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Dialogue

Shock Therapy and its Consequences in Transition Economies

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ABSTRACT *As a contribution the Dialogue section of Development critiques of mainstream economics John Marangos looks at how shock therapies applied to transition economies in Central, Eastern Europe and the former Soviet Union were economic experiments that went disastrously wrong. They produced suffering, low growth, inflation, unemployment, corruption and crime. He suggests that there were economic, political and ideological reasons for this as the same class that controlled affairs under Stalinism were joined by the multinational capitalist class in the promotion of a 'free' world of a globalized economy with very few benefits to the majority of those bearing the 'shocks'.*

KEYWORDS *shock therapy; employment; privatization; entrepreneurs; foreign aid*

Introduction

The transition to a market economy in Central, Eastern Europe and the former Soviet Union (CEEFSU) was dominated by the shock therapy process of transition. The shock therapy model of transition involved: immediate price liberalization, immediate privatization, immediate establishment of an independent central bank, immediate achievement of a balanced budget, immediate introduction of free trade and immediate establishment of a fully convertible flexible currency. Jeffrey Sachs – an adviser to the Polish and Russian governments who guided the shock therapy process in these countries – stated that: 'Poland's goal is to establish the economic, legal, institutional basis for a private-sector market economy in just one year' (Sachs, 1990: 19).

The supporters of the shock therapy model argued that the elements of the model would have ensured growth at full employment with low inflation and stability. In summary, the shock therapy model was a neoclassical model of transition advocating the immediate implementation of the necessary reforms to establish a free market capitalist economy. Non-capitalist participatory alternatives were not considered by mature market economies, the International Monetary Fund and the World Bank, which made sure that the only alternative for transition economies was to transcend towards market capitalism.

The shock therapy process did not deliver the promised high living standards to the people in transition economies. Instead, economic collapse, stagnation, inflation and unemployment were characteristics of the process, accompanied with the familiar outcomes of poverty and crime. Could it be argued that, in actual fact, the shock therapy process had the aim to create capitalism in CEEFSU at any cost? Could it be argued that the only way to create immediate capitalism in transition economies required the cooperation of the established elite? Lastly, could it be argued that the only way to gain the cooperation of the established elite was by providing the means for the elite's personal enrichment at a cost to the standards of living of the average citizen? The paper aims to answer these questions by demonstrating that shock therapy and the immediate establishment of capitalism was motivated by the self-interest of the capitalist classes in mature market economies, using the IMF and World Bank as enforcement agents, which required the transformation of the elite of the Stalinist system into a capitalist class. An analysis of shock therapy from this perspective requires an identification of the role of the following elements of the shock therapy model: ideology, initial conditions, institutions, speed, privatization, foreign aid and social policy. In the following an analysis of the role of each aforementioned elements of shock therapy model takes place.

The role of ideology

Ideology always plays a profound role in any political–economic system, especially in the process of change, because each economic system is based on certain values. Non-material factors, such as ideas, theories, knowledge, values, norms, attitudes and expectations, were important in transition economies because they could have both induced and hindered change (Porket, 1998: 148). Supposedly, an ideological foundation for the development of a market system already existed in CEEFSU, based on the values, the deeply rooted individualism and rationality of the people. The need to strive for a better economic position, to accumulate wealth and competition are inherent in human behaviour and, thus, cannot be eliminated. They can be suppressed, not eliminated. These values could have fostered an effective market system as long as all impediments to individual behaviour were removed. The shock therapy model associated governments with bureaucracy, waste and corruption and markets with individualism.

Thus, the ideology transmitted in CEEFSU was that of the triumph of capitalism. 'Proletarian internationalism has given way to liberal universalism' (Sakwa, 1998: 73), and 'the word imperialism is out of style and no longer to be found in the dominant political lexicon, even though imperialism is present and does pillage and kill' (Galeano, 1991: 254). The 'propensity to truck and barter' was presented as innate in human nature and essential for the speed of transition to global capitalism. The fall of Stalinism resulted in the 'retraditionalization' of society and the 'delegitimization of state action' (Sakwa, 1998: 192, 193). All this was in line with the worldwide acceptance of free-market ideology. However, the use of the discretionary power of the government could have improved the outcome of the economic system by reducing market power. The goals of economic policy would have been derived through a participatory political process, and the government and the society would have been prepared to trade of freedom to achieve societal goals. The government should have used economic incentives to encourage individual behaviour appropriate to the social goals. Regulations could have been used where individual motivation was lacking. Individualism should have been combined with the common good, necessitating government intervention.

