Peter Gowan

Neo-Liberal Theory and Practice for Eastern Europe

Eastern Europe's market for policy ideas, suddenly opened in 1989, was swiftly captured by an Anglo-American product with a liberal brand name.[1] This policy equivalent of fast food erected barriers to other new entrants and established a virtual monopoly on advice in most target states in the region. While some critics view it as having as much connection with West European liberalism as a Big Mac has with boeuf bourguignon, it has made up for any deficiency by superb advertising and aggressive salesmanship.

The public launch was handled by the *Economist* on 13 January 1990 with a long article by Jeffrey Sachs of Harvard. Under the significant title 'What is to be done?', Sachs wrote in the style of a Lenin of decollectivization against all the assorted Menshevisms of half-measures. Yet the article is worth re-reading for it reminds us of the *status* of the debate in which Sachs was intervening. It was about how the West should seek to reshape the life of the entire East European region. Only one aspect of the debate and of Sachs's policy concerned the sequence of domestic changes required of governments in the various individual states. Indeed Sachs's programme was about creating an international environment in which the domestic aspect of his policy would become the only rational course for any government to pursue.

Sachs's proposals were enthusiastically supported by both American and British policy-makers and they have become household names in Eastern Europe: every Russian schoolchild learns about the 'three *zatsias*'. Such popularization is also widespread in Western universities where the policy is boiled down to an abstract, universal tool-kit for the DIY construction of Market Economies out of Communism: an immensely attractive format for university teaching. At the same time, Sachs's ideas have received the very highest accolades from the Anglo-Saxon academic world. The Harvard professor gave a famous series of lectures on his paradigm at the London School of Economics. These were subsequently published by MIT. He is widely credited with founding a new discipline, 'The Economic Theory of the Transition'. Since Harvard and LSE professors would buy it and even sell it, few policy intellectuals in the defeated East could have the self-confidence to doubt its scientific credentials.[2]

In truth, Sachs has never claimed to be offering either a tool-kit or a new theory. He is not a crude purveyor of ideological nostrums, but a serious and independent theorist who is nobody's lackey. He is, however, also strongly committed to a vision of a globalized, unified capitalist world which he believes would benefit the whole of humanity and he evidently saw an opportunity for bringing that vision closer by becoming involved in formulating a policy for the transformation of the East European region. Like all rigorous policy, his contains a more or less explicit model of the behaviour of the relevant actors and of the ways in which they will interact in given contexts, faced with given constraints and incentives.

We will first try to clarify what Sachs's policy model has actually been. We will then examine the extent to which the main actors identified in the model have actually behaved in the way the theory predicted. And in the light of that experience we will attempt to draw some conclusions about the real relationship between Western policy and the ideas propagated by Sachs and his followers, and suggest an alternative model for understanding what has happened. Sachs's policy has had various names: shock treatment, radical economic reform, Big Bang, the 'three *zatsias*' or shock therapy (ST). Sachs himself has not been happy with any of these names

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[1] I would like to thank Perry Anderson, Laszlo Andor, Robin Blackburn and Wendy Carlin for their comments and criticisms of an earlier draft of this essay—though of course this is not to say that they concur with all the views expressed in it.

[2] It should be said, however, that Alice Amsden of MIT, together with Jacek Kochanowicz of Warsaw and Lance Taylor of the New School, have provided a damaging challenge to this consensus with their book *The Market Meets its Match*, Princeton 1994, drawing on East Asian experience to challenge Shock Therapy orthodoxy.

but has come to accept the latter name and we will follow him in this, calling his model ST.

I. The Shock Therapy Model

Sachs's model has the characteristic problem-solving form familiar in policy analysis: it says, if you want to achieve outcome A, then you must get actor X to produce output Y, which will then interact with its environment in such a way as to achieve outcome A. The model makes assumptions about the behaviour and motivations of the relevant actors, about how they will respond to given negative or positive incentives and about the context in which they act. We evaluate the model by judging whether it really will achieve outcome A and, if so, whether it will achieve it at least cost.

Sachs formulated his model to solve one big problem: how should the entire ex-communist region of Eastern Europe and the USSR be re-organized in order to achieve, in Sachs's words, 'a recovery of human freedom and a democratically based rise in living standards.'[3]

A very broad spectrum of opinion, at least in the West, would accept this problem-definition and desired outcome. Yet many would be suspicious of a concerted, Western-directed plan for regional social engineering to achieve this outcome. Ralph Dahrendorf expressed two worries on this score. He argued that 'the countries of East-Central Europe have not shed their communist system in order to embrace the capitalist system—whatever that is . . . If any creed has won . . . it is the idea that we are all embarked on a journey into an uncertain future and have to work by trial and error within institutions which make it possible to bring about change without bloodshed.'[4] Dahrendorf's rejection of the whole idea of a Western system is an implied warning against social engineering to achieve a forced decollectivization. Sachs defends such grand planning on the grounds that the world is governed by systems (communism and capitalism) whose main structural features of socio-economic and power relationships are perfectly understandable: however variable in detail they nevertheless have, so to speak, the same basic genetic codes.

But Dahrendorf's second concern is the primacy of respecting the existing tissue of social institutions and of strengthening social institutionalization by introducing openness: the free circulation of ideas and the building of consensus through debate, negotiation and compromise. This approach would place the development of a legal state and political liberalism above schemes for systemic change: the latter should grow out of the 'open society' or 'civil society'. Sachs rejects this, saying that if the states of the region adopted Dahrendorf's approach 'of open experimentation, I doubt that the transformation would be possible at all, at least without costly and dangerous wrong turns.'[5]

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[3] Jeffrey Sachs, 'Understanding Shock Therapy', *Social Market Foundation*, 1994, p. 25.
[4] Ralph Dahrendorf, *Reflection on the Revolution in Europe*, London 1990.
[5] Jeffrey Sachs, *Poland's Jump to the Market Economy*, Cambridge, Mass. 1993, p. 4.

Thus, what might be called Sachs's inverted Leninism[6] is more than a matter of style: it relates to the entire methodology of his model: he is a strong believer that he—or at least the West—can plan in such a way as to enable the peoples of the region to avoid costly wrong turns, and he simultaneously believes that, left to their own collective efforts, they would take wrong turns or indeed might not opt for his goals at all. The corollary of these views is that the policy he advocates will entail a sequence of events in which institutional consolidation and democratic stabilization brings up the rear.

1. Path and Output at a Regional Level

Sachs's policy has had as its object not individual states but the entire post-communist region of Eastern Europe. He advanced his ideas in line with the views of the American and British governments about the transformation of Eastern Europe as a region. He also counterposed his regional goals with an alternative solution which dovetailed with the French government's general approach. We will summarize the regional policy which Sachs opposed before turning to his alternative:

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

The alternative, American approach, for which Sachs was a passionate advocate, involved:

1) Breaking up the Comecon region and above all, breaking East-Central European countries from the USSR.
2) Making a root-and-branch switch to a particular form of capitalist institutional structure in each state a precondition for normalizing relations with that state.
3) Imposing, therefore, a hub-and-spokes structure on the relationship between the West and East-Central Europe,[7] with each target state in the region relating to the others principally via its relationship with the Western hub.
4) Starting the process of regional transformation in the states with the most politically sympathetic governments and then using both negative and positive incentives to extend the required mix of domestic policies across the region as a whole.

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[6] To be more exact we might better say 'inverted Preobrazhenskyism'.

[7] American policy in 1990–92 continued to favour the maintenance of a Moscow-centred economic space in the Soviet region, except for the Baltic republics.

5) The entire process would be carried forward by the capacity and will of Western states to provide, in the main via their multilateral organizations, the necessary positive incentives for cooperative governments and constraints for uncooperative governments.
6) The revival of economic activity in cooperative target states would take the form of trade-led growth directed toward Western Europe, compensating for Comecon's collapse.
7) Cooperative states would gain full access to the market of the EC (partly through radically changing some of its key institutional pillars, such as its trade regime and Common Agricultural Policy), very substantial economic assistance and eventual membership of a greatly enlarged EC.

Sachs's 1990 article outlines this entire approach with cogency. He claimed that keeping the Comecon region together would be sub-optimal: the 'East European common market that some suggest as a precursor to integration with the West would simply be a poor man's club.' He therefore urged its break-up and in effect the start of a competitive race by East European states to prepare themselves for direct entry into the West European market. Secondly, he rejected mixed or hybrid forms of socio-economic system on the grounds that market socialism had proved to be unworkable: the East European states 'must reject . . . ideas about a "third way"' and 'go straight for a western-style market economy.'[8] He urged radical reform in the EC to accommodate an export surge from target states and called for an unprecedented degree of funding for cooperative states from Western sources, especially from Germany.

In 1990 Sachs was able to point out that his model was already being applied by two states in the region: Yugoslavia and Poland. As Sachs, who had been advising the Yugoslav government in 1989 and had then transferred to Poland, explained: 'Poland will bring in the first comprehensive market-oriented reforms in Eastern Europe. Yugoslavia will undertake a similar programme.'[9]

The American approach as articulated by Sachs was, of course, adopted by the G7.[10] Its key element—the fragmentation of the Comecon region and its replacement by hub-and-spoke relations between isolated Eastern states and the West—has subsequently been largely naturalized in Western public and academic discourse. Debate about ST has thereby been reduced to cost–benefit analysis of whether the spokes should accept Western conditionality or attempt an isolationist policy, or some possible half-way house between the two.

[8] Jeffrey Sachs, 'What is to be Done?', *Economist*, 13 January 1990.
[9] Sachs, *Poland's Jump to the Market Economy*, p. 25. Sachs noted that the Yugoslav outcome would differ from Poland's for Yugoslavia would maintain, in large measure, its self-management approach to corporate governance.
[10] Franco-German proposals to keep the USSR and Eastern Europe linked via a free-trade regime were rejected; French ideas for an EBRD which would engage in large public infrastructure projects embracing the USSR and Eastern Europe were emasculated. And the French notion of a pan-European confederation embracing both the EC and the whole of the East were repudiated. Poland, and for a short while Yugoslavia, became the flagships of the alternative approach.

The fragmentation of the Comecon region may seem as natural as, say the hostility of Serbs, Croats and Bosnian Muslims in the 1990s or the hostility of the French towards the Germans in the late 1940s, but to believe that is to ignore the capacity of the West to shape outcomes. This capacity was used by the US to bring France and Germany together. As Richard Holbrooke, the US Assistant Secretary of State for European Affairs, has recently pointed out, this capacity was not used in Yugoslavia and the result was, in his view, 'the greatest collective security failure of the West since the 1930s'.[11] In 1990 and 1991 Western influence was used to encourage the fragmentation of the Comecon region. Sachs was part of that effort and he justifies the break-up not on the grounds that it was bound to happen, but on the grounds that it was desirable from an economic point of view. The policy did not oppose a slide towards national autarky. Indeed, it encouraged such a condition from which it hoped that agreeing to Western terms for hub-and-spoke integration would appear not only the best but the only rational exit.

Thus, at a regional level the path lay through the gradual absorption of the states concerned into the Western economy institutionalized in the various multilateral organizations and especially the EC. The end product would be a unification of Europe in a single (reformed) EC market. This would generate, on a regional scale, the desired outcome of prosperous capitalist democracy.

2. The Key Output of Shock Therapy in Each State

If ST's projected *outcome* in each state is democratically-based increased living standards and freedom, the *output* of Sachs's policy is institutional.[12] Sachs has often named it as a 'market economy' or 'capitalism'. Yet closer examination reveals that specific state-institutional forms are the central output goals of ST at the level of a single country, not capitalism as such. He puts matters as follows: 'At the base of all of this transformation [is] . . . the idea . . . that the post-communist world have the potential to grow more rapidly than the develop[ed][13] world and thereby to narrow the gap in living standards, *if they harmonize their economic institutions and join their economies to the global economic system*.'[14]

Even on the occasions when Sachs says his goal is simply 'capitalism',[15] we discover that he means the very particular institutional matrix which

[11] Richard Holbrooke, 'America, a European Power', *Foreign Affairs*, March-April 1995, p. 40.

[12] A common vulgarization of ST, much favoured by the *Economist*, involves muddling output and outcome and switching promiscuously between the two as each suits for evaluating ST. This propagandistic vulgarization is exemplified in its survey of East European economies of 3 December 1994, p. 23.

[13] Sachs is printed here as writing 'the developing world' but this must be a misprint: the context shows he means the developed world. See 'Understanding Shock Therapy', p. 15.

[14] Ibid., p. 15 (italics in the orginal).

[15] Sachs uses the claim that his goal is capitalism as such to claim that he is politically neutral between all varieties of capitalism, whether Swedish, South Korean or Chilean. Yet the specifics of his arguments refute this apparent neutrality.

excludes most capitalisms throughout history from qualifying as capitalist at all. Sachs tells us that 'the main precepts of capitalism [are] open trade, currency convertibility, and the private sector as the engine of growth.'[16] By this strange formula, Western Europe was not obeying capitalist precepts before 1958 (no convertibility) and the USA was not following capitalist precepts in the highly protected inter-war period. These are thus the precepts not of capitalism but of Sachs, and two out of his three precepts could in theory be applied without a capitalist economy at all: they are to do with the external economic relations of states.

His desired output is further revealed by the six 'core reforms' that he tells us must be achieved:

> (1) Open international trade; (2) currency convertibility; (3) private ownership as the main engine of economic growth; (4) corporate ownership as the dominant organizational form for large enterprises; (5) openness to foreign investment; and (6) membership of key international economic institutions, including the IMF, the World Bank, and the GATT . . .[17]

Thus, four of his six planks (numbers 1, 2, 5 and 6) are about changing a target state's external politico-economic relations and one (number 4) is about a particular form of capitalist ownership: the form which enables companies to be bought and sold easily. Only number 3 refers to what would normally be meant by capitalism. In short, the output of Sachs's model is a very specific political economy: a state as open as it is possible for it to be to the forces of international economic operators: a state with a globalized institutional structure, through which the resources of what he calls 'the global mainstream economy' can flow.

It is this output which lays the basis for the desired outcome in the countries concerned: 'In effect, by rejoining the rest of the global economy, they are able to import some of the prosperity from the rest of the world, usually through the importation of new technologies, organizational patterns and finance.'[18] Or again, when the target states are 'opened wide to international trade' and to international capital, they will gain 'the new technologies, managerial talent, organizational methods and financial capital needed to overcome the dismal economic legacy of the past forty years.'[19]

Creating the free trade regime and the right institutional and economic conditions to attract foreign direct investment (FDI) are the core output

[16] Sachs, 'Consolidating Capitalism', *Foreign Policy*, no. 98, spring 1995.
[17] Ibid. Though always keeping the number six, Sachs's list differs from the above in his Social Market Foundation pamphlet 'Understanding "Shock Therapy"'. Given the name of the foundation for which he was writing, he astutely adds as his sixth core reform the introduction of a social safety net, thus dropping the point about meeting the membership criteria of the multilateral institutions. But he nevertheless makes clear the importance of joining these organizations in his SMF pamphlet.
[18] Sachs, *Poland's Jump to the Market Economy*, p. 3.
[19] Sachs, 'What is to be Done?'

goals for generating the desired outcome: prosperous capitalist democracies. Together, they will produce the efficiencies for growth.

Sachs's theme has been repeated tirelessly by American diplomats and the officials of the international financial institutions (IFIS). As the US ambassador to Hungary put it recently: 'I have often been asked why there isn't a new Marshall Plan to help Central and Eastern Europe. Well, there is—it is here—and it is called private foreign investment ... Foreign investment creates jobs, enhances productivity, generates economic growth, and raises the standard of living. It brings new technology, new management techniques, new markets, new products, and better ways of doing business.'[20]

Another ST enthusiast, John Lloyd, has been particularly critical of those (on the Left) who fail to grasp the link between ST and the reality of global capital. All states must create open institutions that can tap into the huge, mobile capital resources in the world economy:

> The world in which choices are made a hundred times a day as to which economy millions or billions of dollars are invested in, the world in which commodities such as cars and computers and planes are put together in one location from parts made in a thousand; the world in which rivers of data flow to and fro across 'borders' bearing information that a wilderness of KGBS could not analyse, or even capture—that is the world into which the Russian reformers had to struggle to insert their country.[21]

Failure to adapt to the reality of globalization will lead, in Lloyd's view, to disaster. 'The world,' he says 'would not tolerate a "special" Russia if being special meant an unconvertible currency, an unreformed industrial structure and a hostile investment climate ...'[22]

The vision of tapping into the resources of global capitalism to modernize the economy was a powerful motive for Eastern supporters of ST, as Yegor Gaidar illustrated in an interview with the *Economist* in early 1992, just after he had taken charge of the Russian economy. When the *Economist* asked him whether the Russian people would accept the likely 'economic shocks' of 'an extraordinarily difficult transition', he seemed unaware that they were referring to the slump which his policy would cause and thought that the shock would be the flood of FDI that would engulf Russia. He therefore responded by saying:

> It is hard to feel threatened by a possibility that, say, Germany or France will buy up the entire country.... We are also different from East Europeans. We don't have so much xenophobia. The social and political problems connected with foreign investment are easier here than, for instance, in Poland, which is preoccupied with its

[20] Speech by Ambassador Donald Blinken at the Collegium Budapest, 16 March 1995. Mimeo, US Embassy, Budapest.
[21] John Lloyd, 'How to Make a Market', *London Review of Books*, 10 November 1994.
[22] Ibid.

