LIFE IN THE ECONOMIC EMERGENCY ROOM
I have entitled my talk “Life in the Economic Emergency Room,” or, even more aptly, the shock trauma unit, because I want to talk about cases of extreme economic instability, such as Russia is facing now or Poland faced in 1989. More countries have experienced hyperinflation in the 1980s and 1990s than in any other time in history, and we are not done with it yet. This great instability poses enormous challenges for us as economists and enormous pain for countries struggling to overcome past military rule, communist despotism, war, or revolution. And so my focus is on such cases, rather than on the equally interesting and important cases such as Spain’s accession to the European Community and its shift from an inward- to an outward-looking orientation.

International Role

I want to make one basic point about these emergencies. It is such a trivial point that it shouldn’t require repeating, but it seems to be controversial in every case, forgotten in almost every case, and in need of relearning in every case. That is, the ability to succeed in reform has two critical components. One is the capacity of the country itself to reform. Successful domestic reform depends on vigorous political leadership. Equally important is the role of the outside world in helping the country to overcome the crisis. Even in the conference, the role of the interna-
tional community in many of the countries that we are talking about has been very much downplayed. This is not to take away from the accomplishments of anyone who has presented a paper in this conference—many of them, such as Leszek Balcerowicz, former finance minister of Poland, are my heroes. But countries cannot be transformed without the generous and farsighted involvement of the international community.

Despite the lessons of this century, the international community forgets this point again and again, at enormous risk to the world. We seem to be forgetting again—this time vis-à-vis Russia—and the stakes could not be higher. No matter how valiant, brilliant, and lucky are Russia’s reformers, they won’t make it without large-scale external assistance. This was true for Poland, as it was for Turkey, Mexico, and Chile. The papers in this conference fail to reflect this basic point, and so I feel the need to help set the record straight, or at least, to help put it clearly, because we are close to missing a historical opportunity in Russia.

I spoke on this topic recently at the Heritage Foundation. My talk was sparked by a letter sent to me by an analyst there, who believed strongly in Russia’s reforms but not in foreign aid for Russia. This is a common view of free-market ideologues—of which I am one. It is plausible, but it is mistaken. The market cannot do it all by itself; international help is critical.

The International Monetary Fund’s view, all too often, is also based on a misunderstanding of what its own role should be. The IMF officials say, “Prove it to us first that you can do it.” This response reminds me of the British aristocrat walking by the pond one day. He hears a man screaming, “Help, I can’t swim!” And he looks down at the man and says, “Sir, I can’t swim either, but I don’t make such a fuss about it.” Clearly, when there is a cry for help, it is necessary to respond.

Of course, foreign aid is not the main factor in economic success. The reforms themselves are the key. My argument is that foreign aid is critical to helping the reforms themselves take hold. Of course, some people are on the other side of this debate, believing that external help alone is sufficient. Such arguments remind me of the poor man begging to God every night, “God, let me win the lottery.” This goes on for a few months. One night he is again on his knees, begging, “God, let me win the lottery. I am a pious and good man.” Suddenly, the heavens open up with a clap of thunder, and a voice from above pleads: “Give me a break; buy a ticket.” Yes, a country has to buy its own ticket to success. Only then can external help can be fruitful.

Aid is crucial because reforms are inherently very fragile at the outset. There is typically little consensus on what should be done, pessimism is rife, and the reformers’ hold on power and on policy is tenuous. But despite the urgency of timely assistance, the aid package for each country must be put together on an ad hoc basis. The IMF and the World Bank do not by themselves offer a reforming country an adequate interna-}

**Reform Without Consensus**

The conference has failed to stress the fragility of reforms in the early phase. Many participants have suggested that reformers succeed by constructing a “social consensus” in favor of reforms. This is mostly not the case. In deep crises, there simply is no consensus to build upon, only confusion, anxiety, and a cacophony of conflicting opinions. Take the case of Poland, where it is sometimes suggested that the Solidarity-led government was able to carry out its “shock therapy” program because of a social consensus. In fact, there was no consensus on specific economic measures. From the start, Leszek Balcerowicz and his policies were enormously controversial—even though he will surely go down in history as a national hero.

While Poland did have a basic consensus in its desire to “return to Europe,” this certainly did not translate into agreement on the specifics of economic policy. Poland was as likely as any country to succumb to rampant populism and wild, misdirected policies. That it found its way out of the crisis was heavily dependent upon the leadership of Leszek Balcerowicz and the critical involvement of the international community.

Let me describe what it was like when Poland was wheeled into the emergency room in 1989. Poland was in critical condition—with extreme and intensifying shortages, an incipient hyperinflation, and an extreme balance of payments crisis. And most of the doctors leaning over Balcerowicz’s shoulder were screaming contradictory advice. Poland’s economics profession was in disarray. Communist economic concepts (e.g., the primacy of industry over services, or the need for protectionism) still hung heavily in the air; stale arguments of the past continued to stir confusion; and many would-be “market economists” were distinguished by their attachment to a crude Keynesianism that had gone out of style in the West decades earlier. The stark fact was that almost no economists in Poland had professional experience with the problems of monetary destabilization or the implementation of macroeconomic policy reforms.

Consensus on many specifics (e.g., currency convertibility, price decontrol, budgetary discipline) has come to Poland, but only after three years of reform. Now many people are coming out of the woodwork to say they supported the Balcerowicz program from the start. But at the beginning, it was touch and go. The policy debate was not whether the exchange rate on 1 January 1990 should be pegged at 7,500 zloty per dollar or 9,500 zloty per dollar, a question that many Monday-morning
quarterbacks continue to second-guess today. The question was far
more basic and pivotal: Should Poland move quickly to convertibility?
Leszek Balcerowicz will well remember late December 1991, on the eve
of the reforms, when even the central bank governor threatened to walk
out on the basic policy of currency convertibility at the start of the
reform. The central banker’s support for convertibility was contingent
upon Poland’s receipt of the $1 billion złoty stabilization fund at the start
of the program.

