' (Balcerowicz, Blaszczyzk and Dabrowski, 1997, p. 135). Consequently, there was only one viable alternative: 'a money based orthodox program' (Dabrowski, 1997, p. 50).

Shock therapy economists argued that inflation is the product of irresponsible governments, which increase the money supply to finance budget deficits, and/or the result of pressure groups which use their discretionary power to force the government to offer preferential treatment in the form of tax concessions and subsidies. Most importantly, in the transition economies inflation was the result of rent-seeking by the old elite that exploited the weakness of the state (Aslund, 1994a, p. 22). Thus the only way to eliminate inflation was by reducing the role of the government and requiring it to follow specific rules. There was no knowledge available, which permitted detailed fine-tuning of the economy, due to the lack of experience and information in the transition process. The state administration inherited by the command economy was incapable of making any informed decision; consequently the function of the state should be minimised, especially during the initial stages of the transition (Aslund, 1992a, p. 21). 'In fact the need for macroeconomic stabilisation is overwhelming, and any attempt at fine-tuning, especially at the initial stages of transition, appears not only foolhardily but positively dangerous' (Aslund, 1994a, p. 25). To assign the responsibility to bureaucrats and expect success was impossible. 'An important conclusion to draw from this experience is that the costs of such an economic transition are inevitably high; but if inflation is allowed to rise, they will be even higher' (Aslund, 1995, p. 177).

3.2. *Privatisation*

Privatisation and financial restructuring manifested the greatest intellectual and political perplexities of the entire transition program (Sachs, 1991a, p. 26 and Aslund, 1992a, p. 11).

The dominant form of ownership had to be private, and the dominant form of organisation especially for large enterprises should be a corporate structure, as experienced in mature market economies. Private ownership of enterprises constitutes the ultimate form of decentralised property rights because individuals own their equity, which is freely transferable (Woo, 1997, p. 300). Without private property effective market relations cannot exist. 'When there are no capitalists there is nobody to represent the interests of capital' (Sachs, 1993a, p. 29). It was impossible to maintain financial discipline under a soft budget constraint when state ownership dominated. In this context, private ownership of unprofitable firms was still desirable (Aslund, 1995, p. 267). However, a market economy does not prohibit any other forms of property as long as they can survive the market test.

In addition, privatisation was a means of building up popular support for the whole reform program. 'As could be expected, many state managers and workers who were initially opposed to market and political reforms became supporters after being vested with property rights in their enterprises' (Sachs, 1993b, p. 186). Political support for the reform program resulted in shrinking the power of the opponents, thus altering the balance of political power. For example, in Russia the populist character of the voucher system of privatisation preserved the whole privatisation program (Shleifer and Boycko, 1993, p. 51). Political support for privatisation would result in a positive externality in facilitating reforms in the remaining elements of the program. In addition, immediate privatisation would have stopped the reduction in living standards by workers producing goods the consumer wants, which could only take place after privatisation (Layard, 1993, p. 29). Consequently, rapid privatisation was essential. 'Fast privatisation is privatisation that offers large political benefits from the start exactly what a reformist government needs' (Boycko, Sheifer and Vishny, 1993, p. 148). Privatisation of state enterprises was a means of reducing the budget deficit, even in the case of a non-sale of state enterprises such as the transfer of state enterprises to pension funds. This would reduce the budget obligations for social security payments (Sachs, 1997a, p. 248).

The privatisation process should be executed in an equitable manner, that increased effective management, detached enterprises from the government budget and eliminated the possibility of creation of new concentrations of political and economic power (Lipton and Sachs, 1990, p. 130), naturally, taking into consideration the political conditions of the time. As such, 'the key task for Russian privatisation is to break out of the one-by-one, 'voluntary' approach that has frustrated the reforms in Eastern Europe and to adopt transparent and fair privatisation methods that address the ownership system on a comprehensive and rapid basis' (Sachs, 1992a, p. 44). However the choice of the privatisation method ultimately depended on the dispersion of power between the state, managers and workers (Woo, 1997, p. 309).

I believe that the concerns and reservations that shock therapy economists had about the privatisation process were unfounded. The aim of the shock therapy process was to develop an economy based on market relations without the presence of discretionary power. In such an environment it did not matter whom the initial private owners were, because ultimately the only firms that could survive were those employing efficient management practices. Therefore whether the privatisation process gave ownership of state enterprises to the workers or management, or to members of the society, they would only be able to retain their ownership rights if they used their property productively by satisfying market demand at minimum cost. If they used their ownership for non-market purposes it would increase the cost of production. In the long run in a competitive environment this would result in a substantial fall of consumer demand for the goods produced by the enterprise, endangering the viability of the enterprise. For example, if labour-managed firms increased wages instead of repaying their loans it would result in bankruptcy or take-over, and in the removal of their ownership rights and possibly their employment. The only way that labour-managed firms would survive in a free market environment was if they behaved as private firms. Consequently these firms would lose the characteristics that make them labour-managed. Nee (1996, p. 913) argued that collective ownership in China due to market competition had led to behaviour more similar to that of private firms. Meanwhile, workers and management in small and medium enterprises received corporatisation with evident eagerness in Russia (Boycko, Shleifer and Vishny, 1993, p. 154). This was because of the belief, shared by workers and management, that purchasing and keeping control of the enterprise instead of the firm being bought by an outsider would provide them with more benefits and opportunities to explore in restructuring the enterprise. However, any deviation from the enterprise's goals would be heavily penalised by the market process. Hence in a competitive market, which is the ultimate goal of shock therapy supporters, only efficient owners and efficient behaviour would be able to survive, independently of how the initial distribution of ownership takes place. Yavlinsky and Braguinsky (1994, p. 105) agreed that 'the laissez-fair argument maintained that it does not matter who the initial owners are. It is sufficient to create free trade in new assets claims, and the most efficient owners will eventually take over'. The establishment of scarcity prices, the removal of any central control and subsidies, the development of competition by domestic and foreign firms and macroeconomic stability ensure that the managers serve the interests of the enterprise and not their self-interest, damaging in this way the viability of the firm. In addition the development of small and medium-sized enterprises and the spread of entrepreneurial motives contributed in forcing enterprises to behave in an appropriate manner. Aslund (1995, p. 247) justified 'irregular privatisation' in the name of avoiding the obstruction of privatisation by interest groups; in a free market process as long as 'irregular privatisation' does not institute discretionary power it can be justified. Consequently, the development of a free market process would derive an efficient ownership structure, making the method of privatisation unimportant as long as the privatisation process was rapid.