> relationship with Germany. That is why I think that our opening and integration into the Western world is a historical and socio-political chance for the West and for Russia also.

But the really ingenious aspect of Sachs's work has been the way in which he has justified the sudden opening of target economies to global capital as the necessary first steps in government policy for what we would normally think of as capitalism. He justifies a sudden switch to free trade; early convertibility is justified as a means to anchor world prices in the domestic context and as a springboard to economic revival through trade; and FDI is indispensable for privatization and restructuring. All Western authorities have joined Sachs in insisting on these aspects of his policy. The role of FDI is particularly stressed. Thus the joint study by the IMF, the World Bank, the OECD and the EBRD of the Soviet economy, carried out at the behest of the G7 in 1990–91, pointed out that FDI would be 'crucial in the transition'.[23] The OECD concurs in its own study that it is 'crucial to the process of transition to a market economy',[24] and it adds that 'the privatization process must extensively rely on FDI'.[25] Creating the institutional conditions for FDI is thus not only the omega of ST; it is the alpha as well.

3. The Key Shock Therapy Actors

It is precisely because Sachs's goal is an institutional order radically open to global capitalist forces that the central actors in ST are governments. As Sachs explains, 'markets spring up as soon as central planning bureaucrats vacate the field'.[26] But to achieve *the right kind* of capitalist market institutions requires the sustained application of political and social engineering by governments in the target states and in the West—the latter operating in the main through their multilateral institutions. The joint action of Eastern and Western governments is needed to breed the right brand of capitalist private sector and to attract the interest of Western global capital.

Sachs insists on the centrality of Western governments: 'success in the economic transformation will depend not only on the East, but quite fundamentally on the West as well.'[27] He endlessly lists the West's power

[23] See UNCTAD, *World Investment Report 1994. Transnational Corporations, Employment and the Workplace*, New York and Geneva 1994, p. 98.
[24] OECD, *Integrating Emerging Market Economies into the International Trading System*, Paris 1994. The actual OECD formulation here is interesting. It puts its statement in the passive voice, saying: 'The contribution of inward foreign direct investment (FDI) is considered crucial to the process of transition to a market economy.' It thus avoids saying *who* considers it to be crucial, but we are left to infer that the OECD itself believes this to be the case.
[25] Ibid. The OECD does not explain the force of the 'must' here except to say that foreign companies will be central 'in restructuring the state-owned industries'. This, as we have seen, is because the World Bank in Poland and Hungary would not allow industry ministries to restructure before privatization.
[26] Sachs, *Poland's Jump to the Market Economy*, p. xii.
[27] Ibid., p. 7.

resources:[28] the capacity to open or close their markets to East European products; to decide on debt, on grant aid, on loans, and on the terms for loans for political as well as economic purposes, on technology transfers, on currency support and so on; to decide on entry or exclusion from international institutions; to allow Eastern workers to flow westwards. All these give Western governments tremendous bargaining power.[29]

The element in his policy which is concerned with political power is frankly acknowledged by Sachs: 'the problem of reform is mostly political rather than social or even economic.'[30] The task is to change an entire social and institutional order, so power and conflict will be absolutely central to the process.

This centrality of Western power has provoked sharp debate amongst ST supporters over the precise articulation of negative and positive incentives, a debate largely centred on differing appreciations of the motivational factors governing the behaviour of East European governments. Some say the only effective incentives are negative, exclusionary ones.[31] Sachs himself disagrees, insisting that once a government has publicly committed itself to ST and launched the programme, it will have the will to follow through but inadequate means. At this point the West must provide large funds to help the government with economic and political crisis management. ST thus requires that Western governments will provide grants for a target state's foreign exchange reserves, money for social security payments, 'cancellation of most of the debt owed to Western governments and banks', long-term development finance for which 'grant aid is again needed.' So too is free movement of labour westwards. They must also throw open their markets to the East. Failure by Western governments to deliver at this point, says Sachs, will lead to 'criminality, political extremism, civil unrest, hyper-inflation, capital flight, and, in the worst cases, civil war'.[32] Thus for Sachs, once ST is launched in a target country, the West quickly has effective power over the fate of the target state's population.

Yet there is one large gap in ST in this area. Lengthy discussion of the right mix of carrots and sticks to ensure compliance by Eastern governments sits beside an almost complete silence about the carrots and sticks needed to make Western governments comply. There are two possible explanations for this silence. One would be that the end product of ST in the East

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[28] Though he curiously downplays them in 'Understanding "Shock Therapy"'. He also eschews public discussion of the tactics of conditionality despite the fact that this must have been part of his daily working diet in his consultancy work in the region.

[29] John Lloyd also recognizes the power of the G7 states but he misleadingly calls them 'the world' and proceeds to talk about what 'the world' will or will not tolerate. See 'How to Make a Market'.

[30] Sachs, *Poland's Jump to the Market Economy*, p. xii.

[31] Stanislaw Gomulka has largely subscribed to this view, pointing out that Western macroeconomic support or debt reduction would encourage indiscipline among target governments similar to the soft budget constraints enjoyed by state enterprises under communism.

[32] Sachs, 'Beyond Bretton Woods: A New Blueprint', *Economist*, 1 October 1994, p. 28.

would bring such large economic gain for Western interests that no sticks are needed to ensure the West offers generous assistance. Yet Sachs does not argue this: he remains silent on the direct economic benefits of his policy to the West. Instead he has suggested that Western governments can be driven more by political ideals even when they entail some economic cost. Thus in 1990 he suggested that EC governments would end the Common Agricultural Policy because of the dream of a united Europe: 'The EC will just have to accept that free trade in Polish hams is a price to be paid for living in a united and democratic Europe.' And he explains why the German government in particular will be motivated to transfer very large sums to Eastern Europe: it will be like America's cancellation of FRG debt in 1953, an act which laid the basis for Germany's 'spectacular economic recovery'.[33] But we should probably not take these remarks at face value. Sachs is more plausibly implying that the EC and Germany will respond in the ways required by his policy *because America will effectively exert the required pressure upon them to do so*. In other words, for Sachs, the USA will play the role assigned to it in hegemonic stability theory: in its own hegemonic interests, it will force the West European states to be true to their own long-term interest in achieving a globalized world economy.

As far as economic operators are concerned, the same pattern emerges: the need for rather brutal coercion of state enterprise managements and employees in the East while we can expect large flows of money and technology into the target economy from Western TNCs once the right kind of institutional framework is in place. The motivational factors in the behaviour of Western TNCs are left unexplored.

4. The Interlocking Wheels of the National Policy Cycle

Shock Therapy has been popularized by Sachs, the IMF and others as the three '-izations', which, as we have seen, are now familiar to every schoolchild in Eastern Europe: liberalization, stabilization and privatization. More recently a fourth, final step has been added: institutionalization. But this is to express ST as a linear set of steps by a single actor—the target state's government. If we are to recast the policy as a model of interaction of actors with each other and with their environment we get the following sequence:

1) The liberalizing/ stabilizing shock.
2) The international shock.
3) Privatization and FDI.
4) Trade-led growth.
5) Political/ institutional consolidation and growth.

We will examine each of these interlocking wheels in turn.

1. The Domestic Liberalizing/Stabilizing Shock

The domestic shock of ST is a double one: first, the sudden liberalization of

[33] Jeffrey Sachs, 'What is to be Done?'

prices and slashing of state subsidies, coupled with the imposition of wage controls, and second, a very tight monetary and credit squeeze.

Sachs follows neo-classical orthodoxy in viewing the sudden imposition of decontrolled prices, combined with wage controls, as being a creative process of providing a more efficient allocation of production factors than was provided by Communism. Thus the price-liberalization shock is a stimulant to growth, not a depressant. The credit squeeze and tight monetary policy does have a depressive effect, but it is designed above all to ensure that enterprises are forced to restructure by laying off workers rather than borrowing their way out of difficulties.

An interesting feature of the policy cycle is the fact that the liberalization/stabilization shock is to occur *before* the development of either a domestic group of money capitalists—people who have accumulated large quantities of money to be used as capital—or a domestic system of financial markets. Thus state enterprises will not be able to respond to the shock by combining 'downsizing' of the work force with borrowing for investment in new plant. All their restructuring efforts will therefore be concentrated upon one production factor: labour and its price.

Although Sachs says little about this, there is thus a central social dimension to the liberalization shock: a sudden, dramatic weakening of the social power of the industrial working class: the end of state subsidies while wages are controlled involves a large fall in living standards; the removal of control over prices deepens this fall while the onset of unemployment consolidates the shift in the entire balance of social power.

2. The International Integration of the Target State

As the domestic shock takes effect, two steps are required to tie the domestic economy into the global economy: the radical liberalization of trade and making the currency convertible. The key justification of the trade liberalization is to ensure competition from Western companies in domestic product markets and to prevent local oligopolies from raising their prices excessively. Sachs calls this his 'greatest conceptual break-through'.[34] Trade liberalization involves ending quotas and having very low tariffs: a free trade regime. By making the currency convertible for trade purposes, the link between local enterprises and the world economy will be consolidated.

These changes will go hand in hand with the fragmentation of the Comecon region, which will have a temporary depressive effect but will rapidly be overcome as Western Europe opens its markets and the IFIS help to stabilize the local currencies.

3. Privatization, FDI and Restructuring

An absolutely basic component of ST is the transfer of state enterprises into private hands but, curiously enough, this is the issue on which Sachs has been most vague. Of only one thing is he convinced: that handing

[34] Sachs, *Poland's Jump to the Market Economy*, p. 46.

enterprises over to the people who work in them as managers or workers would be absolutely wrong. Yet even on this issue he changes his mind about why. In his book on Poland he says at one point that handing ownership to managers and workers would be 'stealing'.[35] At other times he has said that handing ownership to the workers 'puts workers at excessive risk', presumably because they would bear full responsibility for the enterprise.[36] At other times, he says it would put the enterprise at risk from the workers because they would pay themselves too much instead of investing.[37] His clinching argument, however, is that worker-owned companies would not be trusted by capital markets; but this only begs the question of the form of the target country's banking system.

In 'What is to be Done?', Sachs urged that 'the firms should be sold for cash', through auctions with a board of Western financial advisers and legal experts checking on the deals.[38] He seemed unaware of the ethical difficulties with this proposal: that those in the target state with the cash to buy a steel mill would be very few in number and without question former or current crooks at the head of Mafia pyramids.

He later dropped this idea on the grounds that it would be too slow a process. Instead of solving the problem of where the money capital would come from to buy the enterprises, he wrapped the process up in a mystery: 10–20 per cent of the shares would go to the workers, 'another fraction' of ownership rights would go to households. They would not get the enterprise shares but would get unit trusts in 'investment funds'. These private 'investment Funds in turn would own the shares of the industrial enterprises', appoint the directors and monitor performance.[39] There would be between ten and twenty such funds. He assures us that criticism on the lines that foreigners would end up running the funds and their enterprises is false, but he does not explain how or why. Nor does he address the fact that ST requires privatization in the midst of recession and that therefore the assets fetch very low prices.

Another major issue is whether the state enterprises should be restructured via a state industrial policy before they are privatized or whether they should be sold to the private sector first and restructured by the new private owner. Sachs tackles this by saying that the target state will lack the expertise to do it, while his nebulous investment funds will have such expertise. This is presumably because the investment funds will be private and only the salaried employees of the private sector possess what it takes.

4. Trade-Led Growth

As with IMF Structural Adjustment Programmes, the target economy's economic recovery is designed to develop above all through trade-led growth, rather than a strong domestic recovery. A large flow of imports

[35] Ibid., p. 32.
[36] He doesn't explain this idea of risk. See 'What is to be Done?'
[37] Sachs, *Poland's Jump to the Market Economy*, p. 83.
[38] Sachs, 'What is to be Done?', p. 26.
[39] Sachs, *Poland's Jump to the Market Economy*, p. 89.

will be needed to retool industries and dynamic export growth will follow. This aspect of the project was of course crucial to ST's impact on longer-term economic welfare. As we shall see, the other elements in ST involved a profound depression of the internal market and living standards. There was, however, meant to be a strong trade surge which would act as the growth motor to bring GNP and living standards up towards West European levels in the medium term. This perspective would depend on the response of the political economies of Western Europe to the transformations in the East.

5. Political/Institutional Consolidation

It has been widely understood and accepted by the supporters of ST that the consolidation of a democratic regime brings up the rear of the ST process as its final outcome. The other side of this coin is that during the process of ST the rule is political crisis-management by the executive, blunting and blocking popular pressures for a halt to or reversal of ST.

II. A Balance-Sheet of Shock Therapy in Practice

Sachs has rightly claimed that most governments in post-communist Eastern Europe have to some degree tried to lock themselves into the hub-and-spokes structures of ST and have tried to combine the demands of the international financial institutions and the EC/EU with often conflicting domestic pressures. Some governments have drifted, without any coherent policy, and only a very few, like the Romanian government, have consciously sought a different road to another form of capitalism.

We will argue five main charges against the policy:

1) That its macro instruments of regional fragmentation and domestic shock change have been immensely costly in the short and medium-term.
2) ST's free trade-led policy for economic revival was largely misconceived.
3) Its micro policies for sustained economic revival have tended to weaken rather than strengthen longer-term revival.
4) The practice of ST on the part of Western actors has sharply diverged from the theory in ways that have damaged the East European states.
5) In terms of its own criteria, ST has been a failure.

We will also suggest that the elements of an alternative strategy contained in the positions of both the Gorbachev government in 1990 and the French proposals at that time would have been far less costly and would have offered far better prospects for the future: keeping the Comecon region united in its own reform project, developing new trade and payment arrangements for that region, and removing Cold War trade barriers to East–West trade, while letting each government move forward experimentally at its own pace. The Western powers had the capacity to structure such an alternative, but the dominant Western powers had no interest in pursuing it.

1. The Double Depressive Shock

The implementation of ST has brought a savage double depressive shock to the entire region. Part of this has been the result of the ST model's insistence on breaking up the Comecon area, rather than maintaining regional trade and production linkages through a customs union and new payment arrangements. Part of the shock has come from the implementation of the first elements of the ST domestic policy cycle.

Every serious commentator on the region knows about these effects. When Sachs first published his ST programme in January 1990 in the *Economist*, that magazine had already explained to its readers what the projected effect of ST would be in Poland: officially the government forecast 400,000 jobless, but unofficially 'economists expect up to 3 million.'[40] The actual outcome was, in fact, in many respects worse, as Table 1 illustrates. In Russia, after six months of ST in 1992 real incomes were reduced to 40 per cent of their 1991 levels and production was plummeting.

The OECD's study of the depression pin-points four causal factors, all deriving from ST. It says that the 'stabilization' aspect, especially the credit squeeze via credit ceilings, 'was identified as the important element contributing to the recession, especially at the beginning of the reform process.'[41] The fragmentation of Comecon-region trade had a disastrous impact on industrial output: 'According to some calculations, this volume effect alone can explain most of the fall in output in Hungary and the former CSFR and about one third of the decline in Poland.'[42] It also stressed that key institutional vacuums, as pointed out by critics of ST, such as the absence of a financial system, meant that 'all countries suffered from an inadequate supply-side response', in other words a downward spiral into protracted depression.

Sachs has responded by first of all attempting to distance himself and his policies from the fragmentation of the Comecon region and then by blaming the slump on that fragmentation. He has claimed that 'the decline in industrial production in 1991, and to some extent in 1990, was the result of the collapse of trade with the former Soviet Union, not the result of economic reforms in Poland.'[43] Yet he actively championed that collapse in favour of a hub-and-spoke linkage with the EC. He must also have been fully aware that the IMF was resolutely opposed to preventing such a collapse through a payments union for the region, and he must surely also have been aware that his fragmentation policy would be consolidated through regional bloc arrangements for cutting East-Central Europe off from production linkages with the USSR. As in the case of NAFTA, the EC would consolidate this bloc through rules-of-origin arrangements, severing their production linkages with countries to their east. The Association Agreements between the EC and the East-Central European

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[40] 'Big Bang, Big Adventure', *Economist*, 23 December 1989.

[41] OECD, *Integrating Emerging Market Economies into the International Trading System*, Paris 1994.

[42] Ibid.

[43] Sachs, 'Reply to Jan Adam', *Economics of Planning*, vol. 26, 1993.

Table 1

Indicators of Slump

Real GDP

	1989	1990	1991	1992	1993	1994
Poland	0.2	−11.6	−7.2	1.0	4	5
Hungary	−0.2	−4.3	−10.2	−5.0	−2	1
CSFR	4.5	−0.4	−15.9	−.5		
Czech Rep.				−7	0	3
Slovakia				−7	−4	1

Industrial Production

	1989	1990	1991	1992	1993	1994
Poland	−0.5	−24.2	−11.9	3.9	5.6	N/A
Hungary	−1.0	−9.2	−21.5	−9.7	4	N/A
CSFR	0.7	−3.5	−24.7	−10.4		
Czech Rep.				−10.6	−5.3	0
Slovakia				−14	−10.6	−4

Sources: H. Schmieding, 'From Plan to Market', *Weltwirtschaftliches Archiv*, no. 2, 1993; European Bank for Reconstruction and Development, *Transition Report*, 1994.

countries, which Sachs has commended, devote between one fifth and one quarter of their entire text to this topic.[44]

Sachs's second line of defence has been to claim that Communism was to blame for the slump.[45] He says that there were crises in a number of these economies before ST started. This is true, but the OECD study's charge is that ST made a bad situation catastrophic. Gomulka, a defender of the IMF, calculates that the average fall of GDP during what he calls the contraction phase of the transition was about 40 per cent.[46] Behind such figures is the devastating reality of human suffering which continues for most people in the region in 1995; this, however, seems to be a detail not worthy of serious analysis on Sachs's part.

