The Failure of Neoliberal Transition Policies in Eastern Europe Post-1989

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Outline and Evaluate Peter Gowan's Critique of the Transition Policies Enacted in some East European Countries after 1989

Introduction

Jeffrey Sachs (1994, quoted in Gowan, 1995:5) asked, "how should communist East European (EE) states have been reorganized to achieve a recovery of human freedom and a democratically based rise in living standards"? Sachs argued that the Communist Eastern-European trade block COMECON should be dismantled and individual EE states should trade with the West and pay for imported new technology that would lead to higher living standards, democracy and sustainable market economies by profit generated through exports. He advocated the six core reforms of open international trade as the core engine of economic growth, which mainly Visegrad countries (Poland, Czechoslovakia, Hungary) adopted: currency convertibility, private ownership, corporate ownership for large enterprises, openness to foreign investment, and western aid. To install these reforms, neoliberal institutions like the International Monetary Fund (IMF) and the World Bank (WB) would assist governments to install the neoliberal strategy of Shock Therapy (ST) that would help governments to revive the economic activity in joining the global economic system through trade-led growth. Making use of Peter Gowan's critique, the evidence shows how neoliberal ST has largely failed to achieve its objectives through the six core reforms and has even weakened EE countries by the sudden liberalization of prices. Replacing COMECON with isolated economies has led to high unemployment, industrial output fall, worse living standards, and higher crime and death rates, while at the same, serving to benefit the West.

Open International Trade

Gowan (1995) analysis had favoured keeping a reformed COMECON, but without trade barriers, where each government would have been allowed to make their own experiences at their own pace. However, Bideleux et al (1998) argued COMECON was not fully integrated and, consequently, pursued different roads of nationalistic socialism with little co-operation, insisting that COMECON consisted only 4% of the world market (Sachs). In addition, the block was also dependent on USSR gas and oil. Gorbachev did not want to subsidize raw materials for COMECON countries anymore and had changed by introducing hard currency and world prices. This was because COMECON had no real convertibility of its currencies, which made it difficult to determine profitability. The switch to hard currencies and current world market prices led to a vast decline in industrial output in 1990 and 1991 (Bideleux et al, 1998), where COMECON members experienced trade losses due to loss of cheap Soviet oil (Gros and Steinherr, 2003).

Sachs argued, slow, moderate reforms and market-socialism would have been too costly and accordingly presented two alternatives: isolationism or ST through Western conditionality by dismantling COMECON and opening EE states to world markets. Marangos (2003) also maintained ST was necessary to establish a free market economy through an effective pricing system with convertible currency. This only works with markets open to international competition and economic actors motivated by individual material incentives, like private property. Regulation like keeping entry barriers, distorted prices, badly operated markets and ill-defined property rights would have led to corruption and high inflation. By this view, instead, the radical liberalization of trade through very low tariffs and ending quotas would ensure competition with western companies. Sachs hoped that trade-led growth would be better than strong domestic recovery because imports were needed to improve industries for dynamic export growth.

Gowan (1995) argued that the dismantling of COMECON increased unemployment in East Germany from 9.3 million (1989) to 6.2 m (1993), while in Bulgaria, state enterprises were getting deep into debts and Bulgarian economy slid into recession through collapse of exports to COMECON. Gowan (1995) criticized that the regional fragmentation was too costly because ST produced a double-depression-shock by breaking up COMECON regional trade, resulting in a decline in industrial output and real incomes in EE countries. Domestic demand collapsed by the swift decline in the population's real income and the credit crunch was made worse by the lack of viable financial markets and the abolishment of old coordinating planning mechanisms through budget constraints. Death rates in Russia increased from 11.4 (1991) to 16.2 (first quarter 1994) (UNICEF), through increase of stress-related heart diseases, dietary deficiencies, and murder and suicide rates. WB and Goskomstat (in Gowan, 1995) found 46-47 % of children in 1992 could not maintain food consumption sufficient to maintain normal body weight. Extreme poverty rose by 15-26 % and death from diseases like tuberculosis and diphtheria rapidly in different EE countries, because health was increasingly determined by market access.