The initial confusion, and the difficulty of forming a consensus, is
fueled in most crises not only by inexperience and misconceptions but
also by the extravagant fears that accompany a program of fundamental
change, no matter how promising the program might be in objective
economic terms. While the history of market-based reforms has repeat-
edly shown that free markets, open trade, and an economy fueled by
private ownership are enormously powerful in stimulating rapid eco-
nomic growth, the general public rarely knows it or believes it at the
start. It is always crucial to make policymakers aware of this historical
record, a point that Anne Krueger has properly stressed over the years.

The father of the “German economic miracle,” Ludwig Erhard, has
vividly described the confusion and pessimism that gripped Germany at
the time that he was promoting market-based reforms in the late 1940s.
Here was an economy minister whose government was sustained by a
single vote in 1949 (it was Konrad Adenauer’s own vote that made him
chancellor). While Erhard is now rightly remembered as one of the great
economic policymakers of the century, at the start of the German post-
war reforms he was widely attacked as the cause of Germany’s rising
unemployment, and there was hardly anything miraculous in the situa-
tion, as most Germans saw it. In his memoirs, Erhard remembered the
pessimistic, static outlook:

It was calculated that for every German there would be one plate every 50 years,
a pair of shoes every 12 years, a suit every 50 years, and that only one in every
three Germans would have the chance to be buried in his own coffin. Few
realized,” Erhard writes, “that if the people could once more realize the value
and worth of freedom, dynamic forces would be released. It was a time when
public opinion seemed resigned to the ruin of West Germany. Opposition at
home joined with international criticism. With prices rising every day and the
foreign trade balance becoming more unfavorable, speaking of the future opti-
mistically was only possible through a deep conviction in the market economy. It
still took months before the change became apparent, but this turn toward
salvation in 1950-51 was, as a result, all the more positive and lasting.

Confusion over economic crisis is multiplied by high inflation, a point elo-
quently stressed by Keynes in The Economic Consequences of the Peace.
As Keynes so famously put it.

Lenin was most certainly right. There is no subtler, no surer way of overturning
the existing basis of society than to debauch the currency. The process engages

all the hidden forces of economic law on the side of destruction, and does it in a
manner which not one man in a million is able to diagnose.

The Western economics profession has been spoiled rotten by rational
expectations thinking, by diverting our attention away from the pro-
found misunderstandings that are part of every deep crisis. Few Rus-
ians understand the source of Russia’s current inflation, least of all the
governor of the central bank, who, to combat what has become a 30
percent per month inflation rate, called again for wage and price controls
on 14 January 1993, rather than for tighter credit policy. The central
bank governor is largely innocent of monetary economics. But pity the
rest of the Russian people. They may know a little bit more than the
central bank, but not much. They do understand that the quadrupling of
the money supply in the last six months is somehow part of the prob-
lem, but the confusion over the price of the ruble and the source of the
problem is truly spectacular.

John Maynard Keynes also stressed the particular insidiousness of the confusion
over the causes of inflation. He said that inflation heightens society’s
antipathy to those who make profits in the turbulent market conditions.
Businessmen are converted in the public’s mind into “profiteers.” But,
said Keynes,

these profiteers are, broadly speaking, the entrepreneurial class of capitalists—
that is to say, the active and constructive element in capitalist society who, in a
period of rapidly rising prices, cannot help but get rich whether they wish it or
not. If prices are continually rising, every trader who has purchased stock or
owns property inevitably makes profit. By reviling this class, therefore, the
European governments were carrying a step further the fatal process conceived
in the sublime mind of Lenin. The profiteers were a consequence, not a cause, of
rising prices.

Much of the excess focus on the “mafia” in Russia today reflects this
kind of thinking. There was a real mafia in Russia until recently: the
Communist Party of the Soviet Union—a veritable mafia in every key
aspect. It was an economically corrupt, thoroughly insidious organiza-
tion, and a protection racket at the far reaches of society. But today,
many of those who are called “mafia” are simply traders: Azeri traders,
traders from Turkmenistan, traders from other places.

The confusion, anxiety, and the profound sense of bewilderment
about market forces are inevitable when breadwinners must worry
whether the income will be enough next week to feed the family. The
anxieties created by high inflation underscore what several conference
participants have said: at the beginning, it is essential to stop hyperinfla-
tion, before any other reform. You cannot think straight in the midst of
hyperinflation. The society becomes unglued. What is needed is suffi-
cient stability to permit the government to address other crucial eco-
nomic issues, not to mention actions in other spheres, involving the constitution and the legal structure.

Many Western economists have also fundamentally misdiagnosed the macroeconomic situation in Poland and Russia. With a surprising casualness, they have jumped from the observed declines in industrial production to the conclusion that a demand expansion (such as in increase in money-supply growth) is warranted as a countercyclical "boost" to the economy. Such advice is naive in the face of the huge inflationary pressures in the region and is simply a misreading of the real economic situation. The industrial output decline reflects the profound structural imbalances of the Stalinist economies of the region, with their gross overemphasis of heavy industrial production, rather than a simple shortfall in aggregate demand. Output is declining because the factories lack real customers. Where there are customers, such as in food processing, consumer goods, or exportable production, output in Poland is rising, not falling.

In essence, these economies are undergoing the Schumpeterian "creative destruction" of old, moribund industrial sectors that was put off for 40 years or more. There is simply no reason why the economies of the former Soviet Union should produce 80 percent more steel than the United States, as the Soviet Union was doing in the late 1980s. A decline in heavy industrial production is inevitable, and desirable, as it frees resources for other sectors of the economy, including services, consumer industry, and new export sectors.

