Up for Debate: Shock Therapy: Bolivia, Poland, Russia. Same Policies-Different Results

Gonzalo Sanchez de Lozada

Operate before the patient dies

INTERVIEWER: What does the phrase "shock therapy" mean?

GONZALO SANCHEZ DE LOZADA: At that time, there were two big arguments. First of all, people felt you couldn't stop hyperinflation in a democracy; that you had to have a military government, an authoritarian government to take all these tough steps that had to be taken. Bolivia was the first country to stop hyperinflation in a democracy without depriving people of their civil rights and without violating human rights. And two, there was a big discussion whether you could stop hyperinflation or inflation, period, by taking gradual steps. Many people said you had to take it slowly. You have to cure the patient. Shock treatment means you have a very sick patient [and] you have to operate before the patient dies. You have to get the cancer out, or you have to stop the infection. That's why we coined the phrase that inflation is like a tiger and you have only one shot; if you don't get it with that one shot, it'll get you. You have a credibility that you have to achieve. If you keep to gradualism, people don't believe you, and the hyperinflation just keeps roaring stronger. So shock therapy is get it over, get it done, stop hyperinflation, and then start rebuilding your economy so you achieve growth.

INTERVIEWER: Whose idea was shock therapy?

GONZALO SANCHEZ DE LOZADA: I would say it was very much a discussed idea. This famous decree, 21060, that stopped hyperinflation in Bolivia took three weeks [to formulate]. Victor Paz was sworn as president on the sixth of August; on the 29th of August we came out with the decree. We spent one week saying, "Do we really need to do something? Do we really need radical change?" and then another week debating shock treatment versus gradualism. Finally, we took one week to write it all up. And it was a very big decree-220 articles. It covered all aspects of the Bolivian economy. [The] argument about shock therapy was taking place inside our party, inside of our society, inside of the community of economists. There were people who said, "You can do it; you can bring up interest rates, and you can tighten it." Well, when it gets to the point of hyperinflation, when you study what had happened in history, and we studied the German inflation, you find that they're only stopped when you have political credibility-in other words, when a new government comes in. And if the new government acts very rapidly in the first 100 days and takes steps, initiates a shock treatment that stops it once and for all, then you start working on getting the patient to recover and achieve economic growth.

GONZALO SANCHEZ DE LOZADA: The president, Victor Paz, would direct us with a great deal of wisdom, saying, "Look, boys, you've got one chance, and remember, as

Machiavelli said, 'It's all the bad news at once, and the good news little by little.'" So he said get it all done, and we did it. In this Jeff Sachs was indirectly influential, because in his visits he said, "Look, all this gradualist stuff, it just doesn't work. When it really gets out of control you've got to stop it, like a medicine. You've got to take some radical steps; otherwise your patient is going to die."

INTERVIEWER: Bolivia was, if you like, the first country to tackle hyperinflation in democracy. Was what you did here influential on the rest of the region?

GONZALO SANCHEZ DE LOZADA: Today we accept that there should be an interchange of goods and services, but there should be also an interchange of experiences. After Victor Paz's government, I was still in politics, but I personally spent a lot of time consulting and working with Argentina, with Peru, and in Brazil. Many times they would say, "Well, Bolivia's very different," and I'd say, "Look, if Bolivia can do it, why can't you do it?" I think the Bolivian experience did have influence; it had impact on economic thinkers and on politicians. The fact that we did it in democracy, we did it without great social violence took people to study our case and slowly be influenced.

I don't think we were a dramatic influence. I think if we'd been more important and a significant country we would have had more influence, if we'd been Argentina or Brazil or even Chile, but the fact that we did it in democracy, it was very close to some of the things that Chile had done, but probably more flexible. We learned from a lot of mistakes of Chile.

Ironically, we had a bigger influence in other places. Jeff Sachs took the Bolivian experience and adapted it to the reality of Eastern Europe in Poland, and Poland has been a very successful transition. Then he took it to Russia. I don't say he took a lot more things to Russia, but he took the experience of Bolivia, and there he failed because there wasn't a political will. Everybody has to remember that economics is very tied to politics. Bad economics lead to social problems that lead to political problems, and usually you can't solve economic problems until you have political solutions, and Poland had it; Russia didn't; we did. We had good leadership, and we were successful. Our example was more important than actually what we did. The fact of a little country that could was always embarrassing to big countries that couldn't.

