

Crossing the Valley of Tears in East European Reform

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Source: *Challenge*, Vol. 34, No. 5 (SEPTEMBER/OCTOBER 1991), pp. 26-31, 34

Published by: Taylor & Francis, Ltd.

Stable URL: <https://www.jstor.org/stable/40721281>

Accessed: 18-06-2020 15:33 UTC

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## *Crossing the Valley of Tears in East European Reform*

*The East envisions a return to the mainstream of European democratic and capitalist life. But it will take political leadership and social consensus to survive the lean years of transition. Now the West must show it wants the East to “return.”*

The economic situation in Eastern Europe is mixed and troubling. On the one hand, most of the countries of the region (Bulgaria, Czechoslovakia, Hungary, Poland) are making important progress toward creating a market economy. The results of the past two years give strong evidence that these economies can indeed be converted to the Western European model in a reasonable period of time. There are hundreds of thousands of new businesses, particularly in construction, trade, and services; shops are full of goods for the first time in decades; and inflation is coming under control in almost all countries.

On the other hand, as the result of persistently low living standards and the major dislocations caused by the reforms, the breakdown of the old administrative system, and serious external shocks, the citizenry of Eastern Europe is troubled, restive, and impatient. Unemployment has risen to around 5–10 percent of the labor force in each of the countries, and it continues to mount. The *fear* of unemployment is rising even more rapidly, and that fear could provoke politicians

and the society to a panicked response. The risk of panic brings to mind Roosevelt's aphorism that “the only thing we have to fear is fear itself,” and underscores the fact that it is the *political management* of the economic transformation that is the single greatest challenge facing the region. Will the Eastern European countries find their Roosevelts to bring them through this difficult period?

Regarding practical reform steps, most of the governments have grasped the crucial need for stabilization and liberalization of the economy. In most of the countries as of mid-1991, price controls have been eliminated, currencies are largely convertible for current account transactions, and international trade is quite free. As a result of market-determined prices, shortages have been eliminated. But all of the countries have so far failed to make a decisive breakthrough on privatization and financial restructuring of the state-enterprise sector. This is no doubt because privatization and financial restructuring pose the hardest intellectual and political puzzles of the whole transformation.

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On the side of the West, the support for Eastern Europe has been modest at best. There are some bright spots to be sure: the reduction of Poland's debts to Western governments; the Enterprise Funds for Poland and Hungary established by the U.S. government; the British Know-How Fund. There are also dozens of specific projects supported by Western governments. But at the same time, the levels of direct financial assistance are small, and the financial aid is generally inflexible and unused in many cases. And on the great nonfinancial issues, such as the European Community's (EC) willingness to accept the East Europeans as members at some date in the future, and the EC's immediate willingness to open up to East European exports of agriculture, textiles, and steel, the responses have been far from adequate.

There are several actions that should be taken urgently by the East European Governments and by the West to assure the success of the transformation. In Eastern Europe, the need for progress on privatization is paramount. In the West, concessions from the EC, as well as greater financial support for various aspects of the transformation are at the top of the agenda.

### *Overview of reforms to date*

It is generally agreed that there are three distinct aspects of the first phase of economic transformation in Eastern Europe: economic liberalization; macroeconomic stabilization; and privatization of the economy. In a latter stage, more structural policies involving the public investment budget and regional policies come to the fore. The content of the initial steps may be summarized as follows:

**Economic liberalization:** freeing of most prices; open trading policy (low tariffs, elimination of quotas, ending licensing of trading firms); and a legal basis for private property (commercial code, company law, judicial enforcement of contracts).

**Macroeconomic stabilization:** sharp cuts in subsidies; devaluation of the exchange rate and subsequent currency convertibility; positive real interest rates; and restriction on domestic credit expansion.

**Privatization:** conversion of state enterprises into corporate form, followed by transfer of ownership of state enterprises to the private sector. Transfers may be through sales, free distribution, or other means.

In Bulgaria, Czechoslovakia, Hungary, and Poland, rapid progress has been made in the first two areas, and rather less progress in the third area. All of

the countries were able to eliminate chronic shortages by allowing prices to be decontrolled; all have been able to establish a relatively stable currency that is convertible, or at least nearly so, for current account transactions, and all have put in place a basic commercial code and company law to allow for the establishment of new private enterprises.