However, Sachs and the WB (1996) maintained that life expectancy was worse in slow reforming countries like Romania and USSR, while improved in reformer countries like Poland and Czechoslovakia. Sachs blamed communism, saying that this slump happened before ST, and ST only revealed the degradation that had been occurring under communism, such as the production of too many worthless products what people did not want. Queues reflected this excess demand caused by prices that were too low in relation to wages. Inflation in Poland, Czechoslovakia and Hungary went down since ST from earlier highs and living standards improved, as managers were not subsidized anymore to produce goods that people didn't want. This had improved resource allocation. Even after, they continued to maintain that the introduction to world prices would drive inefficient sectors that were so prominent under communism to the wall, showing its economic irrationality. Therefore, according to this view, depression after the transition was caused by the failure to fully introduce world prices for labour and wages not having sunk low enough.

Russia's restrictions on exports and not increasing energy prices to world market prices were damaging because export pays for imports This meant that foreign trade liberalisation had only a limited effect and stabilisation was delayed. Instead, Russia subsidized inefficient and corrupt import companies until 1993, those of which were unaccountable to profits and losses. Reformers did not use aid efficiently and domestic prices of energy goods weren't liberalized due to the fearful large industrial state enterprises not being able to afford energy prices. The West hoped the aid to Russia could be repaid by rising Russian exports after reforms that ideally sought to increase efficiency. But, when this did not happen, private lenders refused to extend credits to Russia in 1992-3. Gowan (1995) agreed, in this regard, that communism is to blame, but, at the same time, ST made it worse.

Hare and Hughes (1991 in Gowan, 1995) illustrate that the falls in production had not only occurred in the value-subtracting sector, but that even the most efficient were being hit harder than the big value subtractors. For instance, alcoholic beverages were of the biggest values subtractors, but it was the only sector to continue to grow during the slump. Wages in Poland had already fallen 33.6 %, in Czechoslovakia 21.5 %, and 14 % in Hungary (between early 1990 and end of 1992), and there was a 40 % decline in wages in Russia in first six months after the introduction of ST. Schmiedling (1993, quoted in Gowan, 1995:20) says: "the negative impact of all possible disturbances on the profitability of production could always be compensated by a further decline in the real wage." Gowan (1995) argued that there is no evidence that the service sector would be able grow without industrial output decline. He also maintains (1995) that Communist goods were not unnecessary or worthless, as shown by the explosive growth of Eastern European exports in 1990-2. For him, the real reason was that Eastern Europeans were considered a "competitive nuisance".

Sachs favoured dismantling of EC trade barriers for recovery, but Gowan (1995) argued the reduction of tariff barriers were not enough for Visegrad countries and, due to slump, credit crunch and protectionist measures of the

EU (e.g. Polish cars), Visegrad countries could only use export sectors "with low output-capital rations", while an "import bonanza," that was strongly subsidized by the West, devastated domestic companies and worsened domestic trade budget deficits in EE. The UN Economic Commission for Europe suggested that: "until new investments are made on a large scale, prospects for sustainable export growth are slim" (Gowan, 1995:27). Domestic depressive shocks and export-led revival that was restricted by the EC led to a longer depression, by lowering of wages and trade deficits, forcing governments to reduce debts only through spending cuts and reducing reforms to cost-benefit analysis, although ST supporters ignored the fact that individual EE countries were different in foreign debt, inflation, size of private sector etc. Gros and Steinherr (2003) argued lay-offs and corporate tax arrears led to more tax arrears, which undermined strict monetary policy and added to inflation. They agreed that the West should help EE through better trade arrangements and a new multilateral institution for EE should be created to control allocation of goods to use these funds. Visegrad countries recovered their 1989 output, but not their 1978 peak.

