AN UPDATE ON REFORM IN EASTERN EUROPE AND RUSSIA

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ABSTRACT: The paper reviews the experience of Poland and Russia with economic reform, with occasional comparison to China's experience. The author argues that macroeconomic chaos in Poland and Russia preceded reform and was allayed by reform; that there is no necessary tradeoff between reform and growth; and that the Polish and Russian experience shows that it is possible to create clear property rights quickly. JEL Classification #s: E0, O5, P2.

I am honored to be here today, especially in Hainan, where the fruits of China's economic reform are most visible. As a non-specialist in China, I plan to follow my obvious comparative advantage, by limiting my remarks to an update on the ideas motivating reform in Eastern Europe and Russia, and the results achieved thus far. Radical reform in Eastern Europe has been going on for three years, and in Russia, for one and a half. Compared with China, some obvious differences include the speed of reform and the enormous political change. In addition, the initial conditions were different. These are urban industrial societies, whereas China can draw on a vast, underemployed agricultural labor force and can thereby build up new sectors without necessarily tearing down the old ones. Furthermore, Eastern Europe and Russia were already in the midst of macroeconomic chaos. Reform did not *create* that chaos; it was inherited. Shock therapy does not create inflation and instability, but seeks to allay it.

Let me begin with Poland. As regards the objectives of Polish reform, there are three strongly held positions. First, Poland's objective is to become a member of the European Community (EC), with an industrial market economy like those in Western Europe. This will require, for example, adopting over 7000 regulations and laws as a prerequisite for membership, and an ownership structure like the rest of the EC, in which no more than 15–20 percent of the economy is state-owned. Second, Polish reform aims at deep structural adjustment, not just economic growth, because of the Stalinist legacy of over-developed heavy industry. This requires a drop in heavy industrial output, to free up resources for light industry and services. (In China, by contrast, rural reform freed up agricultural labor, obviating the need to shrink heavy industry directly.) And lastly, Poland's reform had to eliminate macroeconomic instability—an inflation rate of 54 percent per month in October 1989, immediately after the new government was sworn in.

Poland's reform strategy stressed speed: rapid legal reforms, freeing up prices, ending the deficit, to achieve a market economy within five years and membership in the EC by the year 2000. Thus as of January 1, 1990, almost all price controls, subsidies and trade barriers were eliminated, and in mid-1990, a rapid privatization campaign began. This had the effect

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China Economic Review, Volume 4, Number 2, 1993, pages 85–87

ISSN: 1043–951X.

of transforming Poland into a Special Economic Zone with a population of 40 million—roughly the size of Guangdong Province.

What have been the results of reform thus far? Reform did *not* lead to chaos.

1. In three years, Poland has created a fully-marketized economy. Roughly 55 percent of GNP and 60 percent of employment are now in the private sector. For retail and wholesale distribution the figure is more than 90 percent; construction, around 75 percent; road transport, around 75 percent; industry, perhaps 35–40 percent. In another two or three years, Poland may be virtually indistinguishable from the EC market economies in management and ownership.
2. Like China, Poland has opened the door to world trade, with some dynamic results. Exports to the West are up 75 percent since 1989. The big problem in this area for Poland, as for China, is protectionism (especially the EC).
3. Poland has achieved rapid structural change: a rapid shift from heavy industry toward light industry and services. The private sector is growing at around 40 percent per year; the state sector, and especially heavy industry, is contracting. In 1992, the private growth finally outweighed the public-sector contraction, producing around two percent overall GNP growth. Growth in 1993 will be between three and five percent.

What lessons does this experience teach us?

1. The supposed conflict between radical reform and growth is a red herring. There is in fact no tradeoff between fast reform and GNP decline. Hungary steered a gradualist course; GNP fell in 1992 and will fall in 1993. Poland reformed rapidly, and has experienced the *smallest* overall decline in industry and the fastest recovery because its private sector has grown so rapidly.
2. In terms of the welfare impact, there are losers as well as winners from reform. In heavy industry—steel, coal—reform has meant unemployment. In light industry, this is true principally for the old city of Lodz with its antiquated textile mills. But the private sector has brought to its workers a significant increase in living standards. There are now some 1.7 million private firms in Poland—one for every 10 workers in the labor force. Furthermore, the unemployment statistics can be deceptive. The official rate is 14 percent. But in urban areas, structural unemployment is very low. The urban unemployment rate is around eight percent, with an excess demand for many kinds of labor (Poland is importing labor from Rumania and Ukraine). The higher unemployment is mainly in rural areas. And this probably reflects the fact that many rural workers register as unemployed to collect a monthly benefit.

Now let me make some brief comments about Russia's reform experience. Clearly, the task is much more difficult and complex than in Poland. At the start of reforms in 1992, a new sovereign state was coming into existence, after the collapse of the Soviet Union. The monetary system was in chaos: in each of the 15 new states, central banks were issuing rubles in a "beggar-thy-neighbor" game. Unlike Poland, there was no consensus within the political elite. There is an ongoing struggle, with most of the executive supporting radical reform and the legislature, with its heavy representation from state-owned factories and farms, resistant to reform. President Yeltsin inherited a budget deficit of around 25 percent of GNP (an IMF guess, based on very imperfect data), and no functioning central bank. Thus Russia began reform under even more unstable circumstances than did Poland.

Given all this, the results are encouraging, though still very worrisome. Russia has avoided chaos, social unrest, and hyperinflation. Inflation is running at 15 percent per month, but could be below 10 percent in the near future, and 5–10 percent by the end of 1993. Russia has been able to progress on democratization, aiming for a new constitution within 12 months, and multiparty elections this year or next. There has also been rapid progress on privatization. Since January 1990, some 75,000 state-owned enterprises have been turned over to private hands. Using the voucher system, hundreds of large enterprises are being privatized each month. In April 1993 alone, one million workers moved from the state to the private sector in Russia, five percent of the industrial labor force, using vouchers. The Russian strategy is that workers and management receive roughly half the shares, in the form of transferrable common stock. Another 30 percent or so is sold to the general population. Investment funds are key players in this process.

I conclude that there is a reasonable chance that Russia will avoid chaos. The democrats are the likely winners in the political arena. The privatization battle is being won by the reformers. Hyperinflation has so far been avoided, and stabilization is on the horizon. In the last three weeks, the ruble has been strengthening (reflecting tight credit control); there are now lines to change dollars into rubles!

This experience of both Russia and Poland shows that it is possible to create clear property rights quickly. Macroeconomic tensions are inevitable. And the four key areas for future reform are taxation, central-local relations, the financial system, and completion of the privatization process.