3.3. *Institutional structure*

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. The transition economies did not have any capitalist institutions; in direct contrast they were command economies (Dabrowski, 1997, p. 44). 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. As such 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. Actually the process towards a market economy required the destruction of the legal and political processes of the past (Boone and Federov, 1997, p. 184).

Markets require a definite assignment of entitlements and procedures guaranteeing the execution of contracts. Transition economies had to develop appropriate laws and institutions, which included defined property rights and well-enforced rules of contract which were essential if they were to be able to obtain the benefits associated with the market process. 'Without law, there can be no property rights and without these there can be no real economic stabilisation or development' (Aslund, 1997c, p. 14). Company laws should stimulate the establishment of new enterprises and remove licensing restrictions imposed on the domestic market and in international trade. An effective market system requires bankruptcy laws to facilitate the elimination and reconstruction of failing enterprises (Aslund, 1995, p. 264). For equity markets to be operative there must be specific rules and procedures (Boone and Federov, 1997, p. 181). Of course, the integration of transition economies in the international market would provide a stimulus for the adoption of a consistent institutional structure (Thomas and Wang, 1997, p. 222). In addition, the institutional structure would also guarantee that there would be no return to the old state of affairs. Consequently, the reforms could not prosper until authorities and individuals developed respect for law and legal processes (Boone and Federov, 1997, p. 184).

The institutional structure was one of the most challenging aspects of the transition modelling process. It was unfortunate, however, that most Russian and East European reformers as well as the citizens discounted the significance of the institutional structure, especially with regard to the corporate structure of the enterprise (Sachs, 1991a, p. 30). This was because it was laborious and time-consuming, and once operative it was very difficult to change. Consequently, if the development of institutions appropriate to the market process was so complex and time-consuming and since it is a fundamental element in the operation of an efficient market process, this raised doubts regarding the feasibility of the shock therapy approach.

However, these doubts were unwarranted. Property rights and the institutional structure, like any other good, are produced as a result of consumer sovereignty, that is due to effective demand. 'Contrary to the common economist's assumption that a system of property rights is a precondition of a market economy, the development of market institutions is often a prerequisite for a viable private property regime' (Rapaczynski, 1996, p. 102). Thus 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, 1992a, p. 11). Some simple rules would be adequate; as the markets evolved the legal system and enforcement mechanisms would evolve at the same time.

Intentionally designing efficient institutions was impossible. Governments and individuals did not have the knowledge to structure institutions. Past information was not adequate and the past experience of centrally administered socialism was irrelevant. Nobody could pre-determine the market outcome; thus there could not be any prescription to develop market institutions. Consequently, the development of the institutional structure was path-independent, which implies that the development of the necessary institutions was not culturally embedded. Institutional change comes as a result of free market relations, which would deliver in due time the best outcome in response to the need for structural change based on the universal principles of self-interested behaviour.

Individuals participate in the market process based on an evident set of rules. The culture of respect for property rights in mature market economies is not the result of habits, convictions or religious beliefs. These could not sustain the complicated and innovative behavioural pattens; rather they are the result of a self-enforcing process initiated by the spontaneous market behaviour. 'The reason why most people perform their contractual obligations, for example, is not that they are afraid of remorse or state coercion, but that in the extended context in which they are expected to conduct business, a breach would be against their best interests (Rapaczynski, 1996, p. 89). These self-enforcing mechanisms would not precede the emergence of market relations. Likewise they would not be the result of government action. While government initiation may develop the necessary institutions, market produced institutions frequently appeared beforehand and as such were more operative. The development of the institutional structure was a very elaborate procedure, which the government has not got the knowledge to implement. These institutions are 'nearly never created by conscious design' (Frydman, Rapaczynski and Turkewitz, 1997, p. 42). In this context, since people are rational and they make efficient choices using market relations, the market outcome is an efficient outcome. Capitalist institutions the result of the market process can only be efficient institutions. Government supervisory bodies are inherently inefficient in providing an effective overseeing mechanism. Accordingly, any interference from the state would only subvert enterprise ethics; thus it should not intervene in the market process (Aslund, 1995, p. 213). As long as the soft budget constrain existed and firms were not compelled to finance their activities through the banking system, whatever form the institutional structure took, it would not be able to enforce the rights of outside creditors. Furthermore as long as political considerations did not allow the closure of inefficient enterprises, bankruptcy procedures would be totally ineffective. Consequently, enterprise managers had much to gain from antisocial behaviour because antisocial gains could not be punishable or were not even considered illegal (Aslund, 1995, p. 299).

Thus institutional change is a derivative. The most important goal was the development of spontaneous development of market relations through the removal of most restrictions on individual activity. Therefore, institutional structure served to aid the development of the new market relations and as such new market relations served to aid the development of the institutional structure. 'Indeed, the legal responses are often only effective against a background of self-enforcing market mechanisms' (Rapaczynski, 1996, p. 102). Indeed Aslund (1995, p. 274) declared that Russia for example, featured a high level of economic and political pluralism, which results in the evolution of the necessary market institutions. Consequently, a radical reform process did 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, Boone and Johnson, 1996, p. 249).

