



POLITICS AND MARKETS

A dialogue with Jeffrey Sachs on economic reform

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The 1980s saw what seemed to be a triumph of capitalism and democracy, producing a consensus that human progress can develop only with political and economic freedom. Freely elected regimes replaced dictatorships in many countries of Latin America, the former Soviet empire and Africa. Many countries launched economic reforms to eliminate crippling distortions by freeing market forces. Institutional blockages in Brazil and Russia now paralyse economic policy. Both countries began 1993 under threat of hyperinflation as they seek alternatives to failed political systems. A leading advocate of economic reform over the past decade is Professor Jeffrey Sachs of Harvard University, a founding member of the Fernand Braudel Institute of World Economics, who since 1985 has advised governments in crisis in many countries: Bolivia, Poland, Russia, Costa Rica, Slovenia, Mongolia, Estonia and Peru. Youthful in looks and style, Sachs often provokes intense political controversy over the orthodox solutions he proposes for the economic disorganization embodied in chronic inflation surging into hyperinflation in many countries during the late 1980s and early 1990s, as well for his recommendations for international financial assistance and debt reduction to support orthodox reforms. He will participate in a special seminar on hyperinflation in Brazil and Russia on April 14-16, 1993 and in an international conference on Governability, in May 1994, both organized by the Fernand Braudel Institute of World Economics in So Paulo and other Brazilian cities. These meetings will focus on problems of managing scale in big cities and countries and on the survival of complex societies. Braudel Papers publishes here a dialogue between Sachs and Norman Gall, executive director of the Fernand Braudel Institute of World Economics, on the prospects for economic reform as a way of reversing impoverishment and disorganization.

GALL: Why are both Brazil and Russia threatened by hyperinflation at the same time? Are there common underlying causes?

SACHS: Both Brazil and Russia are in deep crises of the state. Hyperinflation is always produced by a collapse of state finances: large public deficits leading to monetary instability. You have to ask why the financial system is allowed to go to such extreme chaos. The answer almost always lies in deep deficiencies in the political system's capacity to address difficulties arising from the role and workings of public finance. Brazil and Russia show similarities of huge countries and regionally disparate societies attempting to manage a transformation from a failed state-lead model of industrialization to a workable democratic model of a more modern economy. In both countries this transformation is proceeding with some successes but with big problems. In both Brazil and Russia the state took on excessive responsibilities. This was carried to extreme and insane dimensions in the Soviet Union, where the state took on responsibility for everything and became a totalitarian monstrosity. Brazil also adopted a model of economic development in which the state controlled the economy to a large degree and operated many of its productive units. This development strategy eventually led to economic disaster for two reasons: First, it was based on very naive economic ideas. Second, the system became so corrupt that the role of the state itself

became more a vehicle for transferring income to privileged groups, a parasitic organism draining the health and wealth of the economy, rather than an effective agent of economic development.

GALL: Consumer price increases in 1992 of roughly 2,000% in Russia and 1,150% in Brazil. Each is a continental nation of roughly 150 million people having trouble managing problems of scale over huge territories. Both countries suffer from chronic inflation that erodes living standards, disorganizes public finances and weakens institutions of social protection. In each country, political power rests with a national Congress now blocking reforms to end the bankruptcy of the state and the disorganization of the economy. Past authoritarian regimes, the military in Brazil and the Communists in Russia, created the political structure of both Congresses as part of their efforts to control the transition to more liberal systems. Leaders of both Congresses fear hyperinflation much less than they fear loss of their privileges and political power, derived from warped electoral system.

SACHS: Russia's inflation rate for 1992 was higher than Brazil's in part because of Russia's deliberate policy of price liberalization that yielded inflation of 250% in the single month of January 1992. In the old Soviet system, the money supply had been swelling out of control. The budget deficit in 1991 was around 25% of GDP. Until January 1992, inflation had been repressed by price controls. So the only place you really saw the hyper-inflation was in black markets. In January, the repressed inflation was opened by freeing prices. At official prices, all trade was collapsing. No one was selling in the official networks anymore. There was a frightening problem of inability to get grain to the cities to make bread. So the government feared that unless prices were liberalized, there would be more wreckage of the system, because money was ceasing to have any use at all. After that initial jump of inflation in January 1992, which let out all of the steam from the monetary system, inflation was high, but coming down from roughly 40% in February, to 30% in March, to about 20% in April, and 12% in May. But then intense political pressures led to more printing of money, for bailouts of enterprises that couldn't make it at the new prices. By the start of 1993, Russia was on the brink of hyperinflation. If hyperinflation comes back, there would be political devastation in Russia. If the government can't provide a working monetary system, a working payment system, a mechanism for international trade and some basic stability, resource rich regions of Russia will accelerate their move to leave the Russian Federation. We already see tremendous pressures in the oil and mining regions. They ask: "Why should we be part of Russia? We want an independent state. We want freedom from the tax system. We want to set up our own free trade area, have our own taxes and not pay taxes to the center." The territorial integrity of Russia is at stake. It is likely to collapse if the government can't supply the minimal public goods that any state is supposed to provide. This is the test of governability. This could mean the end of democracy because there are important groups in the society, the Red Army and others, that would seize upon this as a cause for political reversal. So avoiding hyperinflation isn't merely a matter of economic efficiency, or living standards, or of reforming sooner or later, or providing stability for foreign investment. It's a test of the governability of the country. If this test can't be met, new democratic institutions are not likely to survive.