The qualitative results are also similar, though the quantitative outcomes in the four countries have depended on many factors, including: how long the country has been undertaking market reforms; how badly the country has been hit by the collapse of Soviet trade with Eastern Europe; and how unstable the initial conditions were in the country at the outset of reform.

As a rough outline, we can note that Hungary has been reforming the longest, and is in some sense "ahead" of the other countries, in that the overall infrastructure of a market economy is best developed. On the other hand, Hungary has a high foreign indebtedness and moderate macroeconomic instability. Poland undertook many liberalizing measures during the last years of the 1980s under the Communist regime, but in an inconsistent manner that helped to spur profound macroeconomic instability. Thus, Poland has had to reform from a starting point of hyperinflation and an extreme debt crisis. Without doubt, Poland's reforms have been the most comprehensive and decisive in the region, and Poland has made enormous progress in stabilization and in the development of the private sector. Czechoslovakia started the reforms in 1990 from a cold start; the Communist regime had been among the most repressive and unreformed of the region. While Czechoslovakia has had more macroeconomic stability than Hungary and Poland, and has less foreign debt, it has also had much less development of the private sector. Bulgaria also started the reforms late, and in a situation of grave macroeconomic destabilization, as the result of heavy foreign indebtedness and a particularly heavy dependence on the Soviet Union in trade. Still, Bulgaria is making important though little-noticed progress as a result of a very bold economic program introduced at the start of 1991.

In all cases, though, the broad outcomes are the following:

1. An elimination of chronic shortages, usually through a rise of prices that outstrips the rise in nominal wages;
2. After an initial jump in prices when price controls

are eliminated and subsidies are cut back, an ongoing inflation on the order of 2–3 percent per month;

3. A sharp cut in the budget deficit;

4. A rise in exports to Western markets (at a fairly dramatic pace in the cases of Hungary and Poland);

5. A drop of living standards for at least part of the population (though also a significant increase for a small part able to take full advantage of the new trading opportunities);

6. A rapid development of private enterprise (in construction, wholesale and retail trade, international trade, and services) in many cases on a scale overtaking the state sector;

7. A modest increase in private enterprise in industry, though on a scale which is still small compared with the state sector;

8. A steady rise in unemployment and cutbacks in jobs in large industrial enterprises, particularly in those that were dependent on exports to the Soviet Union.

These first steps in economic reforms have provoked a complex political reaction. In Poland, for example, there is clearly public relief that the chaos of the hyperinflationary period of 1988–89 has been ended, and that forty years of chronic shortages have also been eliminated. The public can see a dramatic transformation of the country; hundreds of thousands of new shops and newly privatized shops now cater to the public's demands. On the other hand, the squeeze in the living standards of some portion of the public, combined with growing unemployment and the fears of much higher unemployment in the near future, have cast a pall on developments. The fact that some of the adverse effects (or fears of future adverse effects) have been rather concentrated in heavy industry, coal mining, and small-scale farming, and also by region (Eastern Poland), has probably contributed to a sharpening of the political reactions against the reform program.

One response to the political challenges to the reforms is to strengthen the social safety net in Eastern Europe, so that "losers" in the reform do not feel the sense of panic that can accompany necessary change. But here, the opportunities are limited by the meager financial means of the governments. All countries have introduced unemployment insurance, job retraining programs, welfare payments, and pensions protected at least partially against inflation, but the level of benefits is undeniably low, in line with the very fragile fiscal capacity of the governments and the generally low living standards of the region. Financial assistance from

the West for a strengthened social welfare system is surely needed.

### *State industrial sector*

Without question, the Achilles Heel of the economic reforms in Eastern Europe is the state industrial sector, for several reasons. First, it is vastly overgrown, as a result of the forty years of Stalinist development model. It is therefore in need of substantial reduction in scale as well as restructuring and modernization. A substantial fraction of the East European labor force, typically 30–40 percent, is in the industrial sector, and the "iron triangle" of industrial workers, state managers, and government bureaucrats constitutes a formidable pressure group for protection, subsidies, and wage increases.

