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From shock to therapy

Post-communist transition and the Washington consensus

Ten years ago, when the post-communist transition to market economy and democracy begun, so-called ‘Washington consensus’ was thought to represent the received wisdom on the proper way to step from stabilization to growth. According to this belief a tough financial policy, accompanied by deregulation and trade liberalization, would be enough to eliminate stagnation and launch economic expansion. The proposals for reform based on this reasoning were used to address structural crises in various regions, despite the fact that they had been developed mostly as solutions to problems in Latin America. This orientation in policy reform have had an important impact on the course of the post-communist transition, too.

The policies of the Washington consensus were not drafted in order to solve the crisis in post-communist countries entering a period of transition toward a market economy. The early consensus was actually aimed at distorted market economies. For this reason, nations facing other challenges have never found satisfactory answers to their most pressing questions in the Washington-backed policy. Its interpretation vis-a-vis the post-communist countries suggests that it would be sufficient to liberalize prices and trade and then fix the financial fundamentals, and - of course - privatize the state assets. The faster and more, the better. Subsequently, growth should occur and be sustainable. Unfortunately, it has not been the case.

Such approach has partially failed with respect to the transition economies because it has neglected the significance of institution building even when the other fundamentals are by and large in order. This oversight explains why so many Western scholars did not at first properly understand the true nature of the challenge. Institutions can be changed only gradually, and they exert a very strong influence on economic performance. It was quite naive to expect robust economic growth so soon after the fundamentals (but not the institutions) were in place. In fact, in the real economic affairs, it is not possible to sustain fundamentals if they are not backed by solid institutions.

Rapid growth was anticipated because it was assumed that market institutions, if they did not appear out of thin air, would rise up quite spontaneously the 'day after' liberalization and stabilization. However, the 'day after' liberalization and stabilization was even more depressing than the 'day before'. Because of the neither plan, nor market systemic vacuum, productive capacity was being employed even less; savings and investment were declining, and instead of rapid growth there was rapid recession. The lack of appropriate institutions turned out to be the key element missing from the transition policies counseled by the Washington consensus. Liberalization and privatization, unsupported by well-organized market structures, generated not sustained growth, but a lengthy period of contraction. This was not an inherited problem; it was the result of poor policy.

Under some circumstances, the reasoning of the Washington consensus may be relevant in dealing with the challenges faced by distorted, less-developed market economies. However, in these economies, market organizations have already been in place for years. The post-communist economies possessed no basic market organizations, since such organizations had not existed under the centrally planned regime. Therefore, because the absence of these organizations had apparently gone unnoticed until after the beginning of the transition, the market had no place to set roots and grow. Especially if the liberalization was rapid and the privatization radical, but in other cases, too, there could be no adequate and timely positive supply response. The misallocation of resources and of investments merely continued, although now for different reasons. This has been the main cause of the great transitional depression, lasting so long (even the whole decade in Russia and Ukraine) in several post-communist countries

The economic policy orientation based upon neoliberal monetary orthodoxy had a tremendous influence on the course of changes in Eastern Europe and the former Soviet republics, as well as in the Asian socialist economies, but from the results it appears as though these nations did not all draw the same policy conclusions. A number of less-developed and transition economies realized quickly that there can be no sustained growth without sound institutional arrangements. Especially Poland was able to move from ill-advised early „shock without therapy" to therapy without shock in 1994-97, when this country GDP grew by 28 percent under the well-known program „Strategy for Poland", in which the implemented policy not always had followed the IMF orthodoxy. An attempt to return to it after 1997 has slowed down the growth again and caused growing social tensions.

Yet lessons are learned and since the mid-1990s the IMF and the World Bank have been paying more attention to the way market structures are organized and to both the institutional and behavioral aspects of market performance. Now they know that liberalization and institutional organization are both required for the market and economic growth. Because of the bitter experience of transitional contraction it has become clear that there will be no sustained growth unless the sound fundamentals – a balanced budget, balance in the current account, low inflation, a stable currency, liberalized trade, and a vast private sector – are supported by appropriate institutions. Indeed, they do matter even more than stabilization.

There is now a consensus that the Washington consensus ought to be reconsidered, revised, and adjusted to reflect the lessons learned under real conditions. Both the Russian malaise and the Polish success prove that such revision is necessary.

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