The role of the initial conditions

The course of economic development initiated by the shock therapy process could have been considered radical in a historical context, since the experience of mature market economies demonstrated gradualism as the appropriate procedure. In the meantime, the imposition of the shock therapy model was based on an inadequate understanding of the institutions of the previously state-socialist countries, and it ran counter to the historical traditions, present-day realities and actual possibilities of transition economies. The transition process, for shock therapy supporters, was not peculiar, complicated or enigmatic. 'In fact in many ways it is a well-trotted path' (Sachs, 1993a: 2). The problems faced had to be solved by ordinary means and the 'uniqueness' of the situation required unhesitating and determined action. Many elements of the transition programme did have general application across economies the shock therapy supporters argued. The development of market relations was path-independent, which implies that the development of market relations was not culturally embedded.

However, despite all their systemic similarities, the transition economies differed considerably from each other in many respects. The transition to a market economy was, by its nature, a path-dependent process. Path-dependency meant not only that transformation would have been affected by the initial state and, therefore, by the history of the system and country undergoing transformation, but also that steps taken earlier would have influenced the direction and speed of later policy choices. Shock therapy apologists sometimes repeat the excuse: 'you can't make an omelette without breaking a few eggs'. Cohen (1998: 249) argued that, if we were to learn anything from the past, 'there would be no omelette, only a mass of broken eggs in the form of crushed hopes and lives'.

The role of institutions

The shock therapy transition model recommended economic policies independent of the present institutional structure. This presumably reflected their basic assumption of perfect knowledge. In the certain or calculable probabilistic world of neoclassical economics, there is no need for forward contracts since there cannot be any deviation from the foreseeable agreed terms of the contract. However, equations do not embody institutions.

Economic policy cannot ignore institutions since the institutional framework of an economic system is a basic element of its economic dynamics. Economic behaviour is highly influenced by institutions, since individuals are not only atomistic beings, but also most importantly social beings. This is because economic behaviour is positioned in socially constructed institutional structures and not in an impersonal market process. Economic behaviour takes place within a 'socio-economic context', with individual constraints 'which promote and prevent, reward and punish his or her actions' (Kregel *et al.*, 1992: 85). Political–economic reforms fail not because market liberalization proceeds quickly or slowly, but because supportive institutional reforms develop too slowly. The pace of institutional development determines the pace of reforms.

Culture was extremely important in the development of the institutional structure. Culture provided a language-based conceptual framework for encoding, interpreting, processing and utilizing information, thus influencing the way informal constraints were specified. Conventions and norms were culture-specific. The future is uncertain and not calculable, so rational expectations in the neoclassical sense are impossible. Most economic activity is based on accepted conventions (Robinson, 1974: 8). For example, preferences were not exogenous in transition economies. Socially defined conventions about consumption substantially influenced consumer preferences. Because information was difficult to acquire, and limited, individuals depended on socially determined behaviour and conventions. The shock therapy transition model, however, ignored the specific elements of culture in the development of the institutional structure. In the shock therapy transition model there was no concern with the efficient design of institutions, the political and cultural consequences and how the existing institutions influenced transition to a market economy. Shock therapists ignored the importance of social institutions and the role of the state in the market.

The aim of market institutions was to encourage self-interest and, at the same time, safeguard the society from any tarnish of civic values by individualism. Institutions control the diverse individual interests in an efficient manner. Failure by suitable institutional structures to restrain the pursuit of self-interest inhibits the development of a cohesive society. This was exactly what happened in transition economies. Corruption could not have been reduced in transition economies until the institutions of a market economy were fully established. When the state started to disintegrate, which resulted in an inability to foster an institutional framework, the only path remaining was that of a criminal sociopath (Bunknall, 1997: 21).

In CEEFSU institutions of private property did not exist. There was no independent judiciary and no bourgeois state to enforce private property rights. Yet, without these guarantees, most capitalists remain reluctant to put money into productive investments. Hence there has been little productive investment and little development, and the economy continues to sink even after privatization. The result was widespread corruption – the term Mafia lost its exclusive Italian connotation (Holmstrom and Smith, 2000: 1) – in which the new bourgeois was developed in a process of 'kleptocracy' (Eyal *et al.*, 1997: 62). What shock therapy economists did not recognize was that the institutions of Western capitalism, including the legal, political and economics infrastructure were not easy to replicate. As a result, trust in such institutions was seriously undermined and slowly disappeared.