This is more and more clear to outside observers, although it was not clear to many Western observers and analysts in the first couple of years. What has made it clear is that every country of Eastern Europe has had an output decline of between 30 and 50 percent, whether the country is reforming or not reforming, doing it fast or doing it slow, doing it coherently or incoherently. Those whose reforms were the hardest and the fastest, like Poland, have actually had the smallest cumulative declines and the quickest return to growth. Hungary, which reformed more gradually than Poland, continued to have a decline of industrial output in 1992, even as Poland's industry started to grow, particularly in the new consumer goods and export sectors.

At the critical moment when reformers are fighting for financial stability, Western calls for allegedly more "humane" policies can seriously undercut the political support for the reformers. Just as there has been a casualness in interpreting the nature of the industrial output decline in the East, there has also been a casualness in judging the "harshness" of the reforms in terms of their effect on living standards. It was widely alleged that Poland's reform program caused a real-income drop of one-third. This led some outside observers to argue that the Poles should "ease up," or go more slowly, just at the moment that decisive stabilization measures were most necessary. We now know, on the basis of careful analysis, that no such sharp drop in living standards in fact took place. The calls for gradualism therefore threatened the hard work of financial stabilization, while being based on naive interpretations of shaky statistics.

When one examines what Poles have actually been consuming since the start of the reforms, the idea that living standards collapsed is clearly put to rest. One charge was that Polish pensioners were suffering terribly as a result of the reforms. The fact is Poland more than took care of its pensioners. If you compare per-capita meat consumption between 1989 and 1991 (which should be a sensitive indicator of monthly consumption) for retired persons and pensioners, it went up 11 percent in volume; for employee households, it went up 2 percent, and for the country as a whole, it went up 2.6 percent. For fruits, similarly, pensioners saw a 10 percent rise in fruit consumption per capita and employees an 11 percent rise. Taking into account a small drop for farm households, there was an 8 percent rise for the country as a whole.

Over the last three years, Poles have been buying the Western consumer durables that were out of their reach for decades. Perhaps the best indicator of this is VCR ownership in Poland. During this period of supposed "great depression," VCR ownership among employees has risen from 1.9 per hundred households at the end of 1988 to 41 per hundred households at the end of 1991. Automobiles went from 30 to 38 per hundred households; stereo radios from 22 to 38; and color televisions from 41 to 82 per hundred households. And all of this was happening at a time when many or most economists were arguing wrongly that the reforms were too hard, too dangerous, too costly, too destructive—exactly what one hears about Russia today.

What does one do in these circumstances? If you are the reform team, I think it is absolutely clear. You lead; you press forward. The key reform input that is missing in most economic analyses is political leadership. Leszek Balcerowicz was not a household name in Poland three years ago. He had to earn the public trust through results. Alexander Hamilton, the first US Treasury secretary, faced similar difficulties in the early days of the American republic. He was very much influenced by Jacques Necker, the last French finance minister of the ancien régime, who wrote a Machiavellian guide for finance ministers. Necker said that a great minister must have five attributes: genius, regularity, prudence, firmness, and breadth of knowledge. Necker maintained that flexibility or willingness to compromise, which might be harmless or even advantageous in other ministers, was an unforgivable failing in a finance minister! A weak and compromising minister of finance was worse than a dishonest one. Toughness has been and continues to be an extremely important attribute in this position.

The reform team must make its reforms an accomplished fact. A key human attribute is attachment to the status quo. We even have detailed
theories and empirical evidence of this bias, which Twersky and other economic psychologists have analyzed with great insight. When people are offered a choice between A and B, according to basic economic theory, that choice should be made independently of whether they start with A and are offered B as an alternative or if they start with B and are offered A. But what psychologists have found is that an individual who starts with A and is offered B is much more likely to choose to stay with A than he is to choose A if he started with B. This is the basis for the theories of loss aversion and status quo bias.

If reformers want free prices, they should not stand around and talk about it—they should do it, because everyone will be against freeing prices until it has been done, until it is an established fact. But once done, there is no going back, or, at least, little chance of going back. The Russians will probably not go back to price controls because Yegor Gaidar acted rapidly at the start of 1992 to free prices.

**Laissez-Faire Policies**

Strategy in the shock trauma unit requires the use of radical, laissez-faire policies, for a reason that is rarely recognized: it is a political strategy, not just an economic strategy. I learned a great deal from the brilliant former minister of economy of Bolivia, Gonzalo Sanchez de Lozada, who used to say, "Thank God, I don't have to decide on the weather because if I did, the farmers and the city people would be at me every day." And he said the same thing about prices for bread and other things. A government facing political and economic collapse (the case at hand) must give up responsibility for market prices in order to focus on the core functions of government that are not being met: law and order, public security, a stable monetary system, and basic social welfare. Governments that have reached hyperinflation cannot, self-evidently, be expected to develop complex industrial policies or structural policies. After all, they aren't even carrying out their most fundamental tasks.

Nonetheless, many economists would have such governments also take on many ancillary responsibilities, for example, government-led restructuring of enterprises, or an industrial policy. In the case of Russia, such advocates of big government somehow believe that, even though the government cannot now even avoid a quadrupling of the money supply over the second half of 1992, it can somehow manage 200,000 firms in a politically sound, technically competent, and responsible way. It is a ludicrous supposition, of course. What radical laissez-faire policies entail, in circumstances of extreme crisis, is shocking off the secondary burdens of government so that the government can focus on its core functions.