Second, the state industrial sector in all of the countries was built up in substantial part as a supplier to Soviet market. Until 1989, the Soviet Union provided a totally protected and stable market. Indeed, the classic definition of marketing in Polish industry was: "Load the train, ship it East." In the past year-and-a-half, however, the Soviet market has virtually disappeared. A decline in exports was expected as a result of the dismantling of the Council for Mutual Economic Assistance (COMECON). What was unexpected, however, was the nearly total collapse of the Soviet economy and Soviet trade this year.

The collapse of Soviet trade is partly the result of the Soviet Union's debt crisis in 1991, forcing the allocation of scarce foreign exchange to debt servicing and away from imports. It is also the result, however, of the unconscionable incompetence of Soviet policymakers in the sphere of the monetary system. Simply put, after the end of the barter system within COMECON, and the putative shift to "dollar-based trade," the Soviet authorities failed to introduce a *payments mechanism* in the Soviet Union, by which enterprises could regularly obtain dollars in return for rubles.

Third, the industrial sector is potentially explosive both politically and economically, because it now operates virtually without legal and institutional norms. While the situation varies country by country, it is roughly correct to say that throughout Eastern Europe the enterprises are not subject to any effective corporate governance, other than an unhealthy kind that sometimes emanates from the workers' councils within each firm. In the West, enterprise managers are governed by a board of directors who are legally obliged to govern the firm in the interests of the shareholders. In Eastern

Europe, there is no effective governance of managers, and as a result there are no clear incentives to manage the enterprises in an efficient manner.

Governance used to be provided by a system of commands from the state administration and the Communist Party, backed up by terror or its threat. With the merciful collapse of Communist terror, governance of the industrial sector has also collapsed, with striking and pathological effects. There are incessant wage pressures that are not checked by managers who represent real owners of the firms. In the absence of centralized wage controls, therefore, there is the tendency toward a wage explosion, of the sort that has occurred in East Germany (where wage controls were not imposed). The wage explosion in East Germany has had devastating consequences for it has led to the virtual bankruptcy of the entire East German industrial sector. Wages have risen to around 50 to 60 percent of West German levels. The wage explosion resulted from a variety of factors: the lack of wage controls; the East German public's belief that they "deserved" West German wage levels; the unwillingness of politicians in West Germany to speak out on behalf of rational wage policies; and the pressure of West German unions to help raise East German wages, lest the lower wages in the East undermine the wages in the West.

In most of the rest of Eastern Europe wages have remained more realistic than in Eastern Germany, although they have been kept under control partly by highly unpopular centralized incomes policies, which are both economically inefficient and politically debilitating for the government.

Also, there is self-dealing and conflict of interest by state managers that is rife, and that is not controlled by legal norms or by boards of directors. Managers engage in the following kinds of activities: intentionally bankrupting firms to buy them back cheaply; establishing private firms to do business, in sweetheart deals, with the state enterprises that they manage; accepting unfavorable joint venture and takeover offers that provide personal benefits for the manager, while rejecting favorable offers that put the manager's personal position at risk. ("Favorable" or "unfavorable" refers to the value of the offer compared to the value of the capital that is being sold to the foreign bidder.)

Finally, there is the phenomenon of "zombie" enterprises, in which incompetent managers simply run down the bank balances and other capital of the enterprise, while failing to adjust in a satisfactory way to the new market conditions. In the case of many Polish firms

that were hit by the collapse of the Soviet market, enterprises simply continued to produce the normal output levels and buildup inventories, waiting for a miracle of some sort. Finally, in mid-1991, the bank balances have run out, and a politically and economically troubling spate of insolvencies has hit the country. Once again, the absence of a capital market (in which a takeover might occur) and the lack of corporate governance, have contributed to these profound managerial failures.

### *Difficulties of privatization*

The proper long-term solutions to the industrial sector problems are clear. The enterprises should be privatized, and then restructured under private control. By privatizing quickly, the onus on the government for restructuring will be greatly reduced and the pressures from the firms for subsidies and protection will be easier to resist. Presumably, the private owners will do a better job than the government did on saving the viable parts of industry and sloughing off the unviable parts. Another factor easing protectionist pressures would be successful Association Agreements between Eastern European countries and the EC. These agreements should presumably guarantee open markets on both sides, and therefore bind the East European countries to free-trade policies.