The role of speed

Capitalism required a class of capitalists and a class of proletarians. These classes did not come into existence naturally and spontaneously. It was impossible for Russia, with a history of nearly 1,000 years of autocratic rule, to convert rapidly to capitalism since social norms, attitudes and the way of thinking restricted the development of capitalist institutions. The early hopes and expectations for a rapid transition 'were naïve at best' (Kagarlitsky, 1993: 88; Weisskopf, 1996: 286; Zwass, 1999: 236). The teleological theories of progress behind the neoclassical models of transition were inapplicable for transition economies.

Given shock therapy's insistence on the need for speed, there was no time for a native capitalist class of small private entrepreneurs to mature over decades or centuries into large corporations. For the shock therapy approach to be able to set up the basis for 'normal' capitalist accumulation, capitalists had to be created as soon as possible. 'There was no feasible way his [Sachs's] privatization could be done legally, legitimately or morally' (Holmstrom and Smith, 2000: 9). This class had to be 'hothoused', virtually overnight. In the end, a combination of elements was essentially drafted to privatize the economy, using criminal methods: the underground Mafia, the nomenclatura and segments of the intelligentsia. Thus 'spontaneous privatization' was a deliberate strategy by the nomenclatura and criminal elements to transform itself into a capitalist class. Indeed, economic advisors – the highly paid missionaries and the Harvard Institute for International Development (HIID) – bear much of the responsibility for the creation of CEEFSU's criminal capitalists. Currently, there is an investigation into whether, and to what extent, the HIID broke US laws. It has been claimed that they channelled hundreds of millions of dollars from the US Agency for International Development into the hands of corrupt privatizers. Also, it is being ascertained to what extent Harvard academic advisors personally profited in the process (Holmstrom and Smith, 2000: 9).

The introduction of market relations in CEEFSU has not delivered the desirable results. Burawoy and Krotov (1993), Burawoy (1996) and Reardon (1996) argued that the collapse of centrally administered socialism and the implementation of shock therapy gave rise to merchant rather than industrial capitalism. In merchant capitalism exchange dominated production and trade was orchestrated by the state by distributing export quotas, licenses and money credit. This was because, in an environment of chronic shortages in transition economies, enterprises were motivated by the maximization of profits, not through production but through trade, buying cheap and selling dear. The new entrepreneurs, the previous managers, operated in an environment of monopolistic behaviour, illegal transactions and against weak state competitors. The introduction of market relations could not have eliminated such behaviour, as there was a blossoming of premodern forms of exploitation. Monopoly and barter increased because of the disintegration of the party state. The withering away of the party state led to the reconstruction of the economy and the emergence of a fragmented, anaemic and ineffective liberal democracy, incapable of introducing a market economy with hard budget constraints. Hence, the new entrepreneurs, rather than thinking long-term, tended to seek quick enrichment and, in fact, were highly ambivalent toward capitalism, since they were used to weak state competitors, behind-the-scenes transactions and monopolistic behaviour (Share, 1995: 573).

Merchant capitalism did not evolve into industrial capitalism. Rather it inhibited the development of capitalism by conserving anti-capitalist forms of production upon which it survived. That is to say, merchant capitalism, as both Weber and Marx demonstrated, was a development away from bourgeois industrial capitalism (Burawoy and Krotov, 1992: 17–18). Corruption under the previous regime was a result of necessity, due to the shortcomings of the central administration of the allocation of resources. Today, however, due to the adoption of the shock therapy process of transition, corruption has become the predominant medium of accumulation. This unprecedented level of corruption resulted not only in a loss of tax revenue but also in the erosion of the evolutionary process of the development of the capitalist class. In addition, capitalist ideology based on the rule of law has been eroded. The voluntary relationships between economic actors in the market system have been replaced by a combination of greed and fear, making the development of a civilized capitalist system impossible. ‘Today, as yesterday, the process of primitive accumulation is not a pretty one’ (Holmstrom and Smith, 2000: 4). Consequently, ‘there is no market road to a market economy: it requires a strong centralized state that dictates the transition to economic actors’ (Burawoy, 1996: 275).