[44] See Patrick A. Messerlin, 'The Association Agreements between the EC and Central Europe: Trade Liberalization vs Constitutional Failure?' in J. Flemming and J.M.C. Rollo, eds, *Trade, Payments and Adjustment in Central and Eastern Europe*, RIIA and EBRD, London 1992.
[45] The *Economist* has followed suit, claiming that while 'all the post-communist economies suffered deep recessions . . . Much of this hardship was, however, the legacy of communism's failure, not the product of capitalism's arrival' (3 December 1994, p. 24). No one has, of course, suggested that the slump was caused by 'capitalism's arrival'. Others initially sought to deny the existence of slumps on the grounds that the statistical indicators were wrong.
[46] Stanislaw Gomulka, *The Role of International Financial Institutions: The Polish and Russian Experience 1989–93*, paper to Conference on the Role of International Financial Institutions in Eastern Europe, Munich, April 1994, p. 23.

The *Economist* tried to justify Sachs's view in the case of Russia by making the bold claim that communism caused too much supply for demand levels and too much demand for supply levels! 'The transition from the rationing of central planning to the allocation of goods by the market was bound to require such a sharp fall in real wages: queues, in effect, reflect excess demand caused by prices that are too low in relation to wages.'[47] Having explained that goods had been too much in demand, it went on to explain that goods had also been too much in supply: not enough people wanted them! The government, it said, should not provide credits to enterprises, because to do so 'will buoy the production of unwanted goods'.[48]

There is one argument that some, like Gomulka, have sought to mount for the view that the ST slump simply revealed the waste under communism. This argument begins by saying that measuring the inputs and outputs of some East European enterprises at world prices, they were actually subtracting value from inputs. So the introduction of world prices would drive these sectors to the wall: hence the ST slump, though triggered by price liberalization, was caused by the economic irrationality of communism.

For this to have been the cause of the slump, the falls in production would have occurred in the value-subtracting sectors. Yet the production falls were across the board and in the Hungarian case we find that sectors identified by Hare and Hughes as the most efficient were in many cases hit harder than the big value subtractors, as Table 2 indicates. Indeed, Hare and Hughes identified alcoholic beverages as one of the biggest value subtractors, yet it was the only sector to continue to grow during the slump!

In any case, this argument is theoretically muddled. As Schmieding has pointed out, price liberalization is about altering *relative* prices and thus falls in some sectors would be compensated by rises in others whose products would at the same time leap upwards in relative value.[50] And the overall value of output should remain the same or nearly the same as before, on one condition: that factor prices really did move flexibly in line with relative prices on the world market. The shift to world relative prices would then quickly move from a static output levels[51] to a surge of growth as the supposedly more efficient allocation of factors in the world market was reflected in a redistribution of factors in the economy.

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[47] *Economist*, 3 December 1994, p. 24.

[48] *Economist*, 15 August 1992, pp. 11–12. A Russian reading such explanations could be forgiven for wondering if the *Economist* was simply driven by hatred of the Russian economy.

[49] Their study was for the European Commission. See G. Hughes and P. Hare, 'Competitiveness and Industrial Restructuring in Czechoslovakia, Hungary and Poland' in *Commission of the European Communities: European Economy*, special edition, no. 2, 1991.

[50] My discussion here draws heavily on Holger Schmieding, 'From Plan to Market: The Nature of the Transformation Crisis', *Weltwirtschaftliches Archiv* (Journal of the Kiel Institute of World Economies), vol. 129, 1993.

[51] I have slightly telescoped Schmieding here, omitting some nuances in his argument that are not relevant to this discussion.

Table 2

The Relationship Between Falls in Output and Industrial Competitiveness in Hungary, 1987–1991 (1987=100)

Industry	*DRC ranking*[1]	Competitiveness ranking[2]	Percentage output fall[3]
Fur, shoes	1st	2nd	50.8
Clothing[49]	5th	5th	29.9
Precision instruments	12th	3rd	44.2
Electrical engineering	15th	8th	42.3
Rubber	23rd	12th	39.2
Building materials	6th	14th	36.4
Food industry	2nd last	2nd last	11.9
All industries	33	33	29.4

Notes:
1. DRC = Domestic Resource Costs.
2. Competitiveness ranking as measured by value added at world prices less labour costs and depreciation as a percentage of world price by industry.
3. The percentage fall in output in 1991 from 1987 levels.
Sources: J.C. Brada, I. Singh and A. Torok, 'Firms Afloat and Firms Adrift: Hungarian Industry and the Economic Transition', *Eastern European Economics*, January-February 1994, and G. Hughes and P. Hare, 'Competitiveness and Industrial Restructuring in Czechoslovakia, Hungary and Poland', *Commission of the European Communities: European Economy*, special edition, no. 2, 1991.

Some IMF economists seized on the issue of factor price flexibility in 1992, claiming that the depression was caused by the failure to fully introduce world prices for labour. Wages, they said, had not sunk low enough or fast enough. In short, the depression was caused not by ST but by the failure to implement it fully on the wages front.

Sachs could hardly adopt this argument since it would imply that ST has not been tried, particularly as wages have picked up a bit in most countries since 1992. But in any case, it is unsustainable. Real wages in Poland fell 33.6 per cent from the beginning of 1990 to the end of 1992. In Czechoslovakia in the same period they fell 21.5 per cent and in Hungary by 14 per cent. In all cases the falls were heaviest in the crucial first phase of the depression. The *Economist* noted that after six months of ST in Russia real wages had dropped to only 40 per cent of their average for 1991.[52] By any standards these figures show extraordinary downward flexibility. As Schmieding comments, 'In a trivial sense, all economic crises can be related to a downward rigidity of real wages in a neo-classical framework. The negative impact of all possible disturbances on the profitability of production could always be compensated by a further decline in the real wage.'[53]

[52] *Economist*, 8 August 1992, p. 68.
[53] Schmieding, 'From Plan to Market', p. 225.

At the domestic level, these slumps were, in fact, the direct consequence of two aspects of the ST shock: the collapse of effective demand—emphasized strongly by Kornai—and the credit crunch to impose a hard budget constraint upon enterprises. This credit crunch was exacerbated by the absence of any viable coordinating mechanism for redeploying factors of production: the old planning mechanism was destroyed and a capitalist mechanism—viable financial markets and a financial system—did not exist.

What concerns us here is not the continuing debate over the relative weight of the two factors, but simply the undeniable fact that the depression was a core feature of the entire ST programme. ST supporters have advanced a host of other arguments to justify the depression effect of the model. They have claimed that communist industrial goods were worthless; that there was a need for a growth in services; that the goods were no longer 'necessary'. This argument has been nicely expressed by Garton Ash with his remark that returning the region to capitalism is like transforming a fish soup back into the aquarium from which it was made.[54] But this argument seems to rest more on anti-communism than hard evidence. What the evidence shows is that when the EC lowered its Cold War barriers in 1990–91 to imports from the Visegrad countries, the latter's exports surged as follows: taking 1989 as 100, Poland's exports to the EC rose to 208.2 in current US dollars in 1992, Czechoslovakia's jumped to 250, and Hungary's to 178.6. These gains were not confined to traditional export sectors, which were in any case more diversified than typical middle-income country exports, but applied right across the board. As Richard Portes says: 'The explosive growth of Central and East European exports to the West in 1990–92 does conclusively refute those who claimed that these countries couldn't compete—that quality was unacceptable, marketing was poor and so on.'[55]

The argument that the service sector was underdeveloped is used by Sachs to suggest that a drastic reduction in industrial output was necessary. But this neither explains the slump in industrial output—the industrial slump was not caused by workers flooding into new service industries!—neither does it justify it. The service sector can grow without causing or requiring *an output decline* in industry.

The key justification is in fact one that is not usually stated bluntly and publicly: namely that there was no need for this industrial output in the East since Western Europe's economy was already saturated with overproduction. In other words, East European industry stood in the same relation towards Western Europe as the European Airbus industry stands in relation to Boeing: it is worse than unnecessary, it is a competitive nuisance.

The Human Costs of the Slump

The human costs of the ST drive for rapid decollectivization have, almost

[54] Interview with Timothy Garton Ash, *The Oxford International Review*, winter 1994, p. 5.
[55] C. Randall Henning et al, eds, *Reviving the European Union*, Institute for International Economics, Washington DC, April 1994, p. 173.

certainly, been on a qualitatively lower scale than the human costs of collectivization in Eastern Europe after the war, when repression in the late 1940s is taken into account. Comparisons with the USSR in the 1930s would be absurd. But these costs have nevertheless been considerable.

According to UNICEF, the excess mortality in Russia, Ukraine, Bulgaria, Hungary and Poland between 1989 and 1993 was 800,000.[56] This figure includes excess deaths in the USSR before the start of ST in January 1992. Michael Ellman gives the figure for excess deaths in Russia alone in that year as 82,000 and says there were 'substantially more' such deaths in 1993.[57] The crude death rate in Russia rose from 11.4 in 1991 to 14.4 in 1993 and 16.2 in the first quarter of 1994.[58]

UNICEF explains that the transition has generated the health crisis in three ways: by increasing the levels of stress-related heart and circulatory diseases—these accounted for 32–80 per cent of the rise in deaths in the region as a whole; by producing dietary deficiencies, and by causing socio-psychological tensions which have sharply increased murder and suicide rates. It comments that the East European health crisis 'has no historical precedents'.[59] In Russia the number of murders rose by 42 per cent in 1992 and a further 27 per cent in 1993.[60] Between 1989 and 1991 homicides in Hungary increased by 43 per cent. In 1993 the suicide rate had increased from its 1989 level by 133 per cent in Poland, by 150 per cent in Romania and by 153 per cent in Russia.[61]

The problem of poverty and malnutrition has become very serious in many countries. A study in Russia by Goskomstat and the World Bank defined the poverty line as the income needed to maintain food consumption sufficient to maintain normal body weight at an average level of activity—an austere definition by Western standards. The study showed that 37 per cent of the Russian population fell below this line in 1992, while the figure for children under fifteen was a horrifying 46–47 per cent. A study carried out by CARE and the US Centers for Disease Control in 1992 found that on average Russian pensions were below what the World Bank estimated to be the minimal nutritional support level for a person living alone.[62] Using UNICEF's definition of mild malnutrition (less than 2,300 calories) the percentage of Poland's population suffering such malnutrition was negligible in 1989 but had reached 17.9 per cent in 1992.

If we define the poverty line as 40 per cent of the average wage in 1989 and the extreme poverty line as 24 per cent of the 1989 average wage, then by 1992 those in extreme poverty amounted to between 15 per cent and 26

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[56] UNICEF, *Economies in Transition Studies, Regional Monitoring Report, 1994. Crisis in Mortality, Health and Nutrition*, Florence, 1994.
[57] Michael Ellman, 'The Increase in Death and Disease under "Katastroika"', *Cambridge Journal of Economics*, no. 18, 1994, p. 349.
[58] Ibid.
[59] UNICEF, *Economies in Transition Studies*, p. 63.
[60] Ellman, 'Increase in Death and Disease'.
[61] UNICEF, *Economies in Transition Studies*, p. 53.
[62] Cited in ibid.

per cent in Poland, Bulgaria, Romania, Russia, Ukraine and Albania; those in poverty were an extra 28 per cent to 38 per cent. Life-threatening diseases have increased sharply in Russia. Typhoid and paratyphoid increased 13 per cent in 1992 and 66 per cent in 1993; diphtheria increased 109 per cent in 1992 and 290 per cent the following year. Deaths from tuberculosis increased 15 per cent in 1992.[63]

2. The Failure of the Shock Therapy Trade Regime

What Sachs called his 'conceptual breakthrough' of throwing target economies open to a radical free-trade regime was justified in the first place by its supposed ability to address the problem of oligopolies in the East, which would respond to price liberalization by raising prices while reducing output, but it was also designed to prepare the way for trade-led recovery. These goals neatly dovetailed with the ultimate goal of creating open-door economies in the region for trade as for FDI. As it turned out, state enterprises were not the main culprits in raising prices. The most aggressive price increases were in the service sector and were carried out by private enterprises.[64]

In any case, the view that the Visegrad economies were heavily monopolized seems to be false. There was not, of course, perfect competition but they were roughly as monopolized as the free-market USA, according to the findings of Alice Amsden and her colleagues. Even Czechoslovakia, singled out as being particularly monopolized, had little more concentration than the USA. Thus in 1990 the largest hundred Czechoslovak companies accounted for 26 per cent of industrial employment while in the US the figure was 23.8 per cent.[65] In Poland, the degree of concentration was on a par with the USA. Given the fact that small economies, far more trade-dependent than the USA, could be expected to have higher levels of concentration in key sectors, Amsden's view is that the real problem for much industry in the region was too much fragmentation, rather than too little.

Amsden takes sectors where East-Central European economies have had growth potential and demonstrates the over-fragmentation problems. In detergents, 80 per cent of the market is controlled by two companies in the UK and by three in Germany. But in Poland there were seven, none big enough for scale efficiency. In crude steel output Czechoslovakia ranked fourteenth and Poland seventeenth in the world, yet the biggest Czechoslovak steel producer (VSZ Kosice) ranked only 30th and the biggest Polish enterprise (Huta Katowice) ranked only 32nd in size. Unido reported in 1991 that the steel industries of the region generally faced the problem of undersized plants. The same fragmentation problem has existed in machine tools and in pulp and paper.[66] Sachs is well aware of this, saying that 'the giant firms in Poland are small players in the European market'.[67] There are also lots of alternative ways of preventing

[63] Ibid.
[64] Amsden et al, *The Market Meets its Match*, p. 89.
[65] Ibid., p. 96.
[66] Ibid., pp. 94–5.
[67] Sachs, *Poland's Jump to the Market Economy*, p. 50.

monopoly price rises without throwing open the door entirely to imports—most obviously through regulatory bodies—but he ignores such possibilities.

The trade regimes established in 1990–91 in the Visegrad region are presented by Sachs as conforming to the West European model but they were actually very different: quotas were abolished, other non-tariff barriers were not established, anti-dumping instruments and safeguard instruments were not created, export promotion instruments were not set in place. Instead a one-club trade regime consisting of very low tariffs was introduced.[68] The result was a predictable export bonanza into the region by West European companies which, as Giles Merritt of the Philip Morris Institute warned in 1991, 'could do irreparable harm'.[69] The assault on domestic producers was especially devastating in the consumer goods sectors. Between 1989 and 1991 consumer goods imports into Hungary nearly doubled and in the first eight months of 1991 alone they rose in Poland from 18.2 per cent to 31.6 per cent of total imports. The trade figures of the target countries do not necessarily accurately reflect events. Thus while Czechoslovak statistics show a 2 per cent growth in imports from France in 1991, the French figures show a rise of 180 per cent. During the 1990s, the traditional EC deficit in trade with the region turned into a surplus. Systematic studies have not yet been published on the extent to which these Western exports involved the dumping of products in the East, but there is ample anecdotal evidence of this.[70]

The overall value of imports to Visegrad countries rose in the first half of 1993 by 7 per cent as compared with the corresponding period in 1992. This was the highest import surge since the mid 1980s. Imports to Hungary increased by 6 per cent, to the Czech and Slovak republics by 18–22 per cent and to Poland by 27 per cent. This export bonanza was the result of more than market forces. It was strongly subsidized by Western governments through export credits and credit guarantees to their own exporting firms. These supports were presented as aid for the target countries of the export drive. Indeed, according to Sachs virtually all Western aid to Russia has been in the form of such export subsidies. They enable exporters to make risk-free breakthroughs into target markets while leaving the country concerned burdened with extra debt. An important dimension of this effort has been attempts by West European states to seize the markets in the former Soviet Union previously supplied by East-Central Europe. Anthony Solomon, former president of the New York Federal Reserve, calculated that Western export credits were enabling about $4 billion of East-Central European export trade to the USSR region to be diverted to Western suppliers.[71]

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[68] This is one of numerous examples where Sachs's claim to be introducing Western institutional models applies only to Western *ideological models for others* rather than to Western practice.

[69] Giles Merritt, *Eastern Europe and the USSR. The Challenge of Freedom*, London 1991, p. 111.

[70] The present writer bought a Philips short-wave radio, costing $75 duty free at Vienna airport, for $14 in Kiev!

[71] Cited by Merritt, *Eastern Europe*, p. 111.

A particularly damaging dimension of these policies for Poland and Hungary has been their impact on agriculture. At a time when the IFIS were demanding an end to agricultural subsidies in the Visegrad countries, the break-up of collective farms and very large wage reductions bringing falling food demand, the full force of heavily subsidized EC agricultural exports hit the Visegrad markets. The EC's so-called humanitarian food aid programme for Poland in 1989–90 had prepared the way by destabilizing demand conditions for peasant suppliers. The result has been that the most important private business group in the region when Communism ended, the Polish peasantry, has become the most powerful social group in the country opposed to ST and to the EC.