GALL: I'm sure that President Boris Yeltsin understands this. How much does the rest of the political community understand this?

SACHS: There is less understanding of this in Russia than in any other place that I've ever worked. That's why there's such a virulent attack on mainstream economics and such great confusion. Populist politicians voice scorn for policies that are essential for the survival of their country. You have such politicians in Brazil, Peru, Bolivia, Argentina and in many other places. But I've never seen so many of them as in Russia. Unlike Brazil, which has been talking about inflation for decades, Russia for 75 years had no notion of money as an object of policy. Money was a technical instrument, basically subordinated to the central plan. So ideas of monetary economics, budget deficits fueling inflation, the inflation tax, seignorage, financial instability, were neither on the political agenda nor the intellectual agenda. They are on the agenda now because failure to do these things would lead to the

complete breakdown of even the most primitive division of labor in Russia. I saw it happening in the autumn of 1991. Not only were shops empty. Factories refused to trade with each other. Grain wasn't coming in to the cities. When a shoe factory wanted to sell its product, it drove its truck out to the state farm to barter shoes for meat to feed its workers. This is a collapse into primitive exchange. This couldn't support an economy of \$300 per capita income, level of India or sub-Saharan Africa, let alone Russia's \$1,000 or \$2,000 per capita income. This was a grave risk to the basic social order. Who understands this? Keynes was right when he said that one of the most insidious aspects of inflation was that it could wreck a society in a way that not one man in a million could understand. What he meant was that while monetary dynamics could be analyzed, as he did so brilliantly in his 1923 tract on monetary reform, almost nobody else really understood what was happening them. It's very hard to explain in a highly politicized, polemicized environment. Russia is a big country, a diverse country. It's hard to find the levers and mechanisms to carry out policy. It's so easy to attack, so easy to blame the finance minister. This is a very confused situation, and a very dangerous one.

GALL: Do you feel that Yeltsin is losing political power to the hardliners?

SACHS: As your question suggests, the problems are more political than economic and social. This is not well understood outside Russia. The pressures on Yeltsin are not coming from the grassroots. There has been no insurrection against economic reforms. Nor has the pressure come from economic collapse of the economic reforms. The pressure comes from the fact that political liberalization has not gone far enough. While he heads a radical reform government as the first Russian leader elected in 1,000 years of Russian history, Yeltsin still faces legislative bodies and a bureaucracy that are holdovers from the old system. The hardliners are not able to win complete victory right now in part because they do not reflect what the society wants. They say they do, but they don't. On the other hand, Yeltsin has not been able to win big victories because the political establishment is entrenched against him. The People's Congress was elected under the one-party system and is filled with party hacks. This stalemate is dangerous for Russia and one reason why basic macro-economic stability has not yet been achieved. It is a warning of political failure in the future. The way to solve the political problem is not to compromise the reforms but to move forward to further democratization starting with local elections, which I think would undo much of the grip on power of the old nomenclatural system. Then national elections should be held for a new legislative body. Fuller democratization will create uncertainties of other sorts. But it is the way to resolve today's political paradox. The political stalemate has increased the risks of open hyperinflation. The hardliners now give easy credits to the military-industrial complex. The money supply is growing at about 30% a month, fueling a big resurgence of inflation. Hyperinflation breeds more political and social instability. Society accepts the need for changes much more than the People's Congress. The way to overcome this resistance now is to exercise responsible economic policies and to back that up by more movement toward political democratization.

HYPERINFLATION AND GOVERNABILITY: A CONFERENCE The Fernand Braudel Institute of World Economics is organizing an international conference on Governability, sponsored by the United Nations, to be held in Sao Paulo and other Brazilian cities in two phases during 1993 and 1994. The first phase will be a seminar on The Threat of Hyperinflation in Russia and Brazil, to be held in Sao Paulo, and Joinville on April 14-16, 1993, supported by the newspaper O Estado de S.Paulo, and Grupo Brasmotor. The second phase will take place in May 1994 in Sao Paulo, and another Brazilian cities. We will be focusing on problems of managing scale in big cities and countries and on the survival of complex societies. Among the speakers are Professor Jeffrey Sachs of Harvard University; former Russian Prime Minister Yegor Gaidar; Rubens Ricupero, Brazil's Ambassador to the United States, who is president of the Fernand Braudel Institute of World Economics and was president of the Council of GATT until 1989; Norman Gall, executive director of the Fernand Braudel Institute of World Economics; William Waack, Moscow correspondent, O Estado de Sao Paulo; Dr. Professor William McNeill of the University of Chicago; Roberto Macedo, of Universidade de Sao Paulo and former Secretary for Economic Policy, 1991-92.

GALL: There are striking differences between Brazil and Russia. Russia remains a major power, as it has been for the past three centuries, while Brazil's role in the world economy and power structure, rooted in European colonialism, remains marginal. Russia's education system has produced a large surplus of high-level specialists, while Brazil suffers from desperate shortages of trained manpower. Despite enormous fiscal distortions, Brazil remains a functioning market economy, with sophisticated financial institutions that, in a way, have worked to hold the country together despite these crazy fiscal transfers. However, Russia and other former Soviet republics face the daunting task of creating modern markets while at the same time dismantling the parasitic bureaucracies running the state system of production, distribution and credit that has caused crushing welfare losses. We now can see the difficulties of big countries in managing problems of scale. How would you envisage economic reforms in a big country like Brazil?