The crucial policy problem is the interval until privatization occurs. To put the timing issue into perspective, consider the fact that under the aggressive privatization campaign of the Thatcher era, the United Kingdom succeeded in privatizing approximately fifty enterprises during the 1980s, roughly five firms per year. The British privatizations typically followed a pattern in which the firm was "prepared" for privatization through an internal restructuring; the firm was "valued" by one or more investment banks to get a base price for an initial public offering (IPO); the IPO was widely advertised and promoted; and then the IPO was finally carried out several months after the start of the process. The whole episode could take a year or more. In Poland, there are roughly three thousand state industrial enterprises, and some eight thousand state enterprises in all sectors of the economy. At the Thatcherite rate (which benefited from a sophisticated capital market and a large private sector to absorb the state firms), the Polish task of privatization would take several hundred years! "British-style privatizations" cannot be the main answer for Eastern Europe.

As a halfway house to privatization, there is a need at least to “commercialize” the enterprises, that is, to convert them from their current status as enterprises governed by workers’ councils, to enterprises governed by Supervisory Boards (boards of directors) operating according to normal corporate law. While commercialized enterprises are still 100 percent Treasury owned, at least they are covered by the normal commercial law, and have corporate governance according to a professional board of directors appointed by the Treasury. Many East European policymakers, and certainly much of the East European public, underestimate the importance of creating a corporate legal structure for the industrial sector. After decades of neglect of legal norms under Communism, the potential benefits of legal reform seem to be underestimated. Thus, unfortunately, even this important step of creating a corporate legal environment has not been viewed with sufficient urgency in the East European countries, with the result that the pathological behavior discussed earlier continues.

Clearly, in addition to commercialization, new methods of privatization must be found in Eastern Europe to speed the process. In Poland there are plans to freely distribute a portion of the industrial shares into mutual funds, whose shares in turn will be distributed to the adult Polish citizens. There is also some discussion of distributing shares into new private pension funds that would take over some of the obligations of the state social security system. In Czechoslovakia there are plans to sell enterprises in return for “vouchers,” a kind of scrip that will be issued by the government to the public for the sake of distributing shares to the public. In all countries there is the intention to auction small and medium-sized enterprises, and to encourage worker-management leveraged buyouts.

These novel approaches will prove vital to the economic health and recovery of the East European economies. They should be championed by the Western international financial institutions (IMF, World Bank) and governments.

Ironically, there remain great pressures within the East European countries slowing the process of privatization, and the Western advisers have done relatively little to weigh in on the side of rapid privatization. The delays in Eastern Europe may be attributed to several factors:

1. The widespread attraction of the “British model” of privatization (through individual sales of firms), despite the fact that the resulting timetable for

privatization could be disastrously slow. (In Poland, there were grand hopes—and illusions—of carrying out hundreds of IPOs in a year or two. So far, in the course of the year since the Privatization Law was passed, there have been fewer than ten IPOs);

2. The political opposition of many state managers, some workers groups, and some of the bureaucracy, to rapid privatization;

3. The general distrust and confusion of the public over virtually *any* privatization scheme. Every scheme is viewed with cynicism and doubt, since the public is convinced (sometimes with cause) that the enterprises are being ripped off by managers or sold out cheaply to foreigners;

4. The profound logistical difficulties of converting thousands of enterprises into joint stock form, giving them some crude valuation, organizing boards of directors, and putting in place basic institutions of the capital market (stock exchanges, securities laws, enforcement institutions);

5. The lack of experience with basic financial market institutions and corporate law.

Western advisers are often of little help, and are occasionally harmful. Many investment bankers want the business of “British-style privatizations,” and so they promote standard methods of privatization. Some Western advisers also stress the need to “restructure” the enterprises before privatizing them, a process that if applied widely would be far too slow, and for which the governments are not only ill-equipped but also subject to excessive political pressures.