Meanwhile, as far as Eastern target states were concerned, efforts on their part to engage in direct export promotion were banned by the World Bank.[72] By 1991 the Visegrad governments were under mounting pressure to reverse their open-door policy and in general tariffs and import surcharges were imposed. In Poland, President Lech Walesa publicly accused Westerners of trying to ruin Polish industry.[73]

Granting Market Access to the EC

The notion of trade-led revival of course meant an export surge to the EC. The IMF shock depression combined with currency devaluation was designed, as in Latin American structural adjustment programmes, to turn the target states towards trade-led recoveries. Sachs's model therefore laid cardinal importance on the swift dismantling of the powerful trade barriers blocking Eastern exports to the EC. The issue of EC market access was incorporated into negotiations on so-called Europe Agreements with the East-Central European and Baltic states and on Partnership and Cooperation Agreements with the other, former Soviet republics. The basic exchange involved the supposed granting of access to the EC's goods markets in exchange for opening both goods markets and fixed-asset markets in the country concerned to West European companies.

The results of the negotiations with the Visegrad countries were strongly asymmetrical in the EC's favour,[74] although the EC presented them as

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[72] See Amsden et al, *The Market Meets its Match*. The OECD supported the establishment of export credit insurance and financing, via export credit agencies (ECAs), provided they would follow the OECD Arrangement on Guidelines for Officially Supported Export Credit. The OECD explained that, 'This would put them on an equal footing with OECD countries and therefore not distort trade.' This is false since various major Western countries do not stick to these guidelines. By 1994 various East European countries had set up ECAs but, the OECD explains laconically, they have not been able to work because 'funding has been restricted'. OECD, *Integrating Emerging Market Economies into the International Trading System*, Paris 1994.

[73] Cited by Jan Adam, 'The Transition to a Market Economy in Poland', *Cambridge Journal of Economics*, vol. 18, 1994, p. 613.

[74] For a thorough analysis of the European Agreements' trade aspects, see Patrick A. Messerlin, 'The Association Agreements between the EC and Central Europe: Trade Liberalization vs Constitutional Failure?' in Flemming and Rollo, *Trade, Payments and Adjustment*.

Table 3

Sectors of Export Strength in Early 1990s

Sector	*Country with Export Strength*
1. Food/agriculture	Poland, Hungary
2. Textiles/clothing	Poland, Hungary, CSFR
3. Iron and steel	Poland, Hungary, CSFR
4. Chemicals	Hungary
5. Coal	Poland
6. Fuel	CSFR

Source: C. Mastropasqua and V. Rolli, 'Industrial Countries' Protectionism with Respect to Eastern Europe: the Impact of the Association Agreements Concluded with the EC on the Exports of Poland, Czechoslovakia and Hungary', *The World Economy*, vol. 17, no. 2, 1994.

asymmetrical in the target states' favour, by focusing only on tariffs rather than non-tariff barriers (NTBs). While tariffs were reduced on most items, it did not significantly reduce its NTBs on the goods that mattered to the Visegrad economies. At the same time, the Visegrad economies were required to get rid of their NTBs by the GATT and the OECD. The EC built into the Agreements a battery of protection instruments—notably anti-dumping and safeguard instruments which did not conform to GATT rules,[75] while the Visegrad economies largely lacked such instruments. At the same time, the EC preserved its right to employ the Cold War protection instruments applied to State Trading Countries against the Associated states—a clause which does not require comparison of domestic and export prices, and gives protectionist measures a free hand.

Given the slump, the credit crunch and investment collapse in the Visegrad countries, their export effort would have to be concentrated in their traditional export sectors, with low capital–output ratios. To appreciate how asymmetrical the Europe Agreements were, we must therefore focus on the treatment of those sectors.

Without exception they faced severe protectionist barriers from the EC under the Europe Agreements. The CAP was not modified significantly and the bulk of agricultural exports from Poland and Hungary—grain, livestock and dairy—are in core CAP sectors. Chemicals continued to be subject to State Trading Country anti-dumping measures; textiles and apparel were subject to a form of managed trade which would be very damaging to the Visegrad textile industry; steel would face restrictive price agreements and anti-dumping instruments, and other sectors like Polish cars were subject to so-called Voluntary Export Restraints (in other words, quotas).

The trade aspects of the Europe Agreements came into force on an interim basis in March 1992. By the second half of the year East-Central

[75] Ibid.

European exports to the EC were in decline and during 1993 these exports slumped in an alarming way. In the first half of 1993 the combined value of exports from all the East-Central and East European countries fell by 13 per cent in dollar terms as compared with the first half of 1992. The decline affected exports to the West, to transitional economies and to LDCs. This reversed the earlier pattern of a counterbalancing of declines to the CMEA area with rises to the EC.[76] The overall result was a trade deficit of some $7.2 billion in the first half of 1993, compared with a deficit of $1.5 billion in the same period in 1992.

Although the Czech Republic's trade deficit worsened as its imports grew by 21 per cent, its exports grew by 13 per cent. By contrast Polish exports fell by 7 per cent and Hungarian exports fell by over 23 per cent. The fall in Hungarian exports was especially strong in industrial consumer goods (down 30 per cent), in foodstuffs (down 17 per cent) and in agricultural products (down 59 per cent).[77] The dollar value of exports of clothing, textiles and footwear declined by 48 per cent in Hungary. In iron and steel products, Hungarian exports declined by 20 per cent. Thus traditional export sectors were losing their position but new manufacturing exports have not emerged: among the few exceptions was car production in Poland. The UN Economic Commission for Europe concludes: 'Until new investments are made on a large scale, prospects for sustainable export growth are slim.'[78]

These very bad trade results for Poland and Hungary in the first half of 1993 are no doubt partly explained by the EC recession and especially that in Germany, where imports from Eastern Europe as a whole declined by 10 per cent in the first half of 1993. But the Western recession cannot be the entire answer, because Polish exports had already dropped substantially in 1992, when the German economy was not yet in recession.

The UN *ECE Bulletin* stressed that in 1992 and 1993 EC importing countries resorted more frequently to the use of anti-dumping and safeguard actions against ECE imports. During 1992, France, Germany and Italy imposed new quotas on steel imports from the region and the EC itself imposed anti-dumping duties on Visegrad steel products.[79] Following an outbreak of foot-and-mouth disease in Italy, allegedly deriving from illegal Croatian cattle imports, the EC banned all cattle imports from the entire East-Central European region—some of whose countries have not had incidents of the disease since at least the early seventies. This led to threats of retaliatory measures until the ban was dropped. Hungary's main meat export to the EC, pork, was totally banned on an indefinite basis following an incident of swine fever.

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[76] UN Economic Commission for Europe, *Economic Bulletin for Europe*, vol. 45, 1993, p. 63.

[77] In 1993, the year after the Agreement came into force, Hungary's food and agricultural exports to the EC dropped 28 per cent. Poland's dropped 12 per cent. See OECD, *Agricultural Policies, Markets and Trade. Monitoring and Outlook 1994*, Paris 1994.

[78] Ibid, p. 69.

[79] Mastropasqua and Rolli.

It should, in this context, be stressed just how much was at stake for the EC in its trade relations with ECE. Even in the most sensitive sectors (agriculture and apparel), a total liberalization of imports would have produced a decline in the EC sector's output of only 2 to 4 per cent. The most highly protectionist sectors in the EC were therefore not mortally threatened.

A final aspect of the EC's market access policy has been very important: the role of its rules-of-origin clauses in the Europe Agreements which impose the hub-and-spoke pattern on economic linkages between economic operators in the target states and the EC/EU. They do so by blocking the re-export to the EC of products partly produced outside the target state—whether in a neighbouring Visegrad state or in the former Soviet Union. For most industrial products (for instance, those subject to Annex II in the EC–CSFR Agreement), the Europe Agreement protocols give a rule in the form of a threshold expressed in terms of value added to the products in the Associated country: imported inputs should not represent more than 40 per cent or 50 per cent of the value of the production. Thus the Agreements impose a local-content requirement of up to 60 per cent. Although this threshold is the main form of rule, two other sets of definitions are also applied to some products:

a) products originating in an Associated country are those wholly obtained in that country.

b) products originating in an Associated country can be those 'obtained in the Associated country in the manufacture of which products (not wholly obtained in the country and not obtained in the EC) are used', provided that the said products have undergone 'sufficient working or processing'. The basic definition of 'sufficient working' for this purpose is a change in customs headings at the four-digit level of the Harmonized System, differing from that in which all the non-originating materials are classified. These kinds of arrangements embrace these economies in a condition of trade dependency towards the EC, locking the development of the division of labour in the target state into EC requirements.

The tragic result of these politico-economic interactions has been that the domestic depressive shocks policed by the IMF and designed to lay the basis for an export-led revival have largely led these countries up a blind alley, prolonging the depression. The origins of the revival, in so far as it has come, have been led not by foreign trade but by domestic consumption.[80] *Yet the policies of the IFIs have been overwhelmingly directed at reducing domestic demand pressures, stamping out inflation, lowering wages and reducing government deficits through spending cuts.*

Fiscal Crisis and IMF Policy

The ST slump plunged most governments in the region into a deep fiscal crisis. This is a normal by-product of slump, though made far worse by the fact that ST did not prioritize a transformation of tax systems and a

[80] Stanislaw Gomulka, *The Role of International Financial Institutions*, p. 11.
[81] Sachs, 'Understanding "Shock Therapy"', p. 26.

strengthening of administrative apparatuses. Thus a fall in industrial production during the slump which approaches 50 per cent for the region as a whole, in conditions where in most countries the tax system was almost exclusively focused on the turnover of industrial enterprises, was bound to create a severe fiscal crisis. Again, since ST downgraded the importance of building a capitalist financial system, governments could not fund their deficits by borrowing on domestic bond markets. Thus deficit spending would directly fuel inflation.

As with the slump, Sachs tries to avoid responsibility for these fiscal crises: he says there was 'a nearly generalized fiscal catastrophe in the region' *before* ST with 'huge budget deficits.'[81] In fact the Czechoslovak government had a slight surplus in 1990 and went into deficit only in the first two years of ST. The Hungarian budget followed the same pattern from a slight surplus in 1990 to deficits in the following years. Poland did have a serious state budget deficit in 1989, of 6.1 per cent, but the deficit shot up higher than ever to 7 per cent in 1991 and 6.8 per cent in 1992 as a result of ST. Fiscal information for Russia is not available before 1992, but Gaidar's first year of ST left the budget deficit at 18 per cent of GDP. And these ST deficits occurred despite the slashing of state price subsidies.

The ST fiscal crisis presents governments with a choice: either to opt for inflationary funding of the deficit, or to gain Western funds to plug the hole in the deficit, or to massively cut back on spending. The IMF has strenuously pressurized governments to take the last course. It has justified this by the argument that the overriding priority of policy is the need to combat inflation. This has been the policy of the IMF during this virtually unprecedented slump which has devastated the lives of hundreds of millions of people during the last five years. In so far as the policy has been followed by target governments, it has deepened the slump and caused long-term damage to the social and administrative as well as economic infrastructure of the region.

There has, however, been one major exception to this rule, an exception which goes far to explain the country's beginnings of a return to some growth: Poland. Here alone has the IMF encouraged really major Western financial support, in the form of a cancellation of half of Poland's debt to both public and private creditors. This has transformed the financial position of the government and has also created the basis for stronger confidence in the future on the part of private capital. Hungary has had heavier per capita debts and has not defaulted, unlike Poland—as well as Bulgaria and Russia—yet it has not even gained significant debt relief, much less forgiveness.[82] Even in Poland, recovery has still been undermined by the IMF's drive in the early 1990s to make the fight against inflation through government spending cuts the centrepiece of policy. Its catch-phrase has been that there is no trade-off between financial stabilization and growth. But in an Eastern Europe whose recovery has had to be domestic-consumption led, the causality has flowed in a

[82] There has been low-level debt rescheduling for Hungary and also for Bulgaria but these measures have not had macroeconomic significance. At one point IMF officials publicly raised the case for relief for Hungary, whose debts in per-capita terms have been higher than Poland's, but the G7 has taken no action on this.

diametrically opposite direction from the IMF's policy: without growth there could be no financial stabilization. IMF policy for financial stabilization tended to deepen recession and thus further destabilize finances.

Gomulka has tried to explain this slump-deepening policy by the fact that the IMF's mission is supposedly the world-wide fight against inflation.[83] In other words, economic recovery in the region is not part of the IMF's job. This does not explain why the IMF was opposed to plugging deficits by Polish-style debt reduction or the recent Mexican-style transfer of macro-economic support funds. Gomulka, very much an IMF insider on its East European operations, explains the IMF's thinking on this. He is worth quoting at length:

> The impact of foreign assistance can be substantial, even vital, only on a few occasions, especially when it is in the form of grants and debt reductions. However, large grants, if not linked to performance, reduce the financial *discipline* of local economic agents, and may have an impact on transition economies similar to that of a soft budget constraint on state enterprises ... Most of these economies are already heavily indebted, and this gives them little room for contracting new debt. A far more important foreign impact may come from the inflow of Western private investment and know-how. However, internal reform efforts rather than external financial assistance seem needed for this inflow to take place.[84]

Gomulka, though slightly evasive, does acknowledge that debt reductions and grants can make a vital impact. His basic point belies his own earlier suggestion that the IMF was simply fixated on inflation: helping governments ride the slump would not provide sufficient pressure upon them to push through institutional engineering to gain FDI, and this FDI would be the real lever of recovery.

The meaning of this is clear: the IMF was using the slump as an instrument for rapid social engineering at a micro level to create the desired goal of a state open to FDI. The IMF's domestic neo-liberal agenda could have been displaced by debt cancellation or macroeconomic grants. Sachs himself has nicely summarized the resulting policy in the case of Russia:

> the sums [transferred from Western public bodies] have been derisory ... Virtually all Western 'aid' has come in the form of export credits to Russian enterprises, with short periods of repayment, rather than in the form of grants and long-term loans to the Russian budget ... Overall support from Western governments for the Russian budget, vitally needed for stabilization, has been essentially nil ... In 1994, there was essentially a complete collapse [of] ... international assistance from governments on behalf of Russian reform ...[85]

[83] Though this is nowhere, of course, mentioned as its mission in its charter.
[84] Gomulka, *The Role of International Financial Institutions*, p. 25.
[85] Sachs, 'Consolidating Capitalism', pp. 60–1.

Sachs has not supported this policy. His ST model presupposes massive debt cancellations and grants for macroeconomic assistance as well as for more political purposes. He predicts catastrophic consequences in many parts of the region from Western failure to deliver this aspect of the policy, even warning of civil war. Yet he does not acknowledge the obvious corollary: that, as regards his assumptions about the driving forces within Western governments and IFIS, his ST model was built on sand. His ex-post-facto attempts to shift blame onto people like Gomulka, for thinking like 'bureaucrats' preoccupied by waste, cannot absolve him of 'bureaucratic' intellectual errors in not grasping the political drives governing the Western powers and the IFIS they control.

3. Shock Therapy's Micro-Policies for Restructuring

At the level of microeconomic restructuring, the ST model and the IFIS have shared a common approach. The restructuring should not be carried out by government industrial policies. It should be left to 'market signals' and 'market forces' and especially to Western market forces entering through FDI. The task of target governments is Simply to depress wages, to impose hard-budget constraints upon state enterprises and to privatize for cash. Market signals and forces will do the rest. Public-sector interventionism would certainly be necessary, but it would take the form of the World Bank (WB) and the IMF exerting the necessary leverage to ensure this approach was followed.

The Primacy of Market Forces

It is now generally recognized that the 'market signals' of slump conditions were thoroughly distorted and could give no guidance as to which enterprises could survive and prosper in normal market conditions. R. Vintrova's study of the CSFR confirms this: she shows that there was a significant downward restructuring 'toward simple energy and material-demanding production processes, which are becoming much more advantageous to export, especially due to the rapid devaluation.'[86] Vintrova comments: 'While certain economists characterize the current economic decline as a "curative" structural crisis, they are unfortunately very far from the truth.' Domestic demand was now greatly distorted by the swift decline in the population's real income: 'if we were to respond to market stimuli at the moment, it would be necessary to shut down even industries with a promising demand.'[87]

Brada sums up the Hungarian experience by pointing out that the 'dramatic losses of output mean, as a matter of fact, the quasi-disappearance of whole industries. To give just one example: in the consumer electronics field, the two major domestic players on the market . . . had to declare bankruptcy in 1991 and 1992.' In iron and steel major producers were 'coming very close to disappearing from the market.'[88]

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[86] See R. Vintrova, 'The General Recession and The Structural Adaptation Crisis', *East European Economics*, vol. 31, no. 3 (1993).
[87] Ibid., p. 83.
[88] J.C. Brada, I. Singh and A. Torok, 'Firms Afloat and Firms Adrift: Hungarian Industry and the Economic Transition', *Eastern European Economics*, January-February 1994.