SACHS: One obvious point is that reform in big countries is vastly more complex than reform in small countries. There is a basic reason for this. In small countries, the reform can be imported in two ways. One is that a great deal of successful reform in small countries is simply opening up the country to the international environment as the key organizing principal of the economy. International trade, trade in technology, trade in capital and so forth, is the greatest single engine of economic conversion for poorer countries to catch up with richer countries. When you are a small country, thus potentially open to international trade, the needed economic strategy is simpler. When you turn to a country like Brazil or Russia, while international trade can play a role, it is not going to be the key to economic change. It is going to be important, but not the fundamental organizing principle of reform because big countries are more self-sufficient. The second point about big and small countries is that small countries import ideas much more readily than big countries do. Importing ideas into a big country like Brazil is much harder. Brazil is the country in Latin America that has participated least in the sea change of international ideas about the state and the private sector and the nature of political economy in the last 15 years. Ideas about liberalization and privatization have come to Brazil more fitfully. You still have leaders in Brazil that still espouse old, flawed and failed policies. This is less likely to happen in small countries. It's hard to give a blueprint because Brazil has so many different problems. The model of state-led industrialization has failed, so basic ideas of liberalization and privatization are very relevant for Brazil. Clearly, the public budget has been viewed as a grab-bag for political interests for decades. The political system has led to the bankruptcy of the state and its inability to meet basic social needs. Brazil needs a political system that is democratic, yet protects the fisc against special interests, whether sectorial or class-based or regional. Brazil has one of the most unequal income distributions in the world. There is no medium- or short-term remedy. Revolutionary solutions are even more disastrous. Bad income distribution dramatizes the need for an adequate educational system, health care system and infrastructure development. But the government is bankrupt and unable to manage. One idea that all big countries come to in the end is the need to decentralize. A better fiscal federalism puts many of these tasks on a local level. Big countries can barely function from the center anymore. China's success, to a great extent, has come from decentralization. A key for Russia's success in democratic and economic reform will be decentralization of the political system and shifting fiscal responsibilities from the central government to the regions. This also can play an important role in Brazil, because the central government cannot cope with the complexity of the current problems, nor avoid the political pressures for state spending in the present situation.

GALL: In a number of countries, among them Brazil, the modernization process that has taken place over the last few centuries is being undermined by inability to manage problems of scale. Do decentralization and privatization represent an effort to eliminate or reduce these problems of scale?

SACHS: Absolutely. Many of the ideas of liberalizing and privatizing economies are actually survival mechanisms for the state as a political institution. A lot of what is involved in the current reforms is protection the state from destructive self-abuse. One main reason for privatizing or liberalizing an economy is simply to take the government out of the

political line of fire for responsibilities which it cannot manage. It can't manage them administratively, technically nor politically. A democratic state cannot assume responsibility for managing the millions of interactions that take place in a society. When a democratic government is put in the middle of conflict, it tends to respond by abusing public finances, papering over problems in the short run but leading to ultimate state collapse in the long run. Radical economic reform is a radical way to try to enable the state once again to try to perform its core functions, providing basic internal physical stability, an end to physical violence, a basic public order, a working monetary system, and a set of social institutions to prevent destitution, starvation and public health disasters. The economic disasters in Brazil and Russia happened in part because the state has been overwhelmed with a thousand other tasks that it simply can't manage. Shedding these tasks, getting rid of them as rapidly as possible, isn't motivated mainly by economic theory, but by the need for a working political model in which the state is able to focus enough attention on its core functions so that these basic needs can be met. Decentralization, privatization, liberalization are all attempts to divest the state of responsibilities it cannot now fulfill.

GALL: From where we sit here in Brazil, observing the high inflation economies in Latin America and seeing many monetary gimmicks and monetary fiascos, one is tempted to say that monetary policy doesn't exist. The only policy that counts is fiscal policy. Germany, the United States and Italy, among other rich countries, have very serious fiscal problems. I think that monetary policy was used in the United States in the early 1980s to mask and cushion the impact of bad fiscal policy. What do you think of this proposition?

SACHS: There is an important idea lurking there. The hard thing for democratic societies to manage is fiscal policy. There are very deep institutional and political pressures that lead to rampant fiscal mismanagement in Brazil. I would not go as far as you do, however. At a technical and a management level, there is certainly a distinction between monetary and fiscal policy. It's possible to go for years with a tight monetary policy and a loose fiscal policy. The United States did it in the 1980s. Therefore, from an analytical and policy perspective, it is not true that the two are really the same. However, they obviously are linked over several years in all countries. They're certainly linked even in the short run in most developing countries. The critical issue is that, in developing countries, there is a very limited capacity to finance budget deficits outside of monetary instruments. In some countries, the only way to finance budget deficits is simply by borrowing from the Central Bank, or from the banking system. Elsewhere there can be other ways to finance the budget deficit using very short term debt instruments. Even then, these debt instruments are kind of a "quasi" money. So it's almost like using a "near" money to finance the budget deficit. This raises many technical issues. Your underlying proposition --that the deep problems tend to be fiscal problems and that monetary policy can't solve the fiscal problems-- is absolutely correct.

