



Jeffrey Sachs

Poland's Jump
to the
Market Economy



Lionel Robbins Lecture Series

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Jeffrey Sachs

The MIT Press
Cambridge, Massachusetts
London, England

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This book was set in Palatino by .eps Electronic Publishing Services and was printed and bound in the United States of America.

Library of Congress Cataloging-in-Publication Data

Sachs, Jeffrey.

Poland's jump to the market economy : based on the Lionel Robbins Memorial lectures delivered at the London School of Economics, January 1991 / by Jeffrey Sachs.

p. cm. — (The Lionel Robbins Lectures.)

Includes bibliographical references and index.

ISBN 0-262-19312-4

1. Poland—Economic policy—1981– 2. Poland—Economic conditions—1980– 3. Capitalism—Poland. I. Title. II. Series.

HC340.3.S21 1993

338.9438—dc20

93-1738

CIP

The Lionel Robbins Lectures

Peter Temin, *Lessons from the Great Depression*, 1989

Paul R. Krugman, *Exchange-Rate Instability*, 1989

Jeffrey Sachs, *Poland's Jump to the Market Economy*, 1993

Pedro Aspe, *Economic Transformation the Mexican Way*, 1993

To Walter Ehrlich,
whose lifetime of
commitment to freedom
and truth
deeply inspires all who
know him.

Series Foreword

The greatest challenge of this decade is how to change from communism to capitalism. It is a political and practical challenge, but it also requires the exercise of powerful economic reasoning.

Should prices be freed quickly or suddenly? How speedily should inflation be controlled? When should currencies become freely convertible? How should state property be privatized, and when? How can foreign finance help?

The world has been fortunate that one of its leading economists, Jeffrey Sachs, has devoted years of his life to thought and action on these questions. His conclusion, reached already by 1989, was that action should be as rapid as possible on all fronts. Since then he has applied his strong mind and tenacious powers of persuasion to developing appropriate plans of action in one country after another, as it abandoned communism. Rarely does an academic economist have such an immediate effect on world events.

Poland was the first country to change, and it became the testing ground for the big bang approach that Sachs advocated. He played a major role in the design and follow-through of the Balcerowicz Plan, which adopted this approach. To some people the approach was and remains anathema. But increasingly the evidence has been swinging in Sachs's favor. In Poland, the recession that followed the

initial shock has bottomed out and strong growth has resumed. And other ex-communist countries that have not adopted shock therapy have done no better than Poland.

It does seem that the worst place to be is in-between capitalism and communism, and the best policy is to hasten through that phase as rapidly as possible. One can only admire the courage and intellectual clarity with which Jeffrey Sachs has stuck to that belief, in the face of often quite violent criticism.

The London School of Economics was delighted when he agreed to give the annual Lionel Robbins Memorial Lectures only one year after the Polish experiment began, and while the jury was still out. He has now updated the lectures but without, I am happy to say, having to alter any of the major arguments. His lectures focus on the Polish experience as an illustration of the fundamental principles he espouses.

This book is full of excellent economics and wise politics. It is beautifully written and a major contribution to the debate.

Richard Layard

Preface

It is almost exactly three years since the start of Poland's economic big bang and two years since I delivered the Lionel Robbins Memorial Lectures at the London School of Economics. That occasion provided an excellent opportunity for me to review the developments of the first year of Poland's reform and examine the basic propositions of radical reform in the face of a range of criticisms. I had expected to polish and publish the lectures soon afterward, but my work as economic advisor to the Polish government and the fast-moving events in Russia disrupted those plans. When I became economic advisor to the Russian government at the end of 1991, I put the lectures aside and could work on them only in fits and starts. Now, two years later, I am delighted to offer a revised and updated version of the lectures.

The intervening time has slightly changed the character of the lectures. Originally they were an elaboration of Poland's reform strategy, with only very early results yet evident. Now, in view of the delay, it is possible to assess the results of the reform more thoroughly. I am delighted, of course, that my early optimism concerning the reforms has been sustained by the events of the past two years. Although Poland's economic transformation is still far from complete and its young democracy is still fragile, almost all

observers—most important, the Poles themselves—concur that the country is on the right track to democracy and a market economy tightly integrated with the rest of Europe.

Some of the economic accomplishments have been nothing less than remarkable. Poland's private sector is booming, with more than 700,000 new businesses registered in the two-and-one-half years since the start of the radical reforms. It is estimated that more than half of employment and GDP is now found in the private sector. Poland's industrial enterprises continue to make headway in new export markets in the West, with Poland's hard-currency-area exports rising from \$8 billion in 1989 to around \$14 billion in 1992. Western creditors have also wisely agreed to a two-stage cancellation of half of Poland's debts, thereby eliminating one of the great burdens on the economy and offering to Poland a true chance for a fresh start. Perhaps most important, the sense of panic that gripped the country in the early days of reform has dissipated. Confidence is returning. Most Poles report that their living standards have improved since the communist period.