3.4. *Monetary policy*

Financial stabilisation was extremely important and urgent because it 'is a prerequisite for social stability and for many other reforms' (Sachs, 1996a, p. 131). As a consequence, monetary policy was central in achieving stabilisation and liberalisation (Dabrowski, 1997, 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 constrains. Most importantly, there must be only one central bank with the effective instruments of monetary policy. It was essential to realise that the control of the money supply and credit required one independent central bank and not several independent regional banks with the power to issue money, as for example what was taking place in Russia with the republics, after the collapse of the Soviet Union. The new political environment produced a very unusual monetary system: a monetary union of fifteen independent states with fifteen independent central banks (Dabrowski, 1997, p. 46). The IMF, the European Union and other international organisations oddly enough recommended the maintenance of the rouble currency area with 15 central banks having the right to print roubles and monetary policies to be coordinated; the excuse was that the non-Russian republics were not ready to manage their own currencies (Granville, 1997, p. 101). Sachs and Lipton (1997, p. 80) emphasised that it was impossible to coordinate 15 independent central banks, which had the independent right to issue rouble credits, and were not willing to cooperate between themselves. This was because the several central banks would compete with each other and were under extreme political pressure to provide credit in their specific regions, destabilising the whole economy. There would be an incentive to free ride by issuing rouble credits at the expense of the rest of the members. Due to the existence of the rouble zone, Russia was forced to offer credits to the non-Russian republics of around 10% of GDP in 1992 (Sachs, 1997b, p. 128). 'It is nearly self-evident proposition that a single currency area should have a single bank of issue' (Lipton and Sachs, 1992, p. 237). The persistence, especially by the IMF, in artificially maintaining the rouble zone ensured hyperinflation and the failure of stabilisation policies in the non-Russian republics (Sachs, 1997b, p. 128). Consequently, 'there should be one currency, one central bank, and one monetary policy in one currency area' (Aslund, 1992a, 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 the pressure groups and increases in the money supply, a reduction in the exchange rate and an increase in inflation. 'The first obstacle to stabilisation is the lack of central bank independence' (Lipton and Sachs, 1992, p. 231). The money supply may rise overly due to budget deficits, extra-budgetary non-economically sound expenditure, and loans from the state banking system (Sachs, 1997a, p. 244). 'Therefore printing money is the way to destroy real credit over a longer horizon, even though it makes it available in the short run' (Fischer, 1996, p. 295). There must be an unconditional ban on central bank financing of the budget (Fedorov, 1997, p. 123). That was why it was essential that the central bank was and remained independent. History revealed that the legal arrangements encompassing a central bank perform a critical role in deciding central bank policies (Lipton and Sachs, 1992, p. 258). Thus monetary policy would be restricted and cheap credit to firms and government should be abandoned; interest rates should be the result of market forces. 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.

The central bank needed to establish credit targets to hold overall money growth to levels consistent with a rapid elimination of inflation (Sachs, 1993a, p. 49). This was because inflation is a monetary phenomenon (Aslund, 1993, p. 99 and Rostowski, 1993, p. 105). Thus monetary policy should follow a specific rule, that is increasing the money supply in line with the increase in real output, as the quantity theory of money states; the monthly rate of inflation is equal to the rate of growth of the money supply minus the rate of growth in output (Sachs, 1994, p. 5). In this way the danger of inflation would be reduced. This was possible only by establishing an independent central bank and in its constitution the aforementioned rule should be written. Consequently, the monetary authorities should adopt noninflationary macroeconomic policies by substantially reducing the budget deficit through the elimination of subsidies and preferential treatment of state enterprises. As Aslund (1995, p. 220) reasoned, 'the evidence is clear: the quantity theory of money is applicable in Russia, too. As has been shown, inflation can be explained by the increase in money supply and the velocity of money'. Money indeed matters. All this was thought to be so obvious that Macesish (1991, p. 8) argued that money and monetary theory are ideological neutral.

3.5. *Fiscal policy*

The elimination of hyperinflation would require the reduction of large budget deficits. Since the budget is the main source of money creation, and is 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. Even though the savings would not be large, 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 since the source of their survival, government subsidies and inexpensive credit, had been eliminated. A balanced budget — even better a surplus (Aslund, 1992a, p. 66) — and fiscal responsibility were essential guarantee to new firms and foreign investors that the transition government was serious in putting its economy in order. The budget deficit is directly linked with the inflation rate; the inflation rate is an increasing function of the budget deficit expressed as a percentage of GDP. 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 it was recommended to transition economies by the IMF and other international organisations to 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) recommended that while inflation could be reduced by reducing the budget deficit, it could also be reduced by altering the way in which the deficit was financed. Inasmuch as the budget deficit was financed by foreign financial resources (such as foreign borrowing, grants, aid) or by domestic borrowing (by the creation of government Treasury bill market) it would not result in inflation. The introduction of a Treasury bill market would have allowed flexibility in fiscal and anti-inflationary policy by permitting the government to borrow from the domestic investors rather than printing money. Consequently, it was possible to have low inflation and a budget deficit, which could finance the necessary social programs. A Treasury bill market could also have absorbed the excessive savings due to monetary overhang, that is, forced savings due to the inadequate supply of goods and services under the previous regime (Frydman, Rapaczynski and Turkewitz, 1997, p. 63). The benefits of Treasury bills have been recognised by transition economies by taking initiation and establishing a Treasury bill market (Sachs, 1997a, p. 246).

The insistence of the IMF on focusing on budget cuts rather than deficit-financing (Sachs, 1994, p. 8) had required the prerequisite that IMF aid was conditional on a reduction of the budget; as such, the aid could not be used to finance the budget deficit. For example, while the Russian government revealed that it would like to sell bonds to finance the budget deficit the IMF did not displayed any interest in the proposal (Sachs, 1994, p. 9). However, the loans provided by the IMF were of a very short-term nature at commercial rates, which financed government imports. 'Why is the IMF incorrect in simply pressing for greater budget cuts in the deficit? Such cuts are economically and politically unjustified' (Sachs, 1994, p. 7). There might be some concern for financing the budget deficit with external resources since they would increase the public debt. However there was an argument for the provision of grants rather than loans, as for example with the Marshall plan. Nevertheless, even if the provision of external financing took place in the form of loans the transition economies would be able to repay them back in the long run. For example the public debt of Russia, in 1993, as a percentage of GDP was less than that of almost all OECD countries (Sachs, 1994, p. 8). These loans would be managed productively and used to fight inflation. 'There is therefore room to borrow now in support of stabilisation and consolidation of the reforms' (Sachs, 1994, p. 8). In addition, privatising state enterprises could finance the budget deficit. This would result in the removal of the responsibility of the government to subsidise them, with a further positive impact of the budget (Sachs, 1997a).

With respect to the tax structure, there was a need for the introduction of new taxes consistent with the market process e.g. a Value Added Tax system and income tax, instead of taxes on profits of state enterprises under the old regime. Boone and Fedorov (1997, p. 179) recommended that a tax reform of a transition economy should incorporate: abolishing the excess wage tax; 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 in public investment spending (Sachs, 1997a, p. 246).