Currency Convertibility

ST supporters argued oligopolies existed in EE economies and that they should be tackled by sudden price-liberalization. This would help through exports and convertible currency to link local EE companies with the world economy, particularly by raising prices and growth and reducing output. However, Gowan (1995:195) showed that Visegrad countries had the same monopolization as the kind in the USA and less monopolization than Germany and Britain. In fact, industries in EE were rather fragmented (Amsden, 1994 in Gowan, 1995) and small players in European markets. Furthermore, not state enterprises, but rather the private service sector had raised prices the most. Instead, Gowan (1995) argued that regulatory bodies could have been used to prevent the price increases through monopoly, which Sachs had ignored.

Private Ownership

Private ownership was seen as the main engine of economic growth. Sachs argued industries should not pass from governments to workers and local managers, because they would reward themselves too much and the responsibility would be too much for them. Capital markets could not trust worker-owned companies. Sachs proposed that Western financial advisers and legal experts organize the sale of EE companies. However, Gowan (1995), Gros and Steinherr (2003) criticized that only former black-marketeers of the Mafia, influential people in governments, and corrupt bureaucrats in import-export state sectors and currency speculators, who were encouraged by the West to be the new domestic capitalist class, had the money and expertise in money-accumulation, along with the funds to upgrade companies. This meant that privatization would lead to corruption, which is what haunts EE economies today. Market incentives were clearly impaired without clear ownership rules (White et al, 2007). Furthermore, Gowan (1995) argued that Sachs also did not explain why he had advised that foreigners should run funds and enterprises and why investment funds have more expertise than governments to restructure industries.

Gros and Steinherr (2003) argued that the break-up of collective farms and very large wage reductions led to the falling food demand for peasant suppliers. Therefore, state-owned enterprises should have been given to workers who could have had a share in the company, because a domestic capital market was what was needed. Initially, the Polish state switched from ST and worker-management buy-out and moved very quickly away from ST to the "sensible pragmatism" of state subsidies. Aslund (in Bideleux et al, 1998) highlighted that Czechs favoured free marketeering, but also used subsidies to avoid unemployment and bankruptcies.

Corporate Ownership for Large Enterprises

Lloyd (1996) proposed the utopian nature of national-led economics, while globalization through TNCs (transnational corporations) would be inevitable and Western companies should be involved in privatization. However, Gowan (1995) argued that TNCs play only a small part in globalization. He suggested that globalization of TNCs and national autarky go hand-in-hand, with the governments of the EC, the US and Japan fighting for their own domestic monopolistic TNCs and their own world market shares. For instance, western institutions offered duty-free and low tariffs in exchange for investing in target countries. VW, as an example, only invested into Skoda when the Czech government wrote off Skoda debts, giving 2 years tax holiday and VW trade protection, but VW did not keep promises and invested less. Furthermore, financial and economic market institutions and behavioural rules in the economy were lacking. ST supporters were too preoccupied with replacing new market institutions entirely, rather than in changing the existing institutions to reach the original goals set in place (Gros & Steinherr, 2003). However, ST was impaired because of the absence of reliable financial institutions. The major failure of ST was in excluding the state from building market institutions and promoting economic recovery. ST was rushed before substantial and effective institutions were put in place. White et al (2007) argued ST was against time, but reforms needed more time and more money than that which was provided for by the West.

Gros & Steinherr (2003) maintained that recovery did not happen quickly, despite several IMF packages, because the packages were not properly implemented and flawed. The West did not emphasize factors, like bankruptcy rules, modern commercial banking system, rule of law, efficient tax-collecting systems, and appropriate legal infrastructure, that would support market economies. This may reveal that perhaps there was a shortage of legitimate capitalists.