The World Bank too is often on the wrong side of this debate. Too many World Bank programs are implicitly predicated on an honest, technically competent, smoothly operating, and market-friendly bureaucracy. World Bank programs for sectoral restructuring often build in new and heavy responsibilities for ministries that rather should be closed because of incompetence, corruption, and lack of need!

**Resorting to Self-Help**

I return now to the main theme: international assistance in support of radical reforms. There are two kinds of assistance: self-help and real help. Self-help is what happens when a finance minister increases national income by stopping debt payments while appealing to the international community for understanding. Self-help is needed because our international financial institutions, particularly the IMF, simply don't operate fast enough or coherently enough to handle the financial crisis in the absence of self-help.

Consider the case of an overly indebted corporation in the United States that is unable to service its debts in the short run. Under Chapter 11 of the US Bankruptcy Code, the debtor enterprise can file for bankruptcy to obtain a "standstill" on debt servicing. Under the standstill, creditors must refrain from attempting to collect the debt, pending a collective solution to the indebtedness problem. Moreover, the law provides ways for the enterprise to borrow new working-capital funds even after filing for bankruptcy, in order to ensure the continued efficient operation of the firm.

No such procedures operate with heavily indebted countries in the grip of a balance of payments crisis. A country cannot file for an immediate standstill in an international bankruptcy court. Perhaps it can achieve one, following months of laborious negotiations with creditors, but usually only after tremendous damage has been done by capital flight, a withdrawal of trade credits, and other hostile creditor actions. Moreover, there is no routine way to obtain the working capital vitally needed to keep the economy functioning. It is literally the case that Macy's had an easier time raising $600 million in emergency working-capital loans after filing for bankruptcy than did Russia in 1992. Macy's got the loan three weeks after the filing of the bankruptcy petition; Russia's $600 million financial rehabilitation loan from the World Bank was not fully negotiated during the entire 1992.

The United States actually started with self-help in 1790, when Alexander Hamilton unilaterally cut the interest rate on the US foreign debt. He in fact gave the creditors a menu of options, in the time-honored fashion: the creditors could accept low interest and par bonds, or they could accept a cut in the face value by not converting, or they could keep with their 6 percent interest rate loan and expect servicing of that part of the debt to sink to the bottom of priorities. In effect, he unilaterally
subordinated the debt of those creditors who were not willing to cut the debt burden. Interestingly, this was done in Paris, where most of the debt was held—an early and effective "Paris Club" rescheduling.

Now let's turn to real help: structured financial assistance to support a reform program. The point I want to make is that the traditional arguments against development assistance (for instance, the influential arguments made by Lord Bauer in past years) are largely irrelevant to the kind of financial aid needed by countries in acute economic crisis. The case for development aid in traditional thinking is that it helps countries to grow by filling the "savings gap" and/or the foreign exchange gap. We are after something else here, to help countries to reform, with growth coming mainly as a result of the reforms rather than as a result of the aid itself. The aid functions to bolster the social and political situation in the country and to help the government manage its strained finances in a noninflationary way.

Critics of traditional development assistance are usually right to point out that aid is almost too small, by itself, to make much of a direct dent on overall living standards or growth rates. (The $100 billion annual flows from West Germany to East Germany, however, offer a unique and conspicuous exception.) Even the famed Marshall Plan funds, at around 2 to 3 percent of recipient-country GDP, were surely too small to serve such a purpose. But revisionist historians are grossly mistaken when they conclude that the Marshall Plan therefore had only a tiny effect on Western European economies. The Marshall Plan had the effect that I am stressing: it allowed market-friendly governments to survive and to function long enough for their economies to recover, driven by market forces. Erhard's Germany was the case par excellence.

The conservative critique of foreign aid is that it bolsters governments. That might be undesirable in the case of corrupt authoritarian regimes not implementing economic reforms, but it is exactly the goal in the case of the radical reform governments of Eastern Europe and Russia. It is true that you cannot make bad governments do good things with aid—conditionality is not so powerful. But what you can do is help good governments to survive long enough to solve problems.

Sometimes aid cannot work when the government is uninterested in real reform. It is necessary to walk away from a lousy government, which is something that international institutions also have a hard time doing. But when the IMF walked away from Poland early in 1992—after Jan Olszewski came in as prime minister based on a highly populistic campaign platform and with recklessly populistic rhetoric—the IMF departure shook the place up tremendously and effectively. It was the IMF at its absolute best. It surprised the Poles. Quickly, Olszewski appointed Andrzej Olechowski as finance minister, giving the country a fighting chance of staying on track, despite difficulties posed by the rest of the cabinet. When the Olszewski government fell soon afterward on other grounds, the new government came in committed to a continuation of the reform path.

In the Polish case, the capacity of international financial institutions to walk away had an important and hugely favorable impact. The other case—the one that I have been lucky enough to be part of several times—is the case in which there is already a good government. We wake up one day, and Russia has a dynamic 35-year-old reform leader, dedicated to radical economic reform—something we could never have dared to expect. This is not the time to engage in a debate about whether foreign aid can help or not, or whether foreign aid props up bad regimes. This is an opportunity to seize. It is precisely the opportunity we failed to take in 1992 and must quickly take in 1993, if it is not already too late.

Case Histories

Before going into the particulars of the Russian case, I would like to remind the participants of this conference that at some point almost all of their countries have required significant international help (for US participants, I have already alluded to the situation in 1979).

Adenauer would not have survived without the Marshall Plan; he barely survived with the Marshall Plan. And the Social Democratic Party was not exactly the moderate, market-friendly party that it became in the late 1950s after the proven success of Erhard's market reforms, which forced the party back to a mainstream position. Aid was absolutely fundamental to getting postwar Germany onto a healthy long-term path.