3.6. *International trade and foreign aid*

The shock therapy approach was in favour of complete liberalisation of the international trade sector by currency devaluation to the black market level and removal of trade barriers. Radical trade liberalisation was an essential component of a successful trade performance in transition economies (De Menil, 1997, p. 275). This was because free international trade was the most effective way of installing real competition since the transition economies were considered small economies in the international arena and they were in very close proximity with the mature market economies of Western Europe. It also seemed likely that free trade was the way to initiate competition. The transition economies were dominated by all-powerful monopolies with economic and political power. Competition with foreign firms would substantially reduce or, (even better), eliminate monopoly economic power and, consequently, political power. Trade liberalisation would create positive externalities by stimulating, for example, privatisation even though privatisation may be taking place slowly due to political pressures and sectoral interests (De Menil, 1997, p. 275). Transition economies would be able to import a rational price system and would be able to benefit by the transfer of technology, which would stimulate increases in productivity growth. This was also beneficial for the reduction of environmental pollution, since foreign investment would be able to modernise plants and equipment (Esty, 1997, p. 378). Due to international integration a substantial increase in exports would take place with the mature market economies and take away the previous reliance on the Soviet Union. The increase in exports would be due to the low-wage and high-skill characteristics of these economies; exports would stimulate growth, which would reverse stagnation and stimulate an increase in living standards. The international market was able to supply technology, managerial expertise, organisational techniques and financial capital. Transition economies would be able to adopt new technology, thus raising the skills of the workforce. The transition economies were able to offer new markets with short-term and long-term trade and investment opportunities, as well as ensuring the peaceful economic development of the region. This did not imply, however, inaction on the part of mature market economies rather 'the greatest foreign policy misjudgment of our time would be to assume that such a system will automatically fall into place' (Sachs, 1995b, p. 50).

The argument that Russia and Eastern European countries should not open their borders to free international trade and should not introduce a convertible currency, since the enterprises were inefficient and could not survive in fierce international competition, was not true at all. Ricardo had argued that international trade is the product of comparative — not absolute — advantage. Any country can engage in free trade, and similarly, any country can have a convertible currency (Sachs, 1993a, p. 51). Current account convertibility can be introduced in one shot, as the experience of Poland indicated in contrast to the experience of Western Europe in the 1950s (Balcerowicz, Blaszczyk and Dabrowski, 1997, p. 159). As well restrictions on capital account convertibility were ineffective due to modern market technology (Sutela, 1992, p. 92). It was necessary to add that it is fruitless to attempt to identify the firms or industries, which have comparative advantage, because nobody, not even the government, had the knowledge to predict the market outcome. Hence a convertible currency was essential to achieve a reliable price system competition, monetary discipline and make the comparative advantage principle workable. The policies recommended by the shock therapy supporters ensued that the liberalisation of foreign trade was irreversible (Aven, 1997, p. 67).

Protectionism was inconsistent with the shock therapy model. Moreover, protectionism by mature market economies 'could undermine the economic logic of reform and eat away the political and social consensus of the reform program' (Sachs, 1993a, p. 102). However, there might be some justification for a low tariff in the initial stages of transition, around 10–15%, to avoid an import boost, protect for a very short time domestic industry and to raise state revenues (Aslund, 1992a, p. 48).

A freely floating exchange rate would adjust to reduce inflation and stimulate competition. The achievement of a stable foreign exchange market was only possible by maintaining a restrictive monetary policy. The government might wish to maintain a fixed exchange rate. In this case the central bank would need to buy or sell foreign currency to maintain the fixed rate. I believe that both fixed and floating exchange rates are consistent with the shock therapy approach, since neither involves government discretion. Nevertheless, the fixed exchange rate eliminates the instability caused by a fluctuating exchange rate. Empirical evidence suggested that economic growth increased faster to those countries that used fixed exchange rates to achieve stabilisation and undertook deeper reforms (Fisher, Sahay, Vegh, 1996, p. 62).

Sachs (1996b, p. 149 and 1997a, p. 249), Aslund (1995, p. 183) and Sutela (1992, p. 92) were in favour of a pegged exchange rate in the start of the stabilisation program, and then after one or two years a move towards a flexible rate. This was because the pegged exchange rate has some advantages in conditions of high inflation. Firstly, a pegged exchange rate secures the government's pledge to stabilisation by establishing clear monitoring targets and 'tying the government's own hands' (Sachs, 1996b, p. 149). Secondly, the pegged exchange rate brings certainty and facilitates economic actors in planning and in formulating expectations around a new low-inflation equilibrium. Lastly, it facilitates households and enterprises in building their real cash balances after high inflation. Thus, if velocity is high and rising, a dedication to a pegged exchange rate with the backing of international organisations and mature market economies can restore trust in the currency (Sachs, 1997a, p. 250). Consequently, 'exchange rate instability would make it even more difficult to arrive at any kind of predicability and thus equilibrium' (Sutela, 1992, p. 93). All these elements assisted in reducing high inflation in transition economies. The international experience revealed that the most successful stabilisation programs were based on a pegged exchange rate, such as Bolivia 1985, Israel 1985 and Mexico 1987 (Sachs, 1997a, p. 251). With respect to the transition economies, the early peggers that are Czech Republic, Estonia, Hungary, Poland and Slovakia performed a lot better than the floaters, both in terms of success of disinflation and the cost of disinflation. The peggers achieved inflation below 100% per year by 1994 (Sachs, 1996b, p. 149). It was the intention of the Gaidar government in Russia to peg the exchange rate however the necessary financial resources required for the stabilisation fund of six billion dollars did not exist. Again this highlighted the urgency and the importance of foreign aid. Nonetheless the IMF was not willing to establish a stabilisation fund as long as the exchange rate was not stabilised, in others words when is was not required (Aslund, 1995, p. 67, 183).