Of course, as I shall describe, many key problems remain. Unemployment is high, though fortunately less severe than had been feared. Poland's budget remains in chronic deficit, threatening the hard-earned financial stability. Privatization of large-scale industrial enterprises remains slow, indeed nearly paralyzed, by the inability to achieve a political consensus on a program of mass privatization. And political institutions are still fragile, with twenty-nine political parties in the parliament, and the fragility that comes from a multiparty coalition government with no less than six parties!

Poland's economic reform approach has had enormous influence in the rest of the region. Czechoslovakia launched similar comprehensive reforms at the start of 1991, as did several other smaller countries. More dramatically, the first

post-communist government of Boris Yeltsin in Russia launched a massive program of "economic shock therapy" at the start of 1992 clearly informed by the Polish experience. I have had the high honor of advising the Russian government on that program since its inception.

After three years of Poland's reforms and one year of Russia's reforms, I remain absolutely convinced in the potential for successful economic reforms throughout the region. Events have disproved the idea of a "Homo sovieticus" spoiled by decades of communism. As soon as economic and political liberties were established, new entrepreneurs surged forward with energy, determination, and capacity. Market activity has spread from the Elbe to Vladivostok, often even before legal norms have been put in place. It seems that the deadening decades of communism did not dull the acquisitive spirit, but rather sharpened it.

As I shall stress, therefore, the problem of reform is mostly political rather than social or even economic. Society accepts the need for change and is ready to slough off the brutality and artificiality of the communist system. This is especially the case when governments take care to provide targeted relief for the most vulnerable groups in society. Many of the economic problems also solve themselves: markets spring up as soon as central planning bureaucrats vacate the field.

The reformers must be able to maintain the direction of reform against the organized opposition of the old guard, the disorganized opposition of new populists who seek to gain power by playing on the public's fears, and the understandable anxieties of the general public. In the end, economic reform becomes a profound problem of leadership in a newly democratic setting, in which FDR's soothing words have never been more relevant, "Let me assert my firm belief that the only thing we have to fear is fear itself."

The West can play a crucial role in this difficult transition by helping to assuage the fears and thereby give the reforms

time to take hold and become self-sustaining. As I shall stress in the case of Poland, the early Western assistance with a stabilization fund for the zloty and the two-stage cancellation of part of Poland's foreign debt have been extremely important in helping to keep the reform program on track and in giving Poland the chance for a true fresh start. The most important step remains, however. Poland's "return to Europe" will be secure only after it has firm commitments on a timetable for Poland's accession to the European Community.

The past four years have been a time of enormous personal challenge and fulfillment. I have been afforded the high honor and responsibility of advising several governments in Eastern Europe and the former Soviet Union on the design and implementation of economic reform programs. In 1989, I began assisting Poland's Solidarity movement on the day it was legalized, and I worked with some of the world's greatest democratic leaders—Lech Walesa, Bronislaw Geremek, Adam Michnik, Jacek Kuron—on the strategy for replacing the defunct communist system with a vigorous market economy. I then became an advisor to Poland's first noncommunist government and its remarkable first Deputy Prime Minister for Economy, Leszek Balcerowicz. Since then I have been honored to provide advice to governments in Slovenia, Russia, Estonia, Mongolia, and elsewhere.

Throughout this work, I have learned much more than I could have taught, and have built a debt of gratitude to countless talented and remarkable individuals. My greatest thanks go to my colleague David Lipton, who joined me in advisory work and study around the world during 1988 to 1992. In Russia, I have been extraordinarily privileged to work with Professor Anders Åslund of the Stockholm School of Economics, a Sovietologist and economist of unsurpassed scholarship, vision, and insight. Dozens of col-

leagues, students, and policymakers around the world with whom I have been privileged to work in recent years have contributed to the ideas of economic reform described in these lectures. I hope that they will understand my inability to mention them individually here, and accept my gratitude expressed collectively. Of course, many of their scholarly contributions are cited throughout the lectures.

Whatever I have been able to accomplish in recent years, I owe to my wife, Dr. Sonia Ehrlich, an accomplished physician, and mother and wife nonpareil, whose dedication to freedom in Eastern Europe and Russia has been both lodestar and sustenance during years of wearying travel and separation from family. To Sonia, and my children Lisa and Adam, my love and thanks for your patient understanding.

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What Is To Be Done NOW?

I am particularly pleased to be at the London School of Economics because, as Professor Robbins and the esteemed faculty over the course of generations have proved, economics can be put to the service of mankind. I hope to demonstrate this in the very specific case of the transformation of Eastern Europe.