Collapsed markets and the ST credit crunch meant that enterprises faced a desperate liquidity crisis. The result was an investment collapse further undermining efficiency. In the CSFR investment activity dropped 29 per cent in the first three quarters of 1991. There was a capital famine for modernization. Vintrova comments: 'No major investment has yet begun in this direction, and the necessary climate for it will not exist in the immediate future ... An upsurge in investment would only be seen in the monopolized branches of the raw materials and energy complex.' The investment goods industry 'begins a self-sustaining recessionary spiral, gaining speed as it goes on. This is hardly a curative restructuring of production.'[89] Brada explains that in Hungary this investment collapse led to a dramatic under-capitalization of many industrial firms. The share of gross fixed investment in GDP fell, in Hungary, from 28.8 per cent in 1980 to 17.8 per cent in 1990. Another factor stressed by Brada is the desperate struggle for market share by state enterprises, subordinating all other goals to that priority. Managers of loss-making industries also used up their firm's assets to cover current losses and keep the company going at any price.[90]

In a normal Western capitalist economy such a catastrophic slump would lead to crisis management by the government. During the comparatively very minor recession in Western Europe in the 1990s, the German, Italian and French governments provided massive targeted subsidies to particular industries and enterprises. In addition, credit conditions would be eased and the budget would go heavily into deficit. The governments of Poland, Hungary and elsewhere therefore turned towards an industrial policy which would involve helping state enterprises to restructure. The IFIS opposed such efforts. Thus while in a country like the Federal Republic of Germany government subsidies to industry are over 3 per cent of GDP, the IMF and WB have campaigned vigorously and effectively against such subsidies in the Visegrad countries. They dropped from 5.4 per cent of GDP to 2.4 per cent in Hungary by 1991 while in Poland they were reduced to a mere 2.4 per cent of budget expenditures by 1991 and in Czechoslovakia to 2 per cent of GDP in the same year.[91] These results were achieved by threatening to withhold IMF or WB loans.

The WB has also blocked governments from restructuring state-owned enterprises *before* privatizing them. Sachs has claimed that this was an unrealistic option because governments lacked the personnel resources needed. But the WB took no chances and banned them from applying what resources they had. It explained that 'Such physical restructuring is best done by private owners.'[92] It therefore required that the financial capacities of Poland's Industrial Development Agency be prohibited. The WB's agreement with the Polish government on this matter explains:

> IDA's existing financial portfolio will be transferred to financial institutions. Loans to enterprises will be sold or transferred to financial entities capable of managing credit risks ... IDA's equity

[89] Vintrova, 'The General Recession'.
[90] Brada et al, 'Firms Afloat'.
[91] Amsden et al, *The Market Meets its Match*, p. 116.
[92] Quoted in ibid., p. 117. In this case the WB was dealing with Hungary.

> investments in enterprises will be transferred to equity holding entities, such as independent companies, private funds, privatization funds or private equity holding companies. It was confirmed during negotiations [between the WB and the Polish government] that transfer of IDA's financial portfolio will be completed by June 30th, 1992.[93]

The WB stance was the same in Hungary. The MDF government had decided to pursue an industrial policy through the Ministry for Industry in the typical West European manner. The fact that the MDF had made this a centrepiece of its election programme in 1990 did not weaken the political will of the World Bank. It would not allow it. Matters were resolved in 1992 in the following way: 'The government is committed [to the World Bank] to reducing the role of the ministry [of Trade and Industry] in the economy rapidly, and the restructuring, revitalization and government of the bulk of industrial enterprises is to be left to market forces.'[94]

The World Bank has similarly sought to emasculate national development banks, so central not only in Western Europe, where the European Investment Bank operates, but also in China and many other parts of the world. The Polish government established a Polish Development Bank in 1990 to lend funds to enterprises on a long-term basis. The WB intervened and ruled that this body must limit such lending to 15 per cent of its capital. The rest of its lending should be only to commercial banks.[95] In Romania the WB's adjustment loan has been made conditional upon the government privatizing the Romanian Development Bank and a second state bank.[96] Another field of economic policy where Western public bodies have been decisive has been in seeking to end significant subsidies to agriculture in target countries. The impact of this in the trade field was noted above.

The significance of this campaign to ensure that the future structure of the economy should be determined by market forces needs to be underlined. Since most of these countries lacked private capitalists with the financial resources to buy large enterprises, these decisions were to be largely transferred to foreign capital. As we have seen, all the IFIS knew this and stressed how central foreign capital would be in privatization.

Yet this foreign capital would come overwhelmingly from Western Europe, a region already saturated with overproduction and facing historically high levels of structural unemployment, fiscal strain and social tensions. Any insertion of East European companies into West European product markets would therefore be considered highly undesirable by governments committed to neo-liberal economic management and fiscal retrenchment. At the same time EC companies were driving to capture ex-Soviet markets from their previous suppliers in

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93 Quoted in ibid., p. 117.
94 Quoted in ibid., p. 119.
95 Quoted in ibid., p. 121.
96 Virginia Marsh, 'Consolidation and Reform', *Financial Times* Survey of Romania, *Financial Times*, 25 May 1995, p. 35.

Eastern Europe. In short, there was not a single West European productive sector that would welcome strong exporting in high value-added products by East-Central European countries. Yet the planning, ab initio, of the new industrial and agricultural forces in the East was to be left largely to Western operators.

This is not a debate about the gains to be made in technological transfer or other areas from FDI. Such gains can without doubt be important but only on the condition that there are strong national infrastructures and policies for controlling, directing and absorbing such a transfer, as is the case in the West. Yet the struggle was precisely about this control going largely to Western actors.

4. Western Subsidies for the Purchase of East European Assets

Western public bodies have pushed for the swift opening of state assets in the East to FDI and for full rights for foreign companies to participate in privatization.[97] Eastern governments which failed to take such measures could not expect the Western institutions, especially the IMF and the EC, to ease exclusionary embargoes on their participation in the Western product or capital markets. Thus, the IMF and WB loans to Romania were blocked because its privatization scheme limited participation by foreign investors. Western political pressure was used to gain the only two major deals concluded between Romania and Western multinationals.[98] Equally important has been IMF pressure for governments to sell state assets, including the public utilities, to Western companies in order to reduce fiscal deficits.

Such Western pressure on the asset supply side has been combined with Western state subsidies to Western multinational companies at all stages in the process of privatization. In East-Central Europe, the EC has largely funded the state privatization agencies, setting up units in the target state's relevant ministries and staffing them with EC nationals on the EC payroll. It has paid for the studies by Western accountancy firms and investment banks of the industries of target states and it has given subsidies for the actual purchase of assets by EC firms, thus giving them an edge over other competitive bids. The main instrument of this effort has been the PHARE programme.[99] While other forms of aid funds related to the region take the form of loans, PHARE, the great bulk of whose funds go to West European companies, takes the form of grants.

This programme was decided upon in 1989 and came into operation at the start of January 1990.[100] Its name is an acronym for 'Poland, Hungary:

[97] For a useful summary of Western governments' stance on these issues, see OECD, *Integrating Emerging Market Economies into the International Trading System.*
[98] See Virginia Marsh, 'Privatization: A Complicated Programme' in *Financial Times* Survey of Romania.
[99] For a fuller analysis of both PHARE and TACIS, see Peter Gowan, 'Los Programas de ayuda PHARE y TACIS de la Union Europea', *Revista de Economia* (Madrid), no. 738, February 1995.
[100] See PHARE Regulation No. 3906/89, *Official Journal* L375, 23 December 1989 and the amending Regulation No. 2698/90, *Official Journal* L257, 21 September 1990.

Table 4

PHARE and other Western Grant Aid[1] to CEEC (Millions of Ecu)

CEECS *Year*	PHARE *Committed*	 *Paid*	Total G24 *Grants*
1990	500	171	960
1991	775	283.9	1,120
1992	1,015.5	433.9	1,120
1993	1,040	443.6	1,120
1994	835	492[2]	—
1995[2]	—	770	—

Notes: 1. Excluding debt reduction. G24 grants converted from $ to Ecu at $1 = 0.8 Ecu. 2. Projected in EC budget.
Sources: UN Economic Commission for Europe: Economic Bulletin for Europe. vol. 45, 1993, p. 94, and EC Commission, and EC budget for 1994, *Official Journal of the European Communities*, 7 February 1994.

Assistance for Restructuring Economies'.[101] PHARE has been subject to a torrent of criticism largely because the EC has sought to dissimulate its purpose, presenting it as both a recipient-driven partnership with target governments and as a means of transferring funds to people in the East. When it was set up, its main priorities were said to be transferring funds and other forms of aid to assist agriculture, environmental protection, small businesses, educational development and the restructuring of industry. Since PHARE has not in fact been about these things, the criticism has been inevitable.

PHARE policy-making powers are not shared between the Community and the recipient country's government: they lie exclusively with the Community, although the regulation setting up PHARE does say that, 'account should be taken, inter alia, of the preferences and wishes expressed by the recipient countries concerned.'[102] The EC Commission has claimed that the target governments do, nevertheless, control implementation, citing the fact that PHARE units are in all the recipient country's relevant ministries, and PHARE money is in large part disbursed by these units. According to the EC's Court of Auditors, however, the purpose of this decentralization is not to give control to the target government's officials since 'almost none' of the leading personnel in these management units are nationals of the recipient countries: they are

[101] Bulgaria, Czechoslovakia, Yugoslavia and East Germany were included in PHARE in September 1990. East Germany ceased to be a participant after German unification. PHARE aid to Yugoslavia was suspended in 1991 (though humanitarian aid continued to Bosnia-Hercegovina and to Macedonia). Albania and the Baltic states joined the programme at the end of 1991 (See Council Regulation no. 3800/91, *Official Journal* L357, 28 December 1991); Slovenia joined in August 1992 (see Council Regulation no. 2334/92, *Offcial Journal* L227, 11 August 1992).
[102] Article 3, paragraph 2 of the PHARE Regulation.

from Western Europe, appointed by EC bodies and work under the supervision of the Commission and of EC/EU delegations in the recipient countries.[103] The real effect of this administrative decentralization has been to make it impossible even for the Court of Auditors to trace how PHARE money has actually been spent, since the Commission has advanced it to these local management units and has been unable to supply the Court with the detailed information. Thus, although the Court's reports can be taken to be the most reliable source on PHARE, it is itself in the dark about much of the programme.

Thus, one of the biggest early PHARE projects was 50 million ecu for pesticides for Poland. The Auditors were unable to trace where these actually went, though it did establish that some at least was re-exported to the EC.[104] Also in the agricultural field, at the start of 1990 a project was started to supply loans for private farmers in Poland and Hungary, but two years later no loans had yet been granted. In 1990, the Polish fund was quite large—160 million ecu. But as late as January 1993 the Commission was unable to give the Court information about the fund's activities even though it has promised a first report for 1991.[105] The same pattern applied to another big PHARE project: to provide loan facilities for small and medium-sized businesses in Poland and Hungary. At the end of the second year of this project no actual loans had been paid in either country.[106]

The chief of the EC Commission's staff of economic advisers on Eastern Europe has explained why he thinks giving recipient governments a role in PHARE would have been a bad idea by claiming: 'typically it takes much longer for the recipients to specify their priorities than it would for the donors to impose theirs; demand-led aid is prone to exploitation by rent seekers and hence may not be cost-effective.'[107] These views are not shared by the EC's Auditors nor confirmed by the facts. Thus Portes seems to assume that rent seeking is an East European rather than a West European problem. In one of the biggest PHARE projects, Tempus—for exchanges in higher education—East European rent seeking was dealt with by, in the words of the EC Auditors, ensuring that there was 'practically no involvement of the educational authorities of the recipient country'.[108] On the other hand, it seemed to favour Western rent seeking,

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[103] See the Court of Auditors' Report in the *Official Journal of the European Communities*, 15 December 1992, p. 219.

[104] Court of Auditors' Annual Report for 1990, *Official Journal*, 13 December 1991, p. 177. PHARE pesticide aid to Albania was declared by the European Parliament in March 1994 to have involved the export of toxic waste. The Parliament called for the aid to be immediately withdrawn and asked the Commission to make a report to it on PHARE aid as a whole and especially on PHARE agricultural assistance. See the *Proceedings of the European Parliament*, 11 March 1994 and the *Bulletin of the European Community*, March 1994. The Parliament also wanted to know whether the Commission had verified whether Albania had needed agrochemicals.

[105] Ibid.

[106] Court of Auditors' Report on 1991, *Official Journal*, 15 December 1992, pp. 216–17.

[107] Portes in C. Randall Henning et al, eds., *Reviving the European Union*, Institute for International Economics, April 1994.

[108] Auditors' Report, *Official Journal* C309, 16 November 1993, p. 191.

handing the implementation of Tempus to a private organization, the European Cooperation Fund (ECF), which has devoted itself to the business of educational exchanges and has been bidding for Tempus exchange money.

Portes's readiness to raise the issue of delay is also curious. Thus from the start of PHARE in 1990, the governments of Poland, Hungary, Bulgaria, Czechoslovakia and the GDR had made environmental improvement measures a priority. The EC Commission agreed. But in Poland, after the government had given this sector priority for three full years, the Commission had carried through not one pilot investment project that would directly improve environmental conditions. The Hungarian government had produced proposals for some two hundred priority projects for tackling environmental problems, but the Commission did not select a single one of these, while it did fund the construction of a wildlife park and even supplied a central management building for it.[109] Projects regarded as urgent by recipient states, for example the construction of sewage purification plants in highly polluted areas such as the Black Sea, the Baltic, Warsaw and northern Budapest were rejected by the Commission.[110]

In January 1994, the European Parliament criticized the Commission's lack of action on environmental issues and its failure to back recipient government proposals such as those for the Danube Basin, the Black Sea, and the Baltic. It criticized the fact that PHARE funds were used only for studies and it urged the Commission to use local consultants more often for PHARE.[111] Yet within an ST framework, most of these criticisms can be dismissed, for the purpose of programmes like PHARE is privatization and FDI. Since, within the framework of ST, FDI is crucial to privatization, modernization and growth, Western governments would be justified in helping in these tasks, and much of PHARE has been geared precisely towards that. Thus there was a great deal of criticism of the fact that PHARE was mainly devoted in the early years to studies of the target economies by Western consultants. Thus, the fact that in Poland the only product of the so-called 'loans for farmers' project was a study of cooperative banking there caused some ridicule for telling Poles what they already knew;[112] but for FDI the task was not so much transferring Western information east as transferring Eastern information west. Such a study may have been valuable for, say, Crédit Agricole in encouraging it to try to take over agricultural banking in Poland. Or again, some forty studies by Western consultants of Polish industries were carried out during 1990 and 1991. Similar studies were carried out in their hundreds across the region and transferred vast quantities of economic information westwards. The charge was made repeatedly that East European consultants were never used and should have been. Yet it is surely not obvious that these would have known the kinds of profitable opportunities that Western multinationals sought in the region. Even if they did

[109] Court of Auditors' Report on 1992. *Official Journal*, 16 November 1993, p. 185.
[110] Ibid.
[111] Parliament adopted a resolution on these issues on 18 January 1994. See *Official Journal* C 61, 14 February 1994 and the Bulletin of the European Union, 1994.
[112] Court of Auditors' Report on 1991, *Official Journal*, 15 December 1992, p. 216.

have an inkling of this, they might not have been sympathetic. The Slovak Ministry of Privatization criticized these PHARE consultancies on its industries for not corresponding to its specific needs.[113] Again, this criticism would be beside the point from an ST perspective since the specific needs to be met would be those of potential Western investors; these needs depended upon their global strategies, not on what, from an ST point of view, were narrowly national perspectives.

From this viewpoint, the only criticism of such studies would have been if they were used not to further Western FDI but to undermine East European enterprises that posed a competitive threat in Western markets. Given PHARE's lack of transparency, it is difficult to gain information on this front. One such case became a scandal: the Commission's spending of just under 950,000 ecu on a study of how to restructure the Czechoslovak iron and steel industries.[114] The sum was not even included in the programme for PHARE aid to Czechoslovakia. This was one of a number of such contracts for amounts of between 800,000 and 950,000 ecu not directly covered by any particular programme. Studies of this sort were obviously of great political sensitivity when the Community was engaged in protection measures against the competitive threat from the Czechoslovakian steel industry.[115]

The Commission has, in fact, increasingly sought to promote PHARE as a support programme for FDI rather than pretend that it is about transferring funds into the hands of East Europeans. In the words of A. Mayhew, the Director of the Commission's Directorate-General for External Relations: 'The countries of Central-Eastern Europe have criticized the [PHARE] programme for providing too much technical assistance, too many studies, if you want . . . we are now trying to move much more into the area of investment and away from studies which do not lead to any investment.'[116]

PHARE has also been the principal funder of the privatization agencies set up as government bodies in Eastern Europe.[117] The PHARE commitments here have been detailed and thorough: thus in Poland and Hungary they have included paying for official cars and official equipment and, in the Hungarian case, for a financial adviser.[118] The fact that target govern-

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[113] Ibid., p. 218.
[114] Projects for less that a million ecu can avoid the full clearance procedures and the study had not been asked for by the Czechoslovak authorities. But this study was carried out without a financing agreement with the recipient government, without any prior commitment of funds and without an agreed programme.
[115] Ibid., p. 215.
[116] A. Mayhew, 'Assessment of the PHARE Programme from the Commission's Point of View', European Court of Auditors: *Cooperation with the Countries of Central and Eastern Europe—Assessment of Financial Aid*, Commission of the European Communities, 1994, p. 148.
[117] The US government has also, however, played a role: it emerged that the US was paying a salary of over $70,000 a year to the head of the government agency dealing with privatization in Hungary, in addition to his regular salary. But this arrangement terminated when it became public and the person concerned lost his job.
[118] In 1994 80 per cent of the Polish privatization agency's operating capital was funded by EU grants. See *Economist*, 17 September 1994.