GALL: Income distribution is much discussed in Brazil, among other countries. In the 1992 election campaign in the United States, experts talked of a political backlash and a popular revolt against the concentration of income that occurred during the Reagan-Bush years. I wonder whether the management limitations of governments make it feasible for them to influence income distribution without creating such distortions in economic activity that will be very costly later.

SACHS: It's a complicated question. During the 1980s income inequalities worsened in the United States. Higher income groups had more economic growth and increases in living standards. Poorer groups suffered losses in real income. When we look for causes, we don't find satisfactory answers. However, one must say that these changes reflected market forces more than government policy during the 1980s. This is a controversial view because the Reagan Administration was intentionally and provocatively against any kinds of income support for the poor in a decade when the poor did worse. One is tempted to blame the Reagan policies, but the trends seem deeper than this. They reflect the market returns to education where skilled workers' wages rose much faster than unskilled worker's wages. Demand for trained workers grows faster than the demands for unskilled workers, widening

the gap between the skilled and unskilled. This seems independent of government policies. Now, I wouldn't want to leave the Reagan Administration and its neglect out of the picture. Government does have an important responsibility here, but of a limited sort. That responsibility is to provide the kind of education and health care that gives a chance for the lowest income groups to develop the human skills and human capital to be able to take advantage of the demand for skilled labor. There the policies in the United States have been inadequate in the last 10 years. Preventive health care in the cities could be vastly improved. We would have a big social return for giving more prenatal care to prevent low weight births which have a devastating effect on whole lifetime profiles for poor people who then require huge budget outlays for the society for decades into the future. These future expenditures could be reduced by well-targeted and generous support for poor pregnant women. There's no question that enhanced preschool educational opportunities, so called Head Start Program in the United States, provides real opportunities for helping the poor get onto a track for better skills and education. All of this has been neglected. Although this would not have overcome the trends of the 1980s, it would have done two things: First, it would give more assurance that in the long term the income chances of the poor would be more open to their choice rather than to their circumstances. Second, much greater attention to health and education would help keep our society together. This is the crisis that the U.S. is now experiencing in its politics. The social mood reflects the fact that, whether or not Reagan's policies caused this widening of income inequality, there's no question that neglect of inequality has led to widespread perception of growing class conflict in our society. Divisions that always existed have worsened. Society must learn to cooperate. Our political leaders must continue to tell us that we're all part of the same society and that we benefit enormously when all members of the society partake in the benefits of economic activity. The idea that this can be neglected by the state, which really was the ideology of much of the Reagan Administration, is disastrous. It has bred cynicism that is dangerous for our political stability.

GALL: What can Brazilians do about their income distribution problem, which is much worse than that of the United States?

SACHS: Brazilian income inequality is perhaps the worst in the world. When one looks at the official statistics and looks at the gap between the rich and the poor, the share of income going to the top 10 % of the population divided by the bottom 40 %, Brazil ranks about the worst in the world right now. This is a part of the continuing inability of Brazilian society to reach basic consensus on direction of social and economic development. There is no miracle cure. Direct redistribution to close this gap would be disastrous. While revolutionaries may dream of overcoming these divisions by radical means, history shows that such methods not only fail, but damage future generations. The populists dream of doing this just by printing money to give to the poor. That venture is doomed to fail. It creates such political and social instabilities that the backlash and uncertainties created by populism do more damage to the poor than any short-term help that they get in this way. What Brazilians have to do is take careful account of this in an honest and nonpolemical way and to address inequality through long-term policies of the sort that I was mentioning. Development of human skills of the poorest is, without doubt, the only lasting solution.

GALL: What if there are not enough people to teach the poor these skills? This is the classic problem in Latin America. It may not even be a problem of monetary resources. In Europe, an educational system to be able to staff a bureaucracy began in the 12th century. It was only until the late 19th century that a critical mass of skills was formed in Europe to allow Britain, the most advanced country in Europe, to legislate universal public education. Now, in Latin America, they're trying to do this in one generation with tremendous failures. I think that this is a desperate problem, but it is not an easy to invest in skills when there is a massive shortage of skills both on the production side and on the education side. Eastern Europe and the ex-Soviet Union do not face a problem of this kind.

SACHS: It's a totally different phenomenon because of virtually universal literacy in Russia and very high levels of education. There is no miracle answer. But if the government were to

get out of the business of running industry, get out of all the things that it has been involved with unnecessarily, deciding whether somebody can buy a computer in Brazil and so forth, it could do much better in developing education. I recently supervised a doctoral thesis of a Colombian economist, Juan Luis Londoo, who studied what now seems to be a powerful trend towards improved income distribution in Colombia over the past 40 years. We studied the possible causes for this historical trend in Colombia. It seems clear now that the turning point in Colombia's income distribution came in the end of the 1950s and the early 1960s, when the Colombian government made big investments in primary education, a fundamental part of the country's development strategy. Skills of the poorest people were improved. So we shouldn't despair. Even in Latin America, some countries are far advanced along this path. I'm sure that Brazil, despite great difficulties, could do better than it has been doing.