During the past three years, I have had the high personal honor of participating in the design and implementation of the economic reforms now under way in Poland, Russia, and other countries in the region. The reforms in Poland, introduced on January 1, 1990, have been especially far reaching, and have been widely recognized as a model for the reforms in other parts of Eastern Europe and the former Soviet Union. For reasons of personal experience, and because of the more general interest in Poland's reform strategy, I will focus mainly on Poland throughout these lectures. Where necessary, though, I will highlight important differences between Poland and other parts of Eastern Europe.

The title of my talk, "What Is to Be Done NOW?", is an obvious allusion to the question raised by Lenin at the beginning of the century, concerning the same region. What Lenin (1902) proposed as an answer—a dictatorship of the proletariat, led by an elite political party—resulted in one of the great disasters of the twentieth century. It may seem

reckless, therefore, even to ask the same question. Indeed, some have claimed that any attempt to develop an economic blueprint for Eastern Europe's future development betrays the same mistake as Lenin's: the false, and dangerous, presumption that human society can be arranged, rather than simply allowed to evolve.

I think that this is wrong, a mistaken analogy to the recklessness and hubris of earlier revolutions. As I will explain, the current revolutions under way in Eastern Europe are not utopian, nor do they seek to impose a new social experiment, as was the case in Lenin's revolution. Today's revolutions are of a relentlessly pragmatic character. This makes all the difference.

Eastern Europeans are uninterested in the counsels of perfection that have caused so much trouble in the past. They are instead interested in putting in place the economic structures and strategies that have proved their worth in other countries, particularly in the neighboring countries of Western Europe. This interpretation, which I think is repeatedly confirmed in the statements and actions of Eastern European leaders and in the political choices of the general population, is the basis of the rest of my views on how to conduct the economic changes now under way. The motivation of the Eastern Europeans, in a simple yet compelling phrase, is "to return to Europe."

It has often been said that although hundreds of books offer advice on how to convert a capitalist economy to a socialist economy, starting with or preceding Lenin, no book describes how to go from socialism to capitalism. But this is not really true. The task ahead is not as mysterious nor as complex as it might seem; in fact, in many ways it is a well-trodden path. I do not agree with extravagant statements often made about the uniqueness of this situation, and therefore I do not feel that we are helpless in the face of the task ahead.

Although parts of the transformation represent uncharted territory (such as massive privatization of industry), many other aspects of Eastern Europe's reform tasks are quite familiar. Many other countries that were once cut off from the rest of the world by inward-looking, authoritarian regimes have successfully opened up and become integrated into the global mainstream economy. By doing so, they have tended to enjoy enormous increases in real income. 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. The prototypical case in Europe that I will refer to is that of Spain, which in many ways provides a kind of guidepost to the path that the countries of Eastern Europe should follow.

The hardest part of the transformation, in fact, will not be the economics at all, but the politics. The years ahead will provide innumerable challenges to the fragile democratic order now taking shape in Eastern Europe. After decades of stagnation, the Eastern economies must change fundamentally. But change, as Schumpeter reminded us, involves destruction as well as creation. There will be losers together with winners in Eastern Europe. In many cases, the winners will not be sure about their economic successes for years to come, well before politically important groups identify themselves as potential losers. The great political task is to follow the path of reform in the face of inevitable anxieties, vested interests fighting for the status quo, and demagogues ready to seek political power by playing on the public's fears.

Guideposts of Economic Reform

To make clear what I have in mind about the existence of clear guideposts for economic reforms, I would like to refer

to the writing of a great scholar well known to you, Professor Ralf Dahrendorf (1990), who has written a fascinating book on the revolutions of 1989. I am going to focus on a point of disagreement—which is somewhat unfair because I agree with most of what he writes in his very thoughtful book. Let me quote what Dahrendorf says and then try to put it in some perspective in the context of Poland. He writes,

The common language we speak today is not the language of the West, now adopted by the East. It is an intrinsically universal language which belongs to nobody in particular and therefore to everybody. The countries of East-Central Europe have not shed their communist system in order to embrace the capitalist system—whatever that is. They have shed a closed system in order to create an open society. The open society, to be exact. For while there can be many systems, there is only one open society. If any creed has won in the events of last year, 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.

Although the book is mostly, and rightly, a celebration of freedom in the open society, I consider Professor Dahrendorf to be mistaken in his view that Eastern Europe did not shed the communist system to adopt capitalism. In my view, that is precisely what they have done, and all of their actions are directed toward this purpose. I should like to compare Dahrendorf's statement with one made in 1990 by Poland's chief negotiator with the European Community (EC). Concerning Poland's aim to negotiate an "association agreement" with the EC, as a stepping stone to full membership, he says,

The most important thing will be to harmonize economic policy and legislation. Poland will try to take an enormous step forward in coordinating its economic and monetary policy with that of the EEC, followed by policies on industry, customs duties, commerce, company law, conditions for residence, and the pursuit of eco-