INTERVIEWER: Tell me about your meeting with Lech Walesa.

GONZALO SANCHEZ DE LOZADA: I met Lech Walesa at a big university seminar in Holland, and he came up to me and said, "I've always wanted to meet a Bolivian, especially a Bolivian president, because they're always making us take this very bitter medicine, saying you have to do it because this is what the Bolivians did. Now I know you, you're not that bad a guy, but I sure used to hate you."

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Moises Naim

Government can cure inflation

INTERVIEWER: What was the significance of the reforms implemented in Bolivia for the rest of Latin America?

MOISES NAIM: The story of Bolivia in many ways is also the story of the reforms of Latin America during the '90s. The central lesson of Bolivia was that Bolivia was able to change the subject, the subject being hyperinflation. These countries-because of the debt crisis, because of the structure of the economy and the government spending that had been accumulated during the prior stages-had horrible bouts of hyperinflation, inflation of thousands and thousands percent, in which prices will jump from one day or another. You wake up one day, and money did not have any meaning. It created all sorts of horrible consequences for the poor, for productivity. You cannot live, run a country, run a company, go to school, if the country is just dominated by the obsession of prices that are changing and you don't know the value of anything. You don't know the value of your salary; you don't know the value of anything. That was very common throughout Latin America. Bolivia was one of the first countries that was able to adopt policies that crushed hyperinflation, and a central message was that fighting inflation was possible, that Latin America was not condemned to live with a high inflation, and that was a very, very important message.

INTERVIEWER: How did that Bolivian experience resonate in bigger countries like Brazil and Argentina?

MOISES NAIM: Yet again we have the power of ideas at play. Once the idea that these countries were not condemned, were not the slave of inflation, that inflation was an illness that was neither chronic nor impossible to cure, then the similar ideas [took hold elsewhere]. And it's not only Bolivia. The same was being explored elsewhere-even Chile had the same instance. So essentially, little by little during the '80s and early '90s, the idea that inflation could be cured by government policies and that it was not that dependent on this global economy. ... Countries were not just the victims, the passive recipients of what happened elsewhere and [of] decisions made in the power centers of the world. The countries could take some decisions that would make the life of their citizens better. That was a very important idea.

Brazil, Argentina, and Mexico and other countries all have very, very dark, horrible episodes of inflation. Some have hyperinflation. We're talking about 10,000 percent inflation and more. These were larger countries, and one could argue Bolivia could do it because it was a small, isolated, not very well-developed country. How can the same remedies be applied to a country which is a continental-size country like Brazil?

The fact of the matter is that if governments spend much more than what they collect, then you end up getting inflation. That today may be almost banal, but for many years that was not clearly seen among policymakers in developing countries.

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Jeffrey Sachs

Not an overnight solution

INTERVIEWER: The plan that Goni [GONZALO SANCHEZ DE LOZADA] was urging on you, which I think you helped devise at least, came to be known as "shock therapy." Why the phrase? What does it really mean?

JEFFREY SACHS: I never picked the phrase "shock therapy," and I have to say don't much like it. It was something that was overlaid by journalism and public discussion. It sounds a lot more painful in a way than what it is. Goni had in mind another economic reformer, whom we discussed quite a bit, and that was Ludwig Erhard, who, after World War II, as the designer of Germany's postwar economic miracle, had started out with very bold moves in 1947-48 to get Germany on a market economy track, and to end monetary chaos in the country, and had acted quite decisively. In fact, in one weekend he had just wiped away the price controls, a very dramatic weekend in Germany. It had ended years of intense shortages by ending these price controls. So history in the 20th century had shown many cases where, when you're in monetary and economic crisis, a decisive stroke can at least end the monetary chaos. I had actually gone to Bolivia with that message as well, with a set of pictures from a well-known economics paper that had demonstrated that many of the hyperinflations, the famous high inflations of the 20th century, had actually been ended decisively even in a day. Goni definitely liked that, but he wanted to go further because it wasn't just ending the hyperinflation, but trying to reconnect Bolivia to the world economy with normal economic institutions was also part of his goal.