### *Present economic risks in East Europe*

It is easy to become overly pessimistic about the economic transformation in Eastern Europe. On the whole, the progress of reforms to date is encouraging. The economies already operate subject to market forces and with substantial private ownership in trade and services, albeit with a very large state-owned industrial sector that continues to be inefficiently managed. Prices are decontrolled, central planning has been completely dismantled, and the private sector is highly profitable and growing rapidly, though from a very small size. In all of the countries, new entrepreneurs are coming to the fore, with a flair that dispels old notions that socialism had created a “homo sovieticus” in which the market-spirit had been vanquished.

And yet, the situation remains decidedly fragile, even explosive. The positive benefits certainly warm

the heart of a trained economist more than the citizens in the countries themselves. They are less aware of the fact that the burgeoning of new firms promises economic growth down the road than they are of the fact that many large industrial enterprises are going bust. While they appreciate the end of shortages and queues that plagued daily life for decades, they are also worried about making their low monthly earnings cover the new and higher market prices. And most of all, many are confused — failing to understand why the end of communism did not bring immediate prosperity; why they have both markets and low living standards at the same time.

Reformers aren't necessarily popular in this environment. Ludwig Erhard, the father of the postwar German economic miracle, was not hailed as the creator of prosperity until several years after the start of his free-market reforms. Two years into those reforms, in 1950, Erhard was widely attacked in Germany as the creator of high unemployment rather than high living standards. The Adenauer government, of which Erhard was a part, just barely survived politically in the difficult first years, and its political survival depended heavily on the generous Marshall Plan funds that were flowing into the country.

In Eastern Europe, Leszek Balcerowicz in Poland and Vaclav Klaus in Czechoslovakia will be remembered as the fathers of their countries' economic miracles, *but only if the reforms are given the time to work*. And time may be very scarce indeed, given the sullen attitudes of the population; the fertile ground for populism; the powerful political forces supporting protection and subsidization of failing industries; and the potential for political stalemate or worse in several of the countries.

The specific groups calling for protection or subsidies differ by country. In Poland, it includes the farmers on minuscule plots, the coal miners, and the industrial workers in sectors that formerly produced for the Soviet market. In Czechoslovakia, it includes the workers in the heavy industry of Slovakia, which was particularly dependent on Soviet trade. These groups surely need help to adjust, but the risk is that assistance could come in a manner that would stymie the necessary adjustments in the economy.

The greatest risk in the region is that the populism, the confusion of property rights, and a splintering of political power in the parliaments, will lead to weak governments unable to take the remaining decisive steps to private ownership. In that case, the economic

situation will almost surely deteriorate, macroeconomic instability will rise, and as in Latin America, democracy itself will be put at risk. The risk is heightened by the fact that each of the Eastern European countries has adopted proportional representation as the basis for parliamentary representation. This voting system surely increases the likelihood of weak, splintered political parties, and governments that are dependent on fragile, multiparty coalitions.

### *Crucial role of the West*

The key fact about economic reform, then, is that several years must pass before the fruits of reform are widely evident. The sociologist Ralf Dahrendorf (in his 1990 book *Reflections on the Revolution in Europe—In A Letter Intended To Have Been Sent To A Gentleman in Warsaw*) called this intervening period a "valley of tears," and it may be observed in nearly every country that has undergone a radical economic transformation, from postwar Germany and Japan, to Chile and Mexico in the 1980s. The time in the valley depends on the consistency and boldness of the reforms. If there is wavering or inconsistency in economic measures, it is easy to get lost in the valley. Argentina has been lost for forty-five years.

Passing through the valley of tears requires first, and foremost, political leadership, and second, enough social consensus to sustain a stable set of policies. But even Moses and the Israelites would not have made it through the wilderness without some manna from heaven. External assistance can be vital in the perilous first years of change. And Moses did not face reelection for forty years (though he certainly faced a leadership challenge at the base of Mt. Sinai). Poland's radical reform government faces parliamentary elections at the end of October, and Czechoslovakia's does in less than a year.