The successful pegging of the exchange rate not only aided the achievement of macroeconomic stabilisation but also provided externalities in other areas of the reform program. Russia was not able to benefit from such externalities since 'failures of macroeconomic stabilisation undermined reform efforts in nonmonetary aspects of the economy' (Sachs, 1996b, p. 149). Under flexible rates the stabilisation program was more contractionary than with the pegged rate, and sometimes it failed thereafter. After the successful implementation of the pegged exchange rate in reducing inflation, 'there is a strong case for moving to a more flexible exchange-rate arrangement once high inflation has been eliminated and the economy has been substantially remonetised' (Sachs, 1996b, p. 150).

Foreign aid, from mature economies or international financial institutions, was important in several respects. Because foreign reserves in transition economies were depleted, international foreign aid would give them the opportunity to increase foreign reserves; to finance budget deficits which had the aim to stabilise the price level and to reduce the burden associated with the transition costs, especially the burden to the ordinary people and to finance imports in the light of falling domestic production. Furthermore the conditional nature of foreign aid and international credits could be used to pressure the government and the people in supporting the transition plan (Aslund, 1995, p. 183). Importantly, foreign aid and borrowing would reduce the need for monetary financing of the budget deficit. The budget deficit and the necessary social programs could be financed by foreign aid and borrowing from international organisations without increasing the money supply (Sachs, 1997a, p. 247). The shock therapy model presupposes debt cancellations, international transfers, balance of payments and budgetary support as a means of overcoming stagnation and maintaining political support for the reform program. Without relief from the large debt problem the much-needed capital inflow would be restricted, removing a major source of economic growth. All external debt should be frozen and rescheduled to ease the burden and allow the transition economies to start afresh (Fedorov, 1992, p. 110). It was the responsibility of the mature economies to assist as much as possible the transition economies because 'the world has much to gain from the emerging system, and much to lose if we fail to act decisively to put it in place' (Sachs, 1995b, p. 50). One of the aspects of foreign aid was to eliminate the short-term social problems associated with the transition program such as the reduction in living standards and the rise in unemployment. Consequently, 'this money could help to make a democratic and economic transformation feasible which otherwise would not be feasible' (Sachs, 1992b, p. 210).

Hence the role of the mature market economies was substantial in this respect, first of all in providing the necessary financial resources as a form of foreign aid to alleviate the short-term social problems associated with the transition. 'The continuation of the reform thus has two ingredients; a sufficient rise in unemployment to control inflation, plus enough positive developments to maintain support for a reform government. It is difficult to see how the second element can possibly be achieved without Western support' (Layard, 1993, p. 31). Secondly, they should maintain their markets open for the products produced in transition economies, while asserting the need for the continual commitment by transition economies to free trade. For these benefits to materialise they needed to be accompanied by the privatisation of state enterprises. 'Opening up the economy is not something independent of the inner workings of the domestic economy' (Sutela, 1992, p. 94). This reaffirms the fundamental thesis of the shock therapy supporters of the interdependence, mutually supportive and interactive character of economic relationships.

3.7. *Social policy*

There was also a need for the development of social policy, consistent with a market economy, inasmuch as the social policy under the previous centrally administered structure was inappropriate. Radical reform such as the shock therapy approach could provide a redirection of resources to the poor, offering them the necessary opportunities for participation in the market and political processes. In contrast, a gradual process of reform would provide opportunities for the privileged classes and opponents of the reform to use their power to appropriate the benefits of social expenditure programs (Graham, 1997, p. 340).

Thus the state should remove itself in the productive sphere and concentrate on the provision of services. The social spending program under central administration was contributing to severe budget deficits. To be able to fund large social transfers, transition economies had to impose high taxes which would result in distortions, capital outflow, tax invasion and illegal economic activity through the black market (Sachs, 1997a, p. 253). While there was a need to reduce social transfers, there were vast obstructions through the political process in contracting these expenditures. Meanwhile, there was a need to assist the poor and the vulnerable classes during the transition process. The transition process involved transforming disguised unemployment into open unemployment, creating discontent (Balcerowicz, Blaszczyk and Dabrowski, 1994, p. 83). Thus a safety net was vital for the success of the reform program. 'The implementation of short-term safety net programs to protect the poor and/or vulnerable has become as much a political as an economic necessity in many countries' (Graham, 1997, p. 344). Accordingly, providing adequate social benefits was politically more important than reducing the budget deficit (Aslund, 1997c, p. 17). The reduction in the real wage required to bring equilibrium in the labour market did not automatically mean a reduction in living standards by the same percentage. A well, targeted safety net for the Soviet Union in 1991 would had required only 2.4% of GNP (Aslund, 1996, p. 239).

Social policy should not be discriminatory, and thus should be available to all the people in need. Social policy should not encourage dependency. This was why it was recommended as a safety net and not a welfare state. As the safety net should be provided only to those who cannot participate in the market process for reasons such as sickness, loss of employment, pregnancy. The assistance should be short-term, thus discouraging dependency. A welfare state is discretionary, discriminating between people depending on race, colour and family circumstances. It does not encourage individuals to return to work and as such it encourages dependency and is a drain on scarce financial resources. Consequently, employment policy should streess that 'the natural situation of a person must be to earn his own living. This has so far remained the case in Russia more than in many countries, and with care Russia can avoid many of the mistakes that have been made in the West' (Layard and Richter, 1997, p. 162). In addition, while the reform of health services and social security would provide for only those in need, those who could afford them would be able to choose between private providers.

The development of an appropriate safety net was one of the most challenging aspects of the reform program, so as to ensure that those disadvantaged by the initial development of the market process were not trapped in poverty, unequal opportunities and low living standards. All transition economies had initiated unemployment benefits, job retraining, welfare payments and pensions, which were partly indexed for inflation. Nevertheless, all this could only have taken place by gravely burdening the state finances. This was why foreign aid was so important. Graham (1997, p. 336) stressed that 'no level of external support or resources can substitute for domestic political commitment (and allocation of resources) to addressing the social cost of reform'. On the other hand, political commitment alone was not enough to finance the necessary social programs. Consequently, the generosity of the mature market economies and of the international organisations was essential. It should be remembered that the safety net programs had to enhance the political sustainability of the economic reforms.