Many of my Japanese friends have been neglecting their own recent history in their consideration of aid to Russia. US assistance was absolutely fundamental between 1947 and 1950 in giving the Yoshida government the opportunity to put in place a real stabilization program to unify the exchange rate, create a market economy, carry out land reform, and the rest. When the Japanese shrink from helping Russia because of the truly nasty periods in their past relations, they must remember that the US decision to give large-scale aid to Japan three years after World War II was also not the most palatable policy for Americans as well. Yet it was surely the right thing to do and was vital for Japan's later magnificent success. On another point, some Japanese economists now say to the Russians, "Don't go with the IMF, don't go with stabilization: we have a different way." They also forget that the United States imposed a rigorous IMF-style stabilization plan (the Dodge Plan) in 1949 that was key to a decade of subsequent stable growth in Japan. Many leading Japanese politicians opposed the Dodge Plan because it forced a cutback in vote-getting public spending. Yet, the plan was carried through and was crucial in providing a stable financial base for Japan's growth in the 1950s.
Bolivia's successful stabilization and structural reforms, which enabled Bolivia to end hyperinflation and to achieve sustained economic growth (equal to Mexico's cumulative growth since 1986), similarly required self-help and real help. The self-help came early in 1986. I was called in Cambridge one day to come quickly to La Paz. The problem was most odd: after just two months of a fragile anti-hyperinflation effort at the beginning of 1986, Bolivia was being pressed by the IMF to devalue the currency once again! Without the devaluation, the IMF claimed, Bolivia would not be able to service enough of the debt that year.

Bolivia was drowning in debt. The debt service due was more than total government revenues, and debt reduction was surely going to be needed. But this was still early in the debt crisis, and the IMF and the creditor governments had not yet acknowledged the role for debt reduction. The IMF was still insisting on debt servicing, despite the obvious potential harm of such an approach. The Bolivian government eventually cut short the debate, saying, "Look, we can’t pay, and we’re not going to pay." Eventually, after heated arguments, the IMF acknowledged the need for a complete standstill on debt servicing and cancellation of a substantial part of the debt. In 1987 the IMF became the sponsor of Bolivia's debt buyback operation with the commercial banks. The success of the Bolivian buyback eventually contributed to an overall rethinking of the debt strategy, culminating in the Brady Plan.

International assistance has also played a key role in Mexico's economic reform and recovery. Mexico is the World Bank's second largest customer—with $19 billion in loans outstanding at the end of 1991. It is by far the largest US Export-Import Bank customer. The Brady Plan was designed originally for Mexico following an emergency bailout in 1982 that was crucial in helping Salinas to get off to a good start. The lesson from Mexico is that when the United States is focused, for foreign policy reasons, on managing a financial workout, the right things can happen.

The strength and coherence of Chile's economic reforms in the 1980s are well-known, but Chile's economic success also depended on external help. I have been criticized by one of Chile's erstwhile US advisers, Steve Hanke of Johns Hopkins University, for calling for foreign assistance for Russia, even though Chile itself was a major beneficiary of international assistance after 1982. Between 1983 and 1987, official loans to Chile went from $1.2 billion to $3.9 billion, an increase of 16 percent of Chile's average GNP over the four years, or an average of 4 percent a year. Did the aid provide the solution for Chile? No, the grapes did: the answer was Chile's trade liberalization, which began to show its full fruits, as it were, in 1985. But would the reforms have lasted until that point without the international help? In my view, not likely (and almost certainly not had Chile been a democracy in the early 1980s).

Let me turn to Poland. I cannot stress enough the heroism of the Polish economic team and its capacity to operate amidst profound confusion and intense political and economic difficulties. But here too, international help was crucial. The billion-dollar zloty stabilization fund for Poland, not actually even touched, was of principal importance in helping Leszek Balcerowicz to convince the rest of the government, and the general public, to accept his program. Many of Balcerowicz's closest advisers did not believe it was possible to move quickly to convertibility; international help was essential to get them to contemplate such a policy. Viewed through the optic of the Polish experience, the IMF's treatment of the ruble stabilization fund—to delay its mobilization until after stabilization is achieved—is a serious tactical misjudgment.

Also critical for Poland was the two-stage debt cancellation, which was engineered in 1991 by the Group of Seven with resolute US leadership. The strength of that deal lay not only in the financial lift that it gives Poland and in the hope that it offers to the Polish people, but in the key tactical fact that it comes in two parts. Part of the debts were canceled in 1991; the other part—a significant chunk—only is to be canceled in 1994, and only if Poland is still in compliance with its IMF program at that point. This is an enormously powerful and politically salient kind of conditionality; deep debt reduction is not something a government or country lightly walks away from.

Turgut Özal led very successful reforms in Turkey during the 1980s, following the financial collapse at the end of the 1970s. It is important to remember, however, that Turkey's financial recovery also owes much to timely international assistance. In 1979 Turkey's financial fragility was of enormous strategic concern to the United States, Germany, and NATO, especially with the Iranian revolution under way. The OECD countries coordinated massive financial assistance to Turkey, so that during 1979-82 Turkey never had to make net resource transfers to the rest of the world (in contrast to the major Latin American debtor countries, which were pushed initially into large negative resource transfers). The West cushioned the adjustment process during the critical early years. Official aid to Turkey averaged $623 million from 1975 to 1978 and then went to $1.1 billion in 1979, $2.7 billion in 1980, and $1.8 billion in 1981. There was an emergency OECD loan, a special $1 billion in short-term credits, and a very generous debt rescheduling.

Israel, which had a successful stabilization in 1985, also has had very extensive international backing. During the first year of stabilization, the United States gave an extra $1.5 billion in aid (above the usual $3 billion per year). This was grant money that amounted to about 6 percent of Israeli GNP.