The time is urgent for the West to throw a lifeline to the radical reformers. The glue holding together the reforms is the basic social consensus in Eastern Europe that success will be achieved by "returning to Europe," that is, by becoming part of the mainstream of European democratic, capitalist life. But if Western Europe shows that it doesn't really want the East to "return," then the consensus will break apart, and the intense pressures already facing the governments of the region are likely to undermine the reforms. Worse yet, given the stingy attitude of the West to date, and the undoubted cases of rapacious Western investors intent on profiteering from

the gaps in adequate legal structure in Eastern Europe, there is already evident a risk of xenophobic backlash among part of the Eastern European population.

The key step would be for the European Community to signal that the East can indeed return, in the concrete sense that the East European countries can expect to become members of the European Community after they pass the key hurdles of economic reform. Nothing would so much channel the energies and political passions of the East Europeans as a clear track to membership in the EC. If, as is presumably the case, such a track were to require policies such as free trade, an elimination of state subsidies to industry, and private ownership, then those controversial steps would become imbued with greater meaning, indeed urgency. The great pressures that now threaten to undermine the reforms could be effectively dissipated. Elections would be fought on the question of which political movements would be most likely to return the country fastest to Europe.

But, alas, the chance for this positive dynamic may be fading, as a result of the complacency and shortsightedness of many countries of the European Community and the European Commission. There seems to be more fear than welcome of eventual membership for the East European countries. In the critical negotiations between the EC and Czechoslovakia, Hungary, and Poland on Associate Membership, the EC has so far made no concessions on the critical issue of agricultural trade, and only limited concessions on textiles. It has remained vague on the question of eventual membership. So far the European Community is more responsive to France's small farmers and Portugal's textile producers than it is to the great geopolitical opportunities for a united Europe and the great risks of political destabilization in the East.

The need for greater financial assistance to Eastern Europe is also vital. On aid, the record is mixed. The IMF and the World Bank are starting to mobilize support for the region, but as usual, the IMF support can be considered modest at best. When the IMF loans its money, it often sets conditions on reserve accumulation for the borrowing country that, in effect, make the IMF loan nearly untouchable under the terms of the program. The World Bank's support to the region is growing, and is reaching meaningful levels. Direct government-to-government aid of the G-24 (the twenty-four advanced industrial countries), coordinated by the EC, has been on a rather limited scale. The U.S. aid contributions to the entire region have been only a few hundred million dollars

a year. And the new European Bank of Reconstruction and Development (EBRD) has hardly started operations, although presumably its role will grow over time.

Part of the problem is that aid has been offered in forms that are difficult to use. Almost none of the aid is in grant form. And the loans that are made available are generally difficult to use because of the conditions attached. Most of the official export credits that have been granted to the Eastern European countries have remained largely untouched. One important step of the EC would be to examine how to mobilize more quickly and effectively the money that has already been committed, but that has not been disbursed.

The overall amounts of aid flowing to the region from the G-24 governments should be raised by at least \$3–5 billion per year. Part of this should be used to strengthen the provision of social services; part for much larger-scale technical assistance; part should be for straightforward, untied, balance-of-payments support; and part should be to support a more intensive investment in upgrading infrastructure. The region has notoriously dilapidated communications and transportation, and a devastated environment. These infrastructure problems are not adequately being addressed by the small amounts of money that the governments in the region are currently able to devote to these problems.

Another crucial form of financial assistance is debt relief for the heavily indebted countries of the region. Certainly the most impressive single step made by the West for the region has been the cancellation of half of Poland's government-to-government debts this past Spring. This effort, led by the United States, is of fundamental importance for Poland's future. But debt problems remain serious. Poland's commercial bank creditors have not agreed to a comparable debt reduction, and they threaten to capture part of the benefit of Poland's official-debt relief unless the Finance Ministers of the G-7 countries effectively insist that the commercial banks take a comparable hit. (In Poland's Paris Club Agreement reducing official indebtedness by half, the government creditors insisted that Poland should seek comparable relief from the banks. Nonetheless, the commercial banks have been stonewalling, hoping that Poland will simply cave in and start servicing a large part of the commercial bank debt. Such a step would not only jeopardize Poland's financial stability, but would undermine the objectives of the Paris Club relief.) Also, Bulgaria and Hungary remain heavily indebted, and so far there has been no attention from the Western governments to their very serious debt problems.