Openness to Foreign Investment

ST supporters argued openness to foreign investment would be crucial for the attraction of foreign direct investment (FDI) because it would create jobs and enhance productivity, growth and more efficiency. This would be through more efficient ways of doing business and new technology that could raise the standard of living in EE countries. Lloyd (1996) suggested that hostile investment climates and nonconvertible currencies would not be tolerated by the “world”. According to the WB, OECD and IMF, Western market forces through FDI would be crucial for transition, instead of governmental industrial policies. Target governments had to depress wages, impose hard-budget constraints on state enterprises, and privatize. Along with that, state intervention would only be able to follow IMF and WB guidelines. They blocked governments from restructuring state-owned enterprises before privatization because only private owners would be more efficient and capable of managing credit risks. For instance, WB and IMF refused loans to Romania, a country that had limited privatization of public utilities. Personnel in state privatization agencies of EE countries who adhered to ST were partly staffed by EC nationals, and full rights were given to foreign companies to participate in privatization.

However, small and medium-sized companies in Visegrad countries never received EC loans. Investment only increased in monopolized raw material and energy industries, which belonged to the ‘New Rich’ in EE and Western companies. Hence,

“there was a significant downward restructuring ‘toward simple energy and material-demanding production processes, which are becoming much more advantageous to export” (Gowan, 1995:31).

Western consultants transferred information about EE economies west, but not vice versa. Hence, the needs of Western investors and their global strategy were seen as paramount. While the WB ruled that the Polish Development Bank should only lend 15% to enterprises, target states were told to end agricultural subsidies. Sachs (1994 in Gowan, 1995) argued that state subsidies, wage controls, tight monetary, and credit squeeze would ensure a more efficient allocation of production factors before domestic capitalists and a domestic capitalist system emerge. IMF and WB withdrew funds against Visegrad governments that helped their own companies. Gowan (1995) argued that while Western governments would subsidize their companies, EE companies that were not helped often became bankrupt. Gowan (1996:31) criticized that “if we were to respond to market stimuli at the moment, it would be necessary to shut down even industries with a promising demand.”

IMF and WB demanded that expenditures in educational and health infrastructures, public research, and technological development in Visegrad countries were cut. However, Gowan (1995:53) criticized “that he decision by Western governments to insist upon the payments of fees by students (in Hungary) had no basis in economics.” However, EE governments had only three choices: inflationary funding of deficits, to gain Western funds to pay for deficits, or to cut spending, which the IMF favoured for fighting inflation. The consequences were long-term social and economic infrastructure problems and only Poland received substantial funding through a cancellation of half of its debt. Gowan (1995) maintained that capital would only have been able to flow if institutional and policy frameworks attracted the right kind of investment. Hence, depression-led transformation undermined the attractiveness for investors, as shown by decreasing flow of FDI. Instead, the shaky economies of EE offered high speculative yields for global finance. Gowan (1995:16) argueed that: "Western banks walked away from the market with some $ 250 million dollars of speculative profits". He maintained that the results of ST were small investment flows and large sell-outs to Western investors, showing that perhaps Sachs didn't understand the real intentions of the West.

Western Aid and Membership in Key International Economic Institutions

Gowan (1995) and Sachs both suggested it was in the interest of the West to help EE countries to implement ST and political reforms to avoid increasing crime, political extremism, hyperinflation, capital flight, civil war etc. The West would open its markets to EE products, services and manpower, cancel their debts, grant loans, and include them in international institutions. However, Gowan criticized how the West uses this power with more negative incentives and that Sachs does not show what Western governments and TNCs gain from assistance. For Gowan (1995), the six core reforms were more about political economy because only private ownership is a typical capitalist device of economic growth. Sachs wanted states to be open, so global economic operators would buy and sell resources from EE easily. This doesn't hold when seeing how EE pays more money to the West through loan repayments and interests than the West pays the East through annual aids. Gowan (1995) and Sachs both agreed, though, that the EU should do more to help EE countries to assist and consolidate the transition to market economies and democracy (EBRD Transition Report for 1996). Henderson (1998) maintained transition was much slower, costlier and only happened in Visegrad states, while other EE countries were neither stable nor recovered from output decline, most especially because foreign investment went into Visegrad countries.