Indonesia also was the recipient of an extremely generous debt cancellation deal in 1969 arranged by the German banker, Herman Abs, as head of the creditor committee. It was the second case of debt cancella-
tion in the post-World War II period, after Germany itself in 1953. The cancellation allowed Suharto to end a very high inflation and begin a very successful period of economic stabilization and liberalization.

The point is that there are few miracles; reforming countries need help, no matter how good the reform team. If you look closely at successes, you will find that help was at hand. And if you look closely at the help, you will discover its ad hoc character. Either the US president was concerned, or there was a special strategic need, or there was a creditor government focused for some other reason. Mexico was an obvious concern because of its 2,000-mile border with the United States. Poland was of critical concern as the first postcommunist country, and the mother country of large numbers of Polish-American voters in Chicago. In Turkey, the key was NATO’s strategic concerns in the midst of the Iranian revolution. And so forth.

Reform in Russia

This pattern of assistance is dangerously accidental. It is too little based on conceptual understanding and a coherent analytical framework. There is no place where this lack of understanding and institutional response has been more evident than in Russia since the collapse of communism. The Western policy has been shocking in its neglect and in its incapacity to face the real economic issues in Russia. This incapacity was epitomized by Secretary of State Baker’s thrust toward symbolism over reality in the formulation of Western aid, and in the IMF’s failure to mobilize large-scale international support.

I have found the Western performance nearly unbelievable. I must say that my greatest personal mistake this year was to say to President Boris Yeltsin, “Don’t worry; help is on the way.” I believed deeply that the assistance was too important, and too crucial to the West, for it to be messed up as significantly and fundamentally as it has been this past year.

On 28 October 1991 Yeltsin made a remarkable speech in which he said Russia was to become a normal country and that it wanted to become a democracy with a market economy. The next morning, when I opened the Financial Times, I was reminded of one of Solzhenitsyn’s famous characters in the Cancer Ward. The character is a party apparatchik who lies waiting in the cancer ward, anticipating the one-year anniversary of Stalin’s death. He fantasizes about the big black rims that will run around the newspaper that day in commemoration of the Great Man to whom he dedicated his party service. When the paper arrives on that day, there is no black rim, and in fact not even a mention of Stalin’s death. He knows that a political earthquake has occurred; his political life is finished.

I woke up on 29 October 1991—the day after Yeltsin’s speech—similarly expecting red, white, and blue banners around the Financial Times, with Western leaders praising the speech and saying that a new day had dawned in international cooperation. But there was not one mention of Yeltsin’s speech by anybody: not the World Bank president, nor the IMF managing director, nor any G-7 leader. It came and it went. One week later Yeltsin appointed Yegor Gaidar, and again, no reaction.

The G-7 finance deputies arrived in Moscow soon afterward. I assumed they would talk to Gaidar about his problems. The man, after all, had a rather large task: an empire falling apart, hyperinflation, fundamental system transformation, and the army. But the G-7 deputies only wanted to talk about one thing for three days: the foreign debt. It was really important to them to get the Russians to sign an agreement on the “joint and several responsibility for the old Soviet debt” and to get Russia to agree to continue to service all the interest and short-term debt as it fell due! The G-7 deputies did not spend five minutes with Gaidar actually discussing the overall economic situation, much less what the West might do to help.

The Russians, of course, had almost no international reserves. (The Communists were not ones to hold on to reserves in prudent safekeeping for the next government!) I wrote in The Economist a few weeks later that while countries normally should have reserves equal to three months of imports, Russia had only three days of import cover. The minister of foreign economic relations took me to task for “exaggerating” the financial soundness of the country: the truth was the Russians had only about three hours of reserves! And yet the G-7, without looking carefully at a single number, pressured the Russians to sign a debt agreement guaranteeing continued debt servicing. Under pressure, the Russians signed. The last reserves were paid to the G-7 creditors, and then the reserves hit rock bottom, and within weeks the debt agreement fell into abeyance.

The next milestone on the way to “saving Russia” was Secretary Baker’s White House conference in January 1992. Secretary Baker forgot one thing—to invite even a single Russian. It was not exactly an oversight. The Russians were asking the United States to discuss the financial situation and the incipient hyperinflation. But the purpose of the conference was “humanitarian” rather than financial. A cynic might suggest that one goal was to orchestrate the landing of a C5A transport with food and medicine, with Baker and CNN in Moscow to greet it. The White House believed it was “too early” to discuss finance. And lest a Russian might have caused embarrassment by asking for financial assistance while in the White House, none was invited.

The IMF, meanwhile, told the G-7 in January 1992 that Russia did not really need much financial help. The balance of payments scenario that they had worked up showed that there was almost no financing gap.
This is because the IMF, after 45 years, still does not have sound standards for determining the financial gap. The IMF had simply assumed that imports would fall again in 1992 after falling by 45 percent in 1991. If imports shrink far enough, the financing gap is of course zero! The only sense in which a financing gap can be understood is in a normative sense: how much financing does a country need in order to be able to sustain an adequate flow of imports? But a senior IMF official rejected this view as naive, claiming that a financing gap “has nothing to do with need.”

The Russians and their financial advisers put up a major ruckus and told the IMF officials they ought to look again at the import numbers. They considered it unacceptable to design a program for 1992 with imports falling several billion dollars below the collapsed level of 1991. Subsequently, the IMF decided that the financing gap was in fact somewhat higher. I suppose that the US Treasury decided it.