Bolivia was a country that had gone through a revolution in 1952. It had gone through a period of socialist romanticism; it had gone through a period of massive state ownership; and it had gone through a period of narco-dictatorship. It had gone through several periods of military rule. Its political and economic institutions were a morass of corruption, inefficiency, non-transparency, and he wanted to pull those out root and branch. Now it's not so easy, of course, and an economic program is not a single declaration, it's not a single event. Even if you can end a hyperinflation in a day, which sometimes you literally can do, to change society in a way that promotes economic prosperity, that's the work of a generation. It's at least the work of several years of policy reform, of politics, of legislative change, of international negotiation. It's not something that one decrees and one wills in a moment.

When I have used the term "shock therapy," I've used it in two different senses, and sometimes these have been misunderstood, or there's been a lot of confusion. One sense is a real sense of shock therapy, and that is when you are in monetary chaos, whether it's a hyperinflation or extreme shortage of goods, because of massive price controls. In a decisive action, one can end the monetary chaos and get money working again to be able to buy goods, to bring goods to the market, to be able to operate a supply and demand, and normal market exchange. This can happen very quickly, and it seems miraculous when you've gone from mass shortage to goods in the shops again. That miracle was one weekend in Germany in 1947, and it occurred many times since, and I've watched it. There's another sense in which either of us use the term of shock therapy, but it's not the way that it's often understood. By that I've meant not something that you do in a day or a week, but something that in the course of a few years of hard work and a lot of politics and a lot of political and institutional change.

An economy can be reoriented from a dead end, a dead end of socialism or a dead end of mass corruption or a dead end of central planning, to a normal market economy. Many people have interpreted me to believe that this can happen overnight, and that is where the misunderstanding comes from. In the Bolivian context, while the hyperinflation was ended immediately, the hard work of helping to remake the Bolivian economy, that's been 15 years of continuous effort since then, and continuing institutional change, and continuing institutional innovation.

Three steps to Bolivian reform

INTERVIEWER: What were the key points of the reform package in Bolivia?

JEFFREY SACHS: The idea of the reform in Bolivia was first, to stop the hyperinflation; second, to make the economy open for international trade; and third, to change the role of government so that government would help to regulate and create rules of the game, but not to control and micromanage the economy. In stopping the hyperinflation, the key is to stop printing money. You have to find real revenues as a way to stop printing money. So the first step is what's called fiscal reform, changing the budgetary practices. In Bolivia, the main thing was actually raising the oil price sharply, so that the government, when it sells the oil, which it owned, was earning enough money to pay the teachers. It was very, very simple. Sort of paradoxical for a non-economist that you raise the price to end inflation, but by raising the price of oil to a realistic level, that closed the budget deficit enough that the inflation stopped.

But the hard work is beyond that. That's a good start. The hard work was then creating a market economy. Getting the government out of places where it didn't belong. Allowing private business to operate. Allowing international trade to operate. Creating mechanisms for real social policies so that the health and education needs could be addressed. Creating a legal setting which provides the rules and, again, opens the economy to international trade and getting private investment going and creating a real social policy, where children are getting education... that was the real work of the subsequent reform.

The Bolivian experience resonates around the world

INTERVIEWER: Bolivia is a tiny country, but what happened there was extremely significant. Could you comment on that.

JEFFREY SACHS: Yes. I was a macroeconomist and a monetary economist at the time, and have seen more and have been able to broaden my understanding considerably as a result of this experience. I didn't really know, at the beginning of my own involvement in Bolivia, how much institutional change and how much [of a] historical turn there needed to be. What Goni really did sense early on was that not only did Bolivia need, as he used to say, to reinvent itself (and that was the phrase that he used with the public), but he knew that Latin America more generally was going to have to do the same thing. And he said to me, in one moment of reflection in late 1985, as we were struggling late into the night with a problem, he said, "You know, this is extraordinarily hard, but what's happening here, this is going to have to happen all through Latin America." And I found that a bit of wisdom that not only stuck with me but that I watched it unfold, one country after another, and then ended up being an economic advisor in a number of those other countries as well. That really was the first time that I had gotten the sense that we were so deeply in an institutional revolution. Of course at first I saw it in Bolivia, and then I came to understand better what Goni had understood, that this was going to happen in the Americas, but then we saw it was something that was going to happen throughout the world.