GALL: In discussing social justice, an ugly word can be used here, which is parasitism. Few people pay taxes or adequate fees for the public services they receive. It's not just the rich people getting special deals from the government, such as favorable exchange rates, or lower interest rates or special subsidies. In Brazil, half of the people on retirement pensions are under 50 years old. The social security system is bankrupt, so it can't pay decent pensions nor meet its medical care obligations because so many people --doctors, pensioners, real estate speculators, contractors and politicians-- are living illegitimately as parasites on social security funds.

SACHS: In Poland I'm often attacked for not caring about the social cost of reform. The fact is that in many areas, the so-called social safety net is strangling the economy. Some parts of Poland have the highest ratio of disabled pensioners to total population of any place in Europe. Looking closely at the situation, many of them aren't disabled. They are on the public dole because of patronage politics in local regions. The whole system worked in a corrupt and abusive manner. In many societies, not just Brazil, the public treasury has been raided by acquired rights that drain the public sector of its vitality. You see it in Italy now, which is in deep crisis because of decades of patronage politics, with lots of young retirees, so-called disabled pensioner and so forth, just like in Poland. You see the same thing in Brazil. It's deeply entrenched and very hard to change without strong executive leadership, the lack of which has been Brazil's curse in recent years.

GALL: Everyone talks about the social costs of stopping inflation. Bolivia is much poorer than Brazil. What happened there?

SACHS: When I first got to Bolivia in 1985, annualized inflation was 60,000% over the previous six months. I gave a speech to a business group, pointing out that this was not only the seventh highest inflation in world history, but also one that with appropriate measures could be ended quickly, as most hyperinflations end. Someone from the audience asked: "But what about the devastating social costs of doing that?" I was stunned at the question. I was stunned because the social costs of not doing it were so great. This really was a case of survival in the most literal sense. Failing to stabilize at that point truly would have meant a destruction of the most basic standards of living. Moreover, much of what fueled the hyperinflation at the time was a scam. It wasn't the poor that were benefitting from the hyperinflation. It was those who understood how to use the system, those who had gotten cheap loans to build houses, and ended up paying back pennies to the dollar on their loans, those that were able to get favored access to foreign exchange, or those who were able to buy flour cheaply, that the government was selling on the theory of subsidizing bread. They then exported the flour at world market prices, over Bolivia's many porous borders, to all its neighbors, thus capturing an enormous amount of income that bred all the printing of money, fueling the hyperinflation, that was needed because of the huge budget deficits, opened up by these subsidies themselves. So this was a case where the hyperinflation was devastating the most vulnerable parts of the society, where the direct budgetary expenditures that were being paid for by printing money, more often than not were going to the least deserving parts of the population, and where the whole society had been viewed as being run by cheating. So to be asked about the social costs of stopping the inflation, rather than the

total social devastation of failing to stop the inflation, represented a mind-boggling misunderstanding of the circumstances in which they were living.

GALL: What's happening in Bolivia now?

SACHS: Bolivia still is a very poor country, but its economy and political system are much stronger now as a result of economic stability and sound policies. It has benefited enormously in recent years from becoming a consolidated democracy with a basic consensus for an open market economy integrated with the rest of the world, with a financial system that is transparent and responsibly managed and a government of modest size that is professionally and transparently managed. Bolivia is now in its sixth year of low inflation, about 10% for this year and in its sixth year of economic growth. Per capita income has been growing at about 2% yearly. Overall GNP growth is about 4% a year. Bolivia is no Asian tiger. Bolivia's growth rate now is at its long-term trend and with real prospects of increasing in the future. It now has a serious government and a reformed political system and a good prospect of continued democratic development and constitutionalism. Bolivia formally has a Presidential system. But it wisely moved to a kind of quasi-parliamentary system since 1985. Successive Presidents recognized that they can't really govern alone, that they need a working majority in Congress. So two governments formed a coalition to get that working majority. It started in 1985 under President Victor Paz Estenssoro (1985-89) with General Hugo Banzer. That allowed them to carry out the stabilization program. Since then, President Jaime Paz Zamora (1989-93) also governed in coalition with Banzer, who will run for President with Paz's backing this year. The Bolivians expect another coalition after the June 1993 general election. So the political system works on parliamentary norms now. A President builds a working majority in Congress and forms his cabinet from that majority. It seems that they have found a Bolivian-style working democratic order. Expectations in Bolivia are strong that the Presidential-Congressional democratic stability will be maintained.

GALL: At one point it seemed that Brazil's new President, Itamar Franco, was groping toward this kind of thing.

SACHS: The Bolivians kind of discovered it in the sense that it is not prescribed in the Constitution and they have little historical experience with democracy. I should add that a country like Bolivia is only going to really make an economic breakthrough when its neighbors are healthy as well. The most depressing factor for Bolivia's medium-term prospects is the continued disorder in Brazil.

GALL: Some respected Brazilians say that the only way to break the political impasse and reorganize the system is to let the hyperinflation happen.

SACHS: That's very dangerous. It's like letting your four year-old child play in the middle of a busy street so he can learn the rules of traffic.

GALL: Over the past two or three centuries, improvements in human welfare and life-expectancy have been associated with increasing investment in basic infrastructure, especially in transportation, communications, water and sewage systems and education. In some countries the infrastructure now is going to hell. Why is public investment stagnating or declining now in both rich and poor countries?