In the midst of the IMF discussions, the Russians and the IMF received a fax from one of the investment banks that was helping to manage the foreign debt. It said that a new calculation had been made that showed the amount of interest due was $1 billion more than had been expected. Given the previously determined target level of imports for 1992, the financing gap would have to be raised by $1 billion. The next morning the IMF produced a table that showed Russian exports now at exactly $1 billion more than they had estimated the night before, so that the financing gap remained unchanged. One of the Russians went to one of the top IMF people, and I went to the deputy, and we each asked what had happened. The senior man said, “We thought about it last night, and we think your export capacity is higher than we had estimated. We had ered.” The fellow I went to said, “We got the fax on debt servicing; we had to do something since we had a cap on the maximum financing gap that we could acknowledge.”

This is not the way to behave in these circumstances: it is deeply damaging to the process. Unless there can be an honest assessment of need, based on serious criteria, rather than calls to the Treasury to find out what it is permissible to admit, the world system will not make sense. And of course, this episode deeply poisoned the Russians’ understanding of the whole nature of the IMF negotiations: they understood afterward that it was a highly cynical game and not a substantive discussion. If those are harsh words, it was a harsh situation.

Finally on 1 April—for reasons ranging from speeches and appearances by Richard Nixon, to Bill Clinton’s speech that day, to German pressures on the United States, to the sitting of the People’s Congress in Russia—Bush announced a $24 billion aid program of the G-7. I thought this was the breakthrough. It took me the following four months to understand fully that there was nothing in this at all—no program and no concept. The $24 billion figure was based on a loose estimate of what various countries might or might not contribute, through their export-credit agencies, in short-term credits. In the end, what materialized was dreadful, unconditional, corrosive of the political process in Russia, and thoroughly lacking in meaningful support of the reforms.

What happened? Without going into excruciating detail, it became clear that what was to be counted was anything that could be found. At one point, for example—and it is still a live issue today—the German payments for troop relocation found their way onto the $24 billion tally. The first day that the program was announced, I called the German finance ministry to learn exactly what would be in the $24 billion package. The German government made clear that troop relocation money had nothing to do with the $24 billion aid program. About two months later, it reappeared on the list after the G-7 realized they could not come close to any of their initial targets. I called Germany again to confirm my original understanding. The IMF again took it off. Then in recent days it has come back on the list, to justify last year’s effort.

In the end, here is what happened. First, there was supposed to be $2.5 billion in interest relief. There has not yet been a debt rescheduling. Gaidar came and has gone, and the G-7 never got around to a Paris Club rescheduling! Paris Club rescheduling is not the most difficult thing in the world. It is what deputy finance ministers do routinely for around 40 other countries in the world, yet they could not manage it for Russia during an entire year. Second, there was supposed to be $4.5 billion from the international financial institutions. The World Bank managed loans of $670 million, but these loans came so late in 1992 that they were not disbursed in 1992. The World Bank also lent a few million dollars in very useful technical assistance, mainly for the privatization ministry and the employment service.

The IMF was even less timely. In effect, the IMF told the drowning man not to worry. After months of negotiation and at great political cost to Russia, the IMF came up with a scheme—and I can only imagine how Boris Yeltsin understands this to this day—in which IMF Managing Director Michel Camdessus explained, the IMF would loan $1 billion to Russia, but the money could not be used in 1992 (it had to be held as reserves). This money was not touched during the balance of 1992.

There also was supposed to be $11 billion in grants and loans. In fact, there was only $500 million in grants, and about $10 billion in commodity loans, almost all under four-year maturity. There were two investment loans of about a billion dollars or so: one from Germany, one from Italy. But basically all the bilateral money was unconditional, uncoordinated, and not linked to any reform, with $2.5 billion of it coming due in 1993. Almost all was short-term money at market interest rate: good for Iowa farmers and extremely costly for the Russian budget.

That was the sum total of the Western aid effort: no program, no conditionality, no linkage to reforms, no strategy, little interest. I have
also had six times more permanent advisers on the ground in Moscow than the IMF has had. The IMF has had two, and I have had 12. That is not something of which I am proud. I find it extremely peculiar in these circumstances that in the area of technical assistance, the IMF, the World Bank, and others have relied almost totally on fly-in help, which simply cannot do the job, with the complex issues Russia faces.

What Ought to Be Done?

The reformers are in an extraordinarily precarious situation right now. Gaidar was dumped, I think, partially because Yeltsin was besieged on all sides internally, and no support was forthcoming from the outside. Gaidar therefore left, and Viktor Chernomyrdin, an apparatchik of the Gorbachev cabinet, has become prime minister. Yeltsin found vigor at that point and fought to keep the reform cabinet intact, which he succeeded in doing. In fact, he also made two important additions. The first was Sergey Shakhrai on the political side—a young, vigorous constitutionalist—and on the economic side, Boris Fedorov, the new deputy prime minister in charge of the finance ministry and the economy ministry. That means that the ministries remain in the hands of the reformers.

The real balance of power and influence and the capacity to move forward, however, remain unclear. Yet, it is not much less clear than it was in Poland or other places in deep crisis. The reformers are the people that know what to do—the ones with the energy, ideas, and the capacity to operate, and they are in charge of the key ministries. There is little point in asking where the power “really” lies. Most likely it lies nowhere in particular; it is there for the taking. And if the reformers act coherently and aggressively, they have a chance to carry these reforms through.

Of course, there is a real risk that the reformers in Russia will get bogged down. With the constitutional referendum planned for April 1993, the reformers may come to be seen as a lame duck cabinet. So they must start acting, and acting fast and vigorously right now. Fortunately, Fedorov has done exactly that. He is a sharp, tough guy who fits Jacques Necker’s description of what a finance minister should be: a strong man who knows what to do. His statements over the last few days have been clear and coherent, and he already has succeeded in getting Chernomyrdin to roll back a price decree announced last week before the new government had assembled for its first meeting. Next week, he will put on the table a program of financial stabilization that is wide-ranging, detailed, and professionally drawn. The plan will call for increased interest rates, cuts in subsidies, the unification of interest rates charged by the central bank, and a tight credit program and fiscal reform. In other words, it is a broad-based stabilization program. His capacity to implement this program, however, may well depend on whether the West is clever enough to act right now to back up Fedorov and the overall reform effort.