JEFFREY SACHS: Poland was another country in crisis. If Poland had been in Latin America, it would have started this kind of change in the early 1980s. And, indeed, in Poland in 1979 and '81, [the] economic system collapsed, and Poland entered a horrendous financial crisis. Great social unrest occurred and great social change started to occur. And the Solidarity movement, which became the major force of Poland's revolution and probably the leading force of the end of communism in Eastern Europe, emerged. Now, if this had not been under the shadow of the Soviet Union, society in Poland would have begun dramatic change in the early 1980s. But of course what happened was that the rise of Solidarity was followed quickly by military crackdown under the watchful eye and pressure and urging of the Soviet big brother. Poland for 10 years, basically during the period of the 1980s, was like a pressure cooker. It was a society that desperately needed change. It was an economic structure that had utterly collapsed. It was a country that would have spun into chaos were it not for this incredibly oppressive force from the outside.

JEFFREY SACHS: The end of 1989 was a terrifying and unpredictable period. A Solidarity-led government had come in but even then, two-thirds of the Parliament, because of the way the elections were only partially free, in the summer of 1989 two-thirds of the Parliament was still in the hands of the Communists. Who knew what was going to happen to Gorbachev? Who knew whether any of this reform would continue? Everybody knew very well about the Prague Spring and how it had been crushed. Everyone knew about the end of Solidarity in the early 1980s with the imposition of martial law. It was terrifying. And here was a country in hyperinflation, in chaos, in despair, financially bankrupted, shops empty, starting an experiment, as it were, that had never been done before. So was it unpredictable? Yes. Was it frightening? Yes. Was it uncertain? Yes. Why should one have any confidence? The things that Poland had going for it, first and foremost, was that Solidarity had a reservoir of trust of the public, which was absolutely phenomenal and critical. Second, Poland had in its long and often tragic history one overriding knowledge, which is that it wanted to survive as a nation and be part of the mainstream of Europe, and that it was willing to endure great sacrifice to do that. And if the Soviet Union would leave Poland alone, I did believe that market economics would work in the end. And even not just in the end, but sooner than most people believed.

But I can tell you that there was phenomenal skepticism, phenomenal criticism, phenomenal views that this kind of rapid reform was going to lead Poland into utter destruction, and a lot of attack. So it wasn't an easy period.

The Polish "return to Europe"

INTERVIEWER: You have been criticized for going too fast. Some have said that gradual [change] might have worked better. What is your answer to that?

JEFFREY SACHS: At this point, in the year 2000, Poland has just had an extraordinarily successful decade of change. It's the country with the highest income standards compared to where it was 10 years ago. It's a member of NATO, it's a leading candidate for quick admission to the European Union. It's a very vibrant democracy. There's a lot of foreign investments and a lot of exports. I'm thrilled and believe that the Poles have acquitted themselves beautifully in the pages of history.

INTERVIEWER: Was Poland's reform very different from Bolivia?

JEFFREY SACHS: The main goal of Poland, fundamentally, was to have Poland become, as it should be, a normal part of the European economy. Like the old discussion of how do you make a sculpture of an elephant? You just cut away everything that doesn't look like an elephant off the block. [For] the question of how do you make a market economy of Poland, you cut away everything that doesn't look like a European economy.

Maybe you could say this is facetious, but the basic point was there really was a role model, and there remains a role model: The role model is the Western European economy. Not in every detail, but in the basic structures, so that Poland can comfortably be integrated within the European Union, can be a normal part of the functioning markets of Europe. And this was the basic mode or force of the revolution, what the Poles called in their slogan "the return to Europe."