3. Conclusion

Sachs (1996a, p. 132–3) was confident that the experience of the transition revealed the ability of the centrally administered economies of Russia and Eastern Europe to transform rapidly to market economies. While it was easy to become discouraged with the transition process, two years after initiation of shock therapy Sachs (1991a, p. 26) was confident that 'the results of the past two years give strong evidence that these economies can indeed be converted to the Western European model in reasonable period of time'. The shock therapy model highlighted the urgent need to shift from the position of shortages and hyperinflation to a situation where the quantity demanded and the quantity supplied reached equilibrium. This involved reducing the high levels of inflation and rapid depreciation, reversing the budget deficit and stopping the decline of output. This required the removal of all restrictions to allow prices and wages to equilibrate. To get rid of the hyperinflationary pressures the budget deficit had to be reduced by abolishing subsidies and increasing taxes substantially. Monetary policy should also be restrictive by eliminating the cheap credits provided by the central bank and the money supply must target the growth rate of the GDP to reduce inflation. To introduce competition, a free trade regime was imperative to be able to counterbalance the highly monopolised domestic industry. Concurrently, a fully convertible currency would reduce inflation and make free trade possible. Hence the objective was to reduce aggregate demand by reducing the budget deficit, the money supply, real money balances and real wages. In essence the shock therapy model is an orthodox macroeconomic stabilisation program emphasising price liberalisation and strict budgetary policy (Aslund, 1995, p. 66). The experience of Poland was regarded as a success story: high growth, low inflation, and privately owned economy (Balcerowicz, Blaszczyk and Dabrowski, 1997, p. 131).

The implementation of the shock therapy approach, in particular in Poland, has resulted in: the elimination of hyperinflation and of shortages and queues; the establishment of money as a medium of exchange; the development of a substantial private sector; state enterprises started to restructure; output reflected consumer sovereignty; rapid technological modernisation took place; international trade reflected market signals and ecological benefits by stopping pollution. Due to the implementation of the shock therapy model in Russia, 'the main goal of the Russian economic transition has been accomplished: Russia has become a market economy'. The essential feature of such an economy is that 'the market is the main instrument of allocation' (Aslund, 1995, p. 3). Hence a successful transition process required political democratisation, radical reforms and ample financial assistance by the mature market economies (Sachs, 1992b, p. 209). The radical reform process of shock therapy did not increase unemployment, did not halt the development of the private sector and did not hinder the evolution of the institutional structure. These countries have performed better even though they suffered a decline in output in the beginning of the transition but they were the first ones to achieve positive economic growth (Aslund, Boone and Johnson, 1996, p. 226).

The course of economic development initiated by the shock therapy process could be considered radical in a historical context, since the experience of mature market economies demonstrated gradualism as the appropriate procedure. The implementation of the shock therapy process had to do not only with the aforementioned benefits associated with the free market process. Also by the mere fact that transition economies were surrounded by mature market economies, with a dominant world ideology of free market. Transition economies were entering economic development at a later stage than mature market economies thus they would be influenced by their strategy of economic growth.

The transition economies surrounded by mature market economies were determined, to achieve the standards of living of those of the advanced economies by adopting the dominant view of the free market. It was a sad reminder of the past because it seemed similar to the strategy of Stalin's famous call in 1931: 'we are fifty of hundred years behind the advanced countries. We must make good the distance in ten years. Either we do it or they crush us' (Berliner, 1988, p. 161). Consequently the implementation of the shock therapy approach can be interpreted as a voluntary decision of the transition economies. The transition economies aspired to narrow the income gap and sought to do so as quickly as possible and at any cost. This was extremely difficult due to the pre-existence of poor economic conditions, which constrained their growth potential. There appeared to be a contradiction, which resulted in tensions (Ofer, 1987, p. 1769). However, tensions resulted in impatience and impatience resulted in extreme, more radical and more rapid reforms, in our case the shock therapy process, than those utilised by the mature market economies when they started their economic development. 'Haste, impatience, and radical action translate into a high time preference, a high discount rate for future benefits for the sake of short-term achievements' (Ofer, 1987, p. 1799). Hence the shock therapy process of transition can be interpreted by the need of the transition economies as latecomers to achieve the standard of living of advanced economies. This resulted in introducing the reforms without delay with the thought that the benefits would be immediate as well.

However it is possible to interpret the shock therapy process as a strategy imposed upon the transition countries. International funding depended on implementing the policies, which satisfy the dominant view, that is, the free market. To be able to secure international funding by the International Monetary Fund and the World Bank transition economies had to satisfy the conditions imposed with regard in implementing the shock therapy approach. Otherwise no funding would be available, effectively leaving no real choice to transition economies. For example, the IMF and World Bank loans to Romania were stopped because the privatisation strategy adopted limited foreign ownership (Gowan, 1995, p. 34). How can we explain then the implementation of a gradualist approach by a few countries? The promises of substantial funding never materialised, as already has been pointed out by the shock therapy supporters, and this encouraged the transition governments to ignore the recipe of shock therapy forced by the IMF and World Bank and choose to go on their own course.

The shock therapy model assumed large debt cancellations and large financial assistance in the form of grants and long-term loan. Instead foreign aid has been substantially bellow the necessary amounts and in the form of export credits. Meanwhile financial support by mature market economies has been modest, if not totally inadequate. It was estimated that the Soviet Union would require about 30 billion dollars a year in the first two years of the reform process and then 20 to 25 billion dollars a year in the third and fourth year (Sachs, 1992b, p. 215). In 1995 Russia received roughly \$380 million in U.S. aid that is one-sixth of the aid to Egypt (Sachs, 1995b, p. 57). Mature market economies and commercial banks gave more financial support to Gorbachev than to supporting the transition process (Aslund, 1995, p. 282) The IMF and the World Bank, the only real financiers of the transition process, 'have proven to be largely inefficient' (Sachs, 1995b, p. 61). Financial assistance has been very small and financial aid totally inflexible. Sachs (1994, p. 5) was insisting that there was a need for a change in the timing and character of foreign aid in the transition economies in particular in Russia. Financial assistance should have taken the form of grants, not loans. The IMF had refused to support the establishment of a stabilisation fund. Even when the IMF announced in 1995 the possible establishment of stabilisation funds it continued to inform countries that these funds would be available only after inflation had been reduced (Sachs, 1996b, p. 150), in other words when they were not needed. In addition, the response of the European Union in assuring full membership at a future date and opening the European market to East European products had been far from desirable. 'So far the European Community is more responsive to France's small farmers and Portugal's textile producers that it is to the great geopolitical opportunities for a united Europe and the great risks of political destabilisation in the East' (Sachs, 1991a, p. 32). Meanwhile Russia, for example, never had the possibility of stabilising without 'massive foreign assistance' (Layard, 1993, p. 32). Unfortunately, 'the international community had not woken up' (Aslund, 1995, p. 99).