The role of privatization

In conditions of general uncertainty, it was impossible to carry out privatization without weakening economic links and undermining managerial confidence and efficiency. This resulted in destabilizing production, destroying productive forces, increasing unemployment and generally deepening the crisis. Privatization simply resulted in enriching the managers, without any benefit to the workers or to production. The collapse of central administration passed power from the central authority to the managers, who appropriated – ‘stole’ – the enterprise’s assets through spontaneous privatization, transforming themselves into a new bourgeoisie. In Russia, due to the sluggish institutional structure, the former Russian nomenclatura, often in collaboration with Mafia–like groups, allegedly composed of former KGB officers, was more successful than its Central European counterparts in turning public property into private wealth. Eyal *et al.* (1997: 62) characterized post–Stalinist Central Europe as ‘capitalism without capitalists’, while the emerging Russian structure was ‘capitalists without capitalism’. Those running Russia are ‘the same old crooks (quite literally) who ran it before’, the ‘self–professed Communists turned-anti-Communists’, but nowadays they have money to spend and invest abroad (Ticktin, 1998: 90; Cohen, 1998: 244). Trotsky had argued that it was self-evident that members of the ‘bureaucracy’ would, in the end, have preferred to own property, rather than to have administered state enterprises (Ticktin, 1998: 81).

The myth behind the development of the widespread ownership of private property through the free distribution of vouchers – ‘peoples’ privatization’ – had not materialized, nor had the dream of ‘people’s capitalism’. For the transition towards capitalism to succeed, it was essential to gain the support of the managers. Support was gained by allowing management to keep its privileged position and, at the same time, to substantially increase their fortunes despite the ‘free distribution of shares’. Control still rested with management, who disregarded the owners of vouchers. They considered vouchers to be inconvenient, as they did not help raise capital but required a dividend payment. In many cases in Russia, managers encouraged workers to buy more shares in the enterprise so as to strengthen their own control, which resulted in the concentration of large amounts of capital in the hands of the few. Finally, the bureaucracy 'got what it wanted: a title to property and the right for the first time to be defined as a 'class' in its own right' (Ticktin, 1998: 90). In such an environment 'it is not the state which is privatizing the soviet enterprise, but the soviet enterprise which is privatizing the state' (Clarke, 1992: 5). In reality, privatization was a misnomer; it was, in fact, 'decentralization' (Eyal *et al.*, 1997: 71; Cohen and Rogers, 1996: 102).

At the end, 'not only despite, but because of marketization' (Parish and Michelson, 1996: 1045) through the free distribution of vouchers, a dominant class of private owners emerged. We should not at all be surprised by the outcome. The voucher privatization of state enterprises in transition economies was reminiscent of Roemer's coupon economy. Roemer (1996a: 386) and Bardhan (1993: 149) demonstrated that, if vouchers representing shares in the nation's firms were equally distributed to all citizens and held as traditional private property, with the right to sell, such vouchers would have rapidly become concentrated in the hands of a few. It was individually optimal for the weak and disadvantaged to sell the vouchers (Nolan, 1995: 107). Under Roemer's version of market socialism, the poor and the middle class would have been only able to exchange, not liquidate, their vouchers and, therefore, would have remained the dominant voucher–holders (Roemer, 1996b: 29).

The initial distribution of ownership should had been a major concern, because it would have determined the distribution of power and influenced equity and efficiency. Because markets did not approximate perfect competition and were dominated by domestic and international monopolies, the initial distribution of power increased inequalities. In addition privatization, through the distribution of free vouchers, did not change the competitive environment. Thus monopoly power was not reduced and success in business was linked inextricably to the personal relations enjoyed. As a result, the entry of new firms was obstructed and innovation stifled.

The transition economies lacked private capitalists with the necessary financial capital to purchase enterprises, making foreign ownership the only alternative. It was not by coincidence that foreign capital came to the rescue of transition economies. This was an act of purposeful action by the mature market economies, ensuring that foreign ownership was the only permissible medium of privatization. A process, like shock therapy, implicitly had the goal of initiating the destruction of any institutional barrier inhibiting the penetration, influence and power of foreign capital. The International Monetary Fund and the World Bank were responsible for creating the depression in transition economies through the collapse of domestic markets and COMECON, the development of the hard budget constraint, and the provision of foreign aid conditional on satisfying specific 'shock therapy' targets. In such an environment, the only interested buyers come from abroad at a price 'for next to nothing' (Gowan, 1995: 45). There was 'a brutal struggle to steal everything they could get their hands on' (Holmstrom and Smith, 2000: 7). Equally important was the pressure exerted on governments of transition economies to sell state assets and public utilities to multinational companies (the only possible buyers) to reduce fiscal deficits, lower inflation and discipline the labour market by inducing high unemployment. Effectively, multinationals practiced 'cherry-picking' in the name of global integration and national disintegration (Radice, 1993: 10). Packages of incentives and legal regulations were often negotiated on a case-by-case basis, making the process appear arbitrary and even corrupt (Smyth, 1998: 366). As Bucknall (1997: 8) stated, 'it must be great fun remaking nations, a chance few ever get, and it must be even better when it is personally profitable'. Nevertheless, 'this does not so much suggest a new era on the globe as something rather old fashioned which, in the days of communism, used to be called imperialism' (Gowan, 1995: 60).