It was the general guiding force of trade liberalization, macroeconomic stabilization, privatization, which were the basic dimensions of the change. And it's even, at the level of extreme detail, the direction that's given for thousands and thousands of specific regulatory changes in adopting what in Europe is called the *acquis communautaire*, that body of law of Brussels, of the European Union, which is what all member states take on as a common undertaking. Since Poland wants to be part of Europe and literally wants to be part of the European Union, it means taking on that *acquis communautaire*.

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Leszek Balcerowicz

You must succeed on the first try

INTERVIEWER: Did Latin America's experience of reform have any impact on your thinking?

LESZEK BALCEROWICZ: Well, I studied experiences of Latin America's stabilization before 1989, because I was interested in the experiences of various countries, and this was useful, because in Poland, the starting conditions were more difficult than ones that existed in, say, former Czechoslovakia or in Hungary. In Poland, we had some Latin American problems like high inflation, plus typical problems of socialist economies, structural problems. Studying macroeconomic stabilization was useful, and one lesson I drew from various studies was that it's absolutely essential that the first attempt is successful, because every next attempt would be socially more costly.

One has to establish credibility. One has to be tough on stabilization, and being tough is good for the people in a way, because it reduces the risk of a failure of another attempt. And I was impressed, in a negative sense, by various successive failed stabilization programs of, let's say, Argentina, and I knew how costly it was. So this part of the Latin American experience was useful, and I thought that from this point of view, from the point of view of stabilization of a socialist economy, what we had at the beginning was not basically different from, let's say, Latin American economies. Classical instruments would have to be used: first of all, a radical reduction of the budget deficit, tightening monetary policy, and others.

INTERVIEWER: On January 1, 1990, what was going through your mind that day and the days that followed? What were the first signs you had that things were changing?

LESZEK BALCEROWICZ: First, I did not have a blind faith in the success, but my determination was based on more intellectual fundamentals. ... People who were making the decisions for Poland, like myself at that time, [we were debating]: either we go slowly, which would delay change (and this, for me, was a completely hopeless option, no possibility for success), or we go very rapidly because of the economic, political, and psychological environment, and this option was only very risky because of the amount of uncertainty. But a very risky option is much superior to the hopeless option.

So I rejected [going slowly]. I knew that if we go slowly we are condemned to failure, like let's say Belarus or Romania. Every country which went slowly went down. But I also knew that even if we chose the right option, we may fail, because of the amount of uncertainty. This is why I was so determined to persist, because I knew that the dangers, the real dangers, appear later. So in a way I knew that we made the right choice, that there is no better option. But I also knew that there was a risk, and we were looking for signs that the program was working, and various parts of the program have various maturities, so to speak, because solutions have various maturities. For example, shortages. I always believed the shortages could be removed very quickly once you liberalized and removed rigidities on the supply side and the price formation, perhaps, introduced some macroeconomic stabilization-and it worked.

INTERVIEWER: Did you feel as if the Soviet leadership was closely watching what was happening here?

LESZEK BALCEROWICZ: Well, I was so focused, so concerned with Poland at that time that I was not following very closely Russian, or then Soviet, developments. But I knew that at least younger members of the team were following Poland's developments very closely, because for them it was a natural experiment; by reforming Poland, we were giving other countries the possibility to learn from our experiences, including our mistakes and achievements. So I knew that the younger people of the team were in Poland. I remember meeting them in Poland, talking about Poland's economic reforms, and I had the impression that we were in basic agreement about the same philosophy, first, with respect to the target system, what sort of economic system you want as a result of transition; and second, about the strategy of transition, about speed and radical nature of the first phase.

INTERVIEWER: Many people say that Poland was generally a success where in Russia, the success, if there was some, was not so great, and it created a distorted kind of capitalism. What were the main differences in the way reform was tried in Russia as compared to Poland?