Table 5

PHARE Programmes by Sector (Millions of Ecu)

	1990		1992			
	C	*per cent*	*C*	*per cent*	*P*²	*per cent*
Agric/Rural Development	136.0	27.4	273.0	11.9	167	18.8
Economic Restr/Priv/finance	112.3	22.6	445.2	22.9	164.6	18.5
Environment	102.5	20.6	273.5	11.9	59.8	6.7
Human Resources³	36.8	7.4	488.3	21.3	226.9	25.5
Infrastructure	139.2	6.1	21.5	2.4		
Humanitarian aid	66.5	13.4	340.7	14.9	202.1	22.7
Miscellaneous	42.9	8.6	252.1	11.0	46.9	5.3
Total	497	100	2,290.3	100	888.8	100

Notes: 1. C = Commitments. 2. P = Payments. 3. This covers education and training, the social sector and public administration.
Source: EC Court of Auditors' Reports.

ments do not always appreciate this aid produces ridicule on the part of supporters of ST. As with its attitude towards Western export credit 'aid', in 1994 the Polish government refused to touch an EU grant fund designed to match the amount of money invested by EU companies in privatized Polish companies. Under the title 'Looking at Gift Horses', the *Economist* poured scorn on this rejection of 'free money' by a government 'running a budget deficit of more than $3 billion'. For the *Economist* the advantage of giving the EU company a rent that could enable it to beat a Polish (or American) competitor was evidently too obvious to warrant justification.[119]

5. The Theory and Practice of FDI

It is no exaggeration to say that FDI has been offered to the peoples of the region as a deus ex machina bestowing some universal panacea. FDI was presented both by ST theorists and the Western multilateral institutions as both the key means for restructuring state enterprises in the East and as the lever for bringing dynamic growth and prosperity to the target country. The first of these claims risks circularity: FDI was to be the key means of privatization because Western conditionality and pressure would be geared to ensuring it was the *only* allowable means. The real argument is that FDI is the best, the optimal means of restructuring, because it transfers technology in a whole range of ways and can thus dramatically upgrade enterprise performance in the crucial higher value-added and technology-intensive sectors. The second claim is more quantitative: it is that FDI will be the lever of growth and prosperity because of the sheer quantitative scale of the capital inflows which some countries can attract.

[119] Ibid., p. 47.

Both these claims can, in certain conditions, be true. It is striking that the first claim is advanced by ST supporters as unconditionally true: FDI is bluntly presented as *the* royal road towards technological upgrading, as if these economies were almost pre-industrial. The second claim, on the other hand, does have an important qualification attached to it: that FDI will flow in freely *only* if the target country provides the correct institutional framework and policy framework to attract FDI: failure to produce the institutional structure open to global capital will mean that FDI will not flow in.

We thus have a number of particular hypotheses:

1) That the key variable affecting the size of FDI flows is the target state's institutional and policy framework.

2) That FDI is a growth motor capable of generating national prosperity.

3) That FDI will modernize production systems, in other words that it will be production seeking and it will upgrade technological potential.

4) That without such flows, the transition to a modern economy capable of competing in the new world of globalized capitalism will be difficult, if not impossible.

These propositions are unfortunately either false, or grossly one-sided.

1. Institutional and Policy Frameworks and FDI Flows

Universal experience suggests that an IMF-approved institutional and policy framework does not in itself generate substantial flows of FDI. UNCTAD's very thorough work on this subject does not treat institutional or policy orthodoxy as a significant factor, as Table 6 shows. Indeed, the factors which would attract really large FDI flows are precisely the factors which the ST experience of depression-led transformation in a fragmented regional context would undermine.

This general experience of FDI has been amply proved in the case of the entire East-Central and East European region which has attracted very small flows of FDI, without macroeconomic significance. As the structural transformation deepened in both the Czech Republic and Hungary in 1993, FDI actually fell instead of growing. On the other hand China, which has not followed IMF prescriptions and has failed to do such allegedly vital things as clarifying property rights and guaranteeing contracts, has attracted massive amounts of FDI. In 1992 alone China attracted more FDI than the whole of the former Soviet bloc attracted between 1989 and 1993. The following year China's inflow of FDI doubled over the previous year!

China's institutional structure is, of course, exactly the kind of 'third way' market socialism that Sachs set out to discredit back in 1990. And international experience leaves little doubt that if the Comecon region had remained integrated, if the ST slump had been avoided and if an adequate trade-protection regime had been in place, FDI in the region would by now have been severalfold higher than it has been.

2. FDI and Growth: The Causal Direction

The causal relationship between FDI and growth runs in the opposite direction from that claimed by the propaganda of ST supporters. The

Table 6

Host Country Economic Factors Stimulating FDI

1. Host country economic growth, especially growth outstripping population growth.
2. Size of the domestic market.
3. Degrees of regional integration.
4. High profit rates.
5. High skilled–low cost labour.
6. Improved infrastructure.
7. Exchange rates.

Source: UNCTAD: *World Investment Report, 1994*, Geneva and New York, 1994.

Table 7

FDI Flows into the Visegrad Countries, 1990–1993 (net inflows in millions of US dollars)

	1990	*1991*	*1992*	*1993*
CSFR	199	594	1054	—
Czech Republic			983	561
Slovak Republic			71	100
Poland	88	117	284	850
Hungary	377	1459	1471	1200
Memorandum items:				
China			11,100	25,900
All East Europe & NIS 1989–1993				11,000

Source: DG for Economic and Financial Affairs, Commission of the EC, *European Economy*, Supplement A, no. 3, March 1994, and, for China, UNCTAD, *World Investment Report*, 1994, Geneva and New York, 1994, p. 13.

precondition for FDI on a large scale is domestic economic growth, not the other way round.

There are, of course, other kinds of international financial flows that do not depend upon growth: the vast speculative flows of hot money engaged in casino capitalism. This is undoubtedly the most dynamic aspect of the loose label, 'globalization', and it can dovetail perfectly with broken-down economies which are open to speculative flows. The debt-laden governments of such economies, desperate for new funding, can be driven to bond issues with very high interest rates and very short redemption rates. These economies can be extremely attractive for global finance. Their very shakiness involves offering high yields to US pension funds and high-rolling investment banks. These operators have been making their presence felt in the Visegrad countries. In 1993 the Polish stock market soared tenfold. In January 1994, the *Economist*, believing the surge to reflect economic fundamentals, devoted an editorial to what it called the 'breathtaking' stock market boom and added: 'This expansion is no one-day wonder: it reflects a fundamental and remarkably rapid change'[120] The rise was not so rapid as the crash of the following month, when Western banks walked away from the market with some $250 million dollars of speculative profits.

3. *FDI as Market Capture or Technological Upgrading?*

The ST vision of FDI bringing new, modern technology into production processes in East European economies, presupposes that FDI is mainly production seeking. Yet this has not been true. Empirical studies of FDI in the former Soviet bloc have confirmed the previously known causes of large flows: in former communist countries FDI is principally 'market seeking'.[121] Statistical analysis by the OECD Secretariat has confirmed this for East-Central and Eastern Europe.[122]

The bulk of the flow into the Visegrad countries has gone into the food, cigarettes, chocolate, soft drinks and alcohol sectors, consumer durables and cars as well as into the service sector.[123] Despite the overall collapse in purchasing power, there has been a rapid social differentiation producing a new market among what Anthony Robinson has called 'the growing class of new-rich traders, entrepreneurs and professional people'.[124] FDI in the manufacturing sector has overwhelmingly meant one or two big deals in the host country's car industry. More than half of Poland's and Czechoslovakia's industrial FDI went into a single car industry project: Volkswagen's Skoda project in the Czech Republic, and Fiat's FSM project in Poland.[125]

4. *FDI and Czech Engineering: A Flagship?*

The car industry is, of course, important, and new investment has taken place in this sector. But the Skoda experience illustrates some painful realities. First, progress in ST was irrelevant to VW's arrival. Five months after the fall of communism and before any ST of any kind had been launched, Citroen, General Motors, Renault and Volvo were clamouring for Skoda. VW won the bid by promising DM 7.1 billion of new investment and by promising to raise production to 450,000 cars per year by 2000. It also agreed that a new engine plant for Skoda would be built in Bohemia. Another key attraction of the deal was that VW would use Czech suppliers. VW also pledged to retain Skoda's 21,000 workers. This was a serious package for substantial technological upgrading and for really significant

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[120] *Economist*, 8 January 1994, p. 18.
[121] On this point for developing countries see UNCTAD, *World Investment Report, 1994*, Geneva and New York, 1994, p. 20.
[122] 'the major objective for FDI in Central and Eastern Europe was "markets" . . .' OECD Working Paper no. 43: *Market Access-FDI/Trade Linkages in Eastern Europe*, Paris 1994, p. 5.
[123] By the summer of 1992, some ninety major Western retailing firms had moved into the region. In Hungary they had by then captured 20 per cent of the retail market. See John Thornhill, 'E. Europe Entices the Bold', *Financial Times*, 19 October 1992.
[124] Anthony Robinson, 'An Awesome Task', *Financial Times*, 13 January 1992.
[125] UNCTAD, *World Investment Report, 1994*, p. 100.

Table 8

Sectoral Distribution of Joint Ventures at End of 1992 (per cent distribution)

Sector	CSFR	*Hungary*	*Poland*
Primary	3.9	1.5	4.3
Agric., forestry, fishing	3.5	1.5	4.0
Other	0.4		0.3
Secondary	32.0	46.0	74.6
Technology intensive	15.7	19.3	19.0
Other	16.3	26.7	55.6
Tertiary	64.1	52.5	21.2
Trade	19.7	15.8	3.2
Hotels, restaurants	2.1	0.9	3.2
Business-related services	19.7	20.6	5.2
Infrastructure	14.1	13.2	7.6
Other	8.2	2.0	1.9

Source: UN ECE, quoted in P.J. Buckley and P.N. Ghauri, *The Economics of Change in East and Central Europe*, San Diego 1993.

technological transfer, not a mere bid to capture Skoda's existing market. In return the Czech government gave VW trade protection, ensuring it a monopoly position in the Czechoslovak market, as well as a two-year tax holiday and the writing off of Skoda's debts. The WB's affiliate, the International Finance Corporation, which is supposed to offer low interest loans to Third World enterprises, also stepped in with a sweetener for VW in the form of cheap money.

But in 1993–94 VW reneged on its promises.[126] Its investment plan was reduced from DM 7.1 billion to half of that: DM 3.8 billion. There would be no Czech engine plant, and no commitment to 450,000 cars by 2000. Employees have been cut to 15,000 and more redundancies will follow. VW has also turned increasingly to using its West German parts suppliers rather than Czech subsidiaries, bringing more than fifteen such firms in to replace their Czech competitors.

When companies are unable to compete in world markets, such cutbacks can be necessary. But the interesting lesson of Skoda is that it could compete profitably while its German parent could not. As the *Economist*'s subsidiary, *Business Central Europe*, explains: 'In 1993 Skoda was VW's star performer, the only profitable operation at a time when the concern was racking up world-wide losses of DM 2.3 bn. VW President Ferdinand Piech described Skoda as the "loveliest daughter" of the company, adding that it was the only division capable of undercutting Japanese competition.'[127]

[126] This information on Skoda is drawn from Dean Calbreath, 'Together Forever?' *Business Central Europe*, March 1995, pp. 7–10.
[127] Ibid.

Nevertheless, the strategic needs of VW took precedence over those of the Czech economy and 'in November 1993, VW decided to share the pain' faced by VW Germany with Skoda. The Czech Prime Minister 'has tried to put a positive spin' on these results by saying that Skoda did benefit from management expertise. But the Economy Minister Dlouhy is 'less sanguine' and states: 'Let's hope that nothing more like this happens in the future.'[128]

The Skoda experience of the negative externalities from inserting lead sectors of a target country's production apparatus into the international strategy of a Western TNC is not unique. CKD Praha, the internationally famous heavy engineering group at the heart of Czech industry, produces trams, locomotives, compressors, diesel engines, electrical generators, motors and transformers. It has produced about one third of the world's trams and although it was dealt a devastating blow by the collapse of the Comecon region, 40 per cent of its sales still go to exports and half of these still go to the former Soviet Union. In 1993 CKD management decided to enter a joint venture between its tram-making subsidiary, CKD, Tatra, and Daimler-Benz's subsidiary, AEG. Now it has broken off the co-operation. The CKD spokesperson Vaclav Brom explained why to the *Financial Times*:

> Many foreign companies came to the Czech Republic with one aim: to take part in our companies, to control the business, cancel R&D and transfer research work to themselves and use us as cheap labour. We will never agree with such attitudes. We are ready to co-operate with Western partners, but under equal conditions.[129]

Many other examples of such technologically predatory efforts can be found amongst high-profile Western companies. Thus General Electric, after buying Tungsram in Hungary, closed the latter's production of vacuum equipment, electronic components, floppy disk and magnetic tape products, all of which were considered profitable by Tungsram management. The Hungarian cement industry was bought by foreign owners who then prevented their Hungarian affiliates from exporting; and an Austrian steel producer bought a major Hungarian steel plant only in order to close it down and capture its ex-Soviet market for the Austrian parent company.[130] Such experiences abound across the region.

5. *Small Flow but Large Catch*

Although the flow of FDI funds into the region has so far been very small, the number of state enterprises bought through FDI has been very large. The overwhelming bulk of privatizations of medium and large firms in both Hungary and Poland have gone to foreign buyers[131] and the private

[128] Ibid, p. 8.
[129] Kevin Done, 'Shock of the Free Market', *Financial Times*, 2 June 1995, p. ix.
[130] See UNCTAD, *World Investment Report, 1994*, p. 106.
[131] Of the sixty-five corporations privatized by the Ministry of Privatization in Poland by 1 June 1993, only nineteen were bought by Polish concerns. See *Privatization in Poland*, Information Centre at the Ministry of Privatization, Warsaw, June 1993.

investment funds running large and medium firms in the Czech Republic are dominated by Western capital. In the case of Hungary and Poland, in particular, Western companies have largely been able to take their pick of the assets they wish to acquire and they have bought very extensively. By the end of 1993, some 55,000 enterprises had been acquired by Western companies. In telecommunications, power generation equipment, chemicals, glass, cement and pharmaceuticals, the Western multinationals have eagerly sought control of strategic sectors at minimal cost and without short-term plans for significant new investment but with a view to strengthening their global power in the long term.

Average purchase prices have been minimal, as UNCTAD has noticed.[132] In terms of the average amounts of money in invested foreign equity capital, while developed countries averaged $18 million and developing country affiliates averaged $4 million, the Central and East-European country average has been only £260,000. Hungary, which attracted most FDI in the early 1990s gained over $1 million in only 4 per cent of FDI projects.[133] This has been an absolutely predictable result of ST that some warned about at the start of the process. If you plunge the region into the most severe peacetime depression known anywhere since the Second World War, if you simultaneously bring enterprises to technical bankruptcy through collapsed domestic markets and a fierce credit squeeze, and if you ban governments from restructuring companies before selling them off, then you ensure that Western purchasers can buy them for next to nothing.

Globalization Versus Economic Nationalism?

John Lloyd has sought to defend the ST model and to repudiate the criticism of FDI suggested above by claiming that such views are based upon economic nationalism. He goes on to explain that in so far as there is a new world order it derives 'from the death not of communism but of economic nationalism. . . .'[134] He thus urges us to forget about nationalism and accept the world of what he calls globalized production; by this he means global companies that produce parts in lots of different countries and assemble them in various places. He then tries to find fault with Jonathan Steele of the *Guardian* because in Steele's important book, *Eternal Russia*, this globalized world 'exists only spectrally, if at all'.

Lloyd is here muddling two very different phenomena: globalized *production*, in the sense of large TNCS producing throughout the world with an integrated internal division of labour spanning many countries,[135] with global *product markets. Production* is globally integrated within companies only in a limited sector of the world economy, though an important one. It partially exists in cars and in electronics, though even in South-East Asia, car production has not been internationalized, though electronics has. Outside these sectors, globalized production is marginal. Further, research on such production suggests that it has not been a

[132] UNCTAD, *World Investment Report, 1994*, p. 106.
[133] Ibid., p. 100.
[134] John Lloyd, *London Review of Books*, 10 November 1994.
[135] Ibid.

growing feature of economic relations. The best indicator of the growth of global production is the growth of intra-firm trade (IFT) since by definition it requires IFT. Yet the OECD's research on IFT demonstrates that, contrary to Lloyd's ideology of globalization, IFT does not seem to have grown during the 1980s. The OECD's research on IFT shows that, at least for US and Japanese TNCs, IFT stagnated during that decade.[136] Even if it had been growing, Lloyd's case that nationalism was played out would require him to demonstrate monopolization and nearly insurmountable barriers to entry *on a global scale* to suggest that nationalist economic ambitions were utopian. On the other hand, what does exist across most sectors are *increasingly globalized product markets.* Yet to paraphrase Lloyd, 'these exist only spectrally if at all' in his writing for, if he had understood their existence, he would have noticed the feverish *rise* of economic nationalism, most especially in the USA, the EC and Japan which has become much more intense following the demise of communism. Every day, the *Financial Times* provides us with new evidence of this. In the context of global product markets, each state seeks to concentrate capital in its main sectors of strength in order to gain sufficient scale and power to fight for global market share. The task of the state is to fight on behalf of its own (domestically monopolistic) players in their ruthless drive to capture markets and/or carve up the globe within their cartels.