SACHS: In many countries, a deep fiscal crisis plagues governments bedeviled by large budget deficits for years. To sustain these deficits they incurred heavy debt burdens. Many of these deficits came from bankruptcy of state enterprises, ill-considered increases in social spending and vast overgrowth of the state. Because of these huge budget problems, governments all over the world have cut back sharply on investment in infrastructure, on transport, communications, energy, public health. These cuts have been harmful to public welfare. In some countries, like the United States, this problem is not the overspending of the state, but the undertaxing of the state, compared with the level of the normal public services that U.S. citizens would like to maintain. Elsewhere, countries have tried to

maintain public spending above levels that are sustainable in the long term. In either case, you have a weakening of infrastructure investment. Economists that have examined this in the U.S., where it's been studied most closely, believe that the decline in public investment spending in the U.S. is a significant contributor to the poor economic growth in the last 10 to 15 years. In Latin America and Eastern Europe and Russia, even without such careful calculations, it's clear that collapse of infrastructure spending is not merely depressing economic growth, but is reducing living standards of the population.

GALL: Whether you talk of undertaxing or overspending, you're talking about a big transfer from investment into consumption, which impairs the capacity of some countries to operate complex societies. It affects poorer countries more than rich countries because their reserves of functional capital are smaller. Do you see a growing awareness of this problem? Do you see a movement towards greater public investment or more decapitalization before this problem is faced?

SACHS: The first phase of recognizing this throughout the world came when governments were hit by consequences of deep budgetary imbalances: mainly hyperinflations or high inflations and debt distress. The first reaction was a more or less generalized cutback in government spending. A very crude meat cleaver, which is often the only thing that can be done in a time of crisis. This first phase of reaction can last five to 10 years. It is not a discriminating reaction in which governments cut back in some areas and increase spending in other ways, but an across-the-board cutback in general government spending. Some cuts are merited and some are very costly in the long-term. It takes years, perhaps more than a decade, to reorient spending away from activities that can't be managed and toward needs that must be addressed. That process of deep structural change is underway right now. No reforming country in Latin America, and certainly none in Eastern Europe or the former Soviet Union has completed this process of going beyond cutting back the state to making its role more manageable and efficient. This now is happening in several ways. Budget deficits are coming under control in much of Latin America and in much of Eastern Europe. Governments are trying to shake off the vast range of activities in production and in intervention in the industrial economy that they took on for 40 years. This is crucial for adopting the new rules. While this move to get out of old activities is taking place, progress in restoring priority to core infrastructure is just beginning. It's happening in two different ways. Governments are opening many of these traditional infrastructure areas to private activity where capital is available. So privatization of former state activities, not just in production, but also in provision of services, in health care, in pensions, even in areas of social security, are ways that states can overcome their limited capabilities. You see telephone companies being privatized all over Latin America. Secondly, after the first phase of general retrenchment, some governments are starting to put more money into public health and other core areas. But the reform of those areas and adequate financing for them really hasn't occurred in most of the reforming countries yet.

GALL: What are the most shocking examples of the decline of infrastructure that you've seen in Eastern Europe and the Soviet Union?

SACHS: The degradation of the public health and environmental protection in Eastern Europe and the former Soviet Union have led to a public health disaster. The hospital system in Russia has collapsed. With some emergency assistance, at least minimal care may be maintained. Russia was on the verge of running out of insulin earlier this year. Many hospitals are without basic supplies.

GALL: In Venezuela, hospitals are being closed for lack of water, as are many in the Soviet Union. In Caracas one of the world's largest maternity hospitals was closed after years of mismanagement and lack of maintenance of equipment. Incubators for newborn babies were in disrepair for simple problems. They were piled up in the basement of the hospital and couldn't be fixed because of simple administrative problems. They couldn't run lab tests because somebody had stolen the plug of some of the machines in the laboratory and nobody had gotten another one. So blood tests and other laboratory tests were stopped. The collapse

of the public health system in Latin America may be a decade behind the Soviet Union in this kind of trouble. But it's on the same path. for us. In both Eastern Europe and the former Soviet Union, there have been big increases in both in adult and infant mortality in recent decades. Our work at the Fernand Braudel Institute of World Economics develops the idea that a major shift is taking place, from a political economy of entitlements, or acquired rights, to the political economy of survival. We don't fully understand what this means yet, but we know that humane outcomes can come from this change, only with an increase in the level and intensity of cooperation. In danger are the great gains in the survival of individuals and communities, which mankind achieved in the past two centuries. These gains may recede if the kind of disorganization that we see in Eastern Europe and in Latin America is allowed to continue. Are instincts for survival being awakened?