The role of foreign aid

The international organizations and mature market economies were certainly not sending massive amounts of aid eastwards to facilitate the transition. There was no second Marshall Plan. However, this did not preclude massive political intervention from outside to ensure that the transition economies adopted the 'right' course of economic action. The development policies pursued and funded by the IMF and the World Bank were inimical both to the interests of the people and to the natural environment in CEEFSU. Meanwhile, neither international organizations nor mature market economies wished to see the transition economies descend into complete chaos. Hence the strategy was to provide limited and conditional support for market reforms to allow for the international exploitation of parts of the transition economies, integrate the transition economies into the world financial system, and permit a very narrow sector of their domestic population to enrich themselves. This, of course, would not have led to the rebirth of the transition economies. Nor would it have improved the lives of the ordinary people. However, it would have kept the elite of the transition economies quiet internationally and prevented disturbances in CEEFSU spilling over into the wider world. If the mature market economies could have gained access to cheap resources, then so much the better for them (Arnot, 1998: 234).

If the mature market economies really wished to improve the chances of a democratic consolidation in transition economies they should have forgiven old debts, offered generous new aid, and dismantled their own trading restrictions (Blackburn, 1991a: xv). Instead, the conditional nature of IMF and World Bank funding assured investors that transition governments would not bend to popular pressures to abandon the shock therapy policies. The IMF and World Bank's financial and technical assistance programs to CEEFSU stipulated that recipients could neither place restrictions on foreign direct investment nor encourage development banking. For example, the terms of a World Bank loan agreement constrained the ability of the Polish Development Bank to issue direct, subsidized industrial loans. Moreover, these international organizations barred transition economies from pursuing gradualist reforms or state intervention. The dependence of the IMF and World Bank on the US capital market for their funds has effectively transformed these institutions into agents of United States foreign policy (Barratt-Brown, 1995: 327).

The role of social policy

Social protection was embedded in centrally administered socialism and was expressed as a cumulative series of rights. Today in CEEFSU poverty is endemic, together with humiliation and economic collapse. Transition governments have been pressed by the IMF and the World Bank to cut public spending and, in particular, to eliminate the large public subsidies for housing and food. Privatization exposed the population to the risks of the market without any institutionalized safeguards and ensured the loss of guaranteed shelter and cheap food, which constituted a denial of the collectivist ethic of the previous system. The IMF insisted on spending cuts in education, medicine, culture and even assistance to people disabled by the Chernobyl nuclear disaster (Kagarlitsky, 1999: 26). This was in contrast to the controversial *World Development Report on Poverty*, produced by the World Bank when Joseph Stiglitz was chief economist, which argued that effective safety nets should have been created before free-market reforms were introduced. Indeed, the transition process required an adequate social policy. Its creation should have been an integral part of the transition design, since as it was required to cushion the most vulnerable groups of the population, as well as to ensure political support. However, the shock therapy did not provide adequate resources for an effective social policy.

Conclusion

It has been demonstrated that the shock therapy model incorporated, in addition to immediate liberalization of the transition economies, the following:

- An imposed ideology of free markets;
- No concern about the initial conditions of transition economies;
- Ignored the development of institutions;
- Resulted in the development of merchant capitalism;
- Used privatization methods to facilitate ownership by the Stalinist elite and multinationals;
- Linked the limited foreign aid with the achievement of shock therapy strategies;
- Resources were inadequate to provide social protection.

In such an environment it should not be a surprise that transition economies suffered, and most of them are still suffering, low growth, inflation, unemployment, corruption and crime. In addition, a domestic capitalist class, the same class that controlled economic–political–ideological affairs under Stalinism dominates the economy. Jointed by the multinational capitalist class, the same class that dominated economic–political–ideological affairs in the 'free' world but now it has become truly international it had become globalized.

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