This is a difficult period for the United States, as the new administration will be in office in days; the timing could not be more precarious. The Paris Club issue is still unresolved; a successful Paris Club agreement would be an enormous boost for the reformers, and it would be an enormous vindication of the reforms in President Yeltsin’s eyes. He, like President Walesa, is focusing on the issue of foreign debt and how to avoid utter bankruptcy and isolation. So debt rescheduling is something that can be done, but it must be done through coherent US Treasury policy action in a short period. For the longer term, I believe the West has to return to the concept of a $24 billion program—or thereabouts—and structure it in a politically and economically meaningful way that signals strong support for the reformers and helps them materially.

Consequently, I argue for a four-point program. The first would focus on Western support for social programs in Russia—mainly unemployment compensation and job retraining—both to serve as a political signal and to provide budgetary support, which is crucial to stabilization. The second point is a small-business fund managed by the European Bank for Reconstruction and Development, partly on the theory that supporting small businesses is an enormous political plus and partly on the theory that the EBRD needs a systemic role, and this would be an important one. Third, the G-7 export-credit agencies, World Bank, and EBRD should coordinate funds of several billion dollars for long-term industrial restructuring. This would go for real, bankable projects, not support for old industry. Fourth is real stabilization support: a ruble stabilization fund at the beginning of stabilization and not at the end, an IMF standby, and a deep debt rescheduling.

These are the things that can help the reformers succeed in Russia. It is not a question of peering into crystal balls or wringing our hands, wondering what might happen. To a very large extent, our own actions will determine how the Russian reforms fare in the coming weeks and months.

Editor’s Postscript

The IMF complained, after learning of the above speech, that Jeffrey Sachs had misrepresented its role in Russia. Since no current member of the Fund staff was present to respond on the spot, the director of the External Relations department, Mr. Shailendra J. Anjaria, wrote a letter explaining its concerns and requesting that they be conveyed to the readers of the conference volume. The relevant portion of his letter reads as follows:
The discussion by Mr. Sachs of the IMF's relations with Russia both understated and misconstrued what has been done. The IMF began meeting with the Russian authorities while the U.S.S.R. was still extant, dispatched a major mission to Moscow immediately after President Yeltsin's October 28, 1991 speech, and has worked intensively with his government ever since. In all but one of the past 18 months there has been a Fund mission in Moscow providing policy advice and developing the data base essential to providing financial support. The Fund office in Moscow has also been expanded to four resident representatives. The IMF relies primarily upon headquarters-based staff to do country analyses for the good reason that decisions on economic assistance require thorough preparation and discussion at headquarters, not just in the field. Also, of course, I believe it is important that international and other external advisors not unnecessarily monopolize the time of senior country officials.

The IMF is exerting every effort to help the Russian authorities to develop an economic stabilization and reform that would make large-scale financial support from the IMF and other international institutions and bilateral sources effective. The $1 billion standby arrangement approved in August 1992 was an important early step, intended to bolster Russia's rapidly disappearing reserves and to lead quickly to larger and longer term financial support as reforms took hold. Unfortunately, some of the key policy elements of the Russian economic program were abandoned or diluted almost as soon as the standby was approved. Despite strenuous exertions by all parties in the ensuing months, a new program was still not in place as of April 1993. The problem has not been a shortage of IMF staff in Moscow, nor the admitted difficulties in accurately projecting the Russian balance of payments (Mr. Sachs' statement confused and exaggerated this issue by relating off-hand conversations completely out of context). The central problem has been the inability of the Russian authorities to make or implement credible commitments to control money and credit expansion and the fiscal deficit.

I think all reasonable observers will agree that what has to be done is well known by now, and the decisions needed to put sound policies in place have to be taken in Moscow, by Russians not by advisors from abroad. This institution's responsibility is to encourage this sensitive consensus-building process, often in difficult conditions—a point that appears not to have been fully grasped by Mr. Sachs in his statement.

Jeffrey Sachs asked for the right to reply to these comments, and has submitted the following rejoinder:

The IMF vastly underestimates the importance of timing in successful reform. Despite working "intensively" with the Yeltsin government, it did nothing in November 1991 to head off a disastrous debt deal imposed by the G-7. It did nothing at the end of 1991 and the start of 1992 to warn the G-7 about Russia's urgent financial needs. It did nothing to make the $24 billion announcement in April 1992 into an operational program. It seriously misadvised Russia on the reorganization of the ruble zone at the start of 1992. And it apparently still believes that four staff members on the ground in Moscow can somehow fulfill its vast responsibilities in Russia.

The IMF's delays and inattentiveness contributed materially to the loss of momentum of Russia's reforms in 1992 and to Gaidar's fall by the end of the year. The IMF might reflect on the fact that when Macy's declared bankruptcy in January 1992, the same month that Gaidar launched Russia's radical reforms, the department store received an immediate standstill on debt service, and two weeks later received a working capital loan of $600 million. It took the West 18 months to grant Russia a debt standstill in the Paris Club, and the IMF money, remarkably, came with the condition that it be held in the bank and not actually used to finance imports!

The IMF's performance has not been properly scrutinized. Under current procedures, detailed and independent scrutiny is all but impossible. All IMF operational documents, including IMF advice as well as the terms of the loan agreements, are treated as confidential in perpetuity. Maybe the IMF's continuing involvement with Russia will be the occasion for glasnost on 19th Street.