SACHS: Yes. Some observers claim that Chernobyl was really the greatest single force that opened up the system, and led to the end of Communism. An environmental catastrophe activated the sense of survival. When I first started traveling to what was then the Soviet Union and talking to young economists in 1989 and 1990, they were concerned that the milk that they were feeding their children was poisoned. What could an individual do about it? Their families were condemned to live with poisoned air, poisoned food, poisoned milk, poisoned water. This was devastating psychologically. The most urgent of the forces that led to the end of Communism was the widespread perception among the people, and an accurate one, that the system was destroying them. Unfortunately, the old system has great momentum, even after the political changes. The great political fights in Russia now continue to be between the industrialists who want to keep this industrial machine going, irrespective of what it's producing, why it's producing, and what kind of damage it's doing. They now are opposed by the reformers who say that our goal no longer can be industrialization, as fast as possible, and at any cost. This battle continues today, with the industrialists generating enormous political pressure, that could undermine the basic financial stabilization that is the cornerstone of the first phase of the Russian reform. There is great drama in all this. But I also want to stress the positive side. Postwar history shows that the combination of macroeconomic sanity and integration with the world markets is a powerful recipe for reversing economic decline and for resuming economic growth. These are simple principles. Their simplicity is one of the reasons that they are so fiercely attacked. But the simple principles of achieving macro-economic stabilization and economic integration has done enormous good for countries that have been able to sustain that course for a long period of time. In Western Europe, you had countries that had been politically isolated from the mainstream, like Spain, which lagged behind the rest of Western Europe and was kept outside cultural, political and economic trends by Franco, at least in the first half of his regime, until the late 1950s. Spain started to re-connect with Europe in the 1960s. The reintegration of Spain accelerated in the 1970s and 1980s, after democratization and joining the European Community. It led to an explosion of creativity, wealth creation and improvement in infrastructure and living conditions. Both Spain and Poland were at the same per capita income levels in 1955. Both were peripheral Catholic countries. For one reason or another --in Spain's case, by Civil War and in Poland's by occupation-- both stayed outside the Western European mainstream after having arrived at a similar level of early industrialization and development. Now Spain's per capita income is four times greater than Poland's.

GALL: Wouldn't you say that a constructive period of incubation took place in terms of the work ethos in Spain under Franco's dictatorship?

SACHS: Franco started to open up in 1959, bringing a fundamental change in direction. By 1962 Spain joined the OECD (Organization for Economic Cooperation and Development), the Paris-based community of industrial countries. By the 1970s, Spain, even under Franco, was already starting its export-led growth. Whenever you see positive economic results, there's always an incubation period that's extremely important. In Poland, there was even an incubation period of a sort after 1980, even during the martial law period. Martial law really marked the end of traditional communist rule in Poland, though it did not end some of the worst features of socialism and authoritarianism. The birth of Solidarity in the early 1980s,

and replacement of the old Communist structure by martial law, opened up space for small businesses, for Solidarity activists who left the official sector and started their own activities. These people started to travel, to debate and publish and to set up their own firms. This phase didn't have the vigor of the incubation period in Spain, but it was something real that gave Poland a head start. It wasn't an accident that Jan Krzysztof Bielecki, the reformist Prime Minister, had himself been thrown out of work because he was a Solidarity activist. He started his own trucking firm, and then his own financial consulting firm in the mid-1980s. He got the taste and flavor of free markets. He became a hardened advocate of liberalizing reforms and of integration with the West. Incubation is important. The idea that whenever you see good results there has been many years of building behind it is very important. Perhaps my greatest frustration in being unable to convey and explain this in a general way. I'm often misunderstood and criticized for advocating reforms that, when carried out, don't lead to immediate bliss. Much of what I try to do is to explain that it's one thing to get in place a decent legal and economic framework, but it's quite another to have it deliver its full fruits. That takes many years of working under the new system, under new social and economic and political relations. You need patience with this, without destroying it all by moving every six months to a new invention, a new kind of economics, instead of following sound principles for improvement and giving them enough time and stability to operate.

GALL: Has Brazil been going through an incubation period, like the one you've described for Spain and for Poland? Do you feel that Brazil's instincts of survival have been awakened?

SACHS: Since the mid-1970s, Brazil has failed to keep a steady course in any consistent economic policy and has failed in stabilization and in opening the economy. It has tried half-heartedly a few times to do this. But whenever there has been a slowdown in production or a rise of unemployment, Brazil's worst instinct decided that that it is time for the Finance Minister to go, and for the new one to come up with a new "miracle." Brazil has been the country most famous in the world for trying to pull off an economic miracle rather than pursuing the hard steady course. This has led to nearly 20 years of bad economic performance in Brazil, after decades of fast growth.

GALL: But Brazil had the world's highest growth rate for the 1970s.

SACHS: Starting in the mid 1970s, you see the failure of Brazil to adjust to higher world oil prices, to a growing budget deficit, a falling national savings rate, to a growing public debt and increasing inflation. Irresponsibility in Brazil's economic policy began in 1973-74. Between 1974 and 1979, it still looked like the old model was working. It was feeding on more for foreign debt, more inflation, worsening public finances, lower savings and less capital-formation. The momentum of the past industrial growth continued, but on a more fragile financial base. That was a very vivid and critical moment for Brazil. It can be compared with South Korea, another developing country, at roughly the same level of per capita national income. that also enjoyed vigorous growth in the sixties and seventies. Brazil and Korea both reached the end of the 1970s with growing financial disorder, with heavy and increasing foreign debt and rising inflation. In the spring of 1979, both Brazil and Korea started an adjustment program. Korea went through a deep recession for two years, for which it was unaccustomed. They persevered, despite political instability in 1980 and a terrible harvest. By 1983, they had stabilized financially and opened the economy substantially, with new exports growing. After a four difficult years of growth below what they saw as their potential, they adjusted and then got much better growth. Brazil started the same adjustment in 1979. But within six months everyone was screaming for the economic team to be thrown out. Everyone was saying: "You are ruining Brazil. We have a recession. We can't have a recession in Brazil. We never have a recession in Brazil."