Gros and Steinherr (2003) presented a gloomy picture: in the mid-2000s, EE countries still experienced high budget and trade deficits, property bubbles, internal inequalities, high unemployment, poverty and ethnic conflicts over social distribution. EE countries became more 'informal colonies' and captive markets of the West that uses its cheap labour, having "cherry-picked" its best workers, best companies, technical know-how and EU subsidies. Poland used ST and achieved growth thanks to exports in 1992, but the hardship suffered by the population due to sharp output decline, mass unemployment, and the cancellation of state credits led to anger amongst workers and farmers and tore the solidarity movement apart (White et al, 2007). However, Marangos (2003) argued that even governments that did not support ST, like in Lithuania, Russia and Hungary, were ousted, but agreed with Aslund, Boone and Johnson (1996 in Marangos, 2003) that reforms to become market economy succeeded through gradualism, with slower pace.

Sachs argued that democracy would come through shock therapy and that popular pressures to halt ST must be blocked. However, events in EE showed that the legal, social and political institutions were resistant to ST, while unpopular ST measures ignored citizens who were excluded from decision-making. Gowan (1995) criticized ST supporters who argued that civil society could only exist without political interference, regarding only the political left as danger, but not right-wing nationalism. Instead, former communist parties were re-elected because they offered social support for state enterprises. However, ST supporters and the West supported EE politicians like Yeltsin to overthrow the constitutions to push through ST policies in parliament, while critics of ST were ignored. However, the UN Economic Commission for Europe (in Gowan, 1995:27) argued that only economists and international officials were impressed by reforms, not populations. Too much deindustrialization without replacing manufacturing sufficiently proved dangerous because governments were prevented from state control that could have been protecting the most vulnerable sections of society (Nove,1994 in Bideleux et al, 1998). Even the most important private business and social groups (Gowan, 1996) became opposed to ST, which was too much shock through high unemployment, leading to poverty, apathy and crime, all the while claiming that the supposed benefits were to come in the future. Downturns showed to be longer and deeper than expected. This has led to rising interest rates and increasing demands for social safety nets, burdening both the state and society even more. Brabant (1993 in Bideleux et al, 1998) supported Gowan's point by arguing that ST supporters focused too much on advantages of ST, while ignoring differences between EE countries and underestimating the need for time to change the behaviour of people and institutions and the lack of qualified and experienced personnel in Eastern European countries,.

Conclusion

Shock Therapy supporters suggested ST would modernize EE economies through improved technologies and better living standards. Yet, Gowan claimed that ST led to a decline in living standards, higher death rates, chronic insecurity and impoverishment of large sections of the population and higher crime rates. Gowan's criticism of the new imperialism of the West has been justified by the suggested evidence, seeing that the West did not really help EE countries improve, but did get a chance at 'cherry-picking' the best resources of EE societies. Arguably, this transition was in the political-economic interests of the West. Neoliberal policies were a farce, because they were arbitrary. While Western governments could subsidize their companies and were allowed national-economic management, the IMF and WB punished EE governments for using subsidizes. Furthermore, Poland was forgiven half of their debts, although Hungary had lower debts and attracted more foreign investors. In addition, non-ST Romania grew stronger than pro-ST Poland, all which was ignored by the West. Instead of export paying more for imports and leading to higher living standards and more efficient economies, it seems from this analysis that living standards will not grow for some time unless much more is exported and Western markets are more open. Until then, sufferings in EE might lead to the weakening of democracy, which shows to be happening with its international conflicts, more racism and higher crime rates. Although Gowan's alternative of a reformed COMECON was assumed to be unattainable due to differences and little cooperation between members, insignificance of their trade in international comparisons, and dependence on Soviet oil, Sachs' neoliberal Shock Therapy in Eastern Europe helped the West create exporting tigers, competing on the basis of cheap labour costs and opening up markets for themselves.

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