Sachs (1991a, p. 31) had argued that the reform program could be achieved 'only if the reforms are given the time to work'. In reality, 'Russia and the West have never missed an opportunity to miss an opportunity ... Unfortunately, the West failed miserably to speed the needed reforms' (Sachs, 1997b, p. 127). Accordingly there was an internal contradiction in the reform program: the shock therapy process, while rapid, needed some unspecified time to be operative, depending on fragile coalition governments based on a democratic process of decision-making. Under these circumstances it was impossible for a reform program of this magnitude and social cost to survive a democratic decision making process. Though Balcerowicz (1994, p. 87) argued that it was not necessary to assume that the discontent under shock therapy should be greater than with a gradual approach, as for example with Romania. However, the discontent due to the shock therapy process was shown through the electoral process by replacing the radical reform government with a government in favour of gradual approach. Fedorov (1997, p. 126) recognised the electoral danger associated with the rapid transition process, arguing that 'only a much faster reform movement can save the situation from deterioration which could be politically dangerous'. In contrast, the Polish experience shows that 'severe stabilisation measures are not easily forgiven' (Bin, 1992, p. 189). A democratic political process was inconsistent with the maintenance shock therapy process of transition. The shock therapy supporters hoped that this inconsistency could be avoided by the visionary actions of the leaders of mature market economies and the responsibility assigned to the international financial institutions to stabilise the emerging market economies. It has already been pointed out that the problems associated with the reform process were political, not economic. Thus economic aid was mainly political aid required to support the frail governments that implemented the shock therapy process in a democratic environment. The aim of foreign aid was to reduce the pain to individuals in continuing applying the shock therapy transition process and at the same, hopefully, maintaining support for the government. The support for the governments implementing the shock therapy process was very high at the beginning of the process. When the financial support was not forthcoming popular support started to diminish as the social cost was increasing. The result was that governments, which implemented shock therapy process after one term in office lost power and at the same time disgracing the shock therapy process of transition. The newly appointed governments, usually ex-communists, reversed the course of reform proceeding with a gradualist transition process. Graham (1997, p. 339) was in agreement with this argument because 'failure to resolve the poverty and safety net issues [in Poland] has eroded support for the economic reform process, and in part explains the victory of the former communists in the December 1995 national elections'. Lipton and Sachs (1992, p. 216) were aware of the necessary conditions for the shock therapy process to succeed: 'in our view, the social basis for the reforms exist. The real test will be in the area of political reform and in the extent of Western support'. 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, as Table 1 reveals. In all cases, this occurred after unfavourable election results for the shock therapy governments.

Parker, Tritt and Woo (1997, p. 8) and Boone and Fedorov (1997) recommended a better political management of the reform process in Russia. They argued surprisingly, that in-depth political reforms would have improved the outcome. Nevertheless accepting an argument like this does not solve the contradiction. Correlated with this argument is the issue of the credibility of policy makers. This argument is tautological. To attempt to detect not credible reforms is by looking at the unsuccessful ones (Ickes, 1996, p. 302). Could it be argued that a better political management of the market reform process or more credible policy makers would have made possible the survival of the shock therapy model in a democratic environment without any substantial financial support? Unfortunately, for the shock therapy supporters, the answer is no. In contrast to my view Boone and Federov (1997, p. 185) argued that 'these benefits must be contrasted with the Russian reality that very often foreign assistance has slowed reforms — because it allowed Gorbachev, and Yeltsin, to temporarily postpone making needed policy changes'. However, as I have been arguing, the amount of foreign aid was so inadequate, as demonstrated in Table No. 1, that it was not able to influence the political decision-making process. However, Aslund (1995, p. 312) stated that 'good theory has stood the test, whereas poor theory has proven faulty'. Indeed the failure of the shock therapy program to incorporate the political process, concentrating instead on economic relationships, led to the demise of the model. In the end, 'the problem is political' (Aslund, 1995, p. 312).

Aslund, Boone and Johnson (1996, p. 227) argued that the predictions of the political economy models are not true since the shock therapy process did not lead to public discontent. Actually on Aslund, Boone and Johnson's interpretation of events, the public demanded faster reforms and the dissatisfaction with gradualism was greater. Gradualists had a greater probability of losing elections than shock therapy governments and they often did. On Aslund, Boone and Johnson's interpretation shock therapy governments, lost elections due to the fact that they were not so organised as the former communists and the norm is that incumbent governments became unpopular independent of economics outcomes. Noteworthy, though, is that after the first term in office shock therapy reformist governments were substituted for gradualist reform governments. There is no example of a gradual reform government being replaced by a radical one, after the first term; a gradualist reform government was always replaced only by another gradualist one. The only notable exception was Latvia.

Table 1. Shock therapy and level of foreign aid.

Country	Transition type	Reforms commenced	Gradual shift	IMF agreements start	Financial support end	Million SDR's
Poland	Shock therapy	1 Jan 1990	19 Sep 1993	18 April 1991 8 Mar 1993 — standby[a]	17 April 1994 7 March 1994	1224.0 476.0
Czechoslovakia	Shock therapy	1 Jan 1991	*Slovakia*: 1 Jan 1993 (after the break up of Czechoslovakia Slovakia pursued a gradualist approach). *Czech Rep:* 1 Jun 1996 slow down of some economic reforms-mainly privatisation of health system and railways	*Slovakia* 1 Jan 1993 (IMF quota total) 22 July 1994 — standby — STF *Czech Rep.* 1 Jan 1993 (IMF quota total)		 257.4 115.8 64.5 589.6
Bulgaria	Shock therapy concept — slow implementation	1 Feb 1991	18 Dec 1994	17 April 1992 — standby 11 April 1994 — standby — ESAF	16 April 1993 11 April 1995	155.0 116.0 69.7
Russia	Shock therapy	2 Feb 1992	12 Dec 1993	5 Aug 1992 30 June 1993 — STF[b]	4 Jan 1993	719.0 1078.3