In line with this drive, the big Western players moving into Eastern Europe have typically tried to require governments there to provide them with monopolistic control of the local market. VW required monopoly-protecting tariffs on Czech car imports before investing in Skoda. Hunslet, the British rolling-stock maker, demanded similar monopoly rights when it bought Ganz in Budapest. General Motors required the right to import its cars duty-free into Poland as a condition for investing in FSO in Warsaw, while requiring high tariffs on non-GM cars.[137] In Hungary, Suzuki has obtained trade protection for its cars and Samsung has done the same for its televisions.[138] For the TNCs 'globalization' and national autarky for their target sector fit perfectly together.

A specific European feature of these developments has been the attempts of the EC Commission to promote its own state-building efforts at an EC level by demonstrating its capacity to defend the base and strengthen the outreach of EC-based multinationals. And in the East European context this has entailed helping then to acquire dominance in their own sectors in the East.

The Interaction of Public and Private Western Operations

There is an uncanny coincidence in the way in which the IMF/WB activities have combined with those of the more predatory TNCs to weaken the

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136 OECD Trade Policy Issues, *Intra-Firm Trade*, Paris 1993. The only reliable data on IFT, according to the OECD, apply to the US and Japan.
137 Richard Parker, 'Clintonomics for the East', *Foreign Policy*, no. 94, spring 1994, p. 60.
138 United Nations Industrial Development Organization, *Industry Development Global Report, 1992/93*, Vienna.

capacity of East European states to bargain effectively with and be able to absorb for national advantage benefits from FDI while minimizing the possible damage. Not only has the WB opposed a national micro-economic strategy involving targeted industrial policy and export promotion, it has sought to weaken the most elementary forms of crisis-management industrial policy, which are normal practice in the West in minor recessions when large swathes of important companies are put into 'intensive care' by the banks. Instead, the WB has urged draconian bankruptcy laws and an asset-stripping, labour-shedding approach to restructuring. It has taken its lead from the signals of collapsed markets and required action as follows: 'Typically, the restructuring plans will involve closing loss-making production units, carving out non-essential activities, divesting non-productive or under-utilized assets and shedding excess labour.'[139]

Both the IMF and the WB have shown not the slightest concern for protecting the educational infrastructures and public research and development budgets, nor in infrastructures for ensuring a future capacity to absorb and diffuse new technologies throughout the economy. Year after year, health and education spending in the Visegrad countries has been reduced.[140] In Slovakia, for example, in 1993 education spending was reduced by 30 per cent. In Hungary in the spring of 1995, the Bretton Woods institutions required the government to charge fees for higher education and for medical treatment as a condition for providing new loans.[141] Against this background we have seen catastrophic declines in R&D budgets across the region.

Shock Therapy, Democracy and 'Civil Society'

Cardinal goals of ST have been, according to Sachs, the achievement of democracy and freedom. Although Sachs has not emphasized the building of 'civil society', this has been a constant theme of ST supporters. Yet these goals have been treated as ends and not means. As ends, they have been discursively very important because they have been used as core justifications of the means of ST. However, the liberal principle that ends should govern means has been operationally rejected within ST in favour of a more 'dialectical' approach: the existing social, legal and political institutions are likely to be resistant to ST, but ST is the only, or best, path to truly democratic, legal and civil institutions, so we must negate the existing institutions from above and outside in order to realize true democracy and civil society.

This has been the substance of much Western conditionality diplomacy. It has also been applied in the funding efforts for various pro-Western

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[139] World Bank, 1993 Enterprise and Financial Sector Adjustment Loan to Poland, quoted in Amsden et al, *The Market Meets its Match*, p. 124.
[140] Except in the Czech Republic, where government health spending rose in 1993 as a result of its decision to privatize health insurance. For an enthusiastic article on the privatization see *Economist*, 28 May 1994, p. 48.
[141] Prime Minister Horn appealed privately to Chancellors Kohl and Vranitsky to support him in resisting this requirement, but they responded by demanding that he fully implement it.

political parties in Eastern Europe, particularly social-democratic parties. In fact, it has been at the very heart of the operational priorities of ST: to subordinate the will of electorates and parliaments to the overriding priority of rapid systemic transformation to capitalism, downgrading constitutional development, social and political consensus-building, and respect for minimal economic and social solidarity. Insouciance on those issues, as Sachs has more or less acknowledged, led to catastrophe in Yugoslavia. The tensions of ST played a central role in the destruction of Czechoslovakia—whose populations were denied a vote on the issue. These features of the drive have been most evident in the policy towards Russia and the former Soviet Union.

The Civil and the Criminal in the New Capitalist Class

The West has urged that those who managed to accumulate money-capital under communism should form the core of the new domestic capitalist class. These people have been mainly currency speculators and black-marketeers as well as corrupt members of state administrations, especially in the import–export sectors. Such people have shown entrepreneurial spirit, albeit of a criminal kind. Lord Howe, appointed adviser to the Ukrainian government in 1991, was quite frank on this point. He urged the need for the development of what he called 'bandit capitalism' in Ukraine and drew a favourable parallel with the great robber barons of American capitalism in the nineteenth century.[142] The governing consideration is to swiftly create a capitalist class with strong entrepreneurial and proprietary instincts: in bandit or mafia capitalism there was a solution.

This aspect of Western policy has often been overlooked, perhaps because ST supporters have urged action to reduce levels of criminality in the East and have often offered a more general rule-of-law discourse. Yet the policy has been faithfully reflected in the pages of the *Economist.* It has argued that in the case of Russia, the communists have had an interest in exaggerating the extent of crime and that, in any case, the entire Soviet project had been criminal. It has urged that the criminal businessmen, 'whose methods of operation hover uneasily between those of Al Capone and those of the early American robber barons . . . need to be encouraged to go legitimate.' To achieve this, it argues, the Russian government has to 'show that it is willing to protect property rights . . . Second, the government has to reduce its interference in the economy . . . The government could be deregulating and liberalizing the economy much faster than it is doing.'[143]

The supporters of ST thus turn the idea of building a civil society in the East into the simple notion of ending state interference, state funding and

[142] Such concepts were also rationalized by neo-classical welfare economists who argued that bandit capitalism was Pareto optimal on the grounds that the politically-connected bandit-capitalists would gain while nobody else would lose since nobody else owned anything anyway.

[143] *Economist*, 9 July 1994, pp. 21–2. Edward Luttwark expands on the same theme in his essay 'Does the Russian Mafia Deserve the Nobel Prize for Economics?', *London Review of Books*, 3 August 1995, p. 7.

state control. Society, it seems, would be civil only if there was no political interference. The respect for popular sovereignty, the building of links between public policy and voter preferences, or responding positively to expressions of public protest or strike action by desperate employees, forms no part of this programme. Strong public protest against the kinds of privatization favoured in the West or against increasingly unpopular examples of predatory Western buy-outs are to be ignored.

The Polish sociologist Wlodzimierz Wesolowski has captured the ST supporters' hostility to democratic will formation when writing of the stance of the new, post-1989 elites in Poland: 'the unvoiced assumption that people had to be demobilized in order to open the way for economic reforms; in parallel, the business of politics should be left to politicians and the emerging class of big capitalists. This was—and still is—the position of leaders of neo-liberal persuasion as well as of many influential journalists.'[144]

With the election in one country after another of governments led by the former communist parties, hostility towards the effects of democratic politics in the region has become most explicit among some of the American supporters of ST, as expressed in various articles in *Foreign Affairs.* One such piece declared that Western efforts to thwart the development of right-wing nationalism in the region were a mistake: 'In Central Europe the greatest danger to democracy and stability does not—and never did—come from the new or old nationalist right. The danger comes from the old left, from remnants of the communist parties . . . Former communist parties hold political and economic monopolies which will take years to loosen; until they do, politics will not become "normal" in any Western sense in Central Europe or elsewhere . . .'[145]

This sense that electoral verdicts in favour of the post-communist parties should not be accepted took a more activist form in an extraordinary piece in the same journal by Michael Ignatieff. He declares that 'All the post-communist regimes are nominally democratic, but in practice the levers of power have usually remained in the hands of the old nomenklatura.' In any case, he explains, 'formal democracy is not enough. Indeed, democracy will degenerate into authoritarian populism' unless new measures are taken by the West. Ignatieff then goes on to spell out how the West must develop what he calls a 'civil society strategy' for the region. This should be a set of programmes administered by the Western states within the post-communist states to fund the mass media, opposition parties, the courts, judiciary and police. The strategy, he says, 'starts with the search for partners outside the state, the leading parties and the bureaucracy.'[146]

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[144] W. Wesolowski, 'The Nature of Social Ties and the Future of Postcommunist Society: Poland After Solidarity', in John A. Hall, ed., *Civil Society. Theory, History, Comparison*, Cambridge 1995.
[145] Anne Applebaum, 'The Fall and Rise of the Communists: Guess Who's Running Central Europe', *Foreign Affairs*, vol. 73, no. 6, November–December 1994, pp. 7–13.
[146] Michael Ignatieff, 'On Civil Society', *Foreign Affairs*, March-April 1995.

Such contempt for the 'formal democracy' of electoral results and such crude proposals for bureaucratic interference in the socio-political life of the region by Western states could only further undermine the already strained polities emerging in the region. The post-communist parties have won support from electorates because, although themselves committed to further privatization, they are seen as seeking to rebuild the shattered social fabric by maintaining some minimal social commitments and by offering some protection to state enterprises which face political discrimination under World Bank tutelage. These parties have also managed to maintain a communicative interaction with large social groups ignored or abandoned, as Wesolowski points out, by the neo-liberal elites.

Constitutionality Versus Shock Therapy in Russia

The most direct and brutal test of the relationship between liberal principle and ST occurred in Russia in 1993. The Yeltsin government derived its authority from parliamentary elections held in 1990 during the Gorbachev period. The Russian parliament elected at that time had then elected Yeltsin as president and, in the autumn of 1991, voted him emergency powers for a year to give him a free hand with economic transformation. By the autumn of 1992, with real wages down to 40 per cent of their levels at the start of the year, the majority in parliament began to swing against the Gaidar economic reforms. By the spring of 1993 Yeltsin was on a collision course with the deputies. Jonathan Steele's important book on the Gorbachev and Yeltsin years has carefully analysed the constitutional and democratic dimensions of these events.[147] Steele reminds us that the decisive shift towards liberal democracy and a legal state took place under Gorbachev, who inaugurated an independent press, the dismantling of the censored press and KGB controls, and free elections. Steele also reminds us that the leaders of the Russian parliament had not started out as opponents of Yeltsin. Indeed, Rutskoi had been a central figure in Yeltsin's rise, not least in August 1991. The swing of opinion in parliament was all too easily explicable in the context of the catastrophic consequences of Gaidar's ST programme during 1992.

From the spring of 1993 Yeltsin embarked upon a drive to flout the constitution in order to crush his erstwhile supporters within the Russian parliament. The parliament's powers were not, in fact, very extensive. Unlike the French parliament, the Russian one could not vote on the government's programme or pass a vote of no confidence in the prime minister. Unlike the US Senate, it could not approve individual ministers. On the other hand, it could not be dissolved by the president and, like the US Congress, did have substantial power over budgetary matters.

Faced with parliamentary opposition to his economic programme, Yeltsin decided to announce the dissolution of parliament, an act expressly prohibited in the constitution. When the MPs sought to resist this act by occupying the Parliament building, Yeltsin had them surrounded and cut off, and this led to the ill-judged but constitutionally legitimate effort by the parliament to strip Yeltsin of power. Yeltsin responded to a march on a radio station with a military assault on the

[147] Jonathan Steele, *Eternal Russia*, London 1994.

Parliament building, the arrest of parliamentary leaders, and the closing down of Russia's supreme court, which had properly opposed his attempt to violate the constitution. Yeltsin also imposed censorship and closed down hostile newspapers. MPs who had participated in the occupation of the Parliament building were thrown out of their flats within three days of Yeltsin's victory.

Western governments and ST supporters supported Yeltsin's unconstitutional acts. The parliamentary leaders were branded by John Lloyd and others as the Old Guard, although none had such good credentials for that title as ex-CPSU Politburo member Yeltsin. Lloyd says that 'Yeltsin was faced with the alternative of surrendering to the Old Guard or breaching the constitution'. This is propagandistic: the parliament had not been asking Yeltsin to surrender: they had been opposing his ST policy. If Lloyd was more candid, he would admit that the choice was between pursuing ST or respecting the constitution. And that is why Lloyd is, as he says, 'glad that Yeltsin won'.[148] All this was, in any case, an ex post facto rationalization on the part of Lloyd. At the beginning of 1993 he had classed as the sole political achievement of 1992 the continued functioning of the combination of parliament, president and government. His list of nine dangers for Russia during 1993 made no mention of a threat from the parliament and one of his list of five hopes for the year ahead was for a 'consolidation of democratic institutions'.[149]

After the coup of autumn 1993, the *Economist* declared that one should not be surprised that a Russian like Yeltsin would ignore constitutional proprieties. After all, it explained, 'Russia being Russia' the hope that 'a free-market democracy' could be established there by consent was probably 'always absurd'. In short, we in the West should not expect Yeltsin to behave by our standards.[150] The *Economist*'s editor did, however, expect that his readers would have forgotten the journal's own past editorials. We could thus be relied upon to assume that the flouting of the constitution was Yeltsin's idea rather than a Western one. Yet a full five months before Yeltsin made his move, at least one influential Western voice was urging the path of illegality: the *Economist* itself. In its 1 May 1993 editorial it raised the question of whether Yeltsin should continue a war of attrition with his opponents in parliament. It acknowledged that doing so 'has powerful attractions. For one thing, it is legal . . . Yet to continue trench warfare would be a mistake . . . He should abolish Parliament, introduce a new constitution, and call elections.' After all, the constitution had 'become a weapon that Parliament exploits cynically to block reform.'[151] This view was backed by an accompanying article which explained: 'Mr Yeltsin's dilemma is that, to continue with economic reform, he has got to get rid of the present Parliament, which is blocking him at every turn.'[152]

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[148] Ibid. The *Economist* was more honest, stating that if Yeltsin had not confronted the Parliament, 'little would have remained of his . . . ability to press on with the reforms Russia needs . . .' 9 October 1993, p. 15.
[149] Lloyd, 'Yeltsin's Year of Living Dangerously', *Financial Times*, 5 January 1993.
[150] *Economist*, 9 October 1993, p. 15.
[151] *Economist*, 1 May 1993, p. 14.
[152] Ibid., p. 41.

By far the most astonishing aspect of the entire experience of ST over the last five years is the extraordinary resilience of democratic commitment throughout the entire ex-communist region. The populations of the region have not only suffered atrocious hardships but have elected governments on political platforms that have subsequently been blocked, in Hungary, Poland and Slovakia, by Western pressure. Attempts at ultra-nationalist backlash by the Christian Nationals in Poland, the Republicans in the Czech Republic, the Slovak Nationalist Party or the Csurka breakaway from the MDF in Hungary have all been repudiated by the electorates of the region. In general, the extreme right has been far weaker electorally in Eastern Europe during the 1990s than in Western Europe. Just as the far right has gained more support in West Germany than in East Germany, the showing for the far right has been greater in Austria, Italy, France and Belgium than in the great bulk of Eastern Europe. Instead, voters have turned back to the one political current in the region that has received no support whatever from the West: the ex-communist socialist parties. These have achieved victories in Poland, Hungary, Bulgaria, Lithuania, Estonia, Ukraine and have become important also in the former GDR.

In this context, East European democrats must wonder why Ignatieffs in the West propose Western financial intervention against authoritarian populist currents in Eastern Europe, instead of spending some of that money tackling the extremist militias in the US or fascism in Western Europe. Similar cynical smiles are being raised in the region about the EU's worried insistence that the East-Central European states settle all their ethnic and territorial problems by internationally binding treaty once and for all as a precondition for moving towards possible membership of the EU. Why, they wonder, are Western revisionist claims excluded? Why ignore the revisionist claims by the Italian government on Slovenia, claims which led Italy to block an EU Association Agreement with Slovenia being negotiated in 1994? Why ignore German claims on the Czech Republic over the Sudentenland? Why ignore Greek claims over Macedonia? Unlike the East-Central European problems which are merely potential disputes, these claims by EU members on their eastern neighbours have all been active issues. And this leaves aside the question of double standards for the two halves of Europe: no pressure for urgent resolution by treaty is being applied to Britain's dispute with Spain over Gibraltar and with Eire over Northern Ireland.

ST supporters have certainly been both dismayed and embarrassed by the victories of the ex-communist parties in the region. They have also, rather oddly, been surprised that those declaring themselves liberals, now inextricably identified with ST, have been on the retreat in most countries.[153]

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[153] The *Economist* had imagined that the Suchocka liberals would win in Poland's 1993 elections (5 June 1993, p. 43). It predicted that the opposition in Estonia would not be able to question what it saw as the triumphantly successful policies of its ST government (19 November 1994, p. 54). Yet this government was able to marshal only 5 per cent of the vote in March 1995 elections. It predicted that the Hungarian elections would be a contest between its favourites in the Young Democrats and the Free Democrats. Yet the Young Democrats achieved insignificant results and the Socialists achieved an overall majority.

Yet, despite the resilience of the democratic process in Eastern Europe, the message of the electoral victories of the ex-communist parties provides an important challenge to the West. It is a warning that the electorates of the region reject the drive for ST as implemented by the Western powers over the last five years. Voters in the region were initially prepared to trust Western policy and its local supporters. With the possible exception of the Czech Republic, their views have now changed. If the West is not prepared to alter its stance towards the region under ex-communist governments, voters may well turn towards most desperate remedies. The trend in Hungary looks ominous from this point of view. The decision by Western governments to insist upon the payment of fees by students had no basis in economics: it bears the hallmarks of an attempt to use symbolic politics to undermine the authority of the Socialist party. The possible consequences of this approach are already indicated by the surge in support in opinion polls for the Smallholders party, now under the influence of Csurka's far right ideas. Its following has leapt to 20 per cent of the electorate.