LESZEK BALCEROWICZ: Well, I think the same basic approach applies both to Poland and Russia and Romania and Ukraine. I am against the argument that there are such specificities in some countries that you need a completely different approach, like with the case of Brazil. Brazil was different; Brazil had to apply classical solutions to be successful. So I think that the same best treatments [should be used] for certain economic diseases. Like if you want to remove shortages you have to liberalize. If your problem is high inflation, you have to do macroeconomic stabilization and have some technical discussions, but basic directions are clear. If you have inefficiencies because of a state ownership, you have to privatize. If the banks are unhealthy, then they either are politicized, being state-owned, or being private but closely linked with political authorities, like in South Korea. You may have private banks, but still politicized. So arm's-length privatization solution-it's the same approach.

I think specifics in themselves do not matter so much. You may have two people, a Chinese man and a Russian, but if both suffer from tuberculosis you would not say because one is Chinese you need a special medicine. The mere fact of a specificity does not necessarily call for specific treatment. And the same goes for Poland and Russia. I think this should have been a similar approach, the same direction. In the Polish case, for some reasons we are able to maintain the implementation of a program for a longer time.

My first period in the government was 800 days. Basically [I worked with] the same team over two years, and during that time we managed to stabilize, remove shortages, do the bulk of liberalization to prepare the foundation for the capital market, stock exchange, privatization; to make currency convertible; to strengthen the independence of the Central Bank; to build the basic social safety net in which we made some mistakes, but the mere existence [of it] was important.

In Russia, for political reasons, reformers were not given the same amount of chance. So after only half a year, there were disruptions in the economic program, especially on the fiscal side and on the monetary side. So the stabilization effort was not given a chance, and this is the main reason why Russia is less successful than Poland. One has to look for political underpinnings of economic policy and perhaps the role of personalities, because economically speaking, Russia's starting conditions were not very difficult. There were possibilities for improvement. For example, the fact that Russia had a huge military sector created conditions for reducing this sector and then spending more on some other issues. So something which is a liability may be an asset, because you may make some reduction and improvement.

Perhaps paradoxically, Russia's true liability was huge natural resources-natural gas and oil, because they created such strong temptations in the privatization process that they had to some extent poisoned this process. We did not have such huge natural resources. So this is one of Russia's specificities. Another is unstable politics. And third and related fact is the following one: What for Polish people or for the Czech people, for the Slovak people, for the Hungarian people was a liberation from Soviet oppression, for the Russians, it meant a loss of prestige, the different psychological atmosphere. I know that many intellectuals in Russia were supporting this change, but ordinary men probably had different impressions. Psychological climate in Poland was better during the first phase than the psychological climate in Russia.

What role does culture play?

INTERVIEWER: What role does culture play in countries' ability to adjust to capitalism and free market?

LESZEK BALCEROWICZ: I think the role of culture is widely exaggerated, and it is a sort of easy theory to explain. I think that one should look to hard facts first, and the hard facts are what are your starting conditions are, especially economic. Then economic policy: Is a tried economic policy wrong? Some geographical factors may play a certain role. But only as a last resort should one look to so-called cultural factors, because they are so difficult to define and so easy to try to explain successes or failures of transition, and I was always very doubtful about it.

I remember when South Korea was a success, everybody was saying, "This is because of the special culture." But I said: "Look, you've got North Korea. You have the same culture, and it pervades in North Korea." So what it shows is that there are by far more important factors-economic policy, institutional structures, reforms. So I think cultural factors first should be precisely defined and then used as explanations [as] a last resort, only after one has exhausted the economic explanations

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Yegor Gaidar

Shock therapy as a Russian reform

INTERVIEWER: To what extent did the Polish experience of shock therapy influence your thinking about reform in Russia?

YEGOR GAIDAR [via interpreter]: We watched everything that was taking place in Eastern Europe very attentively and with a great interest. It was understood that it had a most direct relation to what could happen in the Soviet Union. Especially in Poland, because despite all the differences between Poland and the Soviet Union, we nevertheless thought that Poland was the most important for us as a source of lessons, experience, and assessments of possible alternatives. Of course, we also watched what was happening in Hungary and in Czechoslovakia.