GALL: This was during Delfim Neto's time?

SACHS: Mario Henrique Simonsen was Planning Minister and Delfim Neto was saying: "Why are we stepping on the brakes? We should be stepping on the accelerator."

Unfortunately, Brazil changed course. The result was a failure to persist in adjusting. A new attempt to escape the problems by rapid growth meant a deeper fiscal crisis and a huge increase in Brazil's foreign debt between 1979 and 1982. Since then, unfortunately, Brazilians have come to believe that nothing works in Brazil, neither orthodoxy, nor heterodox shocks of ten different varieties. So what happens in Brazil is that one policy gets tried for six months or a year. Then the team gets thrown out and a new one comes in. Another policy is tried and given high marks for six months. Then a downturn may start and the new team is thrown out. Brazil is always searching for a miracle, so it has a hard time thinking clearly about the long term anymore. I cite the episode in 1979 as a characteristic case of failing to see through any policy long enough to have it work. The political system doesn't support a long-term view. The vested interests are still powerful in Brazil. It's instructive that Argentina, which had many of these problems for decades, seems to have turned the corner ideologically, even if many problems remain in Argentina. The sense that it's time to get on with real change is present in Argentina, but this feeling is still weak in Brazil.

GALL: Orthodoxy never was tried seriously in Brazil. Our friend, Javier Gonzalez Fraga, former president of Argentina's central bank (1989-91) and a member of our Institute, gave a seminar in Sao Paulo last year about the reforms in Argentina. He said that the Argentines who had the world's worst inflation rate, whose price level has multiplied 60 billion times since 1960, while the world price level multiplied just 14 times. He said that the Argentines did not take the question of inflation seriously until they saw the face of death. Do you think that the survival instincts of the Brazilians are being awakened at this point? Or you think that they still have to sink deeper, and suffer more, before they take these basic decisions?

SACHS: Survival instincts have been awakened. There used to be disdain for talk about budget deficits, for opening the economy, for privatization. Now the right policies are on the agenda, even if they don't get implemented. The fact remains, though, that Brazil is still a society with very powerful interest groups --trade unions or entrepreneurs, or governors of key states-- that still can get public money for their advantage and to the detriment of the society as a whole. There is more attention now to realistic policies, but they are still blocked by political and social paralysis.

GALL: One final question. Each of us separately have been trying to deal with the problem of the future of complex societies, the management of the increased scale of complex societies. How do you see this now?

SACHS: What fascinates me most right now, and is of particular relevance in Eastern Europe and Russia, is the transforming of institutions. We ask each other: How can we hope to put in place capitalism in Russia, in the next decade, if capitalism took 300 years to emerge in the West? My answer is that capitalism has institutions that are transferrable, across countries and societies. New technology, like a fax machine or a personal computer, can move across borders. So much of what I find myself doing right now is hoping to think of ways to make some of the gains in 300 years of capitalism transfer and work effectively in different contexts. Starting a banking system, based on market principles and normal central bank functions. Getting company law and corporate structures working. A lot of the work goes beyond planning the budget or the money supply, as means to stop high inflation, or helping to design a new exchange rate policy or a new currency, which are specific actions where technical expertise can be very helpful. The work goes to a broader issue of helping countries choose and adapt institutions that have a longer life and can help to overcome very deep disfunctions. We are forced to deal with the problem of the survival of complex societies, and adaptation to help them survive.

PRIVATIZATION: FAIR, OPEN AND TRANSPARENT

GALL: Brasil recently suspended its privatization program, while Argentina is moving forward very fast. Argentina's ambitious privatization program has been criticized because the bulk of the privatized state enterprises are falling into the hands of 11 private groups. From state ownership, Argentina is moving to a very narrowly based private ownership. Our experience in privatization has shown us that there are many inefficiencies and injustices in the process.

SACHS: There are many issues here and it is important not to confuse them. I think that if people put their money for privatization of an enterprise and the enterprise operates in a competitive economic environment, that's fine. I don't see a big issue in whether the buyers are 11, 50 or 100 groups, if the process of selling the enterprise is fair, open and transparent. If the privatized companies operate in a competitive environment, I think a great advance has been made. Sometimes people ask: What's the difference of going from public to private ownership? The answer is that once the enterprise is in private hands, it will stop ripping off the State. These state enterprises have been protection-rackets. They have helped to bankrupt the Argentine state for decades. Getting them out of the public trough is a big part of the goal of privatization. Once privatization occurs, the enterprise should be cut off from access to the public treasury. If it happens, the Argentine people will be protected from what has been a system of rampant abuse and grave injustice, often committed in the name of the people. There are other issues. I've mentioned the transparency of the process. I think that's important obviously for fairness and for democratic state. Another question arises when you privatize industries that are not in a competitive environment, such as utilities, that should be regulated in one form or another. One thing that one wants to do as much as possible, is to open up the Argentine economy as much as possible to free competition, both through international trade and through ease of entry of new domestic firms. I think that the general direction of policies is right. The Argentine people are going to be vastly better off with these enterprises out of the public trough, with protection for the fiscal system rampantly abused for decades by the vested interests inside these public enterprises.

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