III. Conclusions

However it was introduced, capitalism was bound to come as a bit of a shock to the peoples of Eastern Europe. Illusions about capitalism were very widespread. Workers did not realize that it would entail a radical drop in their living standards, a great intensification of the work process and chronic insecurity, as well as destitution for a minority. There is a danger of blaming ST for capitalism as such.

There were also widespread illusions about what kind of capitalism was on the market from the West. Many East European intellectuals, long disillusioned with dialectics, wanted Swedish-style social-democratic capitalism, not appreciating that if the communist world abandoned state socialism for postwar social-democratic capitalism, this very choice would destroy the possibility of realizing it: without communism, social democracy would be taken off the menu. It could also be said that official opinion, at least in the Visegrad states, continued, despite mounting popular opposition in Poland and Hungary, to be resolutely committed to the ST course and that this was not only due to Western structural power and pressure.

While this is both true and important, it is also important to see why this commitment by these post-communist elites has been so strong. In the Visegrad states the idea of rapid, systematic change has been discursively packaged as a quick 'entry into Europe'. In this form it has been the legitimating discourse for the transformation towards capitalism as such. It has been the way for legitimizing privatization, unemployment, social differentiation and the impoverishment of large sections of the population. Those who have questioned this discourse have been marked as opponents of the transition to capitalism as such. Thus to have abandoned the set of Western policies and conditions entailed by ST would have required an alternative means of legitimating the social transformation.

Yet at the same time, the claim that this pressure from the governments of the Visegrad region prevented the Western powers from pursuing any other policy than ST cannot be taken seriously. The Western alliance had at least as much collective capacity to shape the future of Eastern Europe in the early 1990s as the Americans had in Western Europe in the late 1940s. An orientation towards a genuinely pan-European project based upon retaining the regional links of the Eastern part of the continent for a long transitional period and moving towards a pan-European confederation bringing the two halves together would have been both viable and far less costly for the peoples of Eastern Europe. It was not collectively advanced by the Western powers because it did not serve their economic and political interests.

Evaluating the Outcome of Shock Therapy

The costs of ST have been far in excess of what was, from an economic point of view, necessary. The most damaging cost and, at the same time, the most fundamental feature of ST was the decision to encourage the fragmentation of the Comecon region and to replace it with a hub-and-spoke interaction between isolated, shattered economies and gigantically powerful Western forces. From this, all else followed.

ST supporters tend to ignore this governing feature of the policy and invite us to compare the domestic national policy cycles of the fragments. On this basis, using growth rates as the key criterion, Poland seems to emerge best and Hungary, amongst the East-Central European countries, worst. We are supposed to conclude that ST = Poland = Success. This is a specious line of argument. It assumes that Hungary did not follow ST while Poland did. In reality both liberalized prices, reduced wages, freed trade. Both got stuck over privatization. Yet two very large differences between them stand out: Poland's debt, uniquely, was halved, Hungary's was not even significantly rescheduled; Hungary attracted about half of the entire region's FDI, Poland faired much worse. The only conclusions we can draw are that debt cancellation may be very important from a macroeconomic point of view, while FDI may be irrelevant or worse. As for the vibrancy of the private sector in Poland this rests uneasily next to the country's export performance, 60 per cent of which was being achieved in 1994 by its much discriminated-against state enterprises.

A starker contrast in the policy field would be between Hungary, the Czech Republic and Poland on one side and Romania on the other. The Romanian case may be taken as a paradigm of an alternative, national capitalist strategy of transformation counterposed to the ST cycle of 'opening to globalism'. The Iliescu regime rejected a sweeping liberalization of prices, avoided bankruptcies and large lay-offs of workers, sought to maintain the big industrial enterprises and directed its privatization efforts towards management and worker buy-outs, largely excluding foreign capital. The government was also cautious about liberalizing its trade regime. As a result of these policies it was largely rebuffed by the IFIS.

Romania initially suffered from acute internal tensions as a result of the form of transition from the Ceaucescu regime. It also suffered from an acute hard-currency shortage. Nevertheless, like Poland, the Romanian economy returned to growth in 1993 with a 1 per cent rise in GDP, grew by

3.4 per cent in 1994 and is projected to grow by more than 4 per cent in 1995.[154] The Japanese financial services group Nomura made the following comparative judgement on the Romanian economy's 1994 performance: 'Romania, little noticed by the West, delivered last year probably the most impressive performance in Eastern Europe.'[155]

This does not mean that Romanian experience should be erected as some sort of superior strategy to that of Poland. Since 1989 the Romanian people have probably suffered more than the Poles. It does suggest two possible lines of investigation: first, Romania had no Significant foreign debt and this makes it similar to Poland with its debt reductions; and second, the ST opening to global forces is at the very least no panacea if recent growth records are the standard of judgement: Romania has revived far more strongly than wide-open Hungary or the Czech Republic.

Yet attempts to hail this or that country as a success on the basis of current growth tables are a facile way to judge the outcome of ST.[156] The real test is the one proposed by Sachs: will ST provide higher living standards than those which prevailed in 1989, as well as democracy and freedom? We do not, of course, yet know. But what we can do is work out what would be necessary in order to achieve such higher living standards.

IMF calculations are that even in the most promising country of the region, Poland, living standards will not return to their 1989 levels until the year 2010 at the earliest. Rollo and Stern have calculated that for the region as a whole to return to its 1988 levels of GDP per capita by the year 2000 it would need growth rates of 10 per cent each year between 1994 and 2000. By this measure, on present trends, most of the region will not regain 1988 living Standards by 2010. Even with such growth rates, Rollo and Stern rule out the possibility that the Visegrad states could return to their 1988 development ranking (their position relative to other states) by the year 2010: in the best case, it would take more than twenty years. They have calculated the rates of growth that would be needed in order that the CSFR and Hungary reach Spanish levels of GDP per head by 2010 and that Poland reach Greek levels by the same year: this would require catch-up growth of 10 per cent per annum from 1994 to 2000—roughly the rate of growth of the Asian NICs and somewhat lower than China's growth rate in the 1980s and 1990s. They then assume 6 per cent growth per annum between 2001 and 2005 and growth rates of 4.5 per cent from 2006 to 2010.[157] These growth targets then provide export growth targets, on the assumption that domestic demand will remain depressed in the Visegrad

[154] Virginia Marsh and Kevin Done, 'Unexpected Degree of Stability', *Financial Times*, 25 May, 1995, p. 33.
[155] Quoted in ibid.
[156] Even more facile are the attempts by the *Economist* to hold up various East European economies as being sounder than Western ones on the basis of the size of their budget deficits!
[157] J.M.C. Rollo and J. Stern, 'Growth and Trade Prospects for Central and Eastern Europe', *The World Economy*, no. 199. Their calculations show that 'growth over the whole 1988–2010 period is unlikely, even under the optimistic scenario, to lead to a major improvement in the relative living standards of Eastern Europe.'

states for most of the next twenty years. They assume a growth in exports of almost twice the expected 6 per cent annual rate of growth of world trade: in other words, a growth of exports of about 12 per cent per year. Such export growth would have to be in goods sectors with low capital–output ratios—i.e. sectors that do not require large new capital investments. Given the countries' debt problems and likely repayment arrangements, the resulting balance-of-payments gap that would have to be filled by an inflow of Western capital is unrealistically large. This means 'exports will be required to generate even higher volumes of foreign exchange than assumed above. Thus if capital markets plus aid cannot meet the challenge, goods markets will need to be open.'[158]

These are immensely depressing calculations. They imply that even for a country growing like Poland for the foreseeable future, the population will have to wait for the best part of twenty years simply to return to their living standards under a communist system that had long been in crisis. Even this makes unrealistic assumptions that the West European economies will not enter their next recession in 1997 or 1998, that global casino capitalism will not explode, and that shocks or cycles of other kinds will not hit Poland. This situation is about as bad as when capitalism last held sway in Poland, between the wars when the economy did not grow overall at all between 1913 and 1939. It is a stark contrast with what Sachs likes to call 'the forty ruinous years of communism' when the living standards of the Polish people were transformed for the better. As for the countries still without growth after five years, like Hungary, not to speak of Bulgaria or countries further east, the prospect is far worse.

Of course, events may turn out very different: these countries may embark upon the kind of growth path that we have seen in China or South Korea. But the entire weight of Western pressure has been geared to preventing the region from following the strategies pursued in those countries. As to the fate of democracy and freedom—Sachs's other criteria of a successful outcome—it would probably be unwise to speculate, even if we could be pretty certain that were the EU countries to be subjected to the sufferings lived through in Eastern Europe, democracy could hardly be expected to survive.

Towards an Analytical Theory of Western Behaviour

Sachs's model displays unexpected asymmetries. He gets most of the economics wrong but is rather strong on the ways of using political power to engineer social change in the East; his understanding of how to handle East European politics sits alongside a woeful failure of the model to get the behaviour of Western actors right.

On the economic side, the model produced a slump which Sachs did not predict; a chronic fiscal crisis that Sachs claimed he was there to overcome; an initial export performance that demonstrated competitive potential in state enterprises Sachs believed to be hopeless; an import bonanza that damaged the economies instead of spurring recovery; an investment collapse instead of an investment surge; a domestic consump-

[158] Ibid.

tion-led recovery instead of export-led growth; a trickle of FDI instead of a flood. Yet the economics professor's system of constraints and incentives for Eastern governments to draw them into ST and to manipulate their policy systems was a remarkable success, at least in the initial stages of the programme. Western actors, on the other hand, refused all the roles Sachs assigned them except those involving the imposition of constraints and pressure—with one significant exception which the model gives us no resources to explain: the Polish debt cancellation. Otherwise, debt cancellation was off the menu, as were macroeconomic grants and the radical opening of the EC market; on the other hand, Western state subsidies for exports were in, arbitrary protectionist actions were in, subsidies for FDI by their own firms were in. Sachs seems genuinely perplexed and upset by all this. In an article this year he complains that 'not only the Russian economy but also Russian democracy has been put recklessly at risk by Western neglect.'[159] He calls US policy towards Russia the greatest foreign-policy disaster for decades.

Sachs's diagnosis of this is that the G7 suffer from intellectual problems: they lack vision, or, more cruelly, they are plain stupid. Like a conductor in front of an amateur orchestra, Sachs has been raising his baton repeatedly in front of the G7 yet when he brings it down they continually hit the wrong note. It does not seem to occur to Sachs that they may be playing reasonably well, but to a different score, or a number of different scores. Trying to read these scores requires an analytical approach which rejects the belief of Sachs or Ignatieff that the Western powers are driven by God-like ideals and accept that they are human, all too human, and governed by a will to power. Sachs's ST goal of 'globalized' open-door states in Eastern Europe does indeed then serve their interests because it enables their economic operators to penetrate the region effortlessly with their products and their capital, while the macroeconomic consequences of this opening are policed by their IFIs. Democratic politics can also serve these goals since they are more permeable than many other forms of state and can institutionalize values harmonizing them with the West. In so far as the results of pursuing these objectives are prosperity for all, so much the better: but this is a bonus, not the bottom line.

At the same time, these *regime goals* shared by Sachs and Western governments have not been the exclusive goals of Western powers in Eastern Europe in the 1990s. Another central preoccupation of the EC governments has been the way in which the international division of labour is to be reorganized in Europe as a whole. The USA has also been preoccupied with these problems from the perspective of its own interests and, in addition, it has been trying to reorganize the political balance of power across the entire continent.

It is also fascinating to note the failure of Sachs to understand the roles of the IMF. He accuses its officials of being stupid bureaucrats for failing to disburse adequate funds to target funds flexibly enough, but the IMF can only be as flexible as the leading powers within it allow—and, as the Mexican crisis of the winter of 1994–95 showed, the American government can encourage it to be extraordinarily flexible when perceived vital

[159] Sachs, 'Consolidating Capitalism', p. 60.

interests are at stake. Further, the task of the IMF is above all that of guarding what integrity there is in the global financial and currency systems, rather than producing sustainable growth in crisis-ridden peripheries. In the immensely strained and unstable international financial conditions of the 1990s, the incentive systems open to the IMF have been overwhelmingly negative ones. For Sachs to expect sweeping debt relief for Eastern Europe when the main Western powers are using the debt burdens of scores of states throughout the world as their main instrument for maintaining a semblance of discipline and hierarchy in international affairs is very naive. The very successes of Sachs's own project for globalized capitalism could hardly have been achieved in Latin America without those debt burdens acting as powerful negative incentives.

Sachs's plan, as outlined in January 1990, corresponded closely to American thinking on Europe at that time. The Bush administration feared that the collapse of communism in Eastern Europe could lead to the development of economic and security structures across the whole continent embracing both Moscow and the EC and leading to the marginalization of US power in Europe as NATO withered. This was exactly the vision which President Mitterrand had unveiled to the world in his New Year's Eve address two weeks before Sachs's article was published: a European confederation from the Atlantic to the Urals. Such a scheme would have enabled France to have kept the East-Central Europeans at arm's length while pursuing its plans for strengthening the EC. It would also appeal to Chancellor Kohl, overwhelmingly preoccupied with ensuring a strong relationship with Moscow as he struggled for German unification. The Deutsche Bank president had already outlined an ambitious plan for rebuilding the East as a unified region, a plan which could have brought great synergies between Russian and German economic strength. President Mitterrand had capped this with his own scheme for the process to be planned by a French-led EBRD.

Sachs's ideas for transforming the region dovetailed nicely with the politico-economic policy objectives of the Bush administration. These included the following: to break what came to be known as the Visegrad states from Moscow and require a shock transition to capitalism there; to continue to exclude the USSR from a reorganized Europe and to work instead for the absorption of East-Central Europe into the Western sphere; to pressurize Germany into footing the bill for the rapid transformation of East-Central Europe, which Sachs explicitly called for, while an IMF-led restructuring programme would create exporting tigers competing on the basis of cheap labour costs, which would blast a hole in the EC's CAP, would dissolve the EC's trade regime, would lead to a relocation of production from Germany eastwards, and would thereby exert pressure to reconstruct the EC's institutional order along American lines as a minimalist safety-net, neo-liberal zone. Every single one of these elements was in the Sachs plan, though more delicately put. It was a plan which fitted perfectly with thinking in London.

The Bush administration's scheme would make NATO necessary to consolidate the absorption of East-Central Europe and thus assure US leadership. The likelihood of EC resistance to the US assault on its CAP and trade regime would make the US the champion of the economic interests of the belt of states between Germany and Russia. In this context, Poland was the geopolitical key and it also had a new elite strongly oriented towards US neo-liberal values and able to draw on a long-standing fund of Polish sentiment sympathetic to America. The cancellation of Polish debt, amongst other things, becomes explicable only in this political context.

The French government was unable to carry the day against Washington because the Bush administration's policy offered adequate scope for German interests. In particular, the anchoring of the Visegrad countries to the German economy was a prime goal of Bonn and once the arrangements with Moscow for German unification were consolidated, the German government ceased to pursue its earlier interest in new pan-European frameworks. Thus since 1990 the EC has accepted the fragmentation of the Comecon region and has concentrated upon establishing its hegemony over Visegrad, Romania and Bulgaria while blunting American efforts to use the region as a lever against the EC's trade regime. Through its rules-of-origin package it has thrown a ring around the new Associated states, to give a privileged role for capital based within the EC. It has defended the integrity of the CAP and its trade protection regime and has worked to ensure that the new division of labour in the East will be entirely governed by West European economic operators and their interests: the combination of a tough trade policy and strong supports for the export drive and for West European FDI have ensured this. It has also resisted any hostages to fortune in the form of time-tabled commitments to the entry of the Visegrad economies.

From the EC's point of view, so far the policy has been a remarkable success. Poland, the Czech Republic and Hungary are firmly locked into EC ascendancy. The rest of the region, given Russian weakness, still have nowhere else to go. It is true that the Visegrad states are in a weaker condition for entering the EC than they were in 1989 and would have been if their region had not been shattered, but their accession to the EU is not a priority even for Germany: what counts is their being firmly within the sphere of EU dominance. The task now for the USA is to ensure that the EU's new East-Central European sphere is brought firmly under overall US leadership. This goal is to be achieved through NATO's eastward expansion.

Sachs's vision is stuck in a one-sided preoccupation with regime goals and with important, but partial, issues like inflation, budget deficits and so forth. It does not occur to him, for example, to ask what impact billions of dollars' worth of grants for fiscal stabilization would have had on Russia's military capabilities. Russian stabilization is important, but so too, from an American point of view, is scaling down Russian power.

What remains living within Sachs's plan is its ideological and symbolic role. The idea that economic nationalism is dead and that we live on a cosmopolitan globalized planet is very powerful and even inspiring. The notion that growth in Poland has been produced by the Poles putting nationalism behind them and going the American way is politically helpful. Yet it remains an ideology in which the real driving forces in the world are, to paraphrase Lloyd once more, ‘present only spectrally if at all’. To grasp those driving forces we would need to amend Lloyd’s remark about the new world order bringing the death of economic nationalism. A better formulation might be that in Eastern Europe, the death of communism had led the West to try to stamp out economic nationalism in favour of its own national and collective interests in the region. But 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.