The experience of shock therapy and Polish reform for us was interesting, and not as a theoretical construction. Towards the end of the 1980s, and especially in 1991, it became clear that the development of events [in the Soviet Union] was moving towards a completely different scenario than we thought in the mid-80s. It became clear that the main driving force of transformation was not the organized economic reforms -- they were extremely disorganized and very ineffective in the background of a weak and often irresponsible economic policy -- but a quick process of political destabilization and the collapse of the regime that could only function under the threat of the unlimited use of power to enforce reforms.

We understood that its functioning completely depended on the effective and tough use of power. Without the [use of power], [Soviet] economy would collapse; and it wouldn't wait for a command-it would just collapse. The factories wouldn't supply food because they wouldn't fear the Party. The collective farmers wouldn't fill the granaries with flour. No grain would go to the grain elevators. There would be no place to send the flour for baking bread. There would be no bread in the stores, as no one would bring it. All this we understood. Therefore, because a political process of disintegration took on its own momentum, it was clear that any discussion of gradual reform or the attempt to construct the idea of gradual reform, which was discussed in the 1980s, in no way reflected reality. Because everything was collapsing before our eyes, one needed to think about very tough, decisive steps, dangerous and difficult, for the immediate creation of an alternative market production in a country that hadn't had such production in 75 years. Given our understanding of the need for a radical launch of such mechanisms, [the Polish experience] was very useful to us.

INTERVIEWER: Let's talk about the lifting of price controls.

YEGOR GAIDAR: When we were preparing the decision to unfreeze prices, a discussion was going on between those who considered that the equilibrium of prices would inescapably lead to the release of market mechanisms and to the introduction of goods in the shops (I thought that it would require a little time, but that it would inevitably happen); and those who were convinced that this wouldn't happen, that no matter what the prices were, no one would ever [want to circumvent] the usual chain of distribution, because the chain was very necessary to the whole environment. To be a salesman in a department store in the Soviet system was the same thing as being a millionaire in Silicon Valley, because it was status. It was connections; it was influence; it was respect. [A salesman in a Soviet department store] was a very respected person. He was valued. But what does it mean to be a salesman when there are no queues and no one depends on you, no one needs you? And indeed, trade in the first days was simply sabotaged...

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Mikhail Gorbachev

When shock therapy fails

INTERVIEWER: When you saw Poland, after the victory of Solidarity, adopt shock therapy as an economic policy, did you think that they had an idea that could be applied to the Soviet Union?

MIKHAIL GORBACHEV [via interpreter]: ...Poland was definitely a pilot project, and the fact that reforms started there was significant.

But please understand: no country can repeat the reforms of another country. Any model, even a perfect model, should take into account the facts of development of a particular country, its possibilities, its economic possibilities, its social situation. Every country should conduct its own reforms, should develop its own model taking into account the experience of other countries whether close neighbours or far away countries. There were certain things in the Polish reforms that were useful to us, particularly the overall commitment to market economics, a choice of transition to a market economy. But the situation was quite different there. First of all, in Poland they still had a certain market experience, even under the socialist system. They still had private property in agriculture; they sold their produce in farmers markets. In the Soviet Union it was all state or so-called co-operative property. Everything was regulated according to plans. It was very strict, and we did not have a market to which people could bring products and exchange products. Prices were set very rigidly, both in industry and in agriculture for collective and state farms. So the situation was very different. The Polish experience was not directly applicable. And even though Poland also had a big military sector, a lot of military orders and defense orders, it was not comparable to the Soviet Union, where half the economy, and some people believe more, worked for the defense sector. It's quite a different story. Of course you cannot make a transition promptly for the defense sector to market economics, because that sector is totally dependent on state orders. And therefore shock therapy, immediate shock therapy in our country, would have been a mistake.

Incidentally, whereas perestroika was a reform that was aimed at evolutionary change, political change, creating an infrastructure for market economics, creating a legal base, a legislative base for the market, it all required regulating, adjusting, training personnel capable of working in a market. We had several generations that had had nothing to do with the markets. You cannot just announce markets and then the markets would emerge overnight. And therefore we believed that perestroika could not accept this kind of overnight approach. We believed that it was necessary to have 10 to 15 years at best. I was even saying it will take a generation, and then the mechanism would start working. What did Yeltsin do? Yeltsin broke up the country, using Russia to break up the country. He speculated on people's wishes. He said we'll do it within one year; we will conduct very good reforms, very rapid reforms, and in one year we'll begin to grow, and within three or four years we'll be among the three or four most prosperous nations in the world. I was really amazed at this kind of irresponsible deception of the people. He probably believed what he was saying because he didn't have the vision to start a different kind of reform. And so they just said, "Well, the markets will solve everything. The market will put everything in place."