Albania	Initially gradual then shock therapy	June 91 — gradual July 92 — shock therapy	19 June 1997	26 Aug 1992	25 Aug 1993	20.0
				— standby	13 July 1996	42.4
				14 July 1993		
				— ESAF[c]		
Estonia	Shock therapy	Sept 1992	5 Mar 1995	16 Sept 1992	15 Sept 1993	27.9
				— standby	26 Mar 1995	23.2
				27 Oct 1993		13.9
				— standby and STF		
				12 April 1995		
Latvia	Shock therapy	5 June 1993	25 July 1997	15 September 1992	15 September 1993	
				— STF		54.9
				October 1993		11.6
				— standby	March 1995	11.6
				— STF		
				December 1993		
				— standby		22.90
				— STF		22.90
				24 May 1996	March 1994	30.00

[a] Standby credit
[b] STF: Less demanding than standby credit. New temporary IMF financing facility designed to provide assistance to member countries facing BOP difficulties
[c] ESAF: Enhanced Structural Adjustment Facility
Sources: Economic Survey of Europe 1993–1994, Economic Commission for Europe, 1994 p. 138–139
Keesing's Record of World Events Vol. 40, No. 7, July 1994, Longman, UK.
EIU Country Report, Slovakia, 2nd Quarter 1995, Economic Intelligence Unit, UK. p. 29

Latvia was able to sustain the shock therapy process for a long time and the shock therapy government was able to remain in power after the elections. This can be explained by the financial help received from the IMF. Evidently, one must compare the amount of IMF credit assistance given to Latvia and to other shock therapy nations of similar size and level of industrialisation. Latvia received in total 153.9 million SDRs while Estonia received 65 million SDRs and Albania 62.4 million SDRs. Latvia received a lot more financial assistance than Estonia and Albania combined, yet it is a nation of similar population, size and level of industrialisation to Estonia. The large amount of foreign aid to Latvia, can be justified by the IMF as a country displaying 'a remarkable degree of stability' (Economic Commission for Europe, 1993, p. 233). Thus Latvia could afford to sustain the burden of the reforms directly as a result of its foreign assistance. This example highlights how crucial foreign aid was in helping these nations to implement the shock therapy process. Foreign assistance was able to maintain the shock therapy in a democratic political structure, in contrast with what took place in Albania, where the shock therapy approach, due to the inadequate financial support, could only be maintained by removing the democratic process of decision making and implementing authoritarianism. A non-democratic process is consistent with shock therapy. However, authoritarianism cannot survive for long (Marangos, 1997, 1999). With the violent overthrow of Berisha and with him the shock therapy approach, which was directly linked with authoritarianism, the reform process was discredited and gradualism was the natural course of the new government. Meanwhile, the Skele government in Latvia after the successful elections was short lived — it only lasted five months — because it was forced to resign under serious accusations of corruption. This also highlights an inconsistency associated with the provision of ample financial assistance to facilitate transition; it encourages corruption.

Interesting enough, at subsequently elections, 'radical' reformers returned to power such as Mart Laar in Estonia, Balcerowicz in Poland and 'radical' governments substituted gradualist ones in Bulgarian 1996, Romania 1996 and Ukraine 1999. However, the 'radical' reformers have implemented a gradual process. There are no examples in Russian and Eastern Europe of a shock therapy process being implemented by the 'radical' reformers returning to government. The momentum was lost following the defeat in the elections after the first term in office.

I oppose the view of Szuk (1996, p. 57) who argues the 'nostalgia' for the social benefits associated with the centrally administered economy brought former communists back into office. This is an inadequate rationale because it does not examine the underlining reasons, which are mainly political, for the return of ex-communists to power. Generous financial support by mature economies could only avoid the return of ex-communists to power, but could not achieve the eradication of nostalgia. For example anti-reformist ideas prevailed in Poland in both the September 1993 and December 1995 elections due to people's anxiety mainly over welfare issues (Graham, 1997, p. 339). As Szuk (1996, p. 57) argued, 'the political leaders must work hard to convince the voters of their seriousness as reformers and to explain their policies to an electorate that is understandably chafing at the painful socio-economic measures'. Under the economic conditions described, 'hard work by political leaders' would not be sufficient without some manna from heaven (Sachs, 1991a, p. 31). In contrast to my argument, Aslund (1994b, p. 73) was arguing that 'there is no crippling contradiction between the political and the economic requirements for a successful political-cum-economic transition'. The contradiction could only be avoided by timing the elections appropriately. This was because the timing of the elections was crucial in this respect and thus they should be carefully planned (Aslund, 1994b, p. 72–3). Correspondingly, after the restoration of democracy at an early stage of the transition, a reformist government was very likely to win the elections, which took place in most transition economies. Subsequent elections should take place after the reforms had reduced inflation and eliminated shortages, and before people had become disillusioned by the social costs involved. These prescriptions of the election timing never materialised, and no shock therapy government was reinstated in power. Therefore the shock therapy supporters can only be contented with putting the foundations of the market economy in place and making the reforms irreversible, as they argue; wherever radical reform took place, the succeeding ex-communist government continued the reform process (Aslund, Boone and Johnson, 1996, p. 273), but at a slower pace. Consequently, there might be instability but not a total reversal of the reform (Fedorov, 1997, p. 126). An alternative way, for shock therapy economists to avoid the contradiction between shock therapy and the democratic process is by arguing the 'real shock therapy' was never implemented as Sachs (1997b, p. 127) reasoned about Russia: 'Despite the uproar in recent years about 'shock therapy' in Russia, knowledgeable observers understand that it simply never occurred, an obvious point when one compares Russia's disorganised and partial stabilisation efforts with the decisive actions in the Czech Republic, Estonia, or Poland'. Because in reality, in Russia, 'real laissez fair for the benefit of the private sector persisted only for a period of three months, form February to April 1992' (Aslund, 1997e, p. 200). In addition, 'in Lithuania, Russia, and Hungary, where radical reform never came close to being adopted' (Balcerowicz, 1994, p. 87). Despite of all these arguments, Aslund (1997, p. 316) was adamant: 'yet the case has nevertheless been made: Russia could (and did) reform, and it has become a market economy'.

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