And, well, Yeltsin did use his kind of shock therapy, and he began in the most developed republic of the former Soviet Union with a lot of possibilities, but it was not ready. Russia was not ready in terms of personnel, in terms of law, and shock therapy resulted in a drama and a tragedy for millions of people. Yeltsin brought the country to a dead end. Two-thirds of the people live in poverty. We have a shorter life span, greater mortality, the population is decreasing, industrial production is one half of what it used to be, scientific centers are being destroyed. It's incredible. Putin, therefore, has a difficult legacy.

That's shock therapy applied in a stupid way. In some countries it is possible and necessary, but it should be well prepared. By the way, Poland did not immediately succeed with its shock therapy. After Balcerowicz, serious additional reforms were made, and Poland is now really moving in a stable way. The International Monetary Fund and others also wrote off 50 percent of Poland's debts, so you can see that is also a factor. So it's not as simple as journalists often present it or politicians or some analysts present it, where it's very superficial. Shock therapy, they say, is the way to go; it will save. But no, it does not save. You have to do everything in a very serious and substantial way.

Up for Debate: Shock Therapy: Bolivia, Poland, Russia. Same Policies-Different Results

Joseph Stiglitz

Shock therapy is not the only way

INTERVIEWER: Jeff Sachs would say that there was no other option, that shock therapy and the way it was applied was the way to go.

STIGLITZ: That's absolutely wrong. There were countries that were successful. And most of the countries that were successful did not follow the shock therapy approach. China had a gradualist policy. In retrospect, in 20-25 years, it actually has moved faster towards creating a market economy. They have a bigger stock market than almost any of the other emerging markets. So they've gone a long way, but it was step by step by step. And as they went on, as they did this gradual policy, they had enormous support from the people within their country. It wasn't forced on them, it was really something that everybody became convinced was the right way. Slovenia, is one other very successful country, one of the countries where GDP today is higher than it was at the beginning of the transition. It too followed the gradualist policy. Poland is one of the most interesting cases, because it did use shock therapy to get inflation down. And some people think, therefore, it is a shock therapy country. But that's not right. In fact, what it did was to have gotten inflation down to reasonable levels, and by that I mean 15-20 percent a year, not to the very, very low level. It didn't pursue getting inflation down with a single-mindedness that was the case in some of the other countries. It then took a gradualist policy of restructuring their economy, restructuring their society. And the result of that was the best performance, relative to where they were in the beginning of the transition. So there were alternatives, those who chose the alternatives were more successful than those who chose the shock therapy.

INTERVIEWER: [It is widely assumed that shock therapy did not work in Russia.] What would have been a better road?

JOSEPH STIGLITZ: Well, the better roads were the roads that Poland, Slovenia, China have taken. First of all, they focused on creating new enterprises rather than just restructuring the old. They focused on creating jobs and employment. So as you restructured the old, you had new avenues to use society's resources. Moving resources from low productivity to unemployment doesn't increase societies' wealth, doesn't increase anybody's income. Moving resources from low productivity to high productivity does. But if you have tight monetary policy that has interest rates at 25, 50, 100, 150 percent, you can't start new businesses. And if you can't start new businesses, how are you going to have the new enterprises that are going to create the new jobs? As you are re-orienting the economy, you take out the resources from the inefficient sectors to move into the more efficient sectors. In the United States we talk about what raising interest rates by one percent or two percent does to job creation. In Russia at one point their interest rates were over fifty, a hundred, and up to 150 percent. How could you have job creation? That was called a stabilization policy, but it wasn't stabilizing the society, it was actually leading to these policies that in some sense led to the implosion of the society, the economy and a destabilization of society.